ISBN 9789976780871
9 789976 780871

B6 MANAGEMENT, GOVERNANCE AND ETHICS

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STUDY TEXT

B6

Intermediate level

THE NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS TANZANIA (NBAA)

B6

MANAGEMENT, GOVERNANCE AND ETHICS

STUDY TEXT

NBAA

ISBN No 978-9976-78-087-1

Published by

National Board of Accountants and Auditors.
Mhasibu House, Bibi Titi Mohamed Street,
P.O. Box 5128,
DAR ES SALAAM

Printed by

Tanzania Printing Services Ltd.
Chang'ombe Industrial Area
P. O. Box 9661,
Dar es Salaam, Tanzania.

The content writer is grateful to The National Board of Accountants and Auditors, Tanzania for permission to reproduce past examination questions. The answers to past examination questions have been prepared by National Board of Accountants and Auditors.

FOREWORD.

The National Board of Accountants and Auditors is a professional body in Tanzania, established under the Auditors and Accountancy Registration Act No 33 of 1972 (CAP 286 R.E.2002). The Board has been charged with among other things, the responsibility to promote, develop and regulate the accountancy profession in the country.

In fulfilling its statutory obligations, NBAA prepares National Accountancy Examination Scheme for students aspiring to sit for Accounting Technician and Professional Examinations. Further, for effective implementation of the examination scheme and improve examination results, the Board provides Study Guides for all subjects to assist both examination candidates and trainers in the course of learning and teaching.

The Study Guides have been prepared in the form of text books with examples and questions to enable the user to have comprehensive understanding of the topics. The Study Guides cover a wide range of topics in the NBAA syllabi and adequately cover the most comprehensive and complete knowledge base that is required by a leaner to pass the respective examination levels.

Furthermore, the Study Guides have been prepared to match with the Competency Based Syllabi to enable the learners to be exposed to practical understanding of issues rather than memorisation of concepts. In this case, the Study Guides are characterized by the following features:-

1. Focus on outcomes – The outcomes shown in every topic provides clear understanding on what to be learnt.

2. Greater workplace relevance – the guides emphasize on the importance of applying knowledge and skills necessary for effectively performance in a work place. This is different from the traditional training where much concern has been expressed in theoretical perspectives.

3. Assessments as judgments of competence – The assessment questions embedded in the Study Guides are adequate measures of understanding of the subject matter.

Study Guides are also useful to trainers specifically those who are teaching in the review classes preparing learners to sit for the professional examinations. They will make use of these Study Guides together with their additional learning materials from other sources in ensuring that the learners are getting sufficient knowledge and skills not only to enable them pass examinations but also make them competent enough to perform effectively in their respectively workplace.

NBAA believes that these standard Study Guides are about assisting candidates to acquire necessary skills and knowledge that will enable them to perform as professionals. The outcomes to be achieved are clearly stated so that learners may know exactly the skills and knowledge they are supposed to acquire in a particular topic.

NBAA wishes all the best to NBAA Examination candidates, trainers in their review classes, lecturers in the higher learning institutions and all other beneficiaries of these learning materials in making good use of the Study Guides towards promoting the accountancy profession in Tanzania.

CPA. Pius A. Maneno
EXECUTIVE DIRECTOR
JUNE, 2019

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B6 – Management, Governance and Ethics

Features of the book

‘The book covers the entire syllabus split into various chapters (referred to as Study Guides in the book). Each chapter discusses the various Learning Outcomes as mentioned in the syllabus.

Contents of each Study Guide

‘Get Through Intro’: explains **why** the particular Study Guide is important through real life examples.

‘Learning Outcomes’: on completion of a Study Guide, students will be able to understand all the learning outcomes which are listed under this icon in the Study Guide.

The Learning Outcomes include:

‘Definition’: explains the meaning of important terminologies discussed in the learning Outcome.

‘Example’: makes easy complex concepts.

‘Tip’: helps to understand how to deal with complicated portions.

‘Important’: highlights important concepts, formats, Acts, sections, standards, etc.

‘Summary’: highlights the key points of the Learning Outcomes.

‘Diagram’: facilitates memory retention.

‘Test Yourself’: contains questions on the Learning Outcome. It enables students to check whether they have assimilated a particular Learning Outcome.

Self-Examination Questions’: exam standard questions relating to the learning outcomes given at the end of each Study Guide.

EXAMINATION STRUCTURE

The syllabus is assessed by a three hour paper based examination. 5 conventional questions of 20 marks each need to be solved.

The examination will consist of two sections.

Section A	One compulsory question
Section B	Four questions out of Six

SECTION A

STRATEGIC MANAGEMENT

A1

STUDY GUIDE A1: STRATEGIC MANAGEMENT ESSENTIALS

Get Through Intro

Imagine you have had enough of working for other people and you want to start up your own business. You have always wanted to set up your own radio station and you have heard that the local government is tendering licences.

You need to decide how you are going to convince the government to give you the licence, instead of other people with more experience. In order to do this, you need to show the government your strategy – who your station will be for, how you will finance it and how long it will take to become profitable.

In fact, any business you join will always be looking at where they currently are, and where they want to be in the future. An important role for you will be to help shape that strategy. The more you understand how a strategy is built, the more important and useful you will be to the organisation.

This study guide will teach you the building blocks of how to build a good strategy, maintain it and expand it to stay ahead of your competitors. It will also ensure that you progress well in your career too!

Learning Outcomes

a) Describe what is strategy and strategic management, distinguish them from operational management.
b) Explain how strategic priorities vary by level: corporate, business and operational.
c) Discuss the three strategy formulation, implementation and evaluation activities.
d) Define and give examples of key terms in strategic management.
e) Describe the benefits of engaging in strategic management

1. Describe what strategy and strategic management, distinguish them from operational management

[Learning Outcome a]

1.1 What is Strategy?

What types of issues are strategic and what distinguishes them from operational issues in organizations?

1.1.1 The characteristics of strategic decisions

The words ‘strategy’ and ‘strategic decisions’ are typically associated with issues like these:

- The long-term direction of an organization.
- The scope of an organization’s activities. For example, should the organization concentrate on one area of activity, or should it have many?
- Advantage for the organization over competition.
- Strategic fit with the business environment. Organizations need appropriate positioning in their environment, for example in terms of the extent to which products or services meet clearly identified market needs.
- The organization’s resources and competences. Following ‘the resource-based view’ of strategy, strategy is about exploiting the strategic capability of an organization, in terms of its resources and competences, to provide competitive advantage and/or yield new opportunities.
- The values and expectations of powerful actors in and around the organization. These actors – individuals, groups or even other organizations – can drive fundamental issues such as whether an organization is expansionist or more concerned with consolidation, or where the boundaries are drawn for the organization’s activities.

Overall, the most basic definition of strategy might be ‘the long-term direction of an organization’. However, the characteristics described above according to Johnson, Scholes, & Whittington, (2008) can provide the basis for a fuller definition:

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

1.2 Defining Strategic Management

Strategic management is the art and science of formulating, implementing, and evaluating cross-functional decisions that enable an organization to achieve its objectives. Strategic management focuses on integrating management, marketing, finance and accounting, production and operations, research and development (R&D), and information systems to achieve organizational success.

2. Explain how strategic priorities vary by level: corporate, business and operational.

[Learning Outcome b]

1.3 Levels of strategy

Strategies exist at a number of levels in an organization. These levels are corporate-level strategy, which is the top level, followed by second level that is business level and strategic business unit.

- Corporate-level strategy, concerned with the overall scope of an organization and how value will be added to the different parts (business units) of the organization. This could include issues of geographical coverage, diversity of products/services or business units, and how resources are to be allocated between the different parts of the organization. In general, corporate-level strategy is also likely to be concerned with the expectations of owners – the shareholders and the stock market.
- Business-level strategy, which is about how the various businesses included in the corporate strategy, should compete in their particular markets (for this reason, business-level strategy is sometimes called ‘competitive strategy’).
- The third level of strategy is at the operating end of an organisation. Operational strategies are concerned with how the component parts of an organisation deliver effectively the corporate- and business-level strategies in terms of resources, processes and people.

3. Discuss the three strategy formulation, implementation and evaluation activities.
[Learning Outcome c]

1.4 Stages of Strategic Management

The strategic-management process consists of three stages: strategy formulation, strategy implementation, and strategy evaluation.

Strategy formulation includes developing a vision and a mission, identifying an organization's external opportunities and threats, determining internal strengths and weaknesses, establishing long-term objectives, generating alternative strategies, and choosing particular strategies to pursue. Strategy-formulation issues include deciding what new businesses to enter, what businesses to abandon, whether to expand operations or diversify, whether to enter international markets, whether to merge or form a joint venture, and how to avoid a hostile takeover.

Strategy implementation requires a firm to establish annual objectives, devise policies, motivate employees, and allocate resources so that formulated strategies can be executed. Strategy implementation includes developing a strategy-supportive culture, creating an effective organizational structure, redirecting marketing efforts, preparing budgets, developing and using information systems, and linking employee compensation to organizational performance.

Strategy evaluation is the final stage in strategic management. Managers desperately need to know when particular strategies are not working well; strategy evaluation is the primary means for obtaining this information. All strategies are subject to future modification because external and internal factors constantly change. Three fundamental strategy-evaluation activities are (1) reviewing external and internal factors that are the bases for current strategies, (2) measuring performance, and (3) taking corrective actions. Strategy evaluation is needed because success today is no guarantee of success tomorrow! Success always creates new and different problems; complacent organizations experience demise.

4. Define and give examples of key terms in strategic management.
[Learning Outcome d]

1.5 Key Terms in Strategic Management

In strategic management there variety of terms used in relation to strategy. This section define nine key terms: competitive advantage, strategists, vision and mission statements, external opportunities and threats, internal strengths and weaknesses, long-term objectives, strategies, annual objectives, and policies.

- **Competitive Advantage.** Strategic management is all about gaining and maintaining competitive advantage. This term can be defined as any activity a firm does especially well compared to activities done by rival firms, or any resource a firm possesses that rival firms desire.
- **Strategists.** Strategists are the individuals most responsible for the success or failure of an organization. They have various job titles, such as chief executive officer, president, owner, chair of the board, executive director, chancellor, dean, and entrepreneur.
- **Vision and Mission.** Statements Many organizations today develop a vision statement that answers the question "What do we want to become?" Developing a vision statement is often considered the first step in strategic planning, preceding even development of a mission statement.
    - Mission statements are "enduring statements of purpose that distinguish one business from other similar firms. A mission statement identifies the scope of a firm's operations in product and market terms."11 It addresses the basic question that faces all strategists: "What is our business?" A clear mission statement describes the values and priorities of an organization. Developing a mission statement compels strategists to think about the nature and scope of present operations and to assess the potential attractiveness of future markets and activities. A mission statement not only broadly charts the future direction of an organization but it also serves as a constant reminder to its employees of why the organization exists.
- **External Opportunities and Threats.** External opportunities and external threats refer to economic, social, cultural, demographic, environmental, political, legal, governmental, technological, and competitive trends and events that could significantly benefit or harm an organization in the future. Opportunities and threats are largely beyond the control of a single organization—thus the word external.

- **Internal Strengths and Weaknesses**. Internal strengths and internal weaknesses are an organization's controllable activities that are performed especially well or poorly. They arise in the management, marketing, finance/ accounting, production/operations, research and development, and management information systems (MIS) activities of a business. Identifying and evaluating organizational strengths and weaknesses in the functional areas of a business is an essential strategic-management activity. Organizations strive to pursue strategies that capitalize on internal strengths and eliminate internal weaknesses.
- **Long-Term Objectives**. Objectives can be defined as specific results that an organization seeks to achieve in pursuing its basic mission. Long-term means more than one year. Objectives are essential for organizational success because they provide direction; aid in evaluation; create synergy; reveal priorities; focus coordination; and provide a basis for effective planning, organizing, motivating, and controlling activities. Objectives should be challenging, measurable, consistent, reasonable, and clear. In a multidimensional firm, objectives are needed both for the overall company and each division.
- **Strategies.** Strategies are the means by which long-term objectives will be achieved. Business strategies may include geographic expansion, diversification, acquisition, product development, market penetration, retrenchment, divestiture, liquidation, and joint ventures. Strategies are potential actions that require top-management decisions and large amounts of the firm's resources. They affect an organization's long-term prosperity, typically for at least five years, and thus are future-oriented. Strategies also have multifunctional and multidivisional consequences and require consideration of both the external and internal factors facing the firm.
- **Annual Objectives**. Annual objectives are short-term milestones that organizations must achieve to reach long-term objectives. Like long-term objectives, annual objectives should be measurable, quantitative, challenging, realistic, consistent, and prioritized. They must also be established at the corporate, divisional, and functional levels in a large organization. Annual objectives should be stated in terms of management, marketing, finance/accounting, production/operations, R&D, and MIS accomplishments. A set of annual objectives is needed for each long-term objective. These objectives are especially important in strategy implementation, whereas long-term objectives are particularly important in strategy formulation. Annual objectives provide the basis for allocating resources.
- **Policies**. Policies are the means by which annual objectives will be achieved. Policies include guidelines, rules, and procedures established to support efforts to achieve stated objectives. Policies are guides to decision making and address repetitive or recurring situations. Usually, policies are stated in terms of management, marketing, finance/accounting, production/ operations, R&D, and MIS activities. They may be established at the corporate level and apply to an entire organization, at the divisional level and apply to a single division, or they may be established at the functional level and apply to particular operational activities or departments. Like annual objectives, policies are especially important in strategy implementation because they outline an organization's expectations of its employees and managers. Policies allow consistency and coordination within and between organizational departments.

5. Describe the benefits of engaging in strategic management.

[Learning Outcome e]

1.6 Benefits of Engaging in Strategic Management

- Strategic management allows an organization to be more proactive than reactive in shaping its own future; it allows an organization to initiate and influence (rather than just respond to) activities—and thus to exert control over its own destiny.
- Strategic management help organizations formulate better strategies through the use of a more systematic, logical, and rational approach for decision making. In addition, the process, rather than the decision or document, is also a major benefit of engaging in strategic management.
- Strategic management benefit organization when the process has achieved understanding and commitment from all managers and employees. Understanding may be the most important benefit of strategic management, followed by commitment. When managers and employees understand what the organization is doing and why, they often feel a part of the firm and become committed to assisting it. This is especially true when employees also understand links between their own compensation and organizational performance. Managers and employees become surprisingly creative and innovative when they understand and support the firm's mission, objectives, and strategies.
- Strategic management process empowers individuals within an organization. Empowerment is the act of strengthening employees' sense of effectiveness by encouraging them to participate in decision making and to exercise initiative and imagination, and rewarding them for doing so.
- Strategic planning is learning, helping, educating, and supporting process, not merely a paper-shuffling activity among top executives. Strategic-management dialogue is more important than a nicely bound strategic-management document. The worst thing strategists can do is develop strategic plans themselves and then present them to operating managers to execute. Through involvement in the process, line managers become "owners" of the strategy. Ownership of strategies by the people who have to execute them is a key to success

.

- Organizations that use strategic-management concepts are generally more profitable and successful than those that does not. Businesses using strategic-management concepts show significant improvement in sales, profitability, and productivity compared to firms without systematic planning activities.
- Besides helping firms avoid financial demise, strategic management offers other tangible benefits, such as enhanced awareness of external threats, improved understanding of competitors' strategies, increased employee productivity, reduced resistance to change, and a clearer understanding of performance–reward relationships.

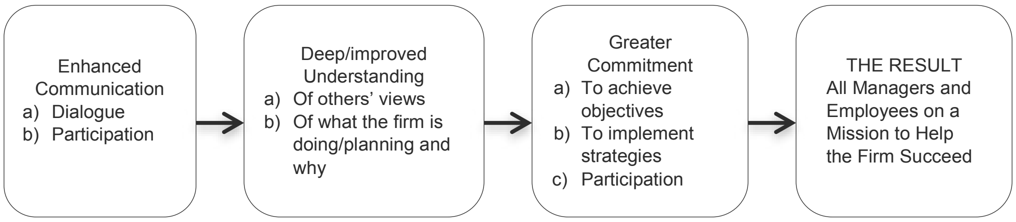


Figure 1: Benefits to an Organization that does Strategic Planning

Self-Examination Questions

Question 1

Assume you are a consultant specialized on strategic management field. You have been invited by TAMECO Ltd which is a newly established company expecting to deal with training on strategic management issues. You have been asked to prepare a presentation to the management about the issue of vision and mission of the organization.

REQUIRED:

(i) Explain how you would define the terms "Vision and Mission" in your presentation.

(ii) Assist TAMECO Ltd to formulate a vision statement of the organisation.

QUESTION 2

It is argued that one can run a business successful without having vision and mission statements. But research has proved that vision and mission are important tools for the business sustainability as well as essential ingredients of a company's strategy.

REQUIRED:

Discuss five main benefits of organizational vision and mission.

QUESTION 3

(a) Kirikiri is an accountant running a medium size shoe company where he has customers from East African countries. His company offers a good and competitive quality shoes in terms of durability and outlook. Due to the tremendous increase of customers over the past two years, Kirikiri has planned to register his firm into a group of large business firms in the market offering the same product.

Kirikiri continued to improve his services as well as making adhoc decisions on his own without understanding the impact of the external environment on his business. This resulted in the failure to earn higher profits in spite of committing to higher investments. Later, Kirikiri realized that strategy is a very important factor in any business.

REQUIRED:

Explain the importance of strategy to any business undertakings.

Answers to Self-Examination Questions

Answer to SEQ 1

(i) Mission statement is written declaration of an organization's core purpose and focus that normally remains unchanged over time. Properly crafted mission statements (1) serve as filters to separate what is important from what is not, (2) clearly state which markets will be served and how, and (3) communicate a sense of intended direction to the entire organization.

A mission is different from a vision in that the former is the cause and the latter is the effect; a mission is something to be accomplished whereas a vision is something to be pursued for that accomplishment.

(ii) Candidate has to write one example of a mission statement by being guided with the following questions:

- What the company does?
- For whom does the industry work for?
- Does it serve its clients in the required way?
- What is the purpose of the company?
- Why the business has been started?
- What image does the business want to convey?

ANSWER SEQ 2

(a) Importance of vision and mission statements

(i) The vision and mission statements provide a reason of purpose to organizations and instill the employees with a sense of belonging. Vision and mission statements are personification of organizational identity and carry the organizations dogma and motto.

(ii) A vision and mission statements define in which the organization operates. Since they define the reason for existence of the organization, they are indicators of the direction in which the organization must move to actualize the goals in the vision and mission statements.

(iii) The vision and mission statements serve as central points for individuals to identify themselves with the organization. It gives them a sense of direction.

(iv) The vision and mission statements help to translate the objectives of the organization into work structures and to assign tasks to that who are responsible for actualizing.

(v) Finally, vision and mission statements provide a philosophy of existence to the employees. They need meaning from the work to do and the vision and mission statements provide the necessary.

ANSWER SEQ 3

(a) Important of strategy to a business

(1) A well designed business strategy will offer a guide on how your business is performing internally.

(2) A strategy can identify trend and opportunities in the future. It can examine the broader changes in market such as political, social or technological changes as well as consumer changes.

(3) A business strategy creates a vision and direction for the whole organization.

(4) By creating a business strategy a company can create a competitive advantage and ultimately understand more about themselves and where they are going.

SECTION A

STRATEGIC MANAGEMENT

A2

STUDY GUIDE A2: STRATEGIC ANALYSIS

Get Through Intro

Imagine you have had enough of working for other people and you want to start up your own business. You have always wanted to set up your own radio station and you have heard that the local government is tendering licences.

You need to decide how you are going to convince the government to give you the licence, instead of other people with more experience. In order to do this, you need to show the government your strategy – who your station will be for, how you will finance it and how long it will take to become profitable.

In fact, any business you join will always be looking at where they currently are, and where they want to be in the future. An important role for you will be to help shape that strategy. The more you understand how a strategy is built, the more important and useful you will be to the organisation.

This study guide will teach you the building blocks of how to build a good strategy, maintain it and expand it to stay ahead of your competitors. It will also ensure that you progress well in your career too!

Learning Outcomes

a) Analyze the broad macro environment of organizations in terms of political, economic, social, technological, environmental (green) and legal factors (PESTEL) and Identify key drivers in this macro-environment and use these key drivers to construct alternative scenarios with regard to environmental change.
b) Explain the Use five forces analysis in defining the attractiveness of industries and sectors for investment and to identify their potential for change
c) Identify strategic groups, market segments and critical success factors, and uses them in order to recognize strategic gaps and opportunities in the market
d) Distinguish elements of strategic capability in organization: resources, competences, core competences and dynamic capabilities.
e) Analyze how strategic capabilities might provide sustainable competitive advantage on the basis of their value, rarity, inimitability and non-substitutability.
f) Analyse strategic capability by means of value chain analysis, activity mapping, and benchmarking and SWOT analysis.

> **1. Analyze the broad macro environment of organizations in terms of political, economic, social, technological, environmental (green) and legal factors (PESTEL), drawing conclusions and giving straightforward advice on the chosen plans**
>
> **[Learning Outcome a]**

The environment is what gives organisations their means of survival. In the private sector, satisfied customers are what keep an organisation in business; in the public sector, it is government, clients, patients or students that typically play the same role. However, the environment is also the source of threats: for example, hostile shifts in market demand, new regulatory requirements, revolutionary technologies or the entry of new competitors. Environmental change can be fatal for organisations. The environment consist of different levels which need to be analysed so as to detect opportunities and threats

- The macro-environment is the highest-level. This consists of broad environmental factors that impact to a greater or lesser extent on almost all organisations. Here, the PESTEL framework can be used to identify how future trends in the political, economic, social, technological, environmental ('green') and legal environments might impinge on organisations. This PESTEL analysis provides the broad 'data' from which to identify key drivers of change. These key drivers can be used to construct scenarios of possible futures. Scenarios consider how strategies might need to change depending on the different ways in which the business environment might change.
- Industry, or sector, forms the next level with this broad general environment. This is made up of organisations producing the same products or services. Here the five forces framework is particularly useful in under- standing the attractiveness of particular industries or sectors and potential threats from outside the present set of competitors.
- Competitors and markets are the most immediate level surrounding organisations. Within most industries or sectors there will be many different organisations with different characteristics and competing on different bases, some closer to a particular organisation, some more remote. The concept of strategic groups can help identify close and more remote competitors. Similarly, in the marketplace, customers' expectations are not all the same. They have a range of different requirements the importance of which can be understood through the concepts of market segments and critical success factors.

1.1.1PESTEL

It is essential for an organisation to effectively and constantly analyse its external environment because, as the environment changes, the strategies of the organisation change. One of the best methods of analysing the external environment is to use the PESTEL method.

Analysing the external environment is not an easy task for the managers of an organisation. There are innumerable variables in existence that could potentially affect the future of an organisation. The PESTEL method classifies those variables within the following framework:

1. **P**olitical
2. **E**conomic
3. **S**ocial
4. **T**echnological
5. **E**nvironmental
6. **L**egal

PESTEL helps to simplify matters by forcing managers to **categorise factors into appropriate slots** (e.g. political, economic, legal etc.). The factors in each slot can then be **further classified in terms of the probable impact** they will have on an organisation. For instance, would they cause a change in demand for the goods / services produced or require the organisation to change the way it operates.

Strategic planners use PESTEL to assess whether the environmental climate is attractive in general or attractive to a certain organisation or a part of the organisation and to estimate changes in the environmental climate that might have an impact upon the organisation.

1. Political

Political factors are caused by the **role that the government plays in shaping the environment** within which the organisation operates. They represent the nature and type of external environment within which the organisation must operate.

Example

On the domestic front, examples include regulations such as the introduction of new taxes. On the international front, an example could be integration of the nation into the EU (for European countries) or the introduction of NAFTA (for US and Canadian companies). New taxes make the product or service an organisation offers more expensive. The increased price could result in a decrease in demand for the particular product or service.

The main purpose of bodies such as the EU and NAFTA is to increase trade between their member countries by removing tariffs, duties etc. that exist and thereby allowing a free flow of goods and services between countries. This would result in organisations facing greater competition from their foreign competitors (as their goods or services would become more accessible).

A country's political system and government policy will **set the rules and regulations of the external environment** within which all organisations must operate. In turn, the combination of these rules and regulations will create the **economic, social and political conditions** that organisations must work under. Naturally, these conditions will **affect the business and strategic choices** that an organisation can and does make.

They will influence decisions the organisation makes such as:

- what goods or services to produce and market
- how to produce and market these goods and services
- what prices to charge
- where to market these goods and services

Furthermore these conditions will change over the course of time, either making life simpler or more difficult for an organisation.

Example

An import duty or tax is imposed on a particular product. For instance in India, a 115% import duty is levied on any new, imported car. The existence of this tax is beneficial for local car manufacturers that produce the same product because their foreign competitors' goods become more expensive.

This has also led to some of the premium car manufacturers taking the strategic decision to start manufacturing in India, in order to avoid the import duty – Mercedes Benz and General Motors, for example, have recently opened new manufacturing plants in India to service the domestic market.

(a) Political factors affecting an organisation

(i) Government policies: each organisation needs to comply with the government policies applicable to it. While assessing the environment, an organisation has to forecast possible changes in the environment as these changes could affect the strategic actions and strategic position of the company.

(ii) Stability and tenure of government: each government has its own beliefs and strategies. For example, one government might be for outsourcing and another might be against it. Therefore, if the government of a country is stable, this makes it easier for organisations to form their strategies.

(iii) Pressure groups: these groups may put pressure on companies to change their strategies**.** For example, the pressure group Greenpeace puts pressure on companies to become more environmentally-friendly.

(iv) Government's planned strategy: planned reforms, implications of regional government's plans and actions on the nation's strategy and subsidies awarded by the government are factors which change the organisation's external environment**.**

(b) Questions for assessment (questions that an organisation needs to ask itself):

(i) How does a change in the political situation affect an organisation?
(ii) Who will win the next election?
(iii) What are the political views of that party?

2. Economic

Economic factors refer to the **macroeconomic factors** that will shape the broader economic environment within which the firm operates. They represent **the financial condition** of the external environment within which the organisation must operate.

Example

An economic example of how the political system and government policy affects an organisation is when interest rates are increased. Rising interest rates make it more expensive for an organisation to borrow capital. This could potentially result in an organisation having to reconsider any planned acquisitions or large item purchases.

In addition, if this increase also results in an extra cost for an organisation's suppliers, it could also increase the cost of raw materials for an organisation. Rising interest rates will also normally mean that consumer spending will reduce leading to a contraction of demand.

(a) Economic factors affecting an organisation

(i) GDP

Gross Domestic Product is the market value of all the goods and services produced within the country. A country's GDP is an indicator of its market size. Low GDP means that the country is still developing. An organisation has to keep such economic factors it in mind while forming its marketing strategies.

(ii) Taxes

A change in the government's taxation policy will affect the organisation's plans. A change in tax leads to a change in cash flow. However this is a micro-environmental change. If the government declares any area to be a tax-free region, then the organisation can take strategic decisions accordingly. Organisations might enter into the production or sale of tax-free goods.

(iii) Exchange rates

Organisations which conduct cross-border business such as the import or export of goods are affected by fluctuations in exchange rates. Fluctuations in exchange rates are considered to be micro-environmental changes except when such differences affect strategic decisions such as where to set up a factory for manufacturing goods.

(iv) Unemployment

Unemployment is directly linked to the purchasing power of consumers**.** It is also one of the indicators of a recession. Since demand for organisations' goods and services is dependent on the market conditions, organisations have to predict changes in the economy and plan accordingly.

(v) Trade factors and tariffs

Each country has its own rules on import and export. Some countries enter into free trade agreements (e.g. the US and Canada). These trade factors and tariffs control the supply of foreign goods in the nation and consequently their sale. Favourable rules increase the demand for the organisation's goods internationally. Therefore these factors change the macro-environment of an organisation by changing its market share.

(vi) Monopolistic practices

If an organisation has a monopoly on a particular product, the organisation has control over the market. If the monopoly is accompanied by cost effectiveness through mass production, it does not result in the exploitation of consumers. On the other hand, if the monopoly does result in the exploitation of consumers, the government will interfere.

(b) Questions for assessment (questions that an organisation needs to ask itself):

(i) Is the economy towards a recession or a boom?
(ii) How are the current economic conditions affecting the organisation?
(iii) Are there any changes expected in the economic conditions and will they have an impact on the organisation?

3. Social

Social factors refer to factors such as changing demographic patterns, changing consumer tastes and preferences and overall societal trends. They represent the **tastes and demands** of the external environment within which the organisation must operate.

Example

An article published by BBC news online magazine described changes which have taken place in the ageing population in the UK. The article recognised two types of pensioners: those who are in poor health or have a low income and those who are in good health or have a high income. Organisations are learning slowly that the aged population is a group of customers which is increasing day by day and which could even determine the future of the UK. The UK Company Saga has benefited tremendously from this demographic change: Saga arranges trips for elderly people who have a love of travelling and exploring new places and who were unable to visit those places in their youth. The organisation aims to provide facilities to these elderly customers which make them feel at home and more comfortable.

(a) Social factors affecting an organisation

(i) Population growth: population growth has an impact on the market share and the purchasing power of consumers. An increase in population is directly linked to an increase in demand for essential goods and services. If this growth is accompanied by a reduction in per capita income, then it leads to reduced demand for luxury goods and services.

(ii) Population profile and education levels: the population profile relates to the education levels of the population. Organisations demanding highly-skilled workers are interested in environments in which such people are available. The unavailability of such an environment could affect an organisation's strategic decisions such as whether or not to outsource a particular function.

(iii) Age and health of the population: the ratio of the working population to the dependants, such as the elderly and the young population, affects the organisation's strategy as it affects the demand for essential goods and luxury goods. If there is a large population of elderly people, then is there is a high demand for the goods required by these people, such as medicines. All these factors help the organisation in planning its strategic actions.

(iv) Disposable income levels: high disposable income which is the result of low deductions from salaries means high purchasing power. High purchasing power results in an increase in the market volume. The disposable income levels of consumers affect an organisation's strategic decisions such as what to produce and the selling prices of its products.

(v) Social trends: social trends in fashions, lifestyle and religion have a huge impact on an organisation's environment. These factors are directly related to strategic decisions such as what to produce and what prices to charge.

(b) Questions for assessment (questions that an organisation needs to ask itself):

(i) What socio-cultural factors are affecting the organisation?
(ii) Will change in these factors have an impact on the organisation?

4. Technological

Technological factors take into account the **effect that technology has** on the way an organisation makes and delivers its goods and services. In addition to looking at present technology, organisations also need to look at upcoming technology and how it will affect the current way of business.

Example

Amazon.com Inc was one of the first companies which sold its products over the internet. This organisation became popular during the dot com bubble of the late 1990s. The organisation launched the model using advanced technology immediately after the bubble burst, but it earned its first profit only in the year 2003.

The organisation initially sold books online. Later on, with the development of technology, it expanded its scope of business. It started selling electronics, MP3s, DVD's, CDs, computer software etc. online.

Every organisation needs to continually assess these influences to see if they are changing the external environment within which it operates. If these forces are **significant in changing the external environment**, then the organisation may have to **significantly change the way** it does business.

(a) Technical factors affecting an organisation

(i) Rate of change and new developments in technology: the rate at which technology is changing is really amazing. Every year, manufacturers of electronic goods and automobiles introduce new models with added features using new technology or even completely new products. Organisations have to keep up with the new market trends and form their strategies keeping in mind that their existing products might become obsolete. Toyota's invention of the hybrid car in response to strategic risk is an example of an organisation changing its strategy because of its external environment.

(ii) Patents granted: an organisation which introduces new technology to the market, takes out a patent on the technology. This means that if another organisation wants to use the same technology then it has to either invent the technology itself or pay a large amount to the patent holder as copyright fees.

(iii) Diffusion of technology: as technology spreads throughout the market, organisations are forced to update their products in order to prevent them from becoming obsolete. Organisations survive due to the profit on the sale of their products and if an organisation's products become obsolete this could signal the end of the organisation. Therefore organisations have to modify their strategies according to the market conditions.

(b) Questions for assessment (questions that an organisation needs to ask itself):

(i) How is technology changing?
(ii) Has the technology we are using become obsolete?
(iii) How have changes in technology affected market conditions and marketplaces?

5. Environmental

Consumers are becoming increasingly concerned with the protection of the environment in which they live. This is, in part as a result of the tremendous surge in media attention directed to such issues as: climate change, carbon emission, waste disposal and recycling, they desire that their environment should be prevented from all harmful effects so that it does not deteriorate over time. In the present era, along with the consumers, the government is also becoming much more concerned about the environment. This has resulted in the introduction of large amounts of legislation designed to protect the environment and encourage its conservation.

Example

Railways are one of the most environmentally-friendly modes of transport because the rate at which harmful gases are emitted is comparatively less than other modes of transport. In addition, the resources used by railways are generally renewable in nature. Network Rail is involved in protecting the largest number of sites of Special Scientific Interest (SSSIs) near railway tracks in the UK.

Protection of the environment is essential because it is a source of resources needed for the production of goods. Harmony between man and the environment is the essence of healthy life and growth. To the organisation its also a source of competitive advantage, e.g., the environmentally friendly organisation may find it easier to win and retain customers, to recruit staff and to encourage investment (ethical investors).

(a) Environmental factors affecting an organisation

(i) Trends: what are the environmental standards in the area? How is waste disposed of? All these trends are important. If there are no specific laws governing environmental issues such as waste disposal, an organisation should follow the practices prevalent in the industry**.**

(ii) Penalties for abuse: there are huge penalties for non-adherence to environmental laws.

(iii) Competitive advantage: companies which adopt environmentally-friendly practices such as planting trees or adopting special measures to reduce pollution, have a competitive advantage.

(b) Questions for assessment (questions that an organisation needs to ask itself)

(i) What are the current rules and regulations affecting the organisation?
(ii) What are the environmental standards published by the government?
(iii) Is the organisation complying with these rules?
(iv) Are there any alternatives for carrying out the organisation's activities?

6. Legal

Legal factors represent the **legislative framework** within which the organisation must operate. They represent the "laws of the land" that the organisation must follow. Organisations have to follow the law framed by the legislatives and always operate within the boundaries of the legal framework. There are various laws which affect **all organisations** such as company law, environment law, employment law, tax law, competition law, law relating to health and safety etc.

Example

Examples include employment laws such as fair hiring practices, health and safety standards for work, and minimum quality standards for products. For instance, in the UK, the advertising standards agency has ruled that no advertisements for "junk foods" will be allowed during the hours in which children's programmes are broadcast. This effectively means that products such as Pepsi and Coke cannot show their advertisements during these times.

(a) Legal factors affecting an organisation

(i) Employment law: organisations have to follow laws on employment such as those related to equal opportunity. Some companies which are engaged in the production of arms, aeroplanes or other products related to national security have to follow special rules prescribed by the government.

(ii) Business, health and safety law, company law

(iii) Marketing laws: organisations have to follow the marketing laws which have been formed to protect the customers. Organisations should not advertise or give misrepresentations to the public in order to sell their products. Such misrepresentation is punishable under the law.

(iv) Monopolies / restraint of law: in a monopoly, one company or a small number of companies with similar interests has sole control of the market. This situation is harmful to society. Therefore the government forms laws to prevent organisations from forming monopolies.

(v) National versus international laws: every organisation has to follow both national and international laws. The European Community has its own laws formed for the social and economic benefit of the members of the EC. In most cases, international laws take precedence over national laws if these laws contradict each other. Organisations have to follow both laws while forming their strategies.

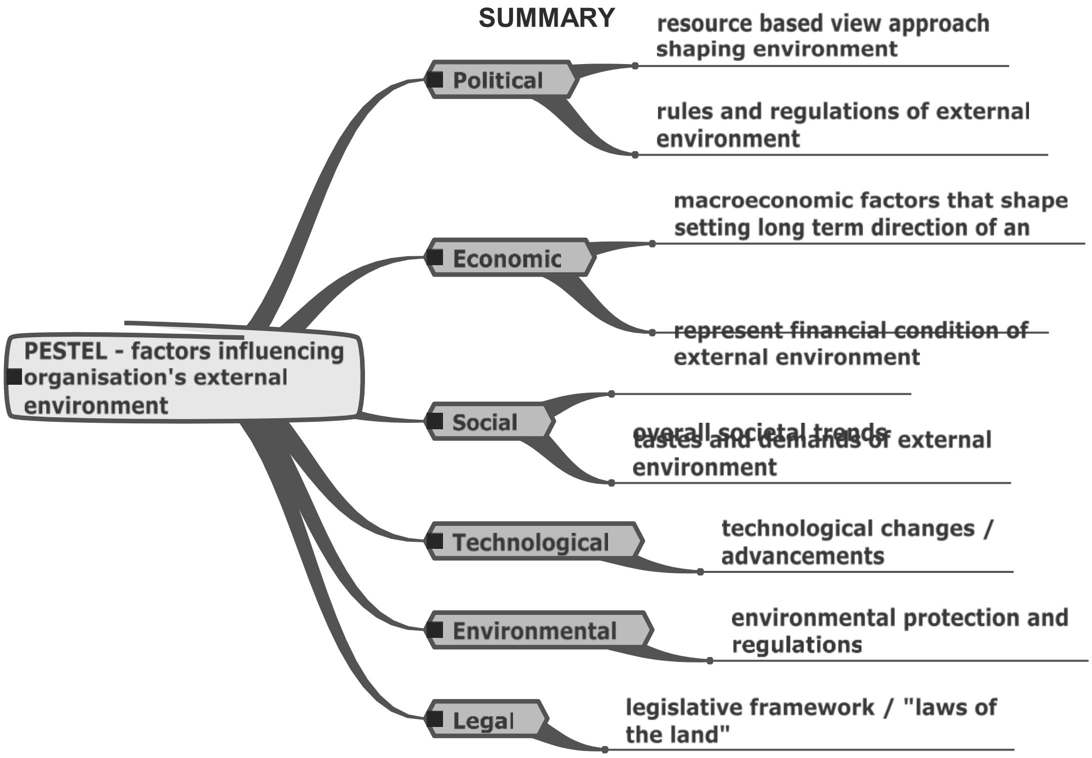
(b) Assessment questions: (questions that an organisation needs to ask itself)

(i) What expected or possible changes might there be in laws and regulations?
(ii) What impact could such changes have on the organisation?

Overall assessment (questions that an organisation needs to ask itself)

What are the environmental factors affecting the business?

The PESTEL framework poses this question to organisations as part of their overall assessment. Each organisation works in a different environment. The way an organisation interacts with its environment also varies. Every organisation has to conduct an assessment of its environment, including the factors that affect or can affect the organisation. Another question that PESTEL asks is: which of these factors are the most important at the present time and which will be the most important over the next few years? Each organisation demands its strategy makers to anticipate future problems and act upon them in advance so that they will not take place. This process of forecasting can be carried out with the help of the factors outlined in the PESTEL framework



All these factors are just the starting point and will reveal the prospective impacts and changes that might affect in an organisation. It is important to analyse the **impact of all these factors on the organisation**. Planners must also assess how these factors will affect their organisation and the way in which business is currently operated. What must be identified here are the **key drivers of change** i.e. the factors that may change the structure of the organisation and its industry.

For instance, only listing those interest rates which may rise is not sufficient as an economic factor. What also has to be considered is the impact these higher interest rates will have on the organisation. Rising interest rates will mean that it will become more expensive for the organisation to raise capital. This could result in any planned expansions or purchases having to be reconsidered.

In addition, if this results in an extra cost for its suppliers, the cost of the raw materials the organisation purchases may also increase.

External environmental forces

2.	**Explain the Use five forces analysis in defining the attractiveness of industries and sectors for investment and to identify their potential for change, drawing conclusions and giving straightforward advice on the chosen plans.** **[Learning Outcome b]**

The profitability and cash flow levels of a business are directly affected by the competitive forces of the industry and the stage of the industry's lifecycle. In order to achieve competitive success, an organisation needs to understand how these forces take shape and how they are to be dealt with.

Strategic analysis in an organisation calls for consideration of competitive forces in the organisation's industry.

What is meant by an industry?

An industry is a **group of organisations** which produce **similar products** or products which are **close substitutes** of each other; strictly speaking substitutes are in another industry. It is a group of different organisations which share a **common method of generating profits, production techniques and product offerings**. The term is used to cover any form of economic activity.

Industries are classified as those belonging to the primary, secondary or tertiary sectors. Primary sector industries or extractive industries are those that get their source of income from naturally occurring resources like agriculture, fishing, and mining. The secondary sector refers to the manufacturing or processing industries which typically uses the outputs of the primary industries and then converts them into other usable or finished goods like textiles, food processing etc. service industries such as banking, insurance, finance and others come under the tertiary sector.

Significance of "industry" in strategic management:

It allows managers to understand the competitive forces at work

Example

Competitive pressures and the need for greater profits are pushing automobile manufactures like Skoda and Volkswagen to re-evaluate their supply chain activities. Automobile manufacturers are going in for mass customisation by introducing a wide variety of products which, in turn, is leading to escalating costs and complexity in manufacturing processes.

1

It informs important decisions about product / market strategy

Although organisations belonging to an industry produce similar products, they vary in many aspects such as work culture, capabilities etc. These organisations also share many common features e.g. exposure to major changes in the external environment which impact upon all the organisations in a particular industry.

Example

After the September 11 attacks on the twin towers in New York, domestic and business demand for air travel dropped considerably which created problems for the tourism and airline industries.

Competition

Competition is what keeps companies innovating and coming up with better products. You must have noticed that if a particular sector has a monopoly, often prices are higher and services are not so good. Let's take the case of the telephone sector in the UK. Until 1981, British Telecom or BT was a monopoly. Until then, it could often take a number of days or weeks to get a phone connection and prices for calls were high. Once the market opened up, competitors came into the market and offered immediate connections and calls for free subject to monthly rentals. BT had to reconsider its strategy as its profits were plummeting.

Definition

Competition refers to a force which motivates organisations to achieve dominance or attain a reward or goal. It denotes a dynamic process of rivalry among firms in which only the fittest survive and succeed.

2

3

Case Study

Parker Pens are very smart elegant pens, generally priced slightly expensively. The question is, who is Parker Pens' competition? At first glance, many would say any other pen companies e.g. Sheaffer Pens, Cross Pens or Waterman pens – all well-known brands. Actually when analysis was carried out, it was discovered that most purchases of pens were not for personal use, but for giving as gifts to other people. Hence actually, Parker Pens' competition were not just the branded pen companies, but chocolates, gift vouchers, CDs, DVDs etc are all considered competition.

4

From the above case study, you should realise that competitors could be a much wider group than you initially thought. Parker pens had to advertise and market their product to compete with other gifts, rather than stressing the benefits of why it was a good writing instrument. Hence they introduced nice presentation boxes for pens and different colours to be more eye catching.

Firms can use techniques such as Porter's Five Forces and life cycle analysis to analyse their position in terms of their competitive strategy and current markets.

Overview of Porter's five forces

Michael Porter of Harvard University and the author of " Competitive Strategy (1980) developed the Strategic Management Model known as the **five forces of competition** which explains the five key factors which must be analysed when evaluating a business's profitability in the future.

By applying the five forces model, the market factors can be analysed so that an organisation can make a strategic assessment of its competitive position in a particular market. Michael Porter's five forces framework provides a simple outlook for **assessing and analysing the competitive strength and position** of a business organisation.

Important points to be considered before applying this model

These forces must be considered for specific strategic business units (SBUs) and not for the organisation as a whole because organisations operate in different industries and therefore the influence of these forces may be different on each unit.
These five forces are dependent on each other.
It is essential to understand the link between the competitive forces and the key drivers in the macro-environment because these environmental factors may influence the competition in the industry.

Sources of competition using Porter's five forces framework

There are five main factors that influence the level of competitiveness in an industry or sector. These factors or forces have been identified by Michael Porter in his famous "five forces" model as the:

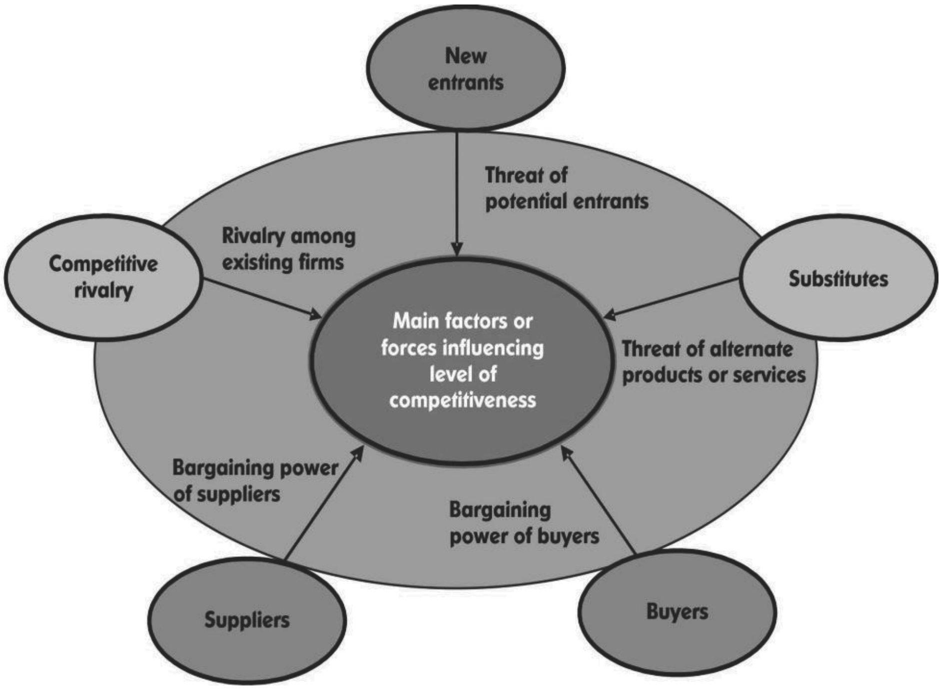
1. threat of potential entrants
2. existence of substitutes
3.bargaining power of buyers
4.bargaining power of suppliers
5.intensity of rivalry among existing firms

An ideal industry would be one where:

- there is little or no possibility of new organisations entering because of significant barriers to entry
- buyers will pay whatever prices the organisation sets
- suppliers will sell at whatever prices the organisation sets
- there are no substitute products
- there is no competition from any other organisation i.e. a monopoly exists

In the above example, all of the five forces are weak; it therefore represents a very profitable or almost ideal industry to enter into. However, this ideal only exists in theory. In practice, every industry usually has at least one strong force. The greater the number or strength of these forces, the more competitive the industry or sector is.

5 **Diagram 9: Porter's five forces model**



1. Threat of new entrants

One of the biggest worries for the organisations of any industry is the possibility that other firms will enter their industry. The **more firms that enter an industry, the more competitive the industry** is likely to become. The more competitive the industry, the lower the level of profits likely to be earned by its organisations. Naturally it is easier to enter some industries than others.

Example

It is much more difficult for an organisation to enter a capital intensive industry such as oil exploration than it is for it to enter into the field of IT consultancy. This is because to enter into the oil exploration business an organisation would have to purchase very expensive assets such as oil rigs, drills etc and acquire mining exploration rights. To become an IT consultancy business, an organisation would only need an office space and computers.

The above example illustrates a **barrier to entry** (i.e. high capital cost requirements). How high the threat of potential or new entrants is will depend upon how many barriers to entry there are. Examples of barriers to entry include:

(a) Whether existing organisations have achieved **economies of scale** (this is particularly prevalent in manufacturing industries): an organisation that has achieved economies of scale is producing very large numbers of a product at a low per unit cost. Therefore, it is **harder for a new organisation** to launch in this industry as it may not gain the economies of scale and therefore will not be able to sell products as competitively.

(b) Whether there is high capital **/ start-up costs**: these result in the organisation having to endure a **longer time period** to recoup their investment. Hence many organisations may not be able to afford to wait for a long period before they can gain a return on their investment. This, in turn, would reduce the likelihood of new firms entering the industry.

(c) Limited access to supply / distribution channels

(d) Patent agreements

(e) Access to specialised and unique skills or capabilities

Example

Although there are a few other cola manufacturers alongside Coke and Pepsi, they have a very limited share of the market. One of the reasons for this is that they have difficulty getting their product to a mass market. This, in turn, is partly because Coke and Pepsi have a long history of not allowing vending machines that sell their products to stock any other cola thereby limiting other cola manufacturers' access to supply / distribution channels. Pepsi and coke also have very strong brand identities.

(f) **Strong customer loyalty** to existing products: any new tobacco manufacturer will have a difficult time getting customers to change over from their existing brands.

(g) Organisations that **enter the industry earlier** have **more experience and exposure** to the market and therefore have an advantage over others in this respect. This is known as the experience effect and will allow the existing firms to operate more efficiently and competitively.

(h) **Product differentiation**: organisations within an industry have created **goodwill** in the market by earning
customer loyalty and building a **brand name** for their products.

Example

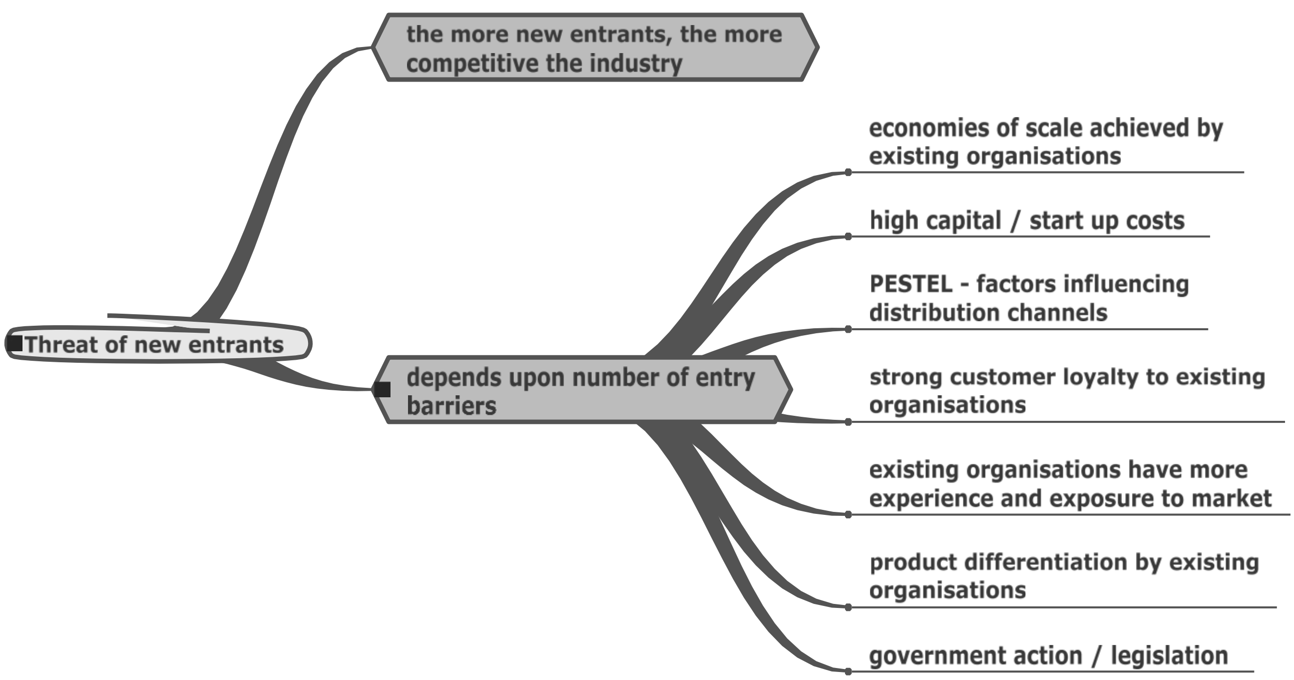
Subway is a leading fast food chain which offers foot long and six-inch sandwiches filled with assorted meat, vegetable and other toppings, which it promotes as a healthy alternative to burgers. This formula has enabled Subway to capture a sizeable portion of the fast food market.

(i) **Government action or legislation**: the government enacts legislation to regulate the markets and takes action to control competition.

Threats posed by new entrants: in order to lower the threat from new entrants, a firm should try to build up strong customer loyalty by offering good quality products at affordable prices and by differentiating its products in order to ensure that people continue to buy its products.

How a firm can reduce threats posed by new entrants: this can be done by building up strong customer loyalty by offering good quality products at affordable prices and by differentiating its products in order to ensure that people continue to buy the products.

SUMMARY



2. Threat of substitutes

The threat of substitutes depends upon the **ease at which a customer can switch to an alternative product**.

What is a substitute?

A substitute is a product from one industry that can perform the same function required in another industry. Examples include butter and margarine; and ferries and low cost airlines. It is important to note that there are different **forms of substitution**. These include:

(a) Product for product substitution

It occurs because of two reasons - convergence and availability of complementary products.

Example

An example of this type of substitution is when a man travels to work by train but decides to switch to a coach service.

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(b) Substitution of need

In this instance a new product renders an existing one obsolete.

Example

The fax machine made the telex redundant and it (the fax machine) has also become obsolete because of email.

(c) Generic substitution

This occurs with products / services that compete for a small portion of a customer's disposable income. The consumers may also decide to do without the particular product.

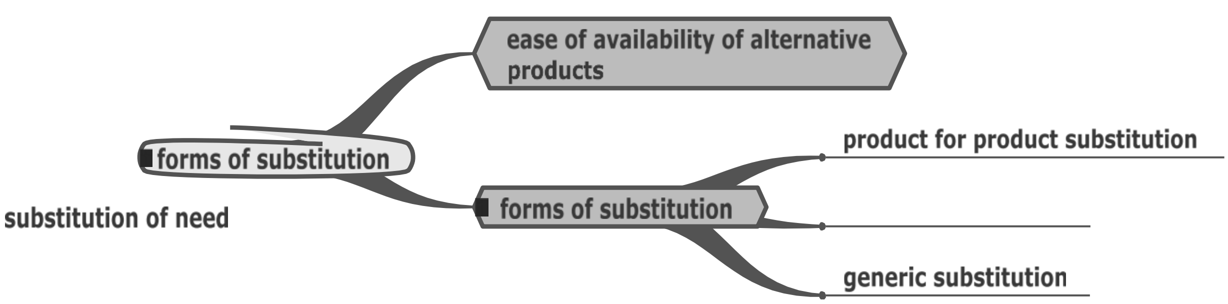
Example

White goods such as toasters and kettles are common examples of where generic substitution occurs. Consumers typically see little performance or quality difference between brands in these types of goods. Therefore, at the time of purchase, they often buy any available model or make.

7

How a firm can reduce threats posed by substitutes: in an industry where there are many substitutes, organisations need to understand why their product might be substituted for a competitor's, and then take steps to ensure that their product is differentiated in some way in the minds of their customers.

SUMMARY



3. Bargaining power of buyers

If buyers have high bargaining power then an organisation will be **restricted in the price** that it can charge for its goods or services. Situations where the bargaining power of buyers will be high are when:

(a) There is a **concentration of buyers (the industry is dominated by just a few customers) and the volumes they are purchasing are large**.

Example

For instance, the multinational Unilever has operations and subsidiaries all over the globe. Recently the organisation has begun consolidating its purchasing for all its companies from one central location. This has resulted in the organisation achieving cost efficiencies and economies of scale as it now mass orders the goods it requires.

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(b) The cost of switching to an alternative supplier is low and involves little risk. A switching cost is the financial and emotional cost associated with changing suppliers.

Example

Long distance phone rates in the US are relatively very low because of the ease at which customers can switch from one long distance carrier to another (over the phone and at no charge with immediate effect). This means that the phone companies must be extremely competitive in order to remain in business.

This was not always the case however; only a few years ago, carriers could levy large cancellation charges and ask for extensive paperwork to be completed if a customer wished to switch carrier. The financial penalty together with the time required to complete the paperwork deterred many customers from changing their carrier.

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(c) The **buyer has the ability to either buy products from another company or produce the same product/ service in-house)**. If the suppliers do not offer a reasonable price or good quality, the buyers may produce the products themselves. This is known as **backward integration**. The threat of backward integration is not desirable.

Example

Sainsbury's (a UK supermarket chain) is able to negotiate discounts from Heinz and other ketchup manufacturers because they also produce their own brand of tomato ketchup. Having a readily available substitute product means they can negotiate a reduction in the price of other manufacturers' ketchups. Given the quantity of this product that is sold, this translates into a significant cost saving for the organisation.

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(d) When buyers have better **information levels**, they are capable of bargaining with suppliers and hence can force the supplier to sell the product at a lower price.

(e) Buyers enjoy high bargaining power when they are aware of the **product differentiation** available in the market. Differentiation is the process of distinguishing a product from competitors' products to gain a competitive advantage. The buyers possess knowledge of the value of the product by differentiation and hence can effectively bargain with the supplier regarding its price.

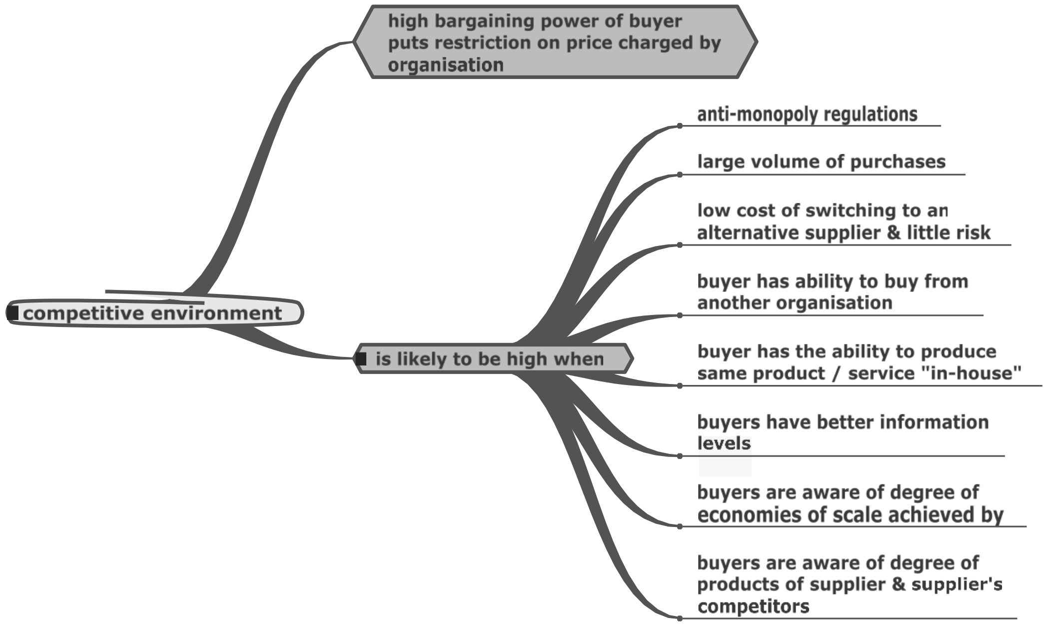
(f) When the buyers are aware of the **quality of products** provided by the supplier and its competitors, they are in a better position to bargain on price with their supplier.

How a firm can reduce threats posed by the bargaining power of buyers: this can be done by having:

- a number of customers such that none are powerful enough to influence
- products that are well differentiated so that the switching cost for the customers is high

- a high market share and good amount of turnover
- products that are of superior quality as compared to the products of competitors.

SUMMARY



4. **Bargaining power of suppliers**

When the bargaining power of suppliers is high, firms normally end up paying a relatively **high cost for the raw materials** and other inputs (remember that labour is also a supplier) they need to be able to produce their goods or services. This, in turn, restricts the price that they can charge for their product or service.

For instance, if the cost of their raw materials increases, firms in all probability will have to pass this cost on to their customers (at the risk of losing business).

Situations where the bargaining power of suppliers will be high are when:

(a) There is a **concentration of suppliers and a large number of buyers**.

Example

The few large chemical companies that supply to the glass manufacturing industry enjoy this advantage. This is because the special chemical they supply is essential to the glass manufacturing process. This chemical is produced by only a few companies whereas there are a large number of glass manufacturers willing to buy the product.

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(b) **Switching costs of a consumer are high**.

Example

Switching to an alternative operating system would be difficult for most computer users given the almost universal usage of Windows. Therefore consumers have very little or no bargaining power when it comes to purchasing the Windows operating system.

(c) If the suppliers do not get the prices they want for their products and they have the ability to directly compete with the buyers. This is known as **forward integration**. An example would be a mobile phone manufacturer operating its own retail shops.

(d) When suppliers can use the **substitute inputs** for their products, they are in a better position to bargain on price because they can insist on lower prices or else purchase the substitute.

(e) Buyers can force suppliers to reduce the prices when they desire to purchase the inputs in **larger quantities**. If the prices are not reduced, they may even cancel the contract for the purchase of inputs which is very costly for the supplier.

(f) Suppliers enjoy high bargaining power when they are aware of the **product input differentiation** available in the market. Differentiation is a process of distinguishing the product input from competitors' product inputs to gain a competitive advantage. When suppliers possess knowledge of the value of the product input by differentiation, they can effectively bargain on its price.

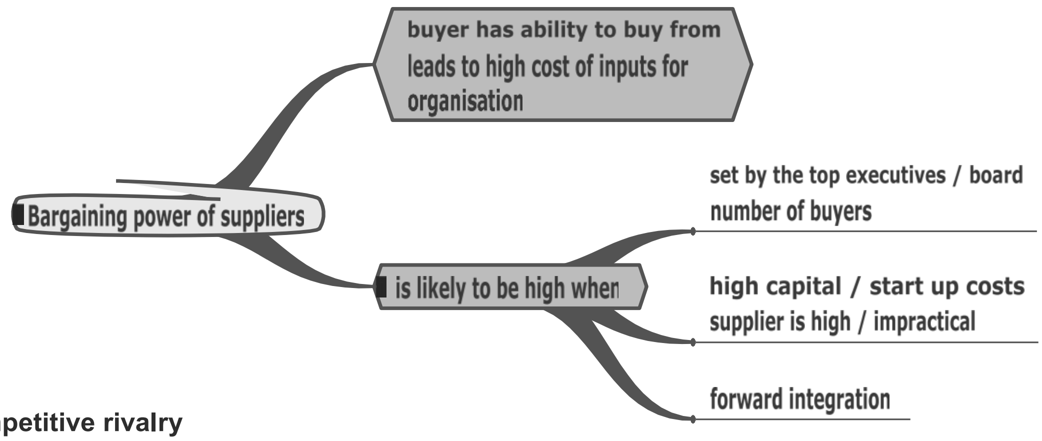
How firms can reduce threats posed by bargaining power of sellers: this can be done in the following ways:

Firms should not be dependent on a single or a small number of suppliers. This would ensure lower level of switching cost in case firms want to switch over to alternate supplier(s).

Where possible, firms should try and develop their own facilities to produce their own raw materials. This would enable them to avoid situations where suppliers increase the prices.

By merging / taking over with the suppliers' business (backward integration), firms can do away with threats of price rises of raw materials.

SUMMARY



5. Competitive rivalry

As important as the number of firms that exist in an industry is the intensity of rivalry that exists between them. The **more competitive the rivalry** that exists between firms, **the lower the level of profits** that typically will be earned by firms in that industry (as firms will attempt to outdo each other in terms of offering lower prices and/or greater quality).

Situations where there will be intense rivalry between competing organisations (when organisations offer similar products/services to the same group of customers) are when:

(a) The **competitors are in balance** (i.e. they have roughly the same size and capabilities).

Example

The Canadian banking industry is said to be amongst the most competitive in the world. The industry is dominated by 5 "major" banks that have approximately the same size, product offerings and reach. In many instances, branches of these banks will almost face each other. Therefore competition for customers is fierce between these banks as they all offer similar products, services and quality.

(b) Competing organisations are **operating in a mature market** (a market that is not growing). Here the only way for an organisation to achieve growth is by gaining market share from one or more of its rivals.

(c) There are **high fixed costs**. Fixed costs are constant costs that an organisation has to incur in a particular period regardless of the level of activity it engages in for that period. Even if an organisation does not produce any goods or services, it will still have to pay its fixed costs for that particular period. A common fixed cost is the rent that organisations pay for their office premises.

Example

Airlines routinely offer discounts and promotional packages as their fixed costs are regular and high (i.e. a scheduled flight must take off regardless of how many seats are empty). Therefore airlines need to fill as many seats as possible for a scheduled flight even if some of the seats are sold at discounted prices.

Continental Airlines is an airline that offers discounts and promotional packages

(d) There are **many exit barriers**. When organisations cannot leave an industry easily, this leads to increased competition. An organisation may be unable to exit an industry because government regulations, heavy investment in fixed assets or large staff redundancy costs.

(e) A **variety of products is available**. As a result, customers have a range of choices and so they may shift to competitors to purchase their requirement.

(f) The **competitors' responses are aggressive**. Each organisation tries to gain a competitive advantage over the others, leading to intense rivalry.

Dealing with intense competition: a firm can deal with intense competition by:

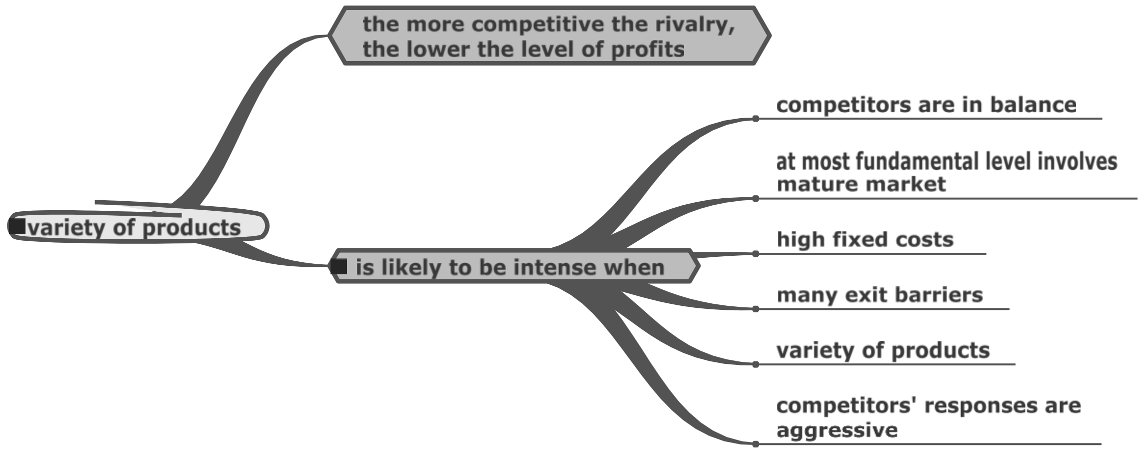
strengthening its brand through innovations and differentiating its products from those of its competitors

having good industry and market knowledge through market research

strengthening its internal processes and ensuring a high learning curve among employees

conducting business in a transparent, ethical and socially responsible manner - this would ensure the support of all stakeholders.

SUMMARY



Case Study

Porter's five forces: consumer products

The five forces concept is perhaps best explained through example. Let's briefly examine the household consumer-products industry by considering rival firms Clorox CLX, Kimberly-Clark KMB, Colgate-Palmolive CL, and Procter & Gamble PG in terms of Porter's five forces:

Buyer power: consumer-products companies face weak buyer power because customers are fragmented (NOT CONCENTRATED) and have little influence on price or product. But if we consider the buyers of consumer products to be retailers rather than individuals, then these firms face very strong buyer power. Retailers like Wal-Mart WMT and Target TGT are able to negotiate for pricing with companies like Clorox because they purchase and sell so much of Clorox's products. Verdict: Strong buyer power from retailers.

Supplier power: more than likely, consumer-products companies face some amount of supplier power simply because of the costs they incur when switching suppliers. On the other hand, suppliers that do a large amount of business with these companies--supplying Kimberly-Clark with raw materials for its diapers, for instance--also are somewhat beholden to their customers, like Kimberly-Clark. Nevertheless, bargaining power for both the firms and their suppliers is probably limited. Verdict: Limited supplier power.

Threat of new entrants: given the amount of capital investment needed to enter certain segments in household consumer products, such as manufacturing deodorants, we suspect the threat of new entrants is fairly low in the industry. In some segments within the household consumer-products industry, this may not be the case since a small manufacturer could develop a superior product, such as a detergent, and compete with Procter & Gamble. The test is whether the small manufacturer can get its products on the shelves of the same retailers as its much larger rivals. Verdict: Low threat of new entrants.

 Continued on the next page

Threat of substitutes: within the consumer-products industry, brands succeed in helping to build a competitive advantage, but even the pricing power of brands can be eroded with substitutes such as store-branded private- label offerings. In fact, some of these same store-brand private-label products are manufactured by the large consumer-products firms. The firms believe that if they can manufacture and package a lower-price alternative themselves, they would rather accept the marginal revenue from their lower-priced items than risk completely losing the sale to a private-label competitor. Verdict: High threat of substitutes.

Degree of rivalry: consumers in this category enjoy a multitude of choices for everything from cleaning products to bath washes. While many consumers prefer certain brands, switching costs in this industry are quite low. It does not cost anything for a consumer to buy one brand of shampoo instead of another. This, along with a variety of other factors, including the forces we've already examined, makes the industry quite competitive. Verdict: High degree of rivalry.

Examining an industry through the framework of Porter's five forces helps illustrate the different dynamics at work. It's not always clear-cut, either, so one wouldn't expect all of the firms in this industry to fall into one big bucket labelled wide moat or narrow moat. Instead, there are firms with distinct, long-term advantages and wide moats, like Procter & Gamble and Colgate, while others have advantages that we think may be less sustainable, such as Clorox and Kimberly-Clark.

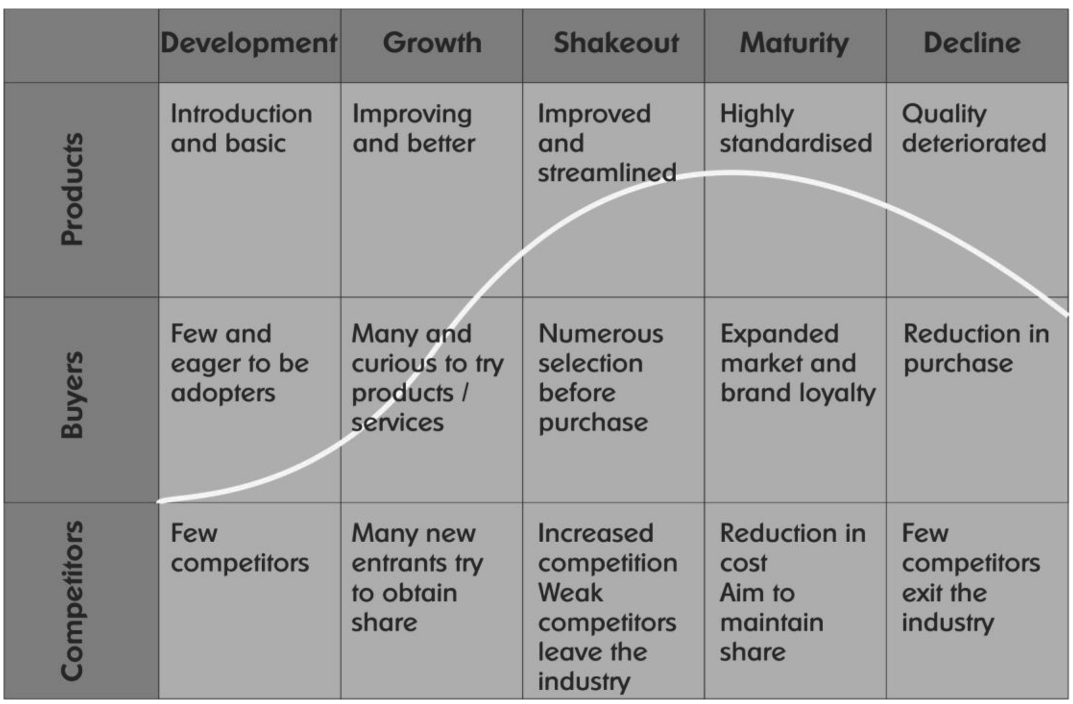
3.2 Lifecycle model
(Source: www.news.morningstar.com)

This model is a tool to analyse the **effects of an industry's growth on competitive forces**. An industry's evolution consists of five phases. The stages of the lifecycle model have a significant impact upon business strategy and performance.

Phases of lifecycle model:

1. development
2.growth
3.shakeout
4.maturity
5.decline

Diagram 10: Lifecycle model



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1.Development stage

There is only a few or perhaps even only one organisation in operation. Naturally competition is very low or non- existent. There is little customer loyalty.

2. Growth stage

At this stage, competition has built up as more organisations have entered the industry. The level of competitive behaviour is not intense as the overall market is growing. Organisations do not need to steal customers from each other to achieve growth.

3. Shakeout stage

At this stage, the size of the market has peaked and many more firms are now operating in the industry. Competition intensifies as the “strong” or efficient organisations strive to drive out the “weak” or inefficient firms.

4. Maturity stage

The intensity of competition remains as the market size looks set to decline. The only way for organisations remaining in the industry to increase sales is by stealing market share from competing firms. Customer loyalty is high.

5. Decline stage

The intensity of competition declines as more organisations decide to exit the industry given the declining market size.

Example

The lifecycle of the ‘walkman’ product very closely follows this model. Sony was the pioneering company as they were the first to market the concept of portable music players with their Walkman tape player. However, within a short time span, other Japanese consumer electronics companies such as Sharp, Sanyo, Aiwa, Toshiba and Panasonic also followed suit, entering the market with their own brands of walkmans.

Over time the market grew with many other consumer electronics companies such as Philips also entering the market. Competition and price wars between the companies intensified.

By the late nineties, walkmans were beginning to show signs of obsolescence and the market size started to decline. Cassettes were avoided in favour of music in CD, DAT and MiniDisc formats. The invention of portable digital music players such as the IPOD has further escalated this trend.

However, Sony and a few other companies still continue to make cassette-based walkmans in limited numbers.

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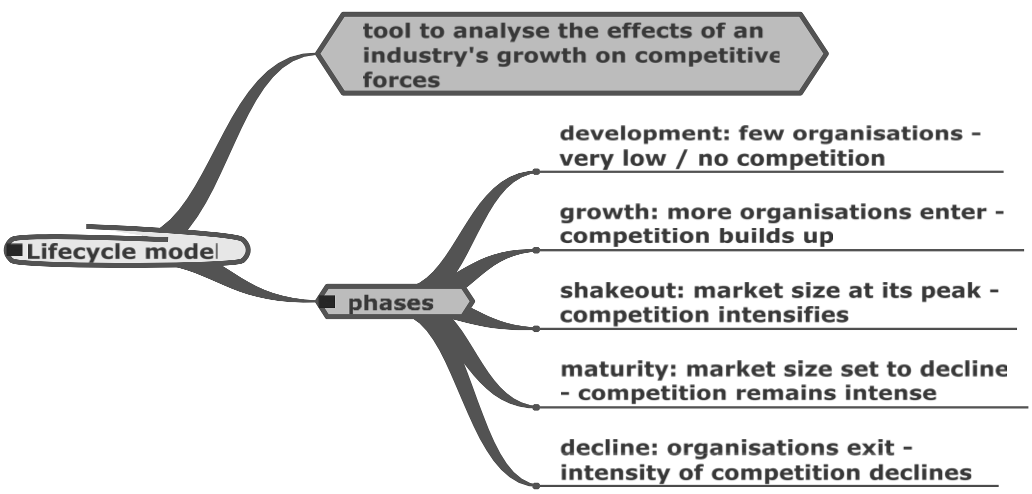
SUMMARY



3.3 Cycle of competition

This model shows the relationship between an established firm and a new entrant. The nature competition that prevails in an industry is uncontrollable and each competitor will have its own influence in the industry. The competitive forces that a five forces analysis will identify are not static in nature. They change and evolve over the course of time. In particular, the barriers to entry for an industry are never permanent. They simply act as a delaying factor. Other organisations will, over time, find a way to overcome them and enter a particular industry.

Technological breakthroughs or changes in government regulation are examples of factors that will erode the entry barriers to an industry. When a new entrant enters an industry, the following interaction that occurs between itself and the incumbent organisation is referred to as the cycle of competition.

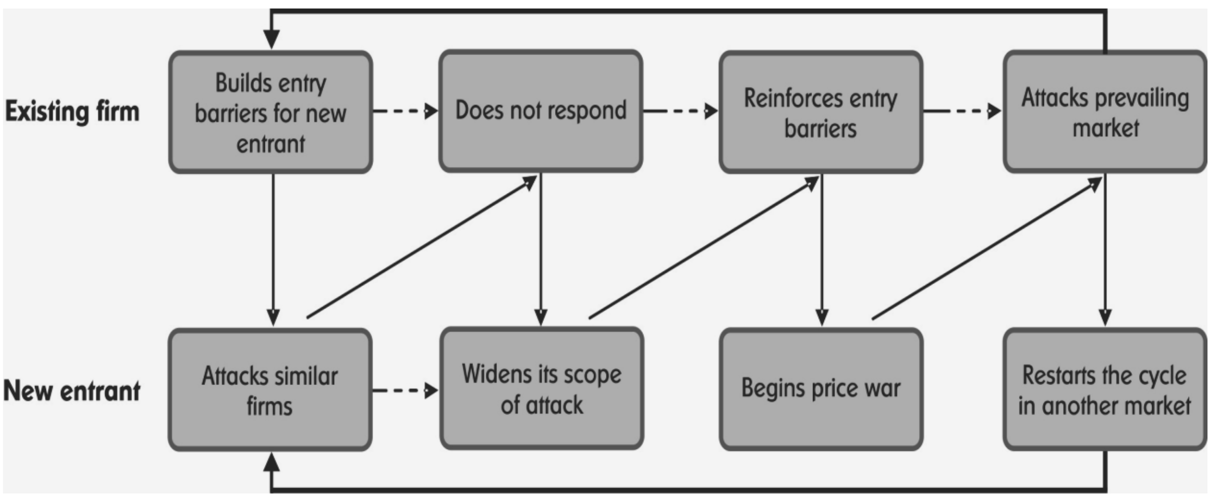
How does cycle of competition operate?

The established firm builds entry barriers for the entrant. If an entrant plans to enter the industry, it must overcome the barriers. The new entrant first attacks the firm which is of the same size and nature so that the impact of the attack is fruitful for the new entrant. The entrant firm attacks the existing firm on a particular geographical area, a market segment or on their technology. If the existing firm **does not respond** to this attack, the entrant widens its scope of attack.

However, if the existing firm **responds** to such an attack, it may be by reinforcing its barriers of entry. It may reinforce the entry barriers by spending more on technology etc. Once the barriers are reinforced, the entrant now begins the price war. As a result, the entrant faces a reduction in margins.

Once the price is reduced by the entrant, the existing firm faces a tremendous challenge and so it may in turn cut down its prices in the prevailing (home) market to force the new entrant to leave the market and make an entry in some other market.

Diagram 11: Cycle of competition



Effects of attack by new entrant or the counter attack by existing firm

When the new entrant or the existing firm attacks, it requires a huge amount of cash and skill.
When the entrant makes an entry in a new geographical area, it involves high risk and huge costs.

Example

In 1929, there were 241 motorcycle manufacturers operating in the United States. By 1954 they had all go out of business / exited the industry except for one, Harley Davidson. The market presence of Harley Davidson was a significant barrier to entry for the American motorcycle market.

During this time, Honda was looking to expand its motorcycle business overseas. It had identified Europe and the States as two key markets. Despite the strong brand image of Harley Davidson, it decided to enter the American market (as it represented one large single market).

Honda entered the US market with its larger motorcycle products (the 250 and 350cc models). It only imported its much smaller end product (the supercub 50cc) for the personal use of its employees and managers.

Continued on the next page

The 250 and 350cc models were plagued with reliability and quality problems. They failed to receive any demand or interest from American consumers. This and the fact that Harley only produced motorcycles of 1000cc and above meant that their entry provoked no response.

However, the public did notice the 50cc bikes that employees used to drive themselves. Interest and demand for these machines grew to such an extent that Honda was forced to start selling them. As time progressed, Honda started producing bigger and better quality machines and began competing with Harley.

In the 1980s, Honda (and the other Japanese companies such as Kawasaki that followed them) was winning. Their bikes were of better quality, more reliable and cheaper than Harleys. In 1972, Harley Davidson had a 100 per cent share of the market for motorcycles with engines of 1000cc or more. By 1982 their market share had dropped to 15 per cent.

Harley Davidson's response was to then prioritise all efforts and focus on improving the quality of their machines. They became one of the first American companies to introduce the Just in Time inventory system.

They also started an aggressive advertising campaign that promoted the company's heritage with the slogan "motorcycles by the people and for the people". They created an inclusive company culture that welcomed customers to join.

Today, Harley's share of the 650cc and above market is close to 50 per cent. Furthermore the company is also present in many other countries including Japan.

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3.4 Hypercompetition

This concept relates to the speed of the competition cycle. If the cycle moves slowly, the competition in an industry settles down many times in a well-established manner. On the other hand, if the speed of competition cycle is high, it is called hyper-competition. This results in frequent competitive change.

Example

There is high level of competition among the mobile phone manufacturers like Nokia, Motorola and Samsung with each of them vying for market share by introducing new and upgraded products.

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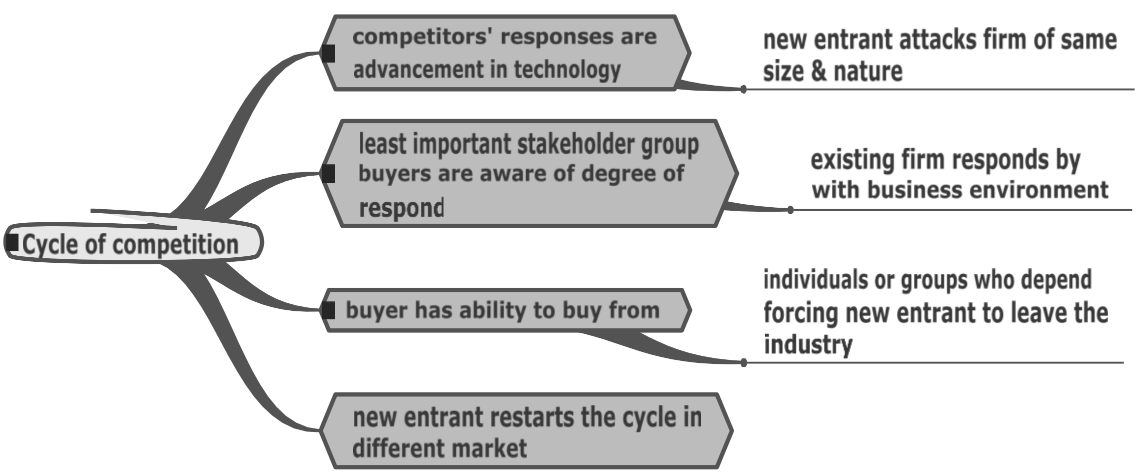
SUMMARY



In order to formulate successful business strategies, firms strive for the best fit decision alternatives. In a competitive market, every firm would try to gain a distinct competitive advantage by building the strategies that embody the cost implication over the life cycle of the product or service as well as the competition cycle.

The strategist will have to consider the following cost implications.

Cost Implications of Life Cycle Model

1. Costs involved at different stages of a product life-cycle

For each of the business functions at each stage of the life-cycle of each product, costs keep on being incurred. Let us try to identify the possible costs at each stage of the life-cycle:

(a) At the introduction and development stage: research and development cost, costs of product design, capital equipment etc.

(b) At the growth and maturity stage: these stages witness both growth and maturity in sales. All the manufacturing, marketing (customer service, promotion etc.), selling and distribution costs (transport and handling) are incurred at this stage.

(c) At the decline stage: as discussed earlier, the demand for the product declines at this stage. The producers may be required to provide after sales service for the products sold in the past. Costs that are incurred in this stage include all costs relating to after sales service including provision of spares, expert services and costs of abandonment and disposal of the product.

2. Conceptualising customer life-cycle costing

A different notion of life-cycle costs is **customer life-cycle costs**. Customer life-cycle costs include the total costs incurred by a customer to acquire and use a product or service until it is replaced. Customer life-cycle costs for a car, for example, include the cost of car itself plus the costs of operating and maintaining the car less the disposal price of the car. Customer life-cycle costs can be an important consideration in the pricing decision.

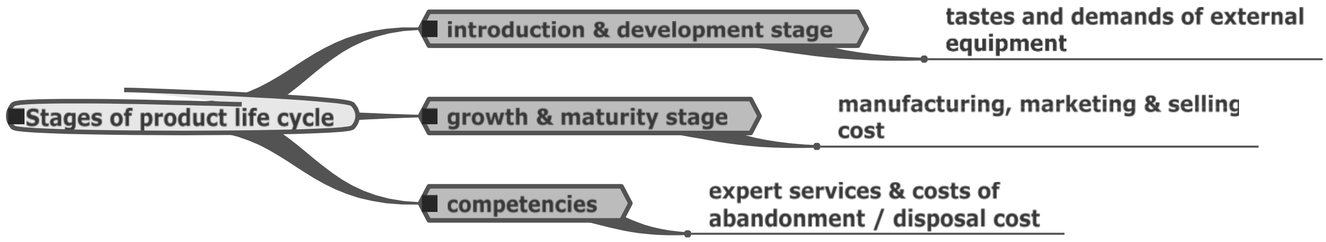
3. Cost Implications of a Competition Cycle Model

(a) When a new product is introduced in the market for the first time, the firm producing it will create barriers of entry for the competition. This could be done through pricing policies, technology barriers, distribution channels, after sales service, spares etc. Building these barriers could entail huge costs. Firms will have to keep incurring these costs if they want to keep the competition at bay. These costs could be related to R & D efforts, advertising & promotional efforts, continuous technology upgrading costs, warranty costs etc.

(b) If a firm wants to enter into new markets with the existing products, the costs of promoting the product, highlighting the unique features, running promotional schemes, introducing higher sales incentives etc. could be very high. Many European car makers have recently entered Asian markets with a bang. Although they are well known international brands, they had to spend a lot to ensure that the cars would suit the conditions and consumer preferences of these countries.

(c) In hyper competitive market situations, the product profitability may start eroding and if the firms still want to compete with the other players, they will have to incur huge selling, distribution and service costs. The 3G mobile industry is the best example of this scenario.

(d) Many companies, in order to be competitive, shift their manufacturing base to low cost countries. This at times is a good strategy as it can bring about long term cost reduction. Automakers the world over have shifted their manufacturing bases to Eastern Europe, South East Asia, India etc. to take advantage of this.



3. Identify strategic groups, market segments and critical success factors, and use them in order to recognize strategic gaps and opportunities in the market

[Learning Outcome c]

Strategic Groups and Market Segmentation

Analysis of the markets would enable a firm to understand, draw and implement competitive strategies in a successful manner.

1. Strategic groups

Definition

JSW defines a **strategic group as:**

"Organisations within an industry with similar strategic characteristics, following similar strategies or competing on similar bases".

(Source: JSW)

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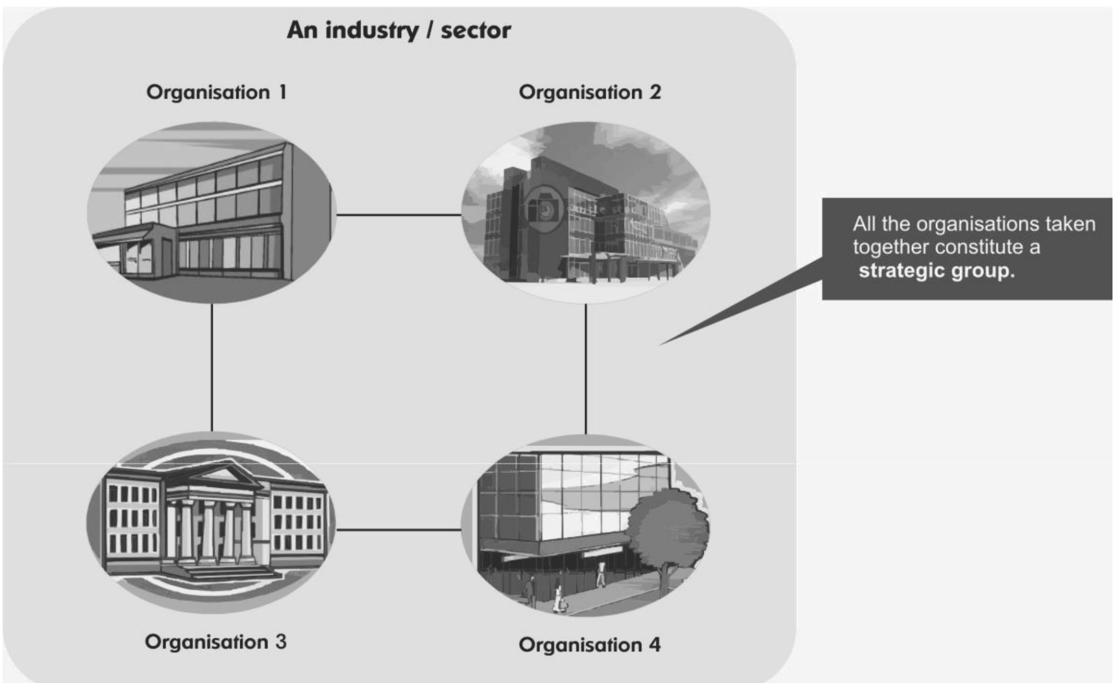
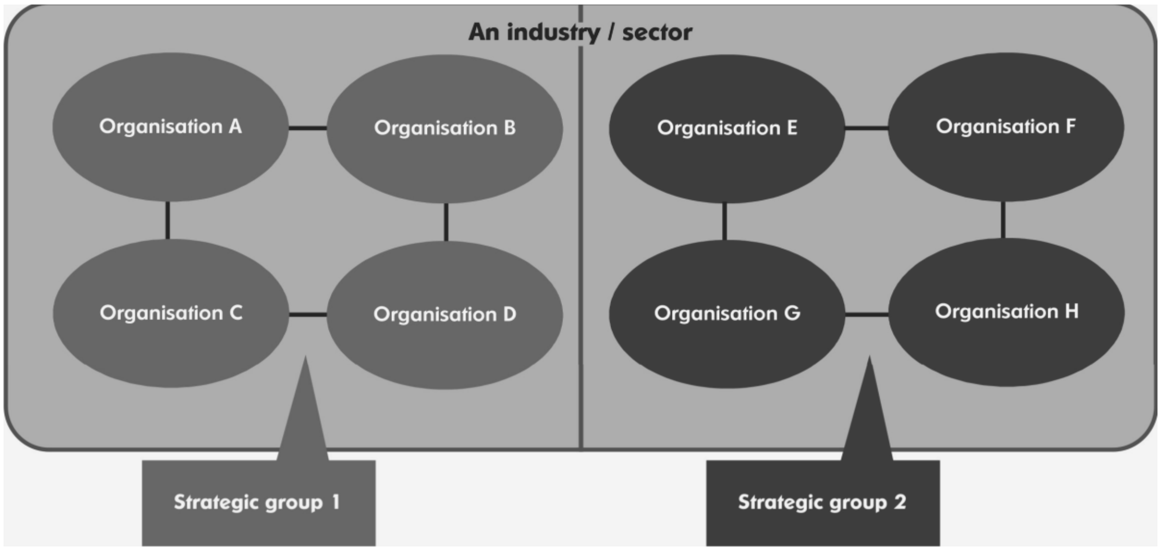
Therefore, strategic groups are the subgroups within an industry that reduce the number of competitors in each market. Normally, each strategic group will have a similar marketing and strategic approach.

Diagram 12: Strategic group within an industry



There may be more than one strategic group within an industry, each with different characteristics.

Diagram 13: Strategic groups



The aim of strategic group analysis (SGA) is to **identify organisations with similar strategic characteristics, following similar strategies or competing on similar bases**.

These groups can be identified on the basis of the following

characteristics:

(a) extent of product (or service) diversity
(b) geographic coverage
(c) distribution channels
(d) extent of branding
(e) number of market segments served
(f) marketing effort
(g) product (or service) quality
(h) pricing policy

Example

In the telecom industry, there are two strategic groups based on the technology used in the mobile phones. One strategic group uses CDMA technology, the other uses GSM technology. Both these strategic groups have different characteristics of usage etc.

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Uses of strategic groups

Members can identify competitors who are in **direct competition** with them.

Members have common interests and so possess negotiating power.

Members can recognise future opportunities and threats to their organisation.

Members can identify any competitive rivalry.

Within strategic groups, it becomes possible for organisations to move from one strategic group to another strategic group.

The mobility of an organisation depends upon the entry barriers between one group and another.
Identifying the specific strategic group to which it belongs is a beneficial exercise for an organisation. It helps an organisation to identify:

which firms are its closest or most direct competition
what the mobility barriers for entering a different strategic group are

Mobility barriers are the entry barriers that have to be overcome if an organisation wishes to shift strategic position from one strategic group to another.

Example

If Suzuki wishes to enter the same strategic group as Ferrari it will have to increase the quality of its automobiles to match the standard set by these manufacturers. On the other hand, if Ferrari wishes to enter the same strategic group as Toyota it will have to greatly expand its product range to serve a mass market.

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In addition to understanding themselves and the competitive forces of their industry, organisations must also understand their customers. Ultimately an organisation's profitability will depend upon how well they are able to satisfy their customers.

2. Market segmentation

Definition

JSW defines a **market segment** as:

A market segment is a group of customers who have similar needs that are different from customer needs in other parts of the market.

(Source: JSW)

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Therefore a market segment is a subgroup of people or organisations which share one or more characteristics and have **similar product needs, in other words they are homogeneous (the overall market is heterogeneous)**. As organisations can be categorised into different industries, customers can also be placed into different market segments. All organisations in a particular industry are not the same; neither are all customers in a particular market. All segments are either consumer or industrial markets.

Market segmentation is the process of **dividing a particular market into a collection of submarkets based upon similar needs or product preferences**. When an individual market segment is homogeneous on the basis of needs and attitudes, there is the possibility of responding similarly to a given marketing strategy.

The main aim of market segmentation is to identify groups of similar customers and prospective customers in order to gain a better understanding of their behaviour, to prioritise the groups to address and to respond with appropriate marketing strategies that satisfy the different preferences of each segment.

Example

The automobile industry has different segments based on its compact cars, luxury and sports car models. The markets for these are based on its price, utility and the lifestyle they want to imply.

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(a) Need for market segmentation

(i) Understanding customers and satisfying their needs better.
(ii) Identifying viable segments, for example, those segments where his competition is not strong.
(iii) By **target marketing:** once a viable segment has been identified, specific marketing plans can be set in train tc meet the precise customer needs
(iv) When the needs of the customers are common, there is opportunity for adequate and clear communication betwe the customers and organisations.
(v) When the market is segmented, if any need of the customer is not fulfilled then an organisation can take measures to satisfy this need by applying new methods.
(vi) When the market provides whatever is needed by the consumer, the consumer in turn is ready to pay even a h price for it which results in a rise in the profits of the organisation.

(b) Bases of market segmentation

The consumer market is often segmented on the basis of the following characteristics:

(i) geographic
(ii) behaviouralist
(iii) demographic

(iv) sychographic

(i) Geographic segmentation

The market is divided on the basis of:

- geographical region such as country, state or continent
- climatic conditions according to weather patterns
- type of population such as rural, urban or suburban

Example

Coolbreeze Ltd sells air conditioners across the country. It has divided its market into two broad regions. One region has an average high temperature throughout the year and the other has a relatively low temperature throughout the year. Hence, Coolbreeze Ltd follows geographic market segmentation.

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(ii) Behaviouristic segmentation

This type of segmentation is based on the consumer behaviour regarding the products. The characteristics of segmentation are as follows:

- user status i.e. whether the user of the particular product is a first time user, a prospective user or a regular user
- customer's readiness to buy the product
- usage rate i.e. how often the consumer uses the product
- brand loyalty i.e. the customer's dependence on and confidence in a particular product's brand
- holidays and events that inspire customers to buy the products

(iii) Demographic segmentation

This type of segmentation is made on the basis of the following variables:

- sex /gender
- age group
- family size
- education
- income
- occupation
- religion
- social class
- nationality
- health

Example

Woodworld Ltd manufactures a variety of household furniture items. It has divided its market on the basis of the level of income of its consumers. It offers luxury furniture items to high income group consumers and low cost furniture items to low income group consumers. Hence, it follows demographic market segmentation.

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(iv) Psychographic segmentation

Here, the segmentation is made on the basis of the consumer's lifestyle. The variables are as follows:

Interests

The interests of the customers are varied. Some have traditional interests while some others have modern interests. The market has to be segmented according to the interests of the customers.

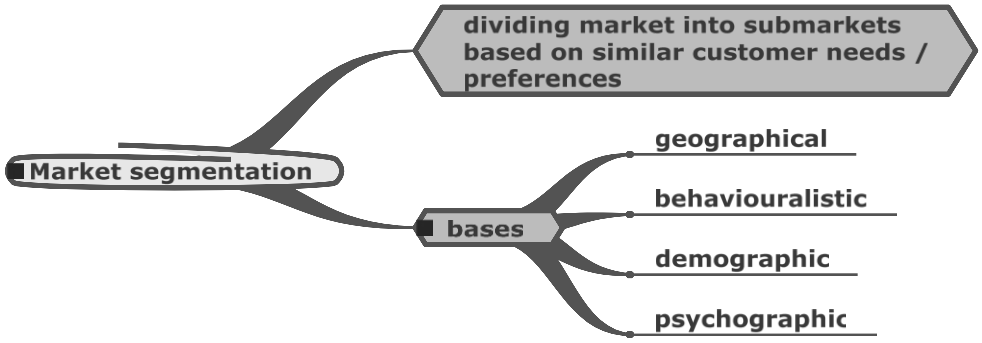
Attitudes and values

Some customers assign a high value to luxury goods whereas, for other customers, luxury goods are not of any importance, i.e. they do not give much value to them. Therefore the market has to be segmented accordingly.

Opinions and activities

The opinion of every individual varies. A product which is necessity for one customer may be unimportant to another customer and the segmentation varies accordingly.

SUMMARY



(c) Segmentation of industrial markets

Industrial customers purchase their product requirements in large quantities. The decision to purchase the industrial products is taken by a large group of people. Many of the variables of consumer markets also apply to industrial markets. The other variables of segmentation are as follows:

(i) Type of organisation: whether the organisation is a manufacturing or a service organisation

(ii) Product or service grouping / type

(iii) Location of the organisation: when the needs of particular firms in an industry are common, they come together in a particular area

(iv) Behavioural features: consumers in an industrial market have different patterns of purchasing compared to consumers in a consumer market. In an industrial market, the consumer's purchase decision is based on the opinion of many people in an organisation. The variables of segmentation are the usage rate and the buyer's status (first time buyer, prospective buyer or regular buyer)

4. Distinguish elements of strategic capability in organization: resources, competences, core competences and dynamic capabilities.

[Learning Outcome d]

Different writers, managers and consultants use different terms and concepts in explaining the importance of strategic capability. Given such differences, it is important to understand how the terms are used here. Overall, strategic capability can be defined as the resources and competences of an organisation needed for it to survive and prosper.

Resources and competences

Tangible resources are the physical assets of an organisation such as plant, people and finance.
Intangible resources are non-physical assets such as information, reputation and knowledge. Typically, an organisation's resources can be considered under the following four broad categories:

- *Physical resources* – such as the machines, buildings or the production capacity of the organisation. The nature of these resources, such as the age, condition, capacity and location of each resource, will determine the usefulness of such resources.
- *Financial resources* – such as capital, cash, debtors and creditors, and suppliers of money (shareholders, bankers, etc.)
- *Human resources* – including the mix (for example, demographic profile), skills and knowledge of employees and other people in an organisation's networks
- *Intellectual capital* – as an intangible resource – includes patents, brands, business systems and customer databases. An indication of the value of these is that when businesses are sold, part of the value is 'goodwill'. In a knowledge-based economy intellectual capital is likely to be a major asset of many organisations.

The efficiency and effectiveness of physical or financial resources, or the people in an organisation, depends on not just their existence but how they are managed, the cooperation between people, their adaptability, their innovatory capacity, the relationship with customers and suppliers, and the experience and learning about what works well and what does not.

The term **competence is** used to mean the skills and abilities by which resources are deployed effectively through an organisation's activities and processes.

Threshold capabilities

A distinction needs to be made between capabilities (resources or competences) that are at a threshold level and those that might help the organisation achieve competitive advantage and superior performance.

Threshold capabilities are those needed for an organisation to meet the necessary requirements to compete in a given market. These could be: -

- *Threshold resources* required meeting minimum customer requirements.
- *Threshold competences* required deploying resources so as to meet customers' requirements and support particular strategies.

Unique resources and core competences

While threshold capabilities are important, they do not of themselves create competitive advantage or the basis of superior performance. These are dependent on an organisation having distinctive or unique capabilities that competitors will find difficult to imitate. This could be because the organisation has

- **Unique resources** that critically underpin competitive advantage and that others cannot imitate or obtain – a long-established brand, for example.
- **Core competences** that critically underpin competitive advantage in ways that others cannot imitate or obtain.

5. Analyze how strategic capabilities might provide sustainable competitive advantage on the basis of their value, rarity, inimitability and non-substitutability.

[Learning Outcome e]

CAPABILITIES FOR ACHIEVING AND SUSTAINING COMPETITIVE ADVANTAGE

If the capabilities of an organisation do not meet customer needs, at least to a threshold level, the organisation cannot survive; and if managers do not manage costs efficiently and continue to improve on this, it will be vulnerable to those who can.

However, if the organization wants to achieve competitive advantage, they need to what strategic capabilities might provide competitive advantage in ways that can be sustained over time?

The resource-based view (RBV) approach to competitive advantage contends that internal resources are more important for a firm than external factors in achieving and sustaining competitive advantage. Resource-based view theory asserts that resources are actually what help a firm exploit opportunities and neutralize threats.

The basic premise of the RBV is that the mix, type, amount, and nature of a firm's internal resources should be considered first and foremost in devising strategies that can lead to sustainable competitive advantage. Managing strategically according to the RBV involves developing and exploiting a firm's unique resources and capabilities, and continually maintaining and strengthening those resources. The theory asserts that it is advantageous for a firm to pursue a strategy that is not currently being implemented by any competing firm. When other firms are unable to duplicate a particular strategy, then the focal firm has a sustainable competitive advantage.

A resource can be considered valuable to the extent that it is (1) rare, (2) hard to imitate, or (3) not easily substitutable. The more a resource(s) is rare (not held by many firms in the industry), hard to imitate (hard to copy or achieve), and/or not easily substitutable (invulnerable to threat of substitution from different products), the stronger a firm's competitive advantage will be and the longer it will last.

6. Analyse strategic capability by means of value chain analysis, activity mapping, and benchmarking and SWOT analysis.

[Learning Outcome f]

The value chain and value network

If organisations are to achieve competitive advantage by delivering value to customers, managers need to understand which activities they undertake are especially important in creating that value and which are not. Value chain and value network concepts can be helpful in understanding this.

Value chain analysis

The value chain is a systematic approach to examining the development of competitive advantage. It was propounded by M.E. Porter in his book, "Competitive Advantage" (1980). A value chain is a chain or a series of value added activities, i.e. where products pass through the activities in a chain, gaining value at each stage.

According to Porter, there are two routes through which a firm can generate superior competitive performance:

By consistently being more innovative than its rivals in finding ways to satisfy its customers. This enables it to differentiate its products and services and so charge a higher price for them as well as enjoy high demand.

By providing customers with the same quality of product or service as rivals but at a low cost to itself. This cost leadership strategy enables the firm to enjoy a superior margin in a market where differentiation is not possible.

He developed the concept of the value chain and value system to demonstrate how management can analyse its business in terms of how it generates 'value' for the customer and the shareholder.

6.2 The organisation is split into 'primary activities' and 'support activities':

1. Primary activities

(a) Inbound logistics: receipt and handling of inputs into the process and disseminating them within the firm, such as warehousing, inventory control and vehicle scheduling.

(b) Operations: this comprises all manufacturing activities including processing, packaging, testing and equipment maintenance.

(c) Outbound logistics: collecting, storing and distributing the products to buyers. This may include finished goods warehousing, delivery vehicle operation, order processing and scheduling.

(d) Marketing and sales: concerned with providing customers with a means to buy and enjoy the product and inducing them to do so. This includes activities such as advertising and promotion, channel selection, sales force management and pricing policy.

(e) Service: post-purchase service to enhance or maintain the value of a service such as installation, maintenance, training and supply of parts and consumables.

2. Support activities

These activities support the primary activities of the business. They are normally classed as indirect because they do not have a discernible relationship to the product of the firm. Porter disputes this. He observes that a so-called indirect activity such as purchasing (or procurement as he calls it) is not a central function but rather is carried out by a number of departments across the firm.

For example, the purchasing of raw materials will be part of inbound logistics, whereas the purchasing of advertising space will take place in marketing and sales. By disaggregating indirect activities according to the primary activities that give rise to them, Porter believes that opportunities for value creation can be identified more accurately.

(a) Procurement

This function is responsible for all purchasing of goods, services and materials. The aim is to secure the lowest possible price for purchases of the highest possible quality. This function will be responsible for outsourcing and e-purchasing.

(b) Technology development

Technology is an important source of competitive advantage. Companies need to innovate to reduce costs and to protect and sustain competitive advantage. Technological development includes a broad range from basic product and process research, through media research to servicing procedures.

Technological development could include production technology, internet marketing activities, lean manufacturing, customer relationship management (CRM) and many other technological developments.

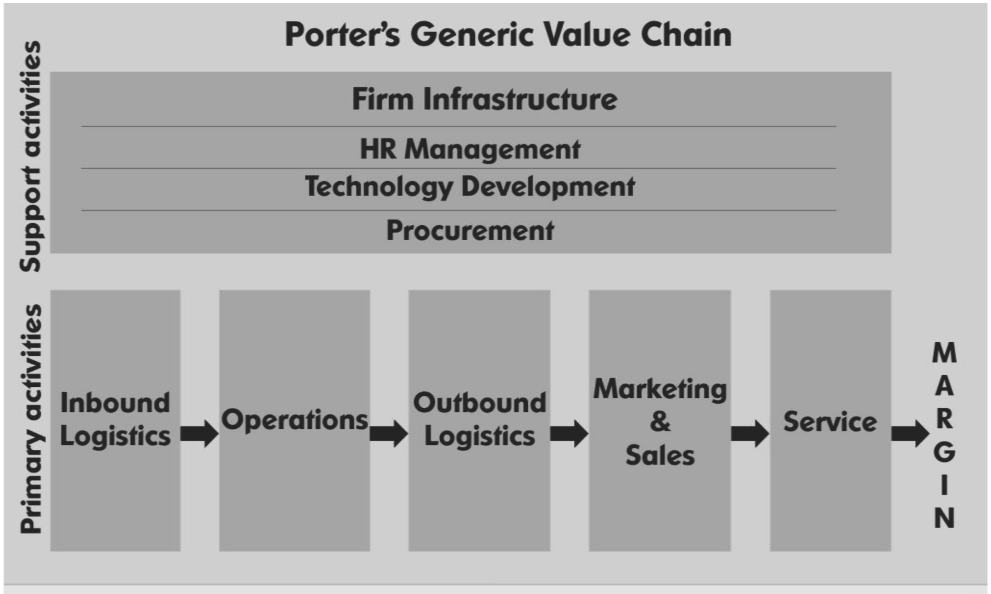
(c) Human resource management

This function includes recruitment, training, development, retention and discharge of staff. In some organisations, the creation of a set system of working and its inculcation by the employees through training is the key resource of the firm.

(d) Firm's infrastructure

The activities of the firm which cannot be traced back to a specific primary activity include general management, accounting, finance and legal services. Note that, in his diagram, Porter does not attempt to segment this support activity according to the primary activities.

Diagram 4: Value chain model



The primary objective of these activities is to offer the customer a level of value that exceeds the cost of the activities, thereby resulting in a profit margin. The quantum of a firm's margin depends on how effectively and efficiently it can perform these activities. The higher the customer perceives the value of a firm's product to be, the higher is the price he is willing to pay.

This price, in turn, will exceed the cost of the activities in the value chain. The firm can improve the quality of these activities in order to generate superior value. Moreover, a firm can obtain competitive advantage by reconstructing the value chain in order to provide lower cost and/or higher product differentiation.

Competitive advantage in regard to products and services takes two possible forms:

Cost advantage can be gained by reviewing costs and implementing a phased plan of cost reduction in all those activities that do not add value or offer adequate margins.

Differentiation can be built into a product by focusing on those activities that are the core competences and capabilities of the firm. The objective is to put in place a programme to perform these activities more efficiently than the competition.

Example

India is today recognised as a global pharmaceutical manufacturing hub, with nearly 50 percent lower production costs than the US. It has the largest number of FDA approved facilities outside the US. This remarkable phenomenon was brought about by the ability of the Indian drug industry to reverse engineer generic drugs to develop new molecules.

Owing to their high quality and very competitive prices, Indian generic drugs have found wide acceptance in the US market. According to some estimates, these drugs have captured around 30% of the US generic drug replacement market valued at around $50 billion. However, as competition tightens, with other countries now beginning to offer their drugs at low prices, Indian companies need to sustain their competitive advantage by continuously focusing on reducing costs and moving up the value chain.

Test Yourself 6

The value chain classifies all business activities into two categories: primary activities and support activities. Explain.

Benchmarking

This section considers the value of *benchmarking*, which can be used as a way of understanding how an organisation's strategic capability, in terms of internal processes, compare with those of other organisations.

There are different approaches to benchmarking:

- *Historical benchmarking*. Organisations may consider their performance in relation to previous years in order to identify any significant changes. The danger is that this can lead to complacency since it is the rate of improvement compared with that of competitors that is really important.
- *Industry/sector benchmarking*. Insights about performance standards can be gleaned by looking at the comparative performance of other organisations in the same industry sector or between similar service providers against a set of performance indicators. Some public sector organisations have, in effect, acknowledged the existence of strategic groups by benchmarking against similar organisations rather than against everybody. An overriding danger of industry norm comparisons (whether in the private or public sector) is, however, that the whole industry may be performing badly and losing out competitively to other industries that can satisfy customers' needs in different ways. Another danger with benchmarking within an industry is that the boundaries of industries are blurring through competitive activity and industry convergence. For example, supermarkets are (incrementally) entering retail banking and their benchmarking needs to reflect this (as does the benchmarking of the traditional retail banks).
- *Best-in-class benchmarking*. Best-in-class benchmarking compares an organisation's performance against 'best-in-class' performance – wherever that is found – and therefore seeks to overcome the limitations of other

approaches. It may also help challenge managers' mindsets that acceptable improvements in performance will result from incremental changes in resources or competences. It can therefore encourage a more fundamental reconsideration of how to improve organisational competences.

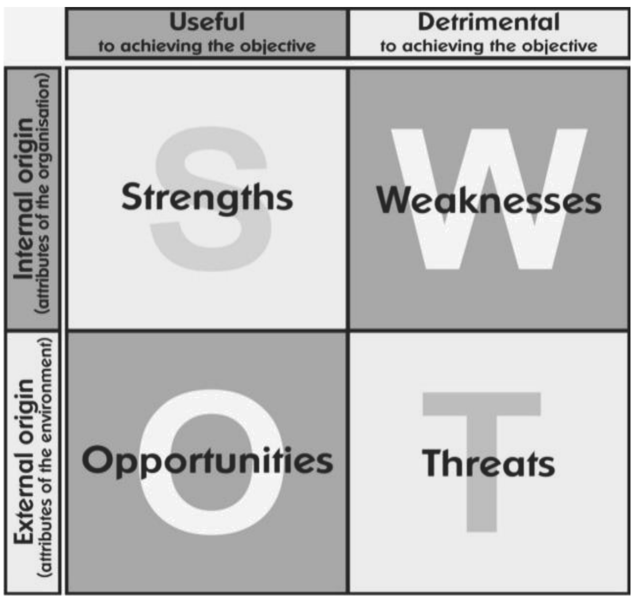
SWOT analysis

A SWOT analysis is a strategic planning tool that organisations use to identify their strengths, weaknesses, opportunities and threats (hence the acronym). Conducting a SWOT involves an organisation carrying out both an internal and an external analysis. With the internal analysis an organisation identifies it strengths and weaknesses. Strengths are attributes of the organisation that can help it achieve a competitive advantage. Weaknesses on the other hand are attributes of the organisation that would hinder it in achieving a competitive advantage.

Identifying opportunities and threats that potentially face the organisation is what constitutes an external analysis. Opportunities are external conditions or situations that could potentially benefit an organisation. Threats are external conditions or situations that could potentially harm an organisation's business.

SWOT analysis is best used as a snapshot of **strategic position** after the organisation has done an internal and external analysis.

Diagram 5: S.W.O.T Analysis



1. Some of the factors that an organisation examines when conducting a SWOT are its / current:

   structure
   culture
   human resources: staff capabilities, training policy, retention
   financial resources
   competitors
   customers
   government legislations
   socio-economic trends

2. Overall the benefits that conducting a SWOT analysis offers are that it helps an organisation to:

   match its resources and capabilities to its competitive environment
   identify strategies that it can follow to achieve a competitive advantage

Example

Tech1 is an organisation that manufactures and markets mainframe computers. It recently conducted a SWOT analysis and identified the following:

Strengths:	highly motivated and technically competent sales force
Weaknesses:	designs of existing products are all over three years old

Opportunities:	the government is set to introduce a tax break for organisations that purchase mainframe computers
Threats:	a number of micro computer manufacturers are planning to start manufacturing mainframe computers

As an outcome of the SWOT, Tech1 decides to design a fresh model so as to better position itself to compete against the new firms that are planning to enter this industry.

SUMMARY

Test Yourself 7

Health Cure Ltd is an international pharmaceutical company operating worldwide. The company is involved in pharmaceutical research. The products manufactured by the company are prescribed in chronic therapy areas like cardiology, psychiatry, neurology and respiratory medicine.

Required:

Conduct a SWOT analysis for Health Cure Ltd.

Self Examination Questions

Question 1

One of the major challenges facing business organisations is the power to compete. Inability to face market competitions results into organisation's failure to perform hence business closedown.

REQUIRED:

By referring to Michael Porter Strategic Management Model, known as the five forces of competition, explain the five competitive forces which must be analysed when evaluating a business's profitability in the future.

QUESTION 2

Sometimes it is difficult for organizations to be certain that they are pursuing the best strategy, but it is possible for most organizations to reduce the likelihood of mistakes that are being made in the strategy they are implementing. This can be achieved by a business to choose its strategy carefully and systematically and follow the strategic management process. Among the processes are external analysis and internal analysis.

REQUIRED:

(a) Briefly describe the purpose of conducting and approach used to perform external and internal analysis.

(b) Name and explain the characteristics of a good strategic decisions.

QUESTION THREE

Bulombora Investment Limited thought of venturing into a new product line. This was discussed at the Board level and the idea was given thumbs-up to proceed. The PESTLE Analysis was then to follow.

REQUIRED:

(i) Enumerate the types of questions that the firm's management needed to be asking in the exercise.

(ii) Explain the process you are likely to adopt when using the PESTLE technique.

Answers to Self-Examination Questions

Answer to SEQ 1

Five forces as narrated by Michael Porter:

(i) Threat of potential entrants

Profitable markets that yield high returns will attract new firms. This results in many new entrants, which eventually will decrease profitability for all firms in the industry.

(ii) Threat of substituted products or services

The existence of products outside of the realm of the common product boundaries increases the propensity of customers to switch to alternatives.

(iii) Bargaining power of customers (buyers).

The bargaining power of customer is also described as the market of outputs: the ability of customers to put the firm under pressure, which also affects the customers' sensitivity to price changes.

(iv) Bargaining power of suppliers

The bargaining power of suppliers is also described as the market of inputs. Suppliers of raw materials, components, labour and service to the firm can be a source of power over the firm where there are few substitutes.

(v) Intensity of competitive rivalry: for most industries the intensity of competitive rivalry is the major determinant of the competitive of the industry.

Answer to SEQ 2

(a) The purpose of conducting an external analysis, a firm identifies the critical threats and opportunities in its competitive environment. It also examines how competition in this environment is likely to evolve and what implications that evolution has for the threats and opportunities a firm is facing. Techniques for and approaches to conducting external analysis are PESTEL framework and Five Forces Model of Industry attractiveness. While internal analysis helps a firm identify its organizational strength and weaknesses. It also helps a firm understand which of its resources and capabilities are likely to be sources of such advantages. Internal analysis also can be used by firms to identify those areas of its organization that require improvement and change. Approaches to conduct internal analysis are VRIO framework and Value chain analysis.

(b) Characteristic of a good strategic management:

- The long-term direction of and organization.
- The scope of an organization's activities.
- Advantage for the organization over competition.
- Strategic fit with the business environment.
- The organization's resources and competences.
- The value and expectations of powerful actors in and around the organization.

Answer to SEQ 3

PESTLE analysis:

(i) Types of questions you would ask:

- What are the key political factors?
- What are the important economic factors?
- What sociocultural aspects are most important?
- What technological innovations are likely to occur?
- What current and impending legislation may affect the industry?
- What are the environmental considerations?

(ii) Process to adopt when using PESTEL technique

- Brainstorm and list key issues that are outside the organization's control.
- Broadly identify the implications of each issue.
- Rate its relative importance to the organization (e.g. critical, extensive, important, significant, moderate, or insignificant).
- Rate the likelihood of its occurring (e.g. certainty, extremely likely, likely, potential, remote possibility, or will not transpire).
- Briefly consider the implications if the issue did occur.

STUDY GUIDE A3: STRATEGIC CHOICE

Get Through Intro

When starting a business or working for a company, it is important to understand on what basis you are competing. Is it price or is it on quality. Are you creating a premium brand, or do you not care about the brand, but just want to sell as many as possible? For instance, if you need to buy a matchbox or a lighter, would you ask for a particular brand? It is likely you would not. Hence most matchbox makers do not spend money on advertising and keep costs to a minimum.

This Study Guide will explain to you what approaches you or your company may take, in order to be competitive. It will also explain the relative advantages and disadvantages. This will ensure that you can help your company meet its goals by ensuring you are one step ahead of the competition!

Learning Outcomes

a) Identify strategic business units (SBUs) in organizations
b) Explain bases of achieving competitive advantage in terms of 'routes' on the strategy clock and assess the extent to which these are likely to provide sustainable competitive advantage.
c) Identify strategies suited to hypercompetitive conditions.
d) Identify alternative directions for strategy, including market penetration or consolidation, product development, market development and diversification
e) Analyze the ways in which a corporate parent can add or destroy value for its portfolio of business units.
f) Analyze portfolios of business units and judge which to invest in and which to divest.
g) Assess the internationalization potential of different markets, sensitive to variations over time
h) Identify sources of competitive advantage in international strategy, both through global sourcing and exploitation of local factors embodied in Porter's Diamond.
i) Distinguish the four main types of international strategy.

1. Identify Strategic Business units (SBUs) in a organizations
[Learning Outcome a]

A **strategic business unit (SBU)** is a part of an organisation for which there is a distinct external market for goods or services that is different from another SBU. The identification of an organisation's SBUs helps the development of business- level strategies since these may need to vary from one SBU to another.

There are external and internal criteria that can help in identifying appropriate SBUs:

- *Market-based criteria*. Different parts of an organisation might be regarded as the same SBU if they are targeting the same *customer types*, through the same sorts of *channels* and facing similar *competitors*.
- *Capabilities-based criteria*. Parts of an organisation should only be regarded as the same SBU if they have similar strategic capabilities. So for a food manufacturer branded goods should probably be considered a different SBU from retail 'own-brand' goods even though they are selling to the same end customers through the same channels.

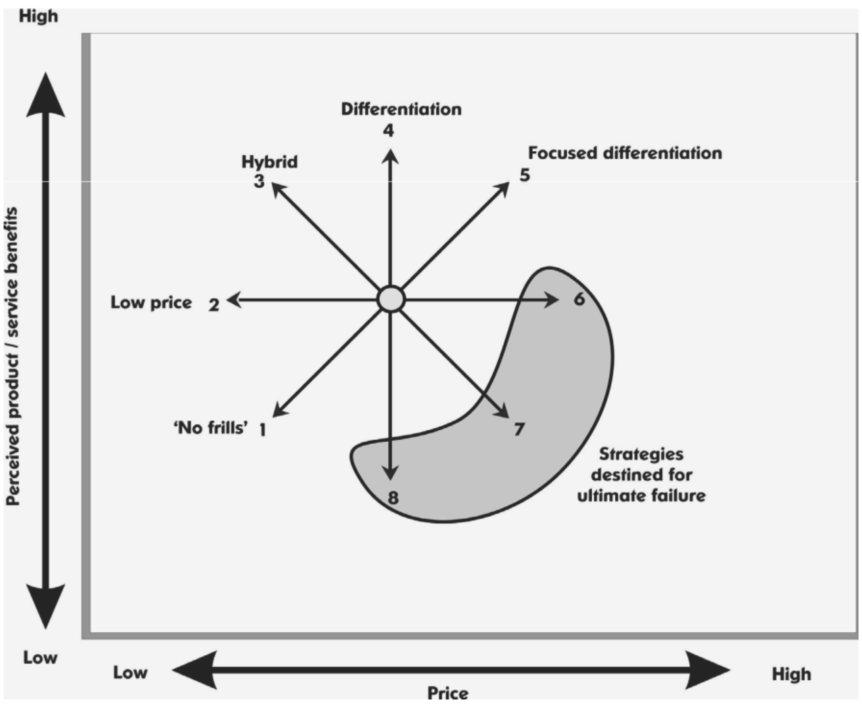
2. Explain bases of achieving competitive advantage in terms of 'routes' on the strategic clock and assess the extent to which these are likely to provide sustainable competitive advantage.
[Learning Outcome b]

Strategy clock

The strategy clock was developed by Cliff Bowman. It is an extension of Porter's generic strategy model. Like Porter, Bowman considered competitive advantage in relation to cost advantage or differentiation advantage. According to the strategy clock, an organisation can achieve competitive advantage by **satisfying the customer needs better than the competitors**. Customers have the opportunity to select suppliers from which they will purchase the products on the basis of cost benefit analysis, i.e. by analysing how much benefit they will receive in return for paying a certain amount of money (and also other inputs such as their time spent on the purchasing process). The strategy clock represents different positions adopted by customers on the basis of selling price and perceived benefits. The most important aspect considered in all strategies is the organisation's cost (compared to competitors).

The strategy clock is depicted as follows:

Diagram 2: The strategy clock



The **numbers** in the diagram above indicate the **positions of the customers** in the market. It is essential to recognise the **critical success factors** in each position of the clock. The two axes considered in the clock are price and perceived (apparent) product / service benefits. The positions in brief are:

Positions 1 and 2 – **No frills and low price** respectively - low price and low perceived benefits (position 1): customers are very concerned with the price. This is the position (1) where low price is the main consideration. This may happen in a market which deals in commodities (commodities are goods and services where it is very hard to differentiate, e.g., glass, aluminium, steel, sugar beet etc). Position 2 gives comparatively more importance to perceived benefits than position 1.

Position 3 – Hybrid - low price and high perceived benefits: the strategy aims to provide higher benefits to customers than competitors at low price. This position is a combination of differentiation and low price.

Position 4 – Differentiation strategies: the aim of this strategy is to provide better products or services than competitors at the same or higher prices. This is usually achieved by offering a different product or service benefit that is desired by the customer; marketers sometimes refer to these differences as **Unique Selling Points** (USPs).

Position 5 – Focused differentiation: this strategy aims to provide higher benefits to customers but at a higher price. These products are called premium products and the extra profit that accrues is referred to as a price premium. These are marketed to a specific segment (niche) of the market.

Position 6, 7 and 8 – Failure strategies: these strategies result in providing lower benefits to customers at higher prices and are destined to fail as they produce unattractive cost benefits ratios for the customer.

Each position in the clock is explained in detail below.

1. Price-based strategies (Positions 1 and 2)

(a) A 'no frills' strategy is a strategy whereby the **prices are very low** and the **benefits to the customers are also very low**. The target customers are very conscious of the prices.

Features of the strategy

(i) This strategy is a useful strategy for a commodity-like market. Customers purchase products from a supplier who can provide benefits at lower prices. So, 'money' is the crucial factor in assessing competitive advantages.

Example

Suzy has bought a new house and wishes to buy a range of appliances including a refrigerator, a dishwasher, a washing machine and a television. She wants to purchase all the items at low prices. Jackson Ltd and Michael Plc are two dealers in household appliances. They have both been operating in the market for many years. In recent months, many new entrants have established their firms in the market.

Jackson Ltd is an organisation which possesses managers with excellent strategic skills. In response to the new entrants in the market, its managers decided to follow a strategy of reducing the prices by lowering the costs of the products. On the other hand, Michael Ltd followed the strategy of improving the product quality and providing more benefits by increasing the prices.

Here, as Suzy is interested in purchasing all her requirements at low prices, she will prefer to buy the appliances from Jackson Ltd the strategy followed by Jackson Ltd is a 'no frills' strategy.

(ii) The customers may be not willing to pay more to obtain better perceived benefits. There may be cases where customers are not able to pay more. These types of customers are very sensitive to price elasticity.

(iii) This type of strategy is a helpful tool for market entry. New entrants can enter the market at low prices.

(iv) It is a challenging task to build customer loyalty because customers may move to competitors if prices are increased by suppliers.

Example

For the airline industry, European low cost no frills airlines are an example of a no frills strategy.

After 11 September 20X1, the airline industry suffered tremendously. The prices of tickets reduced considerably. Many of the airlines suffered heavily, especially flagship carriers (national airlines) e.g. Swiss air. Generally, they had cut costs to the maximum possible extent.

However, the airlines which followed a low cost strategy coped admirably with the problems and actually ended up gaining customer confidence. Ryan air and Easy jet have generally remained cost-effective and are operating at their fullest capacity. These airlines have managed to function offering low fares by reducing their cost to a minimum. At present, to withstand competition in the market, the airline industry has had to manage itself by lowering their costs as far as possible.

Ryanair has adopted a strategy of no frills which resulted not only in reducing the members of cabin crew but has also managed quicker pre-flight groundwork, on top of continuously reducing fares for passengers.

(b) A low price strategy aims to provide **better perceived benefits** as compared to competitors and charge **lower prices** than competitors. It may give rise to a price war in the market amongst the competitors and, in turn, may lead to a reduction in the profit margins.

When a business unit decides to adopt a low price strategy, it may do so in two different ways:

(i) It may enter a market where **competitors are not attracted**. As a result, the unit does not have to worry about the price. An attractive profit margin is therefore likely.
(ii) It may enter a market segment where there are **many competitors** competing on the basis of prices. Pressure on profit margins is therefore likely.

There are many challenges involved in applying a low price strategy:

- A low price strategy results in price reduction because, to survive in the market, the organisation will have to reduce its profit margin.
- Reducing prices is not an easy task. In order to reduce prices, organisations first have to **reduce costs**. Moreover, the costs should be reduced in such a way that competitors are unable to acquire knowledge about the method of cost reduction.

The third position in the strategy clock is a hybrid strategy. To understand this strategy, it is first necessary to understand the meaning of a differentiation strategy.

2. Differentiation strategy (Position 4)

This strategy aims to provide **better products or services** than competitors at **relatively higher prices** or at the **same prices**. In addition, the organisation's aim is to gain a competitive advantage by providing perceived **benefits** that are **different** from those provided by its competitors. Differentiation can be achieved through many different methods including marketing, branding, advertising, core competences and enhancing product features and benefits. It should be noted here that the customers do not buy features; they buy benefits.

An organisation should recognise the scope of its competitors in the market. This is because knowing competitors' scope will help the organisation to make choices as to how it should differentiate itself for the benefit of customers. The art of differentiation strategy involves understanding the customer needs; finding out which of those needs are not yet offered in the market; using core competences and skills to satisfy those needs and thus taking a price premium.

Example

BMW is an example of an organisation which has followed a differentiation strategy. BMW serves a comparatively wide range of the total market but its cars are differentiated in the eyes of the customers who are ready to pay a higher price for a BMW than for a Toyota, for instance, of similar specification. BMW differentiates itself from the rest of the automobile market, by manufacturing cars with fine handling which offer a unique driving experience. New cars such as the Accura TL are often referenced in comparison to a BMW product that has set the standards. BMW has also maintained, besides its technical and luxury features, the category of its automobiles, which are large, luxury cars.

Continued on the next page

BMW produces a car that is unique in the speed, power and status it offers customers as compared to its competitors. Customers are attracted to BMW for its reputation for performance, handling, and enjoyable driving. The BMW name is synonymous with luxury, craftsmanship, and all round excellence. Top of Form Bottom of Form BMW has carefully avoided the smaller car market. However, in recent years, BMW has opted to diversify its range to include the small to medium-sized car market.

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3. Hybrid strategy (Position 3)

A hybrid strategy, as the name suggests, is a combination of two things. Specifically, a hybrid strategy is the **combination of differentiation and low prices strategies**. The strategy aims to achieve competitive advantage by providing **higher perceived benefits by lowering the prices**. This strategy aims to maintain differentiation by earning huge profits. There is the possibility of developing various differentiations i.e. new features in the products.

The benefits of hybrid strategy are as follows

- If the markets for the products or services are larger than the competitors' markets, the profit margin can be increased to a greater extent.
- This strategy is best suited to a situation where an organisation can differentiate and sell products at low prices. For example, if an organisation understands the needs of its customers and accordingly differentiates into the required area, it can gain from this strategy by lowering the cost.
- When an organisation desires to enter a market, it may do so by introducing a product which is not strongly sold by the competitors due to loopholes (drawbacks) in their operations. Here, the organisation should sell a better quality product than its competitors and, if possible, it should make every effort to lower its price. This strategy is applied by organisations which enter a new geographical area where competitors do not function effectively.

Organisations (like Alamart Plc, discussed in the case study above) can achieve high quality at low prices by adopting just-in-time and total quality management systems.

(a) Just-in-time

Just-in-time is an inventory control system that prevents the blockage of funds in inventory and reduces carrying costs. In JIT, items are procured as and when required i.e. 'just in time'. This leads to a reduction in storage space and costs.

JIT helps organisations to achieve high quality and lower prices, and provides the following benefits:

- It reduces the set up time in the factory.
- It reduces the carrying costs of the inventory.
- Highly skilled employees can be engaged in more challenging tasks.
- The reduction in costs may lead to reductions in the prices charged to the ultimate customers.

(b) Total quality management

Management comprises of planning, directing, organising, control and assurance. TQM is a tool to manage the total quality in an organisation. Thus, it is a management tool which controls the quality assurance in all managerial processes. It is a process which involves lowering prices and improving quality, resulting in customer satisfaction.

Example

Toyota, the Japanese car manufacturer, follows a hybrid strategy combining low cost production with cars which are differentiated on the basis of their quality and reliability. Toyota Motor Corporation is primarily engaged in business in the automotive industry. Toyota also conducts business in finance and other industries.

Toyota has three business segments: automotive operations, financial services operations and all other operations. The automotive operations include the manufacturing, designing, assembling and selling of passenger cars, recreational and sport utility vehicles and trucks. It also operates in accessories and related parts.

Continued on the next page

Toyota follows a combination of cost leadership and differentiation strategies where economies of scopes are relevant. A combined attention on both cost leadership and differentiation strategies is often required across the different segments of the value chain.

The production system of Toyota is considered the most efficient in the world. This efficiency enables Toyota to follow a low cost strategy in the global car industry. Moreover, Toyota has differentiated its cars from those of its competitors on the basis of high quality and advanced design. This superiority permits the company to charge a premium price for many of its famous models. Hence, Toyota seems to be following both a low cost and a differentiated business level strategy simultaneously.

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4. Focused differentiation (Position 5)

This strategy aims to provide **higher benefits to customers at higher prices**. These products are called premium products. Organisations following this strategy concentrate in a specific segment of the market. They tend to satisfy unique customer needs and, try to build brand loyalty for the products in the market. Every organisation aims to accomplish the overall organisational goal. So, it is difficult to follow a focused strategy for **a part** of an organisation's overall strategy.

5. Failure strategies (Positions 6, 7 and 8)

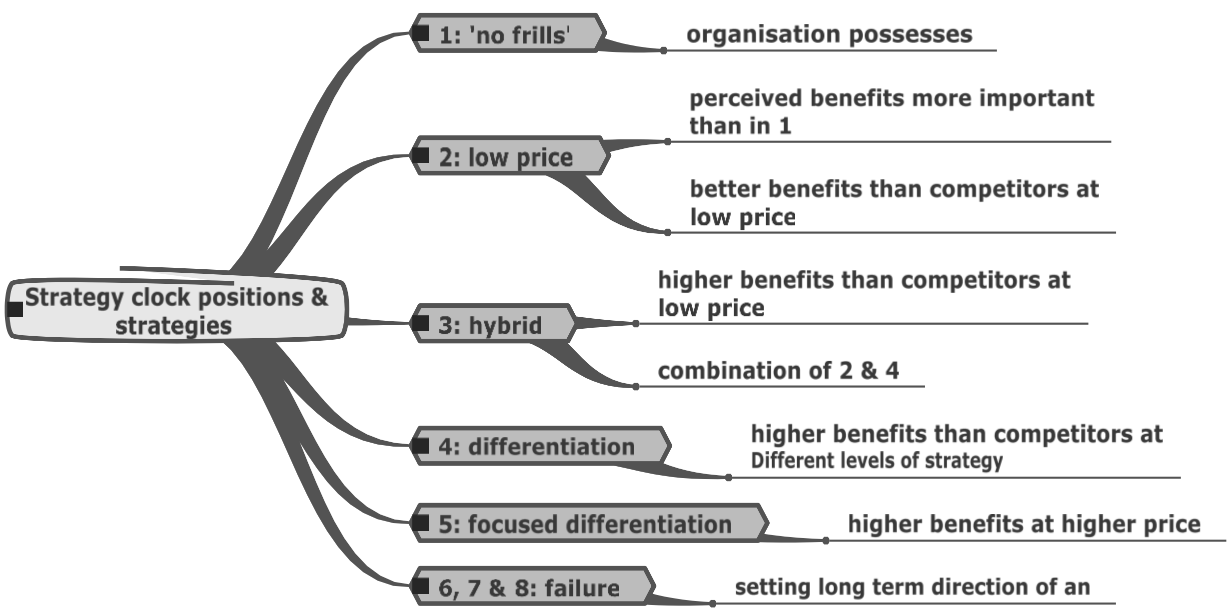
These strategies are not beneficial to customers. There are **no perceived benefits** to the customers. The price is high and the perceived benefits are low. Adoption of these strategies will lead to the failure of the organisation.

Position 6: the price is high as depicted in the clock above. There is **no corresponding increase in benefits**. This strategy is common in monopolies.

Position 7: the price is higher than the competitors and there is a **reduction in perceived benefits** to the customers as compared to position 6.

Position 8: there is a **higher reduction in perceived benefits** to the customers but the price is maintained. When organisations are following failure strategies, they try to leave the market (divest). In such a situation, public service organisations are attracted to enter the market as political forces desire to continue the services.

SUMMARY



3. Explain bases of achieving competitive advantage in terms of 'routes' on the strategic clock. [Learning Outcome b]

1.1 Competitive Strategies

What is competitive advantage?

Definition

Hill and Jones defined competitive advantage as "a '**profit rate**' that is higher than the average".

When an organisation earns profit which **exceeds the average** for that industry, the organisation possesses a competitive advantage over other organisations. An important issue here is **sustaining the competitive advantage**. 'Sustain' means to maintain over time. Organisations aim to achieve sustainable competitive advantages. Competitive advantages lead to better value for an organisation's customers and higher profits for the organisation itself and may be generated / created using core competences, capabilities or resources.

1.2 Price-based strategies and sustainability of competitive advantage

Price-based strategies are mainly focused on the **'price'** element. An organisation is said to sustain competitive advantages when they offer the **same perceived benefits** as their rivals but **at a lower prices**.

1. An organisation may sustain competitive advantage by entering into **'price war'**. A price war refers to the strategy whereby the organisation reduces its price below that of its competitors. The organisation tries to lower costs to a level where competitors are unable to stay in the market. Price war is a **short-term strategy**. The competitor may respond by lowering its price even further and in this way a price war is waged. It is important to note here that to be successful in a price war, an organisation needs to have greater resources at its disposal compared to its competitors and that, ultimately, prices may go up once competitors are forced to leave.

2. An organisation may concentrate on those **market segments** where **low-price products** are in high demand. A disadvantage associated with a low price strategy is that, when customers find that the product has a low price, they may also assume that the quality of the product is low.

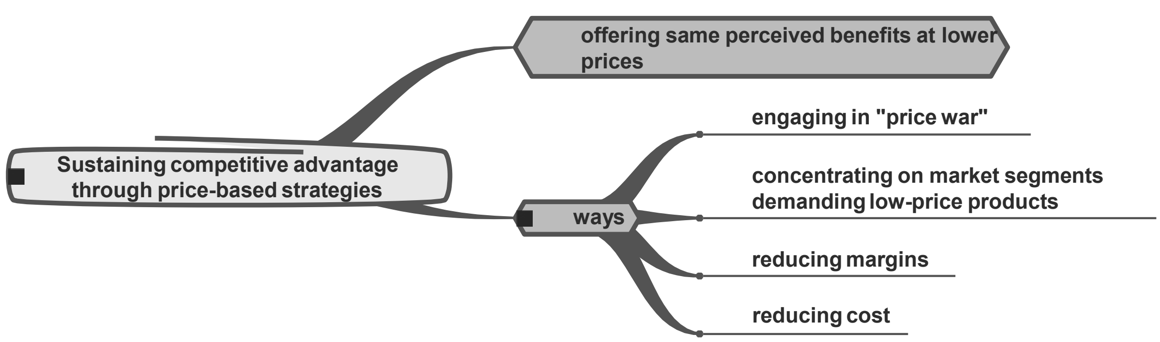
3. An organisation may **lower** its **margins**. Reduced margins refer to reductions in the prices charged to customers whereas the cost may be relatively high. Organisations accept such reduced margins because the lower margins are per head and therefore by increasing the volume of sales, they can increase their overall profitability. They can even increase their profitability by cross-subsidising i.e. by compensating for the loss of one business unit with the profits of another business unit.

4. An organisation may try to **lower its cost.** It may do this by applying advanced technologies, skilled labour, good quality raw materials etc. or by adopting innovative ideas. It should be careful to avoid wastage in the production process. To sustain the cost advantages, it is essential that competitors are not able to obtain the same benefits that may lead to a reduction in their cost of production.

Example

As a nation, it is very difficult to enter into a price war with China. China is best known for its low-cost manufacturing as a result of low wages. However, manufacturers in China are starting to focus on quality as a means of increasing their competitive advantage.

SUMMARY



1.3 Differentiation strategies and sustainability of competitive advantage

Differentiation strategies are mainly focused on the **'product'** element. The kind of differentiation adopted by organisations may be different in different industries. Differentiation is of any advantage only if it creates **value** for the customers.

Differentiation can be related to the product itself, the after-sales services provided to the customers, the marketing techniques adopted, the delivery system etc. When product features are added, there is the possibility that the production, distribution or marketing costs may be higher than the costs for an undifferentiated product. So, the customer must be ready to pay a **higher price** in the case of differentiation. An organisation is said to sustain competitive advantages when it offers **better perceived benefits** as compared to competitor's products.

What are the conditions required to sustain competitive advantages through differentiation strategies?

1. The organisation should protect the **resources** that are important for the organisation to sustain differentiation advantages. Some of these resources, such as the innovative skills possessed by managers, should be preserved so that competitors do not obtain these resources. Competitors may offer attractive incentives to managers to encourage managers to join them. In this case, the organisation must prevent their resources from going to competitors.

   However, there are some resources, which are difficult for competitors to obtain i.e. **immobile resources**. The organisation enjoys added advantages from these resources follows:

(a) When the organisation enters into a contract with a customer to provide some **specific services**, in this case the capabilities and the specialisations offered by the organisation to the customer cannot be easily taken by competitors.

(b) Sometimes the customer wants to obtain the product or service from a particular organisation only. He is unwilling for any other supplier to satisfy his demand. In this case, as the organisation has become an accredited supplier, the competitor cannot easily obtain the organisation's customers.

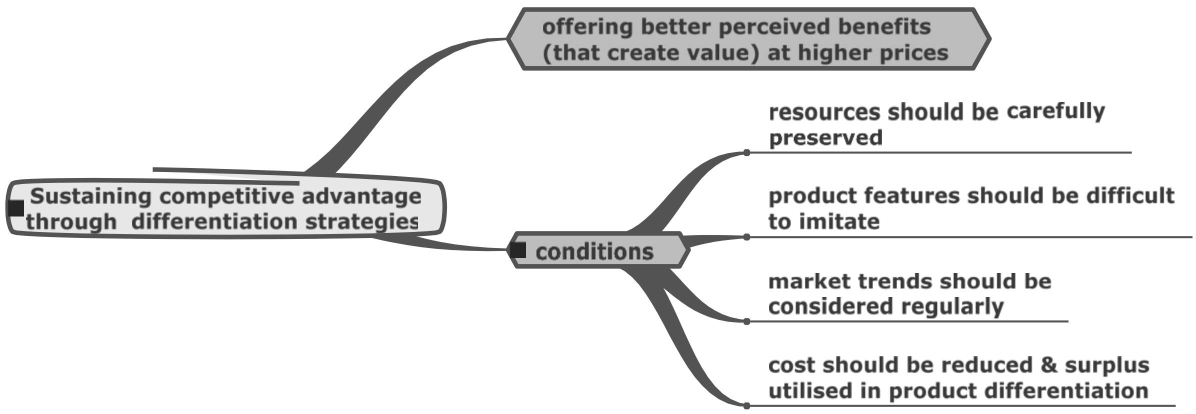
(c) The goodwill which an organisation possesses in the market cannot be easily obtained by competitors. In some cases, competitors propose to purchase the organisation to obtain the goodwill. Here also, the competitors cannot readily take advantage of the organisation's goodwill because customers will not rely on the new ownership easily.

2. **Imitation** may reduce the perceived (proposed) differences between the organisation's product and a competitor's product. If the competitor manages to incorporate the same features as the organisation's product, then the advantage cannot be sustained. So, organisations must add **those product features that are difficult for others to imitate**.

3. Organisation must be aware of **changes in the customer tastes**. The tastes in the current year might not be the same in the next year. The product must be differentiated on a **regular basis** "in accordance with the market trend otherwise competitors may take advantage of the fact that the organisation's products are outdated. The organisations must conduct market research programmes to keep themselves aware about the trend existing in the market. Also, the organisations should provide the customers with customer care services because these kinds of facilities add value to the organisation's product. The customer care department can solve the queries of the customers immediately without causing any trouble to the customer. These services are available to the customers at all time i.e. twenty-four hours.

4. Organisations must try to **reduce their costs** as compared to those of competitors. When cost is reduced, the possibility of earning good margins arises. The **surplus can be invested** in the products that need to be differentiated.

SUMMARY



1.4 Lock-in strategies and sustainability of competitive advantage

The lock-in strategy is an idea originated by Arnoldo C. Hax and Dean L. Wilde. Lock-in is an approach towards sustaining competitive advantages for both price-based and differentiation strategies. Lock-in is a situation whereby the organisation's product is at the top position in an industry and it becomes an **industry standard**.

The lock-in strategy is also called the Delta model. The Delta model links strategy with execution by selecting a distinctive strategic position and then integrating it with a company's collective processes. An organisation's actions must be completely aligned with its strategic position, and the results must give feedback on adapting the strategy.

Factors affecting lock-in are as follows:

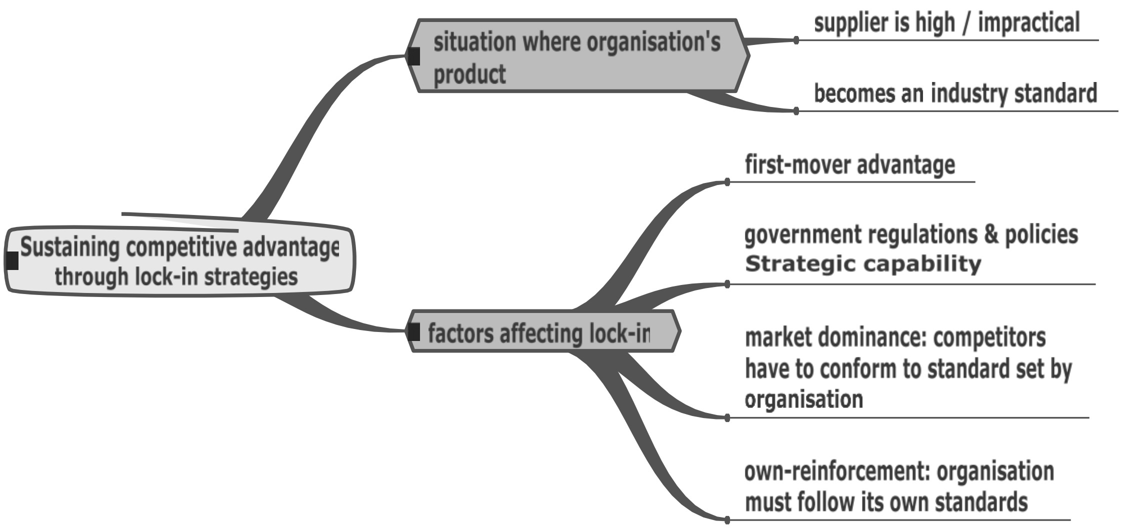
1. **First-mover advantage:** the industry standard is set when a new product is introduced in the market and not at the maturity of the product.

2. **Accurate enforcement:** when the product gains the position as an industry standard, competitors will try to attack this position and the organisation, in turn, will rigorously defend its standard position.

3. **Market dominance:** prospective competitors or other organisations will conform the industry standard if they believe that the standard setter has a significant market share in the industry.

4. **Own-reinforcement:** when an organisation obtains the position of industry standard, it is essential for the organisation to maintain its standards in order to remain at the top position in the market.

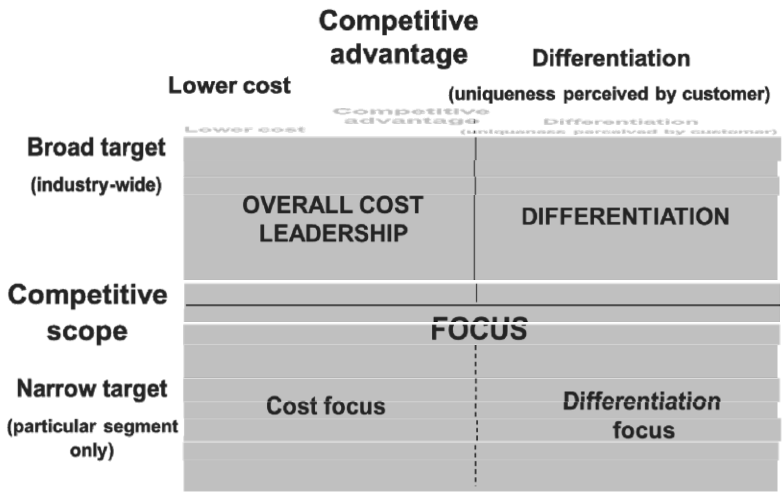
SUMMARY



1.5 Porter's Generic strategies model

According to Porter, an organisation can **achieve competitive advantage** through three generic strategies, cost leadership, differentiation and focus (cost focus and differentiation focus). Achieving a competitive advantage means gaining an edge over competitors. Competitive advantage refers to the ways and means by which an organisation can increase its sales and earn higher profits compared to its competitors.

Diagram 1: Porter's three generic strategies model



(a) Cost leadership strategy

The organisation is the leader in the industry or market in terms of cost. A competitive advantage is gained by reducing the cost to the organisation. It is essential that the organisation attempts to have the lowest cost base in the industry because only producing the products at a **low price is not sufficient** to gain the advantage. The products should also be produced at the **lowest cost**. However, if the technique of cost reduction becomes known to competitors, they can also apply this technique to produce at low cost.

Tip

This strategy emphasises the reduction of the **cost to the organisation** of producing and delivering products or services. It is not concerned with the price paid by the customers.

The cost can be reduced by the organisation in the following ways:

(i) using cheap labour
(ii) using advanced technologies to increase production
(iii) reducing overhead expenses incurred on production
(iv) reducing cost by producing in large quantities i.e. economies of scale

Example

Wal-Mart has followed a cost leadership strategy from the inception of its business. It started its operations in 1962. Wal-Mart was founded by a determined entrepreneur, Sam Walton (Walton), who believed that retailing was a quantity-driven business and his company could grow and achieve goals only by offering better perceived value to its customers. Walton always tried to obtain products at the lowest possible prices from suppliers. During the first two decades, Wal-Mart established discount stores in small towns and tried to gain control over a significant market share.

In the year 1980, the company made heavy investments in information technology to improve its supply chain and tried to expand its scope of operations into bigger cities. When the company realised that the discount stores business was developing at a good pace, in the late 1980s, it decided to enter into the business of food retailing by introducing supercentres.

In the late 1990s, the company launched exclusive grocery shops and chemists in the US, which were commonly known as 'neighbourhood markets'. With its expansion into grocery shops and chemists, the company faced a lot of criticism from competitors regarding its strategies.

Continued on the next page

Wal-Mart followed the strategy of low cost. It gave the benefits of this strategy to its customers by charging them lower prices and providing them with the maximum perceived benefits for their money. A technical analysis of companies clarifies that Wal-Mart's products were usually priced 20% lower than those of its competitors. Wal-Mart earned brand loyalty from rural customers as it provided good quality products at lower prices compared to competitors in the market. The company followed the strategy of earning higher profits by selling in huge volumes.

Efficiency and economies of scale are the two key factors which form the basis of Wal-Mart's strategy. Wal-Mart has earned a reputation as a supplier of high quality products at the lowest price in the market. In this way, the company eliminates competitors from the market and improves revenues and market share.

(b) Differentiation strategy

The organisation aims to produce products which are **different** from those produced by its competitors **and are unique**. However, differentiation is only worthwhile if the difference is desired by customers. The products may be developed in terms of their features, durability or functioning.

The organisation may achieve successful differentiation by:

- incorporating new facilities into the product
- emphasising better research and development
- improving marketing, branding and advertising facilities to make customers aware of the new features provided by the products.

The **Garvin model** is a quality model. It can be applied to the differentiation strategy. This model shows the relationship between quality and performance. According to Garvin, "quality is defined from the point of view of customers." There are various **dimensions** of the quality of a product including performance, features, reliability, conformance, durability, serviceability, aesthetics and perceived quality.

(i) Performance: the general characteristics of the product are satisfactory to the customers. The organisation provides superior products which include advanced features to its customers.

(ii) Features: the product possesses "extra" features on top of the basic features, which provide enhanced facilities to the customers.

(iii) Reliability: the customers can assume that the product is of good quality and will operate for a specific number of years.

(iv) Conformance: the product is produced or the service is provided according to the design specified by the customer i.e. the organisation produces the product according to pre-established standards.

(v) Durability: the organisation provides products which last for a reasonable duration of time.

(vi) Serviceability: this refers to the ease with which the customers may obtain various services. The service quality depends upon the following features:

- **courtesy** i.e. how the employees treat the customer
- **timeliness** i.e. whether or not the task given by the customer is completed on time
- **completeness** i.e. whether or not the customer receives what they desire
- **accuracy** i.e. whether or not the task is completed perfectly as demanded by the customer
- **consistency** i.e. whether or not the services provided to the customers are consistent
- **convenience** i.e. whether or not the services are provided according to the comfort of the customers

(vii) Aesthetics: the physical features of the product are attractive and of good quality e.g. appearance and sound.

(viii) Perceived quality: the customers expect that the product should be safe to use i.e. it should not cause any harm or injury to the user.

The Garvin model emphasises that improving the reliability and conformance of a product results in a reduction in service costs, scrap costs and manufacturing costs which leads to better productivity and ultimately higher profits.

(c) Focus strategy

The organisation concentrates on only **one market segment or niche**. There are two types of focus strategies i.e. a cost focus strategy and a differentiation focus strategy. Organisations can produce low-priced and specified goods for customers. Concentrating on a particular niche area enables them to build brand loyalty.

If an organisation decides to apply a focus strategy it will have to choose between cost focus and differentiation focus. While using cost or differentiation focus, the most important consideration is whether the strategy is beneficial to the niche area.

Example

Martin-Brower follows a focus strategy. An organisation that follows a focus strategy concentrates on satisfying the specialised needs of its customers. Products and services can be designed to suit the requirements of the customers.

An approach to focusing is to service either industrial buyers or consumers, but not both. Martin-Brower, the third-largest food distributor in the United States, serves only the eight leading fast-food chains. With its limited customer list, Martin-Brower need only stock a limited product line; its ordering procedures are adjusted to match those of its customers; and its warehouses are located so as to be convenient to customers.

Example

Another example of differentiation focus is Morgan sports cars. They are one of the UK's largest established Sportscar manufacturers. They provide all types of services including sales, repairs, after sales services and provision of accessories. They appeal to a very narrow segment: primarily middle age but wealthy consumers with a sporty outlook.

(i) Cost focus: the strategy to be applied where the organisation is a **cost leader** in a **particular market segment.**

(ii) Differentiation focus: the organisation applies the strategy of **differentiation** in a **particular market segment.**

The focus strategy has many advantages and disadvantages. The advantages include:

Closer to customer: as the organisations produce at low prices and in accordance with customers' needs, the organisations are very close to the customers. The needs of the customers are given special attention and the products required by them are provided to them with ease.

Targeted marketing: the focus strategy aims to concentrate on only one market segment. This concentration on a particular niche area enables the organisation to build strong brand loyalty in the market and offer outstanding customer care.

The disadvantages for an organisation of following a focus strategy are as follows:

Limited economy of scale: as the focus is on a particular market segment, the economy of scale is limited to that segment only.

If, due to environmental factors, the niche disappears, then the organisation loses a wide range of customers on which its business depended.

SUMMARY

4. Identify strategies suited to hypercompetitive conditions

[Learning Outcome c]

Strategies under conditions of hypercompetition

Hypercompetition is a state of competition in which the level of competition is growing rapidly. In this fast-changing environment, it is impossible to sustain traditional advantages.

Hypercompetition is **high velocity competition** due to quick changes in the technological environment. Hypercompetition refers to strong and rapid competition moves, where competitors move quickly to obtain new advantages and to eradicate the advantages of their rivals. Therefore, a **fast-changing and growing** level of competition is called hypercompetition.

When rapid development in technology is taking place, there may also be rapid development in product features. As a result, in hypercompetitive conditions, technology becomes outdated more quickly and therefore the product life cycle becomes shorter. This means that competitive advantages may not last for a long period of time.

Sustaining competitive advantages in normal competitive conditions has been discussed in the previous Learning Outcome. In the case of hypercompetitive conditions, competitive advantages will be of a **temporary nature**. Sustaining the advantages will be a matter of an organisation's capability and willingness to cope with the changing conditions in the environment. The organisation's capability will be in terms of flexibility, adaptability, creativity and speed.

Example

Hindustan Unilever Ltd, the Indian subsidiary of Unilever Ltd is a reputed company producing branded products in the consumer goods market. The company has various strengths including strong management processes and an attractive distribution chain that give it a competitive advantage over others.

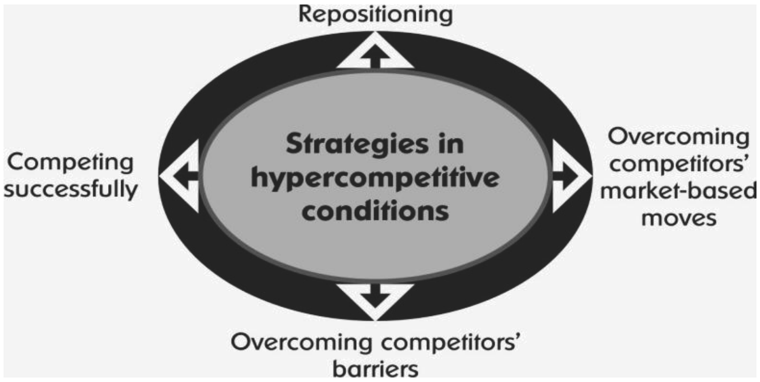
In the last few years, companies like Hindustan Unilever Ltd have not been in a position to price their products on the basis of their own strategies. The prices of the products have been market-driven. However, HUL has managed to hold its position in the market because it has much strength and has taken great efforts to lower its costs throughout its supply chain.

Which strategies are to be followed in the case of hypercompetitive conditions?

The nature of the strategy to be followed in the case of hypercompetitive conditions depends upon the following:

- significant capabilities that the organisation possesses in terms of speed, flexibility, ability to change etc.
- the goals and core competences of an organisation

Diagram 3: Strategies in hypercompetitive conditions



1. Repositioning

A repositioning strategy may be adopted to cope with hypercompetitive conditions. A repositioning strategy refers to **reconsidering the position on the strategy clock**. The positions on the strategy clock have been explained in detail above.

If an organisation is positioned in position 1, i.e. the 'no frills' position, where both perceived benefits and prices are low, it can move towards position 2, i.e. the 'low price' position, where price is low but the perceived benefits are comparatively higher than in position 1. Furthermore, the organisation may take efforts to move towards the 'hybrid' position i.e. position 3 in the strategy clock where price is low but the perceived benefits are high.

There are some risks associated with the adoption of a repositioning strategy such as customer confusion and internal deficits. When an organisation lowers the price and simultaneously provides low perceived benefits and then, after some time, lowers the price further and provides higher benefits, this creates confusion among customers about the strategy followed by the organisation. There may also be the risk of internal deficit. This is because once the organisation lowers the price and provides perceived benefits to its customers, and then further lowers the price, it is possible that the organisation may incur financial deficits.

2. Overcoming competitors' market-based moves

(a) The organisation may attempt to gain a competitive advantage by **preventing the first-movers** from dominating the market. Organisations may enter a market segment by following a 'no frills' strategy where price is low and the perceived benefits are also low. They may try to attract a small segment by offering low prices. Organisations may plan to capture market gradually by penetrating the market with a new product and block the advantages of the first-mover.

(b) As, in the case of hypercompetitive conditions, the competition is moving very fast, organisations have to cope with competition at a higher speed. Another way of overcoming a competitor's market-based move is by copying the competitor's products. Here, copying refers to **imitating the products** produced by the competitor. So, organisation should produce the products with some better features incorporated in it.

3. Overcoming competitors' barrier

(a) The organisation can gain an advantage over others through **economies of scale** in production. The organisation may try to produce in large quantities, which the new entrant would not be able to do due to a shortage of funds. The new entrant won't have the capacity to compete with the organisation. In this situation, the new entrant should make an attempt to develop interest in customers in the home market first and then gradually grow globally.

(b) When there are **technological advancements**, there may be rapid developments in product features. The **product life cycle becomes shorter** because the technology quickly becomes outdated in hypercompetitive conditions. This means that competitive advantages may not last for a long period.

The organisation may try to control the market by blocking new entrants through building **strong entry barriers**. For example, an organisation may patent its products or build a relationship with its suppliers which enable it to obtain raw materials at a lower price than its competitors. In this situation, competitors may try to attract customers by providing facilities to the customers either at **low price or free of cost**.

(c) Competition may be overcome through a **price war**. Competitors may try to **reduce prices** below the price prevailing in the market to gain a competitive advantage and attract customers.

Example

Enjoy More Ltd has been producing mobile phones for the last ten years. It has a huge market share and a good reputation. In recent years, some competitors have started to produce mobile phones which allow users to take photos and to access the internet.

Enjoy More Ltd has to produce mobile phones with camera and internet facilities in order to meet the demands of the market. Due to technological advancements, mobile phones without these facilities have become outdated.

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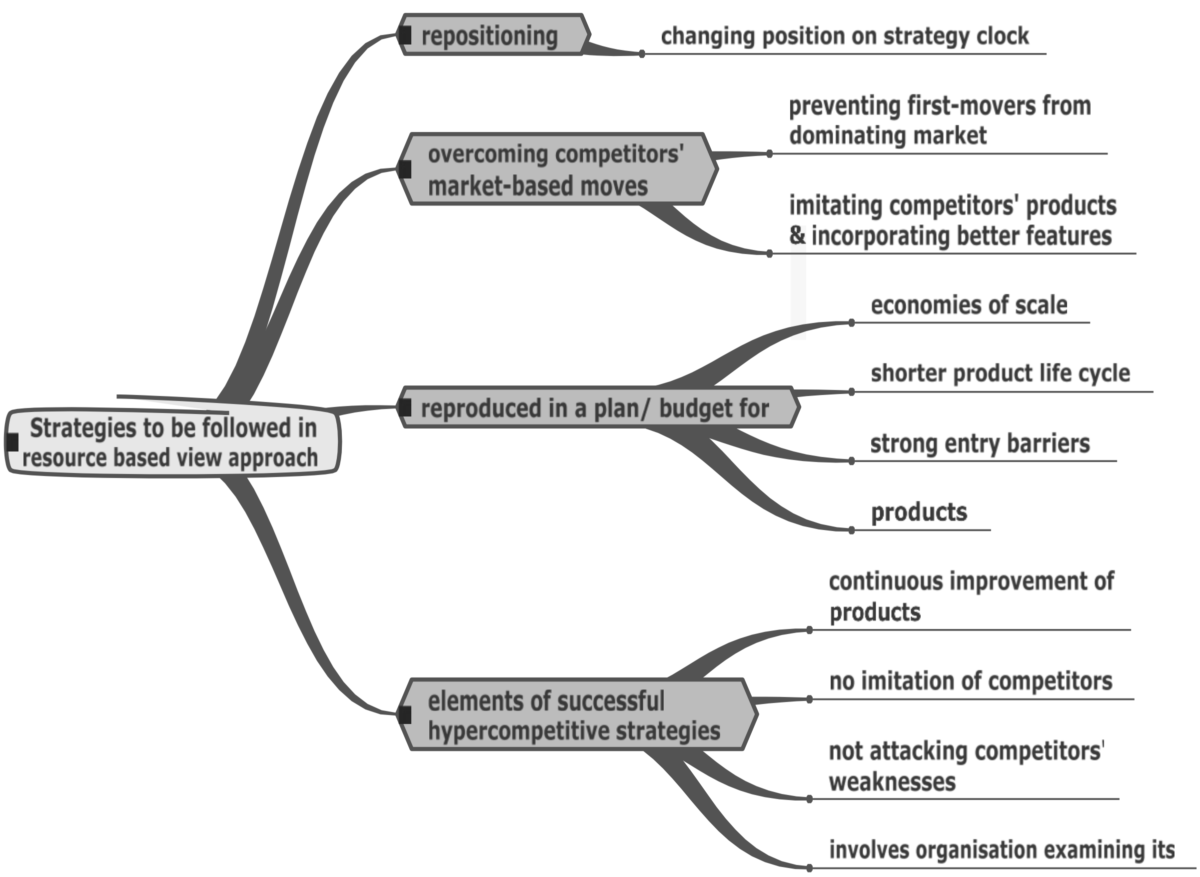
4. Elements of successful hypercompetitive strategies

In the introductory paragraph, it is mentioned that a characteristic of hypercompetitive conditions is rapid change. As a result, organisations have to be capable of changing their strategies according to the conditions prevailing in the market.

(a) The organisation must always try to improve / develop its products in terms of features, quality, durability etc.
(b) The organisation should not imitate its competitors. It should have its own innovative ideas for production.
(c) The organisation should not attack the competitor’s weaknesses because this may make a competitor aware of its strengths and weaknesses and, in turn, may assist the competitor to frame or modify its future strategies to its advantage.
(d) The organisation should not disclose its future strategies otherwise competitors will be able to frame their strategy accordingly. Hence the results of the strategies may not be as predicted.

SUMMARY



5. Identify alternative directions for strategy including market penetration or consolidation, production development, market development and diversification

[Learning Outcome d]

Developmental / growth strategies

The strategy that an organisation decides upon and subsequently follows can be thought of as a **"bridge"** that will help it to go from **"where I am now" to "where I want to be in the future"**. Therefore at the most fundamental level the concept of strategy comprises of two components:

setting the direction an organisation should be taking (i.e. what types of products / services it should be offering); and

choosing the method(**s**) the organisation should be employing (i.e. how it should go about producing and marketing its goods / services)

The main factor that determines the type of strategy an organisation chooses is what Johnson, Scholes and Whittington label as being **"motives"**. They further explain that there are three basic types of motives:

1. Environment based motives	Here an organisation formulates its strategy in response to changes in the external business environment. An example here could be an automobile manufacturer deciding to produce hybrid cars in response to society's growing concern over the environment.
2. Capability based motives	Here an organisation formulates and bases its strategy around its competencies and resources. An example here would be an organisation that manufactures computer screens decides to use its resources and capabilities to also start manufacturing televisions.
3. Expectation based motives	Here an organisation arrives at a strategy as a response to the expectations that have been placed on it by important stakeholders. An example here would be of an organisation that expands its manufacturing facilities to increase production output by 20 percent because its shareholders expect sales of the organisation to increase by this amount.

Therefore as can be seen the motive behind an organisation's strategy will set what Johnson, Scholes and Whittington label as being its "development directions".

Definition

Development directions are "the strategic options available to an organisation, in terms of products and coverage".

In addition to deciding upon its goods / services mix, organisations must also decide upon how they will go about delivering these products. There are two management tools / techniques an organisation can use to decide upon its development directions and the methods it will have to utilise to get to its intended destination.

These are;

1. the **Ansoff matrix** and
2. the **TOWS matrix**.

1. The Ansoff matrix

The Ansoff matrix was developed to help organisations decide upon the type of products it should be developing and for which markets and segments. It is important to note that the term products and services, is used to denote any item intended for sale to a customer and markets, the total number of potential customers. This matrix is in essence a pictorial representation of the strategic options available to an organisation and can be used to help decide upon their strategic choices (i.e. what goods / services to offer and to whom).

Diagram 4: The Ansoff Matrix

	Existing Products	New Products
Existing Markets	Market Penetration	Product Development
New Markets	Market Development	Diversification

As the above diagram depicts, there exists four possible product / market combinations or strategic options available to an organisation.

These are:

(a) market penetration
(b) product development
(c) market development
(d) diversification

(a) A market penetration strategy is followed when an organisation uses its existing product suite to increase sales and profitability. It does this by either "poaching" customers away from competitors and / or increasing sales levels from existing customers. Common tactics associated with this type of strategy include advertising, price cutting, product revisions, etc.

(b) Product development occurs when an organisation develops a new product(s) to sell to its existing customer base. This is also known as switch selling. An example of switch selling is when a bank tries to sell personal loans to its existing retail clients who have a personal savings account with the bank. It is important to note here that this strategy calls for the product to be either entirely new or an existing one that has been very significantly modified or improved. Simply adding additional features to an existing product does not qualify as product development.

(c) The market development strategy occurs when an organisation finds an entirely new market segment for its existing products. Existing products must be targeted towards and launched to an entirely new customer base for the organisation. An example of this is when a company decides to focus more on internet selling than retail selling

(d) Diversification is when an organisation moves into entirely new products and markets. In other words it occurs when an organisation develops an entirely new product and markets it to an entirely new customer base. Diversifications can be either a related diversification (where the newly developed product bears some connection / similarity to the organisation's existing product suite or to its core competencies or an unrelated diversification (which is risky).

Example

Bank1 is a large and traditional multinational bank that offers a comprehensive range of financial services such as personal banking, corporate banking, trade finance and treasury. Bank1 wants to select a strategy that would result in an increase in both sales and profitability (to meet their shareholders' expectations). Using the Ansoff matrix, Bank1 identifies the following four strategic choices that are available to the organisation:

Market penetration

To assign a relationship manager to all of the bank's high networth personal and corporate clients. The primary duty of the relationship manager would be to extract more business (increase "walletshare") from each customer.

Market development

To open branches in countries / cities where Bank1 does not already have a presence.

Product development

To introduce lease financing as an alternative to customers who are interested in obtaining car loans from the bank.

Diversification

To launch a wholly owned subsidiary that will engage in investment banking and venture capital financing activities

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2. The TOWS matrix

As mentioned previously organisations can use a SWOT (strengths, weaknesses, opportunities and threats) analysis to identify their current strategic position. As a next step an organisation can then use a TOWS matrix as pictured below to help identify strategies that will capitalise on their strengths and opportunities and / or mitigate against their weaknesses and threats

Diagram 5: The TOWS matrix

Internal Factors (Strenghs & Weaknesses) / External Factors (Opportunities & Threats)	Strenghs (S)	Weaknesses (W)
Opportunities (O)	SO Strategies	WO Strategies
Threats (T)	ST Stretegies	WT Strategies

A TOWS matrix is a technique designed to help an organisation match its **internal strengths** and **weaknesses** to the **threats** and **opportunities** that are present in its **external environment**. This matching helps an organisation to identify and choose from the strategic choices at is disposal.

There are four main types of strategic choices that an organisation can choose from. These four are:

(a) Strengths and Opportunities (SO) strategies
(b) Strengths and Threats (ST) strategies
(c) Weaknesses and Opportunities (WO) strategies
(d) Weaknesses and Threats (WT) strategies

With an SO strategy an organisation focuses on how it can use its existing **strengths to capitalise** on opportunities that exist in the external environment. This represents the ultimate position organisations wish to be in as all major weaknesses and threats have been mitigated against. The remaining three strategies can be viewed as "stepping stone" strategies that will help an organisation to reach this position.

An ST strategy focuses on how existing strengths can be used to **mitigate against current or upcoming threats**. The obvious objective for an organisation is being able to devise a strategy that will use its strengths to manage or even remove threats that it is facing.

With a WO strategy an organisation focuses on how it can **use opportunities** that have presented themselves in the **external environment** to overcome its existing weaknesses. With this type of strategy an organisation typically focuses on how it can overcome weaknesses that are preventing it from taking advantage of any present or upcoming opportunities.

A WT strategy focuses on **minimising existing weaknesses** so as to help protect an organisation from current and anticipated threats. Organisations employing this strategy are typically in a very weak competitive position and may even be fighting for their survival.

Example

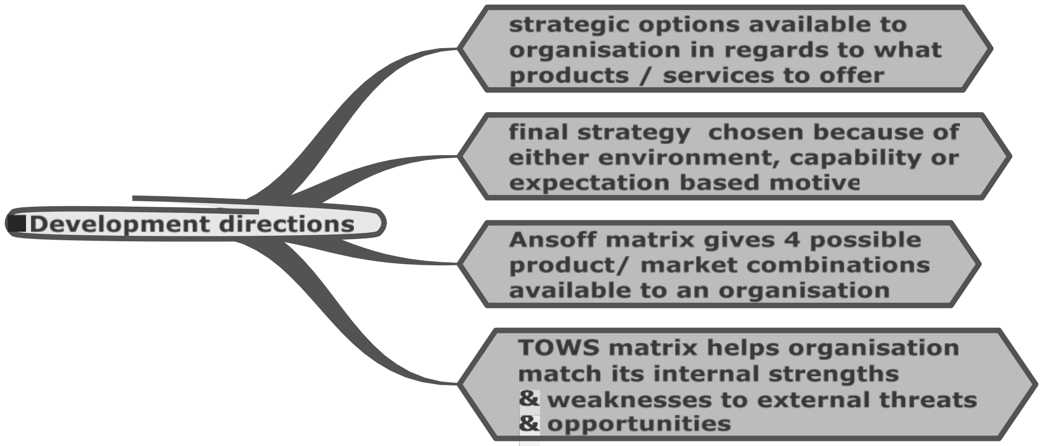
Tech1 is an organisation that manufactures and markets mainframe computers. It recently conducted a SWOT analysis and identified the following:

Strengths	Highly motivated and technically competent sales force.
Weaknesses	Designs of existing products are all over three years old.
Opportunities	The government is set to introduce a tax break for organisations that purchase mainframe computers.
Threats	A number of micro computer manufacturers are planning to start manufacturing mainframe computers.

Using the above information, management of Tech1 come up with the following strategic choices:

SO Strategy	To increase the incentive payments it makes to its salespersons to encourage them to market even more aggressively to take advantage of the increased demand for mainframe computers that should arise out of the government tax break.
ST Strategy	To offer various innovative financing schemes (e.g. zero percent down and payments to be made in monthly instalments) which its sales force will aggressively market to existing and potential customers to help minimise the threat of them buying from a new entrant organisation.
WO Strategy	To have the R&D department work in collaboration with the sales force to quickly arrive at a new mainframe computer design that is in line with current market demands and tastes.
WT Strategy	To design a new mainframe computer so as to be better prepared to compete against the new entrants when they enter the mainframe market.

SUMMARY



1.9 Methods to pursue chosen strategic direction

1. Diversification

Diversification is when an organisation moves into entirely new products and markets. In other words, diversification occurs when an organisation develops an entirely new product and markets it to an entirely new customer base. A diversification can be either a related diversification (where the newly developed product bears some connection / similarity to the organisation's existing product lines and core competences) or an unrelated diversification.

Among all the marketing strategy, the diversification strategy is the most risky as all of its features are new i.e. new product, new market, new facilities and new skills. As there are high risks involved in diversification, organisations may make several attempts before they succeed. A good example of an organisation which carried out successful diversification is Canon, a manufacturer of cameras, which diversified into producing a new range of office equipment.

Reasons for diversification

(a) **Economies of scope in contrast to economies of scale:** an organisation may achieve economies of scope by increasing its number of SBUs so that its total costs are spread over a greater number of business units. The cost per business unit therefore falls. In this manner, diversification takes place.

(b) **Benefits of synergy:** the benefits of synergy refer to the benefits arising out of working together of two or more parts. The benefits arise because the result is greater than the sum of their individual effects or capabilities.

(c) **Corporate managerial core competences:** the skills of managers at different levels vary. The managers at the corporate level have the core competences to share the resources available for the new markets and products which the operational managers lack.

(d) **Increase in market power:** when organisations diversify into new products or markets, they have a diverse range of products or customers which results in increased market power. If one of the products earns huge profits and results in surpluses and another product incurs losses, then the surpluses can be cross-subsidised i.e. used for the improvement of product which resulted into losses.

(e) These are the main **value-generating reasons** for diversification. There are also other reasons but they tend to benefit the managers more than the shareholders.

(f) **Respond to environmental change:** sometimes an organisation may have to diversify because the environment demands it. For example, if technology is developed or there is a convergence of technologies in the product market, an organisation may have to add new features to its products by utilising the new technology available otherwise existing products will become obsolete. In order to add new features, the organisation may have to buy technologies from a business which is utilising them or buy the business itself (i.e. integrate with the other business).

Example

Enjoy More Ltd has been producing mobile phones for the last ten years. It has a huge market share and a good reputation.

In recent years, some competitors have started to produce mobile phones which include a camera feature. In order to face this competition, Enjoy More Ltd must produce mobile phones which meet the needs of the market i.e. phones with camera features. To incorporate this feature, the organisation will have to possess the necessary skills and technologies.

If the skills and technologies are not readily available, then Enjoy More Ltd may decide to takeover another organisation which produces cameras. In this case, technological convergence and the needs of customers are the reasons for diversification.

(g) Spread risk across a range of businesses: organisations aim to earn profits. They always make an effort to develop and expand their business. In a market, there is always a risk of incurring losses. To reduce this risk, organisations diversify their business area and scope so that, if losses are incurred in one area, they can be compensated by the profits earned in other area of business.

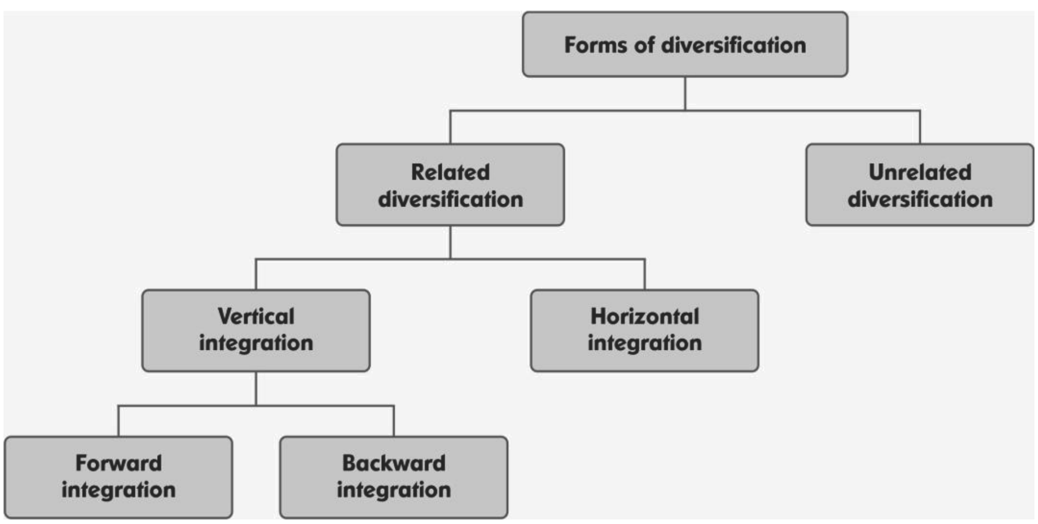
(h) In the case of investors, they invest their funds in such a way that, if any organisation gives lower returns, these low returns can be compensated by the higher returns from other organisations.

(i) Expectations of shareholders: to meet shareholders' expectations of earning higher returns, organisations decide to diversify in product or market.

SUMMARY

2. Forms of diversification

Diagram 6: Forms of diversification



(a) Related diversification

Definition

According to JSW, **related diversification** is strategy development beyond existing products and markets, though within the capabilities or value network of the organisation.

Related diversification is **within the capacities, core competences or value network** of the organisation.

Reasons for related diversification:

Help to spread risk over business products.
Leads to cost savings.
Possibility of transferring skills and capabilities from one business to another.
International development of organisation's brand name.
Helps to build core competences.
Organisations can have control over markets.

Example

Gillette exercised related diversification because it diversified from its chief business of the production of razors and razor blades to the production of related items such as toothbrushes, toiletries etc. In this example, diversification is within the value network of the company because the capabilities required for the two types of production, i.e. the production of razors and razor blades and the production of toothbrushes and toiletries, are different. They require different raw materials, varied skills etc. Gillette diversified within its value network because it sold its new, diversified products to largely the same group of customers.

Example

Procter & Gamble is an organisation which has exercised related diversification.

Haircare: Pantene, Head & Shoulders, Clairol
Household cleaning / care: Flash, Febreze, Fairy
Laundry: Daz, Ariel, Fairy, Bounce
Paper: Bounty, Pampers, Always
Beauty: Oil of Olay, Max Factor

Here, diversification is within both the capabilities and the value network of the organisation.

There are different forms of related diversification on the basis of the organisation's **value network**.

(i) Vertical integration: this is integration in **adjacent activities** in a value system.

It may be of two types:

Forward integration

Definition

According to JSW, forward integration is expansion into activities which are related with the organisation's outputs.

This type of integration extends control over **downstream distribution operations**; those areas of the value system which are closer to end users.

Example

Forward integration took place in the securities industry. Shearson Lehman Brothers bought E.F Huton. Huton was having strong network of retail brokers and Sherson was attracted by it.

Backward integration

Definition

According to JSW, backward integration is expansion into activities related with the inputs into the organisation's existing business.

This type of integration involves extending control over **upstream operations**; those areas of the value system which are further from the end user.

Example

Hi Tech Ltd is a computer manufacturer in the UK. It decided to acquire Superb Ltd, a spare parts manufacturer.

This is backward integration because Hi Tech is producing outputs and it intends to acquire a business which is its raw material manufacturer i.e. which produces inputs.

Example

Shell is a worldwide group of oil, gas and petrochemical companies. The company's main business is the exploration for and the production and trading in a range of energy resources. The company has extensive vertical integration. It conducts exploration, production, transportation, refining, retail distribution and sale of fuel.

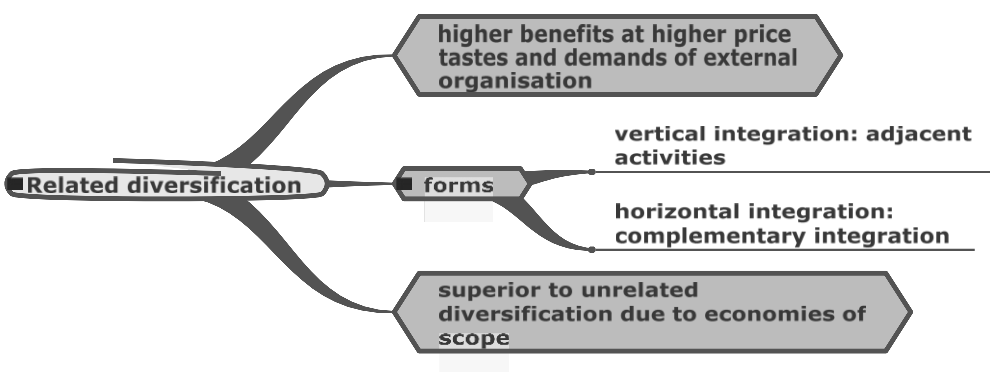
The vertically integrated business model gave significant economies of scale to Shell and provided it with the opportunity to establish barriers to entry both geographically and on a more global scale.

(ii) Horizontal integration: this is integration in **complementary activities** in a value system. It results in the production of substitute products.

Horizontal integration is **useful** in the following ways

economies of scope
reduction in competition
fulfilment of customer expectations
availability of substitutes
economies of scale

SUMMARY



(b) Unrelated diversification

Unrelated diversification is the development of products or services **beyond the current capabilities or value network** of the organisation. It is referred to as 'conglomerate strategy'.

Features of unrelated diversification:

There is value chain interrelationship.
Organisations penetrate into any business where they think they can earn profits.
There is a corporate strategy policy.

Advantages of unrelated diversification

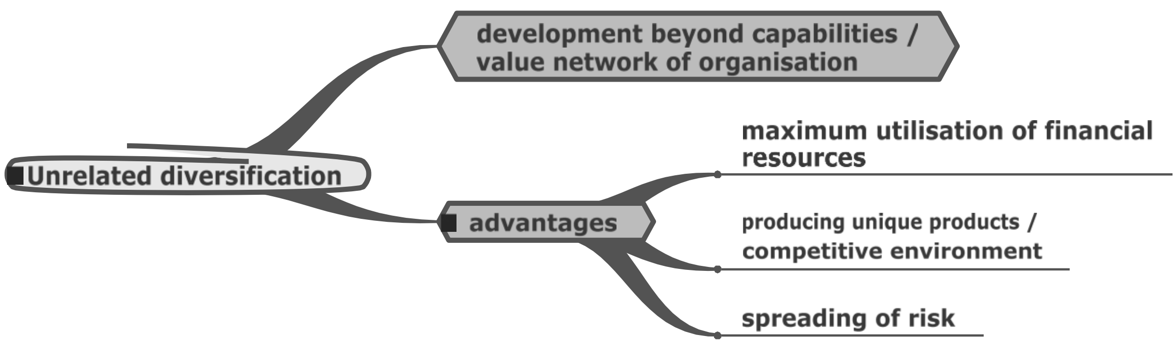
- The financial resources of the organisation can be utilised to the fullest extent in the industry where higher profits can be earned.
- There is the opportunity to maximise the utilisation of underutilised resources or competencies.
- The risk involved in business is spread over different industries.

Example

Virgin is one of the world's most recognised and respected brands. Conceived in 1970 by Sir Richard Branson, the Virgin Group has gone on to grow very successful businesses in sectors ranging from mobile telephony, to transportation, travel, financial services, leisure, music, holidays, publishing and retailing.
The businesses owned by Virgin are as follows:

- Virgin Travel (& Virgin Holidays)
- Virgin Retail (Music & Entertainment)
- Virgin Investments (computer products, promotional blimps, property development)
- Virgin Hotels Group (clubs & hotels in UK, Spain & Virgin Islands)
- Virgin Communications (Virgin Interactive Entertainment, Publishing, Radio, TV)

SUMMARY



It is a matter of debate whether diversified organisations perform better than undiversified organisations.

Related diversification is superior to unrelated diversification because it usually creates economies of scope. However, there are some problems associated with related diversification such as:

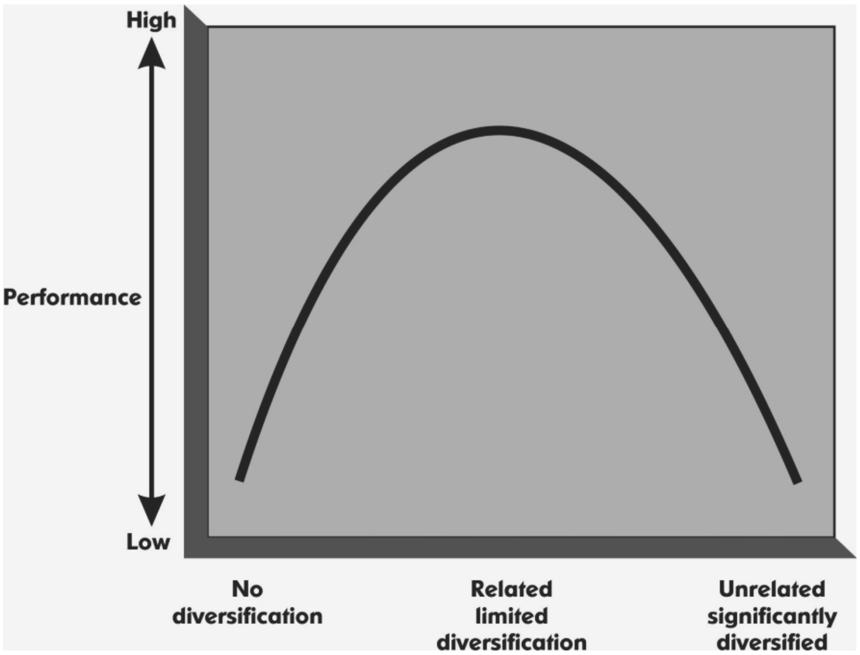
- It is time-consuming.
- It is expensive.
- Difficulties may arise in sharing resources.

Difference between related and unrelated diversification

Basis of difference	Related diversification	Unrelated diversification
Definition	Diversification is **within** the capacities or value network of the organisation	Diversification is the development of products or services **beyond** the current capabilities or value network of the organisation
Economies of scope	There are (usually) **economies of scope**	There are USUALLY **no** economies of scope, (but this is not always the case, e.g. Virgin attempts unrelated diversification but there are still some common HO functions).

There are cases where organisations diversify only to save managerial jobs, share the risk and / or safeguard the status of the organisation. Organisations that exercise related diversification benefit a lot compared to undiversified or unrelated diversified organisations. The relationship between diversification and performance can be depicted as an inverted U-shape because limited diversification is beneficial for an organisation but too much diversification is not.

Diagram 7: Relationship between the diversification and performance



This relationship is general. There are a few **exceptions**:

- Organisations in developing economies perform well.
- Some managers are skilful and hence have improved in developing unrelated diversification.
- Organisations which diversify significantly tend to perform poorly in the long run if senior managers leave the organisation and therefore their skills are no longer available.

3. Market diversification from international perspective

Organisations aim to increase their profits. Profits can be increased by increasing sales. To increase sales, organisations tend to improve their products or produce new products for their existing customers i.e. through product diversification. Organisation may **increase sales** by selling their products in a **new market** i.e. to new customers, possibly foreign customers. This is called market diversification from an international perspective.

It is not easy to operate in an international market. Organisations have to comply with various legal requirements when they decide to sell their products internationally. They have to follow the principles which they use in the domestic market. In addition, there are some factors which have to be taken into consideration while operating in foreign markets which are overlooked in domestic markets.

Example

The air conditioners used in the UK may not be suitable for use in Asia, as the temperatures in Asia are much higher consistently than in Europe

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Requirements of selling products internationally

(a) The international market must be given importance because, like domestic customers, foreign customers also tend to buy products from a reputed buyer who provides high quality products. The international market should not be taken for granted. Organisations have to be **committed to their work**.

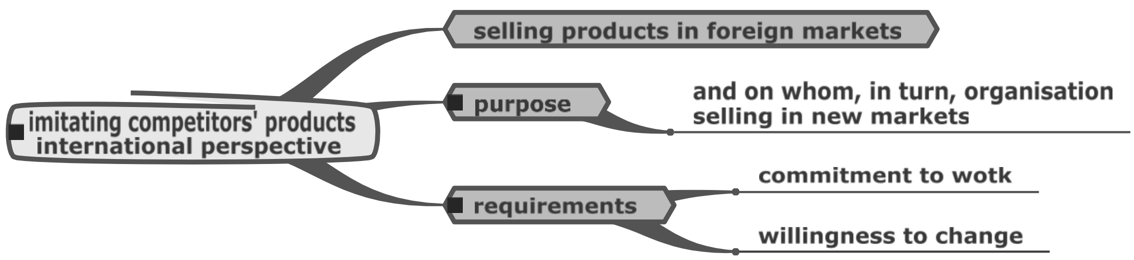
(b) Organisations should not be rigid i.e. they should be **prepared to change** according to the requirements of the foreign customers. When organisations produce new products and their customers desire specific features to be incorporated in the product, the organisations should be willing to make the required modifications.

Organisations may have to adopt **different promotional and marketing policies and pricing strategies** to sell their products in the international market effectively. The buying habits of foreign customers will be different from domestic customers and hence organisations have to aim to satisfy their varied needs. To be successful in the international market, an organisation must know where it should sell its products and how it should sell the products.

Example

In America, people tend to buy in larger lots so that they don't have to purchase frequently. On the other hand, in European countries, people tend to buy in smaller lots and hence they purchase goods very often. Therefore, an organisation which wishes to sell its products in Europe should provide many distribution centres as its customers have the habit of frequent buying.

SUMMARY



6. Analyze the ways in which a corporate parent can add or destroy value for portfolio of business units

[Learning Outcome e]

Value-adding and value-destroying activities of corporate parents

Any corporate parent needs to demonstrate that it creates more value than it costs. This applies to both commercial and public sector organisations. For public sector organisations, privatisation or outsourcing is likely to be the consequence of failure to demonstrate value. Companies whose shares are traded freely on the stock markets face a further challenge. They must demonstrate that they create more value than any other rival corporate parent could create. Failure to do so is likely to lead to a hostile takeover or break-up

There are four main types of activity by which a corporate parent can add value.

- Envisioning. The corporate parent can provide a clear overall vision or strategic intent for its business units.16 This vision should guide and motivate the business unit managers in order to maximise corporate-wide performance through commitment to a common purpose. The vision should also provide stakeholders with a clear external image about what the organisation as a whole is about: this can reassure shareholders about the rationale for having a diversified strategy in the first place. Finally, a clear vision provides a discipline on the corporate parent to stop it wandering into inappropriate activities or taking on unnecessary costs.
- Coaching and facilitating. The corporate parent can help business unit man- agers develop strategic capabilities, by coaching them to improve their skills and confidence. It can also facilitate cooperation and sharing across the business units, so improving the synergies from being within the same corporate organisation. Corporate-wide management courses are one effective means of achieving these objectives, as bringing managers across the business to learn management skills also provides an opportunity for them to build relation- ships between each other and see opportunities for cooperation.
- Providing central services and resources. The centre is obviously a provider of capital for investment. The centre can also provide central services such as treasury, tax and human resource advice, which if centralised can have sufficient scale to be efficient and to build up relevant expertise. Centralised services often have greater leverage: for example, combining the purchases of separate business units increases their bargaining power for shared inputs such as energy. This leverage can be helpful in brokering with external bodies, such as government regulators, or other companies in negotiating alliances. Finally, the centre can have an important role in managing expertise within the corporate whole, for instance by transferring managers across the business units or by creating shared knowledge management systems.
- Intervening. Finally, the corporate parent can also intervene within its business units in order to ensure appropriate performance. The corporate parent should be able closely to monitor business unit performance and improve performance either by replacing weak managers or by assisting them in turning around their businesses. The parent can also challenge and develop the strategic ambitions of business units, so that satisfactorily performing businesses are encouraged to perform even better.

Value-destroying activities

However, there are also three broad ways in which the corporate parent can inadvertently destroy value:

- Adding management costs. Most simply, the staff and facilities of the corporate centre are expensive. The corporate centre typically has the best-paid man- agers and the most luxurious offices. It is the actual businesses that have to generate the revenues that pay for them. If their costs are greater than the value they create, then the corporate centre's managers are net value destroying.
- Adding bureaucratic complexity. As well as these direct financial costs, there is the 'bureaucratic fog' created by an additional layer of management and the need to coordinate with sister businesses. These typically slow down man- agers' responses to issues and lead to compromises between the interests of individual businesses.
- Obscuring financial performance. One danger in a large diversified company is that the underperformance of weak businesses can be obscured. Weak businesses might be cross-subsidised by the stronger ones. Internally, the possibility of hiding weak performance diminishes the incentives for business unit managers to strive as hard as they can for their businesses: they have a parental safety net. Externally, shareholders and financial analysts cannot easily judge the performance of individual units within the corporate whole. Diversified companies' share prices are often marked down, because share- holders prefer the 'pure plays' of stand-alone units, where weak performance cannot be hidden.

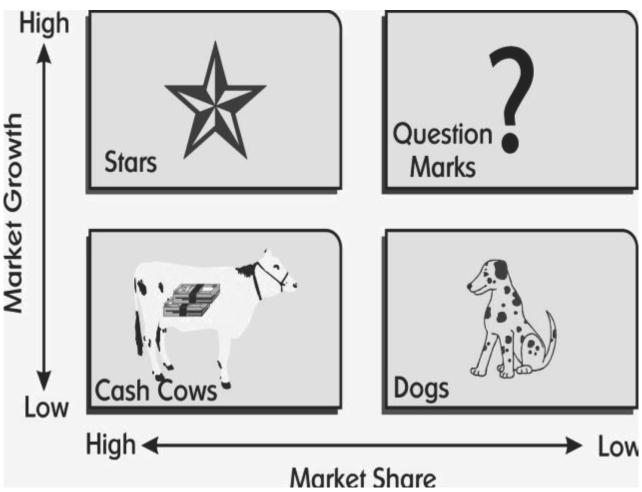
7. Analyze portfolio of business units and judge which to invest in and which to divest
[Learning Outcome f]

PORTFOLIO MATRICES

The corporate parents might adopt for the management of a multi-business organisation. This section introduces models by which managers can manage the various parts of their portfolio differently, or add and subtract business units within the portfolio. Each model gives more or less attention to the following three criteria:

- The balance of the portfolio, for example in relation to its markets and the needs of the corporation;
- The attractiveness of the business units in terms of how strong they are individually and how profitable their markets or industries are likely to be; and
- The fit that the business units have with each other in terms of potential synergies or the extent to which the corporate parent will be good at looking after them.

The growth/share (or BCG) matrix



One of the most common and long-standing ways of conceiving of the balance of a portfolio of businesses is the Boston Consulting Group (BCG) matrix . The matrix explains how market share and market growth are critical variables for determining attractiveness and balance. High market share and high growth are, of course, attractive. However, the BCG matrix also warns that high growth demands heavy investment, for instance to expand capacity or develop brands. There needs to be a balance within the portfolio, so that there are some low- growth businesses that are making sufficient surplus to fund the investment needs of higher growth businesses.

The growth/share axes of the BCG matrix define four sorts of business:

- A star is a business unit which has a high market share in a growing market. The business unit may be spending heavily to keep up with growth, but high market share should yield sufficient profits to make it more or less self- sufficient in terms of investment needs.
- A question mark (or problem child) is a business unit in a growing market, but not yet with high market share. Developing question marks into stars, with high market share, takes heavy investment. Many question marks fail to develop, so the BCG advises corporate parents to nurture several at a time. It is important to make sure that some question marks develop into stars, as existing stars eventually become cash cows and cash cows may decline into dogs.
- A cash cow is a business unit with a high market share in a mature market. However, because growth is low, investment needs are less, while high market share means that the business unit should be profitable. The cash cow should then be a cash provider, helping to fund investments in question marks.
- Dogs are business units with a low share in static or declining markets and are thus the worst of all combinations. They may be a cash drain and use up a disproportionate amount of company time and resources. The BCG usually recommends divestment or closure.

The BCG matrix has several advantages.

- It provides a good way of visualising the different needs and potential of all the diverse businesses within the corporate portfolio.
- It warns corporate parents of the financial demands of what might otherwise look like a desirable portfolio of high-growth businesses.
- It also reminds corporate parents that stars are likely eventually to wane.
- Finally, it provides a useful discipline to business unit managers, underlining the fact that the corporate parent ultimately owns the surplus resources they generate and can allocate them according to what is best for the corporate whole. Cash cows should not hoard their profits. Incidentally, surplus resources may not only be investment funds: the corporate parent can also reallocate business unit managers who are not fully utilised by low-growth cash cows or dogs.

However, there are at least three potential problems with the BCG matrix:

- Definitional vagueness. It can be hard to decide what high and low growth or share mean in particular situations. Managers are often keen to define them- selves as ‘high share’ by defining their market in a particularly narrow way (for example, ignoring relevant international markets).
- Capital market assumptions. The notion that a corporate parent needs a balanced portfolio to finance investment from internal sources (cash cows) assumes that capital cannot be raised in external markets, for instance by issuing shares or raising loans. The notion of a balanced portfolio may be more relevant in countries where capital markets are underdeveloped or in private companies that wish to minimise dependence on external shareholders or banks.
- Unkind to animals. Both cash cows and dogs receive ungenerous treatment, the first being simply milked; the second terminated or cast out of the corporate home. This treatment can cause motivation problems, as managers in these units see little point in working hard for the sake of other businesses. There is also the danger of the self-fulfilling prophecy. Cash cows will become dogs even more quickly than the model expects if they are simply milked and denied adequate investment. Finally, the notion that a dog can be simply sold or closed down also assumes that there are no ties to other business units in the portfolio, whose performance might depend in part on keeping the dog alive. This portfolio approach to dogs works better for conglomerate strategies, where divestments or closures are unlikely to have knock-on effects on other parts of the portfolio.

8. Assess the internationalization potential of different markets, sensitive variation over time
[Learning Outcome g]

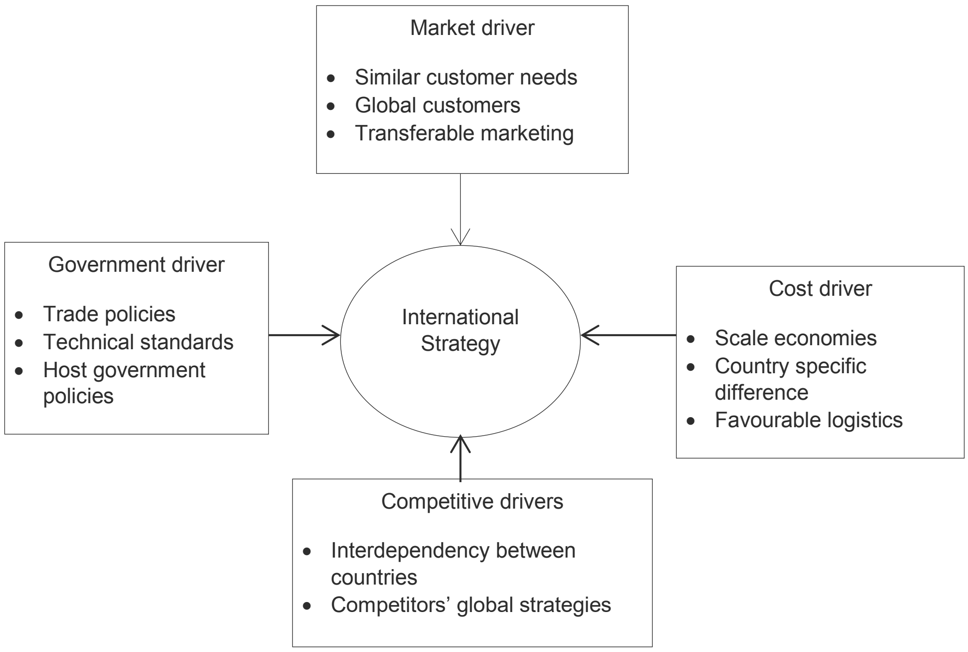
Internationalisation Drivers

There are many general pressures increasing internationalisation. Barriers to inter- national trade, investment and migration are all now much lower than they were a couple of decades ago. International regulation and governance have improved, so that investing and trading overseas is less risky. Improvements in communications – from cheaper air travel to the Internet – make movement and the spread of ideas much easier around the world.

Given internationalisation’s complexity, international strategy should be underpinned by a careful diagnosis of the strength and direction of trends in particular markets. The following are four drivers for internationalization

Diagram 7: Relationship between the diversification and performance

Drivers of internationalisation



- Market drivers. A critical facilitator of internationalisation is some standardisation of markets. There are three components underlying this driver. First, the presence of similar customer needs and tastes: the fact that in most societies consumers have similar needs for easy credit has promoted the worldwide spread of a handful of credit card companies such as Visa. Second, the presence of global customers: for example, car component companies have become more international as their customers, such as Toyota or Ford, have internationalised, and required standardised components for all their factories around the world. Finally, transferable marketing promotes market globalisation: brands such as Coca-Cola are still successfully marketed in very similar ways across the world.
- Cost drivers. Costs can be reduced by operating internationally. Again, there are three main elements to cost drivers. First, increasing volume beyond what a national market might support can give scale economies, both on the production side and in purchasing of supplies. Companies from smaller countries such as The Netherlands and Switzerland tend therefore to become proportionately much more international than companies from the USA, which have a vast market at home. Scale economies are particularly important in industries with high product development costs, as in the aircraft industry, where initial costs need to be spread over the large volumes of international markets. Second, internationalisation is promoted where it is possible to take advantage of country-specific differences. Thus it makes sense to locate the manufacture of clothing in China or Africa, where labour is still considerably cheaper, but to keep design activities in cities such as New York, Paris, Milan or London, where fashion expertise is concentrated. The third element is favourable logistics, or the costs of moving products or services across borders relative to their final value. From this point of view, microchips are easy to source internationally, while bulky materials such as assembled furniture are harder.
- Government drivers. These can both facilitate and inhibit internationalisation. The relevant elements of policy are numerous, including tariff barriers, technical standards, subsidies to local firms, ownership restrictions, local content requirements, controls over technology transfer, intellectual property (patenting) regimes and currency and capital flow controls. No government allows complete economic openness and openness typically varies widely from industry to industry, with agriculture and high-tech industries related to defence likely to be particularly sensitive. Nevertheless, the World Trade Organization continues to push for greater openness and the European Union and the North American Free Trade Agreement have made significant improvements in their specific regions.
- Competitive drivers. These relate specifically to globalisation as an integrated worldwide strategy rather than simpler international strategies. Such drivers have two elements. First, interdependence between country operations increases the pressure for global coordination. The second element relates directly to competitor strategy. The presence of globalised competitors increases the pressure to adopt a global strategy in response because competitors may use one country's profits to cross-subsidise their operations in another.

9. Identify sources of competitive advantage in international strategy using Porter's diamond
[Learning Outcome h]

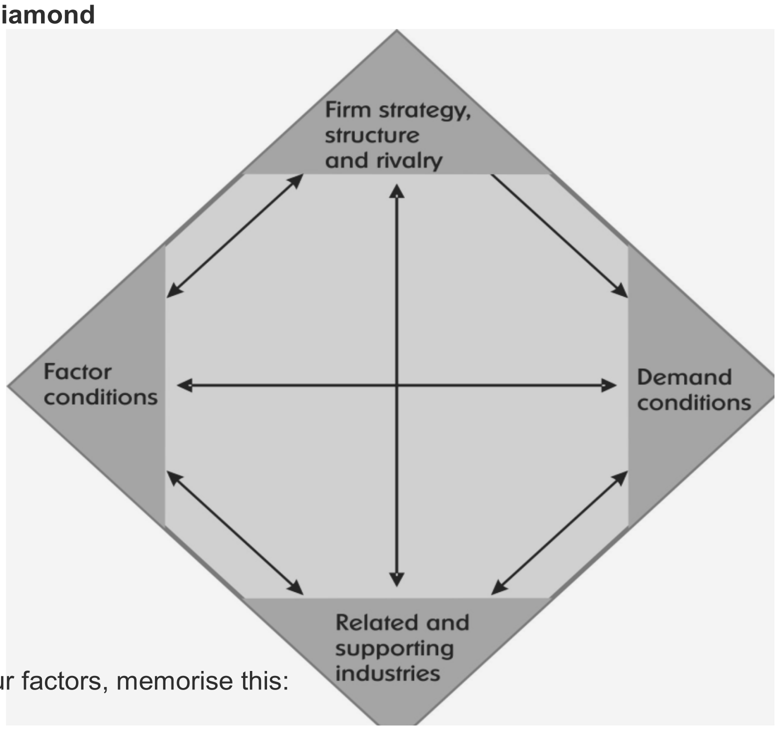
The Diamond

Porter argues that a country achieves a sustainable competitive advantage when its companies / industries achieve a sustainable competitive advantage on a global scale. There are **four factors** which constitute Porter's Diamond. These factors suggest that there are inherent reasons why some nations are more competitive than others and why some industries within nations are more competitive than others.

These factors are as follows:

firm strategy, structure and rivalry
demand conditions
related and supporting industries
factor conditions

Diagram 7: Porter's Diamond



To remember these four factors, memorise this:

Tip

Peter, **F**irst **D**o **R**eading **F**ast.

1. **Firm strategy, structure and rivalry** (i.e. conditions for organisations and the nature of domestic rivalry)

The first factor refers to the **local competitive structure** for a country's industries. Companies that can operate and survive in a highly competitive local environment can be prepared to compete in the global environment. These companies are forced to become, efficient and innovative in order to succeed in a global environment. This factor refers to how the firms manage to cope with the competition.

Example

An example often cited is that of Japanese electronics companies such as Sony. Sony has managed to excel not only in the small and ultra-competitive Japanese market but also worldwide because of its ability to develop pioneering and technologically advanced products (e.g. the Sony Walkman) over the years.

There are many other Japanese electronics companies such as Mitsubishi, Sharp, Murata and Nippondenso which means Sony has to be efficient in its operations and innovative in terms of new product development. Sony pioneered the production of electronic products in the country and gained national competitiveness.

Domestic rivalry and the search for competitive advantages within a nation can help provide organisations with bases for achieving such an advantage on a more global scale.

2. **Demand conditions** (i.e. sophisticated customers in home market)

Demand conditions refer to the **sophistication of local consumers**. The more demanding and discerning a country's customers, the more demanding they will be on suppliers of their local goods and services. When the customers within the country are more demanding and sophisticated, then organisations will be forced to ensure their products are of high quality and differentiated from the competition. Moreover, when the nation's discerning values spread to other countries, it becomes easier for the local firms to compete in the global market. In other words, when the culture or the habits of one country are adopted by other countries, it becomes easier to sell the products into that nation.

Example

Japanese are very fussy about their electronics – they want the latest, the smallest, and the most advanced products. So they ensure that electronic companies consistently innovate to give them what they need.

3. **Related and supporting industries**

The term **"related and supporting industries"** refers to the existence of organisations that serve similar industries and can collaborate. This usually means they are part of the industry supply chain. This increases the possibility of an **ongoing exchange of ideas**. If there is success in one industry, it is advantageous for the success of the other industry. In the case of related industries, an organisation would prefer home suppliers rather than foreign suppliers because home suppliers can provide co-operation and timely availability of resources.

These organisations help each other and the industry as a whole can grow. When industries are related, the firms can co-operate with each other and hence attain a competitive advantage. The supporting industries are not the same as the related industries. The former includes the suppliers and the latter includes the strategic alliances.

Example

Japan has achieved remarkable growth in the low cost consumer electronics industry with the help of related and supporting industries. Government of Japan has simplified the procedures for obtaining approvals for business purposes. The human resources such as skilled electrical engineers also play an important role in it. The industry structures and supporting institutions promote continuous and long-term technical and process improvements.

4. **Factor conditions** (i.e. the nation's position in factors of production, such as skilled labour and infrastructure)

Factor conditions are production for inputs such as:

(a) human resources such as skilled labour

(b) money market (Bond market, repo market) / capital market (debt market, equity market)

(c) physical resources such as availability of good quality raw materials

(d) intellectual resources such as computer

(e) infrastructural resources such as transport system

These factor conditions help in forming the basis of advantage on a national level. It is not sufficient for a nation to have an enormous amount of resources; instead it is essential to **deploy these available resources to the optimum level**.

Where there is an abundance of resources, it leads to their wastage whereas if there is a scarcity of resources, it may lead to innovation. Nations which do not have the required resources make efforts to innovate and create those resources. The key requirement is for the nation's resources to be deployed to offer their maximum advantage.

Example

Companies in Japan appoint highly qualified and technically trained managers. Past studies indicate that approximately 75% of the CEOs in Japanese manufacturing firms are professional engineers. Moreover, Japanese firms take advantage of their existing infrastructural facilities, skilled labour force and advanced production technologies to achieve a low cost of production, higher quality products and availability of the products in short periods of time.

Porter distinguishes between general and specialised factor conditions. **General factor conditions** are the conditions that can be **easily replicated** across nations. Examples include unskilled labour and raw materials.

Examples of **specialised factor conditions** are skilled labour and good infrastructure. **These cannot be easily replicated** across nations (at least not without heavy investment). Specialised factors involve heavy, sustained investment. They are more difficult to replicate. This leads to a **competitive advantage** because if other firms cannot easily replicate these factors, they become valuable.

Example

The number and the quality of Japanese engineers are the factor conditions that have helped its electronics industry earn a reputation for technological excellence.

Test Yourself 9

Describe briefly the four determinants of Porter's competitive advantage (Porter's diamond).

10. Distinguish four main types of international strategies

[Learning Outcome i]

International strategy refers to the geographical dispersion or concentration of activities such as manufacturing and R&D, while coordination refers to the extent to which operations in different countries are managed in a decentralized way or a centrally coordinated way.

The four basic international strategies are:

- Simple export. This strategy involves a concentration of activities (particularly manufacturing) in one country, typically the country of the organization's origin. At the same time, marketing of the exported product is very loosely coordinated overseas, perhaps handled by independent sales agents in different markets. Pricing, packaging, distribution and even branding policies may be determined locally.
- Multidomestic. This strategy is similarly loosely coordinated internationally, but involves dispersion overseas of various activities, including manufacturing and sometimes product development. Instead of export, therefore, goods and services are produced locally in each national market. Each market is treated independently, with the needs of each local domestic market given priority – hence 'multidomestic'. Local adaptations can make the overall corporate portfolio increasingly diversified. This strategy is appropriate where there are few economies of scale and strong benefits to adapting to local needs. This multidomestic strategy is particularly attractive in professional services, where local relationships are critical, but it carries risks towards brand and reputation if national practices become too diverse.
- Complex export. This strategy still involves the location of most activities in a single country, but builds on more coordinated marketing. Economies of scale can still be reaped in manufacturing and R&D, but branding and pricing opportunities are more systematically managed. The coordination demands are, of course, considerably more complex than in the simple export strategy. This is a common stage for companies from emerging economies, as they retain some locational advantages from their home country, but seek to build a stronger brand and network overseas with growing organizational maturity.
- Global strategy. This strategy describes the most mature international strategy, with highly coordinated activities dispersed geographically around the world. Using international value networks to the full, geographical location is chosen according to the specific locational advantage for each activity, so that

product development, manufacturing, marketing and headquarters functions might all be located in different countries.

In practice, these four international strategies are not absolutely distinct. Managerial coordination and geographical concentration are matters of degree rather than sharp distinctions. Companies may often oscillate within and between the four strategies. Their choices, moreover, will be influenced by changes in the internationalization drivers introduced earlier. Where, for example, tastes are highly standardized, companies will tend to favor complex export or global strategies. Where economies of scale are few, the logic is more in favor of multidomestic strategies.

International diversity and corporate strategy

(a) Strategy of internationalisation

Organisations pursue the strategy of internationalisation for the following reasons:

(i) Competition has led to internationalisation because, due to domestic competition, organisations aim to increase their profits by selling their products in the international market.

(ii) Markets have become global markets because the tastes and demands of customers across the globe have grown homogeneous.

(iii) When organisations develop internationally, they can circumvent the shortfalls in the domestic market.

(iv) Organisations may benefit from their strategic capabilities in the following ways:

They can widen their market size. When organisations have greater strategic capabilities, they can operate effectively in the domestic as well as in foreign markets.
When organisations provide value-adding activities to foreign customers, there is the possibility of the strategies and capabilities developed being exploited in the domestic market. This could create competitive advantages for these organisations.

(v) Organisations which expand internationally, develop their skills and knowledge bases which leads to an improvement in the industry overall e.g. the IT industry in the USA.

(vi) Organisations may also enjoy various economic benefits such as the following:

Market size increases which leads to **economies of scale**. As customers across the world have similar tastes and needs, this leads to enormous production and hence national economy benefits.
As sales increase, **income** across the globe also **increases**.

(b) Opportunities that influence organisations to operate internationally

(i) Emergence of new markets

In the present era there has been immense technological development on a global scale. People’s income has increased heavily due to which their purchasing power has also increased. Due to income growth, people wish to have luxurious lifestyles and therefore their demands have increased and varied. To satisfy these **new and varied demands,** organisations have an opportunity to emerge into new markets in foreign nations.

(ii) Fast growth in new markets

Some organisations have the potential to grow at a rapid pace in the new markets compared to the existing domestic market.

(iii) Higher profits

Organisations have realised that selling products in foreign markets will allow them to earn **higher profits** because the prices charged may be higher and / or the labour charges or raw material costs may be lower compared to the domestic market. The demand for the products may be higher with less competition. This may give rise to voluminous sales which lead to higher profits.

(iv) Emergence of new products for the local market

When organisations sell new products in the foreign market, some consumers might purchase the products and wish to obtain the same products in the domestic market. For example, French wines have a good market in the US Therefore, organisations may have the opportunity to expand their scope of production in the domestic market and obtain a competitive advantage over others.

(v) Development of new technology

Organisations utilise modern technology due to which **production is fast** and takes less time. The cost of production can be reduced and hence the margin of profit can be maintained and **economies of scale** can be enjoyed. Hence, organisations are encouraged to operate in foreign markets and domestic markets too.

Example

With the invention of the steam engine in the late nineteenth century, travelling times reduced. As a result, the transportation cost of products and people reduced immensely.

In the mid-twentieth century, the bulk production of telephones and cars resulted in the reduction of the costs of technology due to which many people were able to purchase these products.

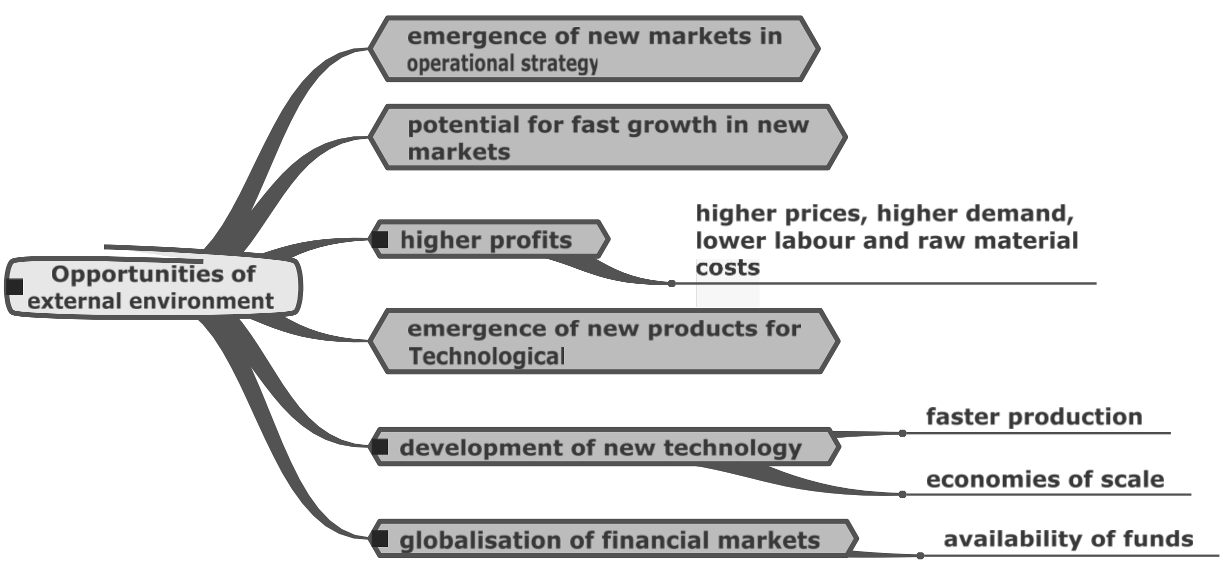
(vi) Globalisation of financial markets

Organisations are attracted to **grow internationally** because they have the funds needed for expansion in foreign markets. In other words the growth in finance availability has led to the development of international markets.

Example

The International Monetary Fund was established by the United Nations in 1945 to provide financial assistance to World Trade and the World Bank which gives and promotes loans to developing and under-developed nations.

SUMMARY



(c) Internal development

With the internal development strategy, an organisation will use its existing resources and competencies to produce its **newly targeted goods / services**. However if the organisation does not currently possess the needed resources and competencies it must go about developing / acquiring them.

Example

LLT Manufacturers is an organisation that designs and manufactures high end leather handbags. Based on the success LLT has enjoyed in recent years, management decides to also start designing and manufacturing leather shoes that will match their handbags. However management realises that their current designers do not have the capabilities and experience to design shoes. Management must then either train their current designers or hire new ones who have the capabilities and experience needed.

Internal development is also often referred to as organic development and represents the most common strategic method organisations employ to move forward. Reasons for this include:

(i) many organisations believe developing their products / services themselves better prepares and positions them to market the same more effectively

(ii) marketing their goods / services directly (instead of using intermediaries such as agents) in turn better positions an organisation to understand the tastes and demands of their customers

(iii) Inadequate resources for acquisitions or inability to identify suitable organisations to form alliances with

(iv) Internal development though a much slower development method avoids organisations having to deal with issues of compatibility that arise out of both mergers and alliances

(d) Mergers and acquisitions

The internal development route is a relatively slow way for an organisation to obtain the **resources / competencies** it needs. This coupled with the existence of a rapidly and continually changing external environment leads many organisations to pursue the mergers and acquisitions route. An acquisition occurs when one organisation buys over and takes ownership of all the resources (and consequently capabilities) of another organisation. A merger occurs when two organisations pool all their resources (and consequently capabilities) together into a newly combined third entity.

Therefore mergers and acquisitions represent a much faster strategic method for organisations to obtain the resources and capabilities they need. They also offer the potential for management to create additional value by creating synergies between the acquiring organisation and the target organisation. In addition, often the key resources of an organisation will consist of intangible assets (e.g. brand name, reputation in the marketplace) which are difficult if not impossible for another organisation to replicate. Mergers and acquisitions therefore represent a way that these unique resources can be obtained.

An organisation will initiate a merger or acquisition either to consolidate or diversify its present position. Consolidation mergers / acquisitions are carried out because an organisation wants to strengthen its current market position. The underlying rationale being that the new combined entity due to its larger size and organisational power should be able to gain advantages such as increased bargaining power over suppliers and achieve operating synergies and economies of scope.

Example

BT Discs and KT Discs are two organisations that manufacture blank compact discs. The organisations are of a similar size and produce approximately 1 million discs per year. After merging, the new entity of BKT Discs is able to produce 2.5 million discs a year as the production methods both organisations use get amalgamated into a more efficient and effective new process.

In addition, given that BKT buys raw materials in greater bulk sizes it is able to negotiate a 10 percent discount from all its suppliers enabling it to sell its compact discs at a cheaper price and gain market share.

Diversification mergers / acquisitions are carried out because an organisation wants to branch out its current market position and expand its products / services offer mix. The main motives behind a diversification merger / acquisition is to reap benefits such as:

- being able to offer their customers a different products / services mix
- obtaining a revenue stream from a different source
- acquiring a different set of resources and competencies
- achieving economies of scope

Example

BOW Enterprises is an organisation that manufacturers fuel injection valves. These valves are the organisation's only product and can be only used in petrol engines. BOW wishes to diversify its position and enter the diesel energy industry. Therefore they decide to acquire KOW Enterprises an organisation that makes turbo chargers (a component that is used in diesel engines). Once the acquisition is finalised BOW will be able to service both the petrol and diesel engine markets.

However despite the motives behind them, all mergers and acquisition have several barriers to overcome if they are going to create synergies and ultimately value. These include incorporating two different sets of human resources, work cultures and work processes into one entity. In addition the two organisations also have to develop ways that they can learn from each other to successfully adopt each other's best practices (and other lessons learned from their respective experience curves).

(e) Strategic Alliances

Definition

Johnson, Scholes and Whittington state that a strategic alliance occurs when "two or more organisations share resources and activities to pursue a strategy".

It typically occurs when two or more organisations want to enter a particular industry or market with a particular type of good / service but do not individually have all the needed resources and / or competences. One of the main types of a **strategic alliance** is a **joint venture**. Here the participating organisations remain independent of each other and instead form a jointly owned special purpose firm. The resources and work each participating organisation is then expected to contribute is explicitly spelled out and formally agreed upon.

Example

Life1 is an American organisation that manufacturers soaps, deodorants and other personal care products. The organisation wants to be able to service the Chinese market but does not have the necessary local presence or knowledge to do so. Therefore it enters into a joint venture with a local company calling the new organisation LifeChina. Life1 will provide LifeChina with all the necessary products which will then be marketed and sold by the sales force and distributors of their local partner.

Another type of a strategic alliance is a **network**. A network occurs when two or more organisations agree to work upon a particular activity in collaboration. Co-branding is a common example of a network and occurs when a single product or service is associated with more than one organisation.

Example

The Senseo coffeemaker carries both the Philips (appliances) and Douwe Egberts (coffee) brands.

Other types of **strategic alliances** are franchising and subcontracting. McDonalds is an example of an organisation that works on the franchise business model. All corporate activities such as marketing and brand building are handled by the McDonalds organisation. The individual owner / operators of outlets (the franchisees) are responsible for all operations and running their individual outlets.

With subcontracting, an organisation typically contracts out part of its work / activities to another organisation. Subcontracting is a fairly common practice in the construction industry (e.g. construction of a building is done by one firm which then subcontracts out installing all the necessary wiring and electrical points to another organisation).

Motives or benefits for organisations to form strategic alliances include:

- the costs and risks of **producing a new good / service** can be shared
- the opportunity for each participating organisation to **concentrate on its core competencies**
- the opportunity for each organisation to **learn from the other participating organisations**
- the opportunity to gain entry into markets / industries that would other otherwise be inaccessible

(f) Collaboration

Collaboration is when two or more organisations come together to cooperate with each other in order to **pursue mutual objectives**. Collaboration is a **strategic option** which provides assistance to the organisation in achieving its goals. Collaboration is beneficial to the organisation if the costs of purchase of business are less than the costs of self-operation. An organisation will typically join forces with another organisation(s) and form collaboration when it wants to enter a particular industry or market with a particular type of product / service but does not, individually, have all the required resources and/or competences.

Therefore, through collaboration, an organisation changes its structure in order to achieve its objective of being able to deliver a particular product / service. It is of vital importance that the organisation effectively manages its relationships with the other organisation(s) participating in the strategic alliance.

Example

Eurofighter project

Four nations (Germany, Italy, Spain and the UK) signed a contract in December 2004 to produce Eurofighter Typhoon, the world's most advanced swing-role combat aircraft. This alliance will enable Germany, Italy, Spain and the UK to meet the demands of their air forces by combining their expertise in cutting-edge electronics and computing.

Collaboration should not be confused with outsourcing. Outsourcing aims to obtain products or services at a cheaper rate than producing these goods/services in-house. Collaboration aims to share knowledge, capabilities and risks amongst different organisations.

Opportunities for improving competitiveness through collaboration

Collaboration improves the competitiveness of organisations in the following ways:

(i) Increasing buying power: purchasing large quantities requires huge funds. When small retailers desire to purchase larger quantities, they may do so by collaborating with others.

(ii) Increasing selling power: while purchasing any products, quality is of the utmost importance. When the buyer has confidence that the supplier will supply a good quality product, the buyer and seller may collaborate with each other for the supply of the product. Hence, the seller may increase its selling power. The collaboration may make it possible to design new products and may also lead to a large reduction in research costs.

(iii) Low risk of substitution: in a market, organisations always have a fear of substitute products. If an organisation is unable to satisfy the customer needs, its competitors will try to produce a substitute product. When an organisation collaborates with another organisation, the organisations may combine their funds for research and development to make the product more sophisticated and in line with the needs of the customer. In this way, collaboration may help to prevent substitution in the market and overcome competition.

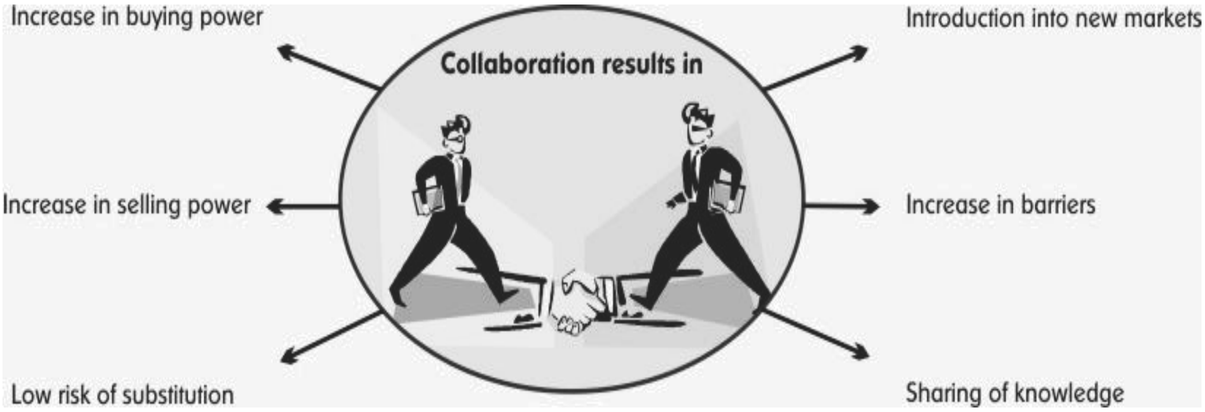
(iv) Sharing of knowledge: two organisations collaborate to achieve a mutual goal. These organisations possess managers with different skills and capabilities. In this situation, knowledge may be shared between the two organisations. The sharing of knowledge may give rise to innovative ideas for use in product development and product innovation.

(v) Increase in building entry barriers: when organisations collaborate, they share their operational and technical knowledge. In doing so, they gain the potential to satisfy customer needs. Sometimes new entrants in the market may try to attract the customers of the organisations. In this situation, the collaborated organisations will try to build barriers for the new entrants so that they are forced to leave the market. In this way, competition is reduced through collaboration.

(vi) Introduction in new markets: sometimes organisations collaborate to enter into a new market. It may be the case that an organisation wants to expand its scope geographically. This is possible only when it has knowledge of the conditions of the geographical area into which it wants to expand. To enter a market, an organisation requires knowledge, skill and competences. It can gain knowledge from an organisation that is already in existence in the particular market. Thus, collaboration also increases the economies of scale in operations.

In some cases, the government itself induces organisations to collaborate with other organisations. In the case of development in the area of information systems, infrastructure facilities etc., it is advantageous for two organisations to collaborate and operate together so that they can share their knowledge and expertise in their respective fields.

Diagram 8: Collaboration and competitiveness



Example

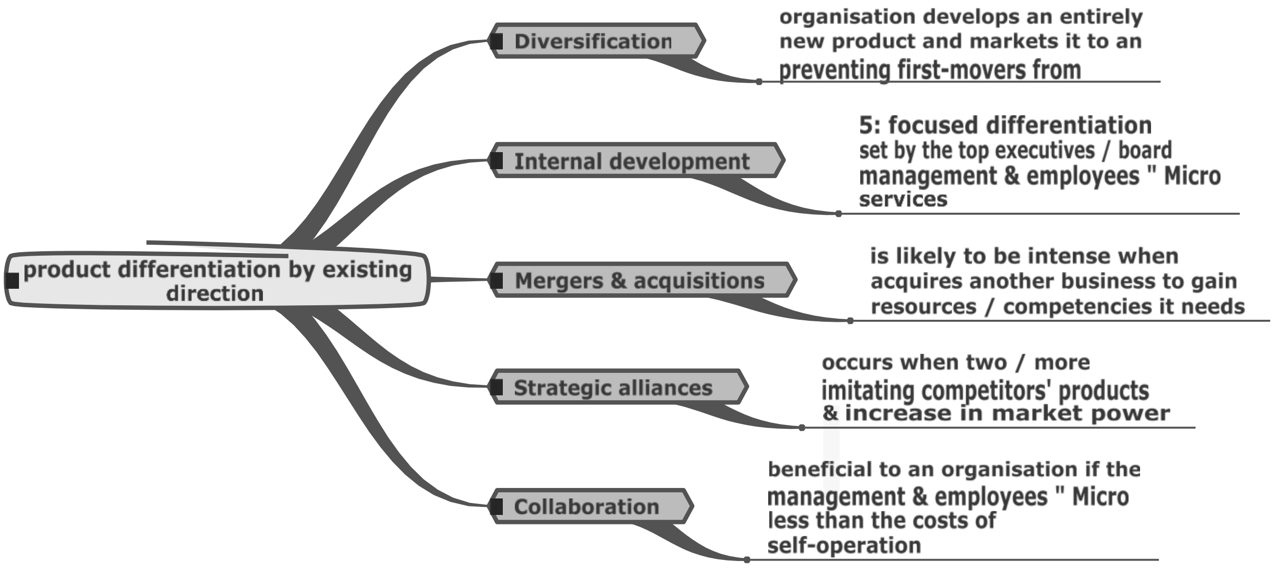
Collaboration between Sony Ericsson and Google

Sony Ericsson Mobile Communications entered into a deal with Google to integrate the search engine company's blogger and web search into Sony Ericsson mobile phones. When the phones are pre-loaded with the software, subscribers to Blogger.com can update their personal blogs from their mobile phones.

Nowadays, people use the internet very often. When a mobile phone offers internet facilities, more and more customers are attracted to it. By providing Google services in its phones, the Sony Ericsson team offers a quick and easy way for customers to blog and thereby attracts more customers to its phones.

The collaboration between Sony Ericsson and Google makes Google web search the standard search engine for all Sony Ericsson phones. The search is highly customised and allows searches from within any page being browsed on the phone.

SUMMARY



Test Yourself 1

Digi-Tech Corp is a multinational company providing customer-focused information technology and communications solutions. The company was a pioneer in developing video density technology (VDT). This technology is used to provide crystal-clear video quality for digital videos from the smallest amount of video data. VDT is Digi-Tech's best-selling product.

The company has approximately 90% of the market share in the VDT market. Most of Digi-Tech's business comes from licensing VDT to electronics manufacturers operating throughout the globe. As the technology became successful, other IT companies tried to produce and market similar kinds of technology but found it difficult to break into the market. The few other companies that are operating in the VDT market have to consider Digi-Tech's standard while producing and marketing their product.

Required:

Identify the way in which Digi-Tech attempts to sustain a competitive advantage.

Test Yourself 2

Cherry Delight Ltd is a newly started ice cream producing company. There are several established ice cream brands in the market. The company has decided to enter the market by offering its products at prices lower than its competitors with the help of effective cost control techniques. Moreover the ice cream flavours being produced by the company are completely different from any of the flavours produced by established ice cream producers.

Required:

State the kind of strategy from the strategy clock which is being followed by Cherry Delight Ltd.

Test Yourself 3

Angel Ltd is a leading manufacturer of skin and hair care products for women such as soaps, lotions, shampoo and body wash. Angel's products are high quality products made from pure natural ingredients and with minimum usage of chemicals. The prices charged by Angel are higher than those charged by its competitors who do not make as much use of natural ingredients in their products.

Recently, the company has started to lose its competitive advantage due to increased levels of competition, a fast-changing business environment and aggressive moves by its competitors.

Required:

Explain how Angel Ltd can respond to these conditions through repositioning.

Answers to Test Yourself

Answer to TY 1

Digi-Tech attempts to sustain a competitive advantage through lock-in. In the case of lock-in, an organisation becomes an industry standard. Lock-in is a position whereby the prospective competitors and other organisations have to conform to the standard in order to grow in the industry. Therefore, the other companies operating in the VDT market have to relate to Digi-Tech's standard while producing and marketing their product.

Digi-Tech was a pioneer in developing VDT, its best-selling product. The company has a monopoly in the VDT market. Other organisations are not able to break into the VDT market. Digi-Tech became the industry standard for VDT by achieving a lock-in position. This is evident from the fact that the efficiency of the products of Digi-Tech's competitors is judged against the standard set by Digi-Tech.

Answer to TY 2

Cherry Delight has adopted a hybrid strategy. It is at position 3 on the strategy clock. A hybrid strategy is an optimal balance between price and the added value perceived by the customer. A hybrid strategy seeks to achieve differentiation and a price lower than that of competitors simultaneously.

In a differentiation strategy, an organisation produces a product that is perceived to be unique in the market. Cherry Delight's products are unique as the flavours being offered by it are different from those offered by its competitors. In addition, the company aims to keep its prices lower than its competitors with the help of cost control techniques. Therefore the company seeks to achieve differentiation together with a reduction in prices.

Answer to TY 3

Angel Ltd is currently facing hypercompetitive conditions. It can sustain its competitive advantage and respond to these conditions by following the repositioning strategy i.e. by changing its position on the strategy clock.

The company is currently following a differentiation strategy. The perceived benefits from Angel's products are better and different from those of its competitors and the price charged is relatively high. However, the company will not be able to sustain a competitive advantage in hypercompetitive conditions with this strategy.

Angel Ltd can change its competitive strategy from differentiation (position 4) to hybrid (position 3). A hybrid strategy aims to provide higher perceived benefits while lowering prices. Angel Ltd is already providing high perceived benefits to its customers. In order to sustain its competitive advantage, it also needs to reduce its prices.

Answer to TY 4

The viability test evaluates a proposed strategy from the angle of whether an organisation has the resources and capabilities needed to implement it. In other words it attempts to determine how practical or even realistic a proposed strategy is. Naturally one of the first and foremost resources that needs to be examined are finances to determine if the organisation has / will be able to obtain the financing the strategy needs.

Answer to TY 5

The following are the factors that explicitly or implicitly influence the pricing decision:

(a) The objectives and strategies of the firm
(b) The market condition in which the firm operates
(c) The customers of the firm
(d) The costs of the product or service
(e) The other factors that influence the price of the product or service
(f) The demand of the firm's product
(g) The elasticity of demand for the product
(h) The stages of the product life cycle
(i) Whether or not the firm can dominate the market and act as a price maker (if it is a price taker)
(j) Level of capacity utilisation by the firm
(k) Whether or not the prices are administered by the government
(l) Whether or not the product has distinctive features (i.e. are there close substitutes?) etc.
(m) All these issues are not explicitly considered in every pricing decision.

Quick Quiz

1. A hybrid strategy is a combination of ____________ and ____________ strategies.

   A differentiation and low price
   B low price and no frills
   C differentiation and no frills
   D focused differentiation and differentiation

2. What is meant by competitive advantage? Is it necessary to sustain it? If yes, why?

3. What is meant by lock-in? State the factors affecting a lock-in strategy.

4. What are the strategies that can be followed in hypercompetitive conditions?

5. Organisations collaborate to make their product more sophisticated and in line with the needs of the customer so as to reduce the risk of _____________.

6. According to the Ansoff matrix what are the four possible product / market combinations or strategic options available to an organisation?

7. In the BCG Matrix, what does "B" stand for?

   A Bankruptcy
   B Boston
   C Balance
   D Boom

8. The price elasticity of demand is measured as % change in______________divided by % change in ______________of the goods.

9. ______________ refers to the strategy of selling a product or service at a high price, to gain high profit while sacrificing high growth in sales.

Answers to Quick Quiz

1. The correct option is **A**

2. When an organisation earns profit exceeding the average profits for that industry, it is said to have a competitive advantage over other competitors. Yes, it is essential to sustain a competitive advantage because a competitive advantage leads to the creation of better value for an organisation's customers and higher profits for the organisation itself.

3. Lock-in is a situation where the organisation's product is at the top position in an industry and it becomes an **industry standard**. The lock-in strategy is also called the Delta model. The factors affecting lock-in are:

   first-mover advantage
   accurate enforcement
   market dominance
   own-reinforcement

4. Repositioning, Overcoming competitors' market-based moves, Overcoming competitors' barriers, Competing successfully

5. Substitution.

6. The four strategic options available to an organisation are

   market penetration
   market development
   product development
   diversification

7. The correct option is **B**

8. quantity demanded, price

9. price skimming

Self-Examination Questions

Question 1

(a) Premium Electronics Corp manufactures a range of consumer electronics products including television sets, refrigerators, CD / DVD players and washing machines. Although there are many big players in the consumer electronics market, Premium Electronics is able to gain a competitive advantage due to its brand image. The company is known for its innovative products that provide new convenience, features or benefits to consumers through technology. The company is also known for its excellent after-sales service which none of its competitors is currently providing. Hence consumers prefer to buy Premium Electronics' products even though its prices are slightly higher than its competitors.

(b) Spicy-Bite Plc is a chain of fast-food restaurants primarily selling burgers, sandwiches, breakfast items, cold drinks, milkshakes and desserts. There are several similar fast-food restaurants competing with Spicy-Bite, however Spicy-Bite is known for providing good quality food at a low price. The company has a significant share in the fast food market. Spicy-Bite's business success depends on its low cost base. Its restaurants are very basic, located in low rent areas and offer a standardised menu. Spicy-Bite positions itself as a high volume, low cost, low margin fast-food restaurant chain.

Required:

Identify the types of strategies that are being followed by Premium Electronics Corp and Spicy-Bite Plc.

Question 2

WST is an Indian IT organisation that creates customised software solutions for businesses from Europe and America. The organisation has just finished a SWOT analysis on itself and identified the following:

1. Strengths

(a) Existence of labour arbitrage (i.e. the ability to create a customised software solution in India at a much lower cost than its counterparts in Europe and America).
(b) Large availability of skilled English speaking engineers.
(c) Time zone differential means work and testing of a program can be done on a 24 hour basis.

2. Weaknesses

(a) Reputation for being a low cost (and not high quality) service provider.
(b) Cultural / national differences with customers.
(c) Not updated on the very latest technologies / programming languages.

3. Opportunities

(a) Large number of untapped organisations still present in the US and Europe.
(b) Potential to move up the software value chain with existing clients.

4. Threats

(a) Appreciating Indian rupee is making WST services more expensive for its customers
(b) Increasing competition from organisations in other countries who are also able to exercise labour arbitrage (e.g. Russia).

Using a TOWS matrix identify four different strategic options available to WST.

Question 3

Briefly explain the market penetration strategy of the Ansoff matrix and state some of its objectives.

Question 4

FIXIT Adhesives Ltd is a Tanzanian-based company that manufactures a range of adhesives for sale to a wide range of customers. FIXIT's products range from adhesives used for household purposes to high performance adhesives, used for industrial purposes. It has three factories manufacturing three broad categories of products.

The first category is contact adhesive products. Contact adhesives are used in laminates which are supplied to furniture and footwear manufacturers in Tanzania. FIXIT's market share for this product group is 10% which has been consistent for the last few years. FIXIT's major competitor for contact adhesives has a reputation for aggressive product innovation.

The second category of FIXIT's products is reactive adhesives used to prevent loosening of bolts and screws in automobile engines. FIXIT's competition in this category is of a smaller size and not regarded as being particularly innovative. FIXIT has had success in meeting the particular adhesive needs of car makers in their new car model programmes. FIXIT has to satisfy the demanding quality standards required by each car manufacturer.

The third category is drying adhesives, which are typically used for household applications. The move into drying adhesives is very recent, aimed at the apparently ever-increasing demand for drying adhesives in the domestic market. The technology to produce drying adhesive was imported from abroad with an ultra-modern factory built to manufacture these products.

After setting up the factory, FIXIT faced the dual problem of excess industry capacity and sales of low priced adhesives in Africa by low cost Chinese producers. FIXIT's market share for this product category is expected to increase rapidly. The main competitor for FIXIT in this category is a Chinese company with access to lower cost raw materials and a 35% share of the Tanzanian market.

FIXIT's current sales and financial performance

	Contact adhesives Tshs million	Reactive adhesives Tshs million	Drying adhesives Tshs million
Sales	1,700	4,510	3,100
Less: Cost of sales	980	2,593	2,650
Gross profit	**720**	**1,917**	**450**
R & D	Low	High	Moderate
Market share	10%	40%	8%

The financial health of FIXIT looks reasonably sound, if not exciting. Sales and costs seem to be increasing more or less in line with one another. However, closer analysis of the performance of the individual factories or product groups reveals some disturbing differences.

Required:

Evaluate the performance of the three product groups of FIXIT using the BCG matrix.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) Premium Electronics follows a differentiation strategy. The company's aim is to achieve a competitive advantage by offering better products at higher prices. The features that Premium's products offer are different from those of its competitors. The company adds enough value to the product to justify its relatively high price. Premium Electronics also offers superior after-sales service. Consumers are prepared to pay a higher price as Premium's products are differentiated in the eyes of the consumers and are widely valued by them.

(b) Spicy-Bite follows a low-price strategy. It provides good quality fast-food items at low prices. Its low price strategy is supported by a low cost base. Spicy-Bite's products are basic and are produced at a relatively low cost and made available to a very large customer base. By producing high volumes of standardised products, the company takes advantage of economies of scale. Although its prices are low, Spicy-Bite preserves a reasonable margin by keeping cost low.

Answer to SEQ 2

1. **SO Strategy:** Target existing customers to obtain more “high end” software creation and programming assignments. Main marketing ploy to be that this work can be done more cost effectively by WST then its counterparts in America and Europe (who are currently getting such assignments).

2. **ST Strategy:** Reduce prices / rates in accordance with how the Indian rupee appreciates to ensure that costs for software development remain constant for customers. Although this will reduce profitability it will also reduce the risk of customers / potential customers having their software developed elsewhere.

3. **WO Strategy:** Introduce training and developing programs that will have staff updated on the latest technologies / programming. Use this as a basis for marketing to existing customers to obtain more “high end” software creation and programming assignments.

4. **WT Strategy:** Hire either expatriate or local managers with Western experience / exposure to serve as intermediaries between WSN programmers and customers (thereby helping to bridge the cultural gap that exists between the two groups).

Answer to SEQ 3

A market penetration strategy is a strategy where an organisation focuses on selling existing products in existing markets. It seeks to achieve the following objectives:

1. **Maintaining / increasing the market share of current products:** this can be achieved by a combination of competitive pricing strategies, advertising, sales promotion, etc.

2. **Restructuring by elimination of competitors:** this requires a highly aggressive promotional campaign, supported by a pricing strategy designed to make the market unattractive for competitors.

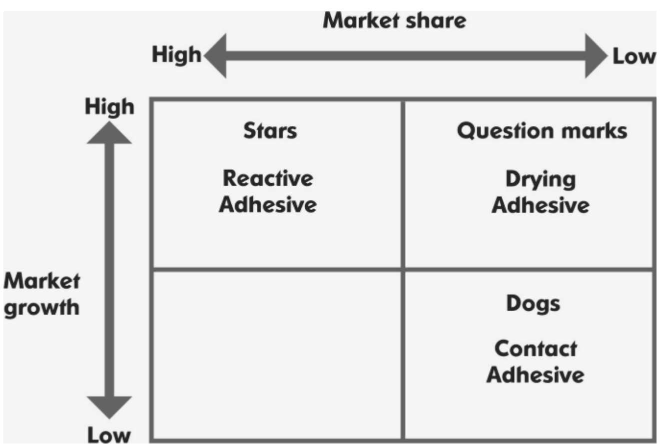
3. **Increasing usage by existing customers:** this can be achieved by introducing loyalty schemes.

Answer to SEQ 4

The BCG matrix suggests the different types of businesses and products in a portfolio. The BCG matrix offers a very useful map in analysing corporate parent’s business units or product lines. The BCG matrix emphasises the relationship between an organisation’s growth and market share.

It is based on the observation that a company's business units can be ranked into four categories on the basis of their relative market shares and growth rates. These categories are: question marks (high growth, low market share), stars (high growth, high market share), cash cows (low growth, high market share) and dogs (low growth, low market share). A company with a portfolio of products could expect some to be in low growth industries and others to be in industries achieving high rates of growth.

BCG matrix for FIXIT Adhesives Ltd



FIXIT's contact adhesives product group can be classified as a dog. It has a low market share (10%) in a mature industry. It also has a low growth rate as the market share has been consistent for the last few years. The cost of sales and the R&D cost of contact adhesives are low compared to the other two categories. Therefore it neither generates nor consumes a large amount of cash for FIXIT. FIXIT should avoid having a dog in the organisation.

Reactive adhesives product group can be classified as a star. It has a high market share (40%) in a fast-growing industry. It generates large amounts of cash but also consumes large amounts of cash to sustain its market leadership. FIXIT should make sure to maintain its large market share for reactive adhesives as it will become a cash cow when the market growth rate declines.

The drying adhesives product group of FIXIT can be classified as a question mark. It consumes large amounts of cash as it is growing rapidly. However, it does not generate much cash because it has a low market share (8%). The drying adhesives group has the potential to gain market share and become a star, and eventually a cash cow when the market growth slows. If nothing is done to change the market share, the question mark will simply absorb great amounts of cash and later, as the growth stops, will degenerate into a dog. FIXIT must analyse the drying adhesives group carefully in order to determine whether it is worth the investment required to increase its market share.

The overall goal of this ranking is to help organisations decide which of their products to fund and how much funding to put into them; and which products to sell.

STUDY GUIDE A4: STRATEGIC IMPLEMENTATION

Get Through Intro

Up until recently, many companies saw employees as just numbers and operated with employees in a strict hierarchy. Many new companies, however, see employees for what they are: the catalysers of change and efficiency. Hence companies structure their organisation to make the best use of employees in order to deliver their strategy. For example, IT companies are known for their flat structures and team leaders, as opposed to bosses. It is the same in advertising agencies and marketing companies. The question is, why are they structured in this way? What was wrong with the old fashioned hierarchical structure?

This Study Guide will help show why a particular structure is suitable to a particular strategy, so you will be able to use this knowledge in real life.

Functional strategies play a vital role in helping an organisation realise its corporate objectives. The functional strategies are related to the activities performed by various units of an organisation. This Study Guide introduces you to some of the main functional strategies.

New business proposals are intended to deliver change and benefits to an organisation and its clients. At the start of a business, companies often take significant efforts in defining and gaining agreement to a business plan to justify the investment. This chapter throws light on the contents of such a business plan.

Learning Outcomes

a) Describe the important issues to be considered in the strategy implementation
b) Analyse the alternative appropriate organisational structures and related activities that may be appropriate to deliver a chosen strategy set out in a given scenario.
c) Analyse the alternative appropriate functional strategies that may be appropriate to deliver a chosen strategy set out in a given scenario.
d) Analyse a chosen business strategy in a given scenario so that an evaluation may be undertaken leading to the drafting of a simple business plan.

1. Describe the important issues to be considered in the strategy implementation
[Learning Outcome a]

1. Strategic Marketing Issues

Countless marketing variables affect the success or failure of strategy implementation efforts. Some strategic marketing issues or decisions are as follows: How to make advertisements more interactive to be more effective

1. How to take advantage of Facebook and Twitter conservations about the company and industry
2. To use exclusive dealerships or multiple channels of distribution
3. To use heavy, light, or no TV advertising versus online advertising
4. To limit (or not) the share of business done with a single customer
5. To be a price leader or a price follower
6. To offer a complete or limited warranty
7. To reward salespeople based on straight salary, commission, or a combination salary and commission

Three marketing activities especially important in strategy implementation are listed below and then discussed:

1. Engage customers in social media.
2. Segment markets effectively.
3. Develop and use product-positioning/perceptual maps.

2. Social Media Marketing

Social media marketing has become an important strategic issue. Marketing has evolved to be more about building a two-way relationship with consumers than just informing consumers about a product or service. Marketers increasingly must get customers involved in the company website and solicit suggestions in terms of product development, customer service, and ideas. The company website should enable customers to interact with the firm on the following social media networks (listed along with the estimated number of current users in millions): Facebook (1,200), Google Plus (500), Twitter (400), LinkedIn (300), Instagram (200), Pinterest (100), and Foursquare (50). To manage this process, larger companies have hired a social media manager(s) to be the voice of the company on social and digital media sites. The manager(s) responds to comments and problems, track negative or misleading statements, manage the online discussion about a firm, and gather valuable information about opinions and desires—all of which can be vital for monitoring strategy implementation progress and making appropriate changes.

The online community of customers increasingly mirrors the offline community but is much quicker, cheaper, and effective to reach than traditional focus groups and surveys. Successful strategy implementation requires a firm to know what people are saying about it and its products. Customers are talking about and creating valuable content around every brand through blog posts, tweets, e-mails, and conversations with family and friends.

3. Market Segmentation

Market segmentation and product positioning rank as marketing's most important contributions to strategic management. Market segmentation can be defined as the subdividing of a market into distinct subsets of customers according to needs and buying habits.

Market segmentation is important in strategy implementation for at least three major reasons. First, strategies such as market development, product development, market penetration, and diversification require increased sales through new markets and products. To implement these strategies successfully, new or improved market-segmentation approaches are required. Second, market segmentation allows a firm to operate with limited resources because mass production, mass distribution, and mass advertising are not required. Market segmentation enables a small firm to compete successfully with a large firm by maximizing per-unit profits and per-segment sales. And third, market segmentation decisions directly affect marketing mix variable: product, place, promotion and price.

Evaluating potential market segments requires strategists to determine the characteristics and needs of consumers, to analyze consumer similarities and differences, and to develop consumer group profiles.

4. Product Positioning

After markets have been segmented so that the firm can target particular customer groups, the next step is to find out what customers want and expect. This takes analysis and research. A severe mistake is to assume the firm knows what customers want and expect. Countless research studies reveal large differences between how customers define service and rank the importance of different service activities versus how companies view services. Many firms have become successful by filling the gap between what customers versus companies see as good service. What the customer believes is good service is paramount, not what the producer believes service should be. Product positioning (sometimes called perceptual mapping) entails developing schematic representations that reflect how products or services compare to those of the competitors on dimensions most important to success in the industry. Product positioning is widely used for deciding how to meet the needs and wants of particular consumer groups. The technique can be summarized in five steps:

1. Select key criteria that effectively differentiate products or services in the industry.
2. Diagram a two-dimensional product-positioning map with specified criteria on each axis.
3. Plot major competitors' products or services in the resultant four-quadrant matrix.
4. Identify areas in the positioning map where the company's products or services could be most competitive in the given target market. Look for vacant areas (niches).
5. Develop a marketing plan to position the company's products or services appropriately.

5. Strategic Finance/Accounting Issues

Several finance/accounting concepts central to strategy implementation are acquiring needed capital, developing projected financial statements, preparing financial budgets, and evaluating the worth of a business. Some examples of decisions that may require finance and accounting policies are:

1. To raise capital with short-term debt, long-term debt, preferred stock, or common stock
2. To lease or buy fixed assets
3. To determine an appropriate dividend payout ratio
4. To use last-in, first-out (LIFO), first-in, first-out (FIFO), or a market-value accounting approach
5. To extend the time of accounts receivable
6. To establish a certain percentage discount on accounts within a specified period of time
7. To determine the amount of cash that should be kept on hand

Five especially important finance/accounting activities central to strategy implementation are listed below and then discussed:

1. Acquire needed capital to implement strategies; perform Earning per share/earnings before interest and taxes (EPS/EBIT) analysis
2. Develop projected financial statements to show expected impact of strategies implemented
3. Determine the firm's value (corporate valuation) in the event an offer is received
4. Decide whether to go public with an Initial Public Offering (IPO)
5. Decide whether to keep cash offshore that was earned offshore

6. Strategic Research and Development (R&D) Issues

Research and development (R&D) personnel can play an integral part in strategy implementation. These individuals are generally charged with developing new products and improving old products effectively. R&D persons perform tasks that include transferring complex technology, adjusting processes to local raw materials, adapting processes to local markets, and altering products to particular tastes and specifications. Strategies such as product development, market penetration, and related diversification require that new products be successfully developed and that old products be significantly improved. Technological improvements that affect consumer and industrial products and services shorten product life cycles. Companies in virtually every industry rely on the development of new products and services to fuel profitability and growth. Surveys suggest that the most successful organizations use an R&D strategy that ties external opportunities to internal strengths and is linked with objectives. Well-formulated R&D policies match market opportunities with internal capabilities. Strategic R&D issues include the following:

1. To emphasize product or process improvements.
2. To stress basic or applied research.
3. To be a leader or follower in R&D.
4. To develop robotics or use manual-type processes.

5. To spend a high, average, or low amount of money on R&D.
6. To perform R&D within the firm or contract R&D to outside firms.
7. To use university researchers or private-sector researchers.

7. Strategic Management Information Systems (MIS) Issues

Firms that gather, assimilate, and evaluate external and internal information most effectively are gaining competitive advantages over other firms. Having an effective management information system (MIS) may be the most important factor in differentiating successful from unsuccessful firms. The process of strategic management is facilitated immensely in firms that have an effective information system. Information collection, retrieval, and storage can be used to create competitive advantages in ways such as cross-selling to customers, monitoring suppliers, keeping managers and employees informed, coordinating activities among divisions, and managing funds. Like inventory and human resources, information is now recognized as a valuable organizational asset that can be controlled and managed. Firms strive to implement strategies using the best information. A good information system can allow a firm to reduce costs. For example, online orders from salespersons to production facilities can shorten materials ordering time and reduce inventory costs. Direct communications between suppliers, manufacturers, marketers, and customers can link together elements of the value chain as though they were one organization. Improved quality and service often result from an improved information system.

8. The Need for Clear Annual Objectives

Annual objectives are desired milestones an organization needs to achieve to ensure successful strategy implementation. Annual objectives are essential for strategy implementation for five primary reasons:

1. They represent the basis for allocating resources.
2. They are a primary mechanism for evaluating managers.
3. They enable effective monitoring of progress toward achieving long-term objectives.
4. They establish organizational, divisional, and departmental priorities.
5. They are essential for keeping a strategic plan on track.

Considerable time and effort should be devoted to ensuring that annual objectives are well conceived, consistent with long-term objectives, and supportive of strategies to be implemented. Active participation in establishing annual objectives is needed for the preceding reasons listed. The purpose of annual objectives can be summarized as Annual objectives serve as guidelines for action, directing and channeling efforts and activities of organization members. They provide a source of legitimacy in an enterprise by justifying activities to stakeholders. They serve as standards of performance. They serve as an important source of employee motivation and identification. They give incentives for managers and employees to perform. They provide a basis for organizational design.

9. The Need for Clear Policies

Policies refer to specific guidelines, methods, procedures, rules, forms, and administrative practices established to support and encourage work toward stated goals. Changes in a firm's strategic direction do not occur automatically. On a day-to-day basis, policies are needed to make a strategy work. Policies facilitate solving recurring problems and guide the implementation of strategy. Policies are essential instruments for strategy implementation, for at least six reasons:

1. Policies set boundaries, constraints, and limits on the kinds of administrative actions that can be taken to reward and sanction behaviour.
2. Policies let both employees and managers know what is expected of them, thereby increasing the likelihood that strategies will be implemented successfully.
3. Policies provide a basis for management control and allow coordination across organizational units.
4. Policies reduce the amount of time managers spend making decisions. Policies also clarify what work is to be done and by whom.
5. Policies promote delegation of decision making to appropriate managerial levels where various problems usually arise.
6. Policies clarify what can and cannot be done in pursuit of an organization's objectives.

10. Allocate Resources and Manage Conflict

i. Allocate Resources

All organizations have at least four types of resources (or assets) that can be used to achieve desired objectives: (1) financial resources, (2) physical resources, (3) human resources, and (4) technological resources. Resource allocation can be defined as distributing an organization's "assets" across products, regions, and segments according to priorities established by annual objectives. Allocating resources is a vital strategy-implementation activity. Strategic management itself is sometimes referred to as a "resource allocation process."

In organizations that do no strategic planning, resource allocation is often based on political or personal factors and bias, rather than being based on clear analysis and thought. Strategists should be wary of a number of factors that commonly prohibit effective resource allocation, including an overprotection of resources, too great an emphasis on short-run financial criteria, organizational politics, vague strategy targets, a reluctance to take risks, and a lack of sufficient knowledge.

ii. Manage Conflict

Honest differences of opinion, turf protection, and competition for limited resources can inevitably lead to conflict. Conflict can be defined as a disagreement between two or more parties on one or more issues. Establishing annual objectives can lead to conflict because individuals have different expectations, perceptions, schedules, pressures, obligations, and personalities. Misunderstandings between line managers (such as production supervisors) and staff managers (such as human resource specialists) can occur. Conflict is not always bad. An absence of conflict can signal indifference and apathy. Conflict can serve to energize opposing groups into action and may help managers identify problems.

Various approaches for managing and resolving conflict can be classified into three categories: avoidance, defusion, and confrontation.

- Avoidance includes such actions as ignoring the problem in hopes that the conflict will resolve itself or physically separating the conflicting individuals (or groups).
- Defusion can include playing down differences between conflicting parties while accentuating similarities and common interests, compromising so that there is neither a clear winner nor loser, resorting to majority rule, appealing to a higher authority, or redesigning present positions.
- Confrontation is exemplified by exchanging members of conflicting parties so that each can gain an appreciation of the other's point of view or holding a meeting at which conflicting parties present their views and work through their differences.

11. Match Structure with Strategy

Structure matters very much for successful implementation of strategy. There are seven basic types of organizational structure: (1) functional, (2) divisional by geographic area, (3) divisional by product, (4) divisional by customer, (5) divisional by process, (6) strategic business unit (SBU), and (7) matrix. Companies, like people and armies, strive to be better organized/structured than rivals, because better organization can yield tremendous competitive advantages.

Changes in strategy often require changes in the way an organization is structured, for two major reasons. First, structure largely dictates how objectives and policies will be established. Objectives and policies are stated largely in terms of products in an organization whose structure is based on product groups. The structural format for developing objectives and policies can significantly impact all other strategy-implementation activities. The second major reason why changes in strategy often require changes in structure is that structure dictates how resources will be allocated. If an organization's structure is based on customer groups, then resources will be allocated in that manner. Similarly, if an organization's structure is set up along functional business lines, then resources are allocated by functional areas. Unless new or revised strategies place emphasis in the same areas as old strategies, structural reorientation commonly becomes a part of strategy implementation.

12. Strategic Production/Operations Issues

Production/operations capabilities, limitations, and policies can significantly enhance or inhibit the attainment of objectives. Production processes typically constitute more than 70 percent of a firm's total assets. Thus, a major part of the strategy-implementation process takes place at the production site. Strategic production-related decisions on plant size, plant location, product design, choice of equipment, kind of tooling, size of inventory, inventory control, quality control, cost control, use of standards, job specialization, employee training, equipment and resource utilization, shipping and packaging, and technological innovation can determine the success or failure of strategy-implementation efforts. Four production/operations issues—(1) restructuring/reengineering, (2) managing resistance to change, (3) deciding where/how to produce goods, and (4) managing an Employee Stock Ownership Plans (ESOP)—are especially important for successful strategy implementation.

13. Strategic Human Resource Issues

Any organization is only as good as its people. Thus, human resource issues can make or break successful strategy implementation. Thus, seven human resource issues need to be considered careful in the strategy implementation. These issues are as follows:

i. Linking performance and pay to strategy,
ii. Balancing work life with home life,
iii. Developing a diverse work force,
iv. Using caution in hiring a rival's employees,
v. Creating a strategy-supportive culture,
vi. Using caution in monitoring employees' social media, and
vii. Developing a corporate wellness program.

2. Analyse the alternative appropriate organisational structures and related activities that may be appropriate to deliver a chosen strategy set out in a given scenario.
[Learning Outcome b]

Case Study

According to a press release in June 2008, GlaxoSmithKline PLC, the world's second-largest drug maker said it is cutting around 2 percent of its research staff, as part of an ongoing restructuring plan aimed at boosting productivity.

Glaxo had also confirmed plans to restructure its research and development operations into smaller units. The aim would be for these units to focus on specific diseases. It was also reported that the units would be rewarded based on performance.

Glaxo had previously split its research operations into therapeutic areas in a move to boost innovation and bring new drugs into the market.

The above scenario shows that GlaxoSmithKline PLC decentralised its research and development operations into smaller units. This made it easier for the company to make the decentralised smaller units concentrate on specific diseases. Thus, companies are constantly changing their structures to better reflect their strategies.

An organisation in the most basic sense can be defined as being a collection of people jointly working towards achieving a shared objective or purpose.

This objective is usually characterised by the organisation's vision / mission statement which highlights the reason why the organisation was created in addition to all that it wishes to achieve and become.

Example

Sony's mission statement in the early 1950s was "Become the company most known for changing the worldwide poor-quality image of Japanese products".

Correspondingly then the selected strategy of an organisation represents how it intends to achieve these objectives. More specifically it outlines the direction an organisation wishes to take (i.e. the type and quality of goods / services it will produce) and the methods that will be employed (i.e. how it will produce its target goods / services).

Johnson, Scholes and Whittington identify three different ways through which organisations determine or arrive at the final strategy that they are going to adopt. These three approaches are strategy selection through innovation, strategy selection through experience or strategy selection through design. With the innovation or "ideas" approach, an organisation selects and bases its strategy solely around an innovation or innovative idea that has emerged out of the organisation.

Strategy selection through design represents a highly rational and top-down approach to strategic development and management. Here the top management / executives of an organisation determine the strategy an organisation will assume through a formal planning process. This strategy will then be communicated to and implemented by the rest of the organisation.

Lastly with the experience approach, the strategy an organisation finally selects is one that has not been formally planned but rather has emerged as a result of individual and collective experiences. Here strategy selection occurs "in the doing". By this what is meant is that an organisation begins with a general strategic route it would like to take which is then amended as and when necessary. Therefore the final strategy selected is not an outcome of a formal planning process but rather a result of experimentation and "learning on the run".

As important as the type of strategy an organisation is implementing is the type of organisation structure it has. This is because as Professor John C. Camillus states: "A key enabler for effective strategy implementation is the ability to align organisational structure with strategic goals and objectives. The structure and strategy of the organisation must be complementary."

The structure of an organisation determines how an organisation will go about delivering the goods / services it has targeted in its strategy. More specifically organisation structures determine which parts of an organisation will perform which activities / functions and how.

They also define the conditions that exist in an organisation such as the:

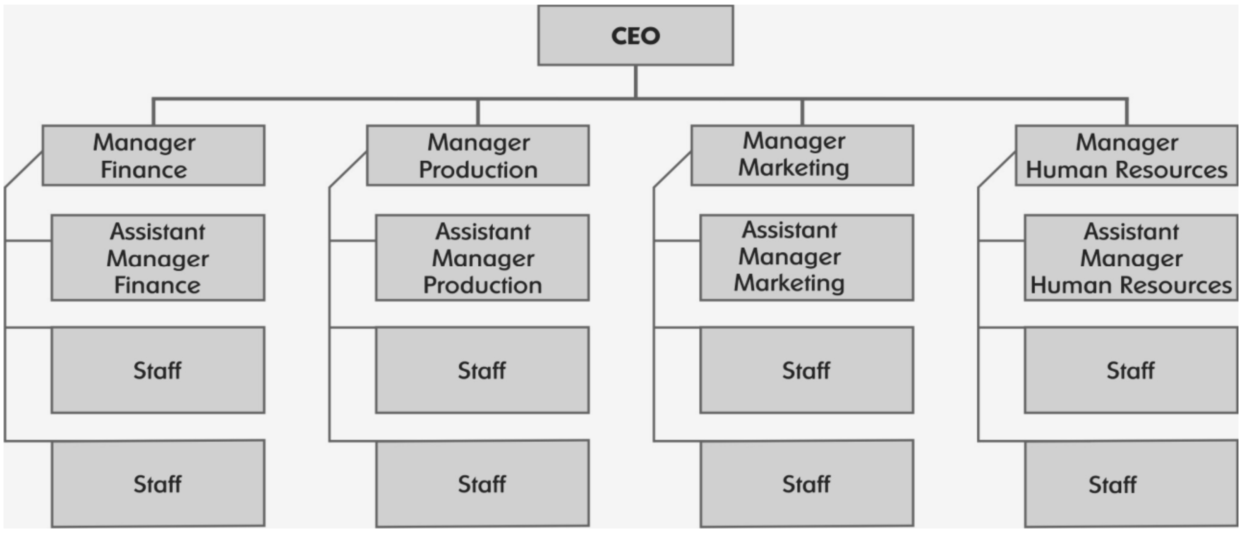
- formal reporting relationships and communication channels
- responsibilities of individuals, groups and departments
- grouping of departments / activities
- type and numbers of hierarchical levels
- span of control of managers
- uses of processes and systems

1.1 The four main ways an organisation can choose to structure itself include:

- structuring itself around its functions
- structuring itself around its customers
- structuring itself around the geographical area covered by it
- adopting a matrix structure
- adopting a network structure

1. **Function focused structure:** an organisation that has a functional structure is divided into a series of departments. Each of these divisions is responsible for carrying out a specific function or activity of the organisation. Each employee of the organisation is then placed into one of these departments and is assigned a specific set of roles and responsibilities to carry out.

Diagram 1: Function focused structure



Advantages to this type of structure include that it:

- helps top management in coordinating and controlling the entire organisation to follow a uniform strategic direction
- clarifies the roles / responsibilities and what is expected of each employee

allows each department to focus on its own work / activities
provides clear accountability at both the departmental and individual level

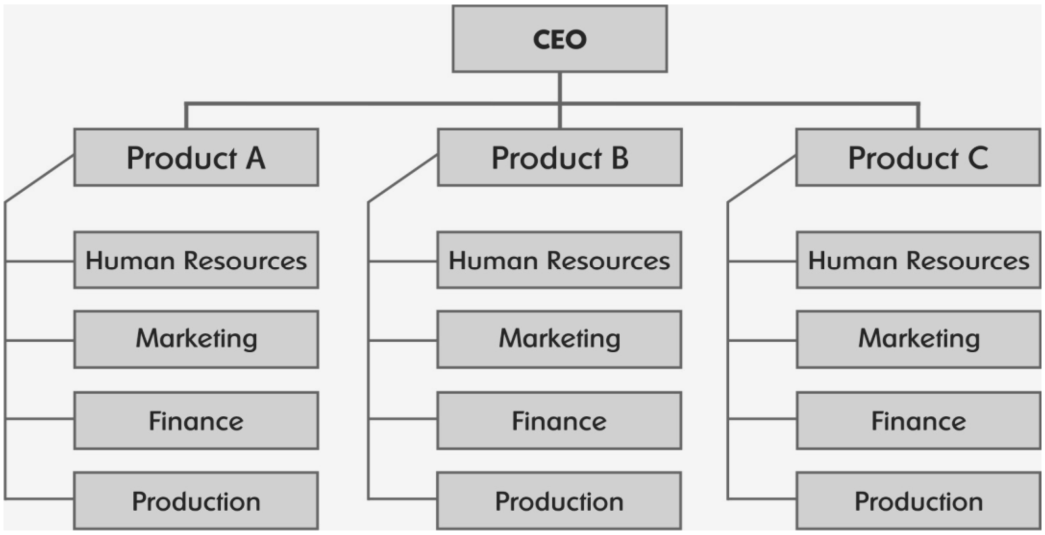
Disadvantages to this type of structure include that it:

creates a rigid and slow moving organisation
leads to a loss of innovation and innovative thinking as employees become more process oriented (focused on following correct procedures and protocol) rather than results oriented
does not allow for sharing of information / ideas across departmental lines (which is viewed as being especially important in today's knowledge economy)

This type of structure is typically suited for an organisation that produces a limited set of goods / services and / or operates in a stable environment.

2. **Customer focused structure:** an organisation that has adopted a "customer focus" will also have a hierarchical structure in place (similar to that of the functional organisation). However here the organisation will be departmentalised along either product, geographical or project lines. Each of these departments then becomes responsible for servicing and meeting the needs of a particular type / group of the organisation's customers.

Diagram 2: Customer focused structure



Advantages to this type of structure include that it:

enables an organisation to be more aligned with the needs of its customers
promotes innovation and innovative thinking as the organisational culture becomes more focused on problem solving / meeting customer needs than following processes and protocol

Disadvantages to this type of structure include:

individual departments can become too autonomous which makes setting and coordinating a single strategic direction to be followed difficult
it limits the sharing of information / ideas across the organisation lines (which is viewed as being especially important in today's knowledge economy)

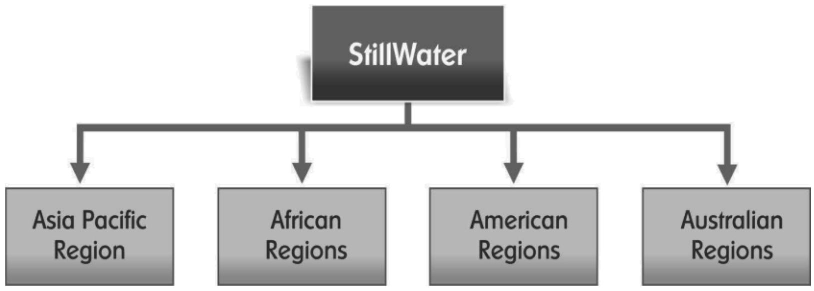
This type of structure is typically suited to an organisation that has multiple sets of customers and operates in a rapidly changing environment.

3. **Geographical structure:** Organisations that **operate in multiple regions or countries** will often structure themselves along geographic lines. Each division or group will be responsible for providing the organisation's products or services to a specific country or region.

Example

Stillwater is an organisation that distills and sells mineral water. The company sells its products across the globe. Therefore, StillWater follows a geographical organisation structure. The company has divided itself into four groups, with each group being in charge of a particular region.

Diagram 3: Geographical area structure

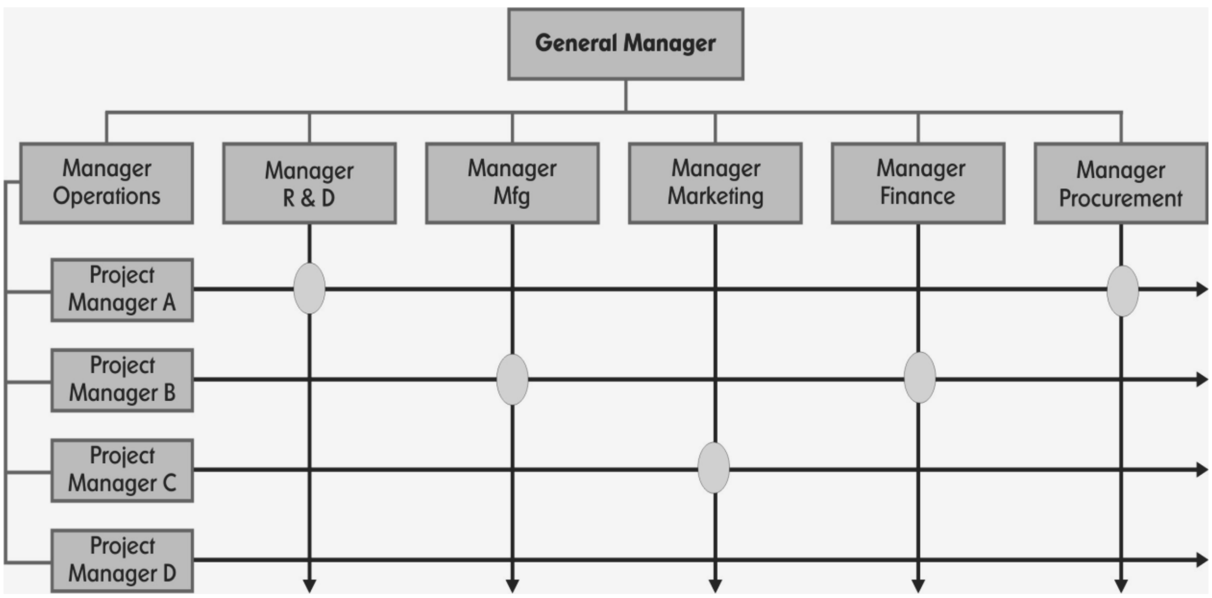


Each region would then have its own functional departments (i.e. HR, Finance, Marketing etc.).

When organisations are spread across the globe or have branches in many parts of a country, departmentalisation by geographical location may lead to provision of better service to customers and be more cost effective.

4. **Matrix structure:** a matrix structure is adopted when an organisation combines elements of a functional and customer focused structure.

Diagram 4: Matrix structure



Advantages to this type of structure include that it:

- facilitates cross organisational learning and coordination as people and resources are shared across the organisation
- makes communication across the organisation more efficient and effective
- creates a flexible organisation as it calls for different functions and divisions to work together
- motivates staff so employees constantly learn new tasks and skills
- encourages innovation and promotes differentiation

Disadvantages to this type of structure include that:

- it can lead to confusion as areas of authority and accountability often overlap between different functions and divisions
- employees can often be unclear on their exact roles and responsibilities as they typically have two bosses and so they can get frustrated
- it makes it difficult to set and coordinate a single strategic direction for the organisation to follow
- it is difficult for firms in stable environments

This type of structure is typically suited for organisations that have multiple product / service lines as well as customer groups and / or operate in diverse geographic regions. In addition, this type of structure is suited to innovative firms such as Intel and Microsoft.

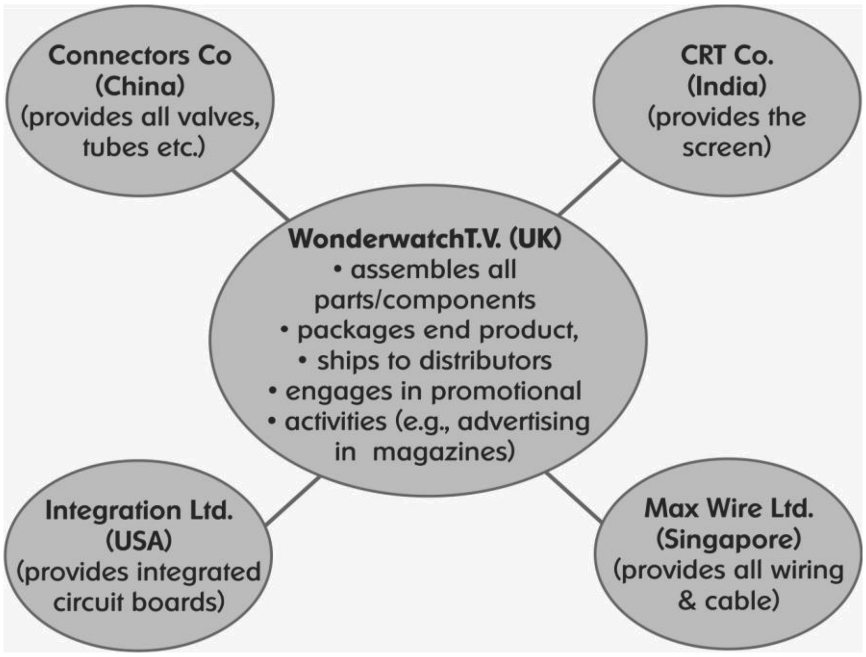
5. **Network structure:** in addition to having their own value chain more and more organisations today are also members of a value network.

Definition

A value network is a network of organisations which have entered into business with each other or have a business relationship with each other so as to create a particular product or service.

Therefore organisations operating in this context will maintain a bare minimum organisation structure that allows it to concentrate on performing its core competencies. The other aspect of the way the organisation will be structured will be to enable it to manage relationships with the other organisation / suppliers in its value network.

Diagram 5: Network structure



Advantages to this type of organisation structure are that it allows an organisation to:

be highly flexible

concentrate on its core competencies

to share information and learn from multiple other parties

Disadvantages to this type of organisation structure are that:

coordination becomes difficult given the multiple parties / organisations involved

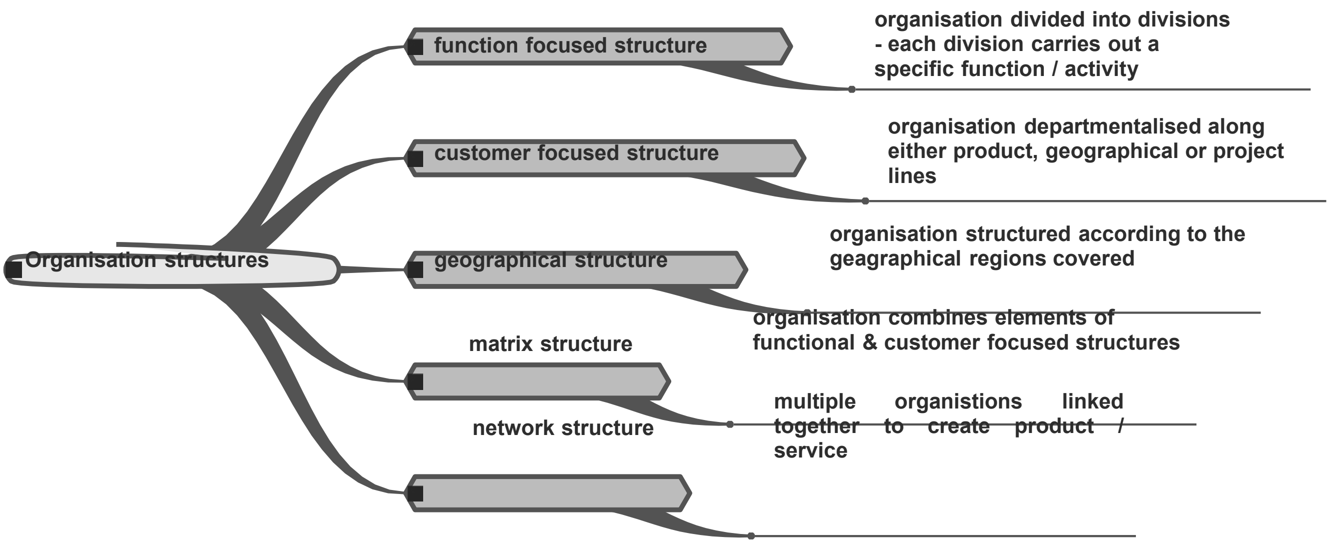
an organisation loses control over much of the activities / functions that go into providing its product / service

This type of organisation structure is suited for organisations that operate in very dynamic and rapidly changing markets.

Overall when it comes to selecting an organisation structure, firms need to follow a system of “backward integration”. By this what is meant is that organisations must first consider the type of goods / services they would like to offer. The next step involves identifying what types of activities and work would be required to produce these goods / services. From here the organisation can then determine the type of structure it should adopt to deliver the goods / services associated with its selected strategy.

For instance a functional organisation structure would be most appropriate for a small engineering firm that produces a single product on a mass production scale and in a stable environment. Whereas for a multinational organisation such as Unilever whose strategy calls for it to operate on an almost global scale and offer a multitude of different products, a matrix organisation structure would be most appropriate.

SUMMARY



There are two main aspects to consider when examining the internal structural relationships that exist in an organisation:

- the extent to which it is centralised / decentralised
- the role of the corporate centre or head office in relation to individual business units

1.2 Centralisation and Decentralisation

The concepts of centralisation and decentralisation deal with how decision making authority is divided / distributed across an organisation. More specifically they identify the extent to which important strategic decisions are made at the lower (operational and tactical) levels of the organisation.

Centralisation calls for the top management or executives of an organisation to assume all decision making authority. This results in a policy of standardisation spreading throughout the organisation as all employees end up following a single set of directives. Middle management and operational staff are given very little autonomy in terms of decision making but are instead expected to simply execute the directions that flow from above.

Centralisation typically results in an organisation becoming more efficient. This is because it helps avoid / reduce duplication of work and efforts across different divisions and enables an organisation to follow a focused strategic direction in a coordinated and clear manner. Other advantages are that it helps to promote a uniform corporate image and vision as well as helping to ensure a standard level of quality is maintained for an organisation's goods / services.

Decentralisation is not as it name suggests the complete opposite of centralisation. Rather it calls for some, but not a complete re-distribution of power and authority from top to middle management and operational staff. It calls for middle management and supervisors to be granted a limited amount of decision making authority.

The underlying rationale behind decentralisation is that it will enable an organisation to adapt to changes in the external environment much more rapidly. It will also empower the employees of the business thereby helping to create a more flexible and innovative organisation.

This leads to the question of which is the better system for which however there is no simple answer. Which of the two systems an organisation should adopt depends upon the particular set of circumstances and conditions it is operating under. For instance decentralisation is particularly beneficial when an organisation has to deal with a great deal of diversity such as a multinational corporation that has subsidiaries / business units in many different countries. However if there is a great deal of interdependence among business units, then a policy of centralisation will benefit the organisation more.

In addition when deciding between the two an organisation also needs to examine factors such as:

- the participation it wants from different levels of the organisation

- the way it wants information to flow across the organisation

Naturally the greater the participation from employees and / or flow of information an organisation would like, the greater the extent of decentralisation that will exist in the organisation. Decentralisation will also result in an organisation having a “flat” organisation structure. Flat organisations have relatively few managerial layers and numbers of managers. Consequently each manager then has a wide span of control and a much greater level of independence is given to each employee. Here, control refers to a mechanism to regulate the functioning of an organisation. Therefore, control is any practice, policy or procedure framed to provide considerable assurance that the organisation’s objectives and goals will be achieved.

1.3 Role of the corporate centre

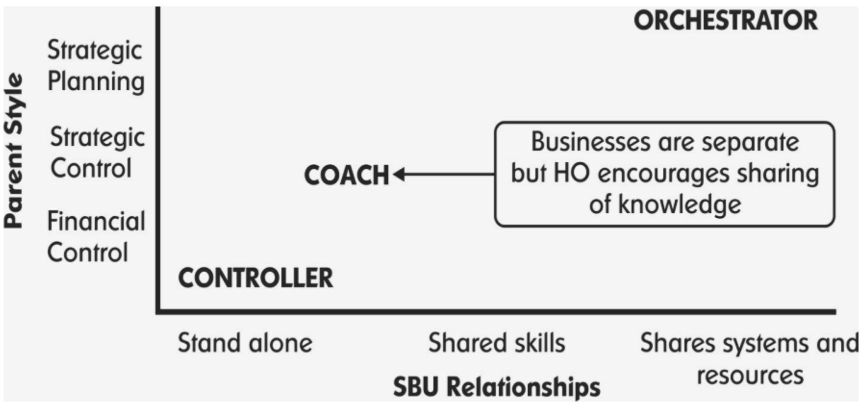
Goold and Campbell identify three generic strategies a corporate centre or head office can adopt in relation to dealing with its individual business units.

These three strategies are:

1. financial control
2. strategic planning
3. strategic control

This model can be explained with the help of a graph, as follows:

Diagram 6: Role of the corporate centre



1. Financial control

With this type of strategy, the corporate centre acts as a provider of finance or banker to the individual business units. Its involvement is typically limited to setting financial targets (e.g. achieving a ROCE of 8%) and monitoring the progress made by the business units in achieving these targets.

The business units are therefore granted a relatively high degree of autonomy as they are left free to formulate and implement strategies of their choice. The corporate centre will adopt a “management by exception” approach meaning that it will only intervene if a business unit is not meeting its targets. If the non-performance continues, the corporate centre may “pull the plug” by discontinuing funding and divesting the unit.

2. Strategic planning

With this type of strategy the corporate centre acts as a planner by setting an all-encompassing strategy for the entire organisation. This strategy is usually developed around a “theme” or strategic direction the corporate centre and all the business units are expected to follow. Here, business units are granted a relatively low degree of autonomy as the role each unit has to play in achieving the overall strategy is spelled out by the centre.

3. Strategic control

With this type of strategy the corporate centre acts as a shaper by setting both financial and strategic targets for the business units. However, coming up with the “nuts and bolts” of the strategy is then left up to each particular business unit. Business units are given a fair degree of latitude as long they achieve the predetermined financial targets and they do not deviate too far from the overall organisational strategy.

1.4 Span of control and scalar chain

1. Span of control

Definition

Span of control is a term used to denote the **number of employees** a manager has under his direct supervision.

A manager is a person who manages resources and people. She / he will be responsible for coordinating their employee's or subordinate's work and will also be responsible for the quality of their output. **The smaller the number of subordinates a manager has reporting to him, the narrower his span of control.** The span of control will widen as more employees come under the manager's direct supervision.

Diagram 7: Wide span of control

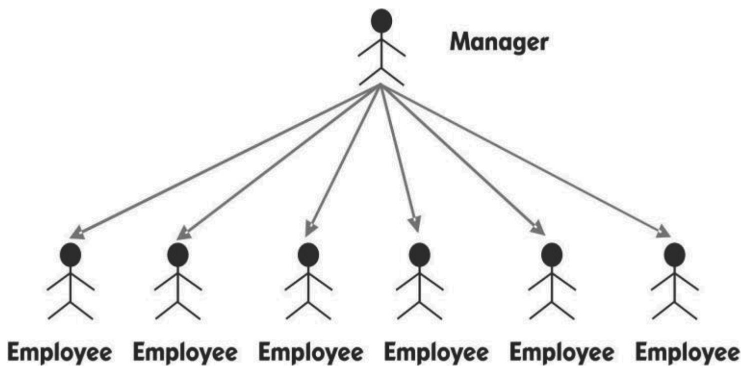
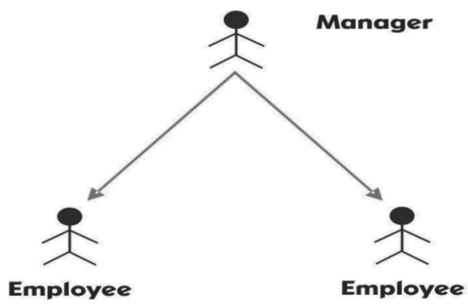


Diagram 8: Narrow span of control



There is no fixed rule as to just how many employees should fall under a manager's span of control. However factors that should be considered when trying to decide on an optimum number are:

(a) **Type of work** being done by subordinates. The more standardised and routine the work, the greater the number of subordinates a manager can supervise;

Example

A manager overseeing an assembly line can supervise a relatively high number of subordinates. This is because the work of each employee is of a relatively routine nature. Routine work is normally easier to monitor and typically requires less interaction with a supervisor.

(b) **Level of skill and experience of the manager and the employees.** The higher the skill and experience level, the wider the span of control can be. Skilled subordinates will require less supervision from a manager. In addition, the more skilful and/or experienced the manager, the more employees he can supervise.

Example

Steel1 is an organisation that manufactures steel bolts. They have two managers, John and Henry, responsible to oversee the manufacturing process. John has been with the company for twenty years and has worked at almost every job involved in the manufacturing process John and Henry, both have master degree in management, however Henry is a recent MBA graduate.

John, because of his experience and knowledge level, has a much greater number of employees under his span of control.

(c) Planning behind the organisation: an organisation with thorough and well laid out policies and procedures make it easier for managers to have a wider span of control (as employees have a clearer idea of their roles and responsibilities).

Example

Mike is a finance manager of a large public corporation. Jane is his counterpart in a much smaller organisation. One of the reasons why Mike has a wider span of control is because the roles and responsibilities of each of his subordinates are well documented in the company's work manual. Jane has to assign tasks to her subordinates on an ad-hoc basis and therefore needs to interact with them much more frequently.

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2. Scalar chain

Another type of hierarchical authority structure that organisations use is the scalar chain of command.

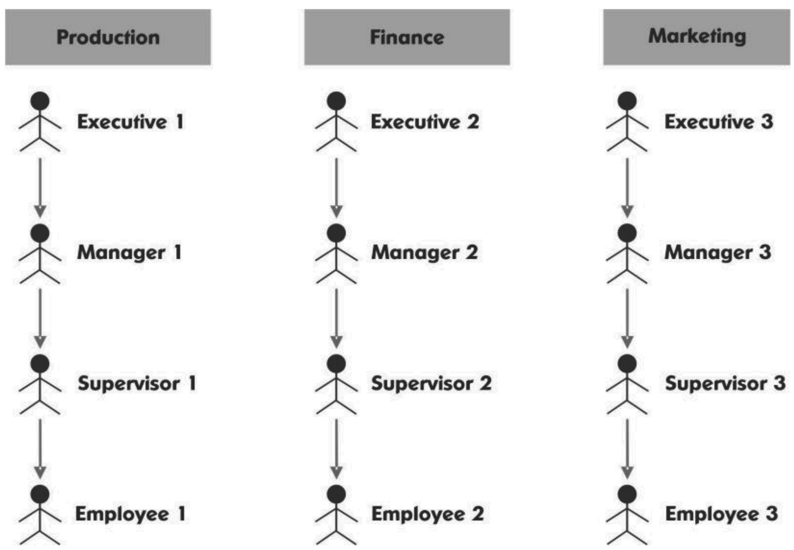
Definition

A scalar chain is an unbroken vertical line of command that begins with the top manager and flows down sequentially.

The rationale behind this model is that it will **allow authority and direction to flow clearly down (i.e. instructions from a boss to her subordinate)** from one level to the next.

Each link in the chain will comprise a manager / supervisor / employee and their peer group. In a scalar chain, a manager will only have authority over subordinates in her direct line of control (for example, Manager 1 will not be able to direct Employee 2 – refer to the following diagram).

Diagram 9: Scalar chain



Advantages

- It simplifies life for all employees, as **each person has only one boss.** This streamlines work requirements and routines as there is a clear **assignment of duties and responsibilities.**
- A scalar chain also **improves communication** between the different employee levels in an organisation leading to more **clear cut coordination** between management, supervisors and employees.

Disadvantages

- It results in a slow moving and rigid organisation.
- The time taken for information / suggestions to reach executives from employees is **too long** resulting in the organisation being slow to respond to environmental changes observed by their front line staff.

This is because front line staff will have to report their suggestion to their immediate supervisor. The supervisor will then forward the suggestion to management who, in turn, will forward it to the executives. Any changes or actions the executives want implemented will be communicated down in reverse order.

1.5 Tall and flat organisations

Organisations get labelled as being either “tall” or “flat” because of the **number of layers** they have that separate the lowest ranked employee from the highest. Generally, tall organisations have a much **larger number of managerial layers** but each manager has a relatively **narrow span of control**. Roles and responsibilities of all employees are typically very well defined in a tall organisation.

Example

A traditional large corporation such as HSBC is an example of a tall organisation. The organisation is very well segmented into different departments and clear guidelines are present detailing the roles and responsibilities of all employees.

Flat organisations have **fewer managerial layers** and numbers of managers. Consequently each manager then has a **wide span of control**. A much greater level of independence is given to each employee in a flat organisation.

Centralisation results in creating a “tall” organisation structure. Generally, tall organisations have a much larger number of managerial layers but each manager has a relatively narrow span of control. Employees have much less independence as their roles and responsibilities are typically very well defined.

Centralisation and a tall organisation structure therefore would suit an organisation that wishes to follow a strategy of offering a single or limited product / service mix and operates in a stable environment. Whereas decentralisation would be more appropriate for organisations that follow a strategy of offering multiple products / services and / or operate in dynamic and diverse markets.

1.6 Activities of an organisation

Activities refer to those tasks in an organisation that need to be performed in order to achieve the organisational goals and objectives. Similar organisational activities are grouped into departments. Thus, **in order to study the activities of an organisation, they need to be looked into in relation with the departments in an organisation.**

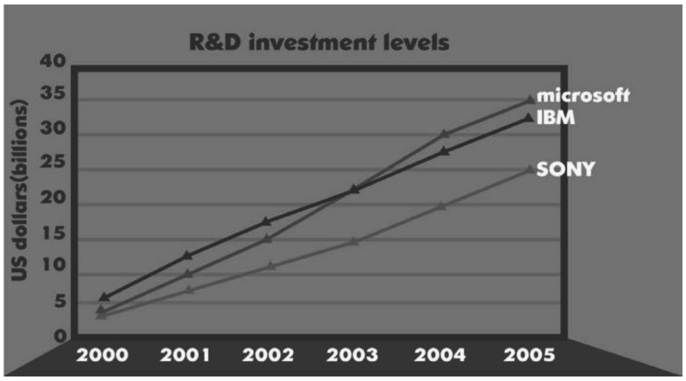
Almost all organisations will have some, if not all, of the following departments in their organisation structure: research and development; purchasing; production; direct service provision; marketing, administration and finance. Each of these departments performs a specific set of activities that contributes to the overall running of the organisation.

1. Research and development

Many believe that the long term prosperity of an organisation depends entirely on how well it can bring innovative new products / services to the market. This responsibility falls mainly on the research and development department. The department’s purpose is **to bring about significant improvement in the existing products, develop new and better products, processes or services and** create effective processes.

Example

During their analyst day on 27 July 2006 Microsoft released statistics showing how it had outspent its competitors on research and development.



Microsoft typically spends around USD 5 billion a year on research and development.

The organisation has research centres or departments in the USA (Redmond, San Francisco and Silicon Valley), the U.K. (Cambridge) and China (Beijing).

This heavy expenditure and focus arises out of Bill Gates' commitment to research and development or as he puts it "because of our optimism (over) what software can do in the decade ahead".

Normally, the research and development department performs the following functions:

- Research and development of new products
- Product maintenance and improvement
- Quality and regulatory observance

2. Purchasing

The purchasing department is responsible for procuring all the goods or services that an organisation needs to conduct its operations. The rationale behind having a dedicated department to perform this function (as opposed to each department handling its own respective purchasing) is the efficiency and cost savings to the organisation as a whole that can be gained.

Therefore the main responsibility given to a purchasing department is **to procure all the goods or services that the organisation will require in the quickest time and at the lowest price, without compromising on quality.**

Example

Swan Inc has set up a purchase department for effective purchases. Ken, purchase manager, has received a requisition note of 100 kg material from the stores department. On receiving requisition, Ken has checked the actual requirement. According to him, only 80 kg materials are required.

He calls for the quotations from different suppliers. From the quotations received, Ken had placed an order with the supplier who was ready to send the materials at cheapest price and in the quickest time. On receiving materials from the supplier, he has checked the quality and quantity of the procured materials.

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3. Production

This department produces the goods an organisation sells to its customers. It is the functional area that is responsible for turning inputs (raw materials) into outputs (finished products). The role of the production department is **to manage the production process** in order to ensure that the products are made **on time** and meet a certain minimum **standard of quality**. This department is also given the responsibility to continually improve the efficiency of the production process.

In recent times, the task of implementing quality control programs such as ISO 9000, Total Quality Management or Six Sigma has also been assigned to this department.

Example

One of the main reasons why Toyota has become one of the 10 largest companies in the world, is its strength in production. The Toyota Production System ("TPS") is both a framework and philosophy used by the company throughout its manufacturing facilities.

TPS is based on two fundamental premises:

'**jidoka**' (automation with a human touch), a system that allows any employee to halt production when a problem or defect is noticed and

'just in time' where inventory is produced in exact quantities and at the exact time when it is needed thereby eliminating waste and storage costs.

These philosophies and systems have enabled Toyota to consistently produce quality vehicles at relatively economic prices.

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4. Direct service provision

The direct service provision department is also commonly referred to as the client servicing department. Its function is to serve as a **single point contact** for an organisation's clients. This department becomes particularly beneficial for organisations whose clients have to deal with several of their departments. The direct service provision acts as an **intermediary between the client and the rest of the organisation.**

Example

An advertising company's client would need to interact with the following departments:

Creative department	to decide upon artwork / graphics for any upcoming advertisements
Copywriting department	to decide upon the text for any upcoming advertisements
Media department	to decide upon what publications the advertisements should appear in

To simplify life for their clients, most advertising companies have a client servicing department that will coordinate with these other departments on their behalf.

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5. Marketing

The marketing department serves as a **link between an organisation and its customers**. The main responsibilities for this department are twofold:

(a) to ascertain the current needs and demands of customers and
(b) to communicate to the market what the organisation's products and services are.

Example

Ronson Ltd is a mobile manufacturing company. Marketing department of Ronson Ltd has identified that customers are interested in handy and light weighted mobiles rather than heavy and large-framed mobiles.

Most organisations also give their marketing department the ability to work closely with the production and the research and development departments, to help ensure that the finished products are in line in with the current market tastes.

6. Administration

The administration department serves a purely **support function.** Its main purpose is to ensure that the overall **day to day functioning** of the organisation goes smoothly. It does this by ensuring that:

(a) All departments have the necessary infrastructure and resources they need;
(b) All buildings and equipment are well maintained and in good order;
(c) All employees are updated on organisational changes and new policies;
(d) Official company policies are observed (e.g. employees arriving on time) and
(e) All supporting paperwork of the organisation is up to date (e.g. requisition forms, time cards etc).

7. Finance

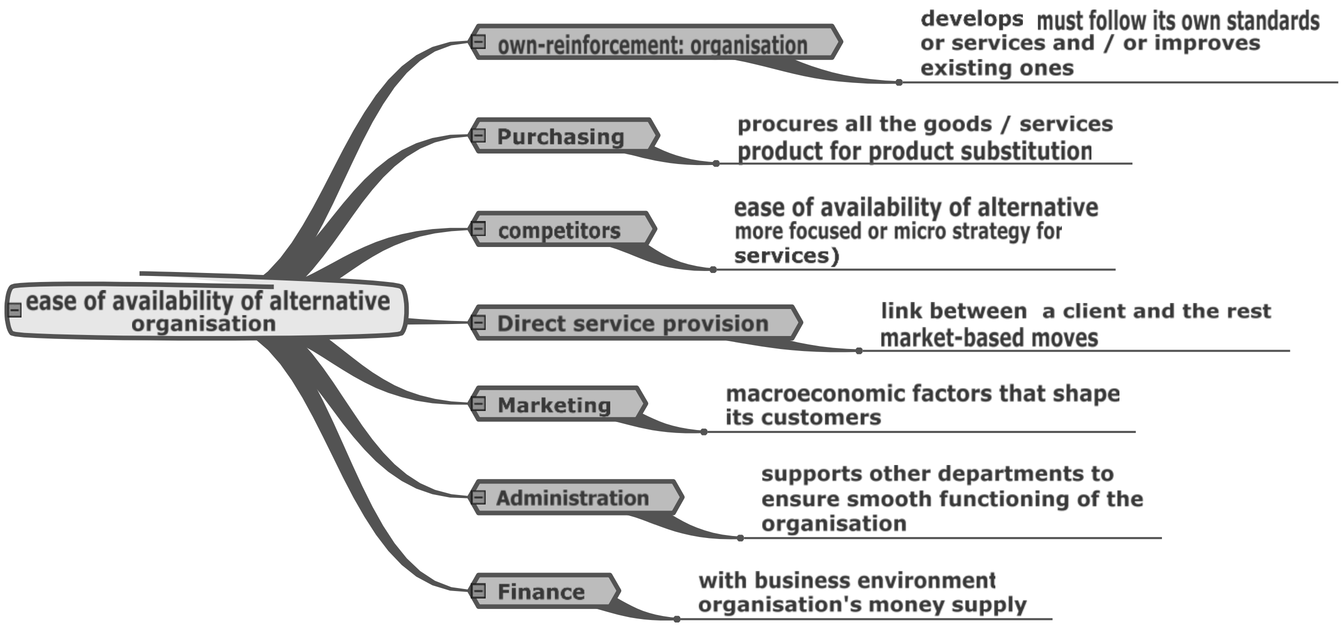
The finance department is involved with **controlling and managing an organisation's money supply.** This department has two main functions: **treasury and control.**

With treasury, the finance department is required to determine how the on-going operations, projects and/or acquisitions of the organisation are to be funded as well as how the surplus funds, if any, are to be invested. Control requires the department to implement and monitor a system of procedures to ensure that there is no misuse or embezzlement of company funds.

Example

Finance manager, Monty, is responsible to estimate financial requirements of business. For the purchase of fixed assets, he has decided to raise finance internally by issuing debentures.

SUMMARY



1.7 Mintzberg's organisational configurations

An organisation's structure determines which parts of the business will perform which activities / functions and how. Its processes represent the way employees are expected to carry out their necessary activities / functions to produce the targeted goods / services (processes have been discussed in Study Guide A1 of this Study Text). Finally its relationships define how employees work and interact with each other.

These three elements go into establishing an organisation's configuration. This configuration will then establish how the organisation operates through integrating the knowledge and activities present in the different parts of the business to effectuate its strategy. Naturally the more aligned an organisation's configuration is with its strategy the greater the probability that the strategy will succeed.

Mintzberg identifies six different types of generic configurations an organisation can adopt. Which configuration an organisation should adopt will depend upon factors such as it's:

- external environment
- type of industry
- culture
- targeted goods / services

1. Simple Configuration

Here the organisation has no formal structure and centres itself around one dominant individual (e.g. the CEO or owner of the organisation). The organisation's direction, activities and functions are all controlled and coordinated by this individual. Work behaviours and processes are all highly informal. This type of configuration is typically found in small entrepreneurial organisations.

2. Machine Configuration

Here the organisation's structure is based around its main functions / departments. Work behaviours and processes are highly formal as all work / activities are planned out in advance by top management. Decision making is very centralised resting only at the apex of the organisation. This type of configuration is usually found in organisations that produce a limited range of goods / service and/or operate in stable environments.

3. Professional Bureaucracy

This type of organisational configuration is suited to professional firms such as law offices or accounting practices which typically have two main groups of employees. The first group is the professional staff of the organisation and the second is the remaining employees who are there to support them in their work. Work processes and relationships rest on the professionals concentrating on their core competencies to meet the needs of their clients whilst the support staff provides them with the necessary assistance.

4. Divisionalised

Here the organisation structures itself around a series of divisions. Each division has its own "head" or general manager. Each division's head then reports to the CEO or overall head of the organisation who assigns them their respective strategic and financial targets. Decision making is relatively decentralised as each division is given the autonomy to decide how to achieve its set goals.

This type of configuration is most appropriate for large scale organisations that are diverse and offer multiple products / services (e.g. multinational corporations).

5. Adhocracy

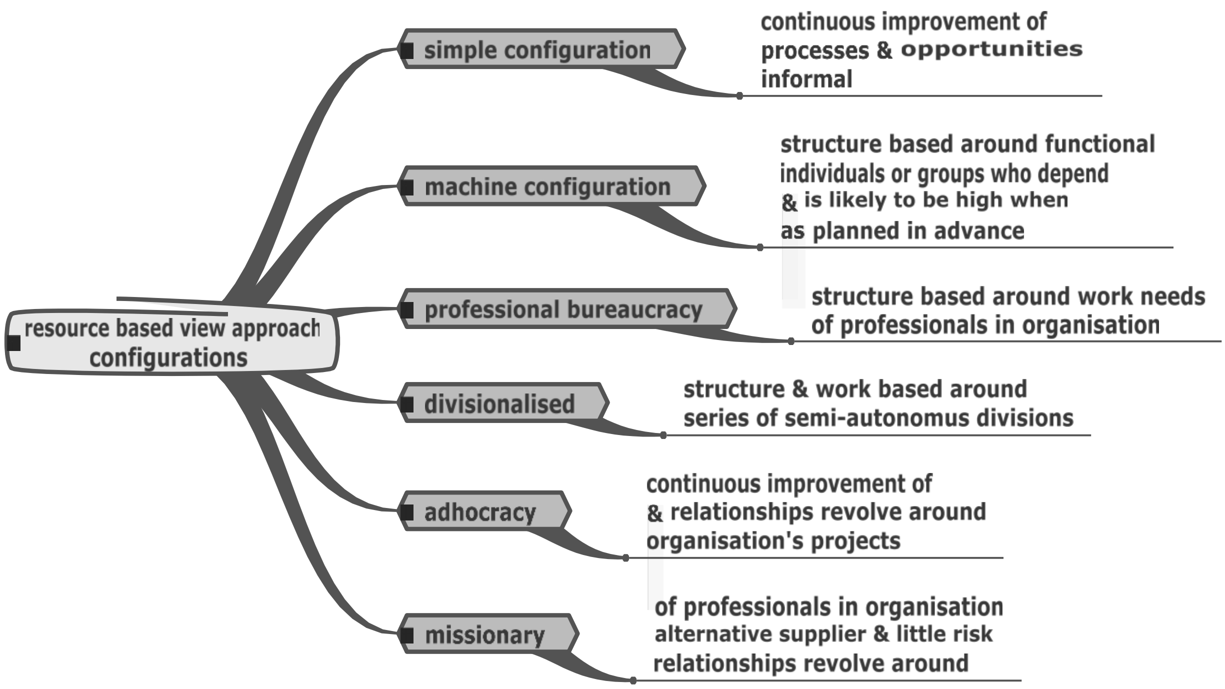
This type of configuration is most appropriate for organisations that operate in a climate of continual change and innovation. Work processes and relationships here revolve around all the projects the organisation has taken on board. Resources such as people and funds are assigned to one particular project for its duration and then subsequently re-assigned to another project. Consulting and software development firms are examples of organisations that typically adopt this type of configuration.

6. Missionary

This type of configuration is most suited to organisations that have a clear and distinctive purpose that all of its employees believe in. These types of organisations will then rely upon cultural processes rather than formal structures to conduct their work / activities. Employees work with a minimum amount of controls / supervision and rely on a system of networks to achieve the organisation's mission.

Charity and volunteer organisations typically adopt this type of configuration. According to Mintzberg, this is a difficult type of structure to maintain, since the external environment can dilute the ideology that forms the basis of the organisation. Perhaps this is the reason why these organisations are rare.

SUMMARY



Test Yourself 1

Addon is an organisation that manufactures industrial adhesive products. Every employee of Addon is a member of one of its four departments, which include finance, production, marketing and human resources. Each of these departments is headed by a manager who reports to the CEO of the organisation.

Required:

(a) Explain which type of organisational structure Addon has adopted.
(b) What are its advantages and disadvantages?

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3. Analyse the alternative appropriate functional strategies that may be appropriate to deliver a chosen strategy set out in a given scenario.

[Learning Outcome c]

Scenario

Bye Bye Bill Gate - June 2008 saw the living legend of Bill Gates consigned to the history books of Microsoft. He chose to retire to devote his life to more philanthropic causes through the Gates Foundation which already has assets of $40 billion. He will continue to be a non-executive and probably work 1 day a week there.

He had already given his role as Microsoft CEO to Steve Ballmer in 2000, when Gates chose to become chief software architect. Now his role will be split between 2 executives – Ray Ozzie (operational issues) and Craig Mundie (long term planning). The planning had been in the pipeline for a long time so it was expected to be a smooth transition.

The above scenario shows that large companies take succession planning very seriously. If Gates had left without clear successors, its share price could have plummeted and employees could have felt unsettled. Succession planning is a part of the human resource strategy of an organisation. In companies of all sizes, succession planning is important.

2.1 Strategic Management and Planning

Strategic management can be defined as “the art and science of formulating, implementing and evaluating cross-functional decisions that enable an organisation to achieve its objective.” The planning process identifies the goals or objectives to be achieved, formulates strategies to achieve them, arranges or creates the means required, and implements, directs, and monitors all steps in their proper sequence.

Strategic management involves streams of decisions and actions with a view to develop effective long term and short term plans and policies that would help the organisation to achieve its desired objectives. Strategic management includes vision and mission formulation, strategic analysis, strategy formulation, strategic choice, strategy implementation and control strategic decision for an organisation to deploy resources to new opportunities.

One sure-fire way to improve the profitability of an organisation is to dust off a timeless tool — the strategic plan. No one strategic model fits all organisations, but the planning process includes certain basic elements that all businesses can use to explore their vision, goals, and the next steps for an effective strategic plan.

Plans could be of two types, viz. long term plan and short term plan.

1. Long term planning

Long term planning is a systematic and formalised process for directing and controlling future operations towards desired objectives to be achieved over a period, normally beyond one year. This is also known as strategic or corporate planning. **The long term plans of an organisation are based on the corporate strategy with respect to key functions such as production, marketing, finance, research and development, human resource etc. and they cover projections with respect to revenues, expenses, capital expenditure, man power planning and other resources.**

Functional strategies evaluate the future implications associated with present decisions and help management in making present decisions and selecting the most optimum alternative. They are prepared keeping in mind the opportunities and core strength of an organisation, and also the risks associated with allocation and commitment of the resources.

2. Short term planning

Short term plans are prepared for a period ranging from one year to three years. Usually, the short term plan period will typically depend upon the production cycle, seasonal cycle, financing or working capital cycle etc. Short term plans or budgets are prepared with precision, based on the current business environment and are normally phased, on a monthly or quarterly basis.

An organisation consists of various functions, processes and activities. In order to accomplish the business objectives, effective planning processes should be in place. Management planning and control has been recognised as one of the most important approaches for ensuring effective performance of the management process.

The strategic planning process involves determining the answers to the following questions:

- Where are we now? This involves situational analysis of the environment in which an organisation is operating. The relative market position is determined by carrying out Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis.

- Where do we want to be? This is an important stage for formulating the strategy framework of an organisation. The corporate objectives, vision and mission statements are finalised. A strategic vision is the roadmap for the future of the organisation. It focuses on the customer, products and geographical markets to be pursued. The mission statement deals with the core purpose of existence of an organisation.

- How do we get there? This stage involves deciding various strategic alternatives to achieve the corporate goals.

- Which is the best fit? This stage involves deciding the best alternative. In this stage, the functional strategies are developed.

- How do we ensure that we reach there? This stage deals with continuous situational analysis, monitoring the performance, taking corrective action if necessary, and ensuring that the corporate objectives are achieved.

2.2 Budgets and budgetary control

A budget is a short term business plan expressed in monetary terms. Budgets are, however, different from forecasts. Forecasts relate to the predictions about the future state of business environment and are used for developing the budgets.

Definition

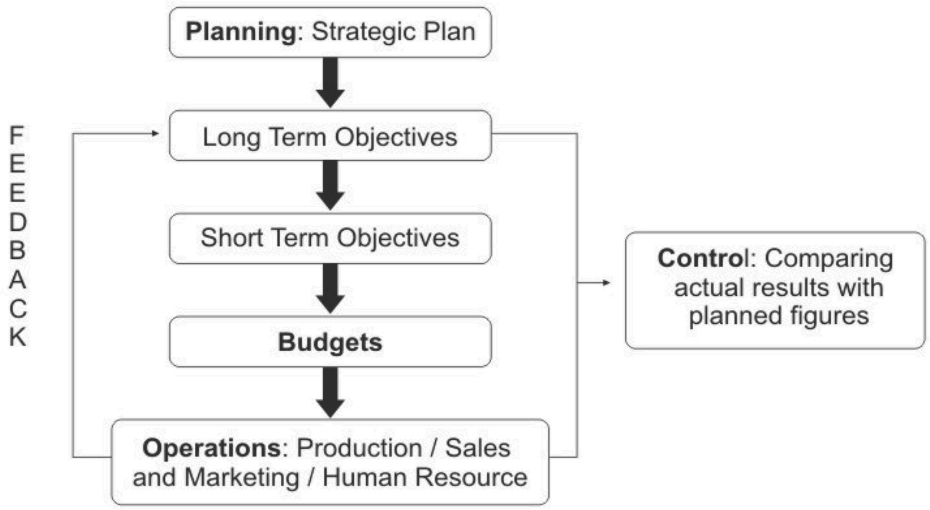
A financial and / or quantitative statement prepared and approved prior to a defined period of time, of the policy to be pursued during that period for the purpose of attaining the given objectives.

It may include revenue, costs and the employment of capital and other resources.

Budgeting is an integral part of the management function of planning, organising, motivating and controlling. One of the central tools used to carry out the management function is a budget.

The following diagram describes the interrelation between Strategic Plan and Budgeting:

Diagram 10: Interrelation between Strategic Plan and Budgeting



The above diagram shows the interrelationship between Budget and Planning, Operations and Control. Budgets usually evolve from the long term objectives of an organisation; they form the basis of operations and control is exercised through a process of comparison of budgeted values with the planned figures. This process not only provides feedback to the operations but also helps in setting budgets for the future.

All organisations attempt to use the available scarce resources to achieve their goals. To achieve long term goals (of usually five to ten years) it is necessary to develop long term strategic plans. These plans are concerned with broad objectives and goals. To achieve long term goals we need to develop short term strategies that are incorporated into annual budgets. These short term plans are more detailed and consider the means to attain the goals. The means by which these short term plans are converted into action is through the budgeting process. Short term plans tend to use more of quantitative data to estimate the future. This includes dollar values, sales quantities, production units, inventory levels, number of personnel, financial ratios etc.

Whether planning is done formally (by the use of budgets) or informally it does not in itself guarantee business success, as it needs to be monitored and adjusted. This function of monitoring and adjustment is called controlling. Keeping in mind that all plans (budgets) are best estimates of the future, management needs to monitor its progress at regular intervals. It needs feedback on achievements and shortfalls so that it can take remedial action. To facilitate this process of monitoring, yearly budgets are broken down into smaller chunks such as months or even weeks so that if remedial action needs to be taken it will not be too late.

The promptness and accuracy of feedback reports is essential to the whole process of controlling. The reports should compare actual results against the budget. These reports are known as variance reports. They require analysis to assess the progress of budget outcomes. Minor variances are usually ignored but significant variances must be investigated so that appropriate corrective action can be taken.

Budgets are prepared for all areas of the organisation, and all levels of management are responsible for their success. Managers at the lowest level must be given some basic information about their area of operations if they are to be held accountable for their department or unit. There is also an accompanying need to supply the manager with details of both actual performance and the criteria by which the budget performance was calculated. Where budgetary control systems are used, management reporting will be able to highlight those exceptions.

Budgeting is a method of communicating the goals of the organisation to the appropriate managers so that, with their involvement and participation, the desired budget outcomes are achieved. The level of support and participation depends on the management's approach to budgeting. Under the **'top-down' approach** (i.e. the traditional model) budgets are the targets and standards that are imposed by top management onto workers. The assumptions under the traditional model are that the employee cannot be relied upon to be self-motivated or innovative. While budget outcomes are only achieved by strict adherence to budgetary controls, the employee is likely to be lazy and wasteful and require constant supervision.

On the other end of the continuum, management adopts a **participative approach**. Under this approach management realises that individuals play the most important part in the budgetary process. It is recognised that workers typically have access to information concerning the operation of their areas of responsibility that is not available to their superiors.

By having their subordinates participating in budget setting, superiors have the opportunity to incorporate that information into budgets to enhance accuracy. This approach is typically known as the '**bottom-up' approach**. The bottom-up approach enhances employees' motivation and commitment to goals and targets. When subordinates are asked to participate in setting budgets, the goals of the organisation are internalised, that is they become the individual employee's goals.

1. Budgeting or Budgetary Process

Budgeting or budgetary process is the process of established short-term financial plans, designed to meet definite goals by making available adequate financial resources to match projected activities.

The process of preparation of budgets is called budgeting or budgetary process. Management planning and control means the development and acceptance of business objectives and goals and successfully directing the efforts towards achieving the desired results. The management system comprises activities such as planning, co-ordination and control.

2. Role of Budgetary Process

(a) Translating strategic plan into executable actions: a budget is a quantitative statement for a defined period of time, usually a year, (and broken down into manageable time periods such as a month or a quarter) which may include planned revenues, expenses, assets, liabilities and cash flows. At an organisational level, the budget aims at planning to achieve goals and objectives that emanate from the strategic plans. For example, if the strategic plan is to achieve market share of 10% over a three year period, the first year budget would be a step to achieve this strategic goal and it will provide for various actions in furtherance thereof. The functional budgets will be drawn to support this premise. For example, it will include planning for resources for marketing, production, customer service etc. which will help the organisation reach the desired targets.

(b) Tracking the actual performance vis-à-vis the budgeted targets: the budgeting process has an inbuilt component of comparing actual performance with the budget, followed by variance analysis. This forms the basis for performance measurement and paves the way for enterprise performance management. Organisations put in robust systems to drive this at various levels of management. The budgeting process is expected to provide alerts and signals for shortfalls in achievement of budgeted results, so that corrective action can be initiated in time.

(c) Control: the budgets provide a performance framework to the managers highlighting the resources they are authorised to acquire and use. Managers can exercise effective control by keeping the costs within the allowed budgets. The zero based budgeting model provides a sound basis to controlling.

(d) Motivating the team: as it lays down the targets to which the reward system is linked, the budgetary process keeps the managers motivated to work to achieve the set targets. The overall targets for the organisation are broken down division/department-wise to ensure no conflicts occur due to individual managers taking decisions.

3. Advantages of Budgetary Process

A budget is the principal document prepared and approved by management, with the following advantages:

(a) Budgets promote a forward-thinking attitude: a budget is a blue print of the desired plan of action or operation. Plans covering the entire organisation and all its functions such as purchase, production, sales, financial management, research and development etc. are expressed through budgets. Many a times, budgets help in early identification of the potential problems.

(b) **Budgets can be used for directing the efforts towards a unified goal**: budgets provide a means of co-ordination of the business as a whole. In the process of establishing budgets, various factors such as production capacity, sales possibilities and procurement of material, labour, etc. are balanced and co-ordinated so that all the activities proceed according to the objective.

(c) **Budgets act as a device for communicating management philosophy and plans**: the budget serves as a declaration of policies and also defines the objective for executives at all levels of management. Complex plans laid down by the top management are passed on to those who are responsible for putting them into action.

(d) **Budgets are used as a benchmark or target:** against which the actual performance is compared, monitored and controlled (system of control). Budgets facilitate centralised control with delegated authority and responsibility. Grouped according to the responsibilities of different executive levels, they facilitate decentralisation of work.

(e) **Budgets are used as a motivating tool:** for managers for achieving better performance. Budgets are instruments of managerial control by means of which management can measure performances in every part of the concern and take corrective action as soon as any deviations from the budgets come to light.

4. Limitations of the Budgetary Process

(a) Budgets can be perceived to be a tool for management to pressurise labour by imposing 'difficult to achieve' objectives / targets. In such a case, the budgets would prove to be non-motivating and would result in stressed relations with labour (in the case of top down approach).

(b) Non achievement of set goals or targets may result in inter departmental / inter functional conflicts and disputes.

(c) Budgets are to be aligned with the corporate goals and strategic objectives. Many a times individual objectives assume top priorities and strategic alignment with corporate objectives may be difficult to achieve.

(d) The budgeting process may be dominated by the influential people in the organisation. This may result in unrealistic estimation of revenue or expenses.

(e) Budgets cannot deal with sudden changes in the economic environment.

(f) The budgeting process is quite time consuming.

(g) Budgets are usually based on traditional business functions and use past data; hence they do not go beyond certain boundaries.

(h) Budgets are used for controlling the costs rather than reducing them.

Some European companies have decided to abandon the use of the budget on account of centralisation, inflexible planning, command and control. The '**beyond budgeting**' movement advocates that budgeting should be replaced with rolling forecasts that embrace key performance indicators (KPI) and incorporate exception based monitoring and benchmarking. However, budgeting still is widely practised despite the criticisms.

The Behavioural Dimension of Budgeting

One of the key objectives of management accounting is to influence the behaviour of the employees in order to maximise their efficiency and attain the corporate goals. It is absolutely necessary that the organisational goals are congruent with the aspiration levels of individual managers. This is usually achieved by responsibility accounting. Responsibility accounting is a system of accounting whereby managers are made responsible for items of costs and revenues so that their performance can be assessed and evaluated. Responsibility must be matched with control, otherwise managers will be de-motivated. Controls are determined by the level of authority of the manager i.e. his power to influence the costs and revenues.

The success of a budgetary system depends on how seriously human factors are considered. Budgets are often used to judge the actual performance of managers. Bonuses, salary increases, incentives and promotions are all affected by a manager's ability to achieve or exceed budgeted goals. Since a manager's financial status and career can be affected, favourably or unfavourably, budgets can have a significant behavioural effect.

Whether that effect is positive or negative depends to a large extent on how budgets are used. Positive behaviour occurs when the goals of individual managers are aligned with the strategic objectives of the organisation and the manager is motivated to drive, stretch and excel to reach there. The alignment of managerial and organisational goals is known as goal congruence.

If the budget is improperly communicated or administered, the reaction of managers may be negative. This negative behaviour can be manifested in numerous ways, but certainly it will result in subversion of the organisation's goals. For example, a manager who deliberately underestimates sales and overestimates costs for the purpose of making the budget easier to achieve, is engaging in unethical behaviour. It is the responsibility of the organisation to create budgetary incentives that do not encourage unethical behaviour.

To discourage dysfunctional behaviour, organisations should avoid overemphasising budgets as a control mechanism. Other areas of performance should be evaluated in addition to budget adherence.

Budgets can be improved as **performance measures**:

- by the use of participative budgeting and other non-monetary incentives;
- by providing frequent feedback on performance;
- by the use of flexible budgeting;
- by ensuring that the budgetary objectives reflect reality; and
- by holding managers accountable for only controllable costs.

2.3 Human resource planning

Human resource planning is carried out in order to ensure that the organisation has the right quantity and quality of human resource (staff) doing the right things in the right place at the right time. Strategic changes always have a significant impact on the people within the organisation, so these changes need to be anticipated whenever possible.

A strategic human resource (HR) plan refers to a planned pattern of deciding how individuals working in an organisation need to be organised, staffed, trained, directed and appraised with a view to achieve the organisational goals.

The objectives of a strategic HR plan of an organisation include:

- achieving the overall corporate goals
- ensuring that the organisation is staffed in the most desired manner
- ensuring that the workforce is engaged in productive activities and are adding value to the goods and services being produced / delivered
- ensuring commitment of workforce in contributing to the achievement of corporate objectives

The strategic HR plan should ensure that the projected demand for human resources of an organisation is appropriately met in the right quantity and quality and on time. Following are some of the component plans of the HR strategy of an organisation:

1. **Recruitment and selection plan:** outlines the sources of potential candidates for job interviews and the process in which the candidates would be actually chosen to work for the organisation.

2. **Training and development plan:** outlines how employees' skill gaps in various areas would be filled with an objective to enhance their productivity.

3. **Employee retention plan:** high rate of employee turnover is a sign of bad management and also proves to be very costly for an organisation. This plan aims at devising ways of retaining valuable human resource of a company.

4. **Redundancy plan:** during difficult business times, an organisation may need to make some of its employees redundant. A redundancy plan would help a firm to plan the timing of such an activity and also be prepared for the costs that may arise due to redundancy.

Human resource development

Human resource development relates to the continuous development of the organisation's staff, its management and its directors. Human resources are an intangible asset to the company. Like any other asset, human resources need to be maintained. It is essential, particularly in today's ever-changing markets, for an organisation to keep the knowledge and skills of its human resources up to date. Below are some of the requirements that relate to human resource development within organisations.

Successful human resource development needs the support of the organisation's leaders and senior managers and a culture that reinforces the management of human resources.

Workers' readiness to learn and change is preferable. Human resource development can be improved by encouraging employees to teach themselves new skills.

Adoption of embedded learning in the work place as an on-going practice.

Line manager's involvement in the development of subordinates, to the extent that it is hard to differentiate between learning and working.

Informal learning and appreciation of its value by the line managers.

Alignment of strategy, culture and commitment.

Environments outside of the organisation, such as technology advancement and market change, may signal a need for human resource development.

A culture that nurtures employees by giving them the training to become leaders.

The senior manager's ability and contribution puts the human resources managements' policies and plans into action.

Continuous learning creates a flow of knowledge and such interactions can lead to emergent, deliberate strategies.

Human resource development must reconcile emergent learning with deliberate control i.e. there should be control on the time employees spend on learning and working.

Succession Planning

Succession planning deals with managing the loss of key persons / managers in the organisation and the identification and development of individuals to fill future vacancies.

As part of this risk management process, a continuous search for potential key players or managers must be undertaken by the human resources management.

Addressing the development needs of new recruits to prepare them for such roles is known as succession planning. This is the responsibility of the human resources management department.

Organisations must find skilled, external workers who can be used for their expertise. Otherwise, skilled workers can be identified early in their career and prepared to take on certain positions through mentoring and providing them with training and new experiences through job rotation.

The management could benefit from such employees' specialised knowledge of the business. Taking out insurance for the loss of a key person is also becoming common. Funds can be used to cope with the problems raised by the loss of a key person.

Succession planning involves a periodic review of those who are in the next lower level to identify backups for senior positions.

Succession planning takes into consideration the course of action that will bring the least possible disruption to the work of the organisation and maintain the effectiveness of its administration.

Relationship of human resource development and succession planning to the strategy of the organisation:

1. McGoldrick and Stewart explain the linking of strategy, culture and the commitment of employees by using the idea of transformational leadership. The idea of transformational leadership consists of four components, namely:

(a) Charisma

(b) inspiration

(c) individualised consideration

(d) intellectual stimulation

Such leadership is capable of aligning an organisation's strategy, culture and the commitment of its employees.

2. Minzberg's design school model of strategic work provides the following features which can lead to the introduction of learning opportunities for employees:

(a) Assessment of internal and external situations gives the organisation an idea of the future trends of markets and an awareness of where it currently stands.

(b) Identifying the threats and opportunities that an organisation can explore, such as e-business, this might require employees to learn new skills.

(c) Identifying strengths and weaknesses: this self-assessment allows employees to learn about and improve upon their weaknesses.

(d) Declaration of intent, values and visions of the strategy makers.

Succession planning ensures an uninterrupted journey for an organisation on its strategy path.

2.4 Marketing plan

A strategic marketing plan refers to the process of creating and implementing strategies for marketing which determine long term goals and positioning activities which an organisation's marketing division should adopt and perform in order to achieve the corporate objectives.

Various components of the strategic marketing plan have been discussed in Study Guide A2 of this Study Text.

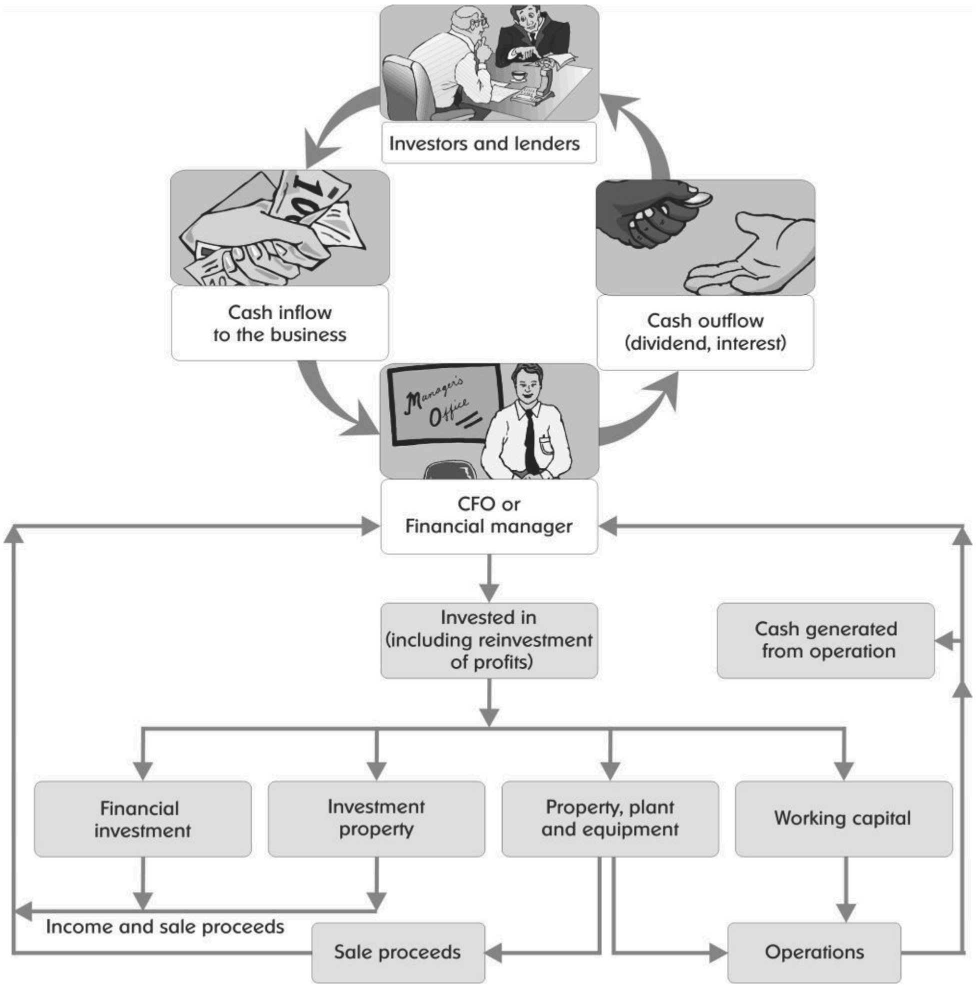
2.5 Planning for finance

Finance is one of the branches of economics, and it deals with the **management of money and other assets**. Finance is related to determining value or decision-making. It also deals with matters related to money and the market.

The finance branch of an organisation distributes the resources required for purchasing goods or services, and for investing or managing activities in an organisation. Finance is one of the most important activities in an organisation because the **funding requirements** of other departments are met by the finance department. Moreover, if adequate financial planning is not undertaken, the organisation cannot function smoothly.

Flow of finance in a business

Diagram 11: Flow of Finance



As shown in the diagram above, there are different directions funds will flow in a business. The Financial Manager or Chief Financial Officer (CFO) has to make and implement decisions at different stages while managing the flow.

The functions of the financial manger may relate to:
- investment
- financing
- dividend policy
- working capital

Example

Market research carried out recently by a company which manufactures and sells digital cameras has revealed a scope to sell an additional 500,000 cameras per year. However, since the factory is currently operating at full capacity, increasing production would only be possible if the company were to invest in an additional production line. Alternatively, the company could buy cameras from another manufacturer at wholesale prices, and then sell them in their stores. When the financial manager was asked to comment, his views were as follows:

Financial Manager: "Before a decision is made, the financial viability of each proposal must be evaluated; one would have to look at the relevant cash flows and weigh up the cash inflows and outflows. If both proposals are deemed to be financially viable, the proposal that would bring the company the most gain will be accepted; after all, our aim is to maximise our shareholders' return." "The next issue would be funding. We must consider the total amount of funding required, and the sources of funds available to the firm: are we going to use reserves, issue shares, issue debentures or use loan finance? Of course the choice will depend on what is available to us, the costs associated with each option and our gearing level among other things."

Continued on the next page

"The working capital needs of the project must also be identified. We will have to decide on the levels of stocks, debtors etc. and how they are going to be financed."

Note: the financial manager has touched on three decisions: investment, funding and working capital. Once funds are raised for the project the financial manager must ensure that they are used appropriately. Once the project begins to yield returns a dividend decision will have to be made i.e. should these be distributed to shareholders or re-invested in the business.

The finance strategy of an organisation should incorporate the following decisions:

1. Investment decisions

A company invests in order to maintain or improve its profit-earning capacity. Investment decisions usually relate to the acquisition of fixed or non-current assets (capital investments) e.g.:

new equipment
automated or more advanced production technology
land and buildings
business units

Investments must be evaluated for financial viability before being selected or rejected. Factors to consider would include the relevant cash inflows and outflows associated with each project, the projects' risks and returns and the company's cost of capital.

It might be that more than one investment proposal is financially acceptable. In such a case the financial manager would have to consider the capital budget i.e. the amount of funds available to spend on capital investments. If sufficient funds are available, it might be possible to take advantage of all financially viable projects, however, this is not usually the case and the financial manager may have to engage in capital rationing.

2. Financing Decisions

The organisation could obtain the required finance either from public or private parties. Below is the list of sources from which the organisation could raise the finance.

(a) Equity sources of finance

(i) Venture capital

Venture capitalists (VCs) provide finance to small and medium-sized businesses that do not have access to stock markets. VCs tend to invest in new businesses and specific expansion schemes. They tend to be attracted to businesses that will eventually be listed on the stock exchange, both because businesses of this size will generate the largest profits and because this also gives them an exit route in the future. VCs will only invest in businesses with good growth potential and will expect the owners and managers to have the drive and ambition to achieve this growth. The investment made in a business may take the form of share capital and/or loan capital and will normally be for a reasonably long period (five years or more).

Venture capitalists provide equity and loan finance for different types of business situations including:

start-up capital for new business ventures.
growth capital to help expanding businesses to fund growth plans.
share purchase capital to help finance the acquisition of an existing ownership interest.
refinancing bank debt to help a business reduce the burden of gearing.

(ii) Equity capital

Raising finance through equity share capital is one of the ways of raising finance. Venture capital, leverage buyouts and growth capital are types of private equity. Finance can be raised by issuing equity to the public. Higher levels of security and governance are attached to the public issues of equity. The company's ordinary shareholders represent ownership restricted to the percentage they own.

Leverage buy-outs: is one of the ways of obtaining equity finance. This type of finance is sought only as a last resort as, along with obtaining the finance, the company has to transfer the business assets or the company itself to the lender along with its financial control.

Growth capital: this is also one way of obtaining private finance. Here the financer gets a minority share in the equity of the company. There is no change of control as is the case in leverage buy-outs.

Advantages of raising capital through issuing equity share capital

(i) As the finance is raised by giving equity rights, the company does not have to return the money raised nor is it under any obligation to pay interest. The company needs to pay the dividend but only if it earns sufficient profits.

(ii) New shareholders may bring extra skills which the company could use.

Disadvantages of raising capital through issuing equity share capital

(iii) Once becoming publicly limited, companies must follow the regulations regarding the issue of information to the general public. Some companies might view it as a way of reducing the company's competitive advantage and may not like it.

(iv) As this option gives a percentage ownership and voting rights to shareholders i.e. it offers a share in the company's profits and results in dilution of control, a company might prefer the alternative of obtaining finance through bank loans.

(b) Preference share capital

The company could raise funds through preference share capital. This resource is similar to raising share capital through equity issue except that the dividend payable requirements are different. Preference shareholders have preference over equity shareholders (but after debt holders) for the receipt of dividend.

(c) Debt sources

(i) Issue of debentures or bonds (loan stock)

The company might take loans by issuing loan stock. These stocks also possess some nominal value such as equity shares. Some interest rates are always affixed to it such as 12% bonds i.e. company will pay 12% per annum on the stated face value of the bonds.

- Bonds may be redeemable in that case they are repaid to the lenders with interest.
- There could be irredeemable bonds which form the long-term liability with the stated amount of interest payable on these bonds.
- There might be convertible bonds which will be converted to equity shares on their maturity.
- Although the face value of these bonds remains the same, their market value may vary.
- The entity and the bond holder may agree on the interest moratorium issues in the early years of the bond's tenure.
- Most of the time bonds / debentures are backed by the sinking funds in which the entity has to set aside some funds each year to reduce the financial impact on maturity.
- An issue of bonds may include a guarantee in terms of charges over the assets.

Advantages

- The cost of debt capital represented by debentures is much lower than the cost of preference or equity capital.
- Debenture financing does not result in dilution of control since debenture holders are not entitled to vote.
- The call provision found in many debenture issues provides flexibility in changing the capital structure.
- In a period of rising prices, debenture issue is advantageous. The burden of servicing debentures, which entails a fixed monetary commitment for repayment of interest and principal, decreases in real terms as the price level increases.

Disadvantages

- Debenture interest and capital repayments are obligatory payments. Failure to meet these payments jeopardises the solvency of the company.
- Various provisions are associated with a debenture issue in order to protect the interests of debenture holders. Some of these provisions are registration of charges, maintaing debenture holders registers and adherence to the provisions of the company's Articles and Memorandum. The protective covenants associated with a debenture issue may prove restrictive.

This is considered a source of finance as public finance is raised without issuing ownership rights.

(d) Bank loans

Companies could approach the bank to meet their finance needs. Companies prefer to take bank loans in the following situations:

(i) When they want to borrow any non-current assets. These loans are known as term loans.

(ii) When a company needs to finance its working capital to carry out day to day operations. Such loans can be taken through an overdraft facility.

(e) Term loan

A 'term loan' is taken by a company from a bank in order to purchase non-current assets. The company repays the loan in agreed instalments with interest fixed at the time of issue.

(i) Care should be taken with respect to the term of the loan. The term should not be more than the useful life of the asset purchased as repayments are generally made from the cash inflows generated from using the asset.

(ii) There is a longer payback time than other forms of loan.

(iii) As cash inflow and outflow are easily measured, cash planning i.e. budgeting is easy.

(f) Bank overdraft

Borrowing through a bank overdraft is a method of short-term borrowing. Companies in need of money for a short period of time and who are expecting cash inflow at various points of time, especially within a short period, often opt for a bank overdraft.

(i) In a bank overdraft, a limit is sanctioned by the bank and a borrower is able to withdraw money up to that limit and deposit the cash inflow and take benefit of the interest.

(ii) A bank overdraft is one of the ways to finance the business' working capital needs. It comes under current liabilities or is shown as a negative figure in the current assets section on the SOFP, which is an advantage as there is no long-term obligation on the SOFP.

(iii) The disadvantages associated with overdrafts are that overdrafts can be recalled at anytime and bear high interest rates.

The process of taking a bank loan has the following advantages over the process of raising finance through the public issue of bonds:

Banks ask for collateral when giving a loan, which is not case with the issue of bonds or debentures. Although there could be bonds guaranteed by the collateral.

Bank terms can be altered more easily than the terms of the issue of bonds.

Following a bank's monitoring is easier than following the security board's norms for public raising of debt.

It is a cheap and fast way of raising finance.

(g) Retaining business profits

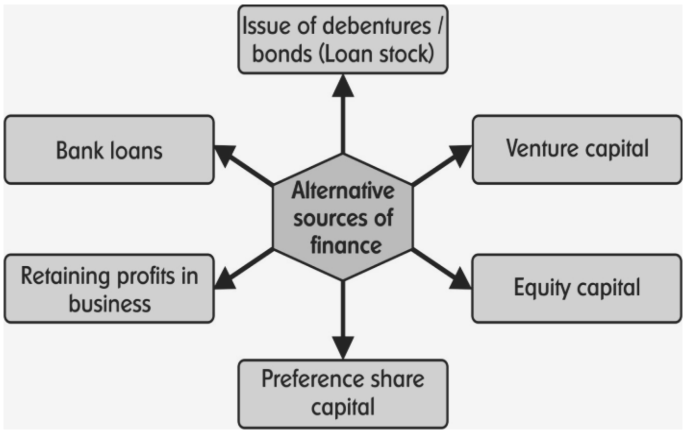
Funding can be obtained by retaining the accumulated profits from the business.

It could be described as self-financing. Although this has disadvantages in terms of the company's inability to declare sufficient dividends to meet shareholders' expectations as the company has diverted funds to other investments.

Shareholders are not motivated to invest in a particular company if they do not get the expected returns.

This might dilute the company's ability to raise future funding through the issue of equity.

Diagram 12: Alternative sources of raising finance



3. Dividend decisions

When shareholders invest in companies they undertake the risk of the success or failure of the business, and thus usually require a return commensurate with the level of risk. Their return can take two forms: dividends and/or capital gains (where the share price increases).

Funds generated from operations can either be retained in the business for re-investment or distributed to the shareholders as dividends. The proportion of dividends to net profits is called the **dividend payout ratio,** and it is the financial manager who will advise the board on an acceptable ratio.

The decision considers:

the required rate of return to the shareholders and
the future investment policy of the company.

4. Working capital management

From your previous studies you would recall that working capital is equal to current assets (stocks, debtors and cash) net of current liabilities; in effect, it is equal to the amount of current assets funded through long term finance.

The financial manager must decide on the following:

the optimal level of working capital
the form the working capital should take
how the working capital should be funded

The financial manager has to strike a balance between the conflicting objectives of profitability and liquidity when managing working capital. The company needs to keep sufficient current assets to ensure liquidity i.e. the company's ability to pay off debts as and when they fall due. However, having too high a level of cash tied up in idle assets incurs an opportunity cost of lost investment opportunities.

Example

On 1 January 20X3 a business had a trade creditor of Tshs 50,000,000 payable on 1 March 20X3 and had a policy of holding cash equal to short term debts. Thus its cash balance on 1 January 20X3 was Tshs 50,000,000. By 1 March 20X3 the company's trade creditors increased to Tshs 70,000,000, and so too its cash balance.

1. Will the company be able to pay off the debt on the first of March?

Yes. It has sufficient cash to cover all its debts.

2. Would this policy ensure profitability?

No. Cash on hand earns no interest; cash in a current account earns minimal interest. The sum of Tshs 50,000,000 would have been idle for two months i.e. January to March. The company would have been better off if it had invested the money for two months and liquidated the investment when the payment was due. This would have ensured maximum return on the money for the two month period.

5. Managing for value

Managing for value is one of the elements of **value based management**. Value based management refers to the management approach which ensures that the organisation is structured and managed on the basis of **shareholder's value**.

The elements of value based management are:

creating value
managing for value
measuring value

Any strategy which creates value for its stakeholders is considered successful. One of the major stakeholders of any organisation is its shareholders. The value is created for shareholders by ensuring large **returns** to them. The returns to the shareholders are in the form of timely dividends. Managing for value is one of the key elements of a manager's task in an organisation for the success of a strategy. Managing for value relates to **maximising the long-term cash generating capacity** of an organisation.

The financial plan of an organisation should ensure that shareholders' value is maximised.

Here, 'long-term cash generating capacity' refers to the ability of an organisation to earn increased funds for use in the future. In an organisation, value creation is essential because an organisation has to maintain its status in a developing market; it also has to gain competitive advantages over other market players. The organisation has to add certain value to its business to sustain itself in the market.

There are various factors of value creation in an organisation, such as operations, financing and investments:

(a) Funds generated from the operations

Operations refer to the functioning of the organisation. There are two aspects to operations: **revenue and cost**. Revenue leads to increased shareholder value and costs lead to a reduction in shareholder value. Funds are generated from sales revenue, which depends on the volume of sales and the selling price. Operational costs include various costs such as production, selling and distribution costs, administration costs, overheads or other indirect costs.

(b) Financing

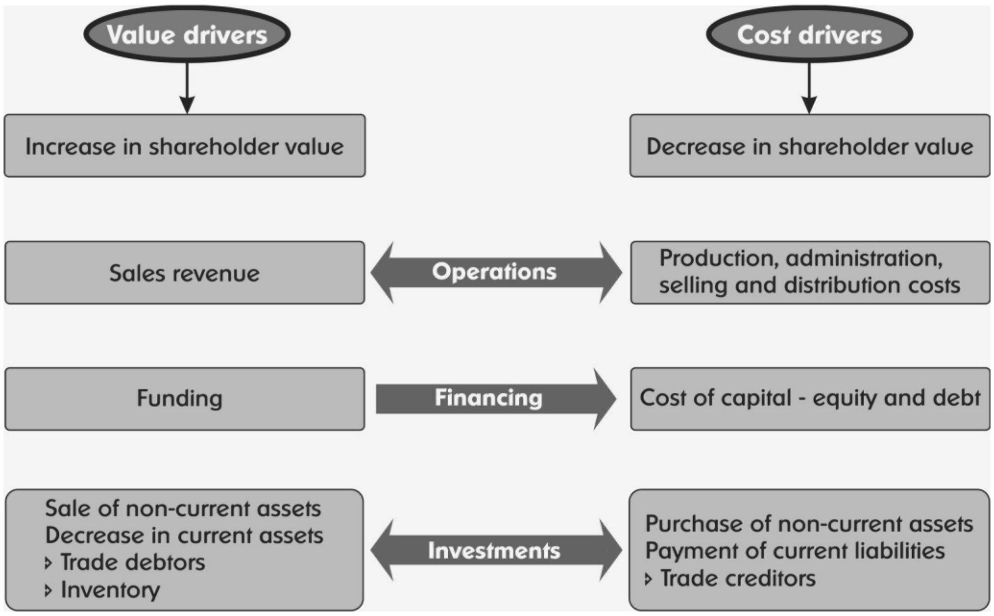
Financing costs is the cost of capital. Cost of capital is composed of two main elements: equity and debt. In case of external loans, the organisation must pay interest, which would lead to a reduction in funds and ultimately a reduction in shareholder value.

(c) Investments

Organisations block their funds in assets. If the investment leads to a generation of funds, it creates value for the shareholder. On the other hand, if the investment is such that it reduces funds, then it leads to reduction in the value creation for the shareholder.

The increase and reduction in shareholder value can also be termed **value drivers** (increase) or **cost drivers** (reduction). These drivers are the main source of value creation for an organisation. These drivers are presented diagrammatically below:

Diagram 13: Value and cost drivers



6. Financial expectations of stakeholders

Management has to develop and sustain stakeholder relationships while it tries to meet its objectives of maximising shareholder wealth. This can, however, be difficult in the event of **conflicting objectives** among stakeholder groups. Consensus theory recognises that each organisation represents a coalition of shareholders, directors, employees, customers etc. each having different and sometimes opposing goals.

Since it is difficult to meet the objectives of each group completely, political compromise results from each party settling for less than their ideal. In this case, shareholder wealth is not maximised, other stakeholder groups will also settle for less. The financial expectations of different stakeholders will vary according to their circumstances. The expectations are:

(a) Suppliers and employees

These stakeholders expect **timely payment** from the organisation. The suppliers expect the organisation to **pay their dues within the credit limit** granted to the organisation. They will often also want to maximise their payments. The employees expect the organisation to pay their **salary / wages on time**. They should expect **incentives** for good work. These incentives can be financial in nature, e.g. bonuses, commissions, etc., or non-financial, e.g. promotions, job enrichment, autonomy, good working conditions, etc.

(b) Bankers

Banks are interested in the organisation's ability to **repay the loan along with the interest**. Banks may consider the organisation's **capital gearing** ratio because it provides the relationship between the debt and equity in an organisation. Moreover, the **interest cover** ratio also indicates the capacity of the organisation to pay interest.

(c) Shareholders

They expect the organisational strategy to be such that it gives them **regular dividends** and that the organisation has **sufficient funds for its long-term commitments**. If the organisation intends to reorganise its business through mergers or acquisitions, the strategy adopted or to be adopted by the organisation should safeguard the interests of the shareholders. The shareholders of the organisation also desire capital growth in their shareholdings. Shareholders' expectations have been discussed under "Managing for value" in an earlier part of this Learning Outcome.

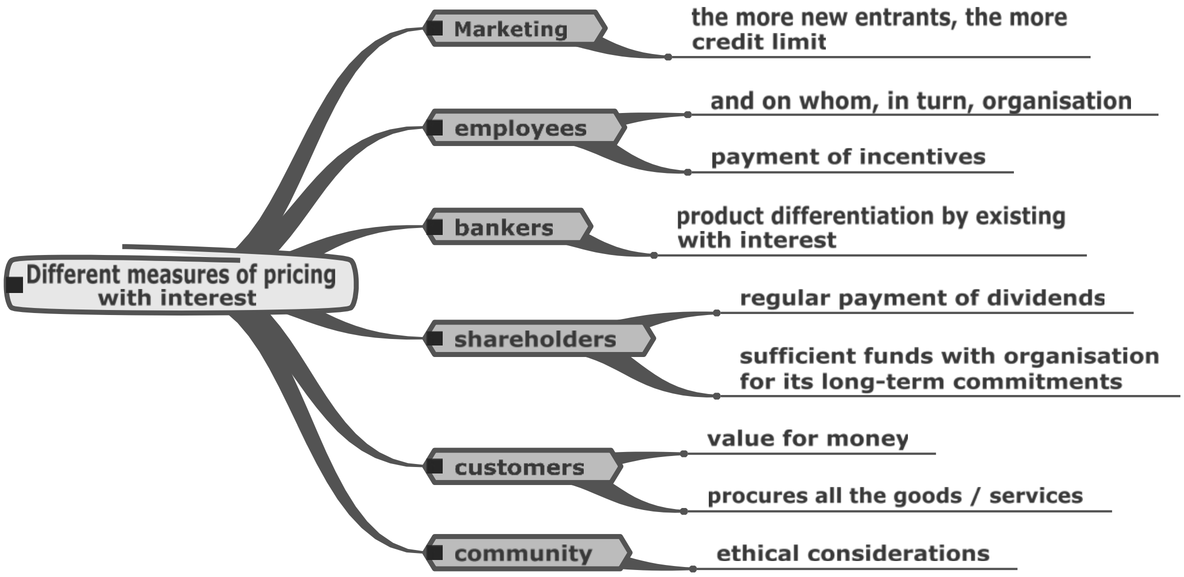
(d) Customers

Customers expect the organisation to provide **value for the money** they pay. They also expect **high quality goods and services** if there is extensive competition among market players, which means that customers have the option of selecting the seller who satisfies their demands.

(e) Community

The organisation's strategy should be capable of providing employment for the community; concern should be given to controlling pollution and other potentially harmful effects on the environment; it should also take care of **ethical considerations** in the community such as abiding by the law and order of society. While implementing strategies, management should pay attention to the financial effects of the strategy on all stakeholders. The financial plan of an organisation should ensure that all stakeholders of the organisation are satisfied.

SUMMARY



2.6 Research and development (R&D) planning

In order to prevent its products and processes from becoming obsolete, technologically and economically, an organisation needs to have a concrete R&D plan in place.

The objectives of a strategic R&D plan of an organisation include:

- ensuring process / product differentiation through innovation
- ensuring the implementation of the strategies of market penetration and market development through product innovation and development
- preventing / delaying product obsolescence
- ensuring achievement of corporate objectives

Categories of research:

- Basic research: refers to research aimed at only enhancing the technical know-how, without any commercial gain as objective.
- Applied research: refers to research aimed at enhancing the technical know-how, and also achieving commercial gains.
- Development: refers to utilising the existing technical know-how of the organisation in order to develop a new (or improved) product before starting the actual production and sale for commercial purposes.

A strategic R&D plan encompasses all the above three categories of research.

Strategic importance of R&D planning:

The strategic importance of the R&D plan can be understood with reference to the following:

1. **Supporting and defending existing business:** the R&D plan supports a business by helping it to modify features of its existing products in order to increase its share in the existing market or making the product acceptable to new customers. This may involve using improved raw materials or processes for production, enhanced environmental standards, etc.

2. **Driving new business:** the R&D plan helps a firm to enter into new business areas by using the existing (or new) technical – know – how. Such a business area may be new to the firm or new to the entire market.

3. **Broadening and enhancing technological capabilities:** a good, futuristic R&D plan enables an organisation to broaden the horizons of its technological capabilities. Such enhanced capabilities can be used either to improve existing products or to launch new ones.

4. **R&D plan and product life cycle:** R&D plans play varied roles in the various phases of the life of a product.

(a) Introduction stage: at this phase, the R&D plan aims to help the company to produce and launch the new product and position it in the market by validating the utility concept of the product and its manufacturing process.

(b) Growth stage: during this phase, the R&D plan aims to help the company to enhance its competitive position in the market by improving the utility of the product or by adding new attractive features to it.

(c) Maturity stage: during this phase, the R&D plan aims to help the company to maintain its competitive position in the market by concentrating on extending the differentiating features of the product or by finding ways to reduce the cost of production.

(d) Decline stage: in the modern business environment, firms try not to phase out their products, but to re – introduce the products with innovative features. The R&D plan helps an organisation to achieve this objective.

Test Yourself 2

Baby-Cosset Inc is a medium sized privately owned company which has produced baby-care products for the last ten years. It has achieved a steady market share for its products. The company is aspiring to grow and expand. As part of this strategy, Baby-Cosset has decided to expand its operations into new markets. It has also decided to add baby clothes to its line of products.

The capital investment required for existing facilities, setting up new facilities for the production of baby clothes and for expansion into new markets is expected to be substantial. Management has approached the company's bank to obtain the required funding for its proposed expansion.

Required:

Explain what the different financial expectations of Baby-Cosset's stakeholders could be in relation to its proposed growth strategy and what possible conflicts could be involved in those expectations.

Test Yourself 3

You are the budget controller of a large organisation and are primarily concerned with budgetary control of large scale administrative expenses.

(a) Indicate broadly what sort of data you would require from the administrative department to be included in an annual budget.
(b) In the context of management motivation and involvement, explain what is meant by lack of goal congruence, giving two examples.
(c) Explain what other problems you might expect in administrative expenses budgets that would not normally be present if you were controlling operating expenses budgets.

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4. Analyse a chosen business strategy in a given scenario so that an evaluation may be undertaken leading to the drafting of a simple business plan
[Learning Outcome d]

Before we discuss the structure and contents of a business plan, it is necessary to understand **benefits management.**

Benefits management ensures that the desired business change or policy outcomes have been clearly defined, are measurable, and provide a convincing case for investment. This should ultimately result in the achievement of that change or policy outcome.

A generic benefits management process typically includes:

1. **Defining the benefits:** this involves ascertaining the types of benefits desired by investing in the business.

2. **Specifying the benefits:** this involves defining the precise financial and non-financial benefit metrics, which can be delivered in relation to the business.

3. **Benefits realisation:** this refers to the delivery of the benefits, as demonstrated through benefit metrics tracking. The benefits could be realised either during or following the completion of the business proposal.

The business plan

Definition

A **business plan** refers to a formal document prepared by the management of a firm, outlining the purpose and objectives of a business and the various strategies that may be adopted by the organisation to attain such objectives. This plan may also contain information regarding the background of a firm and serves as a continuous guide to the organisation's policy and strategy formulation.

The business plan provides a rationale for investment and as such should support robust analysis and rational decision-making. The development of project benefits criteria revolves primarily around the business case.

The purpose of the business plan is to establish why the business should go ahead. As in the case of a business project, the business plan also follows a development cycle as the project evolves from idea to formal proposal. Traditionally, the reason for developing a business plan was to obtain funding for a large financial investment. However, when considered in a broad sense, the business plan is intended to realise benefits by implementing the business proposal.

In addition, a business plan is also necessary:

- to enable priorities to be set among different investments for funds and resources
- to identify how the benefits identified will be delivered – a benefit realisation plan
- to ensure commitment from the business managers to achieve the intended investment benefits; and importantly
- to create a basis for review of the realisation of the proposed business benefits when the investment is complete

Preparing a business plan

A typical business plan document consists of:

1. **Cover sheet**

2. **Statement of purpose**

3. **Table of contents**

4. **Executive summary**: although this summary is placed at the beginning of the plan, it is prepared after the entire plan is drafted. It provides a summarised overview of the entire business plan, highlighting all the milestones that the business seeks to achieve in the proposed venture. The purpose of this summary is to attract the attention of the reader and encourage them to read the entire plan.

Certain important financial and non-financial projections (as mentioned in the table below) can be highlighted here.

	Year 1	Year 2	Year 3
Turnover (units and money value)			
Imports / Exports			
Net Profit before Tax			
Return on Investment			
Cash flow from operations			
Employment			

Readers of a business plan may make certain provisional judgements on the basis of the executive summary. Thus, this summary needs to be very drafted very carefully and appropriately.

5. **Business description**: the following are included in this section:

(a) what is the business about
(b) history of the company and its promoters
(c) form of ownership of the existing business and of the proposed venture (the type of legal entity)
(d) long term objectives of the business
(e) types of products / services offered by the company (including utility, features and benefits of the products, unique selling points, etc.)
(f) the organisation structure
(g) SWOT analysis

6. **The market and competition analysis and marketing plan**: this section of the plan describes the target customers, how they will be reached and who the competitors of the firm are. The firm must ascertain here that it has conducted a market survey and had assessed the viability of the chosen market and marketing decisions.

The following are included here:

(a) details about the product / service
(b) target market
(c) targeted revenue of the company from the proposed venture
(d) competitor analysis (including points describing the competitive advantage the firm has over its competitors)
(e) pricing strategy
(f) placing strategy
(g) marketing communication / promotion strategy

7. **Human resource**: this outlines the company structure in detail and analyses how the production and sales requirements would be met in terms of personnel. The following specific details are included in this section:

(a) recruitment and selection
(b) training and development
(c) HR retention
(d) redundancy

8. **Financial plan**: this primarily outlines the financial requirements of the proposed venture and identifies the sources of funds for financing the venture.

The following form a part of this section:

(a) investment appraisal
(b) details of capital required (long term and short term)
(c) sources of capital
(d) budgetary control system
(e) break even analysis and ratio analysis
(f) forecast statement of comprehensive income
(g) forecast statement of cash flows
(h) forecast statement of financial position

9. **Operation plan**: this section outlines the details of the manufacturing process in case the proposed venture relates to a product or outlines the process of providing a service if the proposed venture is related to the service sector.

The following would be included in the operation plan of a product:

(a) production infrastructure
(b) raw material procurement policy
(c) production processes, including plant and equipment

10. **Appendices**: this section provides supportive data to the main text of the plan. It contains elements which may be of interest to the readers of the plan. Items included here will vary depending upon the type of business.

Following are some of the items that may be included in this section:

(a) questionnaires used for market surveys, along with details of the sample surveyed
(b) copy of contracts with major customers and supplies
(c) documents of lease, licenses and insurance
(d) past financial statements of the company
(e) tax papers of the business and major shareholders
(f) personal financial statements of major shareholders
(g) details of company website
(h) testimonials of customers

Example

Katy Belmont had set up a spa cum beauty salon to cater to the leisure requirements of the residents of Newtown. The spa is now four years old and has over 100 regular customers apart from the same number of occasional clients who visit her spa at least once a month. The spa has been a success mainly due to the 'word of the mouth' publicity. Katy has employed 10 staff members who have been trained by Katy herself. Katy tries her best to keep the costs as low as possible, and in this effort, she does all the administration and accounting work related to her business, herself.

In the past few months, however, the number of occasional clients has reduced drastically, owing to a gym which has started operating in the same neighbourhood which also offers spa services. Katy is now concerned not only about reduction in the number of occasional clients, but she also fears that her regular customers too would leave her.

At a recent seminar conducted by Beauty Salon Associates, Katy met Appy Livingstone who also owns a spa cum beauty salon. Appy's establishment is based in the nearby town of Acton and she too is facing a similar situation in which her clients are reducing in number. Katy and Appy have decided that in order to save their businesses, which are similar in nature, they would team up and start a new spa cum beauty salon under the brand name of Wonder – Spa in an area which can be well accessed by the residents of both the towns. They believe that in this way, they can compete with the spa services offered by the gymnasiums in their respective areas.

For the formation and launch of Wonder – Spa, finance would be required and Katy and Appy have approached a local bank for financial assistance. The bank has asked them to submit a business plan outlining how the partnership intends to grow and develop. Katy and Appy have approached you, a business consultant, to help them in the preparation of the business plan. Write a report for Wonder – Spa outlining the key features that you consider should be included in their business plan. The report should be addressed to the new joint owners, Katy and Appy.

Continued on the next page

Report:

To: Katy Belmont, Appy Livingstone
From: Business Consultant

Key Elements of a Business Plan

In order to obtain finance from the bank for your new venture, it is essential that you prepare and submit a very well organised business plan. Banks decide upon lending based on certain financial and non-financial criteria. The business plan needs to be prepared in a rationally thought-out manner, such that it would convince the bank. All information contained in the plan should be carefully based upon reasonable and rational premise.

To begin with, the very reason for the existence of the new venture should be clearly explained, outlining the nature of the spa and beauty services that would be provided. You must present a very clear picture of the long term commercial and other objectives of the new business and the corporate and other functional strategies you intend to use in order to achieve the objectives.

You, being the promoters of the new venture, will also be required to introduce yourselves at this point by including your personal history, experience in the related field, etc. This would help in establishing your credibility. Since the new unit will be a combination of two existing business units, a SWOT analysis can also be done based on the information (internal and external) collected from the existing units.

In the next part of the plan, you can give a more detailed description of the services that you would be offering, your targeted customers and how exactly you would be making the residents of the nearby areas aware of your presence (including details of communication media supported by information technology). Here, a marketing plan (outlining details of product, place, promotion mix, price, etc.) can be presented. In order to gain the confidence of the bank, it would be good to mention how you would be differentiating your services as compared to similar services offered by gymnasiums (your main competitors).

The marketing research details should also be stated, which would convince the bank regarding the strong premise of the plan.

Personnel play a major role in the type of venture that you are seeking finance for. You need to provide details regarding the type of personnel that you already have (from your respective existing businesses), the ‘personnel gap’ that you may have while implementing the new venture and also discuss how you plan to fill in the gap.

Next would be the section concerned with financial figures. The bank would be most interested in this section, as based on the figures and projections presented by you, they would be ascertaining the cash generating ability of your business (as your repayment ability of principal amount along with interest would be dependent on this). You need to present forecast Statement of Financial Position, Statement of Comprehensive Income and Statement of Cash Flow for at least three years. The figures presented should be realistic in nature, based on rational business conditions. It is a good idea to even include the expected number of clients and the expected growth in such numbers over time.

You would need to present very clearly the timings of requirement of funds. This has to be supported with reasons for such requirements. Since the new venture would be an extension of the existing two businesses, the financial statements of the existing businesses too need to be presented in the plan to establish credibility.

Supporting documents like questionnaires used for market surveys, documents of lease, licenses and insurance obtained, testimonials of clients, etc. can be presented under the heading of “Appendices”. These supporting documents play an important role in reinforcing the credibility of the information presented in the business plan.

After the entire plan is drafted, an executive summary of 2 to 3 pages needs to be prepared. Such a summary will be placed at the beginning of the plan when it is submitted to the bank. It provides a summarised overview of the entire business plan, highlighting all the milestones that the business seeks to achieve in the proposed venture. The purpose of this summary is to attract the attention of the readers and encourage them to read the entire plan.

A business plan prepared on the above lines will help you in convincing the bank to provide the required amount of finance.

Signed,
Business Consultant

Test Yourself 4

Bring out the strategic importance of a business plan.

Answer to Test Yourself

Answer to TY 1

(a) The ways in which an organisation can choose to structure itself are:

function focused structure
customer focused structure
matrix structure
network structure

Here, Addon has adopted a function focused organisational structure because the organisation is divided into four divisions or departments. Each department is then made responsible for carrying out a specific function / activity for the organisation. Subsequently, each employee is then placed into one of these departments and is assigned a specific set of roles and responsibilities. As Addon is the manufacturer of industrial adhesive products, a functional structure is the most suitable structure for this organisation.

(b) Advantages and disadvantages of functional structure organisation

Advantages	Disadvantages
1. each department focuses on its own work and activities	1. creates a rigid and slow-moving organisation.
2. helps management to coordinate and control the entire organisation in a strategic way	2. time required for coordination may be too long
3. identifies role and responsibility for each employee	3. leads to loss of innovation and innovative thinking as employees become more process-oriented
4. provides clear accountability at both the departmental and individual levels	4. does not allow sharing of information or ideas across departments

Answer to TY 2

Different stakeholders have different, often contradictory, financial expectations from the organisation. Management has to address these expectations while it tries to meet its overriding objective of creating value for shareholders. The financial expectations of the different stakeholders of Baby-Cosset Inc relating to its proposed growth strategy and the possible conflicts could be as follows:

1. **Suppliers and employees:** likely to be concerned with the liquidity position of Baby-Cosset. Suppliers would expect that the proposed growth strategy would not have any adverse impact on Baby-Cosset's ability to meet its short-term commitments towards creditors and the credit limit offered to it. Employees will be concerned about timely payment of their salaries and wages.

   However, there may be a decrease in profitability and cash flow during and after the expansion. This may have an adverse impact on Baby-Cosset's short-term commitments to its suppliers and employees.

2. **Bank:** Baby-Cosset's bank will be concerned about the risk attached to the loan that is being demanded for the proposed expansion. It would expect be timely repayment of its loan along with interest. To ensure this, it would check Baby-Cosset's previous record with the bank and its capital gearing and interest cover ratios.

3. **Shareholders:** would expect that the proposed growth strategy will ensure regular dividends for them and will also further increase returns to them.

   However, the loan taken from the bank might affect Baby-Cosset's ability to pay dividends as the company will have to make regular loan repayments along with interest before paying dividends to its shareholders. A possible decrease in short-term profitability and cash flow during and after the expansion process would also affect dividends. However, the growth strategy may lead to higher share prices and capital growth for the shareholders.

4. **Customers:** Baby-Cosset's customers would expect that the baby products and cloths produced by the company should be the best value products available in the market.

   However, expanding into different markets may result in a decline in product quality. Also, as 'baby cloth' is the company's new product, it may not be of sufficient quality to satisfy customer demands.

5. **Community:** the community is likely to be concerned that the growth strategy of Baby-Cosset should benefit the whole community. The proposed expansion is likely to provide new employment opportunities. However, the community will also expect the company to take account of the ethical and environmental impact, such as pollution control and preservation of environment.

   As it is difficult to satisfy each group completely, political compromise results when each part settles for less than their ideal outcome. The company should attempt to identify its most important stakeholders in terms of their centrality to the corporate mission and strategy.

Answer to TY 3

(a) It is assumed that the budget controller has a critical and / or co-ordinating role, but as an administrative manager he is responsible for:

- deciding the nature and level of activities of his department; and
- controlling the cost of providing the services, being a service department.

The following items of data are expected to be included:

- a statement of the philosophy underlying the existence of the administrative department
- a statement of responsibilities covered and services provided by the department
- a statement of costs expected to be incurred in the department for the budgetary period
- explanation of change proposed in comparison to the activities of the current year
- an indication of how cost levels will be expected to respond to the change in the nature or level of the service required or provided

(b) Lack of goal congruence occurs when the likelihood of achieving corporate objectives is reduced by the way in which functional budgets are prepared. For example, if the relationship between two departments is not properly "balanced", the conflict arising from it would adversely affect achieving of the corporate objectives.

Following are the two examples of lack of goal congruence:

- establishment of levels of cost (manpower, outsourcing of services etc.) in the administrative department for providing service levels more than what is expected by the receiving departments: such kind of "budget padding' would result in lack of goal congruence.

- development of the departmental future plans in isolation from the development objectives of the whole organisation: this will lead to imbalance in the growth. Therefore, development plan of administrative department as a service function should be in line with the growth strategy of the whole organisation.

(c)

- It may be difficult to identify a measurable output from the department, being a service department.
- It may be difficult trying to relate cost inputs to service benefits provided.
- Difficulty in setting the bases for a flexible budget does not exist and therefore judgment of changes in cost levels is not easy.
- Cost efficiency as one means of appraising manager performance becomes questionable.

Answer to TY 4

A business plan refers to a formal document prepared by the management of a firm, outlining the purpose and objectives of a business and the various strategies that may be adopted by the organisation to attain such objectives. This plan may also contain information regarding the background of a firm and serves as a continuous guide to the organisation's policy and strategy formulation.

A business plan is of strategic importance to an organisation as it:

- convinces various stakeholders on the credibility of a new venture
- helps the organisation to grow its business and to plan for an uncertain future
- helps the organisation to achieve its long term objectives
- provides a sense of direction to the business and helps in managing cash flows

Quick Quiz

1. What is a business plan?

2. What type of structure requires an organisation to be divided into a number of divisions each of which is responsible for a specific function or activity?

3. In order to be successful, a strategy must be:

   A suitable to management
   B acceptable to stakeholders
   C feasible to customers
   D none of the above

4. Revenue generated from the organisation's operations is a _________ (value / cost) driver.
5. What can the financial expectations of shareholders be from an organisation?

6. A redundancy plan is a part of the _________________ strategy.

7. What is applied research?

Answers to Quick Quiz

1. A business plan refers to a formal document prepared by the management of a firm, outlining the purpose and objectives of a business and the various strategies that may be adopted by the organisation to attain such objectives. This plan may also contain information regarding the background of a firm and serves as a continuous guide to the organisation's policy and strategy formulation.

2. Function focused structure.

3. The correct option is **B.**

   Acceptability to stakeholders is one of the three features of successful strategy. In addition to this, a successful strategy must also be suitable to the goals of the organisation and feasible to the organisation.

4. Revenue generated from the organisation's operations is a value driver as it leads to an increase in shareholder value.
5. Shareholders expect the organisational strategy to be such that they receive regular dividends and also that the organisation has sufficient funds for its long-term commitments.

6. Human resource strategy.

7. Applied research: refers to research aimed at enhancing the technical know-how and achieving commercial gains.

Self-Examination Questions

Question 1

Everyday News Publisher is one of the leading business news providers. It is the first choice for business readers. It publishes newspapers in all counties of Europe. Everyday News Publisher believes in liberal, reasonable and self-sufficient journalism and strives to inspire these values in its editorial staff. The journalism practised by Everyday News puts prioritises on features, reliability and accurateness of their published news.

The company has one of the country's best economic journalists and columnists working for it. Editing is done by one of the best business journalists who earlier undertook and completed and highly successful revamp of the News Times and was also responsible for the organisation's growth.

Apart from a business newspaper, Everyday News wants to introduce several bulletins, including fashion magazines, sports magazines etc.

Required:

Explain why both the strategy and the organisational structure are important for the success of Everyday News Publisher.

QUESTION 2

One the responsibility of the top management is to make sure the company's strategy is properly implemented to achieve a sustained competitive advantage.

Required:

Briefly describe what involves the strategy implementation.

Answers to Self-Examination Questions

Answer to SEQ 1

Organisational strategy outlines the direction taken by the organisation for the type of product or service provided to consumers and also for the method employed in the production of target goods or services.

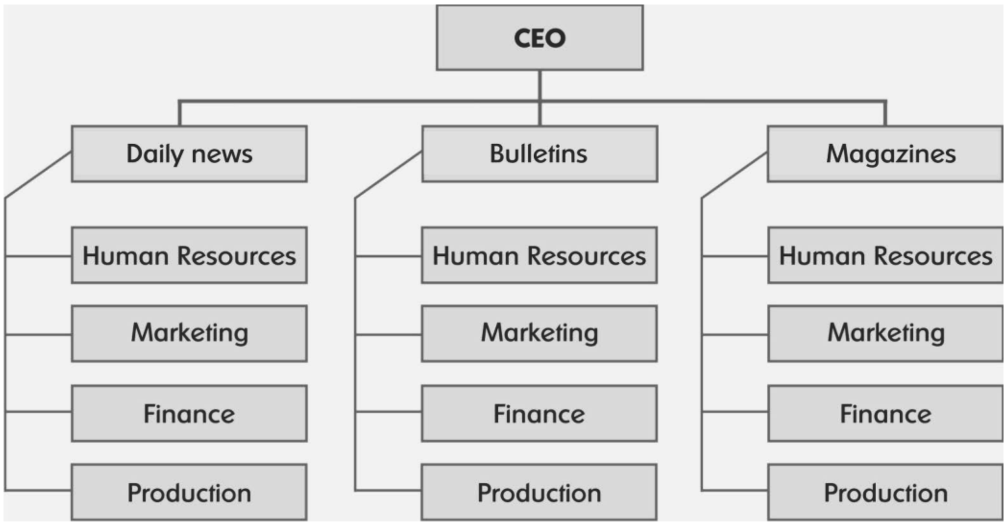
However, organisational structure determines how an organisation will go about delivering the goods and services it has targeted in its strategy. The structure of an organisation defines the activities and the functions performed by each part of the organisation. It also defines the relationship and communication within and outside the organisation, the responsibility of employees, departments and the management, the control of managers, proper utilisation of processes and systems.

Therefore, organisational strategy is influenced by the type of structure the organisation uses. The structure and the strategy of the organisation must be complementary. An organisation can be structured in the following ways:

- structuring itself around its functions
- structuring itself around its customers
- adopt a matrix structure
- adopt a network structure

Everyday News Publisher will have a customer-focused organisational structure. Organisations will be departmentalised along either product, geographical or project lines. The departments will therefore become responsible for servicing and meeting the needs of a particular group of customers.

The following represents the hierarchical structure of Everyday News Publisher:



A customers-focused organisational structure will enable Everyday News Publisher to be more aligned with the needs of its customers. It will promote innovation and innovative thinking as Everyday News will be able to focus on meeting the needs and requirements of its customers.

Answer to SEQ 2

Strategic implementation involve:

- allocation of sufficient resources (financial, personnel, time, technology support),
- establishing a chain of command or some alternative structure,
- assigning responsibility of specific tasks or processes to specific individuals groups,
- it also involves managing the process (monitoring results, comparing to benchmarks and best practices, evaluating the efficacy and efficiency of the process, controlling for variances, making adjustments to the process as necessary),
- implementing specific programs, meaning acquiring the requisite resources, developing the process, training, process testing, documentation and integration with legacy process.

SECTION A

STRATEGIC MANAGEMENT

A4

STUDY GUIDE A4: STRATEGIC EVALUATION

Get Through Intro

The best formulated and best implemented strategies become obsolete as a firm's external and internal environments change. It is essential, therefore, that strategists systematically review, evaluate, and control the execution of strategies. This section presents a framework that can guide managers' efforts to evaluate strategic-management activities, to make sure they are working, and to make timely changes. Guidelines are presented for formulating, implementing, and evaluating strategies.

Learning Outcomes

a) Explain and discuss the strategy-evaluation process, criteria, and methods used.
b) Describe and discuss the three activities that comprise strategy evaluation.
c) Describe and develop a Balanced Scorecard.

1. Explain and discuss the strategy-evaluation process, criteria, and methods used.
[Learning Outcome a]

Strategic evaluation is the process that ensures the company is achieving what it set out to accomplish. It compares performance with desired results and provides feedback for management to take corrective action

- **Evaluation:** We evaluate to know how good our strategic plans are, and how well they are being implemented.
- **Control:** The information we get from evaluation enables us to exercise better control. This means we are able to make better plans and improve the way we implement such plans.

Strategy evaluation includes three basic activities:

1. Examining the underlying bases of a firm's strategy
2. Comparing expected results with actual results
3. Taking corrective actions to ensure that performance conforms to plans

Richard Rumelt offered four criteria that could be used to evaluate a strategy: consistency, consonance, feasibility, and advantage.

- ✓ Consistency: The strategy must not present mutually inconsistent goals and policies.
- ✓ Consonance: The strategy must represent an adaptive response to the external environment and to the critical changes occurring within it.
- ✓ Advantage: The strategy must provide for the creation and/or maintenance of a competitive advantage in the selected area of activity.
- ✓ Feasibility: The strategy must neither overtax available resources nor create unsolvable sub problems.

Consistency

It is important to strive for consistency when setting goals and policies. Organizational conflict and interdepartmental bickering are often symptoms of managerial disorder, but these problems may also be a sign of strategic inconsistency. Three guidelines help determine if organizational problems are the result of inconsistencies in strategy:

- If managerial problems continue despite changes in personnel and if they tend to be issue-based rather than people-based, then strategies may be inconsistent.
- If success for one organizational department means, or is interpreted to mean, failure for another department, then strategies may be inconsistent.
- If policy problems and issues continue to be brought to the top for resolution, then strategies may be inconsistent.

Consonance

Consonance refers to the need for strategists to examine sets of trends, as well as individual trends, in evaluating strategies. A strategy must represent an adaptive response to the external environment and to the critical changes occurring within it. One difficulty in matching a firm's key internal and external factors in the formulation of strategy is that most trends are the result of interactions among other trends. For example, the day care explosion came about as a combined result of many trends that included a rise in the average level of education, increased inflation, and an increase in women in the workforce. Although single economic or demographic trends might appear steady for many years, there are waves of change going on at the interaction level.

Feasibility
A strategy must neither overtax available resources nor create unsolvable sub problems. The final broad test of strategy is its feasibility; that is, can the strategy be attempted within the physical, human, and financial resources of the enterprise? The financial resources of a business are the easiest to quantify and are normally the first limitation against which strategy is evaluated. It is sometimes forgotten, however, that innovative approaches to financing are often possible. Devices, such as captive subsidiaries, sale-leaseback arrangements, and tying plant mortgages to long-term contracts, have all been used effectively to help win key positions in suddenly expanding industries. A less quantifiable, but actually more rigid, limitation on strategic choice is that imposed by individual and organizational capabilities. In evaluating a strategy, it is important to examine whether an organization has demonstrated in the past that it possesses the abilities, competencies, skills, and talents needed to carry out a given strategy.

Advantage
A strategy must provide for the creation or maintenance of a competitive advantage in a selected area of activity. Competitive advantages normally are the result of superiority in one of three areas: (1) resources, (2) skills, or (3) position. The idea that the positioning of one's resources can enhance their combined effectiveness is familiar to military theorists, chess players, and diplomats. Position can also play a crucial role in an organization's strategy. Once gained, a good position is defensible—meaning that it is so costly to capture that rivals are deterred from full-scale attacks. Positional advantage tends to be self-sustaining so long as the key internal and environmental factors that underlie it remain stable. This is why entrenched firms can be almost impossible to unseat, even if their raw skill levels are only average. Although not all positional advantages are associated with size, it is true that larger organizations tend to operate in markets and use procedures that turn their size into advantage, whereas smaller firms seek product or market positions that exploit other types of advantage. The principal characteristic of good position is that it permits the firm to obtain advantage from policies that would not similarly benefit rivals without the same position. Therefore, in evaluating strategy, organizations should examine the nature of positional advantages associated with a given strategy.

The Process of Evaluating Strategies

- Strategy evaluation should initiate managerial questioning of expectations and assumptions, should trigger a review of objectives and values, and should stimulate creativity in generating alternatives and formulating criteria of evaluation
- Evaluating strategies on a continuous rather than on a periodic basis allows benchmarks of progress to be established and more effectively monitored
- Successful strategies combine patience with a willingness to promptly take corrective actions when necessary

2. Describe and discuss the three activities that comprise strategic evaluation.
[Learning Outcome b]

The Three Strategy-Evaluation Activities

1. Reviewing Bases of Strategy
2. Measuring organization performance
3. Take corrective actions

Reviewing Bases of Strategy

Reviewing the underlying bases of an organization's strategy could be approached by developing a revised EFE Matrix and IFE Matrix. A revised IFE Matrix should focus on changes in the organization's management, marketing, finance and accounting, production and operations, research and development (R&D), and management information systems (MIS) strengths and weaknesses. A revised EFE Matrix should indicate how effective a firm's strategies have been in response to key opportunities and threats. This analysis could also address such questions as the following:

1. How have competitors reacted to our strategies?
2. How have competitors' strategies changed?
3. Have major competitors' strengths and weaknesses changed?
4. Why are competitors making certain strategic changes?
5. Why are some competitors' strategies more successful than others?
6. How satisfied are our competitors with their present market positions and profitability?
7. How far can our major competitors be pushed before retaliating?
8. How could we more effectively cooperate with our competitors?

Numerous external and internal factors can prevent firms from achieving long-term and annual objectives. Externally, actions by competitors, changes in demand, changes in technology, economic changes, demographic shifts, and governmental actions may prevent objectives from being accomplished. Internally, ineffective strategies may have been chosen or implementation activities may have been poor. Objectives may have been too optimistic. Thus, failure to achieve objectives may not be the result of unsatisfactory work by managers and employees. All organizational members need to know this to encourage their support for strategy-evaluation activities. Organizations desperately need to know as soon as possible when their strategies are not effective. Sometimes managers and employees on the front lines discover this well before strategists.

A Strategy-Evaluation Assessment Matrix

Have Major Changes Occurred in the Firm's Internal Strategic Position?	Have Major Changes Occurred in the Firm's External Strategic Position?	Has the Firm Progressed Satisfactorily Toward Achieving Its Stated Objectives?	Results
No	No	No	Take corrective actions
Yes	Yes	Yes	Take corrective actions
Yes	Yes	No	Take corrective actions
Yes	No	Yes	Take corrective actions
Yes	No	No	Take corrective actions
No	Yes	Yes	Take corrective actions
No	Yes	No	Take corrective actions
No	No	Yes	Continue present strategic Course

External opportunities and threats and internal strengths and weaknesses that represent the bases of current strategies should continually be monitored for change. It is not a question of whether these factors will change, but rather when they will change, and in what ways. Here are some key questions to address in evaluating strategies:

1. Are our internal strengths still strengths?
2. Have we added other internal strengths? If so, what are they?
3. Are our internal weaknesses still weaknesses?

4. Do we now have other internal weaknesses? If so, what are they?
5. Are our external opportunities still opportunities?
6. Are there now other external opportunities? If so, what are they?
7. Are our external threats still threats?
8. Are there now other external threats? If so, what are they?
9. Are we vulnerable to a hostile takeover?

Measuring Organizational Performance

Another important strategy-evaluation activity is measuring organizational performance. This activity includes comparing expected results to actual results, investigating deviations from plans, evaluating individual performance, and examining progress being made toward meeting stated objectives. Both long-term and annual objectives are commonly used in this process. Criteria for evaluating strategies should be measurable and easily verifiable. Criteria that predict results may be more important than those that reveal what already has happened. Really effective control requires accurate forecasting. Failure to make satisfactory progress toward accomplishing long-term or annual objectives signals a need for corrective actions. Many factors, such as unreasonable policies, unexpected turns in the economy, unreliable suppliers or distributors, or ineffective strategies, can result in unsatisfactory progress toward meeting objectives. Problems can result from ineffectiveness (not doing the right things) or inefficiency (poorly doing the right things). Determining which objectives are most important in the evaluation of strategies can be difficult.

Strategy evaluation is based on both quantitative and qualitative criteria. Selecting the exact set of criteria for evaluating strategies depends on a particular organization’s size, industry, strategies, and management philosophy. An organization pursuing a retrenchment strategy, for example, could have a different set of evaluative criteria from an organization pursuing a market development strategy. Quantitative criteria commonly used to evaluate strategies are financial ratios, often monitored for each segment of the firm. Strategists use financial ratios to make three critical comparisons:

1. Compare the firm’s performance over different time periods.
2. Compare the firm’s performance to competitors.
3. Compare the firm’s performance to industry averages.

A Sample Framework for Measuring Organizational Performance

Factor	Actual Result	Expected Result	Variance	Action Needed
Corporate Revenues				
Corporate Profits				
Corporate ROI				
Region 1 Revenue				
Region 1 Profits				
Region 1 ROI				
Region 2 Revenue				
Region 2 Profits				
Region 2 ROI				
Product 1 Revenue				
Product 1 Profits				
Product 1 ROI				
Product 2 Revenue				
Product 2 Profits				
Product 2 ROI				

Some potential problems are associated with using only quantitative criteria for evaluating strategies. First, most quantitative criteria are geared to annual objectives rather than long-term objectives. Also, different accounting methods can provide different results on many quantitative criteria. Third, intuitive judgments are almost always involved in deriving quantitative criteria. Thus, qualitative criteria are also important in evaluating strategies. Human factors such as high absenteeism and turnover rates, poor production quality and quantity rates, or low employee satisfaction can be underlying causes of declining performance. Marketing, finance and accounting, R&D, or MIS factors can also cause financial problems. The need for a balanced quantitative/qualitative approach in evaluating strategies gives rise in a moment to discussion of the balanced scorecard.

Some additional key questions that reveal the need for qualitative judgments in strategy evaluation are as follows:

1. How good is the firm’s balance of investments between high-risk and low-risk projects?
2. How good is the firm’s balance of investments between long-term and short-term projects?
3. How good is the firm’s balance of investments between slow-growing markets and fast-growing markets?
4. How good is the firm’s balance of investments among different divisions?
5. To what extent are the firm’s alternative strategies socially responsible?
6. What are the relationships among the firm’s key internal and external strategic factors?
7. How are major competitors likely to respond to particular strategies?

Taking Corrective Actions

The final strategy-evaluation activity, taking corrective actions, requires making changes to competitively reposition a firm for the future. Examples of changes that may be needed are altering an organization’s structure, replacing one or more key individuals, selling a division, or revising a business mission. Other changes could include establishing or revising objectives, devising new policies, issuing stock to raise capital, adding additional salespersons, differently allocating resources, or developing new performance incentives. Taking corrective actions does not necessarily mean that existing strategies will be abandoned or even that new strategies must be formulated. The probabilities and possibilities for incorrect or inappropriate actions increase geometrically with an arithmetic increase in personnel. Any person directing an overall undertaking must check on the actions of the participants as well as the results they have achieved. If either the actions or results do not comply with preconceived or planned achievements, then corrective actions are needed.

3. Describe and develop a Balance Scorecard.

[Learning Outcome c]

The Balanced Scorecard

The Balanced Scorecard is a strategy evaluation and control technique. Balanced Scorecard derives its name from the perceived need of firms to “balance” financial measures that are oftentimes used exclusively in strategy evaluation and control with nonfinancial measures such as product quality and customer service. An effective Balanced Scorecard contains a carefully chosen combination of strategic and financial objectives tailored to the company's business. The overall aim of the Balanced Scorecard is to " balance" shareholder objectives with customer and operational objectives. Obviously, these sets of objectives interrelate and many even conflict. For example, customers want low price and high service, which may conflict with shareholders' desire for a high return on their investment. The Balanced Scorecard concept is consistent with the notions of continuous improvement in management (CIM) and total quality management (TQM).

The Balanced Scorecard basic premise is that firms should establish objectives and evaluate strategies on criteria other than financial measures. Financial measures and ratios are vitally important in strategic planning, but of equal importance are factors such as customer service, employee morale, product quality, pollution abatement, business ethics, social responsibility, community involvement, and other such items. In conjunction with financial measures, these "softer" factors comprise an integral part of both the objective-setting process and the strategy-evaluation process. A Balanced Scorecard for a firm is simply a listing of all key objectives to work toward, along with an associated time dimension of when each objective is to be accomplished, as well as a primary responsibility or contact person, department, or division for each objective.

The Balanced Scorecard is an important strategy-evaluation tool that allows firms to evaluate strategies from four perspectives: financial performance, customer knowledge, internal business processes, and learning and growth. Its analysis requires that firms seek answers to the following questions and use that information, in conjunction with financial measures, to adequately and more effectively evaluate strategies being implemented:

1. Is the firm continually improving and creating value along measures such as innovation, technological leadership, product quality, operational process efficiencies, and so on?
2. Is the firm sustaining and even improving on its core competencies and competitive advantages?
3. How satisfied are the firm's customers?

The balanced scorecard starts with defining the mission, outlining the strategies to achieve the mission, understanding the core customer requirement, defining the internal business process and assessing the organisational infrastructure needed to achieve the objectives.

12.2 In the balanced scorecard the following perspectives are considered:

Financial
Customer
Internal business processes
Learning and growth

For each these perspectives, there are different performance measures.

1. Financial

This covers the financial performance measures. This area assesses whether the organisation's strategy and its implementation contribute to the bottom line improvement of the company. This stage represents the long-term performance. According to the founders, Kaplan and Norton, this can be assessed in three stages i.e. rapid growth, sustain and harvest.

Stages	Measures
Growth	Sales volumes, increase in profit etc.
Sustain	Return on investment, the return on capital employed
Harvest	Payback periods and revenue volume

Other measures in this perspective include EVA, increase in revenue and reduction in cost.

2. Customer

Customers are one of the most important stakeholders of the organisation. An organisation cannot grow, sustain and harvest in the long run if it ignores the customer. A customer has a perception of organisations which will help him to take decisions on which organisations to purchase from.

Example

Apple is known for its innovative products. This is the image which Apple has amongst customers and therefore someone who wants a new personal computer or laptop may choose to buy these goods from Apple rather than another company. An organisation may be known for its good customer service. Again, this will attract customers to the organisation.

The image a company has amongst customers can be assessed by customer retention rate, customers' complaints, on-time delivery, % sale of new product etc.

3. Internal business processes

This is about deciding what the organisation should do to satisfy and retain its customers. Internal business processes aim at operations, customer management and innovation. For example, introducing an innovative process or providing after-sales service.

Example

An organisation can perform well in terms of its internal business processes if it is continuously coming up with innovative products.

Example

The following objectives and measures fall under this perspective:

Objectives	Measures
Technological capability	Manufacturing geometry vs. competition
Innovative new product	% of sales from new products
Manufacturing excellence	Cycle time, unit cost and yield
Decrease launch time of new product	Actual launch date vs. plan, actual time taken to launch a new product.
Increase design productivity	Engineering efficiency

4. Learning and growth

This is about focusing on the resources and intangible assets of the organisation, such as the capabilities of its personnel, its employee satisfaction and its information system, that are needed to conduct the activities decided in the internal business processes.

Example

The following objectives and measures fall under this perspective:

Objectives	Measures
Technology leadership	Time to develop next product

Manufacturing learning	Process time to maturity
Information system excellence	Cost feedback available, % of availability of the on-line information of customers
Time to market	Time taken vs. competitors, actual time taken
Product focus	% of products that equal 80%

12.3 The organisation needs to define the following for each of the perspectives mentioned above:

(a) Strategic objective

The strategic objective is the specific definition of a strategy and what it is to achieve from a particular perspective.

Example

From the customer perspective, the strategic objective is to become a preferred supplier; and from the financial perspective, the strategic objective is to achieve a certain % of growth.

(b) Measures

The indicator of the achievement of / progress towards the strategic objective should also be defined within the perspective.

Example

The customer retention rate can be used to measure how far the organisation has achieved its objective of becoming a preferred supplier.

(c) Targets

This is about defining the target values for the measures.

(d) Initiative

Programmes initiated in order to meet the objectives.

Example

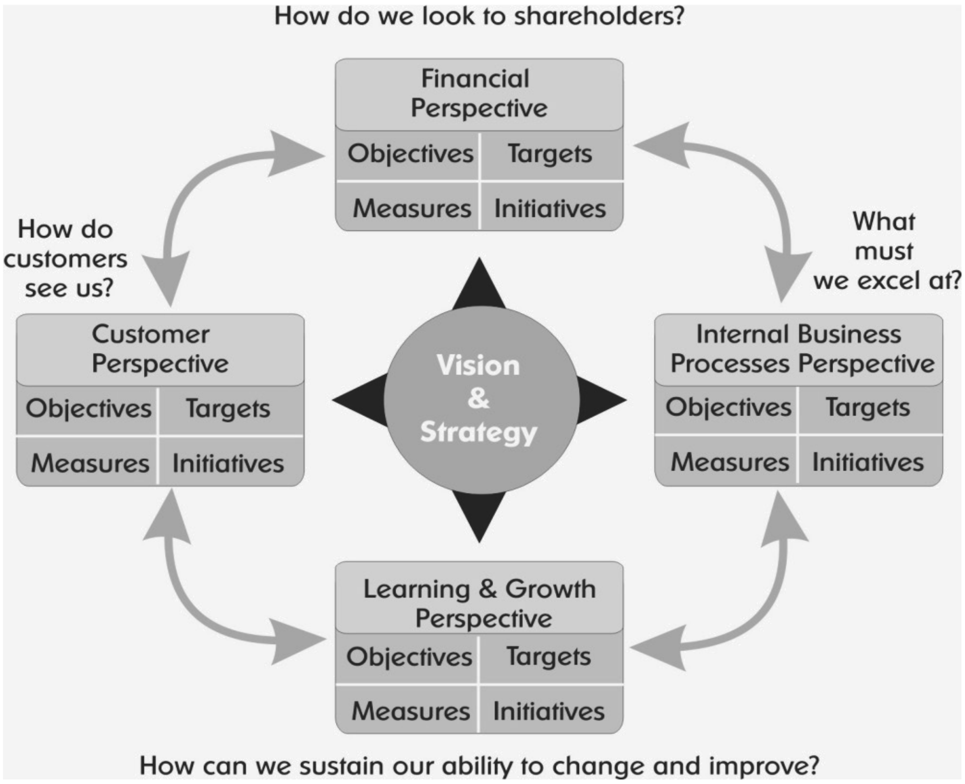
Fly-high is an aviation company operating in Scotland. It uses a balanced scorecard. The objectives, measures, targets and initiatives of Fly-high are presented in the table below:

Perspective	Objectives	Measures	Targets	Initiatives
Financial	Profitability	Market value	25% per year	Optimise routes
	Reduced costs	Plane lease cost	5% per year	Standardise planes
Customer	On-time flights	On-time arrival rating	Leader in industry	Quality management
	Increased customers	Number of customers	99% satisfaction	Loyalty programme
Internal business processes	Reduced delays	Number of delays vs. total take-offs **OR** On-time arrivals / departures vs. total arrivals / departures	Reduce by 6%	Cycle time optimisation

Learning and growth	Product focus (routes)	Route producing 80% sales	Year 1 - 12 Year 2 - 14 Year 3 - 15	
	Employee development	Employee training	Year 1 - 75% Year 2 - 90% Year 3 - 100%	Training programmes

The following is an example of the format of a balanced scorecard.

Diagram 11: Format of balanced scorecard



12.4 Cause and effect relationship

The balanced scorecard takes into account the fact that all these perspectives are linked to each other.

In the balanced scorecard, the following four questions are asked for every strategy:

(a) How do we look to shareholders? (financial perspective)
(b) How do customers see us? (customer perspective)
(c) What must we excel at? (internal business processes perspective)
(d) Can we continue to improve and create value? (learning and growth perspective)

These questions act as a link between the four different perspectives and the measures for those perspectives.

Example

Financial: suppose the growth strategy is adopted and the measure adopted is revenue growth, this will come under the financial perspective.

Customer: assume that loyal customers are providing repeat business which results in an increase in revenue. In this case, the measure under the customer perspective will become customer loyalty.

The next question that arises is what must the business excel at in terms of internal business processes so as to achieve the highest level of customer loyalty?

Internal business processes: assume that the highest level of customer loyalty can be achieved by introducing innovative products into the market. In this case, the measure will be new product development cycle time.

Learning and growth: assume that the new product development cycle time can be improved by providing training to employees on the new development process. Therefore, under this perspective, training to employees will be the measure.

By asking these four questions, the organisation decides the major goals for each of the four perspectives and then decides the performance measures under these perspectives.

Before the origination of the balanced scorecard, some organisations were using both financial and non-financial measures of performance. However, the balanced scorecard is different in that the perspectives in the balanced scorecard form a chain of cause and effect relationships.

Example

Learning and growth: the availability of resources such as skill, competence, information and employee support makes it possible to implement good business processes.

Internal business process: the support of employees and the availability of resources will result in the production of innovative goods.

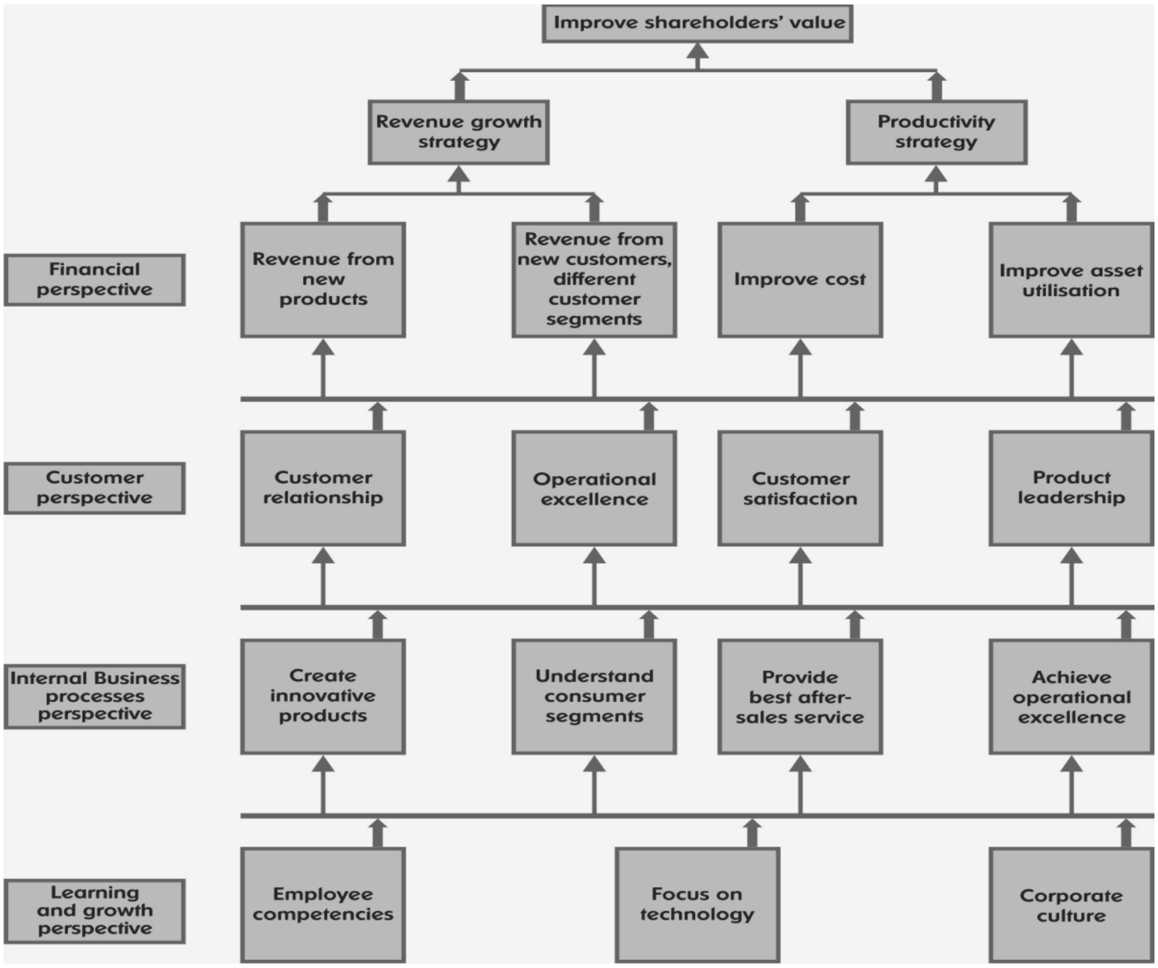
Customer: the production of innovative goods will attract customers and good business processes (such as good after-sales service) will satisfy these customers and therefore they may be retained by the organisation.

Financial: The customer loyalty / satisfaction / retention will result in higher return on investment.

The premise behind the organisation's strategy can be explained with the help of the cause and effect relationships represented in the balanced scorecard.

The linkage between the four perspectives of the balanced scorecard can be explained with the help of the vertical presentation.

Diagram 12: Strategy map (establishing linkage between the four perspectives)



Example

Categorise the following into Financial, Customer, Internal Business Processes or Learning and Growth:

Objective	Measure
1. To be the cost leader in our market by 20X8	a) Actual launch date vs. plan
2. To reduce customer complaints by 99% within 12 months	b) Customer retention rates
3. To reduce product launch delays	c) Return on capital employed (ROCE)
4. To reduce the time to market to a minimum by 20X8	d) Engineering efficiency
5. To increase profitability by 20% by 20X7	e) Time compared to that of competitors
6. To achieve 99% customer satisfaction within 5 years	f) Unit cost
7. To increase market share by 10% by 20X7	g) Employee training
8. To increase design productivity	h) Revenue growth
9. To train and develop all team leaders by 20X7	i) Cycle time
10. To bring manufacturing excellence by 20X8	j) Number of new customers
11. To acquire 10% new customers	k) Customer feedback or complaints

Answer

1. Finance

Objective	Measure
To be the cost leader in our market by 20X7	Unit cost
To increase profitability by 20% by 20X7	Return on capital employed (ROCE)
To increase market share by 10% by 20X7	Revenue growth

2. Customer

Objective	Measure
To reduce customer complaints by 99% within 12 months	Customer feedback or complaints
To achieve 99% customer satisfaction within 5 years	Customer retention rates
To acquire 10% new customers	Number of new customers

3. Business processes

Objective	Measure
To reduce launch delays	Actual launch date vs. plan
To bring manufacturing excellence by 20X8	Cycle time
To increase design productivity	Engineering efficiency

4. Learning and growth

Objective	Measure
To reduce the time to market to a minimum by 20X8	Time compared to that of competitors
To train and develop all team leaders by 20X6	Employee retention rates

12.5 Advantages and disadvantages of balanced scorecard

(a) Advantages of balanced scorecard

(i) The balanced scorecard uses financial as well as non-financial performance indicators to evaluate short-term and long-term performance in a single report.

Example

It takes into consideration financial measures such as ROI, ROCE as well as non-financial measures such as customer satisfaction, engineering efficiency and actual introduction schedule vs. plan.

(ii) As stated above, it takes into consideration short-term as well as long-term performance and hence reduces managers' emphasis on short-term performance.

Example

Instead of considering the quarterly earnings, the balanced scorecard considers the measures such as ROI and EVA.

(iii) The strategic objectives are translated into a coherent set of performance measures. As a result, all the information on the strategies and the performance measures is provided in a single report. This helps management to assess the impact of a particular action on the organisation from four different perspectives.

(iv) Both external as well as internal matters relating to the organisation are taken into consideration e.g. customer satisfaction is considered alongside employee satisfaction.

(v) Adopting the balanced scorecard may enable an organisation to notice in advance any trends affecting the business so that changes can be made in time.

(b) Disadvantages of balanced scorecard

(i) It considers only four perspectives and ignores other stakeholders such as competitors, suppliers and regulators.

(ii) Selecting measures is again a major problem. This is because the measures should be critical. Over the period, these measures may change; however, the change may not be considered.

(iii) Although there are a number of measures, there should not be too many otherwise analysis will become difficult. Furthermore, these measures may be conflicting and therefore confusing.

Self-Examination Questions

Question 1

Strategy evaluation is a key part of the strategy process, which attempts to look beyond the obvious fact regarding the short-term health of a business to the more fundamental factors and trends that govern organizational success.

Required

In view of above discuss the Rumelt's principle of strategy evaluation.

Answer to Self-Examination Questions

Answer 1

The Rumelt evaluation method is a type of business strategy evaluation, which is a systematic analysis of a business strategy to assess alignment with organizational interests as well as gauge effectiveness and efficiency of the business strategy under evaluation.

Consistency
Appraise the consistency of the business strategy. This includes reviewing organizational goals and objectives, and assuring they align, instead of contradict or work against each other. Compare separate departments to guarantee unity. Your business strategy should be directing all business workings of your company. This entails all staff, operations and policies. Power struggles between conflicting departments or inconsistent procedures erode the structural integrity of your business strategy, challenging its effectiveness.

Consonance
Evaluate the synchronization of the business strategy with both internal and external factors and influences. Fundamentally, consonance is harmony and entails an environmental balance. This is essential for your business strategy. In his work "Evaluating Business Strategy," Rumelt identifies two aspects to assess. The first consists of evaluating the company mission, or reason for existence. The second requires examining the competitive edge of your company. Appraise the scope of the company for validation of agreement with internal or external influences. These may be economic trends or legislative enactments that can affect your business strategy.

Advantages
Analyze the advantages of your business strategy by evaluating how well your business distinguishes itself from others in the same market. This includes determining and isolating those products or services that are only offered by your company. It is imperative to generate and sustain those attributes distinctive to your business. Analyze your business strategy to ensure it allows for proper cultivation and exploitation of your company's competitive advantages.

Feasibility
Determine the feasibility of the business strategy as a whole. Evaluate whether your business strategy can reasonably be achieved. Examine financial resources to define limitations. Assess staffing for not only sheer numbers required for accomplishing the business strategy, but also to decide whether current or prospective staff have the skill base or potential skill set for the undertaking. Additionally, consider whether key stakeholders are willing and able to comply and contribute to the direction the business strategy is taking your company.

SECTION B

RISK MANAGEMENT

B1

STUDY GUIDE B1: RISK AND RISK MANAGEMENT

Get Through Intro

The future is always wrapped with uncertainty. Had the future outcomes been known, the decision-making would have been simple! The business decisions are needed to be made against the backdrop of uncertainty. The uncertain future could unfold with surprises; pleasant at times or unpleasant most of the times. The unpleasant side of uncertainty is the Risk. Risks, thus, may bring in opportunities for benefit (Upside) or threats to success (Downside).

Given the dynamic nature of the business environment, the risks faced by the organisations also keep changing. The firms must keep vigil on the developments continually and be able to protect themselves against the downside risks. Enterprise Risk management is increasingly seen as a combination of positive and negative aspects of risk.

The management of risk involves developing effective methods of assessing the risks, their likely impact on the business and choosing appropriate tools to mitigate the negative impact. A risk model can be used as a framework.

This Study Guide will take you through the types of risks a business organisation may be exposed to and the process in which risks can be mitigated.

Learning Outcomes

a) Explain the meaning of risk and business risk including risks arising externally or internally and relating to achievement of;
   i. Strategic objectives
   ii. Operational efficiency and effectiveness
   iii. Reliable reporting, and
   iv. Legal, regulatory and ethical compliance.
b) Identify and assess risks in a given scenario and their impact upon objectives.
c) Identify and explain appropriate responses to risks identified in a given scenario.
d) Identify and explain appropriate high level procedures to mitigate risks in a given scenario.
e) Identify and explain appropriate mechanisms to monitor risk and risk management processes including information and communication systems.
f) Evaluate both inherent and residual risks after mitigation and judge them in relation to shareholder and stakeholder risk appetites in a given scenario.

1. Explain the meaning of risk and business risk including risks arising externally or internally and relating to achievement of:
i. Strategic objectives
ii. Operational efficiency and effectiveness
iii. Reliable reporting, and
iv. Legal, regulatory and ethical compliance

[Learning Outcome a]

Definition

Risk is a combination of the probability of an event and its consequences.

Risk is an ever present part of life since the environment of business is uncertain and decision-making is subject to uncertainty. Every action or decision involves a risk that things will not turn out as we expect. Sometimes there is an upside risk that things will turn out better than we expect. Sometimes there is a downside risk that things will turn out worse than we expect. In most situations both upside and downside risks are present at the same time. Some events arise because of our actions some events arise from outside because of the actions of others or because of natural events.

Risk is the possibility that actual outcomes may be different from those expected. Risk events are those which may or may not occur, and where the probability of their occurrence will be assigned based on past records.

Risk is a measure of uncertainty. However, some authors make a difference between risk and uncertainty.

Uncertain events are those where different possible outcomes cannot be identified and whose probabilities of occurrence cannot be assigned using past records.

Definition

Business risk refers to the possibility of an organisation not achieving its desired amount of profit or targeted rate of return on investment. Factors like sudden fall in sales, industrial strikes, entry of new competitors, government regulations, etc. contribute to the risk element associated with conducting business.

When a business is faced with risk it needs to understand both the probability of events happening and also the consequences. Probability tells us how likely the future events would be and the consequences tell us the seriousness of the outcome. Both probability and consequences may be uncertain.

1.1 Internal and external risks

On the basis of their place of origin, business risks can be broadly classified as internal risks and external risks.

The business environment is constantly affected by changes that take place to the factors which affect the organisation. The factors may be either external or internal.

1. Internal risks

Internal risks can be associated with events occurring within an organisation. These risks can be seen arising during the ordinary course of a business. It is possible for an organisation to forecast such risks by determining the probability of their occurrence. Internal risks include factors like man, material, money, machinery and management that are, to an appreciable extent, within the control of business.

Following are some of the factors that are responsible for internal risks in an organisation:

(a) **Technological factors:** unforeseen changes in the technical know-how used by an organisation may lead to the obsolescence of its products / production and distribution processes. In such a situation, the organisation may lose some of its market share to its competitors.

(b) **Human causes:** internal risks can arise in an organisation due to conscious or unconscious activities of its personnel. Such activities can include acts of negligence and dishonesty, theft, industrial strikes, management incompetence and inefficiencies, etc.

(c) Data integrity: since products / services of an organisation pass through multiple levels before reaching the final consumers, maintaining data integrity is absolutely important at all levels. If this integrity is not maintained, it can pose great risk to the business. For example, if details relating to a particular product of a firm, like bills relating to raw materials, overhead costs, supplier codes, invoices from customers, etc. are not maintained in a proper way, the entire system can be a failure.

(d) Physical factors: such factors include failure of plant and equipment, theft, leakages and fire in the warehouse or factory area, damages in the transportation of raw materials or finished goods and any other form of damage caused to any property of the business.

2. External risks

External risks can be associated with events occurring outside an organisation. It is not possible for the organisation to forecast such risks by determining the probability of their occurrence, and thus, are beyond the control of the management.

External risks arise from external environmental factors like political, legal, economic, suppliers distributors, employees that are not within the control of business. Some of the factors are discussed below:

(a) Competitors

In order to remain in competition, an organisation needs to continuously monitor the activities of its competitors. This is because competitors' actions affect the ability of the business to make profits by influencing the prices, levels of sales etc. Competitors continuously seek to gain market share and profit of another competitor by differentiating their products and services. An organisation has to formulate its strategies in such a way that the competitor cannot gain an advantage over it.

Example

When mobile phones came into the market, they initially had few features. Once the supply for mobile phones increased and resulted in a fall in prices, organisations started adding features to their mobile phones so as to increase prices. As a result, competitors also started adding features to their mobile phones. Organisations which did not keep up with their competitors would be thrown out of the market.

(b) Suppliers

Suppliers' policies also have an impact on the business of an organisation. The costs of production, quality of the product etc. depend on the suppliers' policies.

Example

Royal Plc makes wooden furniture. A special kind of wood is purchased from Antique Ltd. Antique Ltd has increased the price of the wood. This has increased Royal Plc's cost of production. In order to maintain its profitability, Royal Plc has to increase the price of the product. If, due to competition, it cannot do so, it will have to find a substitute for the supplier or for the kind of wood used.

(c) Customers

Nowadays, the customer is king. If customers do not get good service or competitive prices they will easily switch over to a competing organisation. In a market situation where there is perfect competition, the challenge is not to gain a customer but to retain a customer.
The organisation should continuously study the changes in taste and preferences of their customers and formulate their strategies accordingly.

(d) Political

Political factors are caused by the **role that the government plays** in influencing the environment in which the organisation operates. The stability of the government influences the national economy. If the government changes frequently, it cannot provide a stable framework for an organisation to work within.

Example

Party A is in power in a country and its priority is minimising the unemployment level. Due to certain political disturbances, premature elections were held and Party B came into power. Party B's priority is controlling inflation. The policies adopted by both parties may oppose each other. This will affect the organisation, its strategies and its performance.

The political environment can affect the entity's decision on the following matters:

- the type of goods or services to manufacture
- the geographical area to choose for setting up a factory
- the decision about raising funds caused by change in the interest rates

(e) Economic environment

This refers to the macro economic factors that have a bearing on the economic environment within which the organisation works. They represent certain financial variables influencing the environment. The organisation should concentrate on those factors which have a bearing on its strategies and performance. The economic factors include:

(i) Inflation

Inflation corresponds to an increase in the costs of raw materials, wage rates etc. and ultimately results in an increase in the cost of production. This results in an increase in the price for the product.

(ii) Exchange rates

For organisations which have business connections beyond the boundaries of a country, exchange rates are also a key factor which they need to consider. An organisation has to frame its strategies to avoid losses on account of fluctuations in exchange rates e.g. hedges, forward contracts etc.

(iii) Interest rates

Interest rates are a key monetary influence for businesses since they affect the borrowing power of an organisation. Higher interest rates increase business costs and therefore adversely affect the performance of the organisation.

(iv) Fiscal policies

Fiscal policies refer to government policies on taxation and spending, to influence employment and economic activity. The following examples of monetary policy and fiscal policy illustrate how government policies affect the market conditions and the funding environment of an organisation.

Example

The decision by the government to charge custom duties on a particular commodity may have a negative impact on the industries using those inputs. Higher duties increase input costs and the cost of production. This may affect the demand for the product and the profitability of an organisation.

(v) Monetary policies

These policies are concerned with the volume of money in circulation and the cost of borrowing i.e. the interest rate. Impact of monetary policies on funding environment: monetary policies i.e. money supply, the level of interest rates and the conditions for the availability of credit etc. regulate the economy.

Example

A government policy aimed at allowing concessions to computer hardware and software businesses in the form of tax breaks or subsidies will have a positive impact on the suppliers of the products as well as the users of these products. Input costs would be relatively low, allowing products to become more affordable to customers thereby stimulating demand. This will result in an increase in the performance of an organisation. This shows how the funding pattern of government affects the performance of an organisation.

1.2 Risk and strategic objectives

Existence of risk can limit the chances of an organisation achieving its strategic objectives. The relationship between risk and achievement of strategic objectives can be understood by studying the concept of strategic risk.

Definition

Strategic risk is the risk that long-term, fundamental strategic business objectives will fail to be achieved.

Example

The risk of changing customer preferences in the fashion industry is a strategic risk in the fashion business. Choosing to go into this business and positioning at the high fashion end of the market are strategic risks. They may however offer price premiums and higher returns.

SUMMARY

Strategic risk is influenced by the kind of relationships that the shareholders have with the various stakeholders. If the stakeholders do not cooperate, the strategic risks will increase. **The risks may include the following**:

1. Investors may refuse to invest any more in the company.
2. Employees may not be productive enough and may slow down the production process.
3. Suppliers may not supply quality materials on time.
4. Customers may not buy the required quantity of materials or may even refuse to buy if they find better substitutes.

Examples of strategic risks

A competitor introduces a new product that is attractively differentiated from or with a lower cost base than the company's offering.
A bid to takeover the company emerges.
The company's primary product is getting old, uses dated technology and is losing market share.
Consumer taste undergoes a period of fundamental change.

The factors contributing to the strategic risks are:

types of industry / markets within which the business operates
competitors' strategy and new products coming into the market
political state of the economy in which the company operates
capacity of the company to operate in a highly dynamic environment
fluctuating prices of the inputs upon which the business is dependent
the company readiness to adapt to changing technologies

The responsibility for identifying the strategic risks rests with the board. Diversification of the business is one of the ways to combat strategic risks.

Example

A major fashion house that has chosen to position itself as a very high quality premium priced provider faces a risk that any quality problems with products, inappropriate marketing message or adverse publicity could destroy its 'brand' beyond repair.

1.3 Risk and operational efficiency and effectiveness

Existence of risk can limit the chances of an organisation attaining operational efficiency. The relationship between risk and achievement of operational efficiency and effectiveness can be understood by studying the concept of operational risk.

Definition

Operational risk is defined as the risk of loss resulting from inadequate or failed processes, people or systems or from external events.

Such breakdowns may lead to financial losses through error, fraud or failure to perform in a timely manner or may cause the interests of the company to be compromised in some way e.g. staff or officers exceeding their authority or acting in an unethical manner. Operational risk can also be the risk of major failure of information technology systems or events such as major fires or natural disasters.

Operational risks identification and management is the responsibility of the managers of various departmental heads who are responsible for the implementation of the strategy at the lower operational levels. The operational risks should be managed by the staff and reported to the higher management where the matters are outside the scope of their operation.

Example

In a stone quarry, the operational risk might be that the cranes may not work and alternative arrangements may not be available or the stone crushing machines may not operate effectively enough to crush stones or that the workers might go on strike.

The operational risks may have solutions implanted within business processes in a standardised manner and do not require any creative solutions or high level management response.

There is a need to continuously monitor the operational risks in order to assess whether they affect the strategic and tactical plans. For example, in the initial years of operation, a business's operational risk may have its source in the economic environment, the markets in which the business operates or the strategy to focus on particular types of customer.

These are the strategic decisions that might lead to certain inherent, operational risks. These may require a tactical response such as tightening up on credit assessment if the economic environment is too volatile, improving credit ratings and limits if the markets are fluctuating and competitive or a strategic response by diversifying the customer base through regional or overseas expansion so that the risk of failing to capture a specific customer is mitigated.

Example

Vibgyor Plc is a company which produces designer-wear. This year it intends to manufacture overcoats made from the finest handmade woollen fabric. The target customers are upper class Londoners. However, one of its competitors has already started marketing a similar range of woollen clothes in the market. In this case, the strategic decision to target the upper class may lead to the risk that the overcoats might not sell and hence the operational risk that the overcoats manufactured will be stored and hence inventory will be accumulated.

More examples of operational risks are:

1. A **customer** with a history of slow payment **has failed to pay** an invoice on time and there is news that the company is facing liquidity problems.

2. **Dispatches** are being made **incorrectly** with complaints from customers who are receiving the wrong goods and receiving them late.

3. The **rate of interest has increased** on the company's variable rate loans including the overdraft.

4. A **hacker has entered the company's I.T., systems** and there is a risk that customer credit card details have been stolen.

1.4 Compliance risk

Compliance risk refers to the risks of non-conformance with or violations of prescribed laws, regulations, rules, policies, procedures and ethical guidelines. Such risks expose an organisation to payment of fines and damage charges, voiding of contracts, reduced image and business value, etc.

Compliance risks have the following sub categories:

1. **Reporting:** this risk is concerned with possible misstatement in external communications to stakeholders and shareholders including issues of truth, fairness and whether information is properly reliable and informative.

Example

Reporting risk may arise if there is a failure to report on a specific issue such as the quality inspection followed at the various stores of the commercial enterprise before any of the products are displayed for sale in its shops.

The commercial enterprise may fail to follow the laws of health and safety under the state laws applicable if the suppliers supply them with substandard products for sale.

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2. **Risk of material misstatement**: this is also referred to as financial statement risk. It refers to the probability of financial statements made available to the public, shareholders and the regulatory authority not being accurate. This means that **the financial statements are materially misstated.**

The material misstatements are mainly of two kinds:

(a) Error or omission from the disclosure requirement
(b) Errors in the amounts recorded in the financial statements

Example

Examples of financial statement risks:

- non-detection of fraud existing on the date of financial statements
- provision for warranties not made or made less provision
- inability to identify the uncertainties over going concern status of the entity

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3. **Legal, regulatory and ethical compliance:** this is concerned with the risk that any prescribed laws or regulations may be breached or be seen to have been abused. This risk also includes an organisation not adhering to the ethical codes of conduct. Organisations may face this risk due to its personnel not being aware of proper application of laws and standards of ethics or deliberately applying such laws and ethical codes in an improper manner.

In cases of legal or ethical breaches, an organisation stands to face heavy penalties or legal / social consequences imposed upon it by the concerned stakeholder(s). Ultimately, the firm would stand the risk of losing its brand value in the market.

This legal and ethical risk may lead to financial statement risk.

Example

Esteem Club Plc is a hospitality service provider and runs a chain of clubs, one of which is situated in a small town near London. The club provides restaurant services, bar services, lodging and boarding facilities, a swimming pool and recreation facilities such as boating, billiards, tennis, cards room etc. It has recently obtained permission from the state **to sell alcohol in its club**.

Continued on the next page

The legal and ethical risks and related financial statements risks of this can be:

Legal and ethical risks	Financial statement risks
The permission to sell alcohol in the club may be misinterpreted as being applicable to all the facilities that the club provides, whereas the company is actually allowed to sell alcohol only in the bar area. Hence, here there is a risk that the club will face severe penalties from the state since if it sells alcohol in areas that it is not permitted to sell in.	Breach of regulation may require paying a penalty. However, provision relating to breach of regulation may not be made. This means that the profit may be understated
In the restaurant, employees may misappropriate food items and indulge in fraud.	Fraud may remain undetected and therefore loss arising from such fraud may remain undisclosed in the financial statements

Test Yourself 1

Grease (mechanics) Engineering Pvt Ltd (GEPL) is a company engaged in the production of car components which was established in 19W9. The company is experiencing the following problems:

(a) The company has recently installed new accounting software which is not showing the proper financial position as the stock value is incorrectly calculated due to incorrect programming and identification of dates in the database.

(b) The company has recently taken over another company, Holby, which is now suffering losses because of internal problems including a workers' strike and receivables going bad. Holby has been accused in media reports of misleading customers with incorrect labelling on products regarding safety standards. There is now a threat of a loss of goodwill for Grease.

(c) One key process relies upon a single machine and if the machine fails to operate it will adversely affect production.

(d) The company has decided to enter into the production of components for motorcycles. However, there are many well-established competitor companies in the market, so the company faces the risk that it may suffer a loss in the initial stages. This loss is likely to affect the company's cash flow and overall profits.

Required:

Classify the above risks into strategic risks and operational risks.

2. Identify and assess risks in a given scenario and their impact upon objectives. [Learning Outcome b]

Apart from the risks identified in Learning Outcome 1 of this study guide, there are certain other types of risks which affect an organisation and may limit the certainty with which an organisation can achieve its objectives.

Example

If a commercial enterprise invests a lot of money in capital market instruments such as shares, stocks but a lower amount in bonds there is a risk that when the markets go against expectations the company might lose money. This risk increases if the company does not have balanced investments i.e. balance in the amount invested in low risk investments such as bonds as well as high risk investments.

The above risk relates to the liquidity of a company.

Example

Boating Club Plc is a hospitality service provider and runs a chain of clubs, one of which is situated in a small town near Lagos. The club provides restaurant services, bar services, lodging and boarding facilities, a swimming pool and recreation facilities such as boating, billiards, tennis, cards room etc. It has recently obtained permission from the state to sell alcohol in its club. Accordingly, it has started selling alcohol to its clients in all the different sections mentioned above i.e. restaurant, bar, swimming pool, cards room etc.

The permission has been misinterpreted as being applicable to all the facilities that the club provides, whereas the company is actually allowed to sell alcohol only in the bar area. Hence here there is a risk that the club will face severe penalties from the state since it sold alcohol in areas that were not permitted to it.

The above risk relates to the legal risk that a firm may be exposed to. Thus, from the above two examples, it is clear that identification of risks is an important element in the risk management process of an organisation. **Discussed below are some categories of risk and how they impact organisations objectives.**

1. Market risk

Market risk, better known as financial market risk, is the risk that the market prices of shares, bonds, currency holdings, options, derivatives or other asset values and commodities that are used by a company as instruments of working capital or short-term finance will change adversely and impact profitability, working capital liquidity and availability of finance.

Many companies hold financial assets, either to maintain liquidity, to generate returns on working capital reserves, to speculate for gains, to build up investment funds or to act as hedges against other financial risks or as components in a portfolio of short-term financial investments. The impact of the market risks can also be on the management of other risks and can hence lead to the creation of liabilities.

Example

Money.Com Plc holds Tshs100,000,000 as foreign currency holdings. The currency market has been extremely volatile in recent months since there is a threat of war. The risk may lead to a loss of a part of the foreign currency holding. When the market risk is so high it will lead to a liquidity risk that the business will not have enough money in the short run.

As a result of this risk, the company cannot attempt to manage the smaller operational risks such as the risk of an increase in the working capital loan. This risk can be mitigated by increasing the product prices in the short run to recover the increased interest from the customers. However, in this case there is a possibility of losing customers since they may prefer substitute products with lower prices. This will again affect the share prices since the company’s sales will decrease.

Market risks cannot be managed since they are outside the control of the organisation. Examples of such risks are interest rate risks and demand and supply issues in the national and global financial markets that lead to fluctuations in the prices of the shares, bonds etc. The volatility and instability in the markets due to unforeseen events such as war or terrorism may lead to securities becoming too risky e.g. the threat of war in the Gulf may make oil futures and derivatives too risky to deal in. During such times, cash and bonds are a safer investment since they manage risks well.

There is always a risk in derivatives trading that the market price of derivatives may not move in the direction expected for the underlying security. Hedging techniques help to mitigate the loss in such cases since they minimise the losses arising due to market risks. Market risk discussed until now has been mainly the financial market risk. However, market risk can also be related to risks within the goods or service markets in which a company operates, either as a supplier or customer. Be careful to read exam questions carefully to understand the context of the use of the term.

2. Credit risk

Businesses are generally operated on a credit basis. **Credit risk is the risk that accounts receivables will not meet their obligations on time**. Credit risk impacts the business on a day-to-day basis since the recovery of dues from customers is affected.

Management of credit risk is carried out using techniques such as discounting bills of exchange, export credit insurance, export factoring and documentary credits. Credit risk has a particularly strong impact affects when the company exports products and does not receive payments on time.

The credit risk faced by an entity also depends upon factors such as the volume of credit sales made, the terms of credit offered to customers, the credit limits offered to various customers and the credit assessment procedures followed by the company to decide the credit limit and terms of credit to be offered to a particular customer. These are the internal measures that the company has control over and hence, if managed properly, may reduce the credit risk.

Credit risk may adversely affect cash flow and may require additional financing. Since credit risk may involve customers then there may be a risk that revenue streams may be lost and that operational overcapacity may result. There are immediate risks to operating profit and, in the longer term, to gross margin and contribution.

Example

The risk of accounts receivables not paying their debts on time can be high in the export market. In this case, if the company takes out export credit insurance, it will mitigate the risk in the case of late or non-payment.

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3. Liquidity risk

Liquidity refers to the non-availability of cash or cash equivalents in the business. The **liquidity risk refers** to the risk that the business will **not have enough liquidity to fulfil its current liabilities**. In other words there is a **mismatch between the inflows and the outflows** and the cash flow statements may be at a risk of showing a negative cash flow. This risk is the result of having insufficient cash or bank balance. Instead, the business may have illiquid assets that cannot be converted into cash quickly. Assets at times might not realise the expected value due to a lack of demand or the need to obtain funds quickly. Liquidity risk also arises due to the unavailability of easy loans in the market.

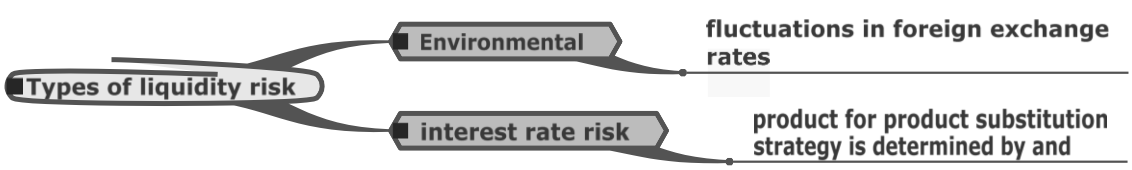
Example

In 19W0, the Bank of New England faced insolvency, because the foreign exchange and interest-rate derivatives held by it faced potential losses and severe illiquidity.

Financial crises in Asia and Russia (along with certain other causes) in 19W8 led to a decline in liquidity and caused the collapse in values of several prominent hedge funds, including Long-Term Capital Management, and sizable losses at many major financial institutions.

The currency risk is the risk associated with fluctuations in foreign exchange rates. This risk is related to the liquidity risk since a company's foreign currency holdings are subject to fluctuations in exchange rates. Interest rate risk is the risk that the interest rates will rise or fall leading to gains or losses. This risk arises due to borrowing and lending. In the above example of the Bank of New England, the bank's liquidity was threatened due to its investments being exposed to currency and interest rate risks.

SUMMARY



Liquidity risk can refer to the risk of insolvency but is more likely to mean that working capital will require an injection of funds from the sale of an asset or the raising of longer term finance. If short-term facilities such as an emergency overdraft are required these may come at a high price and may being payable on demand, create additional risks for the future.

Liquidity risk may affect credit ratings and the ability to raise future finance.

Example

If a company's liquidity position deteriorates then banks and financial institutions may decline any credit facilities to the company, taking into account the poor repayment capacity. This is because if a company has a poor repayment capacity, its credit ratings will decrease and hence it will not be able to attract sufficient capital.

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4. Technological risk

Technological risk is the **risk that technology will change and will adversely affect the organisation**. Technological risk also creates opportunities for a business in that it gives the business the opportunity to innovate and advance its systems in line with changes in the market. Technological risk is associated with the various hardware and software technologies which the business uses.

The advance in the technology will affect the business adversely if the technology base used by the organisation is not updated. Problems associated with updating the business systems are as follows:

- If the business adopts the new technology too early it may have to spend much higher amounts on the installation than would have been required had the business waited for the correct time.
- A delay in the adoption of a new technology is also a risk since a competitor may adopt it and thereby gain a competitive advantage.

Recent comments by former United Nations Secretary General Kofi Annan over the role of genetically modified seed in African agriculture have reopened debate over the risks posed by new technologies. This is another perspective on the technological risks that products that are produced using innovative techniques might not be accepted in the market.

5. Legal risk

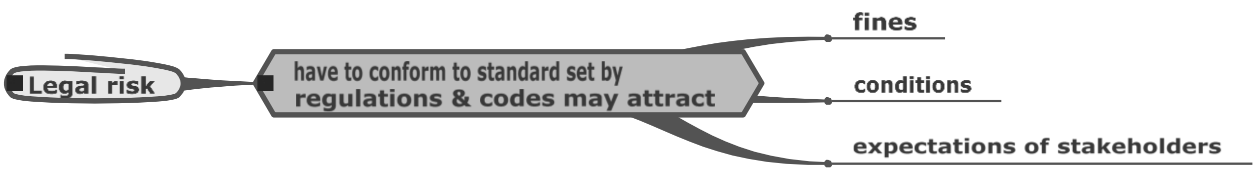
Legal risk arises when new laws, standards, codes and regulations are introduced or the existing ones are changed. The failure to adhere to the laws, regulations and codes may attract fines, penalties and damage to public reputation.

Businesses face this risk since they operate within the legal and regulatory parameters as responsible corporate citizens. They have a responsibility towards promoting lawful behaviour. The legal issues might involve employment issues, environmental legislation, health and safety and many more key areas. Corporate governance codes are a part of the reporting regulations that a company needs to follow. Legal risk is largely associated with the risk of the regulatory and political environment in which an organisation operates.

Example

Bars and restaurants may have to train staff, provide facilities, enforce regulations and put notices in place as a result of laws that prohibit smoking in certain public places. They may also need to consider the strategic impact on their revenues if smokers change their habits.

SUMMARY



6. Health, safety and environmental risk

These are threats to people and the environment arising from **defects in the design of products, processes** and **activities** or the **failure to manage processes and activities.** These failed processes may lead to adverse effects on the business.

Example

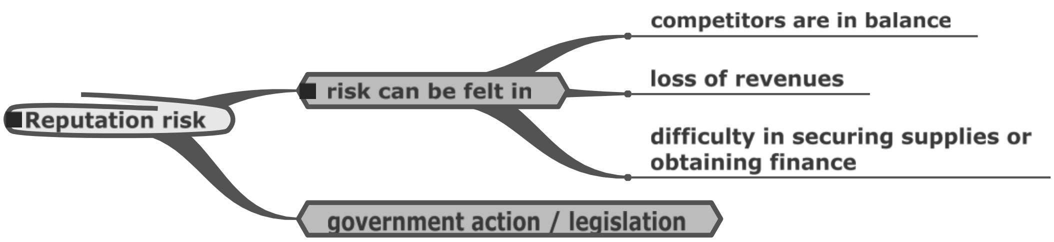
Industrially advanced countries often take advantage of their bargaining position to export hazardous products that are either banned or heavily regulated in the exporting countries. By doing so, they increase the risk to health, safety and the environment in the importing countries.

The impact is similar to that mentioned under legal risk. Industries such as agriculture, farming, chemical, mining and transportation are generally largely exposed to this type of risk. These industries pollute the environment the most and hence face a higher risk of being adversely affected. Waste disposal techniques should be appropriate in such cases in order to cause minimal harm to the environment.

7. Reputation risk

Damage to reputation can arise out of almost all of the other risks. The damage can affect any stakeholder and their attitude towards the company. Damage to reputation can be felt in reduced customer loyalty, loss of revenues and difficulty in securing supplies or obtaining finance. Damage to reputation may cause the share price to fall. Reputation risk can also arise due to bad publicity against the company. The reputation risk may result in a major loss of goodwill towards the company.

SUMMARY



8. Business probity risk

Probity is about honesty and integrity and ultimately the risk here is the risk of fraud. Lack of integrity or perceived lack of integrity in business dealings can lead to damage to reputation. Fraud may have many consequences depending on the nature of the fraud.

Example

The following are some examples of fraud that may lead to a risk to business probity:

- theft by customers or staff
- theft by management
- illegal transactions
- bribes
- deception
- aggressive earnings management and window dressing
- misleading statements to auditors and regulators
- false accounting

Fraud is undertaken for many reasons including:

- personal gain
- corporate gain
- to cover up theft or other fraud
- to manipulate financial reports
- to distort markets

Directors at times may easily indulge in activities in their own self-interests rather than in the interests of the company. This is because they are in possession of sensitive information that can be shared with market competitors to earn a lot of money.

9. Derivatives risk

Derivative risk is the risk related to derivatives, which are complex financial instruments that offer the potential to hedge other financial risks that are driven by interest rate, foreign currency rate and other financial issues. Derivatives are however risky instruments with a high rate of return. The attractive returns on these derivative instruments generate a temptation to buy these instruments. However these instruments induce the investor to speculate rather than to hedge. If the derivatives are not properly structured, residual risks remain. Hedges only cover foreseen risks.

Example

John expects that six months from now the price of the US dollar with respect to the Canadian dollar will be higher than it is today, and would like to purchase US $1,000 six months from now at today's rate. Suppose the current price of US $1,000 is CAN $1,200. In order to reduce the loss that may incur if the US dollar rate falls instead of rising, John enters into another forward contract to sell the US $1,000 at the current market today. This is a hedging technique used to mitigate the loss that may be incurred.

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10. Entrepreneurial risk

Risk which is related to any new business opportunity or new business enterprise is known as entrepreneurial risk. The risk could relate to uncertainties about entrepreneurial skills, unknown market competition, uncertainties in product design and manufacture and so on.

11. Financial risk: these are the risks arising from the way in which a business is financed in the long and short term.

(a) Capital: this risk is largely concerned with gearing, i.e. the mix of long-term debt and equity or shareholders' funds financing used to fund fixed asset, acquisition, development and project investment.

(b) Liquidity: this risk is concerned with the way in which cash, overdrafts and financial instruments are used to provide short-term liquidity for working capital purposes. This risk has been discussed in the earlier part of this Learning Outcome.

(c) Foreign currency risk: when an entity trades with an overseas customer or vendor, there is a risk that the amount to be paid in domestic currency will change due to variations in the foreign currency rate. This risk is to be managed appropriately using techniques such as hedging.

(d) Interest rate risk: when an entity has debt liabilities / assets, it is exposed to interest rate risk. This is because it may contract the deal at a certain rate of interest, for certain duration. However, the actual interest rate during that agreed duration may be different from the contracted rate. This risk is also managed by using hedging techniques.

Test Yourself 2

Winson Plc operates various mines across Mexico. The annual turnover of the company was Tshs400 billion in 20X7. The company has its own research and development team that discovers the various mineral reserves for the company. The company has been consistently performing well for the last five years with little or no deviation in the amount of its turnover.

During one of its reports of 20X7, the research and development department reported that the reserves of the mineral, cuprite have drastically reduced and that they might not be able to extract the required amount of cuprite in 20X8. Cuprite is one of the most expensive minerals and accounts for 55% of Winson's turnover. The report has reduced the chances of maintaining the turnover in the next financial year at the same level since they will not be able to sell Cuprite in the same quantity.

The research team has also reported on another cuprite reserve that it has discovered in a nearby area but the problem is that it is located near a river and hence digging for the mineral in the area is a big risk.

Required:

List the risks that Winson faces being in the mining industry and the risks that the latest report of the R&D department has given rise to.

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3. Identify and explain appropriate responses to risks identified in a given scenario.
[Learning Outcome c]

Example

Besafe Plc is venturing into the manufacture of chemicals that involve the testing and use of uranium and platinum. Both these chemicals may be very harmful to humans. The company has set up its plant at an underground site in a remote area. The biggest risk that the business faces is the risk of serious or even fatal injuries to its employees. The risk management model for the company should begin by identifying the events that could give rise to the risk, then consider the likelihood of them occurring and then consider the various possible injuries the work process can cause to the workers such as health risks and the risk of death.

Study of the risk management model will enable management to better understand how it can effectively respond to the potential risk by creating an appropriate risk management process.

Responding to risks

Once the potential risks associated with a business have been identified, the organisation needs to respond to the risks by effectively managing them.

3.1 An effective risk management should achieve three things:

1. increase the probability of business success
2. reduce the probability of business failure
3. reduce uncertainty as regards the achievement of overall objectives

Example

If a business faces a financial risk then the risk management model should:

- increase the availability of finance for the business in the form of loans, credit facilities or capital in the form of debentures or equity.
- reduce the risk of unavailability of working capital that may lead to stoppage of day-to-day business activities.
- reduce the risk of failure of objectives due to lack of finance.

A risk management model can assist in **understanding how effective risk processes** can be **designed, implemented** and **embedded** into the organisation and its business processes.

Risk management models should always be **tested thoroughly using scenario analysis** for extreme conditions as a result of which the most optimistic, most likely and least likely events and outcomes can be established and that the consequences of even remote possibilities can be known.

(a) The major elements of the risk management process are:

(i) Risk identification: the key stakeholders **identify the risks for the business** so that management can devise proper methods to manage these risks. If a risk is not identified, it could prove to be critical.

(ii) Risk analysis: the **risks facing an organisation**, **should be assessed based on the highest probability of occurrence and the highest possible loss they can incur**. Based on this analysis the risks are categorised and treated.

(iii) Risk planning: planning **for avoidance of risk involves establishing appropriate risk avoidance policies**. These include insuring against possible and known risks such as theft, fire, flood, earthquake etc. Contingency planning involves establishing procedures to recover from adverse events, should they occur.

(iv) Risk monitoring: risks are monitored **on an ongoing basis and as circumstances change** and new risks are identified, newer risk management measures are devised to combat these.

The steps above provide an effective approach for building one-off risk management processes but lack an overall integrated approach. Although risk management is nothing new companies have had to raise their game in recent years in response to changing regulatory environments and attitudes. For US companies the environment was driven from at least two important sources, the output from COSO, the Committee of Sponsoring Organisations of the Treadway Commission, and of course Sarbanes-Oxley.

COSO was created in 1985 to sponsor the US National Commission on Fraudulent Financial Reporting and following investigations into the causes COSO produced their Internal Control Guidelines 'Internal Control – Integrated Framework', that have become a benchmark for many. Their first driver was a series of corporate scandals involving financial statement manipulation. The investigations were headed by James C Treadway.

Following scandals involving high risk strategies, collapse and corrupt practices such as Enron COSO went up a level to address overall enterprise risk management and their model is again a benchmark for many organisations. The **COSO approach is a comprehensive enterprise risk management system that takes a top-down approach to risk management and is widely used as a framework**.

The COSO model begins from clear definition of risk management:

Enterprise risk management (ERM) is a process,

effected by an entity's board of directors, management and other personnel,
applied in strategy setting and across the enterprise,
designed to identify potential events that may affect the entity and manage risk to be within its risk appetite, and
to provide reasonable assurance regarding the achievement of entity objectives

The COSO approach has four clear aims in providing reasonable assurance of achieving objectives relating to:

reliability of reporting
compliance with laws and regulations
strategic objectives
operational objectives

(b) Enterprise risk management encompasses six elements

(i) Aligning risk appetite and strategy: linking risk with return in decision-making
(ii) Enhancing risk response decisions: rigorous selection from avoidance, reduction, sharing and accepting risk
(iii) Reducing operational surprises and losses: through structured event identification and response
(iv) Identifying and managing multiple and cross enterprise risks: assessing the myriad risks that businesses face
(v) Seizing opportunities: through proactive positioning
(vi) Improving deployment of capital: obtaining robust risk information to assess capital needs

(c) The **COSO framework** of enterprise risk management consists of **ten interrelated components**:

(i) Internal environment

Risk management begins with the creation of an environment for people to work in that sets out the philosophy, attitudes and values, operating style and risk appetite within an organisational structure with clear authority and responsibility.

Example

A board may create an ethical code that sets out principles of integrity, objectivity and standards of business behaviour including health and safety and environmental responsibilities. A board may also set up a risk committee of non-executive directors supported by a risk manager and team to create central focus and understanding of risk with links to top management. The environment is however as much cultural as structural or procedural and culture begins at the top. The board sets the tone of attitudes to risk-taking, risk assessment, risk management and reporting. An active involved board can send a message to all staff.

Culture also includes operating styles in terms of how formal they are and whether objectives and actions are aggressively pursued. Staff can understand how much responsibility management wants them to take and how empowered they are including understanding when they need to report and inform managers.

(ii) Objective setting

Business strategies are built from purpose, mission and objectives at a high level. Fundamental decisions on the business, its resources, products, processes, capital and generic strategy are the initial drivers of business risk. Management selects its business model. Decisions involve return and risk and must be linked to the company risk appetite that is driven by the shareholder risk appetite.

Strategic analysis, choice and implementation planning must embrace risk assessment techniques so that management can make informed decisions. COSO also encourages strategic planners to incorporate objectives relating to operations, reporting and compliance at this stage. Strategic planning and objective setting are ongoing processes within a changing environment.

Example

The board may undertake a political-legal, economic, socio-cultural and technological (PEST) analysis of the country in which it operates and looking ahead to the future to understand PEST threats and opportunities. The board may link the PEST analysis to a position analysis such as SWOT to examine business strengths and weaknesses internally and opportunities and threats that exist including those derived from the PEST analysis.

An opportunity may be the driver for a strategy to emerge and the board will discuss operational implementation such as how a new division can be created for a new product and will set out information requirements and the beginnings of compliance plans such as assessment of product and process health, safety and environmental issues.

(iii) Event identification

The event identification process flows naturally from strategic planning and seeks to find the positive and negative events that impact on the strategy. Event identification is part of planning and an ongoing process as the environment changes. Events may be driven internally form what we do or externally from the environment. A technical failure of equipment would be internal; competitor’s response would be external.

Events are often interrelated such that one event leads to others. Building tree diagrams can assist in picturing links and relationships. For example technical failure of equipment could be an event linked to a stock out in our maintenance stores and on to supply chain problems with suppliers.

Example

Introduction of a new low cost product may cause a range of events in a market. Competitors may respond by cutting their prices, changing advertising and promotion or innovative tweaks to design. New product safety laws could impact on the legality of the product. A process fault during production may create health risks if dangerous substances leak.

(iv) Risk assessment

COSO includes assessment of likelihood and impact in this stage of the model. COSO encourages an approach that assesses inherent risk before management action and residual risk after action to control the risk. The assessment may include building best case, expected and worst case scenarios or distributions. Probabilities or textual descriptions can be attached to events. Words such as likely, unlikely or remote are commonly used as descriptors.

Techniques may be quantitative or qualitative. The COSO set of techniques available for assessment of the severity and probability of the risk(s) is discussed in detail in the later part of this Learning Outcome.

Modelling is the key to risk assessment, building models to experiment with outcomes and ultimately to stress test to the limits of possible outcomes. Impact will also include the use of numbers and words as financial impacts and consequences are worked through.

Example

This example takes forward the previous example regarding the possible process fault resulting in the leak of a dangerous substance. The proposed machinery and process may be modelled with a variety of load assumptions, throughput assumptions and operating conditions to assess wear and tear, random faults, operator error and their likelihood of occurring including the overall likelihood of process failure. Technical advice may be sought including the use of supplier data.

The impact can then be assessed with teams of staff with technical support asking 'what if' questions including consequential and flow-through analysis to test possible outcomes. Data should be attached to the outcomes as appropriate including consequential costs and remedial costs. Care must be taken with safety issues since there are reputational consequences. In some cases there may be moral or ethical obligations coming from the environment that make costs a second level consequence. Potential controls need to be considered to see how they affect outcomes. A component replacement policy and maintenance strategy could be relevant here. The assessment can then be reworked to assess residual risk and how overall risk has changed and at what cost.

(v) Risk response

Risk response involves fundamental management choices that have potentially different costs and benefits. The COSO model suggests that assessment develops the potential range of controls that give rise to possible responses.

The four classic responses are:

avoid
reduce
share, and
accept

Management also needs to see the risks overall at an entity level worked through with all events and their consequences for the business in total, taking a portfolio view.

Example

Continuing with the previous example management could consider the four responses as follows:

1. Avoiding the risk would imply using an alternative process that may mean the hazard is eliminated; this could include using different substances.

2. Reduction of the risk would include the replacement and maintenance mentioned earlier along with consequential mitigation routines.

3. Sharing the risk through insurance may be essential but not acceptable in isolation if health and safety is non-negotiable.

4. Acceptance of the risk implies running the process, crossing your fingers and trusting to lady luck! This may involve negligence or criminal negligence consequences.

Overall a cost benefit analysis is being undertaken.

(vi) Control activities

Control activities are the policies and procedures that reasonably ensure that chosen risk responses are carried out. This is where the detailed procedures and controls are created and tested.

Example

If in the previous example management has decided to implement a maintenance and replacement policy it will build the process to carry this out. This will include setting out policies, assigning staff, putting together buying, ordering and stock control procedures with secondary controls built in and having tried and tested routines with schedules for maintenance and replacement. A reporting system should also be put in place along with any required audit of this and the process itself. Mitigation processes will also be required such as necessary alarms, clothing, escape routines and similar techniques.

(vii)Information and communication

There are two key components here:

- the building of information and control systems
- ensuring communication flows

To make control techniques work and to enable effective monitoring information systems are required. These will include I.T. and manual systems that gather accurate and complete operating data and deliver it to the right person at the right time in the right format.

Example

In our example a robust computer controlled system may need to be created to integrate with the machinery so that operating data is built up and fed into maintenance systems. Automated hazard alert systems may need to be built so that emergency routines kick in. The system will include cost data and statistical analyses. Routine reporting will also be required to monitor the overall processes.

Information systems on their own are not sufficient since they need to be utilised and their output acted upon with the right responses.

Communication will need to come from the top as management emphases continuously the importance of risk management so that it is embedded in culture and processes. Communication from the top also ensures staff understanding and how they fit into overall processes.

Communication flows must also go to supervisors, managers and the board. Staffs that operate controls must know when to report, speak, shout or scream and must know that a responsible manager will listen. Lateral communication may also be required where for example technical help is needed.

Communication also ensures the following:

- keeping the board informed
- keeping the risk manager informed
- ensuring data is provided for regulatory purposes
- ensuring that annual report or other similar disclosures can be made

Example

In our on-going example staff should be able to communicate issues such as concerns over replacement cycles and the adequacy of mitigating controls. Operators may also need to call in technical support when they have concerns. If frequent risk events occur they may need to make the problems known to the real decision-makers.

(viii)Monitoring

Monitoring processes should start from the bottom and work all the way to the board. COSO describe three elements:

- On-going
- Separate evaluations
- Reporting deficiencies

The ongoing processes link directly to the information systems already described and go beyond to operational control and feedback systems at a higher level that examine the operational data controls and responses. A manager may receive reports for supervisory purposes.

Separate evaluations are designed to audit processes, controls, feedback and responses including information and communication systems. Audit is a check, gives assurance and examines whether control activities are still right as systems and processes grow, evolve and age. Reporting means, decision-makers know the results and have assessments, evaluations and proposals that can be acted upon.

Example

In our example internal auditors may undertake surprise visits to assess safety and compliance along with audits of the process.

(ix) Limitations

Risk management processes, no matter how well designed and tested and operated, cannot offer any more than reasonable assurance that risks are properly controlled. Everyone needs to know this so that they do not relax in the assumption that things will not go wrong. People will make mistakes or decide not to operate controls or circumvent them to make their life easy or to meet targets.

Example

In our example staff need constant encouragement from the top to follow procedures that are laid down and management are advised to periodically look for them and ask questions. A key question could be 'do we ever turn the controls off?'

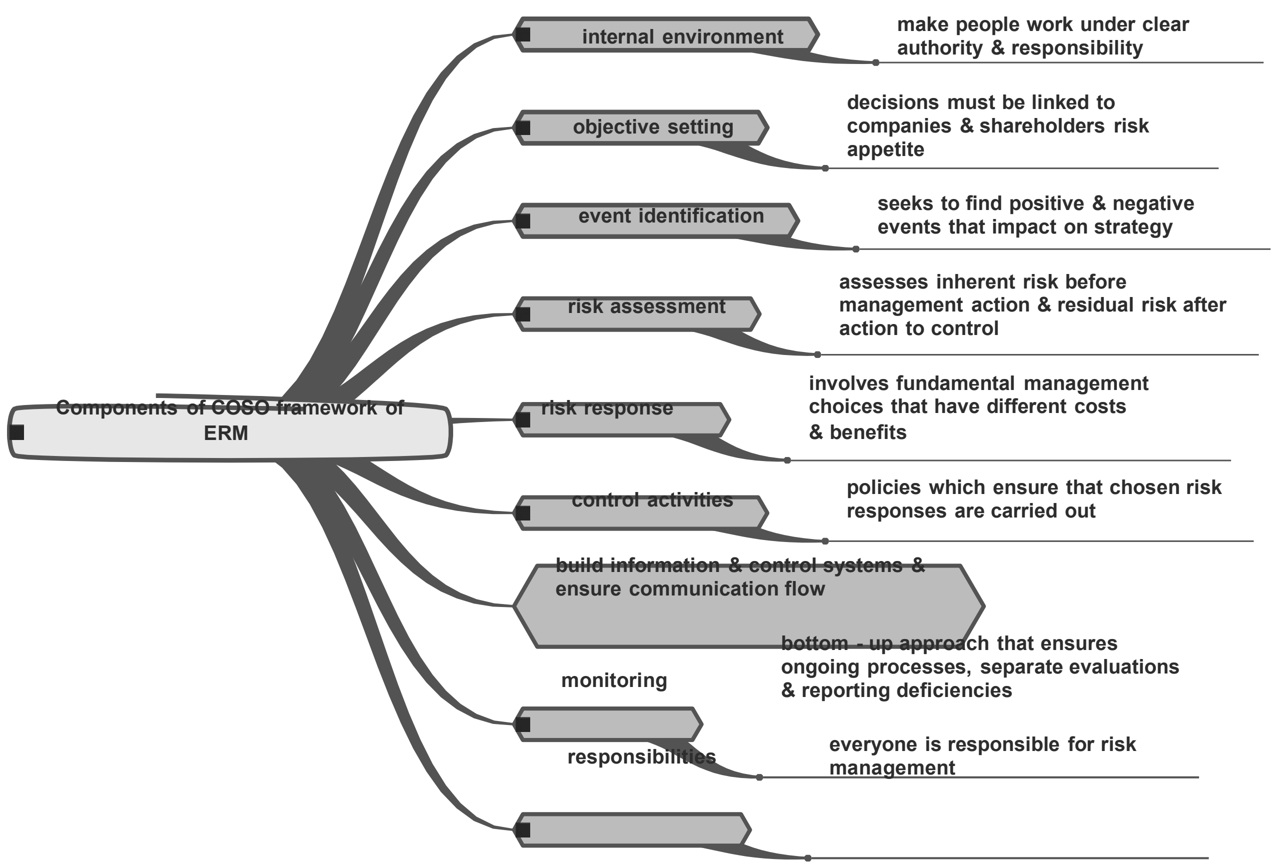
(x) Responsibilities

Everyone in the entity is responsible for risk management.

Example

The annual report should contain sections on the risks faced by the business as a part of the internal control reporting. It should also report on the risk management models that have been devised in order to combat the risks.

SUMMARY



3.2 Assessment of severity of risks using COSO

An assessment of the severity and the probability of risks should be made in order to minimise the impact of the risks on the company's operations. The assessment of the severity of risks also involves correctly identifying the risks. There are two phases in risk management – the planning phase where the risk management is planned and the control phase the occurrences of risks are continuously monitored.

As discussed in the earlier part of this Learning Outcome, assessment of risk forms a vital part of the Enterprise Risk Management system.

1. The COSO methodology describes a set of techniques for assessment of risks under the ERM:

(a) Event inventories

This is an inventory of the various events that are common to the industry, process or activity. This generic list of events is used to identify the common risks that the company faces.

Example

In a software development project, the company may draw up a list of the major software failures, breakdowns and other common events that may disrupt its processes. This will give the company a better idea of how to deal with these risks and devise methodologies to reduce their impact.

(b) Internal analysis

Internal analysis is a routine business activity. Experts from inside and outside the organisation, as well as various stakeholders, provides the company with the information required.

Example

During the launch of a new product, the company utilises internal information such as information on production requirements from the historical records and information on product sales from the financial records. It may also collect information from external sources e.g. by conducting market research on trends and customer preferences.

(c) Escalation or threshold triggers

Triggers are events that warn management of the need for action or a change in action. These are areas of concern for management that are identified by comparing current transactions to pre-defined criteria. These events generally require assessment or immediate action.

Example

A decrease in sales volume is a trigger to modify sales strategies and advertising programmes.
A reduction in the price of a competitor's products is a trigger to reduce prices and bring about a change in the pricing structures.

(d) Facilitated workshops and interviews

Workshops and interviews are held to identify events through discussions making use of the experience and knowledge of the staff and stakeholders. The interviewer leads discussions regarding events that are a potential threat to the achievement of the company's objectives.

Example

A financial controller may hold a workshop with members of the accounting team to identify events that have an impact on the entity's external financial reporting objectives. By combining the knowledge and experience of team members, important potential events are identified that otherwise might have been missed.

(e) Leading event indicators

Data are collected and studied to identify the conditions that lead to the occurrence of certain events. These conditions are known as leading event indicators.

Example

Financial institutions have long recognised the correlation between late loan payments and eventual loan default, and the positive effect of early intervention. Monitoring payment patterns enables the risk of default to be mitigated by timely action.

(f) Loss event data methodologies

Loss events are events that lead to a monetary or physical loss to the company. Repositories of data on loss events are created and a trend analysis is performed by observing these events. This helps management to devise effective solutions and treatments rather than solving individual events.

Example

A company operating a large fleet of vehicles maintains a database of accident claims. Through analysis, it finds that a disproportionate percentage of accidents, in number and monetary amount, are linked to staff drivers in particular units and geographical areas and in a particular age bracket. This analysis equips management to identify the root causes of these events and take necessary action. It may now provide solutions in the form of employing drivers above a specific age limit for certain geographical areas. This might reduce the number of accidents.

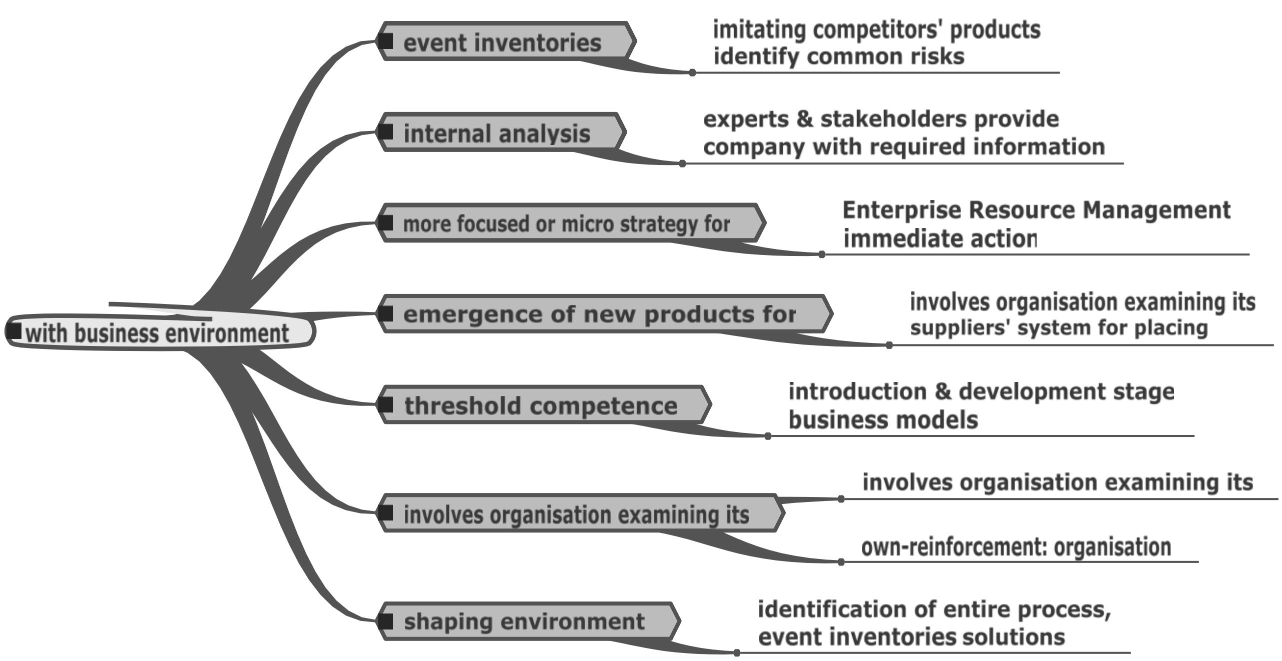
(g) Process flow analysis

Apart from identifying individual events and conditions, a company also identifies an entire process consisting of inputs, tasks, responsibilities and output. Factors that affect the process flow, the inputs and the eventual output are identified and solutions are devised.

Example

A medical laboratory maps its processes for receipt and testing of blood samples. The laboratory maps the entire process from the receipt of the blood samples, their labelling, and transfer of the samples to the laboratory for the actual testing and the handovers between shifts of batch of attendants. The inherent risks in this process could be the risk of incorrect labelling of samples or the risk of handing over wrong samples from one batch to another etc. A range of factors that might affect the process are mapped.

SUMMARY



2. Assessing impact and probability of risks

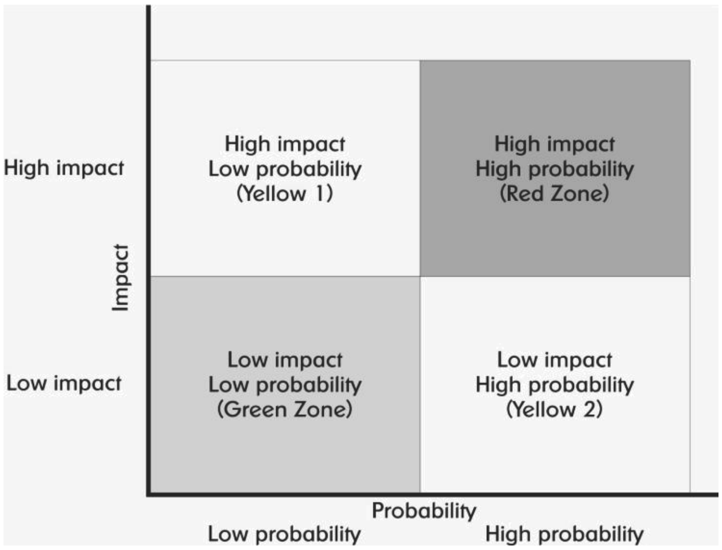
Once a catalogue of risks and risk events has been compiled, each risk needs to be assessed in terms of its probability of occurrence and impact on the company in monetary terms.

Risk assessment is best carried out by mapping the risk probabilities and risk impacts on a two-by-two matrix. The matrix is prepared by identifying four categories of risks. The risks identified are then mapped on this matrix.

The horizontal rows of the matrix represent the impact of the risks: high and low.

The vertical columns represent the probability of the risk: high and low.

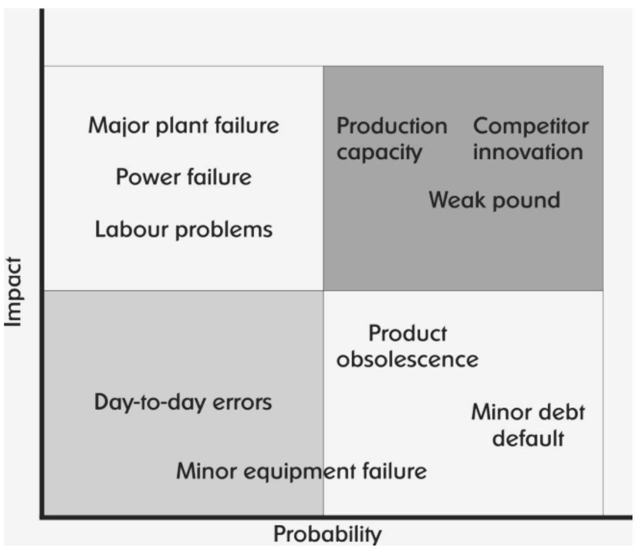
Diagram 1: Risk probabilities and risk impacts



The risk map helps management to identify where immediate control is required. The need to continually monitor risks can be assessed by mapping the risks on the matrix in the quadrant where they belong.

Examples of the risks that may fall in each of these categories are given in the matrix below.

Diagram 2: Risk probabilities and risk impacts (risks that may fall in each of these above categories)



Although this basic structure identifies the risk category, it does not measure the impact of these risks. Quantification of risks is essential in order to manage the risks through setting limits on the maximum risk the company may incur (the maximum risk tolerance). The actual performance needs to be assessed against this limit in order to identify deviations.

Some risks may have mathematical probabilities attached to them. For example, when rolling a die there is a 1/6 probability of rolling any one particular number.

Other risks may be labelled using terms such as likely, unlikely and remote. With many risks there is also a time horizon to consider, for example taxation rates may be unlikely to change over the next three years and hence the risk of profits after tax being affected is unlikely to materialise within three years.

The catalogue of risks can then be extended beyond probability to explore the consequences of the events and risks.

Based on the risk assessments in the form of a risk map, the risks may be prioritised. **Certain risks require immediate action such as the risks falling in the first quadrant of high risk and high probability**. **Others** might **not require urgent action** such as the risks falling within the low probability, low risk quadrant.

The risk mitigation measures also need to be assessed using cost benefit analysis. The expected loss from the risk materialisation should be quantified in monetary terms e.g. the loss due to a machine breakdown in terms of loss of sales or in physical terms e.g. loss in terms of injuries to workers due to an accident in the factory. The risk map helps in prioritisation of risks since the quadrant of the risk decides whether or not the risk needs to be addressed and the urgency of the action required.

Risks can be explored in a systematic way by identifying:

- a description of the risk outcome
- an analysis of the consequences
- an analysis of mitigating factors including controls
- a quantification of the impact in cost terms including opportunity costs, actual costs and lost revenues. This may need to be presented using a timescale table to model the unfolding damage and its cost

Example

In the banking industry, one of the I.T. risks faced is the risk from viruses. This is the identification of the risk. Viruses can threaten the bank's data security in that they may cause the bank to lose sensitive data on its customers. This is the analysis of the consequences. Banks need to control the risk by installing network security systems to guard against network failures and cyber-crimes.

This will include the use of firewalls and intrusion detection systems, anti-virus software, back-up facilities and secure routines for backing up at other data centres. This is the analysis of the mitigating factors. According to one of the major trade groups, managing this risk costs banks almost $1 billion. Failure to manage the risk will also have a cost. Benefits can be quantified in terms of disruption costs avoided and customer gains

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3. Risk assessment

Risk assessment involves bringing together the results of probability and impact. The use of a risk matrix provides a useful tool. The preparation of the matrix as below helps plotting the risks on the matrix by writing the events in each of the four zones.

Diagram 3: Risk assessment

		Impact	
		Low	High
Likelihood / Probability	High	Yellow zone	Red zone
	Low	Green zone	Yellow zone

Risk events can be plotted to the grid individually or to create a risk map of classes of risk as follows.

Diagram 4: Risk assessment (risk events that plotted to the grid individually)

		Impact	
		Low	High
Likelihood / Probability	High	Loss of operational staff	New entrant into market with new technology
	Low	Loss of critical supplier given competitive market	Loss of key customers

The map can also have costs attached to it to quantify the events.

Test Yourself 3

Sherwood is an IT company engaged in the preparation of different kinds of software. It has recently prepared software useful for construction companies. The company has implemented this software on a trial basis in 2 construction companies. The software calculates the costs and revenues related to a project for a year on a percentage completion basis. The companies where the software is installed are not satisfied with the performance of the software, as it is not giving accurate calculations. The cost allocation performed by the software is not correct. What's more, there is a risk of loss of data as the software is not able to keep a proper backup of the stored data.

Required:

State the measures that Sherwood should take to manage the various risks involved according to the COSO methodology.

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4. Identify and explain appropriate high level procedures to mitigate risks in a given scenario. [Learning Outcome d]

Definition

Risk mitigation or risk reduction refers to the planned efforts by an organisation towards reducing the chances of occurrence of specific risks, exposure to the risks or the consequences of such risks.

Example

Tushita Plc is a hydroelectric power generation company in Switzerland. It has power stations across Switzerland that are located at the feet of mountains where waterfalls accumulate the rain water in natural lakes. The board of the company now plans to open a power station near a waterfall which has been newly discovered by the company's research department.

In this case, the board of Tushita should come up with an overall framework for risk mitigation including the ethical and integrity standards of the company e.g. the company does not want to cause the relocation of residents for the purpose of setting up the power station.

Management should come up with a detailed risk management plan that will address all the types of risks that the construction and operation of the power station will involve. This may include environmental risks such as landslides and floods. Management should devise proper safety measures that will minimise the losses that may arise from these risks.

The above example demonstrates the importance of the role played by the highest level of an organisation in mitigating and managing enterprise risks.

Every member of an organisation has a responsibility for mitigating enterprise risk. This responsibility is the highest at the board level and high level procedures to mitigate risks can be discussed with reference to board level considerations of enterprise risks.

The board level consideration of risk requires an understanding of certain concepts such as the risk appetite of the company, residual risk, risk capacity and risk attitude. The strategy of the company should be consistent with its risk behaviour.

4.1 Strategy of the company with its risk behaviour

1. Business strategy

The company's strategy decides the broad objectives of the company and how it will achieve them. In other words, the strategy defines the overall direction of the company and its vision.

Example

The board of an automobile company may adopt a new strategy of manufacturing environmentally-friendly vehicles to sell alongside their traditional portfolio of petrol and diesel cars.

The strategy should be planned in such a manner that the company faces an acceptable risk exposure. Risk exposure is the possibility that the company will suffer losses due to unfavourable conditions or events occurring in the future. These exposures need to be measured and quantified. A Chinese company that sells to the US will face currency risks that could either make products more or less expensive.

These risks are not absolute risks of losing the entire amount of money involved. These measures only give the company a reasonable idea of the possible losses and hence help in risk management. Other risks that result in a qualitative loss cannot be measured in terms of money e.g. the risk to the company's reputation. However, even in this case, the amount of loss may be estimated by calculating the loss of sales.

2. Risk appetite

In order to make profits, a company must take some risk. The risk of loss is inevitable in the pursuit of profits. The risk appetite of a company, i.e. the amount of risk that the company is willing to accept in order to fulfil its strategy, is justified by the expectation of a gain resulting from the risk acceptance. Loss up to a certain limit might be accepted if it results in a long-term gain.

Example

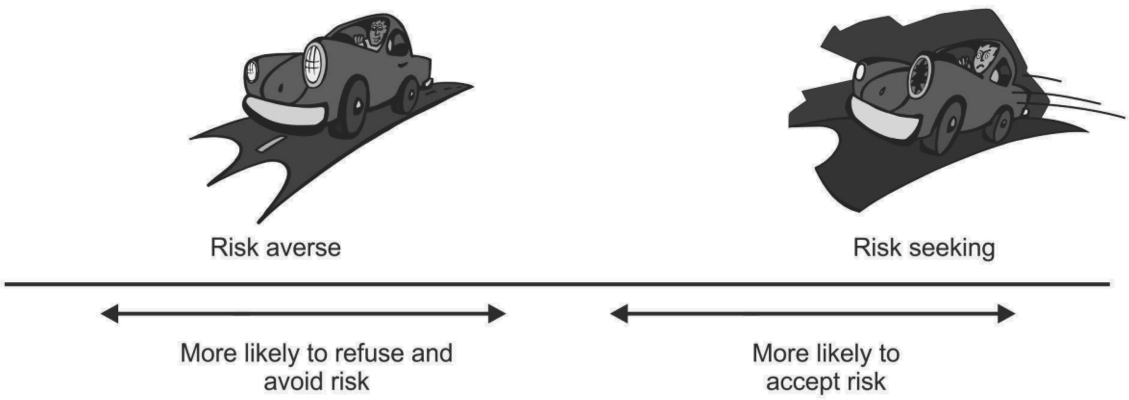
A pharmaceutical company may invest in research and development that depresses current earnings since the gains from new products can be substantial in the long run despite the risk of abortive or fruitless expenditure.

Risk appetite refers to the amount of risk that an entity is willing to accept in order to fulfill its strategy, i.e. the attitude of an entity towards accepting risk. Some organisations are considered as risk loving or risk seeking i.e. they enjoy taking risks and challenges. They often opt out of 'expensive' mitigation strategies. Hence they pursue profit opportunities that risky ventures present because they want to benefit from the risk-return tradeoffs.

Some organisations are considered as risk averse i.e. these organisations are the most cautious while accepting any kind of risk. They avoid risk whenever possible, but are willing to accept some risks. Such an attitude towards risk makes organisations miss out on profit opportunities by resisting or slowly adapting to innovative products or practices. Organisations in the public sector and charities are generally risk averse.

The various attitudes towards risk are demonstrated in the following continuum:

Diagram 5: Risk Attitude Continuum



The two ends of the continuum relate to two extreme situations i.e. risk averse and risk seeking. Again these are theoretical situations as entities generally fall between the two extremes.

Risk appetite has a direct relationship with the risk control of the entity. This is because management is required to respond to changes in the risk assessment over time. Therefore risk loving entities would require to invest in complex systems in order to manage and monitor risks. On the other hand, risk averse organisations may not require elaborate and costly systems to monitor risks.

Example

An aggressive management may opt for short-term funding. This is because the cost of capital is less and since the management is aggressive, they are willing to take risks. However, a conservative management may opt for long-term funding since it is secured although costs somewhat more. The attitude of management towards risk therefore affects their funding decisions and ultimately performance of an organisation.

The risk policy statement outlines the manner in which the organisation will manage its risks. Therefore, based on the risk appetite, the organisation frames its policy on risk.

3. A company's risk strategy is the strategy to manage the risks that the company will face and is ready to accept.

Example

A company that faces currency and foreign exchange risks may operate a treasury department with the objective of hedging such risks.

The risk attitude of a company is the manner in which it deals with risks. The risk appetite and strategy as discussed above depend on the management's willingness / attitude towards risks. It might be averse to certain risks e.g. management will not risk losing the company's credit rating since its finances depend on it; however it may decide to sell the company's products at a price lower than the total costs when it has to enter a new market. Management can either be risk averse or risk seeking.

The risk capacity of a company is the amount of risk exposure that it can bear.

4. Residual risk is the risk that remains after the company has taken all possible measures to manage the risks. The company has to face this risk since it is inevitable.

Example

A company will face risks of attack to its I.T. systems from hackers, viruses and similar threats. A company may employ all available security systems to protect its I.T. systems from attack but these cannot guarantee that all attacks will be prevented. The risk that remains is the residual risk. This may be insurable and be mitigated by disaster recovery routines.

Diagram 6: Concepts in risk management

4.2 Board responsibilities regarding risk management

The specific responsibilities of the board and personnel responsible for risk management are discussed below.

1. Board of Directors

The board of directors is responsible for the overall functioning of the company and hence also for the risk management process. The board appoints the management to manage the affairs of the business for it and hence management is accountable to the board for the implementation of an appropriate risk management process. The board has a responsibility to define the ethical and integrity standards of the company and to effectively communicate these to management.

The board should set up a framework for the risk management process whereby it decides upon the risk appetite of the company. Management can then be delegated the task of formulating risk management methods and implementing them at the tactical and operational levels. The board should reserve authority in certain key decisions such as setting strategy, formulating high-level objectives and broad based resource allocation.

The board of directors oversees enterprise risk management by:

(a) knowing the extent to which management has established effective enterprise risk management in the organisation

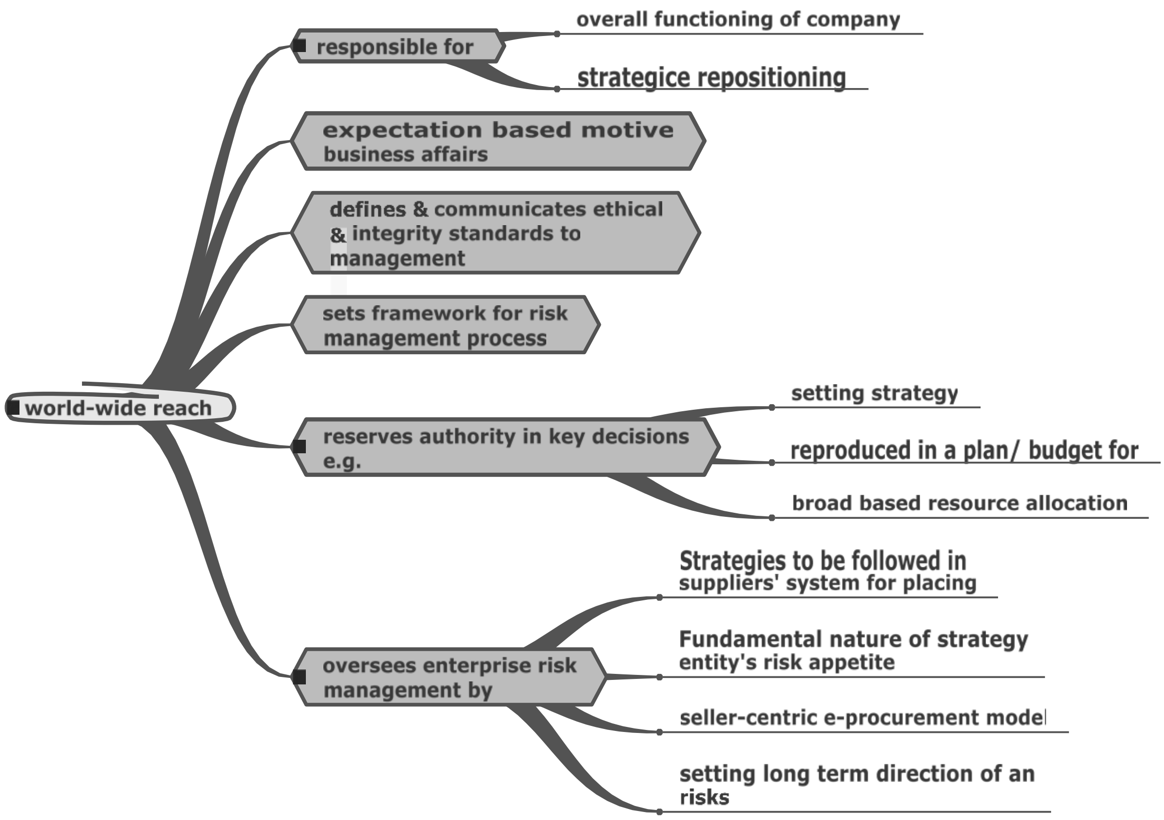
(b) being aware of and concurring with the entity's risk appetite

(c) reviewing the entity's portfolio of risks and comparing it to the entity's risk appetite

(d) being apprised of the most significant risks and reviewing whether or not management is responding to them appropriately

The existence of a risk committee on the board should be encouraged so that the board has the requisite team to focus on effective Enterprise Risk Management (a part of the internal environment).

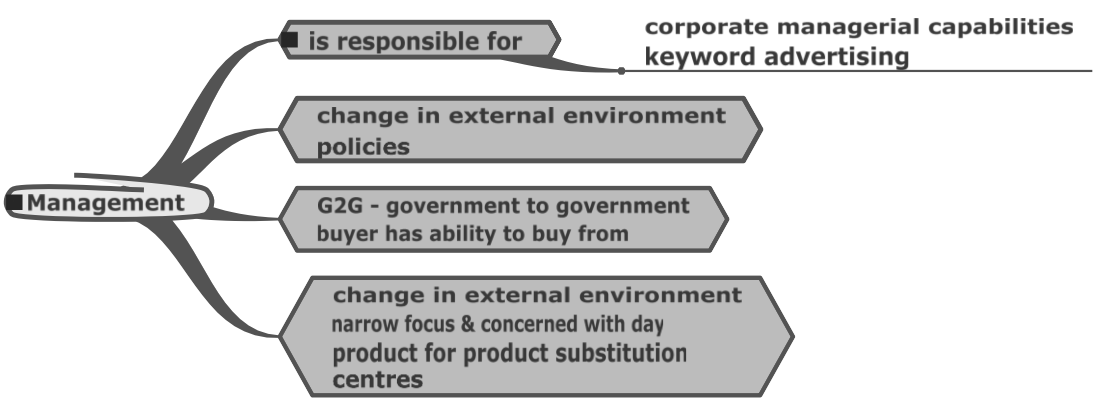
SUMMARY



2. Management

Management is ultimately responsible for setting the tone for the organisation's risk management process. The CEO should assume the responsibility for setting risk management policies that will set the standards of ethics and integrity for the organisation. In large companies, the CEO should provide proper leadership to the senior managers and review the manner in which they manage the business. Senior management then delegates the specific tasks to the managers of individual units.

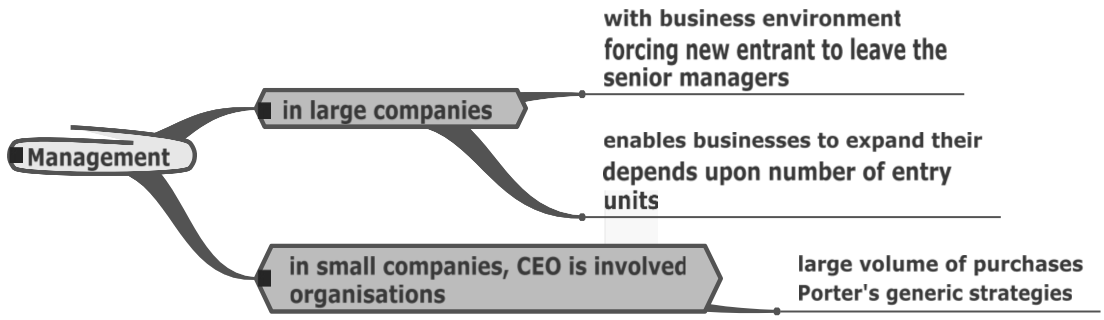
SUMMARY



The scenario changes in the case of a small company. In this case, the CEO is himself closely involved in all the issues the business faces. Therefore the responsibility for framing and implementing the policies is that of the CEO himself.

The manager, in any case, is chiefly responsible for his sphere of activities and for all those who operate below him. In addition, the leaders of staff functions such as compliance, finance, human resources and information technology, whose monitoring and control activities cut across, as well as up and down, the operating and other units of an enterprise are also responsible for managing the risks in their respective centres.

SUMMARY



3. Risk officer

The risk officer, chief risk officer or risk manager is the head of the board's risk committee. He is responsible for monitoring the progress of the risk management process and ensuring its implementation. He works with the lower level managers to effectively manage risks in their areas of responsibility.

Example

A risk manager will request analysis of risks across the company so that overall risks and connected risks can be assessed. The various departmental heads such as the marketing manager and the production manager working together for mitigation of the technology risk that affects production and sales.

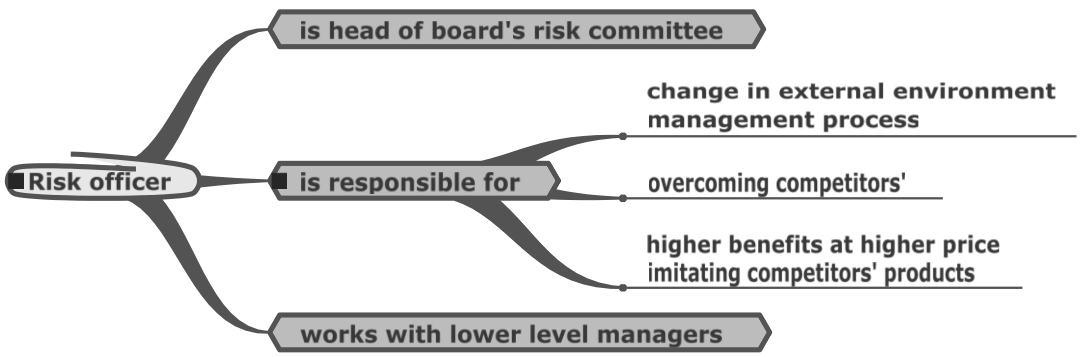
The risk officer may also have the responsibility for monitoring progress and for assisting other managers in reporting relevant risk information up, down and across the entity, and may be a member of an internal risk management committee.

Example

The risk manager may support I.T. managers by reporting risk concerns and feasibility studies for proposals to board level.

The role played by the risk officer is discussed in detail later in this Study Guide.

SUMMARY



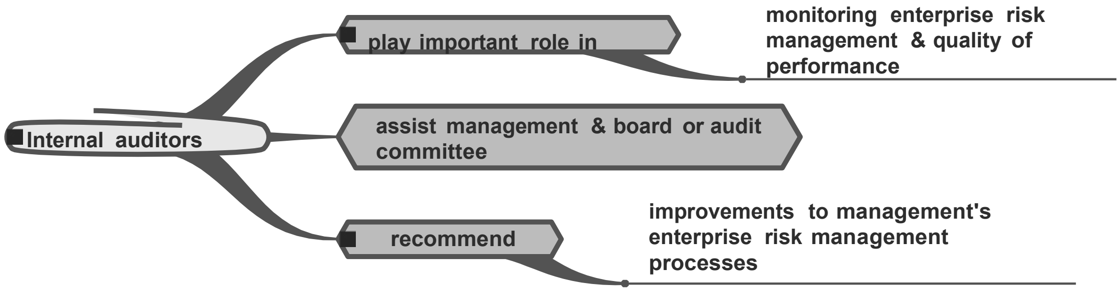
4. Internal auditors

Internal auditors play an important role in the monitoring of enterprise risk management and the quality of performance as part of their regular duties or upon the special request of senior management or subsidiary or divisional executives. They may assist both management and the board or audit committee by monitoring, examining, evaluating, reporting on and recommending improvements to the adequacy and effectiveness of management's enterprise risk management processes.

Example

Manufacturing companies always face the market risk of an increase in the prices of raw materials and hence the risk of a decrease in profit margins. The internal auditor's role in monitoring the management of this market risk will be to ensure that the company has a procedure in place for scientifically determining re-order levels in order to avoid shortages and, at the same time, enable the company to take advantage of the current prices and quantity discounts. On special request from management, the internal auditor may also conduct a management audit in order to monitor whether or not proper purchase procedures are followed.

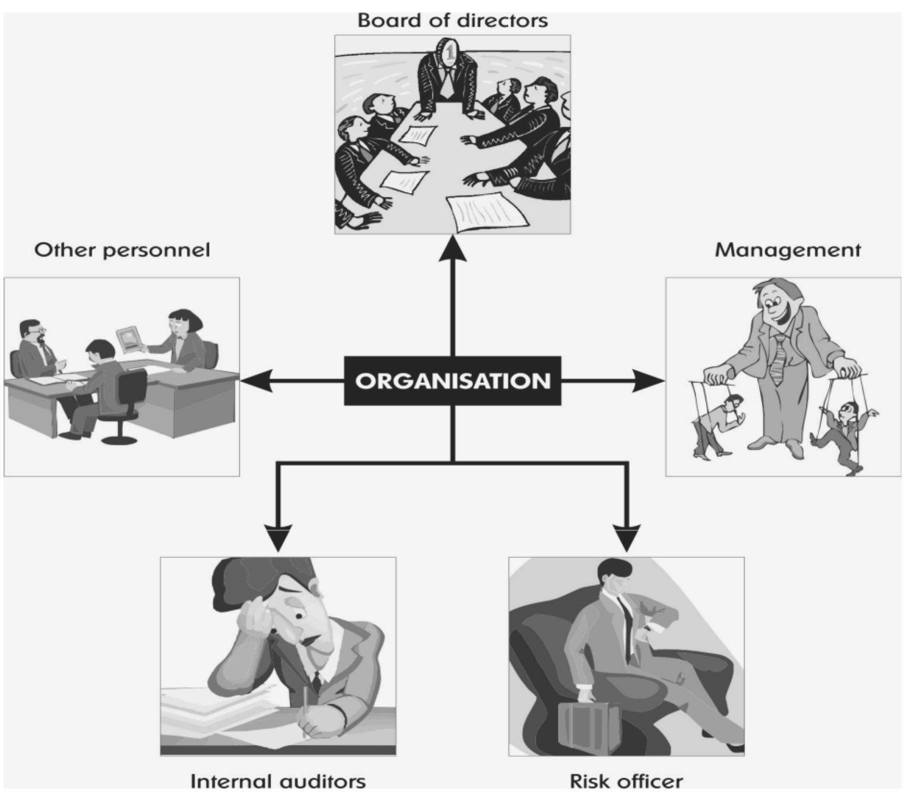
SUMMARY



5. Other personnel

Enterprise risk management is, to some degree, the responsibility of everyone in an entity and therefore should be an explicit or implicit part of everyone's job description. Virtually all personnel produce information used in enterprise risk management or take other actions needed to manage risks. Furthermore, all personnel are responsible for communicating risks such as problems in operations, non-compliance with the code of conduct, other policy violations or illegal actions to the appropriate authority.

Diagram 7: Framework for board level consideration of risks



Test Yourself 4

Backstreet is a company which manufactures woollen textiles. The company is situated in a small town in Estonia and is a famous brand in Eastern European countries. The company produces a variety of sweaters, coats, shawls and blankets.

The recent batch of woollen textiles manufactured by Backstreet has been tested by the quality control department and has been found to cause wearers to break out in rashes. This is because the sheep from which the wool is obtained are suffering from a disease. The quality control department also observed that although this textile is harmful for only 10% of the people who were put to test, it is not at all suitable to the skin of the people residing in Estonia. However, people from Finland are less likely to suffer from rashes due to the different climatic conditions in Finland.

The company manufactures in Estonia and sells its textiles across Europe in Finland, Switzerland and Austria. The company's major markets are Estonia, Switzerland and Austria. Therefore to sell the defective textile in these markets would be a big risk since Backstreet might lose customers.

Required:

State the responsibilities of the board, management, risk officer and the internal auditor of the company regarding the risk of selling the textiles in these markets.

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5. Identify and explain appropriate mechanisms to monitor risk and risk management processes including information and communication systems

[Learning Outcome e]

5.1 Monitoring risk

Risk management for each company differs according to the kind of business the company is involved in. Each business sector has both specific and generic risks associated with it. Risk management cannot be generalised and hence each entity frames its own risk management policies.

Every organisation should have a sophisticated process in place for continuous monitoring of its risk profile. This would help in responding quickly to exceptional events. Monitoring of a company's risk profile is very important as the risk profile forms the basis of the company's objectives, policies, information needs, operational procedures and internal control environment.

Monitoring of risk essentially involves the following:

- identifying risks of exceptional nature (both from external and internal environments) which are sources of major threats to the organisation and ensuring that the organisation's risk profile is always up to date

- passing on the information gathered (as above) to the concerned parties so that appropriate action can be taken to mitigate the risks identified

- appraising the appropriateness and effectiveness (including cost effectiveness) of the risk management strategies and methods already in place in the organisation and recommending as to how such methods can be updated keeping in view the most current environmental situations.

Risk monitoring methodologies and practices vary from organisation to organisation. In general, organisations have a risk committee, a risk manager and internal / external risk auditing system.

1. Risk committees

A risk committee is formed by the board to:

(a) identify the major risks facing the business and provide an insight into the risks that are inherent to the business

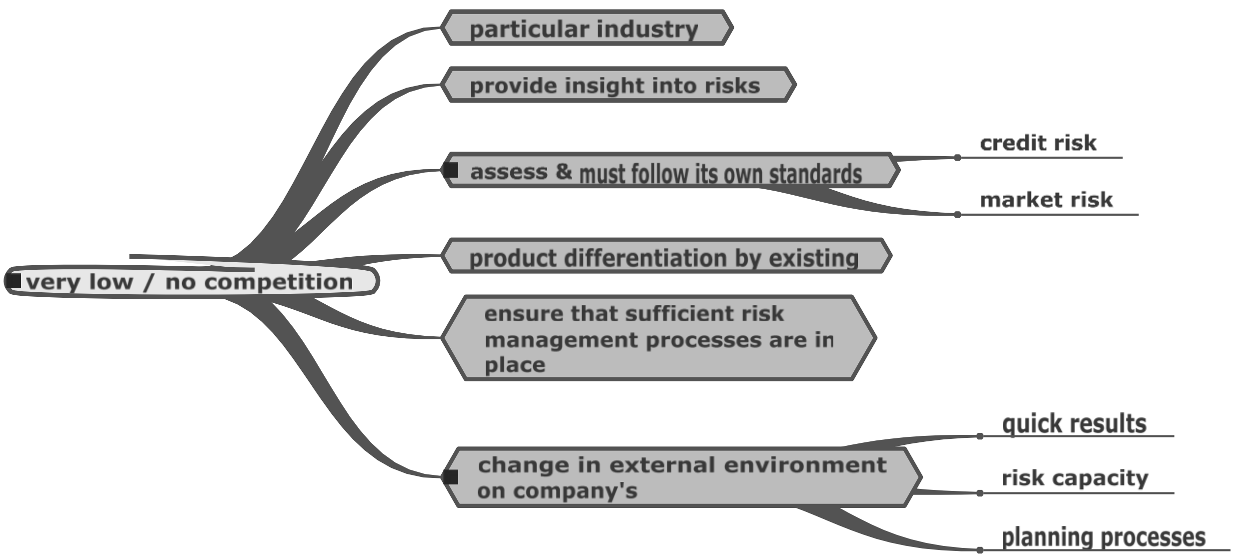
(b) assess and review the generic risks facing the business such as the credit, market, liquidity, reputation, operational, fraud, strategic, technology, data-security and business-continuity risks

(c) create and increase the risk awareness in the company so that risks can be avoided by having an informed approach towards work

(d) ensure that sufficient risk management processes are in place to identify, report and monitor risks

(e) provide recommendations to the board on the risk appetite, risk capacity and risk management of the company

SUMMARY



Generally risk committees do not have the power to take decisions on how to control risk. They can only recommend certain measures to the board. The main function of the risk committee is to identify, monitor and report on the effectiveness of risk management to the board. All the members of the risk committee are also members of the board of directors. A majority of the members are non-executive directors. The committee generally consists of at least three members and the quorum for the committee meetings is generally two. The committee is chaired by a non-executive director and all the non-executive members of the committee are appointed by the board.

The risk committee should report to the board regarding the effectiveness of the risk management systems in place in the company. Internal auditors are generally a part of the risk committee and report to the risk committee. Risk committees that include the risk manager have the responsibility to ensure effective communication of the risks, risk management policies and internal controls that exist within the company to employees at all management levels. This task is generally carried out by the risk officer.

The risk committee is not responsible for supervising the performance of executives and must not become involved in day-to-day operations, management functions or decision-making. The committee may obtain information from and consult with the senior manager of the company when appropriate and may, on notifying the relevant higher authorities:

direct any special investigations

seek the advice of the entity's auditors and solicitors

engage and consult independent experts, where necessary, to carry out its duties

consult external reports and other documents

Example

Suppose that, in an ammunitions factory, a disproportionate number of accidents occur during the night-shift. The risk committee may direct special investigations to identify the reasons for these accidents.

The investigations might reveal that:

the foreman or supervisor is a little slack
some employees have taken on additional 'day' jobs and are tired when they come on shift
the lighting is faulty - insufficient or flickering lights, heavy shadows
night-time temperatures are too low for comfort

If a particular employee is frequently involved in accidents, perhaps he:

has personal problems which are affecting his work
is being overworked
needs better training
should be moved to some other line of work, before he injures himself

These are all possible circumstances which might increase the risk of accidents.

Accidents at a particular machine might indicate the need for improved safety devices, better operating procedures or even replacing the machine with a new and safer model. These observations might come to light when the company's auditors, solicitors or independent experts review the existing risk management procedures and recommend improvements.

If a company does not have a risk committee, the work of the risk committee is carried out by the audit committee since it monitors and implements the internal controls in the organisation. The following is an extract from the disclosure in the corporate governance report of a company of the various duties that the company's risk committee handles.

Case Study

Balamory Ltd is a NYSE listed company. The company is engaged in the business of manufacturing semiconductors for computers. The board of the company has a risk committee whose principal responsibilities are to identify and spread awareness of various risks.

Mr. Richards is the chairperson of the risk committee. The committee meets as frequently as it determines necessary but not less than 4 times in each fiscal year for the discussion of critical risks facing the business. The committee comprises the CEO, a group of NEDs, and the managers of all departments.

The responsibilities of the committee include:

- to define the company's risk appetite
- to review the planning guidelines and the budget to ensure they are in line with the strategies approved by the board
- to review the process of forecasting to ensure that it is appropriate and effective
- to appraise the significant risks faced by the business and actions taken in mitigation, determine whether they are adequate and report upon such risks and actions to the board
- to review and assess the level of liquidity and credit risk
- to review and assess various credit limits and make specific recommendations with respect to economic risk capital

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2. Risk manager

The risk manager is the person who is responsible for identifying and suggesting measures for the management of risk within the company.

The risk manager is a member of the risk committee and is responsible for reporting to the risk committee and to the board. He works along with the risk management committee members.

The risk manager's role in the management of the entity's risk is as follows:

(a) to provide overall leadership, vision and direction to the risk committee

(b) to guide the risk committee in setting up risk management policies and systems for the company

(c) to implement the risk management policies set by the risk management committee and the board. To maintain good working relations with the board and the risk committee since he has to work in conjunction with them and his effectiveness depends on the support of these parties.

(d) to create and improve risk awareness in the company by providing assistance and advice

(e) to assist in the identification of the risks and establish risk identification tools

(f) to establish models for the assessment and measurement of risks and implement risk mitigation strategies by installing proper internal control procedures to manage the identified risks

Example

Sam Spiros the risk manager of a food manufacturer has noticed an increasing number of incidents of production stoppages due to leaks from cooling systems. He has asked for a report on the risk implications of the leaks for staff and to products and for a cost benefit analysis of making changes to or replacing the systems.

(g) to monitor the implementation of the risk mitigation strategies and internal audits that are performed by the internal audit team of the company. They should also assist the departmental heads in sorting the queries that the internal auditors have raised.

(h) This will aid the process of maintaining adequate internal controls in order to avoid risks.

(i) to ensure that the entity complies with the risk rules applicable under relevant codes, regulations, statutes, etc. applicable at the national level and industry specific regulations like risk rules applicable to banks, oil and mining industries.

(j) to report the above matters to management and risk committee as appropriate.

(k) to preparing and present risk incident reports to the internal management and the board as well as to external parties such as auditors and shareholders.

Example

Health and safety incident reports may include the number of accidents that occurred in the factory during the year and the type of first aid that was administered. A log should be maintained and reports should include actions and recommendations should they be required.

(l) to support the external auditors by providing assurance of the risk management and controls in operation in the company.

(m) to develop communication networks to keep management informed of objectives and costs and statistics that relate to the establishment and operation of risk management programmes.

(n) to prepare a risk management policy statement, procedures and manual for practical use for managers and supervisors. This will help the risk management practices to be better implemented at all levels from the top level management to the lower level operations staff.

The risk manager's role may be general, i.e. a company may have only one risk manager, or the company may appoint managers to handle specific risks.

When a risk manager handles general areas he is responsible for identifying, assessing and managing all the risks that the organisation faces at all levels.

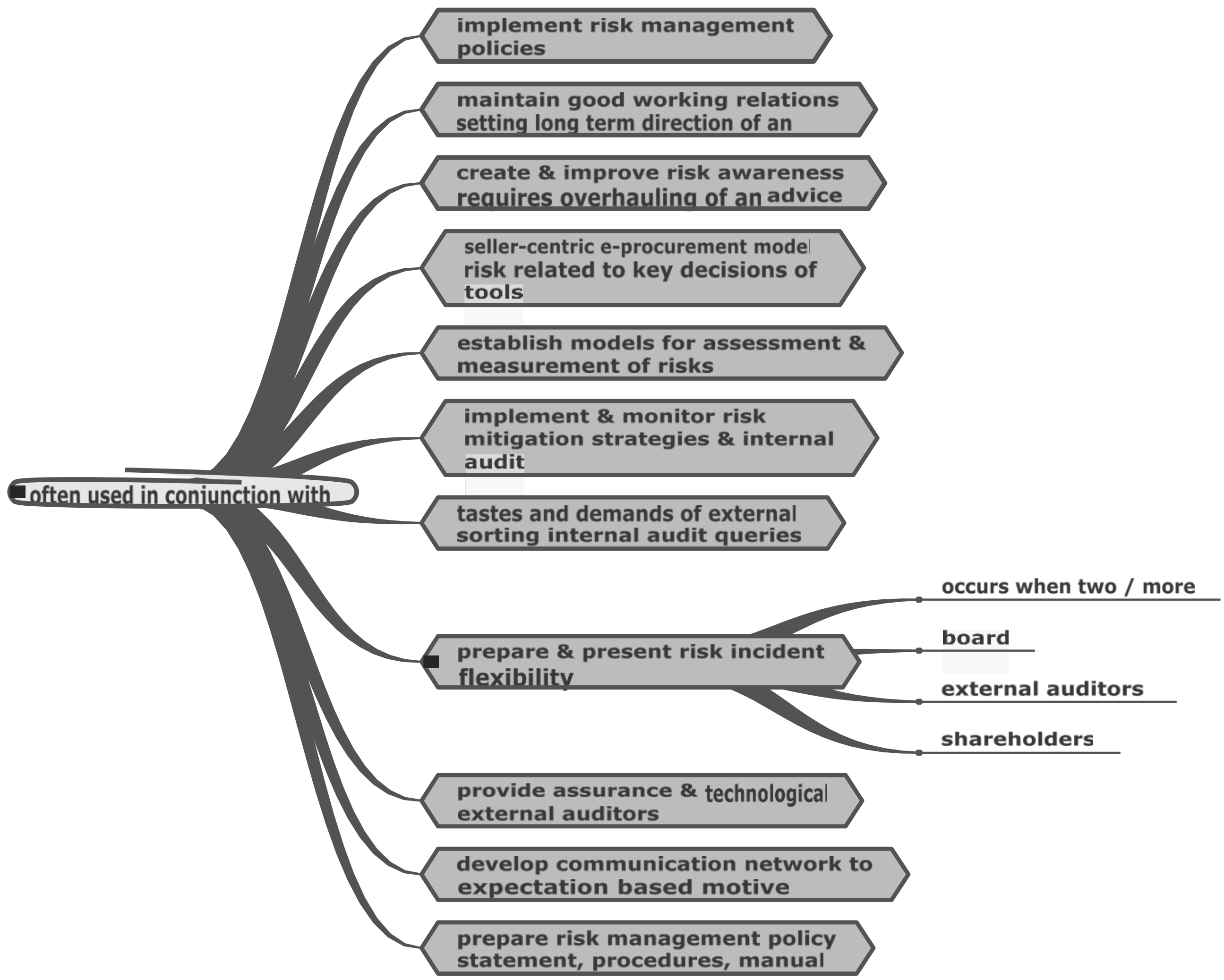
Alternatively risk managers can handle specific risks such as health and safety risk, insurance risk and human resources risk.

The role of the risk manager is not to eliminate the risk but to create risk awareness in the company and thereby manage the known risks in such a way that the losses are minimised.

The risk manager reports on risks to senior management who makes decisions on important matters (like withdrawing from risky activities) based on the information he provides.

The risk manager can therefore **never** issue advice on withdrawing from any risky activity!

SUMMARY



Case Study

Graham and Alex (G&A) is a highly diversified South American financial services provider. It operates in more than 20 countries and provides its expertise and services to clients throughout the world. Its clientele include a broad range of personal, commercial, corporate and institutional customers. It has firmly integrated sustainability practices into its corporate framework, thereby creating economic value by improving its environmental and social performance beyond mere compliance with laws and regulations. G&A has been consistently delivering good results with minimal losses attributed to failures due to operational and business risks. This success has been a result of the robust risk mitigation policies followed at G&A.

G&A defines the duties and responsibilities of its risk manager as follows:

- to define risk / reward appetite and establish key performance targets
- to identify risk, define audit objectives and scope and test and evaluate controls over risks by utilising COSO framework
- to prepare reports and other supporting documentation giving information on the company's situation
- to conduct quality research, categorise issues and communicate the objectives of the exercise and its importance to the company
- to identify key strategic risks that would prevent the achievement of objectives
- to provide effective management and ensure the correct evolution of risk management strategies and the achievement of corporate business objectives
- to review the laws, regulations, policies and procedures in order to interpret their meaning and determine their impacts
- to enhance knowledge of principles, practices, techniques and methods of accounting and auditing
- to consider the adequacy of risk management and internal control through reviewing the mechanisms for the assessment and management of risk

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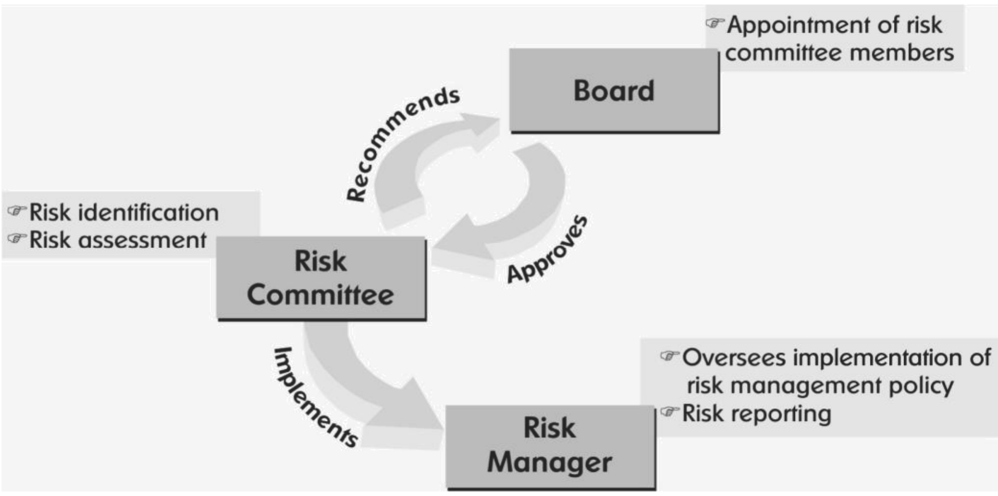
Diagram 8: Flow of risk management process



3. External and internal audit

The risk committee can either collectively monitor all the risks or the risk committee can be an inter-departmental committee that is responsible

For identifying and monitoring specific risks such as:

financial risk
business risk (strategic risk)
operational risk (risk of internal controls)
compliance risk
environmental risk

The risk committee generally has the right to appoint independent external parties to identify and assess the various risks that the business faces. Internal / external auditing of the risks facing the business includes an assessment of whether proper risk control mechanisms are in place and effective.

Risk committees may involve a person external to the company in the planning stage as a risk auditor who will analyse the existing risk management processes and suggest better methods of dealing with the existing and future risks.

Example

A report received as a result of an internal risk audit has been presented to the risk committee of a chemical processing company. The report suggests that there is a possible risk that substances dangerous to the local community could be released if processing machine fails. There is a control system that mitigates the problem but at full capacity would not prevent a harmful release. The committee has asked the board to stop production and replace the machine since the consequences of the release even in small quantities could be catastrophic.

While the risk committee and the risk manager (as a part of the risk committee) audit the risks internally, the external experts review the risks from the point of view of an outsider.

Risk auditing is done when the organisation undertakes an independent review and assessment of the risks, controls and safeguards in an organisation.

The activities involved for this include:

- identifying the risks (could relate to a department / location / specific activity / the whole company); and
- conducting a risk assessment for the risks identified and advising management on managing those risks

External risk auditing occurs when a person from outside the organisation conducts risk auditing.
Internal risk auditing occurs when risk auditing is undertaken within the entity. It occurs in many organisations.

The main advantages of internal and external risk auditing in the monitoring of risks are given below:

- identification of the major risks facing the business, both externally and internally
- assurance that the risk identification procedures in place are able to correctly identify risks on a timely basis
- assessment of the impact of the risks on the business and the probability of their occurrence
- assurance that proper risk management procedures are in existence in the company and that they are effectively managing the risks that the business faces
- identification of the areas where the risk management procedures fail and hence corrective action is required
- reporting by the external or internal auditors of instances of risks that fall outside the risk appetite and risk capacity of the company
- recommendations for the improvement of the risk management systems made to the risk committee

Example

Alfa Beta Plc, an electronics company with its head office located in Newfoundland, holds its entire stock of spare parts in a single national warehouse located in the outskirts of the city. The stock was valued at Tshs200,000 million in the last financial year. Loss of the entire inventory of spare parts is possible.

The probability of loss through theft is 0.1 in any one year. Would it be worth spending say Tshs24,000 on insurance against theft? Or should the company consider spending Tshs10,000 on improved security, and bear the risk? The risk management depends on the management style of the company. Although the probabilities favour retaining the risk, management may be unwilling to run the risk of losing the entire Tshs200,000 million.

Similarly, if petty theft from a small office costs Tshs4,000 a year, is the installation of a new security system costing Tshs20,000 justified? What is the useful life and maintenance cost of the system? Will it continue to save money over a number of years? These are all the questions that the risk committee might face while taking a decision on this risk management procedure.

Risk auditing in such a way is useful in implementing appropriate risk management techniques that suit a company.

Benefits of external risk auditing

The benefit of employing an external party to audit the risks is that a fresh perspective on the risks is obtained and hence many unidentified risks may be identified and managed.

When entities have board members who are at discord amongst themselves; collaboration among the board in arriving at decisions relating to risk assessment is difficult. At such times, external risk auditing would be beneficial for the entity.

An external risk auditor is independent, and so provides an objective opinion on the causes of poor risk management.

External risk auditing is mandatory in some countries (for example,. under the Sarbanes Oxley Act).

External risk auditing (like external auditing) is a good practice as it underpins investor confidence.

5.2 Risk management processes

Discussed below are some of the ways in which risk can be addressed and managed by organisations.

1. Risk awareness at all levels

Risk awareness in an organisation is best spread through the existence of a risk committee and a risk manager / officer. Risk awareness is **important at all organisational levels** and hence risk awareness **should be spread across the strategic, tactical and operational levels** of the organisation. All employees operating at various levels need to be aware of the risks facing the company so that risk management systems can operate effectively and efficiently.

Any decision taken by the board and managers for the company exposes it to risks. The employees and managers at various levels **need to control risks at the appropriate time in order to avoid losses.**

At the strategic level, the risks need to be identified at board level e.g. the threat from a competitor launching similar products that will lead to fierce competition for the company. When the strategic risks are ignored or not identified in time these may result in the business strategies failing.

Example

Colola Plc is about to launch a mint-based soft drink, under the brand name Mimbola, in the market in, February 20X8. A competitor company, Tepsico, is about to launch a similar soft drink in January 20X8. The senior management and board need to be aware of the risk of competition so that the launch of their soft drink does not fail. They may need to launch their product much earlier in order to gain a first move advantage.

Tactical level risks affect the organisation at a divisional or departmental level as tactical management operates at these levels. If not identified at these levels, risks may lead to the failure of established processes that are the responsibility of the divisional / departmental level.

Example

In the dispatch division of a company, the failure to assess the risk of a major transport services strike might lead to the failure of the supply process to customers and will therefore affect the supply chain in the long run.

Similarly, a lack of monitoring of processes might lead to delay and unfinished processes. This will lead to a loss of productivity. The processes will be left incomplete if there are any changes in the personnel handling them or if key personnel resign.

Example

The regional purchasing manager has had a sudden illness and can no longer work long hours. In a case such as this, if the company does not assess the risk of the loss of key personnel it will not be able to properly take care of the purchasing procedures until a new person is appointed.

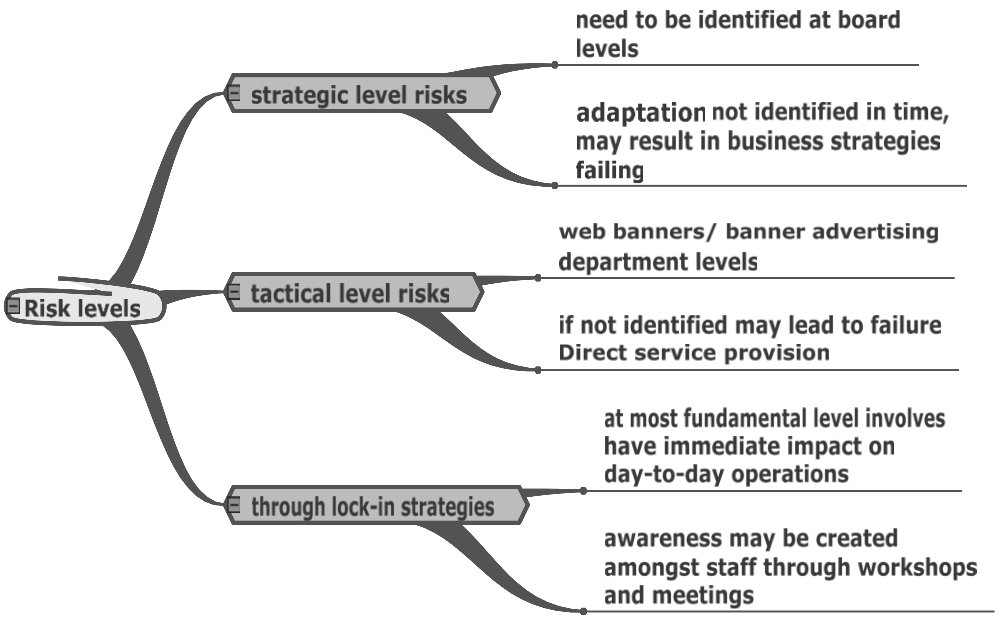
The risks at the operational level, in particular, should be monitored closely as these are likely to have an immediate impact upon the day-to-day running of the organisation. Risk awareness at the operational level may be spread amongst the staffs working at this level through workshops and meetings that make them aware of the risks that routine activities may involve.

Example

In a shop, incorrect and/or late billing may drive customers to other shops. The risk of machines calculating incorrect bills should be assessed and the staff responsible for handling the billing should be made aware of the risk so that they are equipped to handle the problem in future. E.g. by calculating the billing amounts using alternative means so that the process is not hampered.

Risk awareness at all levels is a necessity as any decision exposes the organisation to a risk which should be considered in the process of decision-making. Any failure in the assessment or awareness of the risks may lead to incorrect decisions or the failure of processes and strategies.

SUMMARY



2. Embedding risk in an organisation's systems, procedures, culture and values

Risk embedding refers to the ways by which the systems and procedures of an entity include risk awareness as well as risk management. For example, the policies of an entity relating to non-current assets specify that all non-current assets which are procured need to be immediately insured. Therefore whenever a non-current asset is procured, the administrative manager intimates its details to the insurance company.

Risk management should ideally be embedded in the entire management system of the organisation and not merely restricted to one department or person. Embedding risk awareness in the organisation’s systems and procedures may be done by issuing a risk policy statement and maintaining a risk register.

Critically it also requires top down communication and commitment.

The risk policy statement should outline the various risk management techniques to be followed by staff working at all levels, including management and lower level supervisors.

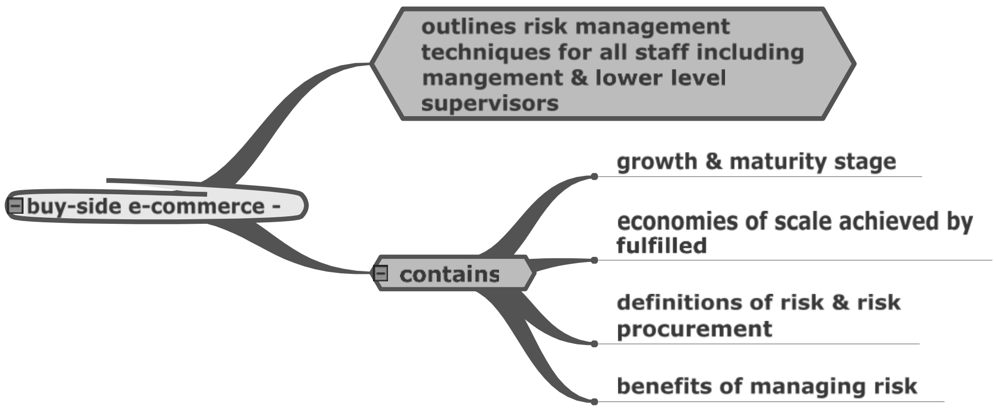
Risk policy statements generally contain the following:

- Objectives of having a risk policy
- Regulatory requirements to be fulfilled in order to avoid risks such as compliance risks
- Definitions of risk and risk management
- Benefits of managing risk and the ways risk should be embedded in strategic level decision-making
- Critical areas of risk management which should be managed carefully
- Staff roles at each level in managing risk as well as those of management, divisional heads and audit and risk committees

Clear classification of risks
Internal control framework
Importance of training in risk management
Methods of obtaining support when faced with risk situations

A **risk register** is a **formal document that lists and prioritises** the various risks that the organisation faces. The register helps the organisation makes decisions on how it should deal with risks. It also **contains such details as who deals with which risks and how.**

SUMMARY



Having risk policy statements and risk registers helps the organisation to embed risk into the organisation's systems by making employees at all levels aware of the risks present. Organisations need to focus on risk mitigation and management from the shareholder's perspective. Risks should be minimised so that they do not affect shareholders' profits in any way.

The **responsibility for the implementation of risk management is that of the board.** Risk can be effectively embedded into an organisation's systems and procedures when the process is driven from the top.

Management may embed risks into the organisation's systems and procedures in the following ways:

(i) By **evolving well-structured and clearly thought out strategies and policies** e.g. while creating a marketing strategy the company should include risk factors such as new entrants in the market, geographical diversity of customers, evolving customer tastes so that the appropriate decisions are taken to overcome these risks.

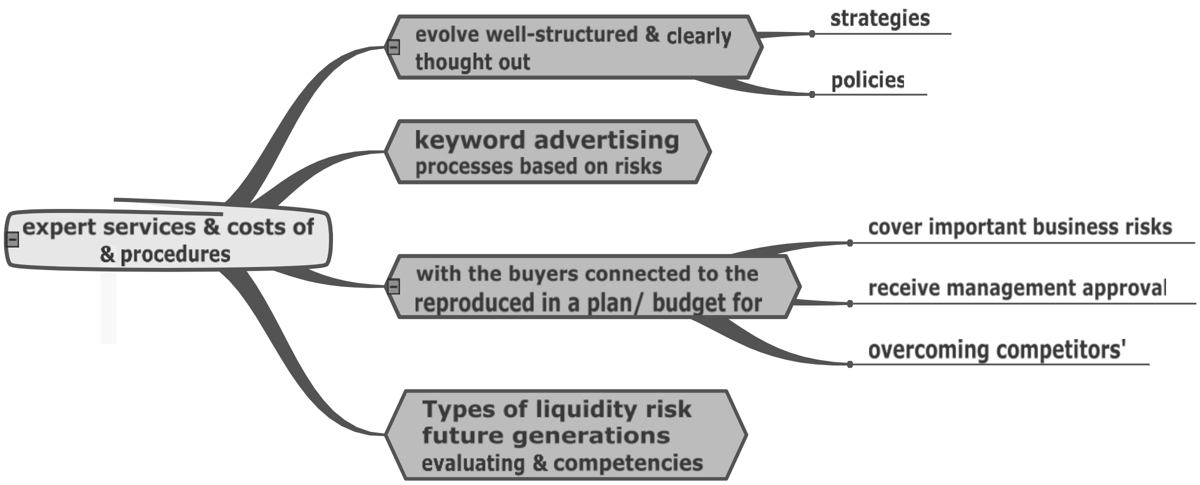
(ii) By **implementing internal control processes based on risk** i.e. the internal controls processes should cover all aspects of risk e.g. the risk of the inventory recorded in the inventory records not matching with the physical inventory in stock may be alleviated by implementing a perpetual inventory system. This is embedding risk in inventory control procedures.

(iii) By **reviewing risks** in order to assess whether the risk management systems:

Cover the most relevant business risks
Receive management approvals at all times
Offer appropriate training to employees with regards to the risk management process

(iv) By **preparing public risk reports which record existing processes of identifying, evaluating and managing significant risks,** which the organisation regularly reviews. The reports should state whether the risks are being managed well. This kind of reporting will keep the management and other staff aware of whether the risks are being addressed.

SUMMARY



The process of embedding risk into the systems and procedures of an organisation aims to ensure that risk awareness is part of the way business is conducted. It aims at embedding risk in the culture of the organisation at the same time avoiding creation of additional processes.

Example

Lancomer Plc deals in high quality window frames and has a set procedure for dispatching sales orders. Details of the risks embedded in the dispatch procedure are given below:

Sales orders are received from the sales officer and goods are dispatched accordingly. The person in charge of the inventory checks the pricelist to calculate the cost of the glass frames being dispatched. Here, there is a risk that if the price list in the computer system is not up-to-date the total cost of the order may be inaccurate. This risk is managed by ensuring that the pricelists are updated daily so that products are dispatched and invoiced at the current price.

There is also a risk that the pricelist may be tampered with and rates may be changed to the advantage or disadvantage of certain customers. This risk is managed by restricting access to the pricelist to the sales manager only by use of a password.

Risk of theft is also present when goods are dispatched from Lancomer's warehouse to its customers. The risk of loss from theft is minimised by insuring all sales as company policy. Risks are embedded in systems and procedures in the above manner when the company takes a risk-based approach towards framing its internal control procedures.

The embedding of risk in the culture of an organisation is the responsibility of the board and senior management who should encourage risk-based thinking amongst staff working at all levels of an organisation. Eventually, thinking about risk should become a day-to-day habit.

Some ways of embedding risk management into the culture and values of an organisation include:

(a) **Aligning individual staff members' goals with the company's strategic goals**. In this way each individual will think carefully before acting or taking any decision and so will avoid risk. E.g. if the strategic goal of the company is to produce safe and healthy products that are environmentally friendly, it will match an employee's own preference for such products. In order to align an individual employee's interests with those of the company, the company may carefully examine the CV of potential employees to ensure that their own objectives match those of the company.

(b) **Including risk management roles and responsibilities in job descriptions**.

Example

When recruiting the sales manager for an area the job description should include the management of various associated risks. E.g. the risk of weakened sales and failed production schedules which result in lost sales orders.

(c) **Establishing reward and recognition procedures for staff** which reward successful risk management. Performance measures should be adapted to account for effective risk management, ensuring that the measures are appropriate and sufficiently focused on future goals. The risks should be communicated on time so that they act as an early warning system and ensure that losses are mitigated.

Example

A company's sales face a decline if a competitor's products are also being launched in the market. The sales manager mitigates this risk by marketing the company's products fiercely and diversifying sales in different geographical locations. The risk of lost sales is reduced by exhausting the current product inventories before the competitor launches its product. The company can later launch its own refined product after the competitor has launched its version in the market.

(d) **Balancing individual responsibility** by resisting to the mistakes committed by individuals and thereby learning with each mistake. This will ensure that the organisation continually reviews and refines its risk management techniques. Management may also do this by sharing its success stories.

(e) **Ensuring that risks are communicated effectively** across all levels of the organisation so that risk awareness is maintained throughout the organisation.

SUMMARY

Below is a case study which illustrates the benefits of embedding risk in the planning and implementation phases of business decisions.

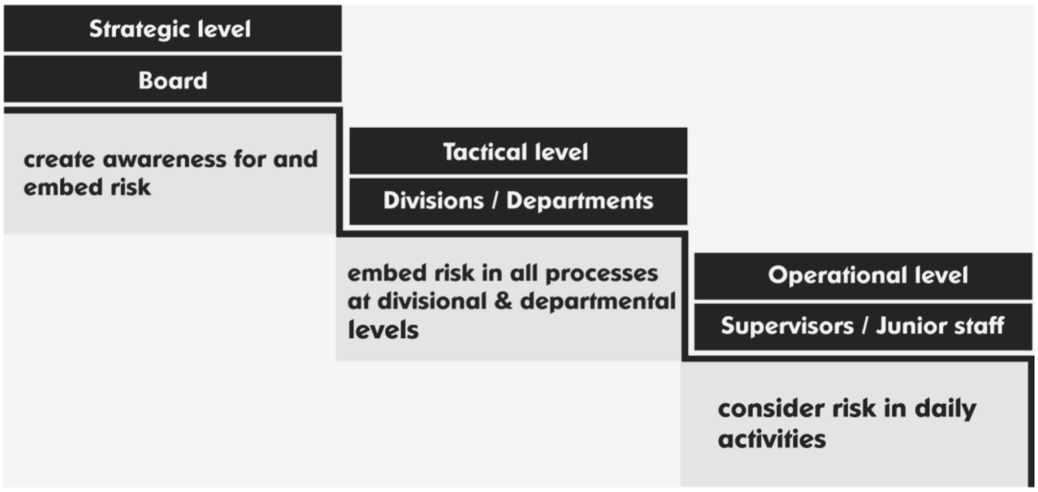
Case Study

Serena Pharma Plc is a multi-national chemical manufacturing company which has operated in Nigeria since 1960. The managing director and board wanted to introduce a culture whereby the planning and implementation of business decisions incorporated awareness of enterprise risk. The company recruited Martin Consultancy which classified each risk and successfully implemented the Total Risk Profiling (TRP) approach across all divisions of the company.

As a result of TRP, benefits have been recognised at the corporate level where the new awareness of risks has led to more effective risk prioritisation and mitigation. Other benefits of the TRP the approach are:

- Creation of a scenario catalogue
- Standardisation of approach to risk management throughout the group
- At divisional level, improved understanding and management of strategic business risks in the context of potential associated rewards
- At group level, the collection of divisional risk information in a common format for consolidation of risk analysis results
- Meeting standards of corporate governance expected by investors.

Diagram 9: Embedding risk in an organisation's systems, procedures, culture and values



3. Spreading and diversifying risk

Diversification of risk is the mitigation of the impact of risk so that even if the risk materialises, the organisation will not suffer significant losses. Organisations face risk as a part of business. Some risks can be mitigated and managed while others cannot. Risks that cannot be managed are the residual risk that organisations must bear to remain in business. The impact of these residual risks may, however, be mitigated by diversifying and spreading those risks across the organisation or amongst the various products manufactured by the company.

Methods of diversifying risks are as follows:

- Diversifying risks through financial management techniques
- Diversification of risks through organic and other forms of business growth
- Risk transfer

(a) Diversification / spreading risks through financial management techniques

Hedging techniques

Diversification of risk through hedging is the most common form of risk diversification. Hedging involves taking opposite positions on two different securities. The losing position on one hedge is often offset by a gaining position on another thereby nullifying the loss. However hedges not only reduce the risk of losses but also the possibility of gains. This is because, as in the case above, the gain from the purchase of securities will be minimised by having to sell an equal number of securities. Hedging techniques are also used to minimise loss by entering into contracts that are a combination of a fixed price and a variable factor.

Example

In a financial lease, the lessor always enters into a contract to receive a fixed sum of money from the lessee every year, irrespective of any benefit derived from the asset leased. Additional payments are variable based on the use and benefit that the lessee derives from the asset over a period of time. In this way, both the lessor and the lessee have hedged their risks to a certain extent.

SUMMARY

(b) Diversification of risks through organic and other forms of business growth

Risks may be diversified by dividing the total amount invested between different business options or in the same business operating in between different geographical locations. Diversification / spreading of risks in this manner leads to risk and possible losses being spread over a larger area or number of businesses so that each area bears less risk.

Example

A shareholder investing in the capital markets will diversify his risks by investing in a number of different companies such as oil, natural gas, construction and clothes manufacturing. This will give him a wide range of industries in which he has invested and the risk of loss in one may be mitigated by the possibility of gain in another. It is unlikely that all the industries will face losses at the same time and that the investor will lose all his money. If the construction industry faces recession, the clothes manufacturing, oil or natural gas industries may perform well and so the loss will be mitigated.

When is diversification appropriate?

Diversification is not appropriate in all situations. Diversification helps minimise losses only in situations where the losses incurred in one area are neutralised to some extent by gains in another.

(i) Companies may diversify in various businesses that complement each other. These businesses are generally different lines of investment in the same profession. By investing in similar businesses, companies guard against the risk of loss from one area by the gain that will incur in another.

Example

Georgia Animations decides to invest Tshs100 billion in the production of movies. It produces movies not only for cinema but also for television and other home entertainment products like video games. By doing this, even if the films produced for cinema do not make any profit, Georgia may yet make money out of the films it produces for television and home entertainment. Cinema and television are two industries that complement each other. This is one of the ways of diversifying risks.

Companies might also diversify their business in the same line of business but in different geographical locations. This may mitigate any risk since low results in one location might be offset by better results in another. Location-specific marketing strategies may result in variable sales results.

Example

Timothi Plc sells woollen clothing across the globe. Winter occurs in different countries at different times of the year. In countries like Nigeria and India the company makes huge sales in November and December; it continues to make good sales until February in Russia and Canada as winter in these countries can last until March.

In this case, the company is taking advantage of the time differential between seasons to diversify the risk of a slack sales situation. The company may also diversify risk by selling its products in different locations.

Example

Tamarind Plc engages in the production and sale of spices. The spices are sold in four countries according to the spice requirements of these countries. In some countries, spices such as pepper, cinnamon and nutmeg are popular, whereas in other countries chillies, turmeric and cloves sell in huge quantities. Tamarind promotes different spices according to which spice is most commonly used in those countries. The risk of chillies not selling in one country is minimised by pepper or nutmeg selling well in another.

(ii) Diversification, however, does not work in situations where two business lines are positively related. In this case, an adverse change in one of the businesses will lead to an adverse change in the other.

Example

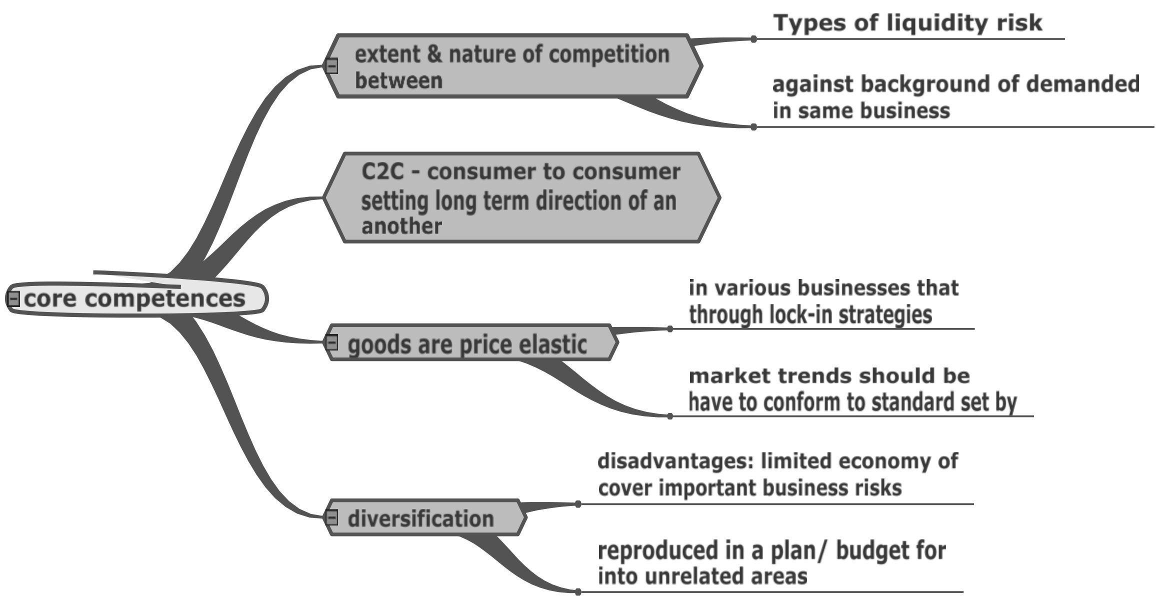
This applies to companies that sell related products e.g. home loan companies who also sell loans for home contents such as furniture. These are related commodities and so when demand for home loans decreases the demand for house insurance and furniture loans will also decrease. In this case if funds are invested in housing finance as well as motorcycle financing activities, this diversification might help.

(iii) Diversification involves a risk when it comes to diversifying into areas that are not related at all. In these situations adverse changes in one business may coincide with either adverse or favourable changes in the other. The outcomes are very unpredictable in each business since the products are totally unrelated. This only leads to partial diversification of risks since risks are only reduced to a certain extent. However if each business faces adverse change then losses increase.

Example

A company dealing in products as diverse as food products, minerals for industrial use and mutual funds will involve a very high risk. These products are not related to each other at all. Diversification of risks will happen only if losses in one business are mitigated by profits in another. Management, in this case, needs to be experienced in managing a diverse business portfolio.

SUMMARY



(c) Risk transfer

Risk can be transferred to other parties if it cannot be mitigated through diversification. This can be done by **conducting business in partnership and through corporations** where each shareholder bears a risk equal to the value of shares held.

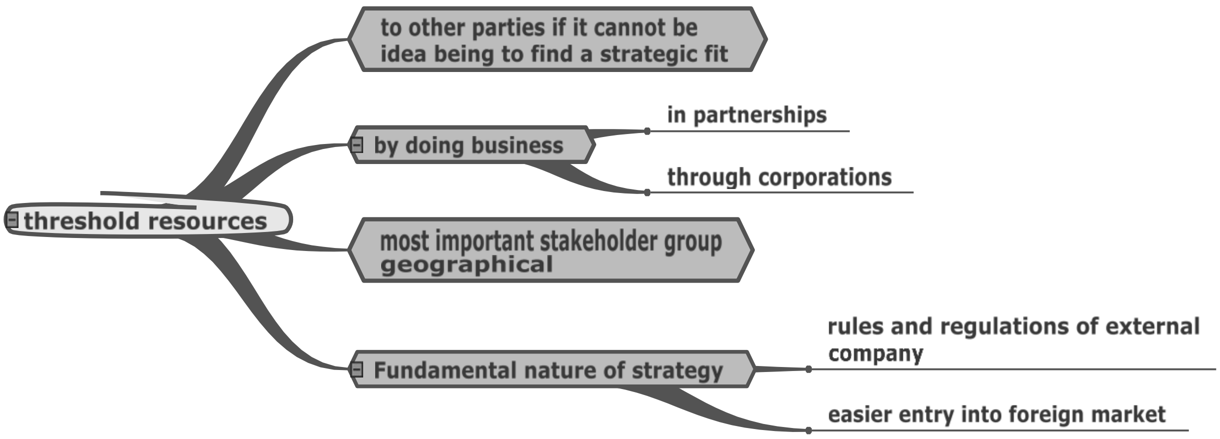
Joint ventures are also a method of sharing / transferring risks to other parties. Insurance is an example of risks being transferred to an insurance company by paying an annual premium. Risk sharing in such cases is preferable when the potential losses are huge and the probability of those losses occurring is low.

Joint ventures are entered into when companies want to enter markets in other countries. Joint ventures help companies to enter into contractual arrangements with local companies to obtain joint control over certain activities. In this way, the companies can enter into foreign markets more easily by utilising local companies' expertise

Example

Large construction companies generally penetrate foreign markets by entering into joint ventures with local companies to build large structures such as flyovers, dams and canals. In building such huge structures, it is necessary to have local knowledge such as business conditions, suppliers and land quality. Joint ventures help overcome these problems by utilising the expertise of local companies. Risk of failure or loss is shared with another party.

SUMMARY

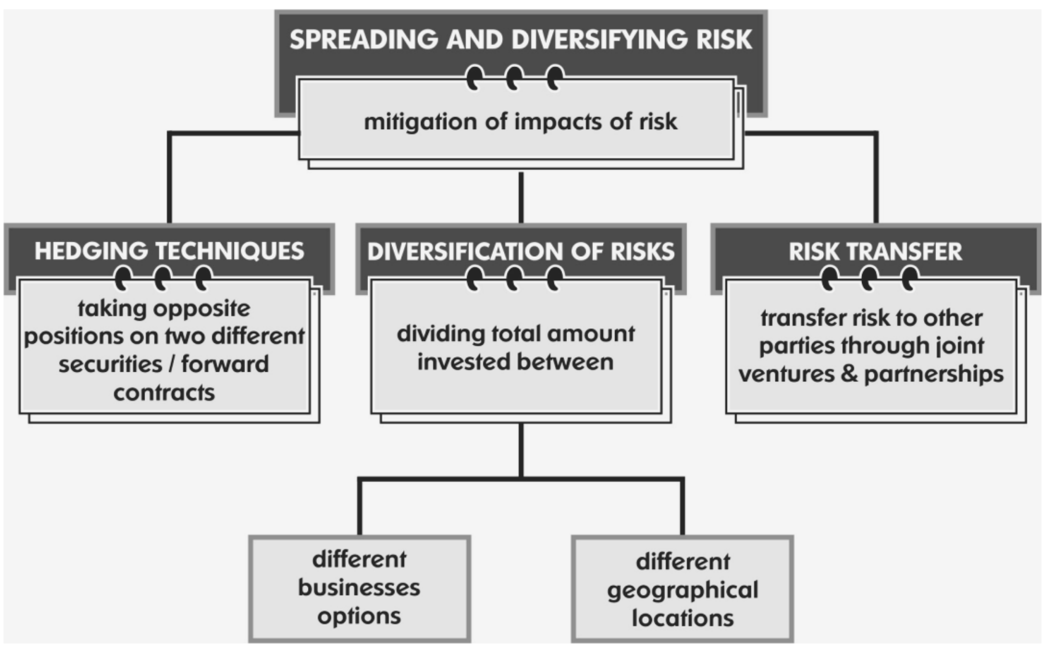


Case Study

In many leading capital markets, the risk of underwriting an entire issue of shares is divided amongst many companies so that each underwriter company bears only as much risk as it is possible for the company to bear. The number of shares each company underwrites depends on its risk appetite and underwriting capacity. This process helps to spread and diversify risks to a large extent. It also allows the client's requirements to be met without exposing any one underwriter to a substantial risk.

The ability to syndicate risk has long been one of the benefits of the London Market and has played a key part in establishing the London Market as the leading international centre for the cover of specialist risks. Financial markets such as the London Market allow individual underwriters to participate in underwriting difficult, complex or very large risk which individual firms, however large, would be unlikely to insure alone. These practices are a good way for companies to diversify risks that are too large for one single company to manage.

Diagram 10: Spreading and diversifying risk



4. Risk avoidance, reduction, acceptance and transference

(a) Risk avoidance

For a given activity and risk type, risk avoidance, can be defined as the elimination of exposure to that risk type for that activity. Loosely speaking, it is the elimination of exposure.

Risk avoidance is usually achieved by:

Not undertaking the 'risk' activity; for example, not entering into a business venture to avoid the risk of loss (however, this also rules out the possibility of earning profits).

Undertaking the 'risk' activity and at the same time undertaking an additional activity to 'reverse' or otherwise mitigate the risk

Example

Trenchit Plc is a UK company that manufactures and sells widgets. It has received an order from a US client for supplying 10,000 widgets for immediate delivery and payment of $1 million will be made in 6 months' time. Trenchit has negotiated with its suppliers to pay them in 6 months' time; however, the suppliers will all be paid in British Pounds. Trenchit's FD has advised management that if the US Dollar has depreciated against the British Pound by more than 20% in 6 months' time than they will not be able to pay their suppliers and risk going into bankruptcy. To eliminate this foreign exchange exposure (FX risk avoidance), Trenchit can:

Not take the order from the US client

Take the order from the US client and make an arrangement with its bank so that the future US dollar payment is exchanged for an amount in British Pounds now

In this example,

The activity is the order from the US firm and the associated cash flows. The risk type that Trenchit is trying to avoid is 'foreign exchange' risk. Organisations generally avoid risk when

A negative / unsuccessful outcome could be catastrophic for the organisation; or

A positive / successful outcome is unlikely.

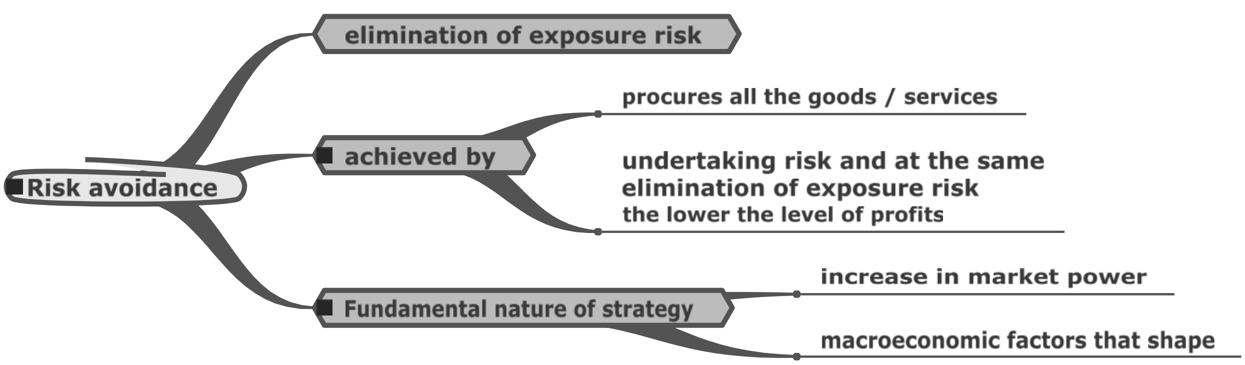
There is usually a cost (premium) associated with risk avoidance activities.

The costs to Trenchit for each course of action are:

The loss of business from the US client

The bank charges Trenchit would incur for this kind of transaction (possibly loaded into the agreed exchange rate or as a separate fee)

SUMMARY



(b) Risk retention / acceptance

For a given activity and risk type, risk retention, can be defined as the retention of exposure to that risk type for that activity. Loosely speaking, it is not eliminating exposure.

It is important to note that often an organisation may undertake the 'risk' activity and at the same time undertake additional activity to reduce the risk (risk reduction). As long as some exposure to the risk remains, it is still considered a case of risk retention. There is usually a cost (a.k.a. premium) associated with risk reduction activities, proportional to the reduction.

Retaining risk to some extent is natural as any business where there is no risk would effectively be a business that guarantees success / revenue. Also, not all risk can be foreseen so knowingly or unknowingly all organisations accept risk. At best, organisations can avoid specific risks, but they cannot avoid all risks. Whether an organisation retains or avoids specific risks depends on the risk attitude of the organisation.

Example

Continuing the above example of Trenchit

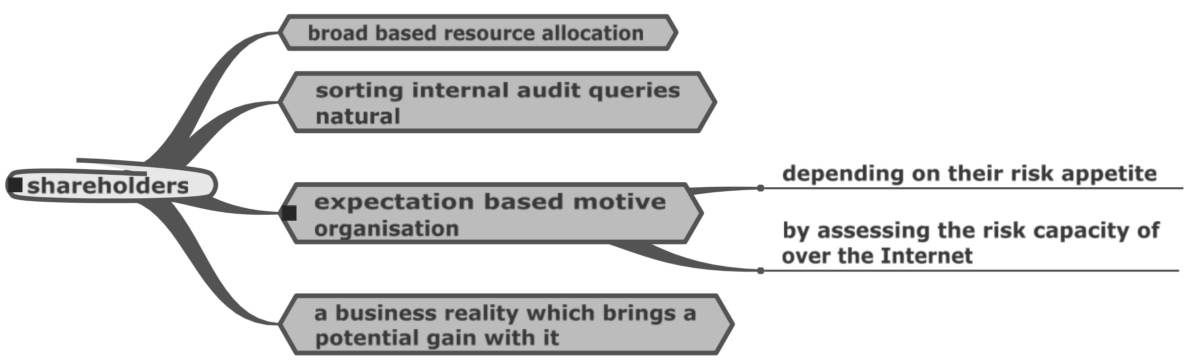
Trenchit has decided that it wants to avoid the foreign exchange risk and decided that the only cost effective way to do this is to agree a rate with its bank now to exchange the $1 million payment to British Pounds in 6 months time (i.e. a FOREX forward contract). This is actually a case of risk retention and not risk avoidance as there is a chance that its bank may go out of business within the 6 months and not be able to honour the contract. Therefore, in reality it still has the foreign exchange exposure and so retained the foreign exchange risk.

Note: although the risk still exists, this may still be a much better and more cost effective solution than risk avoidance because if the bank did go out business, it is likely that Trenchit would also go out of business.

Risks are not always undesirable to an organisation because with the risk comes potential gains e.g. Trenchit management may take the view that the US Dollar is going to appreciate against the British Pound and so actually see the risk as positive. Risk is an inevitable part of doing any business. However, risks need to be assessed properly so that an organisation does not accept risks beyond its capacity.

Since risk retention is a business reality, it is important to learn to analyse risk and use various techniques to minimise its undesirable effects. This is popularly known as risk management.

SUMMARY



(c) Risk reduction

For a given activity and risk type, risk reduction can be defined as the reduction of exposure to that risk type for that activity. Loosely speaking, it is mitigating exposure.

A risk-reducing alternative generally lowers potential returns but can allow an organisation to undertake activities that would otherwise be unsuitable due to the organisation's risk appetite and / or capacity. For example, a company has two officials who jointly sign on cheques. This will reduce the risk of fraudulent cheques being issued.

(d) Risk transference

Risk is mitigated by transferring it to another party to accept the risk or share the risk. Risk transference occurs through legislation, contract, insurance or other means. For example, risk is transferred from the entity to the insurance company when assets are insured. Joint ventures are also a method of sharing / transferring risks to other parties. Banks and financial companies generally provide loans to customers against collaterals. In this way, the risk of non-recovery of debts is transferred.

5.3 Role of IT and communication in risk management process

The role played by IT and communication systems has been highlighted in the COSO framework of Enterprise Risk Management in Learning Outcome 3 of this Study Guide.

Test Yourself 5

Archie Plc is a company engaged in the production of pharmaceuticals. The company has recently conducted a market survey as a result of which the company learned that one of the ingredients in its headache tablets is likely to be banned by the Tanzanian government because, due to its high potency, it is harmful for health.

The company would have to discontinue production in the event of a ban. The company has yet to develop an alternative ingredient.

Required:

State the measures that the risk committee should take to overcome this situation.

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6. Evaluate both inherent and residual risks after mitigation and judge them in relation to shareholder and stakeholder risk appetites in a given scenario.
[Learning Outcome f]

6.1 Inherent risk refers to the risks faced by an organisation in their raw and pure form, before they have been subjected to any risk mitigation attempts by the organisation. Also known as gross risk, this category of risk stems from the nature and size of operations of an organisation, structure and sophistication of its board of directors and the organisation's activities, like strategic planning, budgeting, etc. For example, the retail giant Wal – Mart would be having certain inherent risks owing to its vast size and scale of operations worldwide.

Inherent risks are mainly present due to factors external to an organisation and hence, the organisation can take steps to reduce them, but cannot fully erase the risks.

Residual risk is the risk that remains after the company has taken all possible measures such as applying all control measures to manage the risks. The company has to face this risk since it is inevitable.

Example

Realto is a large supermarket operating in the busy market area of Newtown. It has a large store wherein small, fast moving consumer goods and large items of consumer durable goods are displayed.

Due to its nature of operation (where numerous items need to be displayed for sale), Realto constantly faces the risk of shoplifting of small items which are on display. This is an inherent risk faced by the business.

The risk of shoplifters can be mitigated by installing in-store cameras and having shop assistants patrol the store. However, even after taking these steps, there is no absolute guarantee that all its goods will remain safe. The risk that still remains with the firm is the residual risk.

6.2 Stakeholder risk appetites

Businesses face risks (both inherent and residual) and the stakeholders have an important impact on the risk strategy of a company. The risks that the company faces affect the stakeholders because they affect their interests and the returns they receive from the company.

The impact of the inherent and residual risks on a stakeholder depends on the type of interest the stakeholder has in the organisation and the group to which the stakeholder belongs. The impact can be a two-way impact i.e. the actions of the stakeholders may affect the company and the company's actions may affect the stakeholders. In both situations, if the company's operations are adversely affected then the stakeholders will suffer. The various impacts upon the stakeholders belonging to the various groups are given below.

Diagram 11: Stakeholders impacted by business risks

1. Directors and managers

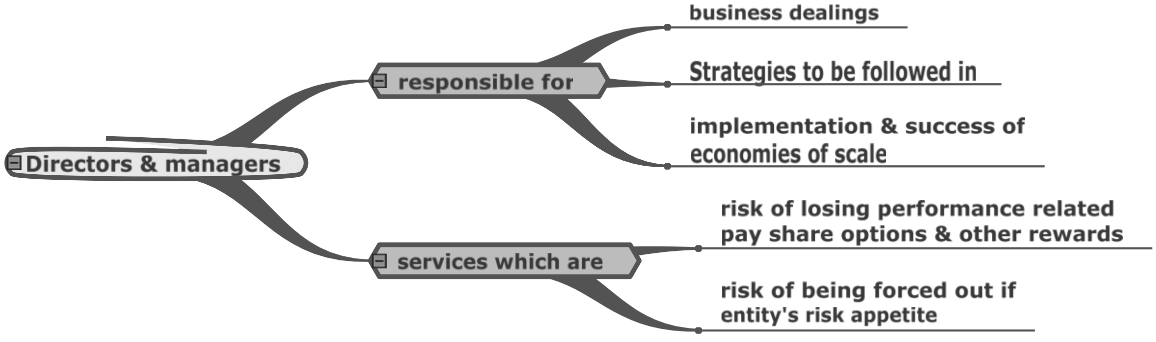
The directors and managers are the key personnel responsible for decision-making and the development of strategy. In addition, they are responsible for the implementation and success of the planned strategy. If the strategy of the business fails or particular strategic objectives are not achieved due to the directors' poor risk assessment or management then the directors will face the risk of losing out on performance related pay, share options or other rewards. Directors also face being forced out if objectives are not met or if the business fails.

Directors and managers as internal stakeholders have some control over their destiny. Directors and managers will receive reward for good performance. There may be an argument for the inclusion of risk management objectives in director's scorecards.

Example

Directors' performance related pay may include both financial and non-financial measures including risk management measures related to the quality, reliability and continuity of processes. Use of share options with restrictions on sale may lock directors in for the long term and encourage greater risk awareness.

SUMMARY



2. Employees

The biggest risk that employees face is the risk of losing their jobs. Employees also face the risk of dangerous working conditions (a health and safety risk) and the risk that incentive plans might not be followed and therefore they might not receive enough incentives etc. Certain risks are associated with the decisions taken by the company. If these decisions go wrong, the employees may be adversely affected. Employees may lose their jobs if the strategy of the company goes wrong and it faces losses.

Example

If there are inadequate safeguards on cutting or drilling machines employees will face risks to health and safety.

SUMMARY

3. Shareholders

Shareholders are one of the most important stakeholders in the organisation. The directors need to align their risk appetites with those of the shareholders in order to provide them with the desired growth and returns on investments. Investors / shareholders are generally diverse and scattered. They are a mix of small individual investors and larger institutional investors.

The attitudes of different shareholder groups towards risks are also different. Whereas small investors tend to invest in the company for a longer term, institutional investors tend to minimise the risks by diversifying their portfolios. In order to minimise its risks, the company should communicate with the shareholders via a transparent reporting procedure regarding the risks that the company faces.

Example

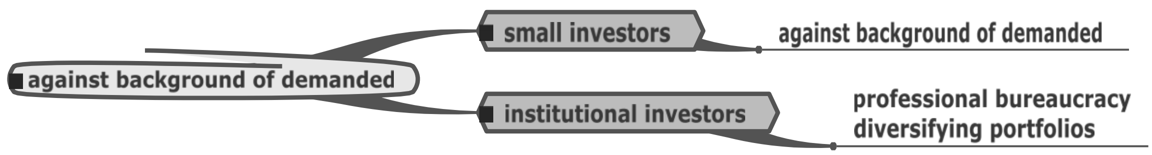
The shareholders of a company may be concerned about a fall in the share prices due to certain adverse events affecting the company. For example, there may be a fall in the share price due to a fire in one of the company's warehouses that disrupts the business and is not covered by insurance. In this case, the company should inform the shareholders of the potential losses to the business, the period of recovery, measures taken by the company to recover from the loss and the probable date when the business is expected to resume normal operations. By doing so, the shareholders will gain confidence in the affairs of the business and may hold their shares.

Ethical issues affecting organisations such as breaches of law, health and safety issues and environmental damage might affect shareholders' willingness to invest in those companies. The risk attitudes of companies should be aligned with those of their shareholders. The management of some companies may be risk averse while, for some other companies, management might accept risks readily.

Exam Focus

Moneywise Plc is a banking company that specialises in secured home and property loans. The bank is proposing to acquire a chain of estate agents and has made its intentions public. The directors regard this as a complementary business with potentially high returns and opportunities for cost reductions. Several institutional investors have discussed their concerns with the chairman since they believe such an acquisition is high in risk given their lack of experience and the difficulties of integrating the businesses. This is an area where the risk attitudes of the shareholders and the company are not aligned.

SUMMARY



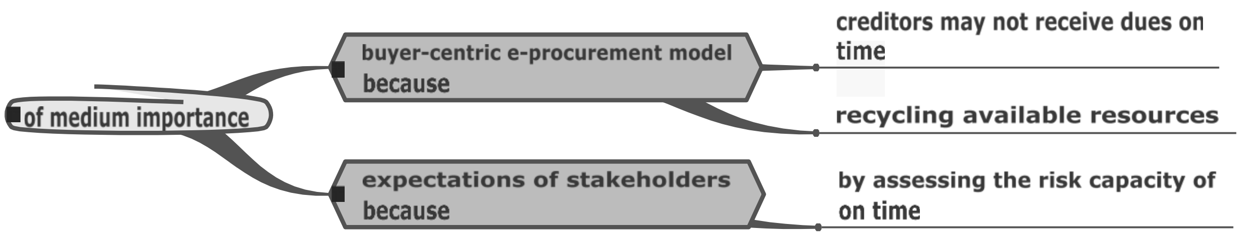
4. Accounts payables

The major risks that accounts payables face from a company are that the company will not pay its dues on time and that it will stop buying products from them. Conversely the risk that the company faces in relation to suppliers is that they will not continue to supply materials may push up prices or may not meet requirements.

Example

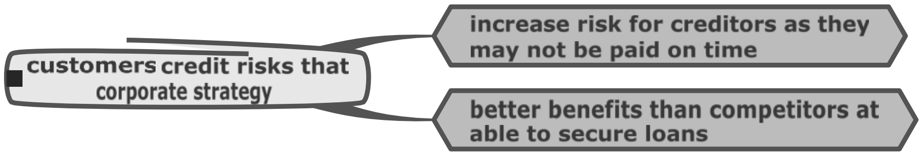
Tenacity Plc manufactures computer chips and purchases raw materials from Data Plc. During the last few months, Data has been facing a liquidity crunch since its receivables from Tenacity Plc have not been paid. This has affected supplier payments and hence Data Plc has stopped any further supplies to Tenacity. Data fears losing money as a result of Tenacity's failure to pay the existing dues on time.

SUMMARY



The other risks facing a company, such as liquidity risk and credit risk, increase the risk for the accounts payables since these reduce the probability of a company paying its accounts payables on time. These risks, in turn, increase a financial risk that the company will not be able to secure loans. This is because, before sanctioning a loan, lenders check the track record of a company regarding repayments made to accounts payables and existing loans.

SUMMARY



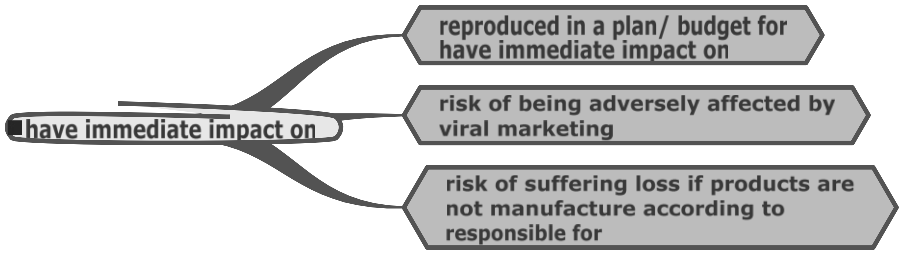
5. Customers

The customers of a company face the risk that they will not be supplied with products of the required quality due to the various operational and strategic risks that the company may face. Delays in supply may affect customers adversely since their businesses might be affected. As a result, a delay in supply has a ripple effect on all the processes that are dependent on the supply. Other risks are in relation to product safety. If the products are not manufactured according to customers' specifications, the customers may have to suffer losses.

Example

Voltamet Plc manufactures refrigerators and purchases compressors from a reputed local supplier. The compressors come with a one year guarantee and, accordingly, the company sells these refrigerators to the customers on this promise. The supplier previously had a bad reputation in the market for supplying low quality compressors that developed faults within six months. Although the company gave him the contract after conducting strict quality checks, there is still a risk of receiving low quality materials.

SUMMARY



6. Communities and general public

This is a broad category of stakeholders that are affected by the manner in which the company conducts its business. These include the environment, the society at large and the local residents of the area in which the company operates. A company may give rise to the following risks:

If a company decides to discontinue the operations of one of its plants located in a rural area (in which it is one of the major employers) then the employment rate in the area will drastically reduce. The pollution caused by a factory may give rise to health hazards if the waste created during the production process is not disposed of properly.

Example

The noise pollution caused by a tile polishing division may impair the hearing of people living in the nearby areas. A sugar factory's practice of draining its production waste in a lake may give rise to health problems in the area surrounding the lake.

A company may also give rise to safety risks by producing products that breach health and safety regulations. E.g. the company may produce a drug that may harm the neurological system and sell the drug without a licence from the health department. This is a risk to the customers who buy the drug.

NGOs and other pressure groups are generally formed in response to the risks that companies create because of the harmful activities they undertake. By operating in a careless manner, companies may adversely affect the community in which they operate.

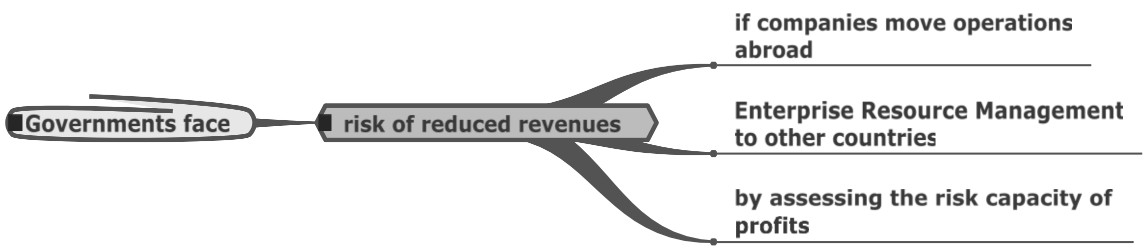
SUMMARY

7. Governments

Governments are mainly interested in companies because they earn tax revenues from them. The major risk in this case is the risk that the companies will move their operations abroad and hence the government will lose revenue. In many western countries, companies have moved or outsourced many of their operations to countries such as India and China since they can obtain cheap, skilled labour in these countries.

In addition to this risk, governments also face the risk of reduced revenues if the companies don't make enough profits.

SUMMARY



8. Banks / financial institutions

Banks and financial institutions are the finance and capital providers for companies. They generally face the risk that a **company will not repay its loans** on time if it stops trading. If the company operates in a high risk business, the banks / financial institutions will conduct an in-depth assessment of the company's creditworthiness and offer a lower amount of money to the company.

Test Yourself 6

Sesame is a company which produces tobacco and tobacco-related products such as cigarettes, cigars, snuff and chewing and pipe tobacco. The company has its own tobacco plantations and children between the ages of 7 and 10 are employed to pluck the tobacco leaves. Child labour is prohibited by the laws of the country. Moreover, there are no proper safety measures in place such as masks to be worn while plucking leaves.

The company is located in a rural area far away from the city. The company creates harmful smoke from its factory processes which is polluting the atmosphere of that rural area. The local people are therefore protesting against the company. The local government authorities are not taking any action against the company since tobacco and tobacco-related products are a major source of revenue for the government as it has levied heavy taxes on these products. Due to the remoteness of the company's location, its suppliers are having difficulty in supplying materials on time.

Local banks who have lent money to Sesame fear that the company's production may be hampered due to the strong agitations against the company by the local residents.

Required:

State the risks involved and the various stakeholders who will be impacted by these risks.

Answer to Test Yourself

Answer to TY 1

Grease (mechanics) Engineering Pvt Ltd (GEPL) is engaged in the production of car components. The company is facing strategic and operational risks.

Strategic risk is the risk associated with the long-term strategy of the business. This type of risk takes time to affect the business hence the organisation gets time to handle this kind of risk.

Operational risk refers to the short-term risks faced by the organisation on a day-to-day basis which immediately impact the business. The organisation must take timely actions to mitigate this kind of risk.

(a) In GEPL, the company has installed new accounting software which shows incorrect valuation of stock and wrong identification of dates. As a result, the company is facing an operational risk since this is affecting the day-to-day accounting of the organisation's records. To solve this problem, the company must consult the software developers in order to ensure proper implementation of the accounting software.

(b) The company has recently taken over another company, Holby, which is now suffering losses because of internal problems. Holby's reputation in the market has undergone a drastic decline since media has accused Holby of misleading customers and incorrect labelling on product regarding safety standards. Therefore there is a threat of a loss of goodwill for Grease in the market as a result of the takeover. This problem is related to strategic risk since it will affect Grease's business in future. In addition to this, the share value of the company may decrease, as a result of which the company may suffer a huge loss.

(c) If the machinery that the company is operating fails, this will affect one of the key processes and therefore this is an operational risk. To solve this problem, Grease must install another machine that will help it to maintain its daily production.

(d) As the company has decided to enter into the production of motorcycle components, the company will face a strategic risk since this is a strategic decision that will affect the cash flows and profitability. In order to remain in competition, the company must take into consideration all future possibilities that may affect the business and should take any necessary steps in advance.

Answer to TY 2

The mining industry faces environmental risks, health and safety risks and technological risks that are inherent to the business of mining. Winson Plc's research and development department has identified that the cuprite reserves in its mines have decreased. This is an environmental risk since the natural resources of the mineral have declined.

The research department has identified another area for the mine. However the area is located near to a river and it is dangerous to dig in the area for the mineral. If Winson decides to mine in the area in order to maintain the turnover of the company there is a safety risk that water might flood the mines and the workers' lives will be at risk.

Winson Plc earned a turnover of Tshs400 billion in the last financial year. The research department's reports have shown that the cuprite reserves have decreased. This indicates that it is probable that the company will not achieve the same level of turnover in the current year. Therefore there is a business risk since a drastically reduced turnover will not attract investors.

Other general risks that the business will normally face include technological risk. Technological risk is the risk that new technology will render the current machinery useless. In other words, competitors might use better research and development techniques and mining equipment that may render the machinery used by Winson obsolete. It may also lose revenue if competitors make use of advanced technology to extract more minerals.

The mining industry also faces a political risk in that the government may put restrictions on the mining of certain minerals such as coal. Similarly the state authorities in Mexico may impose restrictions on the mining of certain minerals that Winson extracts.

There is also an operational risk that the safety equipment installed for the workers may not operate properly and hence the work might be disrupted.

Answer to TY 3

Sherwood is an IT company engaged in the preparation of different kinds of software. The company has recently prepared software for use by construction companies. According to the COSO methodology, Sherwood can implement the following steps to mitigate the risk of software failures.

Event inventories: the software that the company has installed on a trial basis is not providing the correct calculation of the costs of different projects. In addition to this, the software is unable to keep a proper backup because of which the software is losing crucial data.

In order to properly implement any new software, Sherwood should prepare event inventories consisting of common events such as major software failures, breakdowns and other common events that may disrupt the software processes. This will give Sherwood a better idea of how to deal with future risks.

Internal analysis: the company should carry out an internal analysis of the software with the help of experts and study all the construction software available in the market by conducting a market survey. This will help the company to assess the problems and the areas where its software lacks in giving proper service.

Facilitated workshops and interviews: the company may arrange for workshops to be conducted by experts in the software field and the construction industry who have in-depth knowledge of the requirements of the construction industry. These experts will help the company to understand the complications involved in the calculations of the various figures and hence the risks of miscalculations by the software will be minimised.

Loss event data methodologies: repositories need to be prepared of the events that lead to monetary losses, the failures of software programs and the reasons for their failure. Trends may be spotted such as the failure of programs that are not tested under critical conditions or the failure of programs that are prepared by trainees.

Analysis of these trends may help Sherwood to avoid delivering faulty packages that are subsequently rejected by clients.

Answer to TY 4

Backstreet manufactures woollen textiles. A recent batch of textiles has been manufactured using sheep skin from sheep which were suffering from a disease. The textiles have been tested and found to cause rashes in some skin types and therefore the company cannot sell these textiles in some of its markets. Backstreet has good markets in Estonia (its domestic market), Switzerland and Austria.

Board of Directors: the board of directors is responsible for the overall functioning of the company and for the risk management process. The board has a responsibility to define the ethical and integrity standards for the company and effectively communicate these to management. The management can then be delegated the task of formulating risk management methods and implementing them at the tactical and operational levels.

The board of Backstreet should define the company's risk appetite. The company cannot afford to lose its markets in Estonia, Switzerland and Austria hence the company cannot take the risk of selling the textile in these markets. Once this limit is set, the board should effectively communicate this to management.

Management: management may come up with a detailed risk management plan that will address the risks. Management may devise proper safety measures that will minimise the losses that may arise from these risks. Each manager is chiefly responsible for his sphere of activities and all those who operate below him.

Management may arrange not to dispatch these textiles to Estonia, Switzerland and Austria. The entire batch may be sent to the markets in Finland to avoid any loss.

Risk officer: the risk officer is responsible for monitoring the progress of the risk management process and ensuring its implementation. He works with the lower level managers to effectively manage risks in their areas of responsibility.

The risk officer also may have the responsibility for monitoring progress and for assisting other managers in reporting relevant risk information up, down and across the entity, and may be a member of an internal risk management committee.

In this case, the risk manager may work with the sales manager to create a sales plan for selling the textiles only in Finland. He may also ensure that the quality control manager has communicated this to the sales manager, marketing manager and production manager. These are the people who will be most affected the by the defect in the textile.

Internal auditors: the internal auditors monitor the Enterprise Risk Management process and the quality of performance as part of their regular duties. They may assist both management and the board.

They should monitor whether adequate methods are being adopted to ensure that the production is not wasted. The internal auditors should also recommend improvements to the risk management process e.g. ensuring that the sheep are disease-free before their wool is removed. This will ensure that Backstreet does not manufacture such defective textiles in the future.

Answer to TY 5

Archie Plc is a company engaged in the production of pharmaceuticals. The company conducted a market survey in which it discovered that one of the ingredients that the company uses to prepare headache relieving tablets is harmful for humans and likely to be banned by the government.

The risk committee, in this case, has to take the following measures:

(a) Identify the major risks facing the business and provide an insight into the risks that are inherent to the business

The risk committee should identify the risks associated with its production and take the necessary actions to overcome these risks e.g. by removing the ingredient from its headache tablets as it is harmful for health.

(b) Provide recommendations to the board on the risk appetite, risk capacity and risk management of the company

Inform the board of this problem so that the board can take the necessary action to resolve the problem.

(c) Assess and review the generic risks facing the business e.g. credit, market, liquidity, reputation, operational, fraud, strategic, technology, data-security and business-continuity risks

Take into consideration the various risks that may occur and affect its production in future e.g. if company doesn't find a better substitute for its ingredient then the company may be closed down by the regulatory authorities in future. As a result, the company may suffer risks such as credit risk, market risk and reputation risk.

(d) Create and increase the risk awareness in the company so that risks can be avoided by having an informed approach towards work

Ensure that sufficient risk management processes are present that identify report and monitor risks. If the company finds a better substitute for the harmful ingredient, then the company must ensure that the new ingredient will not be harmful to the public and proper precautions are taken in the preparation of the headache tablets.

Answer to TY 6

Sesame is a company engaged in the production of tobacco and tobacco-related products. The risks involved and the stakeholders impacted are as follows:

Risk for employees: the company has employed child labour to pluck tobacco in its plantations which is against the country's law. The child employees face health risks as it is risky for small children between the ages of 7 and 10 years to pluck tobacco leaves without using a mask. If proper care is not taken, their health may be adversely affected.

Risk for accounts payables: the company is located in a remote area and hence the company does not receive materials on time from its various suppliers. This is a risk to the company as production might be delayed due to the delay in supply.

Risk for customers: the products that the company prepares are injurious to the health of customers who consume them and hence the customers are at a health risk.

Risk for communities / general public: the company emits harmful smoke from its factory, which is creating air pollution and a health risk for the local residents. The company also employs child labour, which is not only against the law but is an unethical practice to follow. Therefore this is again a risk to the community and the general public since local children are being encouraged to work under harmful conditions and are denied an opportunity of education and advancement.

Risk for government: the government earns a lot of revenue from the taxes levied by it on the various tobacco products. The agitations against the company have led to a risk of the closure of the factory in the remote rural area and hence the government faces the risk of losing a lot of revenue from these tobacco products.

Risk for banks / financial institutions: the bad publicity of the company resulting from the various agitations against the company is a risk to the company's reputation. This may lead to a reduction in sales and a decrease in revenue which might lead to an irregularity in the company's loan repayments. Hence banks face a credit risk.

Quick Quiz

1. Fill in the blanks.

   (a) _________ risks are a result of internal audit inadequacies and the resultant failure of internal controls.

   (b) Diversification of the business is one of the ways to combat ___________ risks as it gives a company the opportunity to earn from one of the avenues even if some of them fail.

   (c) ___________ refers to the availability of cash or cash equivalents in the business.

   (d) ______________is related to the liquidity risk since the foreign currency holdings of a company are subject to fluctuations in exchange rates.

   (e) _________ is the risk arising from the way in which a business is financed in the long-term and short-term.

2. Who is responsible for reporting to the risk committee and the board?

3. Fill in the blanks

   (a) The ______________ is the person who is responsible for identifying and suggesting measures for the management of risk within the company.

   (b) The main function of the ________ committee is to identify, monitor and report on the effectiveness of risk management to the board.

   (c) All the members of the ____________________ are also members of the Board of Directors.

   (d) The ____________________ has a right to appoint independent external parties to identify and assess the various risks that the business faces.

   (e) ____________________ of the risks facing the business involve assessing whether proper risk control mechanisms are in place and effective.

4. State the four categories of the COSO framework.

5. Who is responsible for setting the tone of the organisation's risk management process?

Answers to Quick Quiz

1.
   (a) Operational
   (b) strategic
   (c) Liquidity
   (d) Currency risk
   (e) Financial risk

2. The Risk Manager

3.
   (a) risk manager
   (b) risk
   (c) risk committee
   (d) risk committee
   (e) internal / external auditing

4. Strategic, operations, reporting, compliance

5. Management of the concerned firm.

Self-Examination Questions

Question 1

Smokeronni has come up with a special division to manufacture the range of cigarettes for women. The division has been set up within the factory premises but as a separate unit distinct from the main factory building. The contract for the construction of the unit had been given to a contractor who worked along with his team of 10 workers at the site to erect the structure. The state laws applicable to Smokeronni required the company to take out a health insurance policy for all employees who work on the company's premises.

The administrative department took out an insurance policy for the employees working in the various departments of the tobacco factory. However, the law required that it should also have taken out an insurance policy for the workers working on the construction site of the new division. There was a misinterpretation of the law in this case. The company's lawyer is in talks with government authorities and there is a possibility that the company might have to fund the health insurance of the workers who worked on the site.

Required:

What are the various risks that the company is facing considering the given information?

Question 2

Regalia Plc manufactures metal sheets. These metal sheets are manufactured from steel alloys. One of the raw materials used is asbestos and this has been declared unsafe to work with by the Ministry of Health and Safety. Regalia has obtained a licence to operate in south London and may manufacture and sell its products only in this area. The finances of the company are managed by an able team of finance professionals.

The professionals have invested the money mainly in shares, bonds and stocks. The company has obtained finance from banks and the interest rates are likely to increase in the next financial year. A new director has recently acquired control of the board and has been appointed as CEO. He is ambitious and wants to expand the company's business.

The business expansion plans include the acquisition of another metal sheet manufacturing company as well as the introduction of new production technologies. These technologies will be imported from Russia and implemented in the company's system of production by a team of experts from Russia itself.

The company, being in the metal industry, needs to file various records with the government and the regulations and requirements change frequently. The company requires highly skilled workers since it manufactures high quality metal sheets. This labour is scarce and there are no formal training policies followed in the company.

Required:

Discuss the risks that the company faces.

Question 3

Waterstreet Plc is in the shipping business. It arranges for industrial cargo to be shipped to various destinations across the world from a Mediterranean port. The company has been operating on the shores of the Mediterranean for ten years. Over these ten years, international trade has seen phenomenal growth and hence the business has grown a lot. Fuel prices are likely to rise in the coming year.

There is severe competition in the shipping industry and while competitors can manage to maintain their freight rates in spite of the increase in fuel prices, Waterstreet will have to increase these rates. Waterstreet has been facing a problem with its ships in seas where the currents are strong. The problem is that the ship does not have enough engine capacity to maintain its speed and so the ship's speed decreases.

Required:

Prepare a risk map and classify the various risks that the company is facing in various quadrants giving reasons for the classification. State the board level considerations for managing these risks.

Question 4

Yotoda Plc is an automobile company which designs and manufactures cars. The company supplies cars internationally to many countries. The company's reputation as a supplier has recently deteriorated due to the lack of after-sales services being provided to its customers. Customers' cars are not being delivered at the promised time and, as a result, customers are being attracted to other car companies that offer almost the same car features as Yotoda.

There is a risk that the company might lose its customer base and market share if the problem persists. A newly appointed member of the board, Chin Hua, is a member of the risk committee of the board. He discusses the supply chain management risk and the manner in which it can be managed with the other non-executive members of the board. On his recommendation, Dilbert Wash, a management consultant, has been hired by the company to look into the matter and work with the risk committee to solve this problem.

The reduced sales have given rise to many risks e.g. credit risk since the customers whose cars are not delivered on time are not paying their dues, liquidity risk since the company is short of cash due to customer non-payment and finance risk since banks and other investors are refusing to provide finance to the company due to its falling reputation.

Required:

State the role of the risk manager and the importance of external and internal audit of the risk in the monitoring and management of these risks.

Answers to Self-Examination Questions

Answer to SEQ 1

Smokeronni Plc is a tobacco company, which is exposed to many inherent risks such as political risk, legal compliance risk and health and safety risk. Moreover tobacco being bad for health there is the constant threat of reputation risk. According to the given information, the risks that the company is facing can be listed as follows:

1. A social organisation is creating bad publicity for the company. This is a reputation risk for the company. The bad publicity may result in a reduction in sales and hence there is a risk that the increased sales may not be maintained in the coming financial year.

2. The state authorities are likely to increase the tax rates on cigarettes and this is a political risk since the company might have to pay higher amounts to the government authorities. This will reduce the distributable profits of the company.

3. The company has insured the health of all its employees but the law requires that anyone who works on the premises should be insured. There is a legal compliance risk in this case since the company has misinterpreted the law and hence has insured only those people who work in the factory.

4. Apart from this, the company also faces a risk related to the health and safety of its employees who work in the factory since tobacco is harmful for the health of employees.

Answer to SEQ 2

The company manufactures metal sheets. The risks that the company faces can be listed as follows:

1. The company uses asbestos as one of the raw materials in the manufacture of steel sheets. This is a material declared to be unsafe to work with by the Ministry of Health and Safety. This is a health and safety risk since the asbestos may affect the health of the employees. The employees may claim heavy compensation from the company if there are any ill effects on their health and hence the company may face the risk of paying heavy amounts to its workers. This is a financial risk.

2. The company has obtained a licence to operate in south London. There is a risk that the products will not sell in this area and as a result the company will incur a heavy loss. The production will remain as stock and will result in over-production. This is a business risk.

3. The company's new CEO wants to expand the business and wants to bring in new production technologies. There is a technological risk here that the technology might not work within the current systems installed in the company. Moreover the trainers coming from Russia may not be able to train the workers properly and hence the production might suffer. This is an operational risk.

4. The company needs to comply with a number of legal provisions and needs to file various records with government departments each month. The state regulations change frequently and hence there is a compliance risk. If the company does not keep itself up-to-date with the latest amendments in law it may not be in compliance with the provisions and this may result in penalties being levied on the company.

Answer to SEQ 3

The matrix for Waterstreet can be drawn up as follows:

		Probability: Low	**Probability: High**
Impact	**Low**	**Shipping industry will decline since customers will prefer airlines**	**Increase in fuel prices and hence increase in costs**
Impact	**High**	**War will disrupt international trade**	**Customers might prefer other shipping companies. Ships will sink or be severely damaged resulting in losses.**

Explanation

1. The probability that the shipping industry will decline due to the preference given to airlines is a remote possibility since shipping will always be preferred due to its cost effectiveness.

2. The probability that the increase in fuel prices will lead to an increase in cost is an event with a high probability and low risk. This is because the company can transfer these costs to its customers.

3. The probability that war will break out and disrupt the business is very low; however, if it happens the resulting loss to business will be very high since the business will have to stop operating.

4. The probability that customers will prefer other companies is high since Waterstreet will have to increase its freight rates due to an increase in fuel costs due to lower margins. This will have a heavy impact since there will be a loss of income. The possibility of damage to the ships is also very high since problems have already been reported and if the ships are damaged, the damage will have a very high impact on cost.

The board level considerations of risk in this case will include the assessment of the various factors involved in the operation of the shipping business. The board of Waterstreet should be aware of and agree on the company's risk appetite by setting profit goals and deciding on the market share the company must capture. The company's risk appetite should then be communicated to management in order to provide them with direction. The board should also ensure that there are proper procedures in place in the company to combat risks such as ships being damaged or sinking and loss of customers.

Answer to SEQ 4

The risk manager is mainly responsible for the implementation of the risk management policies set by the risk committee and the board and assisting in the risk management process. Yotoda Plc is currently facing a high business risk since its reputation in the market is deteriorating due to poor supply chain management policies. Yotoda's new risk manager, Chin Hua, is working with the risk committee and an external expert, Dilbert Wash, to mitigate these risks. Chin Hua has the following major role to play in mitigating the business risk:

1. Create awareness about the various risks that the business may face amongst the employees of the company. In this case, he may make the employees at various managerial levels aware of the impact of the delay in supplies on the sales and the reputation of Yotoda and hence the adverse impact on profits.

2. Identify the various risks facing the business e.g. the credit risk, liquidity risk and finance risk.

3. Establish models that will assess the impact of these risks on the company's profits and revenues.

4. Monitor the proper implementation of the risk mitigation strategies. In Yotoda's case, Chin can come up with a risk mitigation plan along with the members of risk committee and Dilbert e.g. monitoring the supply process to identify the areas where delays occur. Accordingly Chin should ensure that the methods to avoid delays are being followed meticulously.

5. Prepare and present before internal management the reports that highlight the various risk incidents e.g. the loopholes in the supply chain, related supply problems responsible for credit and finance risks.

6. Support Dilbert, in the management of the risk.

7. Develop a communication network so that management is kept informed of the risks involved in the operations.

8. Prepare a risk management policy statement and manual that will help employees at various managerial levels to implement appropriate risk mitigation procedures.

The internal and external risk auditing will help Yotoda Plc to mitigate the supply chain risk in the following manner:

1. The entire process of the supply chain should be monitored and the loopholes where the process fails should be identified. The audit process will help to identify the problem areas.

2. The external auditor may provide a fresh perspective on the problem by identifying various flaws in the supply system e.g. the orders not being processed in time for the delivery process to start and lack of communication amongst the staff that leads to a weak supply process.

3. The audit process may help in the assessment of the existing risk management systems and help the management to improve these through discussions.

SECTION C

GOVERNANCE

C1

STUDY GUIDE C1: GOVERNANCE

Get Through Intro

Whether you end up running a company, being part of a management team or supporting a board of directors as an accountant, you will be involved with governance or corporate governance. Corporate governance is about how companies are directed and controlled. For some accountants, their involvement will be from an external perspective - as an auditor; in such a case you will need to consider how companies are run and more importantly, how well they are run.

For the vast majority of companies that are well run, honest and successful, the recent codes and guidance on corporate governance have helped them improve their board, their relations with shareholders and the way they manage their business strategically - not only in the interests of the shareholders but also for the benefit of all stakeholders. Corporate governance is about putting checks and balances in place to support the successful, control the risk takers and prevent the dishonest from having their way - all in the interests of those who are stakeholders.

Agency relationships are the main reason for corporate governance to have gained so much importance. Agency relationships arise when a principal delegates responsibility for assets and affairs to an agent. The principal requires the agent to be accountable so that he can see how the agent has performed. The position of agent is a position of trust and the agent also needs to account for his stewardship of the assets. Since trust can never be absolute the principal may also require independent checks and controls to be in place through, for example, audit. The use of accounts to create accountability and checks such as audit comes at a cost and this cost together with the reward given to the agent is the agency cost. Delegation comes at a cost but gives benefit in a net return, time to do other things, and with the right agent, an access to expertise.

Company directors are agents of companies and owe duties to the companies as legal entities. Shareholders can be seen as principals. The agency theory argues that for listed companies where ownership and control have become separated, shareholders have, in effect, delegated the running of the company to the directors as their agents. The principals need the directors, who are in effect professional managers, to act in their best interests. Their interests may however diverge since the directors who may seek power and monetary reward will not necessarily wish to maximise profit or maximise shareholder value in the long-run. Agency theory therefore includes ways of aligning behaviour including rewards for directors that relate to return and growth for shareholders and share options that create loyalty and a long-term interest in value.

This Study Guide largely focuses on companies and particularly on the larger, listed companies where ownership and control have separated with professional managers running the company – and with potential conflicts between their interests and those of their shareholders. It also explores agency relationships, accountability issues of boards, effects of bribery and corruption on governance and also the principles of governance like transparency and probity etc.

Learning Outcomes

a) Define the concept of corporate governance taking into account the narrow and the broad perspectives.
b) Identify and based on a given scenario show the link between legal framework and the actual governance practices or lack of it.
c) Identify and based on a given scenario assess the role and responsibilities of an effective board.
d) Identify and based on a given scenario state the differences between the boards of directors of private companies and those of public sector companies or state owned enterprises.
e) Assess the effect of politics and corruption in various forms on the governance of companies both in the private sector and the public sector.
f) Identify and based on a given scenario assess the issues of accountability of management to a board, private and institutional shareholders.
g) Assess the issues of accountability of boards of directors to minority and large shareholders.
h) Identify and based on a given scenario evaluate the issues of transparency for an entity.
i) Explain the importance of probity as a principle of governance assessing issues and their implications in a given scenario.
j) Assess the extent to which a board is focusing on sustainable long-term success in a given scenario.

1. Define the concept of corporate governance taking into account the narrow and the broad perspectives.
[Learning Outcome a]

Businesses are run by people who have diverse capabilities, values, ethics, attitudes, risk appetites and integrity and have differing objectives and ambitions. Cases such as the collapse of Enron in the USA and the collapse of the Maxwell empire in the UK illustrate how ambitious risk takers, who are ultimately dishonest, can dominate businesses so much that they bring down the company in their greedy pursuit of personal financial gain and power. Executives in these companies went largely unchallenged by their board, managers and staff and the external auditors failed to provide an adequate check or balance to their behaviour. As a result, employees lost their jobs and suppliers, shareholders and others lost out financially.

If there had been proper challenge, proper mechanisms and processes of corporate governance, and proper independent audit and oversight then these cases may never have happened.

1.1 What is corporate governance?

In a narrow, technical sense, corporate governance is about two key areas: first of all corporations (in this case, companies) and secondly governance (how the companies are run; in this case how the directors run them). Companies are legal entities registered at Companies Houses (or its equivalent) and have to operate in accordance with their constitution, statute and, where appropriate, case law (e.g. companies formed in England will have to function in accordance with The Companies Act 2006).

The study of corporate governance focuses on the processes, mechanisms and structures that are put in place to enable directors to manage businesses operated as companies, and to provide checks and balances on the directors and executives. **Corporate governance** represents the **set of policies and procedures** that **determine how an organisation is directed, administered and controlled**. It sets the broad framework or parameters within which the people in the organisation must operate. The study of corporate governance also requires you to think about the purpose or role of enterprises in the economic and social framework of a state including their economic and potential social and environmental roles and responsibilities and the extent to which government intervention may be required.

Definition

The OECD (Organisation for Economic Co-operation and Development) defines corporate governance as "the system by which business corporations are directed and controlled".

Example

Although the contents of corporate governance will vary from organisation to organisation, almost all corporate governance approaches will share the following components:

Accountability: managers, executives and the board of directors must always act with the best interests of shareholders in mind as they are ultimately responsible to them. Directors are accountable to shareholders through voting on appointments and through annual and other reporting (e.g. strategies should focus principally upon delivering shareholder value in terms of growth and return at an acceptable risk).

Compliance: managers, executives and the board of directors should be reasonably sure that laws and regulations are complied with (e.g. tax can be avoided but not evaded).

Transparency: annual reports, financial statements and other reports should be objective and relevant information supplied to shareholders (e.g. if market expectations on profit are in doubt, a profits warning may need to be issued).

Independence: non-executive directors, internal auditors and external auditors need to be an effective challenge to executives and must be free to express their opinions (e.g. non-executive directors can often operate most effectively if they join the company from outside.)

Integrity: managers, executives and the board of directors should consider demonstrating high standards of ethics. Their actions and decisions may need to represent not only what is legal but also what is morally right (e.g. most multinational organisations do not allow their overseas factories to use child labour even if the practice is legal in that particular country).

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1. Corporate governance is broadly about two aspects of an organisation:

- the mechanisms by which corporations are **directed and controlled**
- the mechanisms by which those who direct and control the corporation (board of directors) are **monitored and supervised**

In short, it deals with the mechanisms that ensure that those who are in control are **accountable.** The above points are explained in turn below.

(a) Mechanisms by which corporations are directed and controlled

Companies are controlled by those who have the majority of shares and they can appoint themselves or others as directors because of their voting power. Other shareholders may have influence but lack control. Directors run companies through the board of directors as a body and as executives through their management of activities and processes. Authority comes from their legal position and power often comes from their personality and capability to build power bases.

Listed companies generally have substantial investor interest in their success from shareholders who are not directors actively involved in the business.

Many executive directors of large listed companies are professional managers who have been promoted to the board or brought in from outside for their contribution. Boards of listed companies need to engage with and talk to major shareholders.

Directors have the responsibility to craft corporate missions, visions, objectives and targets and to set out and implement the required strategies. To give reasonable assurance that the strategies will succeed, directors need to build appropriate risk management processes, mechanisms and controls, including appropriate information and communication systems for planning, monitoring and controlling the business.

Example

Well-lit Plc manufactures light-bulbs. Its objectives are to become the market leaders in bulbs, make good quality bulbs and make profits. The company has laid down policies and procedures for all its major activities such as the purchase of raw materials, the purchase of non-current assets and sales. All the activities of the company relating to purchases and sales are to be carried out according to these policies and procedures.

The company has a personnel manual where all the personnel rules for recruitment, training, leave, salary, etc. applicable to the employees are laid down. All activities relating to personnel such as recruitment, training, salary, etc. are to be carried out according to the personnel manual of the company.

The company prepares a corporate business plan, annual budgets and monthly MIS reports. The MIS reports include the monthly statement of financial position and income statement and a report of the expenses and revenue which have adverse variances along with reasons for the variances. The MIS is periodically tested by the internal audit function. The MIS reports are considered by the board at monthly meetings. Executive directors must explain the results and set out any actions to be taken.

To summarise, some of the mechanisms by which the company is effectively directed and controlled are:

- the company's strategic plans, its policies and procedures
- the personnel manual
- the internal audit assurance work
- monthly MIS reports
- the monthly board meetings

(b) Mechanisms by which those who direct and control the corporation are monitored and supervised

The board of directors is responsible for the conduct of business so as to achieve the objectives of the organisation**.** The mechanisms by which those who direct and control the corporation are monitored and supervised refer to the methods by which the actions of the board of directors can be examined and controlled.

The mechanisms for such examination and control include internal audits, the inclusion of non-executive directors in the board of directors, setting an audit committee for the company, etc.

Example

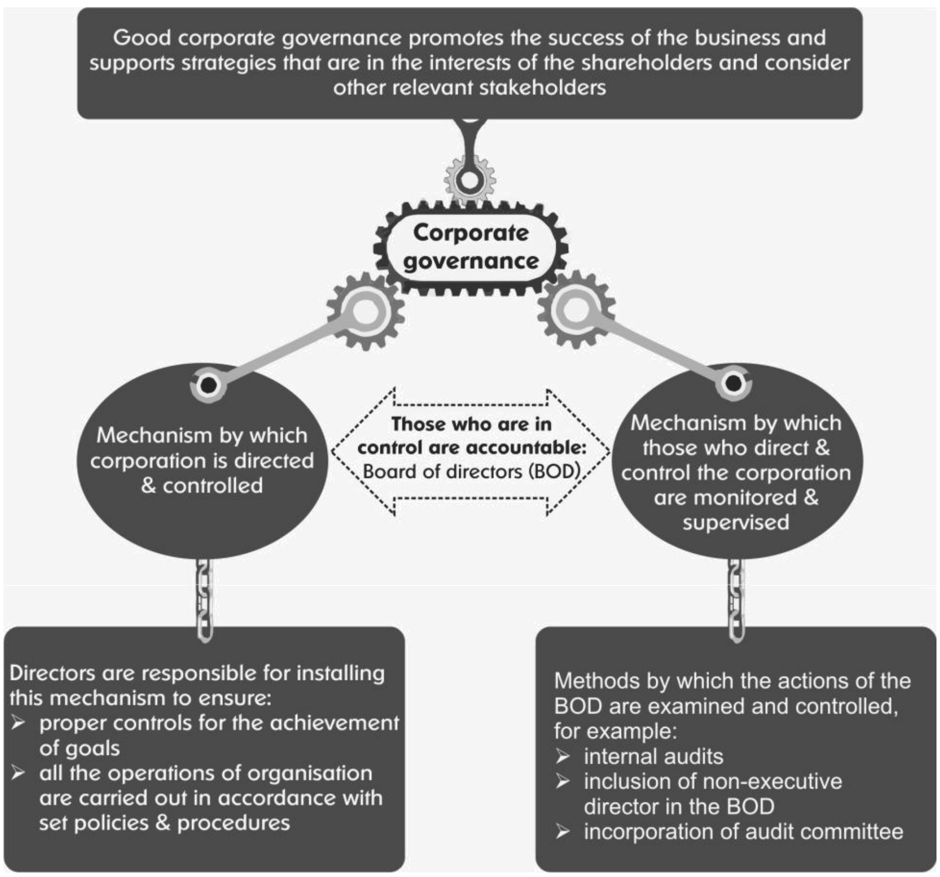
Continuing with the example of Well-lit Ltd,

The following are the mechanisms employed by the company to monitor and supervise the board:

Activity	How it helps in monitoring and supervising the board
The company has three non-executive members on its board. The company has separate persons functioning as CEO and chairman of the company.	This will enable the company to ensure that there is no concentration of power and the decisions taken by the board are unbiased. The non-executive directors can question and challenge the executives.
The company has appointed a firm of chartered accountants to carry out internal audits of the company's activities on a monthly basis. The scope of the internal audit is defined by the audit committee. The audit committee meets each month and discusses the internal audit reports.	The review of the activities and internal controls by the audit committee gives assurance to the board and through disclosure to shareholders that the company has a system of effective controls and risk management processes.
As a policy, the company does not assign any non-audit work to its external auditors and internal auditors.	This will give assurance to the shareholders, that the work of the auditor is objective and reliable.
The administration manager of the company provides guidance on applicable laws of the countries in which the organisation is located.	This promotes ethical behaviour and compliance.
The audit committee reviews the draft annual financial statements, receives explanations and approves the financial statements prior to approval of the main board.	This promotes confidence and improves transparency.

These mechanisms promote **accountability.**

Diagram 1: Corporate governance



2. The narrow and broad perspectives of corporate governance

As mentioned earlier, corporations are run by a board of directors who create a link between the shareholders and the company. However, apart from the shareholders, companies are also responsible towards the larger stakeholder groups who are affected by the operations of the company.

The narrow perspective of corporate governance requires companies to abide by the laws, regulations and disclosure rules that will ensure transparency towards shareholders.

The broad perspective not only necessitates abiding by laws and regulations, but also requires an awareness of the larger responsibilities of the company towards stakeholders like employees, government, environment and local community. Good governance practices in a broad perspective will also include responsible behaviour towards these interest groups, so that no activity carried out in the economic interests of shareholders may harm any of them.

Example

Continuing the above example of Well Lit Plc, all the procedures in place to monitor the board of directors, like appointment of auditors, NEDs and audit committee etc., are procedures that will help good governance practices in a narrow perspective.

In a broad perspective, the company will have to undertake some philanthropy, engage in sustainable development practices and devise policies that will benefit its employees and local community at large. Provision of free or concessional medical facilities to employees, developing public gardens and community centres for general public in the locality etc. are some of the good governance practices.

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3. Important features of good corporate governance

(a) Supports the development of strategic processes, risk management processes and controls that give reasonable assurance that organisational objectives will be met

Business strategies involve risk and significant risks need to be managed through appropriate processes.

Risk management processes include strategic planning, implementation and control and internal controls.

Example

Continuing the above example of Well-lit Plc,

Well-lit Plc is planning to acquire several new businesses that produce complementary products.

The company will use external consultants to undertake due diligence work to assess the businesses, their business strengths, weaknesses and risk areas and the reliability of their controls, accounting systems and information.

The due diligence reports will help the board to assess the targets as well as the potential returns and risks involved. The board will use the information to support appropriate valuations before making any offers.

(b) Prevents any single individual from having too much power and influence

A company which has different people as CEO and chairman ensures that no single individual has too much power and influence. There have been many instances where dominant individuals have used their power to support their ambitions and, in so doing, have taken unacceptable risks eventually leading to business failure. A strong independent chairman can support but challenge an influential CEO. The existence of a balanced board of executives and non-executives will support this.

(c) Concerns the relationship between the company's management, board of directors, shareholders and other stakeholders and aims to ensure that the company is managed in the best interests of the shareholders and considers other stakeholders – (broad perspective of corporate governance)

The board of directors plays a key role in corporate governance. It is the board's responsibility to endorse the organisation's strategy, develop directional policy, appoint, supervise and remunerate senior executives and to ensure the accountability of the organisation to its owners and authorities.

All parties to corporate governance have an interest, whether direct or indirect, in the success of the organisation. Directors, workers and management receive salaries, benefits and reputation, while shareholders gain growth and return. Customers receive goods and services; suppliers receive compensation for their goods or services. In return, these individuals provide value in the form of natural, human, social and other forms of capital.

A key factor in many individuals' decisions to contribute to an organisation (by investing in, dealing with or working for the organisation) is that they will receive a fair share of the organisation's returns. It can be argued that companies have social as well as economic purposes, and that in the long run, economic success requires social and environmental responsibility.

Examples of the types of responsibilities organisations may have to their stakeholders include:

- to deal ethically with their suppliers and customers
- to treat their employees fairly and maintain a healthy working environment
- to be a good "corporate citizen" by paying all taxes and complying with all government legislation
- to return some of their profits to society

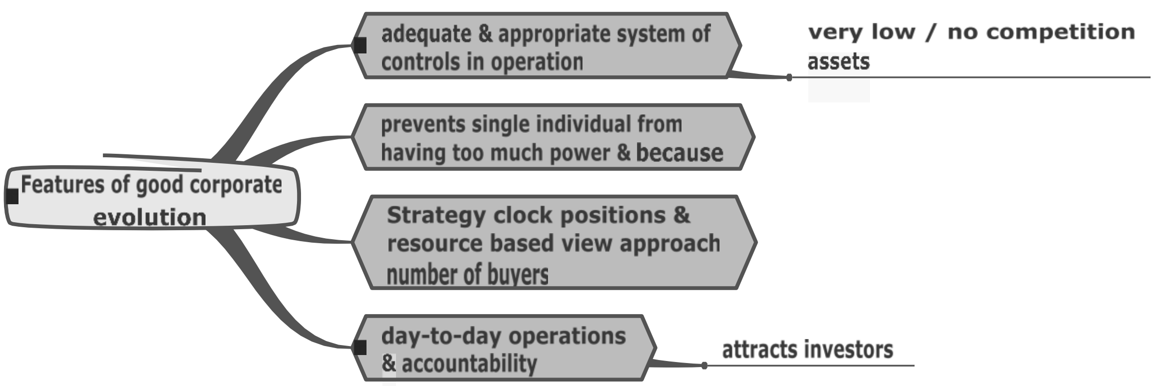
(d) Supports transparency and accountability for investors and other stakeholders

If companies and their directors are to be trusted then they need to provide reliable information about their plans, performance, activities and processes so that shareholders can decide whether to appoint or remove directors, whether to buy, hold or sell shares and whether to get involved in company management. Other stakeholders also need information to help them decide whether to do business with the company, to judge their position as an employee or whether to lobby the company to change its strategy.

Example

The UK Combined Code (now referred to as the UK Corporate Governance Code) and the UK Greenbury Code set out processes to determine and disclose directors' remuneration so that packages and levels of remuneration reflect the performance of directors and their contribution to the achievement of business objectives and can be judged and questioned openly by shareholders in a process that gives confidence that there are checks and balances on executive directors and their capability to determine their own remuneration.

SUMMARY



4. Objectives of corporate governance

Fundamentally, corporate governance codes and regulations provide mechanisms and processes to underpin successful businesses and provide checks and balances to control executive directors of listed companies and to encourage actions in the best interests of the company, its shareholders and, where appropriate, other stakeholders.

1.2 Importance of sound corporate governance

Sound corporate governance ensures protection of the value of shareholders' investment in a company. This is required as usually, majority of the shareholders of a company are small investors, members of mutual funds and individual pension fund members. Therefore their interest relates mainly to enhancing the value of their investment in the company.

Test Yourself 1

Explain the principles of good corporate governance.

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2. Identify and based on a given scenario show the link between legal framework and the actual governance practices or lack of it.

[Learning Outcome b]

2.1 Various Codes and Acts forming the legal framework for corporate governance

The Combined Code in the UK and the Sarbanes Oxley Act (SOX) in the USA are the two major sets of codes and rules that are required to be followed by private companies. Whilst the Combined code has a more principles-based approach, the SOX have a more rules-based approach.

The 'Organisation for economic co-operation and development' and the 'International corporate governance network' are the two major bodies that have developed a set of guidelines and governance standards for good corporate governance practices.

2.2 Organisation for economic cooperation and development (OECD) Report (2004)

1. Objectives

The OECD principles of Corporate Governance were **developed** in **conjunction** with **national governments, other relevant international organisations and the private sector**.

These principles are a **set of corporate governance standards and guidelines.**

The p**rinciples** are intended **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 and to **provide guidance and suggestions** for **stock exchanges, investors, corporations and other parties** that have a role in the **process of developing good corporate governance**.

The principles **concentrate** on **publicly-traded companies.** However, they can also be a **useful tool to improve corporate governance in non-traded companies**, for example, privately-held and state-owned enterprises.

The principles **represent** a **common basis** that **OECD member countries** consider **essential** for the **development of good governance practices**. They are **intended to be brief, understandable and accessible to the international community**.

2. **Contents**

Diagram 2: The principles covered under OECD report

2.3 International corporate governance network (ICGN) Report (2005)

1. **Objectives**

The International Corporate Governance Network (ICGN) was founded in 1995 at the instance of major institutional investors, who included investors, companies, financial intermediaries and other parties interested in the development of global corporate governance practices.

One of its objectives is to **facilitate international dialogue on issues of concern to investors**. Through this process, companies can compete more effectively and economies can prosper. The ICGN also believes that it is in the public interest to encourage and enable the owners of corporations to participate in their governance.

2. **Contents - General points**

The ICGN principles are in line with the OECD principles discussed earlier. The ICGN **deals with the rights and responsibilities of the shareholders, the role of the board, disclosure and transparency,** etc.

The ICGN statement **sets out the responsibilities of institutional shareholders** both in relation to their external role as owners of company equity, and also in relation to their internal governance. Both are of concern to beneficiaries and other stakeholders.

The ownership of equity carries important responsibilities, particularly due to the voting rights that can influence the way in which a business is conducted.

Ultimate owners cannot delegate these responsibilities. Even when they employ agents to act on their behalf, it is up to beneficial owners (i.e. the investors) to ensure that the responsibilities of ownership are fulfilled by those agents.

While some involved in the complex chain of intermediaries between beneficiaries and issuers (i.e. the company) have a simple obligation to provide a service, many have an agency function with a principal fiduciary responsibility to generate optimum returns consistent with the time horizon of the beneficiaries.

Those that represent beneficiaries need to be clear about the objectives of the beneficiaries. This involves careful consideration of key points, including the appropriate balance between short-term return and long-term value. Resources applied to governance and the exercise of votes may generate costs in the short term, but an increasing weight of evidence suggests this will add value in the long term. The ICGN's Statement on Stock Lending explores aspects of this in greater detail.

While it is vital that companies ensure shareholders can exercise their rights of ownership, these rights must be exercised responsibly. Moreover, responsible behaviour on the part of shareholders will reinforce their claim to rights. Even where companies refuse the rights of ownership to their shareholders, this does not absolve the latter from seeking to influence the behaviour of the company. Responsible ownership requires high standards of transparency, probity and care on the part of institutions, which may be met by adhering to the principles set out below.

While practice will vary in detail between national markets, the principles that underlie high standards are constant.

The following summary outlines the main contents of the ICGN report 2005.

SUMMARY

Let us consider the following case study to understand the various legal framework requirements and actual governance practices or the lack thereof. We will identify the framework requirements and the actual practices followed in the real world by applying theory to the case study.

Case Study

Crusoe Plc started a chemical factory in London in 20X0. Its business grew rapidly and it expanded its operations into a number of countries across Europe. The AGM of the company is about to be held and the board of Crusoe has prepared a detailed annual report containing the following information:

Statements by the chairman and the CEO providing information about the changing circumstances that the company faces, the company's future targets and the strategy it intends to follow to achieve them.

A narrative operating and financial review report containing information on the financial performance of the company and the company's future prospects including the risks faced by the company.

The sales and marketing departments' report on company sales and marketing strategies.

A summary of the previous year's financial figures.

Management discussion and analysis stating significant financial trends over last three years that affected the business and their impact on the future strategy.

Continued on the next page

Financial statements including statement of profit and loss, statement of financial position, cash and credit sales, R&D spending, inventory and debt levels over time and cash flow statements.

Names and addresses of subsidiary companies taken over by the company, addresses of head office and other branches of the company.

List of directors and officers along with the posts held, stating the number of executive and independent directors.

Statement of remuneration of directors, NEDs and other employees.

A corporate social responsibility report on the CSR activities carried out by the company that includes a report on a charity foundation established by the company. The foundation set up a hospital in the nearby area in order to avoid delay in the treatment of factory labourers in case of an accident, as there were no good hospitals in the area.

A report on the actions taken by the company to reduce the air pollution created by the chemical factory and to provide childcare facilities for the children of women working in the company.

2.4 Legal framework requirements for disclosures – mandatory disclosures

Mandatory disclosures are disclosures that are required to be publicly made under the regulations of specific laws and rules.

The **main mandatory disclosures** are components of the annual report, which are required to be made under company law and stock exchange listing rules.

The main mandatory disclosures include:

1. The listing rules require disclosure of the efficiency and effectiveness of the internal controls.

2. Company law requires companies to prepare their financial statements such as the statement of profit and loss, statement of financial position, cash flow statement, statement of changes in equity, operating segmental information, auditors' report, corporate governance disclosures such as remuneration report and some items in the directors' report (e.g. summary of operating position).

3. Business review is compulsory in the UK.

4. Companies are also required under the various listing rules to disclose corporate governance information in a separate report.

5. Stock exchanges might also require companies to disclose information with regard to investor interest.

6. Investors need to be kept informed of any major factors that might affect profitability or of business deals such as acquisitions.

Mandatory disclosures are compulsory according to the law or rules and hence any violation of these disclosure requirements might attract civil or criminal action. In the UK, the transparency requirements for price sensitive information require that it be immediately reported to the market. This supports efficient financial markets and avoids creation of false markets in shares. Directors may commit a criminal offence if they deliberately mislead the market and may expose the company to litigation if shareholders lose as a result.

Mandatory disclosures are disclosures that are required to be publicly made under the regulations of specific laws and rules such as company law and the stock exchange Listing Rules hence any violation of these disclosure requirements might attract civil or criminal action.

Case Study

Continuing the above case of Crusoe Plc,

The mandatory disclosures, i.e. the legal framework requirements, will be as follows:

Mandatory disclosures for Crusoe Plc

A board is required to disclose financial information in the annual report according to the provisions of the Combined Code. Crusoe has disclosed the previous year's financial statements, the current year's financial statements, along with the balance sheet, income statement, cash flow statements, cash and credit sales, R&D spending and inventory and debt levels over time. These constitute part of the mandatory disclosures to be made by the company.

The Code also requires the annual report to identify the names and posts held by the various directors on the board. Crusoe has given the address of the company head office and its subsidiaries and the names, addresses and posts of the directors and officers. All this is also a mandatory disclosure.

A statement on the remuneration of directors has been given by Crusoe. This information disclosure is mandatory in the UK. However, in other countries, this is a voluntary disclosure. Since Crusoe operates in the UK, this information forms a part of the mandatory disclosure.

2.5 Actual governance practices - voluntary disclosures

Companies also make certain disclosures that are not mandated by the codes or rules since these form a part of information that they deem necessary to be disclosed to the shareholders and stakeholders. These disclosures enhance the company's relationship with shareholders. Apart from mandatory disclosures, there are certain voluntary disclosures that companies make. These are also components of the annual report and are disclosed although they are not mandated by law or regulation.

1. Voluntary disclosures made by companies may include:

(a) The chairman's and the CEO's statements regarding the company position. These are required since they will instil a sense of confidence in the company amongst the readers. Even if this information is provided voluntarily it needs to be given to enhance value of the report.

(b) A corporate social responsibility report that contains details of the CSR activities carried out by the company. These are generally referred to as sustainability reports now.

(c) A narrative operating and financial review report that is understandable by all readers of the statements i.e. not just the technical experts. This document should be future-oriented and should narrate the financial performance and prospects of the company. Investors generally demand a report of this kind in order to obtain an idea of the various risks and the social and environmental projects carried out by the company.

(d) An annual report that is circulated in the AGM and provides a picture of the company. Beyond this annual report, the company may also make disclosures through the various media forms e.g. press releases, analyst's reports on the company's performance and forecasts made by management.

The major difference between mandatory and voluntary disclosures is that **mandatory disclosures are always compulsory** under a provision in company law, the Listing Rules or any other regulations applicable**. Voluntary disclosures are,** however, **at the discretion of the company**. These disclosures are given by the companies since they add value to the reports and help to improve relations with shareholders.

Case Study

Continuing the above example of Crusoe Plc, the actual governance practices will include the mandatory disclosures by Crusoe as well as the following voluntary disclosures made by the chairman and CEO, marketing department report and reports on CSR.

Voluntary disclosures

1. Crusoe has disclosed statements from the chairman and the CEO which provide information regarding the changing circumstances that the company is facing, the future targets and the manner of achieving these targets. These are voluntary disclosures since the information is not required by the Combined Code.

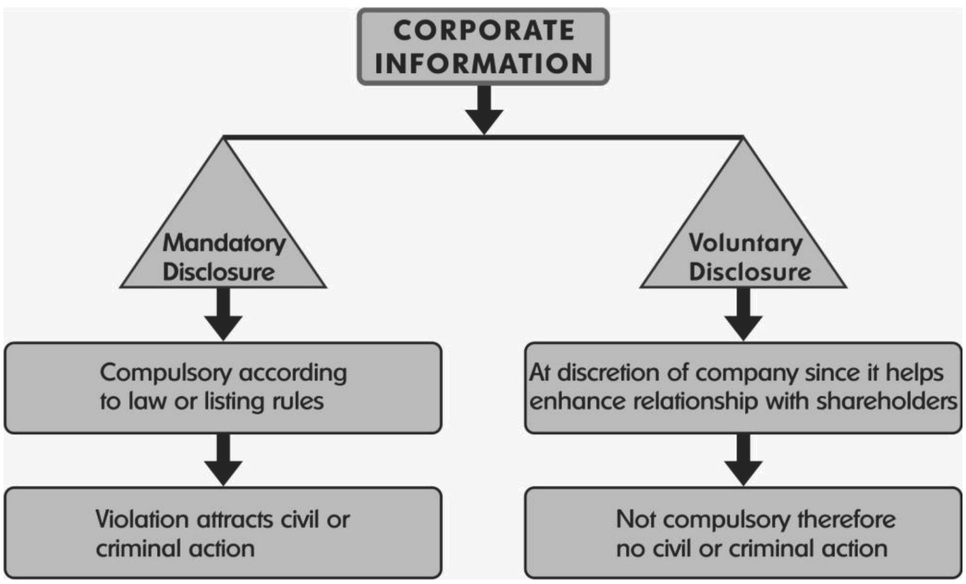
2. A narrative operating and financial review report has also been published giving the financial performance and future prospects including the risks faced by the company. This is a narrative report that is required to make the annual report more understandable since it is in non-technical language.

3. The sales and marketing departments' report on the marketing strategies of the company has also been given. This report will help increase investors' confidence in the company that the company's products will sell in the future.

4. The company has provided a CSR report specifying the social projects taken up by the company such as the setting up of a hospital to ensure prompt medical treatment of the factory workers in the case of an accident and the provision of childcare facilities to help working mothers to take care of their children when at work. This report will improve the image of the company in the eyes of investors.

5. There is also a special report containing details of the air pollution control measures taken by the company. This report highlights the various corporate governance measures that the company has adopted since the chemical factory may lead to heavy air pollution.

Diagram 3: Corporate information



2. The main motivations behind voluntary disclosures in a principles-based reporting environment are:

(a) The new reporting regime requires companies to address their social responsibilities and accept corporate accountability for any actions and decisions they take. Many companies use these disclosures as a tool to build social relationships with shareholders. Social and environmental reporting has been used by companies to portray an ethical image of the company so that the share value of the company increases.

(b) Ethical companies might provide information in the annual report regarding the various risks that the business faces and the environmental programmes that the company has undertaken since they believe that the shareholders need to know this.

(c) Providing voluntary disclosures in the annual reports helps to improve a company's communication with its shareholders since it encourages dialogue and a sense of ownership of the company amongst the shareholders. Such disclosures in the annual report may help to initiate a discussion at the AGM itself. Stakeholders' confidence in the company may also increase.

(d) The voluntary disclosures regarding the risks and the opportunities that the business faces also help to bridge the information asymmetry between the directors and the shareholders.

Example

Ninja Plc manufactures pesticides. Its annual report for the year 20X2 contained a disclosure that the company faces an operational risk if its market competitors reduce the price of their product from the existing Tshs5,000 per litre of pesticide to Tshs4,000 per litre of pesticide. This is because the company will run into losses if it sells the pesticides at a price of Tshs4,000 per litre.

(e) Increased transparency in reporting through the various voluntary disclosures can help to attract and retain institutional and other major investors in the company. This, in turn, helps to reduce the cost of capital since shareholders continue to invest in the company on the same terms, i.e. without the incentive of higher returns, because they believe in the company.

Example

Excellor Plc has been regularly reporting in its annual report about the various foundations it supports and the social benefits that women and children from various backward areas have received through its initiatives. It also keeps the shareholders informed of any upcoming projects along with the various risks that the business faces in the form of competitors, finance requirements, labour unions etc.

Pension Funds (institutional investors) has been investing in the company for the last 10 years and wishes to continue investing even though the company has increased its rate of dividend only once in the last 5 years. This is because the transparency in its operations that Excellor has maintained confirms that it is an ethical company and hence investors can always earn money by trading its shares on the market. This has helped to reduce the cost of capital for Excellor.

(f) Many countries have now made several voluntary disclosures compulsory under law as a part of corporate governance best practices. Therefore any non-compliance can result in civil actions in courts. E.g. companies in the UK are required to publish CSR reports regarding the various social activities they have undertaken.

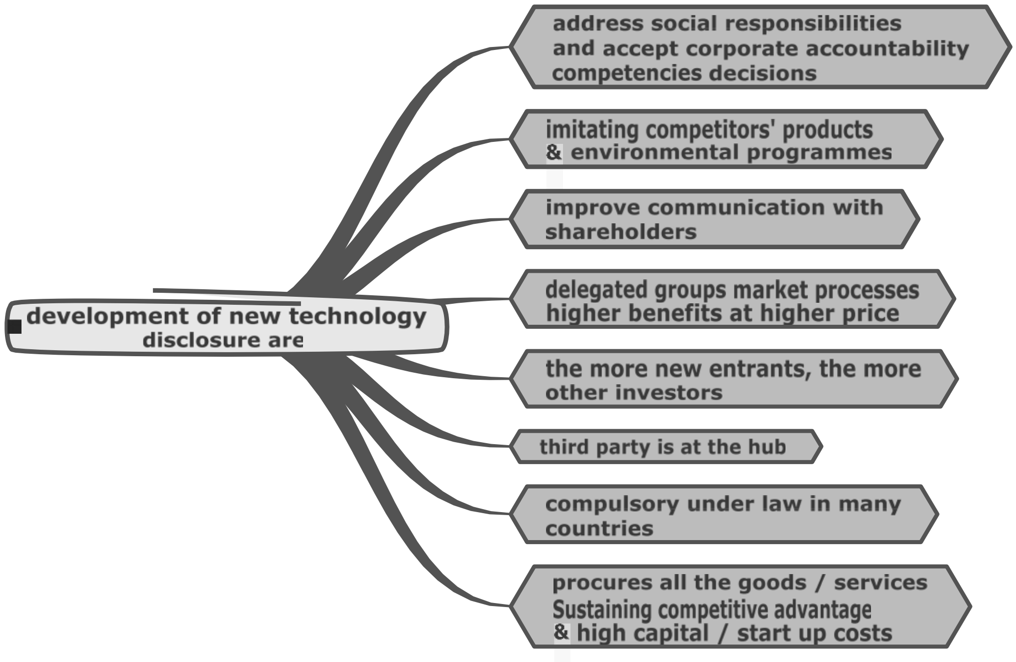
(g) The directors' remuneration in many cases is dependent on the reporting and disclosures in the annual reports that specify the performance of the company and its results. Therefore it is very important to disclose the achievements of the company in order to inform the shareholders of the progress of the business.

(h) Mandatory external reporting of internal controls and risks will ensure accountability. This in turn will mean that internal control failures and business probity risks will be intimated to the shareholders at an early stage and will be nipped in the bud as the existing board can be replaced before the position becomes more serious.

(i) Information on internal controls would enhance shareholder confidence and satisfaction.

(j) Compulsory external reporting on internal controls will encourage good practice in the company.

SUMMARY



A company needs to publish various other reports under the different directives issued by company law. The EU Transparency Directive requires companies to issue an interim management statement (IMS) each year. This is a narrative report that is required in addition to the interim financial statements that are published by the company. The IMS explains the major events and transactions that have taken place in the company in the previous six-month period and their financial effects. Similar to narrative reports, these statements should also contain the future risks and uncertainties that the business will face.

The above directive is an effort towards making voluntary disclosures mandatory and thereby increasing transparency in reporting. Company law also requires companies to publish business review reports that inform shareholders about the performance of the directors in promoting the business of the company. The business reviews contain the assessment report on the company's business and the identification of the various risks and uncertainties faced by the business.

Test Yourself 2

The following is an extract from the corporate governance report of Jestinson Plc, a company that manufactures high quality glass for use in offices and homes.

Read the various sections given in the report and assess whether the board has met acceptable disclosure standards and the purpose of reporting on the areas that have not been given in the report.

Corporate governance report of Jestinson Plc

The company believes in adopting the best global practices in the area of corporate governance and follows the principles of full transparency and accountability, thereby protecting the interests of all its stakeholders. The board considers it a trustee of all shareholders and acknowledges its responsibilities to the shareholders for creating and safeguarding shareholders' wealth. During the year under review, the board continued its pursuit of these objectives through the adoption and monitoring of corporate strategies, prudent business plans, monitoring of the major risks facing the company's business and ensuring that the company pursues policies and procedures to satisfy its legal and ethical responsibilities.

Board of directors

The board of directors provides strategic direction and thrust to the operations of the company. The board has a non-executive chairman and six other directors. Out of these, four members are independent directors. Hence, the company complies with the listing agreement norms for independent directors. During the year, the board of directors of the company has approved and laid down a code of conduct applicable to all board members and employees of the company. This code of conduct has been posted on the company's website. Furthermore, all board members and employees of the company have affirmed their adherence to the code. The company's vice-chairman and managing director's (CEO) declaration to this effect forms a part of this report.

Continued on the next page

Board procedures

The company secretary prepares the agenda in consultation with the chairman of the board of directors, the chairmen of various committees and the vice-chairman & managing director. The agenda for the meetings of the board and its committees, together with the appropriate supporting documents, are circulated well in advance of the meetings. The meetings are normally held in Mumbai. The board also approves by circular resolutions, important items of business which are permitted by the Companies Act, 1956 and which cannot be postponed until the next board meeting. At regular intervals, the management also circulates board notes to the board members on important material developments affecting the company.

Attendance at meetings

During the year under review, the board of directors met 8 times on 28 February, 16 April, 21 May, 30 June, 23 October, 11 November, 2 December and 16 December, 20X2. The attendance record of the directors at each board meeting, and at the last annual general meeting held on 5 May 20X3, is given below:

Name of the director	Type of director	Board meetings attended	AGM attended	No. of committee memberships held (excl. private Cos.) @	No. of outside directorships held (excl. private Cos.) Tshs
Peter Bullock (Chairman)		8	No	Nil	4
Denson Angel	NPD, NED, ID	6	No	3	2
Tony Nair	NPD, NED, ID	6	Yes	3	2
K. Thomas	NPD, NED, ID	7	Yes	2	6
Andrew Shrine	NPD, NED, ID	8	Yes	Nil	Nil
Jack Holman	NED, NID	2	Yes	4	1
Beck Bohemian	NID, NPD	1	No	Nil	Nil
Anna Varghese (Vice-chairman, MD)	PD, ED, NID	8	Yes	1	4

PD: Promoter Director, ED: Executive Director, ID: Independent Director, NPD: Non-Promoter Director, NED: Non-Executive Director, NID: Non-Independent Director

Accountability and audit

Internal control and internal audit

Internal controls are the systems (manual or electronic), procedures and processes adopted by management to provide reasonable assurance regarding the achievement of objectives with respect to effectiveness and efficiency of operations, safeguarding of the company's assets, compliance with applicable laws and regulations, supporting business sustainability under normal as well as adverse operating conditions, reliable reporting and the prevention and detection of fraud, theft and other financial / accounting irregularities.

Jestinson Plc’s internal audit department regularly evaluates the adequacy and effectiveness of the company’s internal controls and financial reporting systems. This is conducted in accordance with the annual audit plan which ensures comprehensive coverage without unnecessary duplication.

The scope of the audit plan is to determine whether the company's risk management, control and governance processes, as designed and represented by management, is adequate and functioning in a manner to ensure that risks are appropriately identified and managed and that employees' actions are in compliance with policies, standards, procedures and applicable laws and regulations. The relevant audit plans are reviewed and approved by the audit and risk management committee on a bi-annual basis. These plans cover the six-month periods to the end of August and the end of February respectively.

The internal and external audit teams coordinate their work by sharing information and planning together to ensure comprehensive audit coverage and avoidance of unnecessary costs. The internal and external auditors have unrestricted access to the chairman of the audit and risk management committee.

External audit

The external auditors' plan is reviewed by the audit and risk management committee to ensure that significant areas of concern are covered, without infringing on the external auditors' independence and right to audit, to enable them to express an opinion on the annual financial statements.

3. Identify and based on a given scenario assess the role and responsibilities of an effective board.

[Learning Outcome c]

Every company is required to have a board of directors to lead and control the company. It runs the company as a body. The board is led by a chairman who presides over the meetings of the board. The secretary is responsible for the formalities of the board such as maintaining minutes of the board meetings, conducting meetings and so on. The governance of the company is the responsibility of the board.

The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholder views and voting in the general meeting. An effective board is essential for the smooth running of the company since it is the only link between the investors and the managers.

Case Study

Rupert Murdoch arrived in the UK in the 1960's coming from a family business background as owners of a regional Australian newspaper. He acquired the News of The World paper and built its success exposing scandals in government. He then acquired the ailing Sun newspaper and transformed it into a saucy tabloid to challenge The Mirror newspaper with a mix of sports, right wing politics and topless girls.

By the 1980's Murdoch also controlled the ailing quality broadsheet The Times and its profitable partner The Sunday Times. Murdoch operated his companies under the News Corporation name, a multinational business and in the UK he took on the print unions automated processes and transformed the companies into popular and profitable businesses. His News Corporation Empire is now listed on the Australian and New York Stock Exchanges and controls the US TV and film network Fox, DirecTV of the US, the New York Post, Wall Street Journal and a host of other media interests worldwide.

Critics argue that Murdoch has the power to meddle in politics as with the Sun when it backed Tony Blair as Prime Minister. His empire has also been investigated by The Office of Fair Trading in the UK who found evidence of unfair market practices. Murdoch is clearly a dominant chief executive who has driven forward his companies to achieve success. Murdoch is both chairman and chief executive and a major shareholder.

In the UK back in the 1980's Murdoch acquired the nearly bankrupt London Weekend Television Company but his rescue plans were rejected by regulators due to his scale and influence. In the event he launched the satellite TV channel Sky and challenged the independent and government backed UK channels. As satellite companies made massive losses in their early years Murdoch was able to buy cheaply the UK government backed rival BSB. Losses and negative cash flow nearly ended the Sky venture but as time went by the company was turned around by its global scale and because it won the rights to screen football league games in many countries around Europe. Sky was eventually listed on the London Stock Exchange as BskyB plc but with News Corporation holding a majority interest.

More recently Rupert Murdoch has been handing control over to his son James as his father had done many years before. In 2003 shareholders had to vote on the appointment of James as chief executive to take over from his father with Rupert remaining as chairman. James was only 29 and lacked experience and some shareholders attempted to block his appointment. The nominations committee headed by a former conservative minister had agreed to the appointment and was subject to considerable criticism. One institutional shareholder described the nepotism as a 'Mockery of the British Corporate Governance System'.

At the last minute in the face of a shareholder revolt New Star Asset Management decided to back James stating there was no conflict of interest between the chairman, chief executive and News Corporation. The vote was won inevitably by five to one and James was appointed. Rupert Murdoch commented that he 'Noted their comments!'

Collectively, the directors as a board are responsible for good corporate governance practices. The vast majority of companies are well run and uphold good standards of integrity however there have been **a number of high profile cases like the above case of Rupert Murdoch, where executive directors have abused their positions and other non-executive directors have not met the requirement of the standard (Combined Code) to challenge them**, including:

one **director dominating the board and taking all the decisions**, creating problems where significant risks are taken and where integrity is lacking

executives, or a small group, **running all the affairs of the board with little challenge by non-executives**

lack of consideration of **broader stakeholder groups other than shareholders**

institutional shareholders not having enough representation on the board either through lack of interest or power of the existing board

company being poorly run by directors because they had poor business judgment

a lack of transparency in the reporting procedures followed by the directors, often combined with the other issues above

Case Study

Continuing the above case study of Rupert Murdoch, we may conclude that it is a perfect case where one man dominated the board and took almost all the decisions for the company. Murdoch's extensive expansion and takeover plans were seldom challenged by any non-executives and his decisions were majorly based on only profit considerations. These decisions made the News Corporation an extremely profitable venture for shareholders but the broader stakeholder groups were never considered at all. Moreover, the risks taken by Murdoch were significant and lacked long term sustainability considerations.

The lack of importance given to the institutional shareholders is also evident from the fact that their opinion was not deemed necessary and important while deciding the person to be appointed as the CEO. In spite of the fact that James had little experience to become the CEO of a giant business empire, he was appointed as the CEO with a five as to one vote. This shows the hold that Rupert Murdoch as the chairman and ex- CEO had over the decisions of the board.

All these practices are against good corporate governance. The News Corporation case is an excellent case of a successful yet one-man dominated empire. Although the company has come a long way and is one of the most illustrious business empires in the world, it has thrown light on some of the most startling facts of bad governance practices and corrupt / unfair practices of business.

3.1 The responsibilities of an effective board are as follows:

1. Setting company's strategic aims. This includes

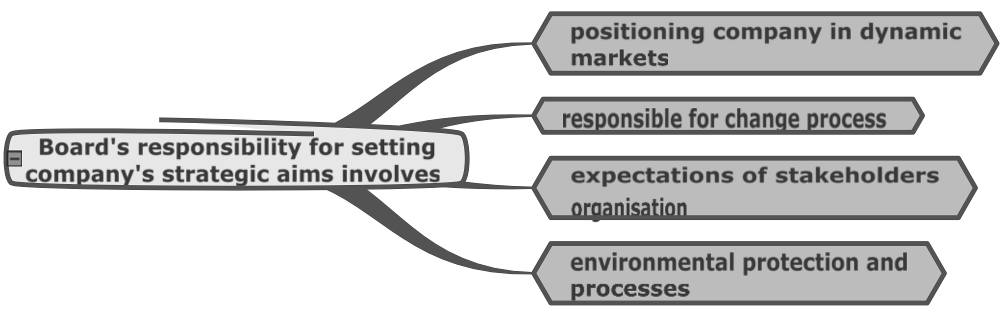
(a) positioning the company in dynamic markets e.g. deciding on products to sell and where in a market they will compete including issues such as pricing, quality, promotion and overall business models to be used

(b) setting corporate direction e.g. this might include objectives for growth and whether this will be organic or through acquisition and how international expansion might take place

(c) reviewing and deciding on key resources e.g. deciding on the major suppliers, the major types of raw materials used and their specifications, hiring the right people for the right jobs. This will also include decisions on how to achieve excellence in the value chain and the extent of investment in technology, I.T. and people

(d) deciding on implementation processes e.g. deciding how plans will be put into place by managers and staff and how projects and processes will be managed to ensure objectives are delivered

SUMMARY



Case Study

Continuing the above case of Rupert Murdoch,

The board effectively performed the above responsibilities of positioning the company in the dynamic markets by taking expansion decisions in order to make the company profitable. It has also fulfilled the responsibility of setting the corporate direction by diversifying the business in areas of news journals, media channels etc. thereby opening the channels for increased profitability. The only hitch was that all these decisions were taken by Rupert Murdoch alone without any challenge from non-executives and unified support of fellow executives who were 'yes men' for Murdoch.

2. Policy formulation

(a) Stating purpose: the purpose of the company should be stated clearly as this will help formulate the policy to be followed. E.g. this will include setting out the markets in which a business will operate and the overall objectives in creating value for shareholders and the relationships with other stakeholders. Fundamentally this is a statement of why the company exists.

(b) Creating vision: the board should consider potential areas for expansion. E.g. a vision is a tangible view of the purpose and objectives that has been articulated so that staff and stakeholders know where the company would like to be in the future.

(c) Creating value: the board should create value by growing the business, improving its capability and processes and translating this into customer value and shareholder margin. E.g. pursuing the right products in the right markets for the right customers, delivering to their value propositions with sufficient returns to satisfy shareholders and other stakeholders.

(d) Developing corporate climate and culture: culture is driven from the top and represents the way people work and crucially their moral and ethical values E.g. directors need to articulate values that drive desires for quality and ethical standards and set examples that employees follow as well as getting involved to ensure attitudes to quality, risk, control, transparency and social and environmental issues are right.

(e) Monitoring the external environment for opportunities, threats and risks: the global economy, local economy and society and the markets in which firms operate are dynamic and unpredictable. The board needs to scan for change constantly and look for innovations in products, processes and technology to create and sustain competitive advantages.

Example

A provider of handheld information technology products has a vision to be a global leader with access to economies of scale underpinned by a flow of new technologies and process techniques. A competitor has taken some market share with a new low cost product that has been marketed successfully at launch as a substitute for some of its products. The board has committed more investment in research and development and is negotiating to buy a small company that may have the next generation of technology. The board is considering outsourcing production to low cost countries. A global marketing team has been formed to attack the competitor using its brand as a key factor in success along with an upgraded product version at a new low price.

Case Study

Continuing the above case study of Rupert Murdoch,

The board had fulfilled the responsibility of creating a vision for the company by exploring new markets for expansion and informing the shareholders and stakeholders about the aim of the company to be a media giant. They have also created value for the company continuously, taking the company to new heights and making it more profitable. It has created wealth and profits for shareholders. The board has successfully taken certain decisions like exposing government scandals to prove that it is a news company operating in the best interests of stakeholders like the readers of the newspapers and the general public at large.

Culture within the News Corporation is a culture driven by a dominating and majority shareholder, CEO and chairman, Rupert Murdoch. He has not essentially resorted to all fair practices in order to turn the newspapers and media channels owned by him into a success. He has resorted to unfair practices according to reports from the Office of fair trading. This will give a wrong indication to the employees and subordinates within the board and set wrong examples. It will encourage fraud and non-transparency in the conduct of business. The opportunities, threats and risks have been assessed properly by Rupert Murdoch in setting up businesses in diverse jurisdictions and nations like the UK and America and running them successfully.

SUMMARY

3. Supervising management

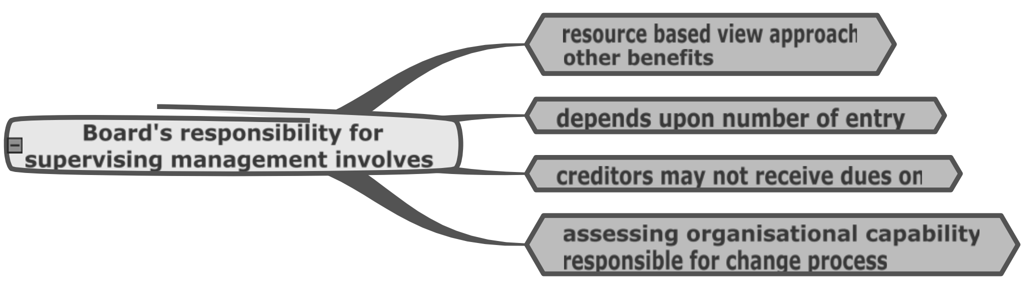
(a) Overseeing management performance: the board should regularly agree appropriate targets linked to critical success factors and strategic objectives so that it can motivate managers and monitor the performance of management and agree changes to plans and tactics. E.g. performance management systems may be put in place at an individual level linked to business unit objectives and results.

(b) Monitoring budgetary control: the board should review progress against budgets quantitatively and qualitatively examining variance analyses and commentaries and asking challenging questions. E.g. the board needs to establish whether strategic objectives will be achieved by examining the evidence. If a sales budget is not being achieved they need to know whether strategic, tactical or operational actions are required and whether there are wider implications for the business or its results.

(c) Reviewing key business results: the board does not need to monitor all results but should monitor the results of key business processes and projects that are important from a financial perspective. Results that are disclosed will have an impact on the share price and ability to raise finance and the board should be able to justify and explain strategy in the light of the results.

(d) Assessing organisational capability in resources and processes: the board should assess the existing resources and processes and always try to come up with better processes and substitutes for resources used that will enhance the productivity and lead to better results. This needs to be done across human resources, products and operational locations and include value chain analysis of key business processes to protect and enhance value adding activities E.g. while assessing the input resources used, the board may question the use of natural gas as a fuel that may be more economical than using LPG.

SUMMARY



4. Accountability

The board owes its duties:

(a) to the company: the board should act in the best interests of the company

(b) to the shareholders (both institutional, private and as a whole): the board should work in the interests and benefit of institutional shareholders and shareholders holding majority shares as well as small, individual shareholders.

(c) to regulators: the board should work within the parameters set by the regulatory authorities of the area in which they operate.

(d) to stakeholders in a broader sense: the board has responsibilities towards all stakeholders including suppliers, customers, employees and society.

Through effective self-assessment and monitoring: board should always assess its own performance by comparing the results it achieves over a period of time and against its strategic and other objectives. E.g. evidence may be sought and discussions held with individual board members to assess their contribution and performance.

The broad objectives that the board should meet are:

(i) to provide superior strategic guidance to ensure the company's growth, prosperity and sustainability
(ii) to ensure accountability of the company to its stakeholders
(iii) to ensure that they employ the right executive team to manage the company

The Combined Code (the UK Corporate Governance Code) defines the roles, duties and responsibilities of the directors. It states that, while fulfilling their duties as directors, **the board should provide an effective leadership within the framework of controls**. They should take care that they keep the business risk at a manageable level.

In addition to the above, the board should have regular meetings with proper agendas. The board should take decisions on those matters for which it has a right to take decisions.

Case Study

Continuing the above case of Rupert Murdoch, the board has acted in the interests of the shareholders i.e. owners of the company. It has created consistent and handsome profits for them and has scaled the company to newer heights with rapid expansions.

Institutional shareholders do not have any say in the management and working of the company since Rupert Murdoch is the majority shareholder and also the CEO and chairman. Hence, he decides the future of the company almost single-handedly. This dilutes the power and influence institutional shareholders can have on a company's working and the board of directors. This is also evident when the opinion of the institutional shareholders has been noted but not considered important enough to re-think the decision of making James, a young and inexperienced executive, as the CEO of the company.

By resorting to unfair market practices, it is a doubt if Rupert Murdoch has abided by all the regulatory requirements of the jurisdictions in which the company operates.

SUMMARY

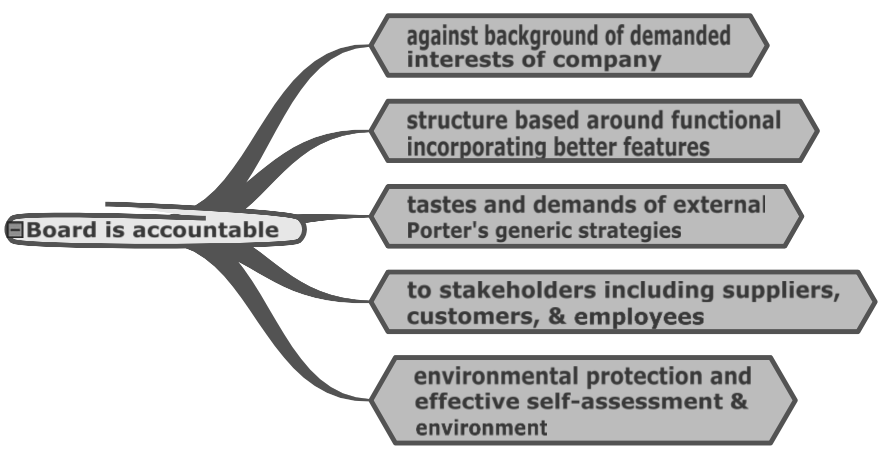
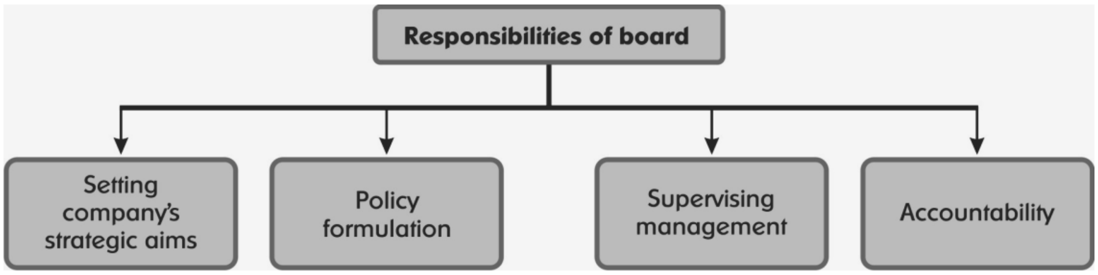


Diagram 4: Responsibilities of the board



Test Yourself 3

Blackberry Plc has recently set up a business to manufacture and sell mobile phones. The company has an adequate capital to support it for the first year of production. It has appointed a team of experts to work with the founders to design the mobiles and a staff of 50 people in the production department to manufacture the mobiles. There is a shortage of skilled employees in the production department and hence it cannot produce more than 10,000 mobiles in the current year. The founders have recruited an able team with good knowledge of the industry to join the board. The board has called its first meeting to discuss business strategy.

Required:

State the responsibilities of the board towards setting the strategy of the company.

3.2 Board composition

A director is responsible for the governance of the company. Collectively the directors are referred to as the board. Amongst them, they elect one person as the chairman who is responsible for presiding over the affairs of the board and all its meetings.

Ideally, the board should consist of a chairman, a chief executive officer and directors who operate under the leadership of the two. Directors are the elected representatives of the owners. They manage the business of the company and safeguard the assets.

According to the Combined Code (the UK Corporate Governance Code), a board should have a balance of executive and non-executive directors on it. This is because the board's decision-making process should not be dominated by any single director or by a group of directors.

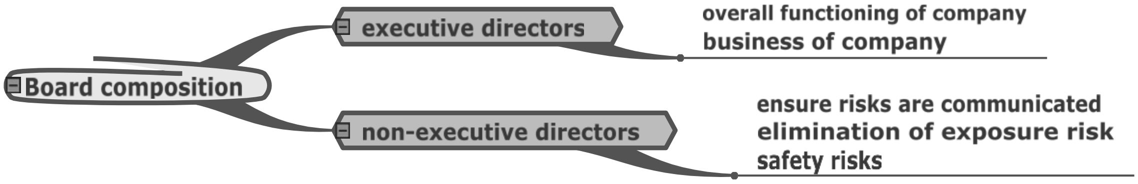
An executive director is a senior manager and executive officer of an organisation, company or corporation. An executive director is usually paid a salary, some performance related pay and may receive share options. Executive directors have industry or activity-relevant knowledge or expertise. They are actually involved in the running the business of the company.

A non-executive director (NED) is a member of the board of directors of a company who does not form part of the executive management team. He is neither an employee of the company nor associated with it in any other way. NEDs are differentiated from executive directors, who are members of the board also serving as executive managers of the company. NEDs should be independent protectors of the stakeholders and act in a supervisory capacity to monitor and challenge the work of the executives.

The Code seeks to ensure that power and information do not become concentrated in the hands of some individuals and the decisions are the combined outcome of an equal participation by the executive and non-executive directors. In reality many NEDs are not truly independent since they act for several companies and may have been executives of the company in the past. As time goes on some NEDs become closer to the company and lose their initial sense of independence.

However, NEDs are appointed by shareholders who as investors will benefit from the checks and balances that they provide over executives who whilst also being appointed by shareholders have often been promoted into or recruited into their management role by executives. Ultimately executives have the power to run the company but are controlled through shareholder voting and non-executive challenge.

SUMMARY



The UK Corporate Governance Code recommends the following with regard to the composition of the board:

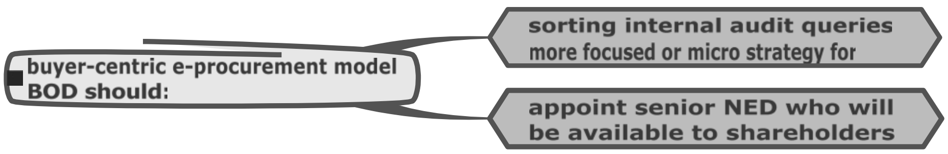
1. 50% of the board should consist of independent NEDs excluding the chairman, excepting smaller companies who should have at least two NEDs on the board.

2. One of the NEDs should be appointed as a senior NED who will be available to the shareholders in case they have any concerns that cannot be solved by contacting the chairman, CEO or finance director.

The Code requires NEDs to have a strong presence on the board since they act as independent supervisors of the activities of the board. The NEDs generally include representatives from each of the stakeholder groups such as accounts payables, suppliers, customers and employees etc. The viewpoints of these representatives make the decisions all encompassing.

It must be remembered that the 'comply and explain' principle applies such that failure to follow the code requires disclosure with explanation that allows stakeholders to judge for themselves.

SUMMARY



3.3 Characteristics of the directors

The directors should possess the following characteristics to be effective business managers:

1. **Proactive:** they should have the ability to look beyond the physical facts to foresee challenges and opportunities and come up with ideas to resolve issues as well as to advance the business. E.g. Directors should lead with innovative ideas that can be debated and discussed.

2. **Motivating:** they should have the ability to motivate the team working under their leadership to perform in order to achieve the best results possible. E.g. directors should boost the performance of their teams by giving them involvement, potential to develop and advance and promotions, incentives etc.

3. **Experienced:** the directors should have experience of dealing with the circumstances he will face as a director. He should be well-versed with the industry conditions and the ways of overcoming problems. Companies should not however be afraid to promote gifted young managers with ideas and drive.

4. **Good listening and questioning skills:** directors should have tolerance, and more importantly learn from others and have the requisite knowledge and attitude to question the areas where they have doubt.

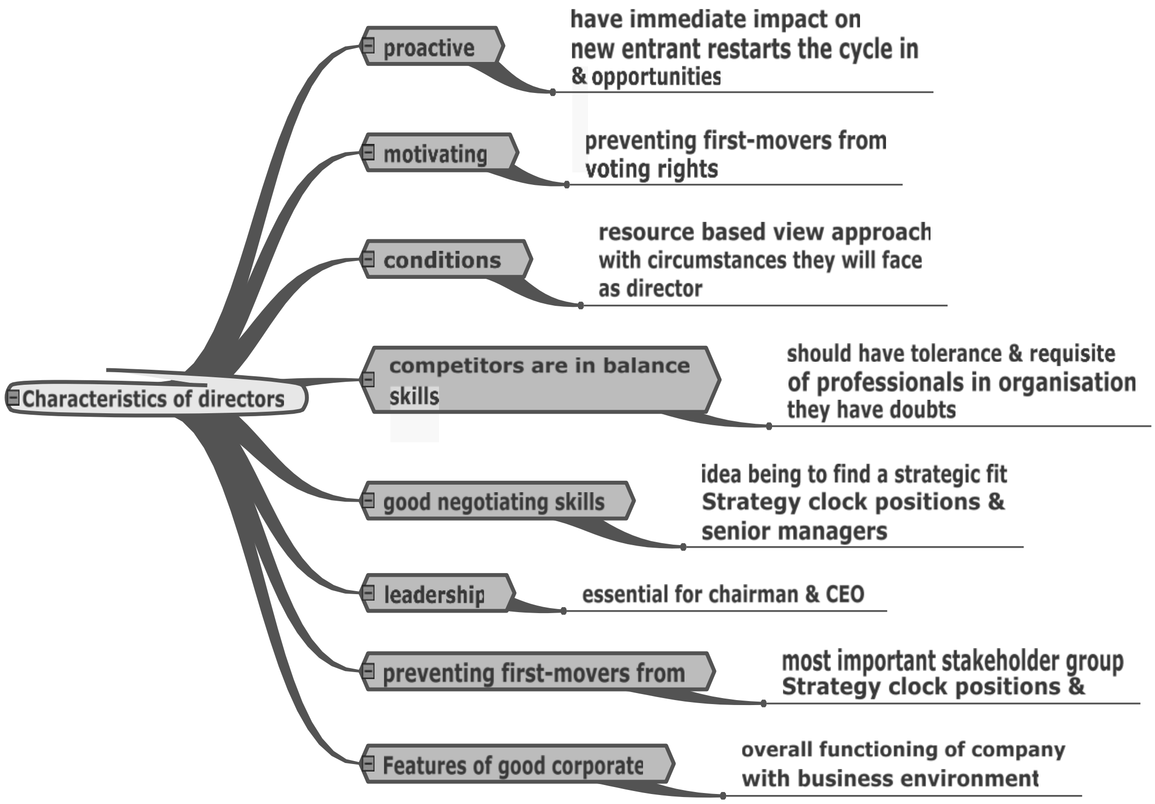
5. **Good negotiating skills:** directors should be able to exercise their influence to negotiate deals for the benefit of company.

6. **Leadership:** these skills are essential for the chairman and the chief executive.

7. **General knowledge of business:** the executives and the NEDs should be well-versed with general knowledge relating to the business of the company. E.g. an NED should be well aware of the markets and the manner in which it operates like the plywood markets should be known to an NED of a wooden furniture company.

8. **Expertise in relevant areas:** directors should have expertise in the areas relevant to the operations of the company. E.g. the director of a company running a chain of hotels should have in-depth knowledge of the risks and opportunities involved in the hotel business.

SUMMARY



Case Study

The directors of Really Property Plc, a successful property investment company have focused their business entirely on the European property market. Recent press reports suggest that companies with global property interests have a higher return and ride out worldwide market fluctuations more easily. The article argues that this explains the underperformance of the Really Property Plc share price in its sector.

The board of Really Property believes the European market offers low risk returns and intends to continue with this strategy. DJC Plc a major financial institution that holds 9% of the share capital of Really Property is pushing for change and has taken a page in a financial newspaper to argue its case.

Implications for the board

The executives may wish to pursue their chosen strategy but must consider the views of a significant shareholder, particularly since the press report may be evidence of more widely held views. If DJC can convince other shareholders it may be able to requisition an EGM to discuss the issue.

The NEDs may play a key role in considering the views of DJC and the chairman may wish to engage in dialogue.

The fact that DJC appears to have moved directly to the advertisement indicates a lack of dialogue. The issues could threaten the share price, particularly if DJC tries to sell rather than to engage in dialogue.

With a balanced board external views are more likely to be considered and questions asked. Ultimately the executives are answerable to shareholders in general meeting and can be removed if a majority votes in favour.

Test Yourself 4

Shikaya Plc, a listed company that manufactures components for the aerospace industry has a single board with six executive directors and three non-executive directors. The chairman and chief executive Simon Spice holds 25% of the shares and was the founder of the company. Three of the executive directors were recruited by Simon. Simon has a team of three key executives who work with him and dominates the management of the company.

Two of the non-executive directors receive limited information and are not actively involved in meetings. One of the non-executive directors is the former marketing director and holds 20% of the shares.

Required:

In context of the principles of the Combined Code (the UK Corporate Governance Code), what are the problems with the management of Shikaya Plc?

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4. Identify and based on a given scenario state the differences between the boards of directors of private companies and those of public sector companies or state owned enterprises.

[Learning Outcome d]

Case Study

Private sector board

Far and Wide Inc is a fast growing consumer goods industry with products ranging from home furnishings, home linen, furniture and upholstery to apparels and cosmetics. It is a dynamic company, adding products to its portfolio each year. The board of the company is a single board with the right mix of executives and non-executives working in harmony towards taking the company to greater heights.

The strategic leadership of the company under the CEO, Mark Weedy, is extremely efficient and has steered the company forward in just 5 years to be the market leader in consumer goods. He is of the opinion that a successful team is the one that performs well and has accordingly appointed extremely efficient managers at each level who are performance driven. The company has a policy to continuously identify key performance indicators against which the performance of the managers may be measured.

The board is quick enough to replace any manager whose performance has not met the set standards. The company hence has maintained an able team that has performance and profit maximisation at the core. Mark has commented in a recent AGM that “We are here to make profits for our owners and that should be the main aim of my entire team of directors as well as managers”.

Public sector board

People Public Plc has been operating in the public sector with a 75% state ownership and the rest of the ownership being divided between minority shareholders and banks for the past 7 years. The company has a board structure consisting of equal number of executives and non-executives working towards the achievement of the goals of the company. The company manufactures low cost water pumps for use by farmers in the state. They have a responsibility to supply these water pumps at subsidised rates to the entire state.

Their main aim is to constantly look for ways to maintain the low cost of the water pumps in order to maintain their promise of providing low cost irrigation solutions to the farmers in the area. This initiative was set up by the ruling political party when it came to power in order to boost the crop harvests. The board of the company is almost constantly under the pressure from the ruling party to manage with the available state finance.

The ministry play a very major role in defining policy and the board has to unconditionally accept their decisions since they are representatives of the state and hence the majority shareholders too. In the board meetings, there is minimum scope for any new innovative ideas that may increase the profits for the state or improve performance since the main aim of all meetings is to ensure budget targets and whether policies have been followed to the word. The board has a nomination committee in place that has developed an efficient succession plan. This has helped the company retain the senior board members for many years.

Continued on the next page

However.in one of the board meetings, the CEO Walter Toody, commented that ‘unless we innovate and give scope for fresh talent to enter the board, we may just stagnate here and ultimately be unable to keep the promises made to the public’.

Every public company is headed by a board which leads and controls the affairs of the business. The board of directors are appointed by the shareholders who are the owners of the company to oversee the affairs of the company. These boards look after the running of the affairs of the company as representatives of the shareholders and stakeholders.

Private companies appoint boards of directors to majorly oversee how the funds of the company are being put to the best use such that it will maximise returns. Boards of directors of public sector companies or state owned enterprises are entrusted with the responsibility to verify whether the management is acting in public interest and for public good. This is because public sector companies are entrusted with the job of using the funds for public interest. The boards of directors of these two types of companies hence behave and operate in a different manner.

Case Study

Continuing the above case of Far and Wide Inc and People Public Plc,

We may observe that the boards of these two companies operate in a very different manner. Although the private company board of Far and Wide Inc is dynamic and performance oriented with rapid expansions in diverse products, the board of People Public Plc operates with an approach to meet the budget targets, and is keener on retention of good and experienced directors on the board. Moreover, the public sector company board is also constantly dealing with a low budget and excessive influence and domination by the ministry and political party. Based on these two cases, we may identify some major differences in the working of private sector and public sector / state owned enterprises.

4.1 Differences between the boards of directors of private companies and public sector or state owned enterprises

The major differences in the working styles and accountability of the boards of directors of private companies and public sector / state owned enterprises arises due to their ownership structure, influence of stakeholders on the board functioning, governance expectations and their business aims. Although private companies are mainly interested in profit maximisation for their owners, state owned enterprises have to deal with the conflicting interests of politicians, bureaucrats and general public. Public sector companies / SOEs have a complex structure where they have to maintain public trust and work for the betterment of the public.

1. Strategy

The boards of private companies tend to act in the best interests of shareholders and investors in order to create wealth and returns for the owners. They formulate strategy in a way that encourages ‘out-of-the-box’ thinking and thoroughly concentrates on implementation. They display an extremely effective strategic leadership. Although boards of state-owned / public sector companies have the same aims, they are also custodians of public trust and property.

They are dominated by ministers and government in the formulation and implementation of strategy, and are answerable to the Parliament. Hence, they not only aim to create wealth, but also keep in mind the public good. However, they tend to be mere followers rather than leaders of strategy.

2. Performance management

The boards of private companies are extremely performance oriented and concentrate on generating performance of a high level at every stage of management and implementation. They follow an approach of identifying key performance indicators and constantly measuring organisational performance based on these parameters. Public sector companies concentrate more on meeting profit targets and keep performance measurement on a superficial level.

They have to concentrate more on meeting shareholder expectations and budget targets. They have an added responsibility to deal with political intervention which may hamper performance and hence these boards are less interested inventuring into new business areas or diversifying businesses, since risk has to be kept at a minimum level. This also leads to underperformance, since businesses stagnate for lack of innovation.

3. Succession and retention of board members

Private company boards, being extremely performance oriented and quick to replace underperformers, do not concentrate on retention of board members. This leads to new entrants in the board who are high on performance but low in team spirit since the team management is very low in private companies.

Public companies, on the contrary, invest more on human capital development since they concentrate more on succession plans, remuneration policies, long term success of the management team etc. This develops loyalty within the board. This, however, has its own set of negatives like less importance given to performance and more to people. However, this is a way of operation for public companies that are always scrutinised for their manner of operations and are expected to behave in a sophisticated manner. Moreover, succession plans are always in place in these companies. However, they fail to attract the best industry talents due to unattractive remuneration plans and ministry influence in the board nomination process.

4. Stakeholder / shareholder management

Private company boards deal with a simpler group of investors - a more closed group. Their main concern is of the shareholders who have invested in the company and are the real owners of the company. In this case, the dialogue is more direct, effective and straightforward. Public companies have to deal with a broader group of stakeholders. They deal with large shareholders, small shareholders, stakeholders such as media groups and labour unions, long term shareholders and short term debenture holders / debt funds etc.

Public boards are hence more trained and efficient to deal with diverse groups and manage their interests well. Public companies being custodians of public interest have a responsibility to deal with these stakeholder groups in utmost good faith and in a polished manner.

5. Risk management and governance practices

Corporate governance and risk management is a major area where private company boards may lack efficiency. In private companies, the board of directors is pre-occupied with the process of delivering results and earning profits for shareholders. Although they understand and manage risks, there is an inherent culture of undertaking risks in pursuit of profits.

Private boards also give less importance to compliances of governance requirements, which have led to the fall of many large companies in the recent past. Public boards are however extremely diligent with governance and risk management. The various committees on these boards, like remuneration, audit and nomination committees, make sure that the governance requirements mentioned in the various codes e.g. the combined code (UK) and the Sarbanes-Oxley Act(USA) are complied with.

Boards of public companies make sure that the governance standards of these companies are maintained well. However, this may lead to a more box ticking approach and may make the company lose out on opportunities of growth in following the code requirements.

4.2 Types of board structures and their advantages

There are two board structures that are followed by companies. The UK system predominantly follows the unitary board system. Two-tier board structures are mainly followed by German and some other European companies. Both systems have their own advantages and disadvantages. Tanzanian companies tend to have a unitary board structure for all companies whether private or public / state owned enterprises.

1. Unitary board structures

A unitary board structure consists of a single board on which both executive directors and non-executive directors are present. Whereas the executive directors use their intimate knowledge of the business to run the company's operations, the non-executive directors are people from outside the company's line of business who can view the company's activities from a broader perspective, under a chairman.

Shareholders are responsible for electing the members of the board and for ensuring, where appropriate, that the board is not dominated by any one individual. An effective board is one that operates under the efficient leadership of the chairman, whose roles include governance, leadership and control of the operations of the company. In a unitary board structure, where executive and non-executive directors sit together on one board, the executives propose and explain chosen strategies and the non-executives provide supportive challenge. In particular the non-executive directors will focus attention on business risk, risk management and controls. The non-executive directors are also a valuable source of advice in crafting strategy and responding to threats and opportunities.

Example

Penguin Plc manufactures and sells sailing boards. The company has a unitary board structure consisting of executive and non-executive directors. In one of the board meetings, the executive directors put forward their proposal to increase their production capacity from 1,000 boards to 2,000 boards per month. The non-executive directors can challenge this decision on the grounds of the risks involved.

The key questions they ask may include: how will the company arrange for the finance for the increased capacity? Will returns and cash flow be sufficient to support the finance? is there sufficient confidence in forecasts of market potential, sales and costs?

The combination of the executive and non-executive directors forces executives to think through their plans in terms of return, risk and feasibility and to consider broader issues of threats and opportunities.

A unitary board recognises that the board is a key organ through which the business of the company is operated. It provides a clear unity of purpose among the board and the shareholders. The decisions are taken in unison by the executive and non-executive directors, keeping in mind that these decisions must be aligned with the interests of the broader stakeholder groups.

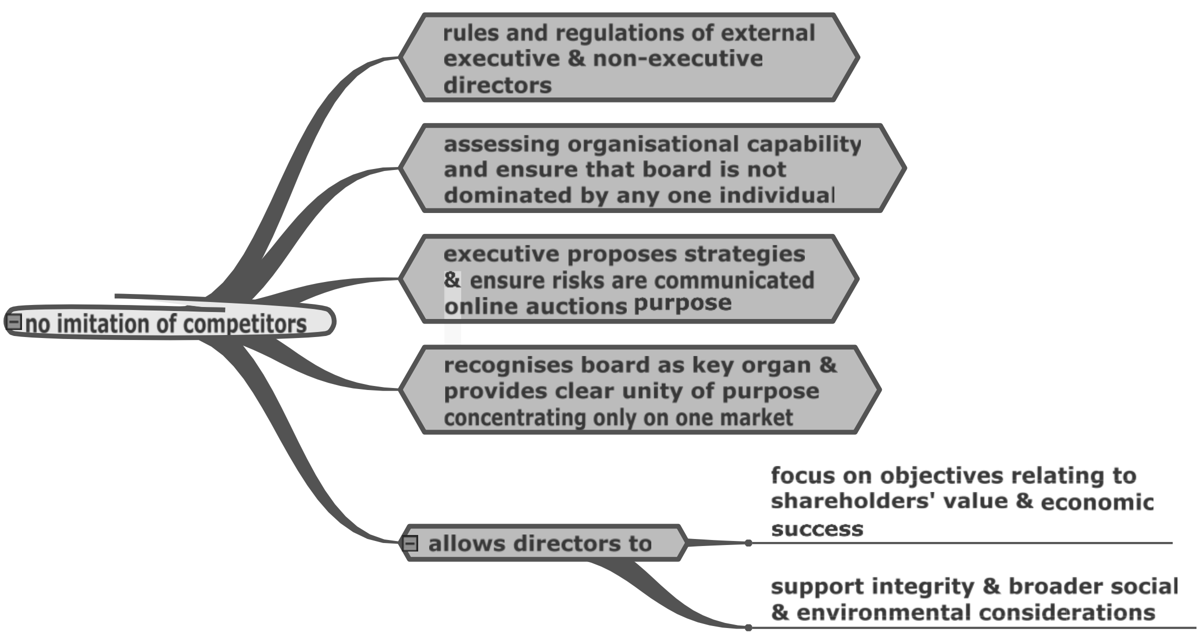
The unitary board allows directors to focus on objectives relating to shareholder value and economic success within a framework of checks and balances that assess business risks and support integrity and broader social and environmental considerations.

Example

A balanced board for a paper manufacturer may enable the company to balance stakeholder interests within an overall objective of delivering increase in shareholder value. Plantation policy and regeneration and recycling policies may balance the interests of sustainability of resources, attitudes in society and the delivery of return to shareholders so that the company keeps its purpose but acts responsibly in its own long term economic interests.

The non-executives may also encourage engagement with stakeholders and transparent reporting in both financial and social reports.

SUMMARY



2. Multi-tier board structures

A multi-tier board structure normally consist of two boards, one consisting of the executives and the other consisting of the representatives of the various stakeholders. This system recognises that the board is responsible towards not only shareholders but also the other stakeholders such as accounts payables, employees, suppliers, customers and the community at large.

Whereas the executive board is responsible for the day-to-day management of the company at the strategic, tactical and operational levels, the supervisory board provides strategic advice and challenges the actions of the executives thereby providing essential checks and balances on the full-time management including the executive directors. The executive directors are employees whereas the non-executive directors on the supervisory board are office holders.

However, two-tier structures are criticised on the grounds that they deviate the management focus from earning and maximising wealth of the shareholders. Executives and management are mainly responsible for economic and commercial performance. Supervisory boards ensure that corporate governance practices are followed by the executives. The executives should understand the importance of all stakeholders to the business apart from the body of shareholders.

The two tier board system often shifts the focus of a company from economic to economic and social purposes. Many argue that the supervisory board stifles progress and innovation and can hold back difficult decisions due to wider debate.

In reality executive or management boards control the company and run the company outside of meetings with the supervisory board being merely a check and balance on their behaviour.

SUMMARY

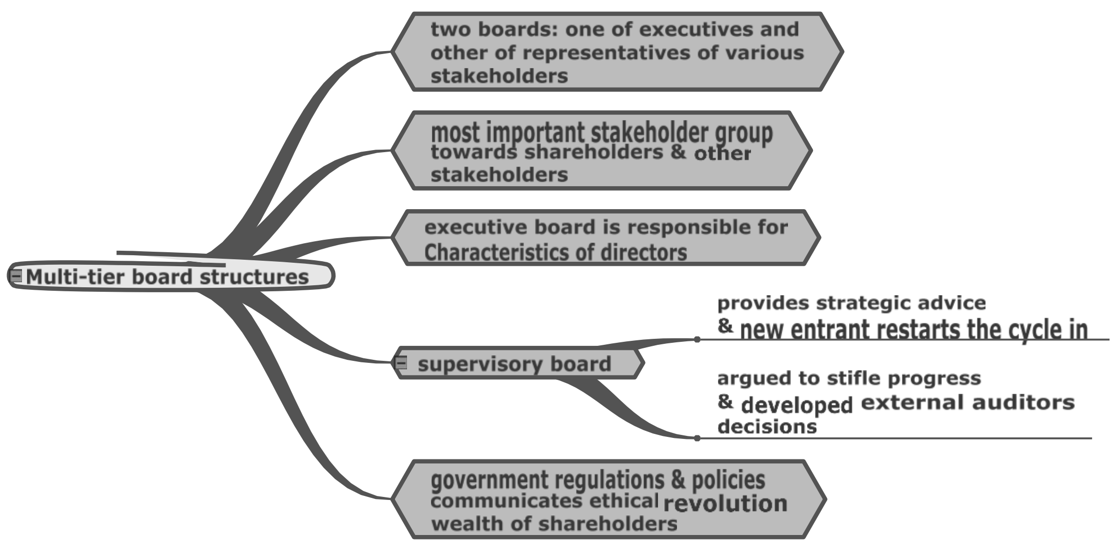
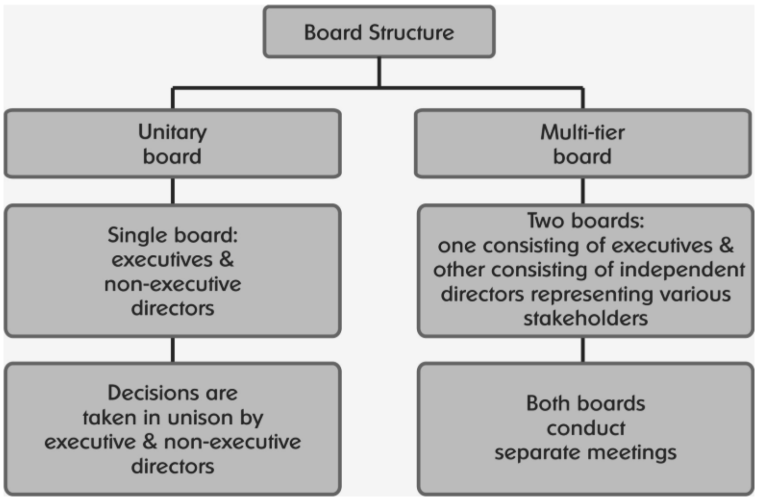


Diagram 5: Board structure



Case Study

The German two tier board model was created in the aftermath of the Second World War as part of a transition to open capitalism. Foreign ownership of German companies was restricted using cross ownership of shareholdings. The board hence consisted mainly of representatives of the investors who were also business partners. The independence of the non-executives was diluted here. The two tier boards were linked to this arrangement keeping outsiders away from boards but also provided for co-determination so that workers representatives who generally make up ten of the twenty supervisory board members have a say in the running of companies. Overall the effect of a supervisory board was to dilute investor control and influence and create stability for German companies. For many years this supported the enviable stability and long-run perspective of German companies that underpinned their economic success.

More recently critics argue that the two tier board is the last remnant of the post war protection and that this is no longer appropriate as globalization gains pace. German supervisory boards are partly appointed by shareholders but have half of their members coming from works councils. All members are non-executive directors. The members appointed by shareholders include ‘professional, non-executive directors’, who may have several such appointments, some investor representatives and political figures.

The pool of professional non-executives is a key feature of the German system. Many critics argue that German companies lack an international perspective because the board is almost entirely German and given the system always likely to be so. Recent events Siemens and VW have also shown that powerful non-executives, using alliances with worker representatives can jointly oust executives because they control appointments to the management board, even where this is against the wishes of investors. Many non-executive directors in Germany are not truly independent because of their multiple directorships and cross-relationships.

Some critics are openly critical of the ‘unholy alliances’ between worker representatives and chairmen and the dilution of investor interests that holds companies back. German investors lack involvement so that supervisory board decisions are more likely to be 20-0 victories rather than 11-9 debates. Many would like to see investors challenging management more directly.

Some German companies have taken advantage of new laws that shrink the supervisory board to twelve members and allow foreign worker representatives. Allianz, Porsche and BASF have done this and found the board discussions more efficient and more appropriate for a Global business. Despite problems few are in favor of dismantling the two tier model that has important checks and balances and that has delivered long-term stability, however changes are likely to gain the benefits of the Anglo-Saxon unitary board.

Test Yourself 5

Braveheart AG is engaged in the business of manufacturing soft toys and toy cars. It has its head office in Frankfurt and operates in five countries. It has a multi-tier board structure. This consists of a managing board of executive directors and a supervisory board of representatives of stakeholder groups which include German employee representatives but do not include professional non-executive directors. The managing board is highly paid due to substantial sales and profit bonuses. The supervisory board receive fees for attendance at meetings; some of them are above the age of 67. They are mere spectators and never challenge management decisions.

This multi-tier board structure has not worked well for the company in recent years. At one stage, investors suffered a shock when it was revealed that the company had been involved in corruption when the finance director and operations director were forced to resign. The executives had concealed information regarding the company’s losses in the soft toy sector from the supervisory board. As the company has a multi-tier board structure there are separate meetings of both boards. The executive board took advantage of this situation to cleverly conceal the information from the supervisory board. The supervisory board only came to know of the corruption through market sources. The directors would have received substantial bonuses in the event that profits were earned.

Some investors in the company are of the opinion that the directors of the company are not acting in the interests of the shareholders, and have questioned how bonuses are given. There are also concerns over financial reporting in the light of the corruption scandal. As the discussion above implies, the multi-tier board structure has failed to perform in this company.

Required:

State in your opinion the reasons why this may have happened.

5. Assess the effect of politics and corruption in various forms on the governance of companies both in the private sector and the public sector.

[Learning Outcome e]

Case Study

Maxwell went into business almost as soon as the war ended, building up a series of successful publishing companies that provided the strong cash flow he needed. Maxwell was acquisitive and grew his operations quickly - eventually floating Pergamon Press Ltd on the London Stock Exchange in 1964.

His empire was always mysterious with a split between a web of private companies and a listed group with trusts in Liechtenstein that gave Maxwell ultimate control.

Maxwell's companies had several cross shareholdings and undertook significant related party transactions. Maxwell was a master of fictitious invoicing and moved assets around the group using revaluations and subjective valuations of intangibles all done to create false profits and to window dress ailing balance sheets. The Pergamon share price was boosted through private company share purchases. All of this was unknown at the time.

Maxwell was a witty, intelligent, larger than life character with a burning ambition to become a media tycoon. In 1964 he became an MP, remaining in his seat until 1970. In 1968 he failed in a bid to buy the News of the World newspaper, a listed company.

The Maxwell style of management was autocratic; he ran his companies without question and surrounded himself with well paid 'yes men'. Maxwell operated on a 'need to know' basis that meant that no one who worked within the business apart from himself could ever see the complete picture. Most of the best managers left since they were mere puppets carrying out his instructions to the letter.

In 1969, an American company, Leasco, launched a takeover bid for Pergamon but soon found when they began due diligence processes that the reported results and position had been manipulated, and complained directly to the Department of Trade and Industry. The DTI immediately investigated, the Pergamon shares were suspended and a series of damming reports emerged criticising Maxwell's business methods, accounting treatments and corporate governance.

The DTI reports concluded with the famous phrases 'the concept of a board being responsible for policy was 'alien'' and that Maxwell was 'not a person who could be relied on to exercise proper stewardship of a publicly quoted company'.

Despite the criticism, collapse of Pergamon and massive legal claims, Maxwell spent the next few years rebuilding his empire; incredibly nobody seemed willing or able to stop him. The legal cases were withdrawn, he was not charged with any offences and the DTI did not disqualify him as a director.

Maxwell saw all of this as proof of his innocence and he was left free to run a public company again.

By now his Pergamon companies were back in action as before, with a cash cow in the form of his 'Jewel in the Crown' magazines and publishing companies.

In 1977, Maxwell approached the London Stock Exchange (LSE) to see what their attitude would be if he acquired a listed company. The LSE suggested that an independent chairman would be required but could not place a bar on his appointment as a director. In due course Maxwell became chairman of the British Printing Company (BPC) after purchasing a significant stake in the nearly failed company. Incredibly, despite reservations around the city and the refusal of some bankers and brokers to act, Maxwell acquired control after a circular to shareholders and gave them two options, Maxwell or a receiver! Regulators were aware that he had never been prosecuted and that there were question marks over the DTI's investigation and had a desire to 'rehabilitate' the offender! The only concession for Maxwell was that he had to be chief executive but not chairman.

Within a few years Maxwell had turned the still listed BPC around and renamed it Maxwell Communications Plc (MCC). Maxwell now had the support of Z Bank Plc and was truly rehabilitated! History then repeated itself as the ambitious tycoon built a complex web of companies, part private, part listed and controlled from a trust in Liechtenstein. MCC, the listed company, had a minority of shares in public hands but was essentially controlled by Maxwell.

Continued on the next page

Maxwell now wished to create a global media empire with MCC at the centre and through loans, share issues and some strong cash flow Maxwell went back on the acquisition trail, including the purchase of the massively overpriced Macmillan Publishing company in the USA and many other similar companies.

Maxwell was a clever man but a risk taker. His empire was growing but not as fast as the debts that were accumulating to fund the acquisitions - a burden that was to eventually bring the whole edifice crashing down.

As before, Maxwell knew how to hide the problems with creative accounting, related party transactions and a complex web of companies.

In 1984 Maxwell even managed to acquire the Mirror Group of newspapers from Reed International using his private companies, but again at an inflated price. Ambition and sentiment came before business sense and in an environment with no checks and balances Maxwell was not challenged. By now there were massive debts to fund and a lack of cash flow to do it.

In 1991 Maxwell floated the Mirror Group but misled investors since the cash was not required for expansion but to fund the debts that now totalled £2 billion.

Surrounded by 'yes men', courted by greedy advisors, bankers and brokers and unchallenged by his auditors Maxwell increasingly had to resort to fraud to keep the empire going. In particular, the domineering bully took control of all treasury matters in MCC, Mirror Group and Pergamon including their pension funds so that he could access the cash and shares needed to fund the ever rising tide of debt and through secret purchases of shares to keep the MCC share price up. Maxwell was by now borrowing from the pension funds and with minimal accounting disclosure, window dressing and generation of false profits, was disguising the true state of the empire.

In November 1991 Maxwell went missing from his private super yacht and was found floating in the sea off the Canary Isles. Stories abounded, was he murdered, did he fall, did he jump?

Initially leaders in politics and business paid their tributes and his sons who were directors stood firmly together telling the markets that they would carry on.

However within days the whole empire crashed, the shares were suspended and as the DTI investigated and liquidators sold of assets, the extent of debts became clear. A shortfall of £400 million and losses for aggrieved employees, pensioners, suppliers and investors made headline news day after day.

Real blame rested with Maxwell himself, his sons as directors, and with the institutions, including the auditors, who gave him their support. The government paid £100 million to support the 30,000 pensioners and out of court settlements, with apologies, with the auditors and advisors brought in a further £276 million.

Corporate governance had failed to keep Maxwell in check and many of the recommendations in the Cadbury Committee report and subsequent codes come directly as a result of Robert Maxwell or 'Captain Bob' as he was known. Maxwell was sharp, he did create success, but ultimately he took excessive risks and sadly, was dishonest. Maxwell abused his position and cared little for his principals or stakeholders, the significant minority of shareholders in MCC and Mirror Group and also his employees. Captain Bob is still with us, as we are still learning the lessons.

5.1 Meaning of corruption

Corruption means misuse of power by various individuals like:

- public servants; when they accept bribes
- officials from companies; when they pay bribes to government officials for securing orders or for not penalising them for not following the civic rules, etc.

5.2 Politics and Corruption of various forms in public and private sector

Bribery is a problem in the private as well as the public sector. Bureaucracy is a feature of public sector companies and bureaucrats often tend to have a lot of power concentrated in their hands. Hence one may observe that bribery exists in the public sector. This is because bureaucratic style of management always gives rise to corrupt business practices and a scope for bribery. Public sector employees operate with an aim to make public life better by providing them with facitlities like public transport, recreation, security through services of police department and military, primary education and subsidised healthcare systems etc.

In doing this they use the public fund, which is the tax-payers money collected by the government. They have huge powers vested in them and hence there is a lot of scope to misuse these powers for own good rather than public good.

Private sector is also involved in corruption when it has to deal with the public sector or government since it does pay bribes in order to get work done. Even within themselves, private companies indulge in corrupt practices in pursuit of profit making. The motive behind such practices is always monetary or other personal gain. Recent surveys and opening up of various scams and scandals over the world has revealed that private sector is no longer a victim of corruption in the public sector but is instrumental in spreading and increasing corrupt practices in partnership with public servants / officials. Although corruption and politics seen to be akin to the public sector, private sector officials have many times commented that they have lost lucrative and huge business opportunities due to their competitors paying huge amounts of bribes to secure government contracts, licences and permissions.

1. Various forms of corruption can be broadly classified as follows

(a) Bribery - Bribery is said to have taken place when a financial or another advantage:

is provided / offered to another person to perform a function / activity inappropriately
is provided (directly / through a third person) to a public official to obtain a business advantage
is received by a person to perform a function / activity inappropriately. For example, a public servant may be paid some money (by a construction company) in order to be awarded the contract to build a bridge.

(b) Embezzlement – illegal appropriation of money provided for the purpose of office, for personal purposes. E.g. if a marketing manager of a company uses the marketing funds for buying gifts for his relatives, this will be embezzlement of company funds.

(c) Procurement – a procedure that involves a systematic process of corrupt practices at each step of acquiring goods or services by an individual or company. E.g. an organisation buying raw materials at inflated prices from the markets in order to misuse budgeted raw material procurement funds to fill pockets of intermediaries and company officials.

(d) Nepotism – misuse of public office power to offer a job or contract to a person from family or friend circle or to close acquaintance even when they are not qualified enough for the job. E.g. – a road contract being given to a relative of the road contracts office manager even when the relative does not fulfil the experience criterion required for the job.

(e) Patronage – political influence and connections being used to elect or employ a person to the public office in order to gain politically from the selection. E.g. persons from backward classes of the society being elected to public office and being given responsible posts in order to maintain good relations with the backward classes section and ensure vote banks.

(f) Conflict of interest – any situation that requires an individual to choose between his duties, demands of his profession and personal gain. E.g. – an accountant faced with a dilemma to choose between disclosures of corrupt accounting practices to the auditors and his duty towards the directors of the company not to disclose any matter that may affect the reputation of the company.

Although all the above types of corruption are rampant in the public and private sectors, bribery is a form of practice that causes more harm than others since it is more rampant practice as compared to others.

5.3 Adverse effect of bribery and corruption on financial information

Corruption and bribery are illegal. So, when entities pay / receive bribes or undertake any corrupt practices, such transactions cannot be reported honestly. However, as the inflow / outflow of cash affects the company, the entity generally uses creative accounting (like payment of bribe is recorded as an expense and the receipt of bribe may not be recorded in the books of accounts) to record such transactions. This in turn affects the accuracy of the financial information provided to the users of financial statements.

5.4 Bribery and corruption in the context of corporate governance

1. Openness, transparency and honesty

Corporate governance is about putting checks and balances in place to control the risk takers and prevent the dishonest from having their way - all in the interests of those who are stakeholders.

If companies and their directors are to be trusted, then they need to provide reliable information about their plans, performance, activities and processes so that shareholders can decide whether to appoint or remove directors, whether to buy, hold or sell shares and whether to get involved in company management. Other stakeholders also need information to help them decide whether to do business with the company, to judge their position as employees or decide whether to lobby against the company to change its strategy.

Therefore, corporate governance must ensure that transparency and honesty is maintained by those charged with governance when carrying out all transactions. This will help to increase the trust and confidence of stakeholders in the way the company is run. For this, it is important that stakeholders are kept informed on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company. The information must be timely and accurate. Transparency can be achieved by way of disclosures to stakeholders.

Furthermore, directors need to be honest in all dealings with stakeholders like customers, suppliers, investors, employees, shareholders and others. Honesty enhances the confidence of the stakeholders in the directors in respect of the fact that their interests are protected. High profile accounting fraud like Enron and World com have proved the necessity of honesty and transparency in good corporate governance practices.

As discussed above, bribery and corruption affects the quality of the financial statements. Existence of such practices in a company also indicates that there is no honesty in dealings with shareholders and the concerned entity is not adhering to the corporate governance principles of transparency and honesty.

Case Study

Continuing the Maxwell case,

Maxwell extensively resorted to unfair practices by creating a web of companies and related party transactions. These were mainly done in order to window-dress ailing balance sheets and report false profits. All this was never reported to shareholders in order to maintain their trust. However, the principles of openness, transparency and honesty have been completely done away with in this case. All these practices adversely affect the trust of shareholders and stakeholders.

Maxwell used all the wrong practices to depict a good picture of his company, which was actually not in a good state of affairs.

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2. Reputation risk

An entity's reputation is also sustained through acting reliably, credibly, trustworthily and responsibly in the market. The reputation of an entity directly influences its stock prices in the financial market. Reputation is built by practising good ethical standards with all stakeholders like employees, customers, suppliers, regulators, etc. A company's reputation is damaged when it fails to meet the expectations of its stakeholders.

Corruption and bribery are unethical practices which affect the reputation of the company. Reversal of poor reputation is more difficult than earning good reputation.

Case Study

Continuing the Maxwell case,

The reputation of the company was always put at risk by Maxwell since he resorted to unfair means of profit earning. These practices brought it under the scanner of the DTI and legal cases against him and the company. Maxwell was a risk taker and in a bid to become a media tycoon, he resorted to dishonest practices that led to the fall of his empire that was built over a period of time. Reputation of a company plays a very important role in maintaining shareholder confidence and Maxwell lost this confidence forcing the company to go into liquidation because of the burden of debts.

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3. Fiduciary duty

Directors are the fiduciaries of the shareholders' trust. They hold a position of trust and hence a fiduciary duty is imposed upon them. A fiduciary duty is the duty to act in good faith of the persons for whom the directors work. **They have a duty to disclose all the information held by them, account for any profits received as a result of the relationship** (of being agents of the shareholders) and to avoid any conflicts of interest with the shareholders. However, by indulging in bribery and corruption, the trust of the shareholders in the directors is adversely affected.

From the above it is clear that unethical practices like bribery and corruption adversely affect the trust and confidence of the shareholders in the directors.

According to OECD, 'increasing intolerance of the adverse effects of bribery and corruption has led to stakeholders mounting an international fight against corruption'.

Indulging in bribery and corrupt practices is not just illegal but also unethical. For example, in the UK, legislation on bribery and corruption is contained in Part 12 of the Anti-terrorism, Crime and Security (ATCS) Act 2001. This legislation discourages acts of bribery by UK companies and its nationals**. In this way, the UK government encourages good corporate governance practices like honesty and openness.**

Corporate governance, which underpins transparency and honesty, includes setting up of controls which mitigate the risk of the entity undertaking bribery and corrupt practices.

Case Study

Continuing the Maxwell case,

We can see that the required checks and balances were not in place and hence Maxwell could get away with the creative accounting that he practised rampantly to window-dress ailing balance sheets. He also resorted to corrupt practices but was never caught and accused since he never gave away any information to any person but himself.

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4. Best practice measures for reducing and combating bribery and corruption

(a) Following are certain bribery avoidance procedures which can be established:

(i) Efforts to combat corruption should start from the government. For this, the government could penalise organisations (by charging them of criminal liability) as well as individuals involved in bribery and corruption.

(ii) Entities can establish a corporate code of ethics, which would include measures to combat corruption. For example, the code should prohibit employees from accepting hospitality and gifts, prohibition of donations to political parties, etc.

(iii) Entities can imbibe values, ethics and culture within the entity as ethically sound decisions form the basis of good corporate governance practices. For this, it is important that the top management is totally committed to following the code of ethics and not indulging in bribery and corruption.

(iv) Entities can include training programmes for staff where the ills of bribery and corruption and the penalties imposed on employees indulging in such practices are clarified.

(v) Periodic anti-bribery audits can be conducted by the internal auditors.

(b) Bribery Act 2010, UK also provides guidance on the procedures which could be undertaken by entities in order to mitigate the risk of the entity undertaking bribery and corrupt practices:

(i) Risk assessment and procedures proportionate to risks

Different entities conduct different businesses. Therefore all entities are not exposed to the same amount of risk. Hence as a first step, it is important that entities evaluate the nature and the extent of the entity's exposure to the risk of bribery. Based on the evaluation of risk, **there must be a direct proportion between the level of risk of bribery (and the complexity of the activities of an entity) and the bribery avoidance procedures which need to be in place.** The risk avoidance procedures are generally in the form of internal controls which are instituted in order to avoid the possibility of bribes.

Example

An entity which undertakes construction of infrastructure facilities for government may be exposed to risk of bribery. The company officials can be tempted to indulge in bribery to achieve the entity's objectives. Such companies need to have controls to avoid the possibility of bribery. On the other hand, a small company which deals with private customers may not face the risk of bribery and therefore they may not require controls to avoid the possibility of the employees indulging in such acts.

Bribery mitigating procedures undertaken by an entity should depend on the size of the entity.

Example

A large entity can include bribery mitigating procedures like punishment and suspension of employees involved in bribery and corruption. However, in small entities where the directors are the shareholders, such procedures may not be effective in mitigating risk.

All entities need to be cost effective i.e. all controls which need to be set within the entity should be based on cost benefit considerations. In order to be cost effective, all controls undertaken should be after assessing the above factors carefully.

(ii) Top-level commitment

Risk avoidance procedures which are set by the entity need the support of key management personnel. This will require a clear corporate code of ethics mentioning the need to avoid practices of bribery and corruption. The consequences of employees indulging in such unethical practices should also be specified therein. Furthermore, management must undertake strict action against employees who do not adhere to the code of ethics. In this way, top level management's steadfast belief in avoiding bribery can be embedded in the culture of the entity. The attitude of the top management will affect the company's integrity, ethics and other factors leading to a positive control environment.

(iii) Due diligence

In order to reduce the possibility of bribery, entities can use external consultants to undertake due diligence activities on the operational staff (of the entity) who carry out various activities on behalf of an entity. The due diligence reports will enable the board to pay more attention to their weaknesses and risk areas and improve the reliability of their controls, accounting systems and information.

(iv) Communication

Entities need to build the right environment and embed bribery prevention policies and control into the culture and processes of their businesses. The controls could be in the form of establishing suitable punishment for staff indulging in unethical practices such as bribery and corruption. This involves training the staff on the entity's policies and procedures as well as communicating the policies to all within the entity.

(v) Monitoring and review

The business environment is constantly affected by changes in the internal and external factors. Dynamic risk factors, by nature, change over time. Therefore, whenever there is a change in the risk (of bribery) to which the entity is exposed, the specific risk management strategies adopted by the entity would have to be continually reviewed by the management in order to achieve its business objectives. Hence it is desirable that entities review whether there is a change in the degree of risk exposure on a continuous basis.

Proper monitoring and review of the bribery avoidance procedures will ensure that the entities set controls where necessary, and this again should be cost effective.

(c) **Barriers to implementing such measures**

(i) Non-implementation of the control procedures laid down: for example, not punishing staff indulging in corrupt practices.

(ii) Management overriding control: for example, management paying bribes although the code of ethics clearly specifies that such practices should not be indulged in.

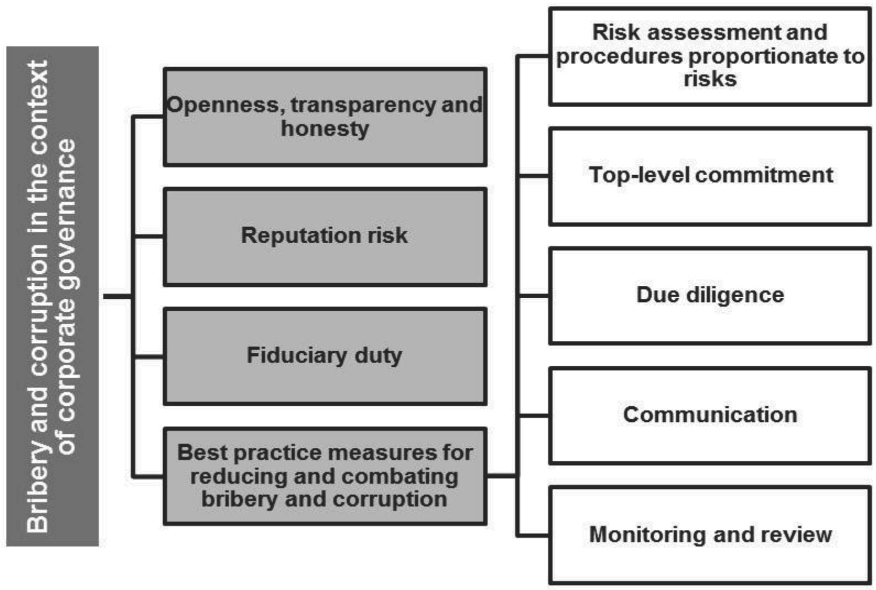
(iii) Code of ethics not including anti-bribery controls: for example, companies preventing employees from accepting bribes but not preventing employees from paying bribes.

(iv) No formal guidance by companies on reporting suspected cases of corruption

(v) Inappropriate risk assessment relating to the entity's exposure to bribery and corruption and the complexity of the operations of the entity: risk assessment is subjective, and risk avoiding measures are proportional to the level of risk of bribery (and the complexity of the activities of an entity). Therefore, an inappropriate assessment of the variables would act as a barrier to implementing anti-corruption measures.

(vi) Inaccurate due diligence assessment: due diligence of individuals require an assessment of factors like integrity, honesty, etc. which are subjective. If external agencies undertaking such activities have a personal relationship with staff (which may not be known to the entity), the reports may be inappropriate. Furthermore, d**ue diligence reports are no guarantee of the integrity of individuals**; payment of bribes is situational and therefore depends on not just the individual's integrity but also on the personal needs of the individuals.

Diagram 6: Bribery and corruption in the context of corporate governance



Test Yourself 6

TriplaPharma manufactures and markets various drugs. The company is in the process of drafting its code of ethics.

Required:

Provide guidance for drafting the code on the following areas:

(i) Giving / accepting gifts
(ii) Reporting violations

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6. Identify and based on a given scenario assess the issues of accountability of management to a board, private and institutional shareholders.
Assess the issues of accountability of boards of directors to minority and large shareholders.

[Learning Outcomes f and g]

Case Study

Arctic Plc, a UK listed company, has 12 institutional investors and a wide range of shareholders. It has recently invested in a business expansion plan to diversify the company portfolio. The CEO, Mira, has carefully prepared a feasibility report and obtained the chairman's nod for the expansion proposal. Mira is fairly new, and is interested in expanding the business in diverse areas in order to make it more sustainable. She has also carefully planned the financial resources required and identified banks that will finance the venture.

One of the institutional investors has, however, openly criticised the working style of the board and the CEO along with the chairman saying that they are inexperienced and have compromised upon the long term reputation of the company by diversifying the business in areas that are not very viable. Mira has asked all the 12 institutional investors to attend a meeting with the board members to give clarifications.

The company has had a reputation of meeting shareholder expectations over the years, and particularly, the institutional shareholders have been very active in maintaining a dialogue with the company.

6.1 Accountability of the CEO towards shareholders as a person responsible for the management team as well as the board

Board of directors (BOD) of a company are elected representatives of the shareholders / owners of the company. They, in turn, appoint the management team of the company that actually runs the company. The BOD headed by the CEO oversees the management of the company. A team of managers is appointed by the board for this purpose. Management is accountable to the BOD for all the decisions that it takes and implements in the course of managing the affairs of the company.

The CEO is the head of a board and is responsible and answerable to the shareholders on the functioning of the management. The CEO is **mainly responsible for the performance of the strategy** as decided by the board and is **accountable to the board** with a responsibility to report to the chairman.

1. The responsibilities of the CEO include:

(a) Taking full responsibility of accountability towards the board for company operations and performance. E.g. the CEO is responsible and accountable to the board for the implementation of the day-to-day working and ensuring that the operations result in the achievement of the desired goals set by the board.

(b) Developing and implementing the policy decisions and executing strategy. E.g. if the strategy of the company is to capture 25% of the market share by the end of the year, it is the responsibility of the CEO to gather resources and employ them towards the achievement of this goal.

(c) Implementing proper risk management, financial, operational, planning and internal control systems. E.g. the CEO should ensure that the work is properly segregated amongst the employees such that authority is not concentrated in the hands of one person, there are proper software packages in place taking care of the entire accounting of the company; proper work procedures are in place etc.

(d) Planning and managing the financial and physical resources. E.g. the CEO should ensure that the company is always in continuous supply of the manpower, machinery, utilities and working capital it requires for smooth routine operations.

(e) Closely monitoring financial operations and monitoring the results in accordance with budgets. E.g. the CEO should keep a check on the amount of expenses and ensure that the managers plan their work within the given budget constraints.

(f) Building and maintaining a strong management team and acting as a link between the board and the employees. E.g. the CEO should effectively communicate the problems of the employees to the management and the board so that they are not given unrealistic targets to meet; he should also effectively communicate the board's point of view to the employees so that they work in harmony with the board to meet the goals of the company.

(g) Acting as a representative of the company towards major suppliers, customers, professional bodies etc. E.g. the CEO is responsible for negotiating deals with suppliers as well as customers by striking the most profitable deal for the company.

(h) Assisting in the selection of the board members.

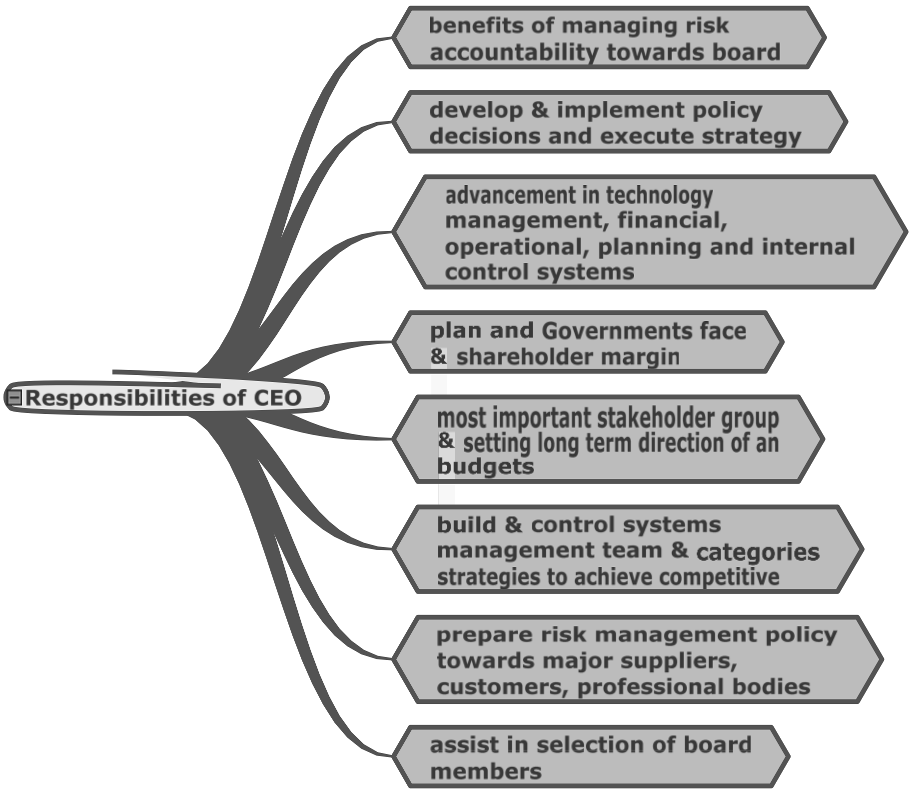
Case Study

Continuing the example of Arctic Plc,

The newly appointed CEO, Mira, had exercised due care while taking the diversification decision. It is the duty of the CEO to manage the resources of the company in a responsible way.

Mira has exercised this care. She has also initiated a dialogue with the institutional shareholders by convening a meeting with them to discuss and clarify the feasibility of the business diversification plan. She had also planned for the finance requirements by talking to banks.

SUMMARY



Test Yourself 7

The executive management of Trinity plc are considering a proposal from their CEO and his CFO to sell their printing business and to use the funds and cash raised from a rights issue to acquire an on-line news provider. They argue that this fits with their newspaper and publishing businesses and that it gives them a start in new technologies where they have fallen behind. The printing business is profitable and can be sold at a premium. The on-line news provider has approached them directly with an offer to acquire the whole share capital.

Operations director Mike Jones is against the idea since they are selling a key part of their own supply chain and putting themselves at risk by losing control of all printing activities. He also believes that the acquisition target is too small and under threat from bigger players and that it lacks any real competitive advantage.

The CEO tells Mike that they must move quickly and must ask the board for approval and that they expect him to support them in a vote. The CEO says 'you are in a minority amongst the executives and must give way, the NEDs will then support us and we can make the move. We need to move into high technology in order to grow in the long term, opportunities like this are rare.'

Required:

Consider the role that the chairman and NEDs should play in the decision-making process and how this would affect the CEO.

6.2 Accountability of management and CEO towards shareholders including private, institutional, minority and large shareholders – Agency theory

Separation of ownership and control is the main reason for the emergence of corporate governance issues as well increased need for monitoring the work of management through the board of directors. A public company's shares are always divided between private, institutional, minority and large shareholders. Management many times undertakes the stakeholder mapping exercise in order to gauge the importance of a particular group of stakeholders. However the management and board are accountable equally towards every shareholder be it private, minority or big institutional shareholders. Institutional and large shareholders i.e. shareholders holding major shares e.g. more than 10% shares of the company have a responsibility and right to influence strategy. In a way they have a duty to represent minority shareholders and protect the rights of the shareholders and their money.

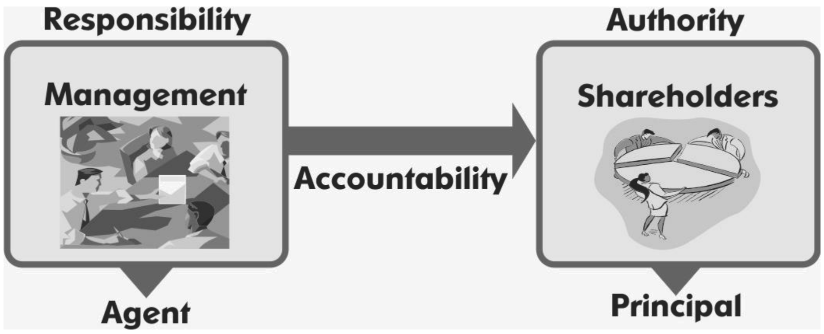
The work of Berle and Means highlighted the concept of separation of ownership and control. The emergence of joint stock companies increasingly led to this separation where shareholders were the principals and the directors, agents. Agency theory is an extension of the concept put forward by Berle and Means of the division of authority and responsibility and of agent's accountability towards his principal. In the context of corporate governance, the theory deals with the relationship between management and shareholders and with other stakeholders and the continuous efforts they take and disputes they face in the process of aligning their interests.

Agency theory suggests that the interest of the business should come before self-interest. This may imply maximisation of profit, growth and shareholder return. Some writers such as Herbert Simon have argued that directors are more likely to act as 'satisficers' than maximisers since corporations as organisations don't act to achieve the best possible results but merely to achieve satisfactory results across several objectives.

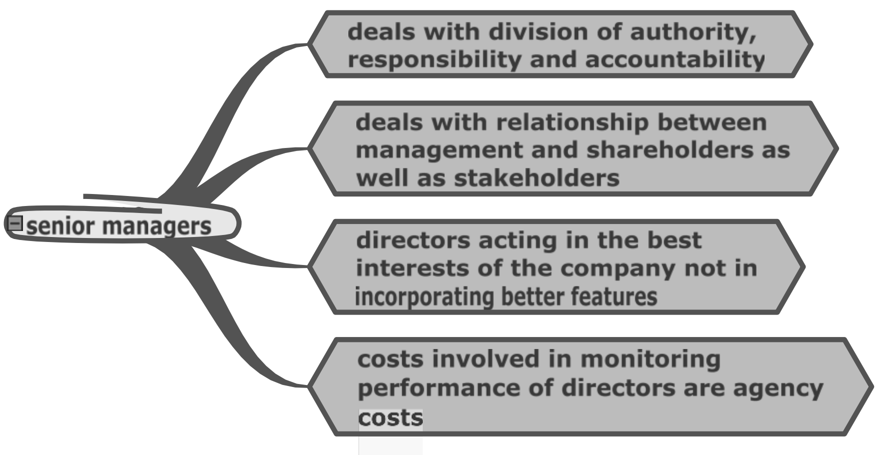
Simple agency theory aims to explore the corporate governance issues involved in the shareholder and director relationship as principal and agent. Whereas shareholders represent the owners of the business, the executive directors / directors look after the running of the business for them. The board of directors is responsible to the shareholders as a body. Shareholders as a body equates to the company as a whole.

It can be argued that directors should manage the business in such a way that ensures that the business will remain in business and make long-term profits. If shareholders require accountability then they will require a process for monitoring the performance of directors. The cost of monitoring is known as an "agency cost".

Diagram 7: Agency theory



SUMMARY



The problem of the agency relationship emanates from the fact that the principals (shareholders) cannot manage the business for themselves and hence have to rely completely on the agents (directors / directors) for this job. This means that the political powers are transferred to the directors who may abuse them. The directors are always protected against the rigours of the capital market and the ups and downs of share prices.

This is because, even when they fail to perform, they are never challenged by the shareholders (who are unaware of the business tactics and lack knowledge of how to make the business successful). Change in management is a drastic step that shareholders will always avoid and takeovers are equally rare, although not impossible in today's dynamic markets. Hence directors are not concerned about losing their jobs.

Shareholders, being the owners, have a right to remove the directors from office. However, there are several issues involved in this and generally they tend to avoid such harsh decisions. This is because it is very difficult to find a replacement and, moreover, the existing directors have experience of the job and are therefore more competent to handle the work than anyone else. Therefore the shareholders, in many cases, vote for takeovers or mergers. This helps to avoid the risk of employing new directors and relying on them to handle the affairs of the business.

There can be a breach of trust by the directors, an intentional act of misconduct for own benefit, negligence or incompetence. This is because the directors are always in possession of more information than the shareholders because they are actually managing the affairs of business. This is called information asymmetry between principals and agents.

Example

Pamela, the chief executive at Beach Resorts, a hotel company with a chain of beach resorts across the USA, in consultation with the board, has decided to open small chain of restaurants across the south-east Asian countries.

Pamela decides to open the first restaurant in Malaysia in the coming week which is the annual shopping festival week of Malaysia, despite the fact that the food and health ministry has still not given the company a license to operate. However, the company cannot postpone the opening of the outlet since they have already made the arrangements and they cannot afford to lose this festive season when people all over the world travel to Malaysia. This is a big risk since, if the authorities come to know of that the restaurant was opened without permission they can permanently cancel their license to operate in the country. This fact can seriously disrupt the market reputation of the company.

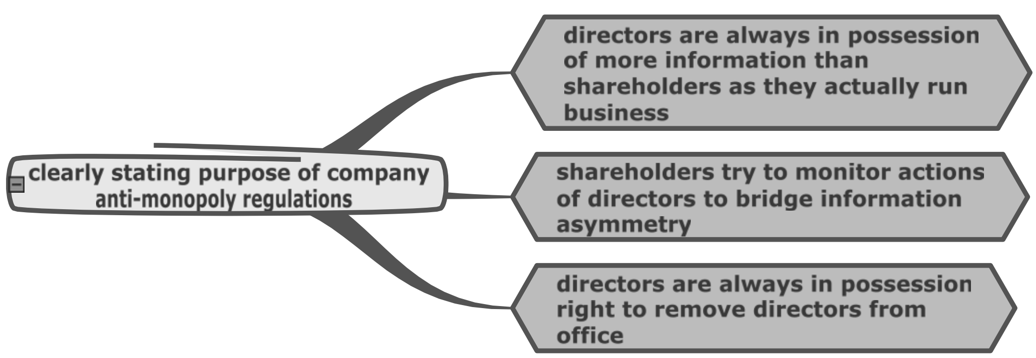
The directors have not made the shareholders aware of this risk and are going forward with the opening of the restaurant. The directors in this case are taking advantage of the information asymmetry between them and the shareholders. They are being short-sighted in grabbing the profits they may earn because of the opening of the restaurant in this festive season but are overlooking the fact that the company might be at risk of losing business in the long term.

To bridge this information asymmetry, shareholders try to monitor the actions of directors. A breach of trust may arise also due to the fact that directors tend to be short-sighted whereas shareholders always aim for the long-term survival of the company. Directors tend to think in terms of their salary package and hence perform only to the extent their perks are guaranteed. In doing so, they might overlook good investment opportunities due to the possible risks involved.

Shareholders, being owners, have limited powers and access to information in comparison to directors. Shareholders are either institutional shareholders holding a large chunk of shares or they are small individual shareholders who are widely dispersed. In the last few years, there has been increasing pressure on institutional shareholders to act more as owners and not just as holders of shares. This is because of increasing instances of corporate excesses and abuses such as directors receiving excessive salaries even when their performance has been poor and scandals that have resulted in pension funds being wiped out and the shareholders losing the money they had invested.

When shareholders act more as owners, the power of ownership will return to them and directors will act more cautiously while making business decisions.

SUMMARY



Case Study

Continuing the example of Arctic Plc,

There seems to be some information asymmetry between the institutional investors and the board of directors, i.e. agents, since they are not so happy with the expansion plans of the CEO. This gap can lead to a loss of trust between the principal i.e. the institutional investors and the agents i.e. the directors. The CEO has tried to bridge this gap by calling for a meeting with the institutional shareholders.

Test Yourself 8

Picket Fences Plc (PFP), a well-established construction company that is listed on the London Stock Exchange appointed a new executive chairman and chief executive last year. The two men have been undertaking a major restructuring exercise that has involved selling off non-core divisions and a series of cost cutting exercises.

Some shareholders are now voicing concerns that the two men are pursuing a short-term strategy that is more in their own interests than the long term interests of shareholders. The two men have contracts that include substantial performance related pay with bonuses based on annual earnings, changes in earnings and increases in the share price. The company has met these targets and the bonuses are due to be paid.

Required:

Explain using agency theory how the alignment issues relating to the interests of the two executives above.

6.3 Accountability towards institutional shareholders

1. Institutional investors (major shareholders)

An **institutional investor** invests on behalf of others to gain return and growth at an acceptable risk. Institutional investors may vote and may, if they have sufficient power, get involved in company policy through dialogue with the board.

Example

Right Banking is an institutional investor in Cleanco Ltd, having 10% of its shares. The CFO of Right Banking meets the CEO of Cleanco periodically. They discuss important matters such as strategy and how the organisation is meeting its objectives in these meetings. Prior to the AGM, the shareholders are sent out proxy forms so that the shareholders and institutional investors can vote either through post or through proxy.

The institutional investors may vote on issues such as the appointment of board members and Right Banking generally discusses all appointments with the chairman. The agenda to the AGM includes an opportunity for dialogue with the shareholders.

Institutional investors (major shareholders) normally manage the funds invested by individuals. Institutional investors include pension funds, insurance companies and investment trusts as well as other collective investment vehicles such as private capital funds).

Many institutional investors act as agents for others including other institutions.

As the table below illustrates, UK institutions control a major part of all corporate equity funding:

UK investors in shares	
Individuals	14%
Insurance companies	17%
Pension funds	16%
Unit trusts	2%
Investment trusts	4%
Other financial institutions	11%
Charities	1%
Banks	3%
Overseas	32%

Institutional investors in the UK are expected to play an important role in the corporate governance of companies. According to the UK Corporate Governance Code:

(a) Based on the mutual understanding of the objectives, institutional investors need to enter into a dialogue with companies (the method of dialogue could be a one-to-one meeting, a telephone conversation, etc. as explained in an earlier Learning Outcome).

(b) Institutional investors must put emphasis on board structure and composition while evaluating governance (this has already been explained in an earlier Learning Outcome).

Case Study

Continuing the example of Arctic Plc,

The institutional investors have rightfully exercised their right to question the management and directors regarding the business policies and plans. One of the institutional shareholders actually went public about criticising the policy of the company; this shows the power that institutional investors have over the working of the company.

Test Yourself 9

Rolta Space has 70 institutional investors who own 60% of the shares of the company. They would like to you recommend good governance practices so that their institutional investors will be satisfied by the company.

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7. Identify and based on a given scenario evaluate the issues of transparency for an entity. Explain the importance of probity as a principle of governance assessing issues and their implications in a given scenario.

[Learning Outcomes h and i]

Case Study

Nadir came to the UK with his father and set up a successful business selling clothes in London. When the Turks invaded Northern Cyprus Nadir took the opportunity to purchase a factory in Nicosia and was soon a major exporter. His companies expanded and Polly Peck plc was the darling of the stock market with its growth and portfolio of successful fruit businesses including the Del Monte label. By the 1980's Polly Peck was capitalised at £12 million and Asil was a wealthy man.

However at its peak Asil became the subject of bankruptcy proceedings by his firm of stockbrokers and at this point with the Polly Peck shares suspended and the company in collapse the serious fraud office began investigations. Asil was arrested but jumped bail and escaped to Cyprus. The SFO had bungled his arrest and whilst being hot on the trail of apparently missing funds of $43 million they have to date been unable to press charges. The Polly Peck group collapsed with debts of $2 billion.

What was clear was that Asil Nadir had dominated his board and was able to do pretty much as he liked with no checks and balances in place and audit failures that allowed the group to operate despite the alleged fraud and its insolvency. The failure of the financial statements to give any warning and the rising share price meant that few questions were asked. The complex web of companies and mysterious transfers of funds enabled much to be hidden.

The losses of jobs, money and confidence led to the creation of the Cadbury Committee on corporate governance to examine the lessons that could be learned.

7.1 Openness / transparency

Corporate governance must ensure transparency and increase the trust and confidence of stakeholders in the way the company is run. Transparency is also concerned with informing financial markets immediately regarding price sensitive information. This ensures efficient markets where share prices reflect the reality of business. A good corporate governance model ensures that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company. Transparency can be achieved by way of disclosures to stakeholders. Disclosures about corporate governance are included in the annual accounts of the entity.

Therefore transparency means openness and sharing information with stakeholders. It also includes not concealing information from stakeholders (unless necessary). Information in this context generally refers to financial reporting, as this is the parameter used by investors for making economic decisions relating to investing in the entity. In addition, corporate governance requires that shareholders be informed about major decisions taken by the company, e.g. the takeover of a new business, issue of shares, etc.

Importance of transparency

1. Transparency ensures gaining trust of investors and regulatory authorities, like taxation authorities.

2. Transparency ensures that truthful and fair reporting of information is made to investors and other stakeholders. This in turn enhances market confidence in the company.

3. It also helps to improve the relationship of the company with its employee unions, for whom provision of information is important.

Transparency versus confidentiality

In the process of ensuring transparency, the board of a company cannot disclose 'all' information. The company would have to maintain confidentiality on sharing information relating to strategic decisions (for example, price sensitive information relating to a probable bonus share issue which is being discussed by the board). The need for maintaining confidentiality of information arises due to the fact that strategic decisions (like pricing of goods) need to be kept secret from competitors.

7.2 Probity / honesty

Overall, corporate governance involves organisations being transparent and honest in all their dealings, be they with customers, suppliers, investors, employees or any type of stakeholder and shareholder. Honesty means not lying or not misleading stakeholders. Honesty is important in building stakeholders' confidence that their interests are protected. Dishonesty can damage shareholder value and puts company reputations at risk. Given the recent high profile accounting frauds (e.g. Enron), corporate governance is especially relevant today.

In addition, the traditional view that corporate governance is an internal and private matter for an organisation has disappeared. Today legislations such as the Sarbanes-Oxley Act in the United States and the Combined Code in the UK are placing many basic requirements on listed companies in regard to their corporate governance systems.

Case Study

In the above case, Asil Nadir had not maintained any transparency in the dealings he made. Through a complex web of companies and mysterious transfers of funds, he built an empire that was under a big burden of debt. This not only caused the collapse of his empire but also a loss of confidence in his company.

A company is expected to make dealings and funds transfers in a manner that is transparent and gives out all the necessary details that may affect the share prices of the company. Share prices are seen as a reflection of business reality. Even when Asil made mysterious fund transfers, there should have been an audit of the transactions whereby the auditors might have brought this fact to light. In this case, nothing happened and hence it is a clear case of breach of the transparency principle.

When it comes to probity, again Asil does not score well. There were many transactions in this case that were done in a secretive and autocratic style. Funds of $43 million were missing without any records. In absence of any checks and balances, Asil was free to conduct the dealings of business according to his own will. This led to many dishonest and uncontrolled dealings. Ultimately, the company collapsed in the wake of heavy debt.

Test Yourself 10

Spencers Telecon is a multinational corporation. The company is located in the UK. It has three branches in the USA, Australia and India. The company wishes to be recognised for its ethical values and corporate practices.

Required:

Suggest the practices to be adopted by the company so as to ensure transparency and probity.(For each of the principles suggest two practices).

8. Assess the extent to which a board is focusing on sustainable long-term success in a given scenario.

[Learning Outcome j]

Case Study

Global Infra (GI)is a major European listed civil engineering company. It has recently won a contract for building a convention centre in Tanzania, Africa. The convention centre will have 3 auditoriums, 6 exhibition halls, 2 restaurants, 1 luxury hotel, 2 ballrooms and several conference rooms for small conferences. This mega project will take 2 years to build and is located on the banks of a river in Africa. GI has received this contract from its client, the Tanzanian government, based on its excellent track record of building convention centres in Europe and America.

'Save the River'is an active environment group who have been opposing the construction of this convention centre for a while. They are of the opinion that building a convention centre on the banks of the river would result in pollution of the river water, endangering human and plant life along the banks of the river. Moreover, the river has been a source of fresh water for the nearby areas for more than 100 years now and this will lead to the pollution of a major water resource. The fish and other water plants will also face extinction if the water is polluted.

Another major group is the people residing on the land that has been acquired for the construction of the convention centre. These are artisans who have been residing on the banks of the river for around 60 years and use the soil from the banks of the river to make earthen pots and other articles that are sold in the local markets. This is an ancient art and has been supported by many NGOs to preserve it. They do not want the convention centre to come up since their habitat will be lost as would their source for raw material. This loss would be permanent.

8.1 Sustainability of development

This refers to the ability of meeting present needs without compromising on the capability of meeting the needs of future generations. It refers to policies and practices adopted by organisations which ensure that the rate of resource utilisation matches the rate at which they can be replenished.

Companies such as Nokia, Starbucks and Shell, report on the sustainability of their activities. However, there are limitations in these types of reports, as there is no precise definition of sustainability e.g.

- Should 'needs' be determined as subsistence living or higher?
- What species, in addition to humans, should be conserved?
- Whether to consider sustaining in the present form or changed / improved form?
- What time frame should be considered for calculating the requirements of future generations?

Case Study

Continuing the above case study of Global Infra (GI),

We may observe that the company has acquired a project that might attract a lot of negative publicity. This is because the construction of the convention centre will result in pollution of the river – a natural source of fresh water and home to different species of fish and water plants. This is a sustainability issue since the construction is a danger to the sustainability environment. Hence GI should think about the long term implications of the construction of the convention centre. The board should definitely consider these implications. Setting up of a risk committee that will thoroughly assess the risk involved will help. The board should also think about how they can compensate the artisans who will lose their homes and jobs. They may restore their homes on another river bank or provide them job opportunities elsewhere. These are certain sustainability initiatives that GI may undertake.

In this case, it is also the responsibility of the government of Tanzania to consider these issues since it is their country.

8.2 Reporting initiatives for sustainability

The board has the responsibility of conducting the business of the company in such a manner that will make the company sustainable in the long run. This will not only ensure long term profitability but also increase the goodwill of the company in the eyes of all the stakeholders. Undertaking sustainability initiatives builds a strong reputation of the company and increases the share values. Certain measures that the board may take in this direction are as follows.

1. The Global Reporting Initiative (GRI)

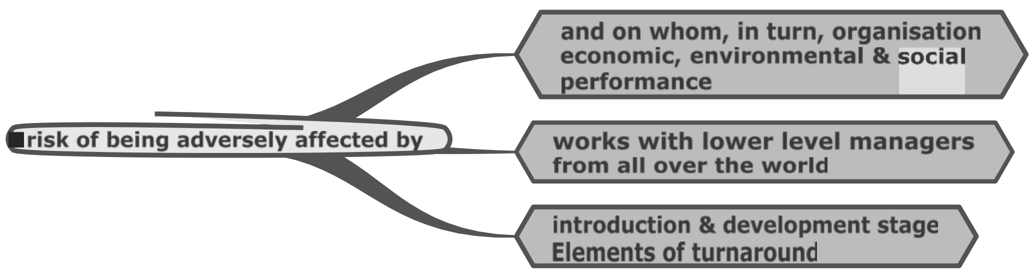
The GRI is a multi-stakeholder organisation that is made up of thousands of individuals and organisations from all over the world, concerned with developing and promoting a sustainability reporting framework.

Sustainability reporting as defined by GRI is the practice of measuring, disclosing, and being accountable to internal and external stakeholders for organisational performance towards the goal of sustainable development.

The framework sets out the principles and indicators that organisations can use to measure and report their economic, environmental and social performance. It strives to encourage organisations to report regularly and transparently.

Presently more than 1,000 companies have adopted the GRI guidelines in their sustainability reports.

SUMMARY



2. Reporting on sustainability of development

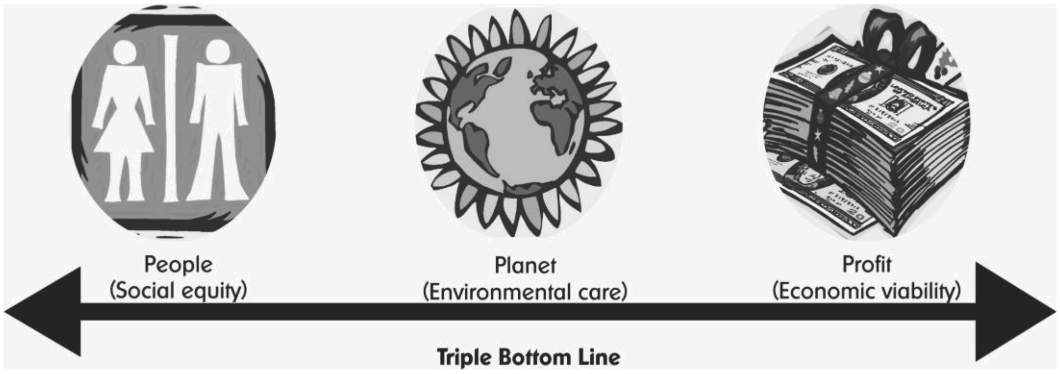
Traditional accounting methods include measuring the company's economic activity with respect to assets purchased / used, liabilities and expenses incurred and income earned. However, such accounting practices do not look at the results of economic activities on those assets which do not belong to the organisation, such as water, minerals, etc. and the liabilities that it does not have to pay, such as waste generated and emissions made. In short, such accounting methods do not examine the environmental and social impact of economic activities.

There is an increasing realisation throughout the world that methods of accounting and reporting on environmental and social impacts need to be developed much further. Existing methods used by some companies include:

- triple bottom line
- sustainability balanced score card
- Sustainability Assessment Models (SAM) and Full Cost Accounting (FCA)
- environmental footprint

(a) Triple Bottom Line (TBL)

Diagram 8: Triple Bottom Line



Sustainable development refers to the impact of economic activity on **value creation in terms of economic, social and environmental factors**. It is also referred to as the 'triple bottom line'. These three factors can be likened to people (i.e. the social factor), planet (i.e. the environmental factor) and profit (i.e. the economic factor). The economic factor is not just conventional accounting (see below) so TBL cannot be taken as conventional accounting plus the social and environmental factors.

(i) People

This refers to business practices involving employees, community and the location in which an organisation operates. A triple bottom line enterprise strives to benefit groups of people without causing harm to any group.

For example:

- Not using child labour, paying fair salaries to workers, maintaining a safe work environment. In short it would not exploit a community or its work force.
- Contributing to the strength and growth of the community by supporting health care and education.
- Ensuring a safe work place.

The measuring of this bottom line is relatively new, problematic and often subjective. The Global Reporting Initiative (GRI) has developed certain guidelines which enable corporations and NGOs to report on the social impact of a business.

(ii) Planet

This refers to measures taken to reduce the environmental footprint. A TBL company strives to do least harm to the environment.

For example:

- careful management of energy consumption
- reducing manufacturing waste
- rendering waste less toxic before disposal in a safe and legal manner
- not producing harmful or destructive products e.g. chemical weapons, lead based batteries
- avoiding over fishing or other practices which lead to depletion of resources

(iii) Profit

This refers to the economic benefit enjoyed by the company and also the wider society as a result of the company's activities. To be sustainable, profits made must be determined after identifying the organisation's wider impact, including resource utilisation and wealth creation.

Example

The following is an extract from the TBL policy of HT Hydro:

HT Hydro is committed to protecting the environment, to meeting the needs of the community and to delivering excellent financial results. As such, we are striving on the path of sustainability by balancing and measuring our performance along environmental, social and economic bottom lines.

Our environmental bottom line consists of the ways in which we deal with the impacts from our operations, measure environmental values with economic ones and plan for a future with more green energy in our system.

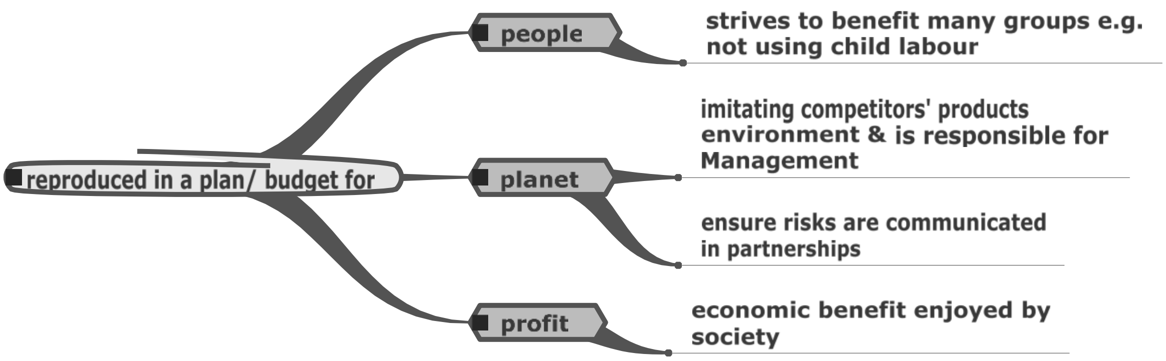
Our social bottom line involves ensuring the safety and well-being of our employees, customers and general public and the health of the communities we live and work with. By being efficient, productive and profitable and by providing value to our customers and community, we take care of our economic bottom line.

Case Study

Continuing the above case study of Global Infra,

It may make a Triple Bottom Line policy and implement it in the convention centre project. This may include setting up of a waste recycling unit in order to recycle the waste generated by the convention centre. This may reduce the environmental damage and benefit the community at large.

SUMMARY



(b) Balanced scorecard

The balanced scorecard, measures whether the activities of a company are meeting its objectives in terms of vision and strategy. It focuses on financial results and human factors. This enables organisations to understand their business well and to act in their best long-term interests. It enables managers to focus on performance and at the same time balance financial objectives with employees, customers and process. Accounting based on the scorecard includes the following:

(i) Financial perspective

This involves a study of whether the execution of business strategies would lead to an increase in the company's profitability. This contains three stages: growth, sustenance and harvest.

The growth stage involves increase in turnover, getting new customers, growth in revenue, etc.

The sustenance stage involves determination of the effectiveness of the organisation in managing its operations and costs, by calculating the return on capital employed the return on investment etc.

The harvest stage is based on cash flow analysis. Some of the most common financial measures that are incorporated in the financial perspective are revenue growth, costs, profit margins, cash flow, net operating income etc.

(ii) Customer perspective

This determines the measures taken by organisations to satisfy customers and thereby enhance sales at the best rate of profit. Therefore it adds value to an organisation.
The measures that are selected are:

the value that is delivered to the customer which may involve time, quality, performance, service and cost
the results of the above measures such as customer satisfaction and market share

(iii) Internal process perspective

This deals with the processes that create and deliver the values mentioned under customer perspective. It focuses on all the activities and important processes required for the company to excel at providing the value expected by customers.

These activities and processes can include both short-term and long-term objectives as well as incorporating innovative process development in order to bring about growth.

Examples of practices by organisations are:

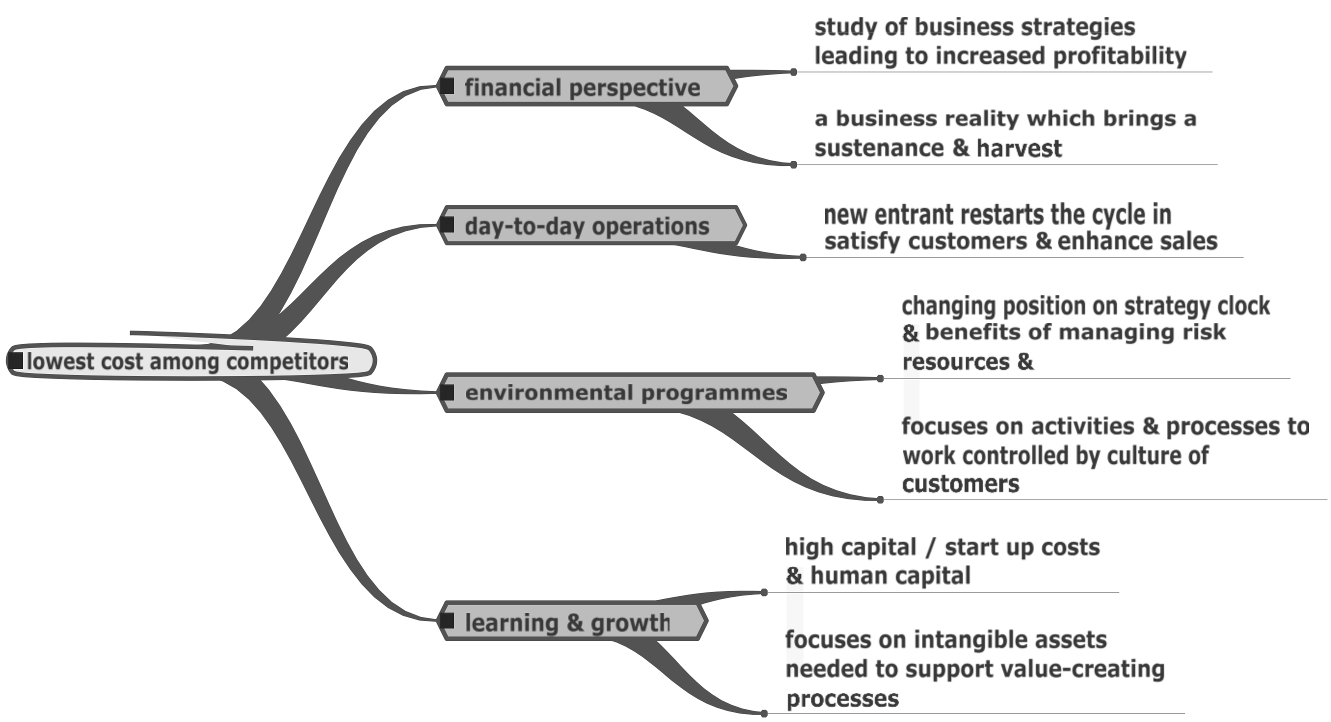
operations management i.e. by improving asset utilisation, supply chain management etc.
customer management i.e. by expanding and improving relationships
innovation i.e. by introducing new products and services
regulatory and social i.e. by maintaining good relationships with external stakeholders

(iv) Learning and growth

This deals with the basis of forming strategy. It focuses on the intangible assets of an organisation, such as capabilities and the internal skills which are needed to support the value-creating internal processes. It also deals with human capital. An improvement in the learning and growth perspective, will lead to the long-term success of the company.

Therefore, an organisation adopting the balanced scorecard will set goals and targets for each perspective mentioned above and set up pointers to compare the actual results with the targets. Such an outlook will ensure that organisations give importance to non-financial factors which lead to the long-term growth of the organisation.

SUMMARY

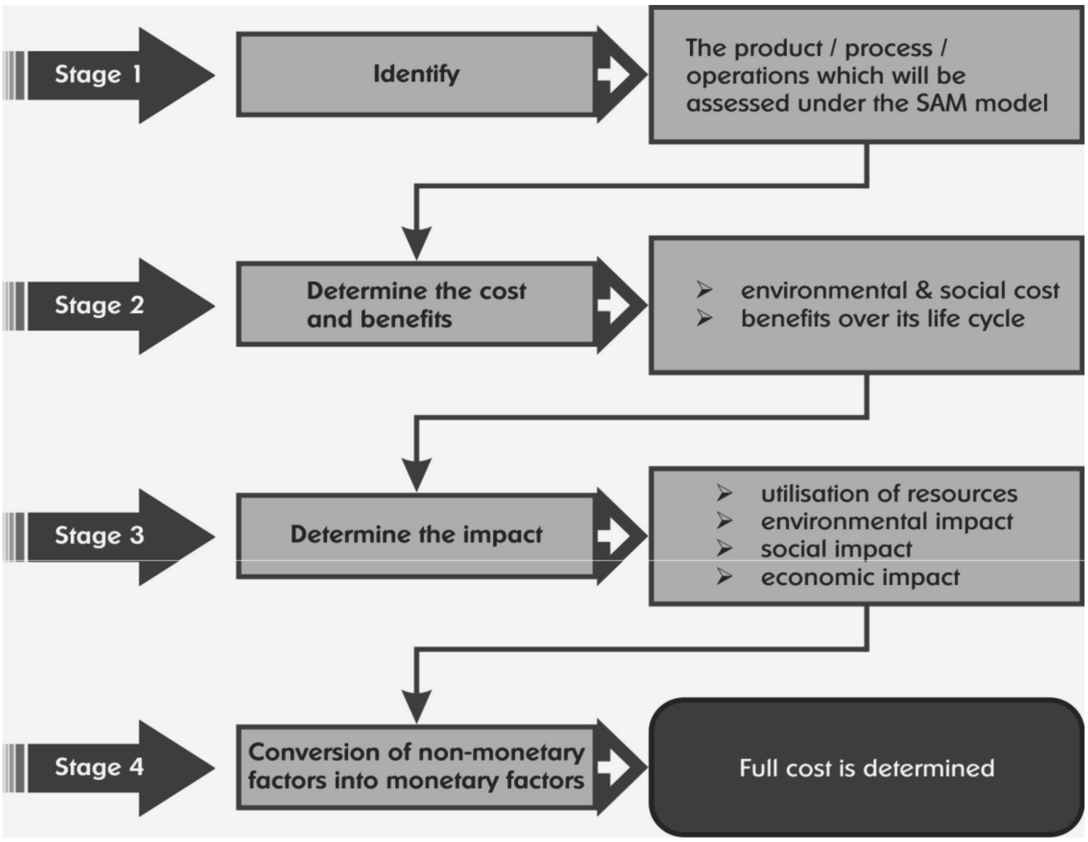


(c) Sustainability Assessment Model (SAM) and Full Cost Accounting (FCA)

As with the TBL, which reports the economic, environmental and social factors for the previous year, SAM measures the sustainability of the products which are produced over the entire life cycle of the company i.e. from the time of using the resource in the process of economic activity up to its final consumption. Therefore this method incorporates the non-financial costs incurred by an enterprise as well as the direct cost of the product and the cost of environmental and social footprint.

FCA is the cost of the total impacts mentioned above under SAM. SAM assesses the performance of a company as an index of sustainability. This method enables one to determine the performance of the company vis-à-vis the sustainability worked out. The SAM method takes into account the cost of the product through its entire life cycle mentioned above. This involves the following stages:

Diagram 9: Determination of full cost using SAM



Therefore the objective of FCA is to internalise all costs which are incurred both within and outside the organisation.

Example

Ranka Petrochemicals Company was set up two years ago. The company's factory adjoins a lake, which is owned by Samson. The lake contains many varieties of rare fish. Mr. Samson makes a living by breeding the fish. The company's activities give rise to an oil spill in the lake that kills most of the fish in the lake.

Mr. Samson has filed a suit against the company for Tshs1,000 million as damages along with Tshs2,000 million for loss of earnings. The court has directed the company to pay Mr. Samson Tshs3,000 million in this connection. The court has assigned Mr. Jackson, an environmental expert, to undertake an independent study of the lake and value the cost of getting the lake into its original state. Mr, Jackson has estimated the cost of such activity as Tshs5,000 million.

Continued on the next page

The company follows full cost accounting. The method of determining the FCA for the oil spill is as follows:

Step 1: identify the process: the process is the oil spill

Step 2: determine the cost incurred: the cost awarded by the court: Tshs3,000 million.

Step 3: determine the impact of the oil spill: the impact of the oil spill was:

This could be whether remedial actions can be taken to return the lake to its original state.
If any of the fish have become extinct.

Step 4: conversion of all non-monetary costs into monetary terms: this involves determining the cost of step 3 i.e. the cost of remedial action Tshs5,000 million.

The cost of losing the fish which have become extinct cannot be determined.

Therefore the cost of the oil spill is Tshs8,000 million (Tshs3,000 million plus Tshs5,000 million).

Test Yourself 11

The Volven Catchment is a part of the Murray River valley. The catchment covers 10.5% of the State of Victoria. The region stretches from close to the outskirts of Melbourne in the south, to the Murray River in the north. It includes the municipalities of Moira, Campaspe, Mitchell, Murrindindi, Mansfield and Strathbogie Shires, Benalla Rural City and the City of Greater Shepparton.

The region supports major agricultural (dry land and irrigated) and forestry industries. Some 189,590 people live in the catchment. Rapid population growth is occurring in some parts of the catchment, notably centres within commuting distance of Melbourne and the City of Greater Shepparton.

The activity of irrigation leads to considerable environmental change. A few decades back, it was the normal perception that such activities led to greater economic and social benefits as compared to the environmental costs. However, public attitudes have changed over time from acceptance of development and exploitation to greater concern regarding environmental issues and sustainability such as:

canal smells
dust
unknown effect of surface area of water from channels
changes in the conditions of water use, including water logging and flooding
changes in sediment transport
impacts on groundwater conditions
changes in flora and fauna
effects on soil and vegetation

Required:

Suggest the ways in which the company in the catchment can communicate to the public the steps taken by it towards sustainability.

Answers to Test Yourself

Answer to TY 1

Honesty, trust and integrity, openness, efficiency, effectiveness, responsibility, accountability and mutual respect are some of the important elements of good corporate governance.

Principles of good corporate governance include:

1. Rights of shareholders and equitable treatment of shareholders

(i) The rights of the shareholders need to be respected and organisations should enable shareholders to exercise those rights.

The methods by which organisations can help shareholders to exercise their rights are as follows:

by effectively communicating information that is understandable and accessible
by encouraging shareholders to participate in general meetings

(ii) Shareholders should be informed about important business decisions made by organisations such as:

major strategic changes made to the core business of the company e.g. acquiring a new business
major corporate changes which can dilute the equity e.g. proposed issue of equity share capital

(iii) Generally, companies practising corporate governance advocate the policy of "one share one vote", leading to equal voting.

2. Recognising the interests of other stakeholders

Organisations practising corporate governance recognise that they have legal obligations to all stakeholders.

3. Role and responsibilities of the board

The board needs to tackle various business issues for which the board members need to be equipped with a variety of skills and understanding and have the aptitude to review and challenge management performances.

The board should include sufficient independent non-executive directors with appropriate skills.
The role of CEO and chairman must not be held by the same person.
The members of the board must stand for election on a regular basis.

4. Integrity and ethical behaviour

In order to promote ethical and responsible decision making, organisations are required to establish a code of conduct for their directors and executives. The code should promote ethical and responsible decision-making.

5. Disclosure and transparency

The role and responsibilities of the board and management should be made known to the shareholders. This will provide accountability to the shareholders. Procedures that ensure independent verification and safeguard the integrity of the company's financial reporting need to be promoted (e.g. carrying out internal audits wherein the internal controls are reviewed). Prompt disclosures of all material matters relating to the organisation should be made to the shareholders (e.g. if a company decides to sell off one of its major lines of business, it will disclose this fact to the shareholders).

Answer to TY 2

The given report of Jestinson Plc contains the following disclosures

(a) The first paragraph states the principles that the company follows in the conduct of its business affairs. This is not a mandatory disclosure but giving this will help the company to enhance its relationship with its shareholders since it strengthens shareholders' belief in the company.

(b) The second paragraph states the composition of the board, which is a mandatory disclosure according to the Combined Code. The disclosure gives the shareholders confidence that the company is compliant with the various acts and rules applicable to it. Hence they are sure that no legal action will be taken against the company. The disclosure also states that the board members have adhered to the code of conduct of the company. Therefore the board is sure that the members are ethical in their behaviour.

(c) The paragraph on board procedures explains the manner in which the board conducts it affairs. This disclosure is also mandatory since it outlines the way the board operates and reveals how organised or unorganised a board is in the conduct of its affairs.

(d) The attendance sheet of the members of the board is a mandatory disclosure that is required since the shareholders need to be aware of the number of board meetings held and whether the directors actively participated in the discussions relating to important business matters.

(e) The disclosure of the internal audit procedures carried out is again a mandatory disclosure according to the Combined Code. The board has disclosed the manner of audit and the scope of audit. This explains the board's procedure of risk management, control and governance of the processes. However the board has not reported any risks that the organisation faces and its strategies for dealing with these risks.

Answer to TY 3

Blackberry Plc has ventured into the business of manufacturing and selling mobile phones. In relation to strategic planning, the board has the following responsibilities:

(a) To position the company in dynamic markets: the market is competitive and Blackberry will need to determine whether it is going to be a cost leader or the extent to which it will develop differentiating factors to gain some premium in price. There will also be a need to develop a product lifecycle plan to innovate and maintain advantage. Positioning requires setting products against those of competitors and getting key aspect of pricing, promotion and the product right.

(b) To set corporate direction: the company needs to consider how it is going to grow and how quickly and how it is going to develop and manage the growth including the extent of focus on products and markets.

(c) To review and decide upon key resources: as the product and marketing strategies develop the board needs to consider the requirements for key resources including people, production capabilities and the supply chain. Financial resources appear adequate in the short run but expansion may require new funding.

(d) To decide the implementation processes: the board will need to consider appropriate organisational structures and teams to support the implementation projects for product development, production capability development and the building of staff resources. The board will set the direction and targets for the process and will need processes to manage people, projects and production processes including adequate management information systems.

Answer to TY 4

The problems with the management of Shikaya Plc in the context of the principles of the Combined Code (UK Corporate Governance Code) are:

(a) Shikaya does not have a balanced board with equal representation from executive and non-executive directors. This means that executives lack independent advice and essential questioning and challenges to their strategy and actions.

(b) Simon Spice is both chairman and chief executive and therefore fails to separate the board management, advisory, leadership and dialogue roles from the executive roles of managing the business on a day to day basis.

(c) The board is dominated by a small group of executives who appear to be heavily influenced by Simon. He dominates from his own position of power as CEO and chairman and with his substantial shareholding and because his team work for him.

(d) The board lacks sufficient numbers of non-executives to provide essential challenge to the executives and to provide sufficient members to staff nomination, remuneration, audit and risk committees.

(e) The two non-executive directors are not in a position to challenge since they have limited information and this also indicates that they may be weak individuals. It is clear that they do not get involved and could be described as passengers.

(f) Effective NEDs have a high degree of independence, one of the NEDs as a former executive lacks objectivity. This is compounded by his substantial shareholding.

(g) There may be concerns since the CEO and the former sales director together control 45% of the shares, insufficient to win votes on their own but a substantial power base to control the company.

Answer to TY 5

The key reasons that led to the fraud are as follows:

(a) Key members of the managing board appear to have control over the provision of information to their own team and more importantly to the supervisory board. This was a control risk that was a factor in the concealment of losses to the supervisory board. It may be that the bonus system creates pressure to achieve and that this may have tempted the directors who lacked integrity to fraudulently conceal the losses.

The supervisory board is intended in part to create checks and balances that control excessive risk taking, strategic mistakes and abuse by the executive directors who run the company. The supervisory board relies on the information it receives but needs to be firm in requesting information and asking the right questions. The supervisory board often relies on the chairman to achieve this. This is a potential disadvantage of the two tier system where the non-executive directors sit in separate meetings. These problems indicate a weak chairman and weak supervisory board.

(b) The members of the supervisory board are retired German businessmen and employee representatives and the board lacks professional non-executive directors who may be better placed to learn how the business works and to challenge the executives.

The supervisory board lacks an international perspective both in the employee representatives and in the independent NEDs. This lack of local knowledge and experience diminishes the effectiveness of the board for a company that operates in five countries both from a business and stakeholder perspective.

(c) There is a lack of alignment between the interests of the directors and the shareholders as exhibited in the remuneration approach; this may be due to a lack of involvement of non-executive directors from the supervisory board.

(d) On the evidence above it may also be the case that the company lacks effective committees to focus attention on risk, controls, remuneration and to provide links to internal and external audit all of which would have provided control over the isolated executive team.

Ultimately the problems have diminished confidence in the company from investors and essentially effective non-executive directors should have prevented this. Whilst this could happen even with a unitary board structure the lack of checks and balances was partly due to the weak supervisory board and its lack of expertise and challenge.

Answer to TY 6

Extract of code of ethics of Tripla Pharma

(i) Giving / accepting gifts

Tripla does not favor bribery and corruption. Exchange of gifts may be considered bribery. Employees may receive / offer meals, entertainment as well as promotional gifts, provided they are reasonable.
For gifts to be considered reasonable, the following guidelines must be referred to:

- gifts must be rarely provided
- gifts must be of negligible value and not be lavish
- gifts offered / received must have a direct link with the contract executed / product or service

A gift can be identified as a bribe if it can be construed to be a favor or provided as a special favor.

(ii) Reporting violations

In keeping with our anti-bribery stance, we would like to encourage reporting of ethical violations. All employees who are aware of or suspect instances of ethical violations within the company should report them to the HR director immediately. We believe that investigation can be more effective if the employees reporting violations identify themselves; Tripla offers to provide whistle-blower protection to such employees.
However, if for any reason, employees wish to report violations anonymously, they may do so.

Answer to TY 7

The CEO, CFO and other executives appear to be attempting to push for a decision without proper consideration by the whole board. The CEO is putting Mike under pressure in order to eliminate potential discussions by the whole board.

Whilst there may be a business rationale behind the move in order to diversify into new technology there is no evidence that other options have been considered. There will be a considerable loss of contribution and consideration needs to be given to the contribution effects of using a third party supplier since in effect the current arrangements only reflect costs of printing. The risk issues presented by Mike need to be considered both in terms of the supply chain and with the loss of control. Investigation of the target must also address the scale and competitive advantage problems. Due diligence work is essential.

The Chairman should play a pivotal role in the consideration of such a major strategic change in direction being involved with the executive directors discussions including Mike and in ensuring full information is presented to the board with time for the NEDs to assimilate issues and ask questions before and during the meeting and before a decision is made.

The NEDs will play an advisory role and are in effect to be consulted. The NEDs will focus attention on shareholder value, issues of risk, the overall financial and operating consequences and the necessity of carrying out proper due diligence work.

The chairman will need to recognise the pressures that the CEO and CFO are putting on their colleagues and assess their reasoning. He must ensure that the board members all have a chance to speak and that a proper presentation is made to the whole board. A vote will be essential and since new capital is involved communications with shareholders may be needed including possibly their approval at the same time as the rights issue is made.

The chairman and NEDs are likely to ask for advisors to be consulted.

The CEO should be in no doubt that the decision requires approval and that due to the rights issue the offer should be conditional unless other sources of finance are used.

Answer to TY 8

The concept of alignment in agency theory is concerned with finding approaches that can encourage or ensure that directors act in the best interests of shareholders rather than their own interests. The issue arises in listed companies when the directors are managers with their own power and reward interests whilst the shareholders are owners with interests in growth, reward and security.

In the scenario the chief executive and chairman have contracts that we can assume have been properly determined by the remuneration committee and disclosed and given approval by an advisory vote of shareholders. If this has not been done then the shareholders may express their dissatisfaction in an advisory vote should they wish.

It is not clear how much involvement the shareholders mentioned in the scenario had in the recruitment process but it is likely that this was largely an internal matter with a vote at a shareholders meeting. Assuming the appointments were properly made the shareholders have to engage with the board in order to influence policy driven forward by the chief executive and chairman. If the shareholders are not happy with the strategy then they have the right to express their views and could seek to remove the two men but this would only be effective if a majority vote to remove them or they decide to resign.

The chairman and chief executive appear to have a form of approval for their plans since their contracts give them substantial short term benefits rather than long term benefits that would arise if share options had been given. Unless the shareholders have voting power or influence then they have to accept the strategy or engage with the board or sell their shares. If disapproval is expressed and shares are sold the fall in share price will put pressure on the board.

Answer to TY 9

Rolta Space should follow good governance practices. This will involve following the practices specified in "the Combined Code" with respect to board members, composition of the board and preparation of the report on corporate governance which is to be submitted to the London Stock Exchange.

The company must pay special attention to its institutional investors by practising the following methods:
Communication with shareholders is given high priority.

Communication is through:

- regular dialogue with institutional investors through one-to-one meeting on a weekly basis and telephone calls to the top 30 institutional investors. The chairman, chief executive and chief operating officer must be available to meet them, to discuss any issues and gain an understanding of any concerns in relation to the company's governance and strategy.

- general presentations of the company's performance, at the time of the release of the annual and interim results.

- issue of its results promptly to individual shareholders and also publishing them on the Investor Relations Learning Outcome of the company's website.

- regularly updating the company's website with news which relates to the company.

- offering subscriptions to these news updates to shareholders and other interested parties.

Answer to TY 10

Tip

The answer can be given in tabular form.

Sr. No	Principle	Suggested practice
1	Openness	(i) The company can prepare a corporate governance report according to the listing requirements of the London Stock Exchange (ii) The company must adopt the policy of informing its shareholders about all decisions taken by the company such as acquisitions, sell-offs of business changes to shareholdings, changes made to the board of directors, etc.
2	Honesty	(i) The company must follow the practice of paying all necessary taxes (ii) The company must be honest in its dealings with employees i.e. making all salary payments in accordance with the terms of employment

Answer to TY 11

The company has adopted the triple bottle line reporting. Under this form of reporting, sustainability development refers to the impact of economic activity towards value creation in terms of economic, social and environmental factors. The company has adopted this structure of reporting because it includes not just financial factors but also environmental, social and cultural elements. This approach provides a more balanced view of water use with socio-economic benefits and environmental consequences.

The adoption of this technique will enable the company to derive the following benefits:

- This approach will lead to a more transparent and informed debate on the sustainable use of resources between all parties. Therefore it would lead to sound corporate governance and ethics systems throughout all levels of an organisation.

- Currently the company's corporate governance initiatives are focused at the broad level. However, TBL will help ensure a values-driven culture is integrated at all levels.

- Such an approach would also lead to an improved management of risk through enhanced management systems and performance monitoring.

The company would also ensure a formal communication with key stakeholders such as the finance sector, suppliers, community and customers. This would allow the entity to have a more proactive approach to addressing future needs and concerns.

The company would also be able to attract and retain competent staff by demonstrating that they are focused on values and its long-term existence.

This would lead to a competitive advantage with customers and suppliers, as well as enhanced access to capital as the finance sector continues to consider non-financial performance within credit and investment decisions.

Quick Quiz

1.

(a) A multi-tier board structure normally consist of two boards, one consisting of the _______ and the other consisting of the________ of the various stakeholders.
(b) The __________ is responsible for presiding over the affairs of the board and all its meetings.
(c) ________ arises when directors put their interests ahead of the interests of the ______.

2. Corporate governance broadly refers to:

A the mechanisms by which corporations are directed and controlled and the mechanisms by which the committees of the corporations are direct and controlled.

B the mechanisms by which corporations are directed and controlled and the mechanisms by which those who direct and control the corporation are monitored and supervised.

C the mechanisms by which corporations are directed and controlled and the mechanisms by which strategies of the organisation are implemented.

D the mechanisms by which corporations are directed and controlled and the mechanisms by which the board of directors works to achieve the results.

3.
(a) Public sector companies are _________ of public interests.
(b) Private companies' main aim is to earn ________ for the owners / shareholders of the company.
(c) _______________ score more on the maintenance of good governance practices.
(d) ___________ have extremely effective strategic leadership and encourage '_________________'.

4. What are the categories of disclosures (highlighted by the OECD and ICGN principles) to be made to shareholders and other investors?

5. Answer in one sentence.

(a) What will a mutual fund manager be interested in while investing in the shares of the company?
(b) Define pension funds.
(c) What kinds of portfolios do insurance companies prefer?

6. In the balanced score card approach, what are the three stages in the financial perspective?

7. What does corporate governance mean in a technical sense and what does the study of CG focus on?

8. Explain fiduciary duty towards shareholders.

9. Briefly explain what is meant by agency theory.

10. What is information asymmetry?

Answers to Quick Quiz

1.
   (a) executives, representatives
   (b) chairman
   (c) Conflict of interest, company

2. The correct option is **B.**

   The mechanisms by which corporations are directed and controlled and the mechanisms by which those who direct and control the corporation are monitored and supervised.

3.
   (a) custodians
   (b) Profits
   (c) Public sector companies
   (d) Private companies, 'out of the box'

4. The OECD and ICGN principles highlight the following main categories of information that shareholders and other investors need to receive from the company:

   (a) Financial information that projects the current as well as future profitability and sustainability of the company.
   (b) The corporate governance practices followed by the company. This information tells the investor whether or not the company is a principled company in which it is safe to invest.
   (c) Information on the company's share ownership such as who owns how many shares and the voting rights associated with the shares since these factors affect the investing decisions.

5.
   (a) Manager of a mutual fund would be interested in the dividends and the price of the shares of the company in which he invests.

   (b) Pension funds are professionally-managed bodies which obtain funds from individuals or organisations. These funds are to be paid to the individuals or the employees of the organisation on a future date in the form of pension.

   (c) Insurance companies prefer to mix their portfolio to include blue chip companies wherein they will receive an assured amount as dividend, and also speculate in some shares which will remain invested for a short term.

6. Financial perspective

   This involves a study of whether the execution of business strategies would lead to an increase in the company's profitability. This contains three stages: growth, sustenance and harvest.

   The growth stage involves increase in turnover, getting new customers, growth in revenue, etc.

   The sustenance stage involves determination of the effectiveness of the organisation in managing its operations and costs, by calculating the return on capital employed the return on investment etc.

   The harvest stage is based on cash flow analysis. Some of the most common financial measures that are incorporated in the financial perspective are revenue growth, costs, profit margins, cash flow, net operating income etc.

7. In a narrow, technical sense, corporate governance is about two key areas: first of all corporations (in this case, companies) and secondly governance (how the companies are run; in this case how the directors run them).

   The study of corporate governance focuses on the processes, mechanisms and structures that are put in place to enable directors to manage businesses operated as companies, and to provide checks and balances on the directors and executives. **Corporate governance** represents the **set of policies and procedures** that **determine how an organisation is directed, administered and controlled**. It sets the broad framework or parameters within which the people in the organisation must operate.

8. Directors are the fiduciaries of the shareholders' trust. They hold a position of trust and hence a fiduciary duty is imposed upon them. A fiduciary duty is the duty to act in good faith of the persons for whom the directors work. **They have a duty to disclose all the information held by them, account for any profits received as a result of the relationship** (of being agents of the shareholders) and to avoid any conflicts of interest with the shareholders.

9. The work of Berle and Means highlighted the concept of separation of ownership and control. The emergence of joint stock companies increasingly led to this separation where shareholders were the principals and the directors, agents. Agency theory is an extension of the concept put forward by Berle and Means of the division of authority and responsibility and of agent's accountability towards his principal. In the context of corporate governance, the theory deals with the relationship between management and shareholders and with other stakeholders and the continuous efforts they take and disputes they face in the process of aligning their interests.

10. There can be a breach of trust by the directors, an intentional act of misconduct for own benefit, negligence or incompetence. This is because the directors are always in possession of more information than the shareholders because they are actually managing the affairs of business. This is called information asymmetry between principals and agents.

Self-Examination Questions

Question 1

IT Zone is a leading IT company. It wishes to follow good governance. **Suggest some good governance practices which IT Zone should follow.**

Question 2

Simply Style Plc is a listed fabric manufacturing company based in the UK but with overseas operations. The company has a broad mix of shareholders both private and institutional with no shareholder owning more than 18%. At a recent annual general meeting of shareholders several institutional members complained that they were not receiving sufficient information and that dialogue with the board was poor. Some expressed concern that whilst the financial statements complied with regulations that there was little or no additional information.

Required:

Explain what is meant by asymmetric information in the context of agency theory.

Question 3

Stechford Plc prints magazines and books for a wide range of publishers and newspaper companies across Europe and North America. The board has recently appointed a new CEO Gerd Moller who joined from a major German company and a new chairman Alan Grant who was formerly a senior executive for the Department of Education and Learning, a government department.

The two men have met to set out ideas as to how the board will operate. Gerd proposes that they should have a management board and a supervisory board. Alan proposes the continuation of the current unitary structure.

Required:

Explain the differences in operation between the two approaches that are being discussed by the two men. You do not need to consider UK regulatory issues of compliance.

Question 4

Lumbar Plc is a timber grower in the Congo basin. The company owns 1,000 sq km of land where it grows timber. The company sells timber to pulp mills which are further sold to various paper mills. The company has various machines which are used for cutting the timber. The company transports the timber in trucks which run on petrol.

Required:

(a) Determine the various elements of costs which would go into the process of manufacture if the company were to adopt the full cost accounting method.
(b) State a few steps which the company and the government can take to act in a socially responsible manner.

Answers to Self-Examination Questions

Answer to SEQ 1

IT Zone can ensure corporate governance by adopting the following practices.

IT Zone can a global ethics and compliance programme. The programme should have the full support of the top management of the company. The objectives of the programme should be:

fostering the highest ethical standards among the personnel of the company

ensuring the prevention of any alleged misconduct and / or violation of law by any personnel of the company through early detection and appropriate reporting
complying with the government standards, set forth by the United States Sentencing Commission's Organisational Sentencing Guidelines

The organisational guidelines which are built into the programme should include the following standards:

The company’s global policies and country-specific procedures should be available to all employees through the personnel and policies website on the internet.

The ethics and compliance programme should be headed by the general manager (corporate governance).The general manager should report annually to the board of directors.

All personnel should be required to undergo six training programmes which should be specially designed by the company to train the personnel for their jobs. In addition, the company should communicate to its employees on all topics which are relevant to the employees and the company.

A helpline should be available, which will enable confidential and anonymous reporting of suspected violators of the company’s business ethics.

Matters should be consistently and fairly investigated, by use of standard investigative protocols.

Answer to SEQ 2

Directors as insiders and managers control information flows and executive directors with day to day involvement have most control unlike the non-executive directors who rely on the chairman and their own insistence to receive the right information.

Shareholders are entitled to enter into dialogue but rely on the decisions of the board regarding the extent of information they receive beyond that which is legally required. Asymmetry refers to the natural imbalance between managers who control the business activities and shareholders who control the company through voting and share transactions as regards the extent of information they receive. The shareholders can encourage and put pressure on the board for more disclosure and through dialogue may be able to change the culture, however their power is limited.

Answer to SEQ 3

The UK unitary board employs a single balanced board with executive and non-executive directors and ideally an independent non-executive chairman. The whole board is responsible for supporting the executive management in generating long-term value added for shareholders and to account to the shareholders for long-term performance. The board will focus on policy formulation in terms of purpose, objectives and vision, with supervision of management both in a performance and compliance role, with accountability to shareholders and wider stakeholders and ultimately providing a creative input into strategic thinking.

An effective board will also set the tone and culture and lead in the setting and compliance with values and standards. The board, particularly through its chairman will create an effective dialogue with shareholders and in particular will engage institutional shareholders. The board with its mix of executives and non-executives keeps discussion in one place and integrates the checks and balances of the non-executive directors over the executive directors and managers. The single board is both a governing and managing body and works as a team. The single board creates one team with one purpose but allows the non-executives to exercise their supervisory role and challenging role within the team in face to face contact and with access to the information they need.

The German two-tier board system separates the managing role of the managing board from the supervisory role of the supervisory board. The managing board of executive directors undertakes strategic thinking, formulates plans and policy and supervises sub-board executives. The supervisory board of non-executive directors led by a chairman works with the executives considers major plans and proposals and reviews performance; it also appoints the executives and deals with their remuneration. Both boards will communicate with the shareholders with the executives dealing with business issues and the non-executives overseeing financial and operational reporting to investors and other stakeholders. The supervisory board takes on a role of representing stakeholder interests.

The two approaches have similarities and all the same roles are covered but the unitary board is generally seen as being more focused on delivering shareholder value with essential checks and balances whilst the two-tier board has a broader stakeholder view in delivering success.

Answer to SEQ 4

(a) The various cost which would go into the entire process of manufacturing are:

- cost of labour
- cost of machinery used for cutting the timber
- cost of the energy used in the manufacture of the machine used for cutting the timber
- cost of repairs on the machine
- depreciation of the machines
- transportation costs
- overheads such as selling overheads and administrative overheads
- cost of pesticides and fertilisers used on the timber
- charge for use of soil on which the timber is grown
- cost of replanting trees
- cost of compliance with the various labour and environmental laws such as compliance with forestry standards, maintenance of public health and safety compliance
- additional costs paid to bodies such as Forestry Stewardship Council for habitat protection

All the above costs are part of the cost of timber, which is to be embedded into the cost of the paper which is manufactured.

(b) In order to take into account the social and environmental accounts of its activities, the company must make transparent it activities in the areas of felling, maintaining soil, habitat, biodiversity, health, safety, employment practices, liaison with local communities, etc.

The company must maintain the highest standards of environmental management systems and get the same audited at periodic intervals. The company must find eco-friendly ways of transportation (such as use of bio-gas) and machines used for felling of trees. The company must develop a system to maintain sustainable costs.

Government must have a policy of imposing fines on companies which break the environmental rules and also increase the funding of the environmental protection agencies monitoring the soil habitat to ensure that the existing legal regime is operating efficiently.

The company can report details of its environmental management system to its shareholders. This would display its commitment towards efficient environmental management systems, corporate responsibility and the implementation of voluntary initiatives and codes of conduct.

Such reporting would help satisfy the demands of stakeholders and also enable the company to track its own progress and identify internal strengths and weaknesses towards environmental and social impacts. It would enable the company and its stakeholders to measure the company's adherence to the defined environmental policies, goals and objectives and it allows stakeholders to participate in corporate goal-setting.

SECTION D

ETHICS

D1

STUDY GUIDE B1: ETHICS

Get Through Intro

Businessmen have to make decisions that sometimes have moral or ethical dimensions. Professional accountants may be involved in the decision-making process or be in a position where they need to consider ethical issues.

Ethics and morals are both concerned with what is right and wrong.

Business ethics is concerned with doing the right thing, however what is right for the business may not be right for all stakeholders and for society.

Moral theory often has an underlying view as to what is good but recognises that there may be conflicts even in doing what is right and good.

Ethical theory provides frameworks to help make the right decision and to understand our reasoning so that we can explain it. Ethical models also help us to understand other people's views and broader issues beyond our often simplified domain.

Professional ethics includes specifically the codes that professional accountants should follow.

Actions and decisions can be 'improved' and that is an objective of our study.

We do have to accept that some people and some people in some situations may not have morals or may ignore morals.

Learning Outcomes

a) Explain and illustrate the meaning of business ethics using information in a given scenario.
b) Identify and explain the role of codes of ethics in private and public companies or state owned companies
c) Identify and explain the ethical dilemmas faced by accountants in the private and public sectors
d) Identify and explain in the context of a given scenario how business ethics; Virtue ethics and moral duties may be linked
e) Identify and explain Ethical theories; Normative Theories; Teleological Theories; Deontological Theories
f) Identify and assess the link between professional ethics and corporate social responsibility
g) Identify and explain how business governance is associated with Compliance and whistle blowing; Global Competition
h) Identify and explain Ethical Decision Making and judgment

1. Explain and illustrate the meaning of business ethics using information in a given scenario. Identify and explain the role of codes of ethics in private and public companies or state owned companies [Learning Outcomes a and b]

1.1.1 Explain and illustrate using information in a given scenario the meaning of business ethics

It widely accepted by majority of scholars that business ethics is the capacity to reflect on values in the corporate decision-making process, from it is determined how these values and decision affect various stakeholder groups. The management establishes ethical standards which are guiding on how the corporate can use these observations to build ethical behaviour. Ethical manager strive for success within the confines of sound management practices that are characterized by fairness and justice. In this case, the businesses use ethics to guide the process of making and evaluating business decisions in various societies. Business ethics concerns itself with adhering to the social principles of the situations in which business takes place.

Ethics can be applied in various areas of the business in order to guide the business operations: The importance of business ethics reaches far beyond employee loyalty and morale or the strength of a management team bond. As with all business initiatives, the ethical operation of a company is directly related to profitability in both the short and long term. The reputation of a business from the surrounding community, other businesses and individual investors is paramount in determining whether a company is a worthwhile investment. Business can exhibit the ethical benefits the among the groups of stakeholders as follows:

The leaders or management team sets the corporate strategy, practices and behavior based on ethical principles, so that leaders within an organization can direct employees. Either, the ethical principles are used to guide them in making decisions that are not only beneficial to them as individuals, but also to the organization as a whole. Building on a foundation of ethical behavior helps create long lasting positive effects for a firm, including the ability to attract and retain highly talented individuals and building and maintaining a positive reputation within the community. Running a business in ethical manner helps the team leader to further ethical behaviors and create stability within the business. An ethical business attracts investors. A business that promotes ethics in its management and operations create an investment-friendly environment. Investors like putting their money where they are sure it is safe. Also, an ethical oriented company is bound to avoid fines by complying with the law. They normally file their tax returns in time as well as making sure that they offer quality products and services.

Furthermore, a business that values ethics attracts more suppliers. Suppliers are always attracted to a company that appreciates their service and pay promptly. But, on the other side the business partners keep their eyes are on business which leaders are working ethically. When the businesses manage to attract partnership it also helps expand the market and improve business relations. In order to withhold a good partnership relation, reputation must be built on a strong business ethics foundation. Similarly, ethical practices among the business leaders is allowing for healthy competitions in the market. It is common to find two or more companies that offer similar services and goods. A company characterized with ethical behavior will not engage in malpractices such as spreading false information about the other company or lowering their prices. Instead, they will allow the customers to choose where they like.

Employees always want to stay longer in a business where the employers value their rights and their basic needs are satisfied. Ethics among the employees can be induced by company management, when leaders manage the organization in an ethical manner the employees can adopt and follow in those footsteps. Employees would make better decisions in a given time when business ethics is applied as a guiding principle. In this regard the business increases productivity as well as employee morale. Also, employees can complete can complete their work with assured honesty and integrity and ethics become an integral benefit for the whole organization. Consequently, employees who work for a corporation can perform their duties at a higher level of loyalty to that organization. On the other side ethics can encourages teamwork whereby, employers and employees who trust one another work together harmoniously and effectively.

A reputation build on good ethics helps create a positive image in the marketplace. This, in turn makes customers trust products and services offered by company. They also pass information to their friends and family, hence it assists to create loyalty among customers. Business ethic is that aspect of corporate governance that has to do with the moral values of managers encouraging them to be transparent in business dealings. Business ethics takes into consideration the feelings of customers in fashioning out the services or goods that is given to our customers. It also takes into account the interest of other stakeholders. Good business ethics is the backbone of every forward thinking business.

On the other side, ethics can assist to attract and increase the number of customers which leads into an increased demand. Therefore, more goods and services are sold. It may seem that a little selfishness might foster business growth sustainability; however this is never the case. Selfish or unethical actions may seem to give your business a temporary boost, but they will thwart your long term goals. Ethical action is the key to sustainability and success in business.

1.1.2 Business ethics and its importance or relevance to good practice

Business ethic is that aspect of corporate governance that has to do with the moral values of managers encouraging them to be transparent in business dealings. Business ethics takes into consideration the feelings of customers in fashioning out the services or goods that is given to our customers. It also takes into account the interest of other stakeholders. Good business ethics is the backbone of every forward thinking business. This is more important now that consumerism has rooted deep into the heart of the customers. Consumerism is a term that is used to explain the rights of customers and the position of the law as far as knowing the content of what they consume is concerned.

1.2.2 Government Guidelines for Ethical Practices for Private Companies and public companies

Private companies are small or medium-sized businesses that are privately owned by an entrepreneur, a partnership or a handful of investors. Although private companies are not required to be as transparent as a public corporation, most government guidelines are the same regardless of a company's size in order to protect consumers, employees and investors. Knowing government guidelines for ethical business practices to monitor the industry and help prevent lawsuits, fines and possible jail time.

Why should you develop a Code of Ethics?

The following are the reasons why the both private and state owned companies adopt Code of Ethics:

1.2.3 **Code of ethics helps to demonstrate to employees it is a responsible company**

Developing Code of Ethics is one way or the other to communicate to the entire organization exhibit to for to employees that the business is committed and responsible. The new employees will be able to know the company standards and expectations. Also, culture can grow among the employees depending upon how the management is strictly adhering to the code of ethics. This kind of company culture creates a kind of positive peer pressure to maintain a high level of work consistent with the values of your company.

1.2.4 **It shows customers how the business value the integrity**

Also, codes of ethics create trust and it is promise for customers that they are reassured to receive quality services and products through the given Code of Ethics. It is from this understanding the customers feel that the company values its integrity and it can operate accordingly. Likewise it gives confident to the other third party groups also it helps the company to exits the culture of responsibility and honesty.

1.2.5 **Promotes innocence and prevent violation of ethics**

The organization maintains code of ethics to promote innocence among the employees. It assists the organization to address matters affecting profitability, integrity and reputation of the employees and business as whole. For instance, implementing code which keeps good working condition and environment protection. It is important for the organization to have specific Code of Ethics attending specific standards and expectations of the staff. Also, the codes will be used to sensitize the employees towards the things that may not have been obvious to them and avoid inadvertent, yet potentially harmful, missteps.

1.2.6 **Provides a clear point of reference when enforcing corrective action**

Code of Ethics is one of the crucial parts of company culture, whereby ethical codes are a documented to serve as a reference for corrective action. Also, it serves as a tool to judge employees who fail to meet standards by terminating or punish them. Likewise, the codes assist to deal with employees' arbitration for those who fail to behave in a manner that meets company standards. Business can so far benefit from codes of ethics as it is used to prevent and avoid potential arm which can be caused by employees' behaviors.

1.2.7 Ethical principles and codes applied in Sales and marketing

According to Borgerson, and Schroeder (2008) marketing can influence individuals' perceptions of and interactions with other people. But ethical marketing is used to harness marketers' actions and avoid distorting those perceptions and interactions. Ethical marketing issues include marketing redundant or dangerous products/services, transparency about environmental risks, transparency about product ingredients such as genetically modified organisms possible health risks, financial risks, security risks, etc., respect for consumer privacy and autonomy, advertising truthfulness and fairness in pricing and distribution. Marketing ethics promotes good practices and prevent wrong doings such as price fixing and legal actions including price discrimination and price skimming. Certain promotional activities have drawn fire, including viral marketing and spam (electronic). Also, creating ads which tend to attack others and sex in advertising.

1.2.8 Ethical principles and codes applied in production

Likewise it is the duties of a company to ensure that products and production processes does not cause harm to individual and environment. In this case the business as te duty to produce products which may not cause arm to environmental (impacts) including: pollution, habitat destruction and urban sprawl. The downstream effects of technologies nuclear power, genetically modified food and mobile phones may not be well understood. While the precautionary principle may prohibit introducing new technology whose consequences are not fully understood, that principle would have prohibited most new technology introduced since the industrial revolution. Product testing protocols have been attacked for violating the rights of both humans and animals.

Either, the benefits of business to code ethics and corporate social responsibility can be summarized as follows:

- Attract customers to consume more of the products produced by the company, which means boosting sales and profits
- Helps to retain the employees and reduce labour turnover as well as increased productivity
- Attracting more employees to work for the business, it helps to reduce recruitment costs and enable the company to attract talented employees
- Also attracting investors and keep the company's share price high, likewise protecting the business from takeover.

1.2.9 Code of ethics assists the employees to observe labor law and safety regulations

Code of ethics assists both employees and employers to observe labor law and safety regulations at work. For instance both employees and employers need observe state laws to ensure there is safety at work and equitable salary and wages as per working environment. These labor laws protect employees from unethical treatment, such as harassment, discrimination, unfair wages, excessive work hours, fraud and scams. For instance the labor Law in Tanzania is helping both employees and employers to determine good working condition, minimum salary and contracts in businesses. For instance, the Safety and Health regulation may require employers in certain industries to abide by additional safety guidelines found in the Act.

Environmental and Health Laws

Profit-seeking private companies hold an ethical, and often legal, responsibility to protect their employees, customers and local environment from potential health hazards. The Health and Safety Act requires employers to provide a safe work environment that will not likely cause illness or physical harm. Inspection agencies such as TFDA the agency for Food and Drug Administration in Tanzania protect consumers by examining production facilities, restaurants and food items to ensure that Tanzanian households are consuming safe and nutritious products. Also, the Laws and regulations by the Environmental Protection Agency (NEMC) protects the local residents and wildlife from the unethical dumping of pollutants that can cause fires, property damage, a toxic environment, disease, deformities, and even death.

Marketing and Privacy Guidelines

The government also has guidelines to protect consumers from unethical marketing and privacy practices, such as false advertising and the misuse of personal data. When marketing to potential customers, it is important that companies do not exagerate claims or mislead their audience. For instance, The Fair competition Commission used to oversee and regulate marketing laws in Tanzania. The agency ensures that businesses respect consumer privacy, are truthful in advertising and product labeling, follow industry guidelines, and refrain from e-mail and phone spam marketing. It also works to ensure the secure storage or disposal of private documents, including financial, legal and customer data. Although it is not mandatory to alert customers to the use of their data, the TCRA prohibits misleading claims regarding customer data usage and storage.

Code of ethics and law to disclose public company reports

Unlike most ethical business guidelines, government requirements regarding public disclosure and transparency are distinctly unique for private companies. National Audit Office of Tanzania under Commissioner Audit General requires public companies to release financial and operational reports to the general public to protect investors and provide data for market analysts. Private companies are generally not required to make financial or operational information public. An exception to this rule would be when a private company begins to take on shareholders. When this occurs, the NAO requires the implementation of disclosure laws, just as it would with a larger public corporation.

2. Identify and explain the ethical dilemmas faced by accountants in the private and public sectors

[Learning Outcomes c]

Ethical dilemma is referred by some authors as what it is not ethical, in this case it regarded as misconduct, corruption, fraud and other types of illegal behaviours. Also, it has been interpreted as wrong doing against principles leading into integrity, honesty, personal values and professional codes. According to Uhr (2002) there two ways to define ethical dilemma, one is the anti-corruption approach and the second is the integrity approach. The anti-corruption approach frames discussion about ethics in negative terms. The integrity approach frames ethics in positive terms. Yet there appears to be general agreement that ethics is about relationships. So ethical dilemma comes into play when individual facing issues which requires judgment about what is ought to be done

(Freakley & Burgh, 2007). Therefore, establishing Codes of Conduct helps to identify standards of official conduct that employees are expected to perform and avoid dilemma.

Ethical dilemma facing public officials

Administrative Discretion

Officials normally exercise their administrative power with discretion. The question is how decisions are to be made to avoid ethical dilemmas. There rules and regulations lay down by legislation within the prescribed procedures. But, the officials have their own discretion to use or abuse the administrative discretion. Especially, when faced with alternatives the choice of the official poses an ethical problem: the choice may be acceptable to only a small section of society. The problem is that the selection of one path of action from among several alternatives is often made on the basis of personal preference, political or other affiliations

Dilemma caused by corruption practice

The ethical dilemma that faces the public servant with regard to corrupt practices as result of private interests primarily concerns his reaction to the situation. If a corrupt practice or an attempt to corruption is discovered, it is quite possible that the official's personal loyalties or party political affiliations may be in conflict with his official duties. Corrupt practices are directly confronted by whistle blowers and other practitioners in public interest. Sometime corrupt people can disclose information for personal gain and cause chaos. Leaking official information at a date prior to the public announcement thereof is a violation of procedural prescriptions and can be an ethical dilemma. Corruption crisis is one among the biggest failures for officials to remain accountable to the public.

Dilemma caused by nepotism or favouritism

Nepotism is a practice to entrust or appoint public official by ignoring merit of principles and give favors to relatives or friends. This may lead into the downgrading of public service quality. This disrupts the esprit de corps and trust and resulting in corrupt administration, owing to the ability of a select few to impair control measures on account of their personal relationship with the policy-maker, and by reason of their not being easily dismissed or replaced by others. In other words, those who are appointed with the view that they will conform to the standards and views of their appointing authority could prove to be problematic.
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Policy making dilemmas

Policy makers are often confronted by conflicting responsibilities. They have specific loyalties to their superiors, but also to society. They have freedom to act on behalf and in the interest of others, but they must also answer to others - their superiors and society – for their actions. The official's obligation to respect the political process may conflict with his view on how the objects of policy making are treated. In other words, the dilemma of the public official is the clash between his view of the public interest and the requirements of law.

Ethical dilemma in accounting profession

In accounting professional the environment can influence the accountants to face dilemmas regardless the firm is either public or private sector. But, what matters here is the responsibility carried out by the accountants and the working environment. Therefore, accountants must remain impartial and loyal to ethical guidelines when reviewing a company or individual's financial records for reporting purposes. Accountants are frequently encounters ethical dilemmas, it the main reason why they should be always vigilant to reduce the chances of outside forces manipulating financial records, which could lead to both ethical and criminal violations. The following are the examples for the sources of ethical dilemma for accountants:

Facing pressure from Management

The management can impose pressure to accountants so as to create balance sheets and financial statements which shows prosperity of the company. The ethical accountants always maintain true reporting of company assets, liabilities and profits without giving in to the pressure placed on them by management or corporate officers. But, unethical accountants could easily be trapped to alter the company financial records and maneuver numbers to paint false pictures of company successes. This may lead to short-term prosperity, but altered financial records will ultimately spell the downfall of companies when the Securities and Exchange Commission discovers the fraud.

Accountants as Whistleblowers

Accounting profession demands the accountants to report discovered accounting violations to the Financial Accounting Standards Board. But, accountants may face dilemma to report as it is an ethical accountant's duty to report such violations, the dilemma arises in the ramifications of the reporting. Government review of company financial records and the bad press caused by an accounting scandal could cause the company's rapid decline and may lead to the layoff of thousands of employees. Executives and other corporate officers could also face criminal prosecution, leading to heavy fines and prison time.

The Effect of being centric or greed

Greed in the business and finance world leads to violation of ethical boundaries in the name of making more money. Accountants ensure that the desire to earn a better living and acquire more possessions should get them way from acting professionally and follow the ethical guidelines for financial reporting. Accountants who are greed they give more priority to their own bank accounts rather than their companies balance sheet becomes a liability to those companies and it may cause real accounting violations, resulting in sanctions.

Omission of Financial Records

Sometimes the account may be forced by executives to omit or leave out certain financial figures from a balance sheet that may paint the business in a bad light to the public and investors. Omission may not seem like a significant breach of accounting ethics to an accountant because it does not involve direct manipulation of numbers or records. This is precisely why an accountant must remain ethically vigilant to avoid falling into such a trap.

3. Identify and explain in the context of a given scenario how business ethics; Virtue ethics and moral duties may be linked

[Learning Outcome d]

Virtue ethics and moral duties has been define by Stan Mack as a the duty to follow a morally correct path. The business owners have ethical responsibilities to stakeholders who count on them to do the right thing. For instance, the business owners have a responsibility of being honest to employees and assisting them on career development. But also, the business owners have a responsibility to respect the customers, who expect to receive exactly what they are paying for.

So far the companies avoid falling because of hiding unethical practices such as fraud and theft from employees and investors. In order to maintain their Stand the companies have to set clear moral standards from the outset. For example, create and enforce a code of conduct that ensures employees treat customers fairly. To avoid even the appearance of unethical behavior, be as transparent as possible in all your dealings with customers, suppliers, employees and the surrounding community. Also, the consumers expect businesses to be good citizens. For example, environmentally conscious consumers often avoid supporting businesses that rely on unsustainable practices or that pollute heavily. Therefore, the business needs to embark on ethical responsibility and consider how morality can affect its profitability.

Virtue ethics

Virtue ethics is person rather than action based. It looks at the moral character of the person carrying out an action.

Moral

Of or relating to character or conduct considered as good or evil: ethical: conformed to or directed towards right, virtuous: esp. virtuous in matters of sex: capable of knowing right and wrong: subject to the moral law.Morality is a Quality of being moral and renders an action right or wrong: the practice of moral duties apart from religion: virtue: the doctrine of actions as right or wrong. Aristotle identifies approximately eighteen virtues that enable a person to perform their human function as follows:

Courage in the face of fear; **Temperance** in the face of pleasure and pain; **Liberality** with wealth and possessions

- **Magnificence** with great wealth and possessions
- **Magnanimity** with great honors
- **Proper ambition** with normal honors
- **Truthfulness** with self-expression
- **Wittiness** in conversation
- **Friendliness** in social conduct
- **Modesty** in the face of shame or shamelessness
- **Righteous indignation** in the face of injury
-

Intellectual virtues

- Nous (intelligence), which apprehends fundamental truths (such as definitions, self-evident principles)
- Episteme (science), which is skill with inferential reasoning (such as proofs, syllogisms, demonstrations)
- Sophia (theoretical wisdom), which combines fundamental truths with valid, necessary inferences to reason well about unchanging truths.

Aristotle also mentions several other traits:

- Gnome (good sense) -- passing judgment, "sympathetic understanding"
- Synesis (understanding) -- comprehending what others say, does not issue commands
- Phronesis (practical wisdom) -- knowledge of what to do, knowledge of changing truths, issues commands
- Techne (art, craftsmanship)

Moral Duty

A duty is an obligation to act in a certain way. Though duties arise from various sources, all duties have a moral dimension. Duties create obligations and expectations. Companies, for example, have many duties including an obligation to treat customers and employees fairly, to assure that their products and services are safe and effective, and to abide by the law. Those affected by a company's actions have a right to expect these duties to be fulfilled. Either, there are two basic forms of duty; prohibitions and mandates. Prohibitions specify things we may or should not do. They are "don'ts", as in don't lie, cheat, or steal. Requirements, on the other hand, are mandates specifying things we must or should do. The 'dos" include be kind, be fair and be respectful. Moral obligations arise from three sources: laws, promises and principles.

1. Law-Based Moral Obligations. Good citizens have a moral as well as a legal obligation to abide by laws; it is part of the assumed social contract of a civilized society. In fact, many laws simply codify ethical standards of conduct fundamental to healthy social relations and effective commerce. For example, the general moral duties to not harm others are embodied in criminal and civil laws prohibiting homicide, assaults, drunk driving, and other dangerous behavior. Similarly, the ethical duty to be honest is enforceable by laws forbidding perjury, forgery, fraud, and defamation among others. Though many forms of dishonesty are not illegal, the moral duty to be honest should be enough to restrain an honorable person.

2. Promise-Based Moral Obligations. The second source of moral obligation is based on a promise or agreement. While not all promises reach the level of an enforceable contract, honorable people and companies recognize and fulfill the moral obligation to do the things they agreed to do, especially if others are counting on them to do so. When we borrow money, promising to pay it back in a week, or tell a friend we will pick her up at the airport, or take a job involving the supervision of other employees, we undertake a moral duty to do what we say we will do and to dutifully perform the responsibilities encompassed in our promises.

3. **Moral Principle as the Basis of Moral Obligation**. The third source of moral obligation is moral principle, a standard of conduct that exists irrespective of laws or agreements. Immanuel Kant expressed the power of moral principle when he said, "Moral principles can be mandated by religious doctrine or derived through rational philosophical reasoning". In some cases, principles such as justice and benevolence simply emerge as the result of an intuitive moral sense. Whatever their source, however, such principles are at the very core of ethics.

Ethical obligations exist in almost every angle of a business environment. Policy and decision-making in areas such as sales, pricing and advertising all involve ethical obligations, as do dealings with staff members, contractors and suppliers. Each has benefits for carrying out an ethical obligation as well as consequences that can cause ethical dilemmas. For example, a business may realize they have an ethical obligation to instruct the sales stall to conduct needs-based selling and not to "oversell." During a month when sales are slow, however, living up to that obligation by not pressuring the staff to "sell" can mean the difference between turning a profit or not.

So far there are internal ethical obligations in business which are related to recruitment and hiring of staff. Also, the business has to ensure safety is maintained as well as healthy work environment and resources are used wisely to avoid situations that have the potential to create a conflict of interest among the stakeholders. In order to avoid dilemma of treating the stakeholders' right, the business has to avoid accepting gifts from suppliers. Meanwhile, the decision to hire the best applicant should be based on the best qualifications. Common supplier-side ethical obligations include considering how and where suppliers get their products and whether to sell products that are not detrimental to the health of customers. Therefore, the suppliers should observe ingredients, date of production and other safety qualities.

Business owners are ultimately responsible for whether a business fulfills its ethical obligations. Accomplish ethical obligation objectives by leading by example. Work with staff members to create ethics standards and a code of ethical conduct. Not only do these actions set clear expectations but may also encourage open communication and discussion regarding ethical dilemmas – and how to solve them – among the ethics team. Conduct ethics training that sets clear expectations and shows staff members how their decisions and attitude towards ethical behavior impacts long-term business.

4. Identify and explain theories associated with ethical and moral view

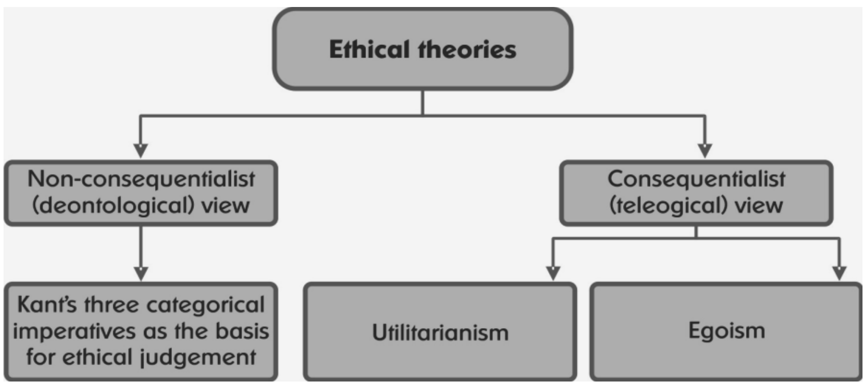
[Learning Outcome e]

4.1 Crane and Matten provide a table categorising major ethical or moral views

	Egoism	**Utilitarianism**	**Ethics of duties**	**Rights and justice**
Type	Consequentialist	Consequentialist	Non-consequentialist	Non-consequentialist
Focus	Individual interests	Collective welfare	Duties	Rights
Rules	Maximisation of self-interest or desires	Act/rule utilitarianism	Categorical imperative	Respect for human beings
Concept of human beings	Man is an actor with limited objectives and knowledge	Man is controlled by avoidance of pain and gain of pleasure 'Hedonism'	Man is a rational moral actor	Man is a being distinguished by dignity
Contributors	Adam Smith	Jeremy Bentham J S Mill	Immanuel Kant	John Locke John Rawls

3.2 Ethical theories are sometimes divided into two types:

Diagram 4: Ethical theories



1. Non-consequentialist (deontological) views

(a) These are theories that **base the moral judgement on the underlying principles** of the decision-maker's motivation. The **answer is right or wrong not because of the consequences that it brings about but because the principles are morally right or wrong**. The German philosopher, Kant's approach is clearly non-consequentialist or 'deontological'. Deontological is based on the Greek word for duty. Deontological ethics, notions based on 'rules' i.e. that there is an obligation to perform the 'right' action, regardless of actual consequences (epitomized by Immanuel Kant's notion of the Categorical Imperative which was the centre to Kant's ethical theory based on duty). Another key deontological theory is Natural Law, which was heavily developed by Thomas Aquinas and is the basis of the Roman Catholic Church.

Example

Beta Plc always attempts to properly apply IFRS in its financial statements. The company consults its Audit Committee and discusses matters openly with its auditors in order to ensure that a true and fair view is given in the financial statements. The company regards objectivity as a fundamental principle that is non-negotiable.

Kant applies a deontological view of ethics in his works. **Deontological ethics are duty-based ethics**. According to Kant's view, individuals have to obey moral laws which are universal. These are to be obeyed by all irrespective of the consequences because they are fundamental principles or categorical imperatives e.g. do not lie. An action is right if it is done out of a sense of duty and responsibility. E.g. parent bringing up his child.

(i) Kant has set out the following three categorical imperatives as the basis for ethical judgement.

A proposition which applies to one person should not change if it is applied to another person or set of circumstances e.g. it is wrong for one to steal and also for anyone to steal. Therefore this proposition has universality. According to this proposition, **one must act in such a way that or action, becomes a law which is universally acceptable**. Therefore if the maxim or rule governing our action is not capable of being universalised then it is unacceptable.

This proposition sets out that **one must treat people as an end in itself and not as a means to an end**. In short, we must always recognise people's rights as unique autonomous beings, e.g. no one can have slaves because the owner would not have respect for his slave and therefore it would be against the categorical imperative.

According to this moral proposition, **every autonomous being is subject to universal laws which they make for themselves**. The autonomous being must also consider that those laws would be binding to others.

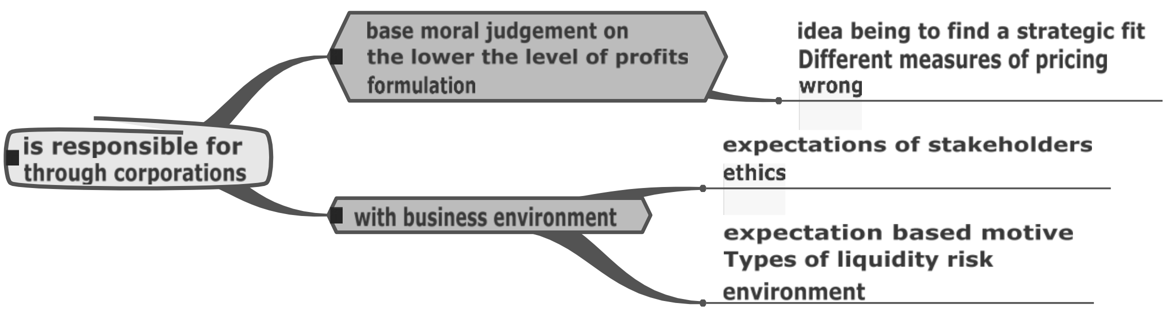
(ii) Criticism of Kant's ethics

The Kant imperatives **deal with only absolute rights and wrongs. Actions are only right and wrong without any scope for a "grey area".** For example, to lie is always wrong.

Duties which are in conflict lead to moral dilemmas. Kant's ethical theory **gives no solutions to** such **moral dilemmas.**

One cannot always take actions without having regard to the consequences. For example, launching a new drug to treat cancer which has serious side effects.

SUMMARY



2. Consequentialist (teleological) views

Virtue ethics, derived from Aristotle's and Confucius's notions, which asserts that the right action will be that chosen by a suitably 'virtuous' agent.One modern approach which attempts to overcome the seemingly impossible divide between deontology and utilitarianism (of which the divide is caused by the opposite takings of an absolute and relativist moral view) is case-based reasoning, also known as casuistry. Casuistry does not begin with theory, rather it starts with the immediate facts of a real and concrete case. While casuistry makes use of ethical theory, it does not view ethical theory as the most important feature of moral reasoning. Casuists, like Albert Jonsen and Stephen Toulmin (The Abuse of Casuistry 1988), challenge the traditional paradigm of applied ethics. Instead of starting from theory and applying theory to a particular case, casuists start with the particular case itself and then ask what morally significant features (including both theory and practical considerations) ought to be considered for that particular case. In their observations of medical ethics committees, Jonsen and Toulmin note that a consensus on particularly problematic moral cases often emerges when participants focus on the facts of the case, rather than on ideology or theory. Thus, a Rabbi, a Catholic priest, and an agnostic might agree that, in this particular case, the best approach is to withhold extraordinary medical care, while disagreeing on the reasons that support their individual positions. By focusing on cases and not on theory, those engaged in moral debate increase the possibility of agreement.

(a) These are theories where the **moral judgement is based on whether the outcome is right or wrong**. These are sometimes referred to as 'teleological' based on the Greek word for goal.

Example

Theta Plc sells a child abortion drug because it believes that it is serving customers who wish to terminate pregnancy for pragmatic or medical reasons.

According to this theory, **if an action has good consequences then it is the right thing to do and vice versa**.

Deontologists believe that actions which are right bring about a good state of affairs, i.e. rightness is dependent on goodness.

Teleologists base their moral theory on the premise that an action cannot be right if the consequences are not right i.e. a teleologist would say that a person acted wrongly if a person tried to do good to another person but the results were bad.

This approach to ethics can be summarised as follows:

(i) The moral value of an action depends on its consequences.

(ii) Actions by themselves do not have any moral values.

(b) There are two branches of teleological ethics: utilitarianism and egoism.

(i) Utilitarianism

This theory is based on the principle that **an action is right if it will lead to giving the maximum satisfaction to the maximum number of people, i.e. an act is good if it provides the greatest good to the greatest number of people.** Doing good for society is the priority and self-interest is not seen as good, acting for others is good. Utilitarianism is based on practical consequences of various policies are evaluated on the assumption that the right policy will be the one which results in the greatest happiness. This theories main development came from Jeremy Bentham and John Stuart Mill who distinguished between an act and rule utilitarianism morality. Later developments have also adjusted the theory, most notably Henry Sidgwick who introduced the idea of motive or intent in morality, and Peter Singer who introduced the idea of preference in to moral decision making.

Example

Rex Pharma manufactures a drug to treat cancer. This drug gave positive results to the majority of its users. However, the drug did not give positive results to a very small minority of the users. Therefore the manufacture of the drug would be a right action since it would lead to the maximum satisfaction to the maximum number of persons.

Therefore this theory is situational and hence subjective.

(ii) Egoism

This theory is based on the principle that **an action is right if by giving the maximum satisfaction to an individual it leads to benefits for society as a whole, i.e. it deals with the concept of "I". 'I am right to do this because it benefits me (and society)'** If a decision-maker takes a decision which leads to meeting his short-term /long-term goals, the decision is said to be right if it also does good for society as a whole. Self-interest can be good if as part of an economic or social system it delivers welfare benefits. People act for themselves and in turn do good for all but their motivation is their own self-interest.

Some writers explain egoism as if it only requires an action to be of benefit to the individual to be morally acceptable. That is not what writers like Adam Smith intended. Smith had a broad view of how social and economic systems worked and integrated the motives of individuals and firms into an overall system.

Although self-interest may appear to be a selfish desire some would argue that being selfish is greedy and implies little or no regard for others.

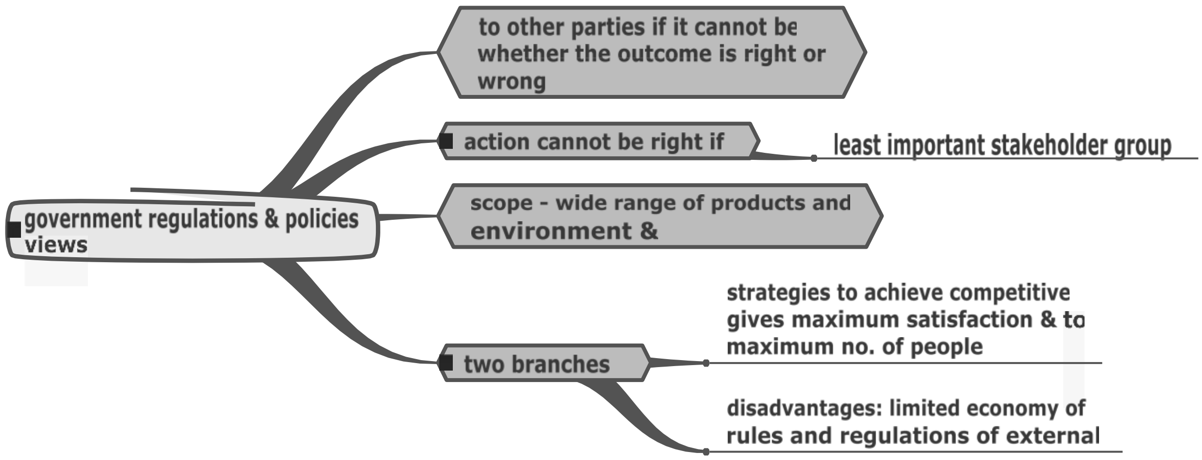
Example

Flexo Pumps Plc charges Tshs50,000 for each unit it sells in order to maximise its profits in a competitive market. Some potential customers cannot afford the price and are unable to buy the product.

At a board meeting the HR director argues that this is wrong and asks why the company cannot reduce its price and settle for a lower profit.

The CEO explains that customers who pay Tshs50,000 are very satisfied and that shareholders receive their required return. The CEO explains that the market price will not fall if they reduce their price and that the action would not give sufficient benefit to outweigh the cost.

SUMMARY



3.3 Deontological versus teleological ethics

Deontologist ethics	Teleologist ethics
Under this theory, the means are more important than the ends. Deontologists believe that actions which are right bring about a good state of affairs, i.e. rightness is dependent on goodness	Under this theory, the ends are more important than the means. Teleologists base their moral theory on the premise that an action cannot be right if the consequences are not right
Deontological ethics are absolute and objective	Teleological ethics are subjective and relative i.e. they are situational

Test Yourself 4

Hole Plc has a non-current asset with a carrying value of Tshs2,000 million. Reliable evidence obtained at the end of the reporting period indicates that the value after impairment is Tshs1,000 million.

The company's financial statements are required by law to give a true and fair view of the company's financial position. Financial director Jim Bone, a qualified accountant, argues that there must be a write-down of Tshs1,000 million since the information provided evidence of conditions existing at the reporting date.

Chairman Roy Skull argues that, since the information was received at the end of the reporting period, morally the company does not need to make an adjustment this year as the fall in value could be argued to have taken place after the year-end. He argues that the share price will fall if profit expectations are not met and that his view is right since it protects shareholder value.

Required:

Could the chairman's argument be against the Kantian concept of a categorical imperative? If so, why?

Test Yourself 5

Soft Fabrics manufactures textiles. The company is located in a village in the UK.

The process of manufacture generates a chemical by-product. There is no law which restricts the dumping of this type of chemical into rivers. The company has the stated objective of being socially responsible.

Required:

State the actions which the company might take if it practiced egoism.

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5. Identify and assess the link between professional ethics and corporate social responsibility

[Learning Outcome f]

Professional ethics encompass the personal, organizational and corporate standards of behaviour expected of professionals. Professionals and those working in acknowledged professions, exercise specialist knowledge and skill. How the use of this knowledge should be governed when providing a service to the public can be considered a moral issue and is termed professional ethics. Professionals are capable of making judgements, applying their skills and reaching informed decisions in situations that the general public cannot, because they have not received the relevant training. One of the earliest examples of professional ethics is the Hippocratic oath to which medical doctors still adhere to this day.

Ethics refer to the fundamental principles of an individual or a group. Social responsibility is how a business performs its activities to meet its wider obligations toward the society and environment, such as by avoiding activities which may be harmful. Strategic planning is an essential preliminary step in the corporate world in which senior management defines the organization’s strategy, direction and decision-making. Ethical values and social responsibility serve an important role in the strategic planning process.

Social Responsibility to the Stakeholders

Professionals must ensure that strategic decisions are reached after taking into account the possible impact on the stakeholders. Stakeholders are suppliers, customers, societies and anybody who is affected by the activities of the business. A socially responsible company treats stakeholders equally is an impact of responsible and accountable professionals towards the stakeholders. Wider perspectives also have to be considered in terms of environmental and social impact of planned activities.

Transparency

Professional Members should provide information transparently and honestly to help all involved discuss, debate and reach better decision-making. This enables the team to identify and monitor any potential risks which may arise and find an alternative solution. In terms of social responsibility, transparency also enhances the company's credibility toward its external stakeholders.

Independence

Professional meetings should provide an opportunity for management team members to raise concerns and come up with new ideas. It should be conducted in a professional and coherent manner and everyone should be independent in providing ideas without fear or hesitance as this helps improve the quality of the discussion and the decisions reached.

Respect

Professional members should respect others' opinions by giving them the opportunity to speak and by listening to their ideas with interest. Constructive comments develop more intellectual discussion but should be dealt with in a way which does not hurt the other members' feelings. Discussion in a friendly environment improves the relationship among the members, strengthens the strategic planning process and results in better decision-making.

Fairness and Truthfulness

During the planning process, the team of professionals should take a fair and truthful look at the possible risks and impact of decisions reached. These need to be thoroughly considered to maintain the welfare of the stakeholders such as employees and the society at large. Professional members should be truthful and frank in providing ideas and comments.

Promoting Professional Ethics and Social Responsibility

Conclusively, Companies can promote professional ethics and social responsibility by specifying a clear code of ethics in the company handbook. Companies can also choose to implement a incentive system that encourages ethical behavior. As an example, employees who consistently make ethical decisions can be applauded and given positions of greater responsibility. Product development teams can include the betterment of the community as a whole as a goal when developing new products.

6. Identify business governance is associated with compliance, whistle blowing and global competition

[Learning outcome g]

Business governance is concerned primarily with protecting weak and widely dispersed shareholders against self-interested directors (Guardians of the Company's assets for the Shareholders) and managers (who use the Company's assets). So in order to keeping the interests of the stakeholders under custody, the business has to establish ethical compliance management. The main focused of business governance is to prevent businesses from collapsing. For instance, an attempt carried by government of Tanzania to protect the public companies such as air Tanzania and Railways Company. The interventions were guided with understanding of compliance standards, opinions from whistle blowers and global competition environment.

Elements of business Governance

First of all there is a Good Board practices which deals with clearly defined roles and authorities, duties and responsibilities of directors should be understood and the board should well-structured with appropriate composition and mix of skills.

Another element is control environment, in this particular element there should be appropriate board procedures, director remuneration should be in line with best practice and the board has to be self-evaluation with well trained personnel. Also, there should be internal control procedures, risk management framework present, disaster recovery systems in place and Media management techniques in use. On the other side, there should be business continuity procedures in place; independent external auditor conducts audits and Independent audit committee established. Meanwhile, the system as to equip with internal Audit Function, Management Information systems established and Compliance Function established

Also, there should be transparent disclosure, this includes disclosure of financial Information, Non-Financial Information disclosed and Financials prepared according to International Financial Reporting Standards (IFRS). Companies Registry filings up to date, High-Quality annual report published and Web-based disclosure

Likewise there should be a well-defined shareholder rights which deals with minority shareholder rights formalized. Well-organized shareholder meetings conducted following policy on related party transactions. In this regard the policy should express extraordinary transactions and clearly defined and explicit dividend policy

Finally there should be board commitments whereby, the Board discusses corporate governance issues and has created a corporate governance committee, and The Company has to exits that it is a corporate governance champion, also deal with corporate governance plan improvement and creates appropriate resources which are committed to corporate governance initiatives. Policies and procedures need to be been formalized and distributed to relevant staff. A corporate governance code should adhere with the code of ethics.

Business ethical compliance management

Compliance management is an organization governing mechanism that detects and prevents corporate crimes as well as mistakes. The system helps the organization to minimize the damage of arising issues by preventing them from occurring through improved business behaviors management and control the processes. Generally, compliance management helps people at all levels in the organization to discover or uncover compliance incidents. The scope of compliance management varies from one corporation to the other. In order to ensure there is a strong foundation on compliance management, the business as to comply with laws and inner regulations. Hence, to develop and maintain self-regulation compliance management system the following thing must be taken into consideration:

`The organizations as to establish compliance standards and procedures to be follow. Also, there should be a discretionary of authority, conducting training programs and effective communications on compliance standards and procedures. The organization should make sure that there is a system to monitoring, audit and whistle blowing report on wrongdoing without fear of retribution. Providing incentives for employees and others to come forward to report issues and take reasonable measures in response to wrong doing and prevent future incidents from occurring. In this regard the board of directors has to create an internal control, in order to provide reasonable assurance on:

Maintaining effectiveness and efficiency in operations by make sure that there is reliable financial reporting system and ensures there is compliance with applicable laws and regulations. Based on the analysis, the risks are managed through policies, procedures, techniques and mechanisms. Control activities include approvals, authorizations, verifications, reconciliations, performance reviews, separation of duties, password procedures and inventories management.

Whistle blowing in organization

Whistle blowing is referred as a process to uncover the wrongdoing or misconduct within the organization or against the public. Whistle blowing policies and guidelines should be implemented within organizations and companies of any size, and whether publicly or privately owned. The organizations are using whistle blowers as tools to govern and reinforce ethical behaviour among staff and employees. These policies need to be written and available to employees in order to be executed and effectively handled internally by the organization. Inserting a whistle-blowing policy into your corporate code of ethics is a good place to start.
Ethics codes incorporate the principles and purposes of the organization and set the general guidelines to follow under the policy. Whistle blowing policies are generally included in an organization's code of ethics or code of conduct. A code of conduct should be well spelled out for by every employee to implement them. They usually cover a wide range of policies and standards that serve as a framework to guide employees. The whistle blowing policy should be implemented in writing and be shared as part of the company's hiring and contracting process, as well as on its internal intranet. There should be a guideline drafted in order to manage whistle blowing activities and the processes for instance:

To identify things which can affect the whistle blowing process such as types of violations covered under regulations in industry and company. Also, ethical codes should stipulate how the organization can access the current rules. Knowing the kinds of violations they are required to be reported. Also understand to whom violation report is needed and what confidentiality rules are applied to communicate. Likewise it gives confident for the whistle blower to be protected from retaliation and their rights should be observed. There should be a clear process and procedures go about in order to effect and resolve the issues raised by whistleblowers. Create continuous training opportunities on how to deal with ethical dilemmas. Support measures may be: performance and reward plans, ethical leadership, and ethics committees.

But, in order encourage internal reporting and stimulate ethical situation the organization need to observe the following aspects: the organization as to encourage internal reporting. Promoting internal whistle blowing that can identify problems before they become a public issue. Also identifying means from which crimes like corruption and fraud can be prevented. Likewise, company has to create internal compliance and ethics committees to review reports and maintain anonymity. Providing quick and effective action – set out a time-scale for dealing with eventualities. Provide feedback. Either, it is important to ensure confidentiality, maintaining records and appoint a chief of ethics officer or ethics committee.

Ethics in global Competition

Governing global completion is an issue which as multiple dimensions with huge impact to organization welfare. Therefore is a need to find ethical mechanisms that can help the organization to avoid consequences. Porter (2006) recommends that there six domains of applied ethics which can be used to the govern competition issues at organization level, at the national and global level as follows:

- Decision ethics, or ethical theories and ethical decision processes
- Professional ethics, or ethics to improve professionalism
- Clinical ethics, or ethics to improve our basic health needs
- Business ethics, or individual based morals to improve ethics in an organization
- Organizational ethics, or ethics among organizations
- Social ethics, or ethics among nations and as one global unit

7. Identify and explain ethical decision making and moral judgment

[Learning outcome h]

Moral judgment

Moral judgment is the process by which one defines what is wrong, good, bad, zany, absolutely bizarre, surreal, quasi-reasoned, ethical vs unethical vs neutral or adjoining deviations to the previous as stated that warrant categorizations of their own accord depending on the nature of the object or entity to be judged (as one's reasoning has to be aligned for justice), fundamentally, in sentient human perspective, against some standard of 'good' as established by rational consensus formed from an established ideal by whose commune the incumbent exhibiting or contradicting moral judgment. Moral judgments involve a process of opinions and evaluations that usually comprise the following:

1) Inaction
2) Intention
3) Motive
4) Character Trait
5) Situational Aspects
6) Environment
7) Historicity that Led to the Cause
8) Retribution and Compensation as Fit for Conformance of the Individual or Matter in Question Back to an Established Consensus [that may need to be evaluated back to step (1) considering new facts as they emerge]

Decision making in business ethics usually requires companies to identify specific ethical standards, which often means different things to different people. As organizations continue to grow and expand, new individuals are hired who may not have the same ethical standards as individuals already working in the company. A difference in ethics often changes how individuals approach the decision-making process. Companies often use the organization's mission statement to build a framework for helping individuals make ethical business decisions.

There are five types of ethical standards: utilitarian, rights, fairness or justice, common good, and virtue. Utilitarian ethics is a standard that attempts to do the most good and limit the amount of harm for each individual. A rights approach protects and respects the moral rights of individuals impacted by decisions. The fair or just style seeks to create equality among all individuals while the common good method focuses on bettering society as a whole. The virtue tactic centers on the ideal virtues necessary for promoting individuals for the company.

Distinguishing Morals from Ethics in Decision Making

For our purpose we will reserve the term "moral" for use in a **personal decision making** context. This means that we will use "moral" when dealing with personal or life decisions with a focus on "right conduct" as the result of a personal choice. Ethical decision making will be reserved for use in a **group decision making** context. Specifically, we will address ethical decision making in business as providing the guiding requirements or goals for right conduct. These requirements often come as the result of organizational definition, agreement, or long-standing custom. There is clear recognition that ultimately a personal choice must be made with respect to right conduct, but business ethics will provide the assessment framework for correct behavior in the business organization.

The Important of various sources of ethical standards in decision making

A large portion of the study of ethics deals with the approach or source of the principles or standards to be used for ethical decision making in business. A number of schools of thought have developed that include the following approaches:

- Utilitarian
- Moral rights
- Universalist
- Cost-benefit
- Fairness or justice
- Common good
- Virtue
- Deontological (based on study of moral obligation)
- Theological
- Contextualist
- Principle-based
- As well as others

It is important to know that, most of the approaches mentioned above, can lead the decision maker to similar choices for most decisions involving ethics. There are obvious and sometimes notable exceptions, but they often involve ethical dilemmas that can only be addressed in the context of the specific decision being made. Here are some of criteria which can help ensure appropriate ethical considerations are part of the decisions being made in the organization: For instance, compliance is one of the criteria guiding an individual to conform to the company's values and code of ethics. But, there should be a way of examining if the mentioned criteria can meet or exceeding the legal requirements. Individuals should endeavor to promote good practice and reduce harm. Likewise, responsibility is another criterion which determines our good citizenship as it assists to respect and preserve rights of others within and outside the organization. The other things are to promote trust or a state of being honest with open communication and build an organization reputation.

Self-Examination Questions

Question 1

Burger Kitchen owns a chain of fast food stores in UK. Give two examples of moral decisions in the business, which will arise at each of Kohlberg's stages of moral philosophy.

Question 2

In the context of a business, explain whether there is any relationship between teleological ethics and the profit-making objective of the business. In addition, give three examples of actions taken by a business which aims to earn profits and which believes in teleological ethics, which would otherwise seem wrong.

Question 3

Jack is a qualified accountant working as financial accountant for Wood Plc. Jack is drafting the annual accounts and has been discussing the figures with the chief executive and the finance director. The profit before tax of Tshs200,000 million is lower than they expected and both men have demanded that Jack look at two issues again in order to bring the profit up to the Tshs300,000 million that the market expects.

The first issue is an impairment adjustment relating to a property following an independent valuer's report that amounts to Tshs60,000 million. The two men tell Jack to ignore the valuation report since they do not agree with it. The second issue is a loss that has been recognised on a long-term contract on the advice of the operations director and the project manager following a re-forecasting exercise.

The chief executive tells Jack that it is up to him to get the figures right 'we do not accept the valuation, in any case the price of property will recover over time, the loss on the contract is too prudent. We can take the loss when it does come!'

Required:

Explain the ethical issues for Jack.

Question 4

Benson & Co is an accountancy firm employing Laura and Martha, qualified systems auditors. The firm carries out assurance assignments for various clients.

1. The clients of the company are small and medium-sized. Often the audit team members offer advice to the management /employees of assurance clients regarding the journal entries to be made. They also advise management on the preparation of financial statements.

2. Benson & Co has following projects under negotiation.

   They have been offered an assignment to design a new ERP system for one of their assurance clients, Johnson Pharma, which manufactures medicines.
   Benson & Co has also received an offer from the Quick Finance Bank as external auditors. Benson & Co do not have enough staff to provide the service properly and have appointed staff on an assignment basis.

As Benson & Co is a newly established accounting firm, they are very keen to increase their client base. They have offered to carry out the assignments for annual fees of Tshs120,000,000 when the fees for the same services would normally have been Tshs225,000,000.

Required:

(a) Assess the ethical threat faced by the company if they accept the assignment offered by Johnson Pharma.

(b) Comment on Benson & Co's practices in accepting the assurance assignments.

Question 5

Mars Ltd manufactures cars. All the raw materials used in the production of cars are locally sourced. The company is considering importing an alternative source of raw materials in the future.

Mr. Sharp is the company's new accountant. Whilst preparing the annual accounts, the accountant noticed that there was one import transaction during the year. This was for 1% of the total purchases made. The company had not adhered to its procurement policy of calling for tenders and deciding on the best vendor. Mr. Sharp ignored the issue.

The company has 250 employees. Employees are given a transport allowance based on their job grades. Mr. Sharp was given a travel expense voucher of an employee to approve. Whilst checking the voucher he noticed that the employee had not attached a receipt. His assistant informed him that it was common practice for employees to claim the maximum allowance for which they were eligible. Mr. Sharp immediately sent out a circular to all employees that, in future, all transport expense claims would have to be supported by receipts.

The manager noticed that the factory inspector had made adverse comments about safety measures on the factory premises. Mr. Sharp discussed the matter with the HR manager and board members and the company took measures to improve safety at the factory. The company has a practice of paying the personal expenses of the company director from petty cash. The payments made to the director are not recorded in the books. Periodically the director would repay the cash to the cashier and settle his account.

Required:

Analyse and explain the ethical issues based on which Mr. Sharp has acted in the various situations mentioned above.

Answers to Self-Examination Questions

Answer to SEQ 1

The following are examples of Kohlberg's stages of moral philosophy which can be applied Burger Kitchen:

Stage 1

Should one not pay taxes?

The simplest answer is no since it is against the law.

Stage 2

Should I employ my competitor's general manager who has very good contacts and so can help me to improve my business prospects?

The simplest answer is yes because this gives us both a fair solution; this is a win-win situation.

Stage 3

Should I use the company's internet / telephone facilities for personal use?

The simplest solution is yes because everyone uses company resources.

Stage 4

Should I provide facilities such as a good canteen, transport and medical facilities for my employees in order to improve the reputation of the company?

The simplest answer is yes since this is what the employees would expect.

Stage 5

Should I refuse to sell a substandard quality product?

The simplest answer is yes since it is clear that society is affected by such issues.

Stage 6

Should I refuse to buy the cheapest supplies because they come from a country where a sweat shop culture prevails?

The simplest answer is yes since employment in sweat shops is universally felt to be a fundamental abuse of human rights.

Answer to SEQ 2

Most commercial businesses have profit-making as their foremost business objective. An entity which makes profit will ensure maximum satisfaction to all its stakeholders i.e. an entity which makes profits will be able to:

- give higher returns to its shareholders leading to shareholder satisfaction
- give good employment benefits leading to employee satisfaction
- supply good quality products and services leading to customer satisfaction, etc.

Due to the above benefits of earning profits, teleologists can justify profit-making as a business action which is right.

The following are three actions taken by a business which aims to make profits and which believes in teleological ethics, that would otherwise seem wrong.

- The business shuts down its factory and lays off its workers since it manufactures goods which are not cost effective i.e. the cost incurred is higher than the sales price. Here the action of laying off its workers is considered to be right by teleologists because the decision will enable the company to earn profits.

- The business procures materials from / deals with suppliers or agents, who can provide very cheap raw materials / services because they employ child labour. Here the action of encouraging child labour is considered to be right by the teleologists, since it leads to profits for the business.

- The business displaces villagers from a site that the company wishes to develop as its factory. Here the action of displacing the villagers is considered to be right by the teleologists, since it leads to profits for the business.

Answer to SEQ 3

Under the IFAC code of ethics Jack is required to be objective in his work. Objectivity means that he is as a professional free to make his own judgments. The chief executive and chairman are putting pressure on him to lose his sense of objectivity and in effect take a biased view of the accounting treatments. Given the existence of the independent property valuation and the combined views of the operations director and project manager there is also a straight issue of truth in preparing the financial statements and that is also an issue of objectivity.

The expressions used by the chairman may go beyond pressure of objectivity and could be regarded as intimidation since they wish Jack to change his view. Jack should ensure that his self-interest of keeping his job and earning future income and promotion does not influence him in his decision. He may wish to approach the independent audit committee, if there is one, who will listen to the circumstances and as non-executive directors will consider the position with less interest than the executive directors.

If Jack does not wish to make the changes he can consider his position and resign since he may doubt the integrity of the directors, such a move would have a cost to him but would protect his own integrity.

Answer to SEQ 4

(a) The firm is required to ascertain the significance of the threat caused by providing such a service.

If the threat is significant, the firm needs to apply the following safeguards in order to reduce the threat level:

The **client** must give his **acknowledgement for establishing and monitoring organisation's system & controls**.

To design and implement the processes of the hardware or software system, even though the audit client designates a competent employee, the **senior management of the client** organisation, should **take the responsibility** of making all **management decisions.**

The implementation of the **system** needs to be **designed according to the capability of the client.**

The audit **client is responsible for the operation of the system** (hardware or software) and the data used or generated by the system.

The firm must assign different team members and partners for both the assignments i.e. design of the ERP and assurance. This will also ensure that both teams have separate reporting lines.

However, if the threat is significant despite applying the above safeguards, Benson & Co must refuse the assignment.

(b) Practices to accept the assurance assignment

(i) Engagement with the Quick Finance Bank would contravene the fundamental principles and give rise to a self-interest threat.

Competence to perform the services: publicly practising professional accountants should be competent enough to provide all services to their client. In this case although both partners have sufficient expertise and knowledge, they do not have enough permanent staff: assistants or trainees, i.e. they should be prepared, at all times, to meet clients' needs.

Self-interest threat: in this case the self-interest threat is caused by a lack of professional competence and due care while taking on the client's assignment.

Despite proposing to employ temporary staff, this assignment would require a regular inspection of the client's systems. To ensure that a competent service is provided, the firm must ensure that the assignment's team members do not change during the time-span of the assignment. Also, care needs to be taken to ensure that they are sufficiently trained and qualified. Furthermore, the firm must recruit more permanent staff members who would take responsibility for their actions.

(ii) Against professional behaviour: in their haste to acquire a strong client base, Benson & Co, take up new assignments quickly and at **considerably discounted rates.** This is against professional behaviour which certainly brings the profession into disrepute. Benson & Co should avoid this practice.

However, if the firm wishes to accept the assignment, then they should not compromise on the quality of the service they provide. The firm must keep appropriate records indicating that:

the required standards of auditing were met

sufficient numbers of qualified staff were assigned to the task

sufficient quality control procedures were maintained such as second partner review and checklists to be completed at the end of each assignment.

Answer to SEQ 5

Mr. Sharp has ignored the issue relating to imports because it is a situational factor affected by moral intensity where the consequences of ignoring the issue will be felt at a future date, when the company increases imports. Mr. Sharp has sent out a circular to all the employees relating to transport allowance because there are 250 employees and if the tax auditors notice the missing receipts, the company would have to pay tax on the expenses. In this case, the consequences can occur soon and so the degree of moral intensity is high.

Mr. Sharp discussed issues relating to factory safety with the board and fresh measures to improve safety were taken because Mr Sharp experienced feelings of closeness with the factory's safety measures. He also felt that the adverse remark would have an impact on the company's reputation and therefore it was necessary to attend to the matter.

The company has a practice of paying for personal expenses of the director from the company's petty cash. This unethical behaviour occurred because the accounts staff was acting on the instructions of their superior i.e. the director.