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Paper P3

Business Analysis

Welcome to Emile Woolf's study text for
Paper P3 *Business Analysis* which is:

- Written by tutors
- Comprehensive but concise
- In simple English
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Syllabus and study guide

Aim

To apply relevant knowledge, skills and exercise professional judgement in assessing strategic position, determining strategic choice and implementing strategic action through beneficial business process and structural change; coordinating knowledge systems and information technology and by effectively managing quality processes, projects and people within financial and other resource constraints.

Main capabilities

On successful completion of this paper candidates should be able to:

A Assess the strategic position of an organisation

B Evaluate the strategic choices available to an organisation

C Discuss how an organisation might go about its strategic implementation

D Model and redesign business processes and structures to implement and support the organisation's strategy taking account of customer and other major stakeholder requirements

E Integrate appropriate information technology solutions to support the organisation's strategy

F Apply appropriate quality initiatives to implement and support the organisation's strategy

G Advise on the principles of project management to enable the implementation of aspects of the organisation's strategy with the twin objectives of managing risk and ensuring benefits realisation

H Analyse and evaluate the effectiveness of a company's strategy and the financial consequences of implementing strategic decisions

I The role of leadership and people management in formulating and implementing business strategy

Rationale

The syllabus for Paper P3, *Business Analysis*, is primarily concerned with two issues. The first is the external forces (the behaviour of customers, the initiatives of competitors, the emergence of new laws and regulations) that shape the environment of an organisation. The second is the internal ambitions and concerns (desire for growth, the design of processes, the quality of products and services, the competences of employees, the financial resources) that exist within an organisation. This syllabus looks at both of these perspectives, from assessing strategic position and choice to identifying and formulating strategic action and its formulation. It identifies opportunities for beneficial change that involve people, finance and information technology. It examines how these opportunities may be implemented through the appropriate management of programmes and projects.

The syllabus begins with the assessment of strategic position and is concerned with the impact of the external environment, its internal capabilities and expectations and how the organisation positions itself. It examines how factors such as culture, leadership and stakeholder expectations shape organisational purpose. Strategic choice is concerned with decisions which have to be made about an organisation's future and the way in which it can respond to the influences and pressures identified in the assessment of its strategic position.

Strategic action concerns the implementation of strategic choices and the transformation of these choices into organisational action. Such action takes place in day-to-day processes and organisational relationships and these processes and relationships need to be managed in line with the intended strategy, involving the effective coordination of information technology, people, finance and other business resources.

Companies that undertake successful business process redesign claim significant organisational improvements. This simply reflects the fact that many existing processes are less efficient than they could be and that new technology makes it possible to design more efficient processes. For some writers, quality issues are at the heart of process improvement and the continual emergence of models and concepts that focus on quality improvement merits its inclusion in this syllabus.

Strategic planning and strategy implementation has to be subject to financial benchmarks. Financial analysis explicitly recognises this, reminding candidates of the importance of focusing on the key ratios and measures that may be used to assess the viability of a strategy and to monitor and measure its success.

Throughout, the syllabus recognises that successful strategic planning and implementation requires the effective recruitment, training, motivation and organisation of people.

Syllabus content

A Strategic position

1 The need for, and purpose of, strategic and business analysis

2 Environmental issues affecting the strategic position of an organisation

3 Competitive forces affecting an organisation

4 Marketing and the value of goods and services

5 The internal resources, capabilities and competencies of an organisation

6 The expectations of stakeholders and the influence of ethics and culture

B Strategic choices

1 The influence of corporate strategy on an organisation

2 Alternative approaches to achieving competitive advantage

3 Alternative directions and methods of development

C Strategic action

1 Organising and enabling success

2 Managing strategic change

3 Understanding strategy development

D Business process change

1 The role of process and process change initiatives

2 Improving the processes of the organisation

3 Software solutions

E Information technology

1 Principles of e-business

2 E-business application: upstream supply chain management

3 E-business application: downstream supply chain management

4 E-business application: customer relationship management

F Quality issues

1 Quality control, quality assurance and quality management systems

2 Quality in the information systems development lifecycle

3 Quality initiatives: Six Sigma

G Project management

1 Identifying and initiating projects

2 Managing and leading projects

3 Monitoring, controlling and concluding projects

H Financial analysis

1 The link between strategy and finance

2 Finance decisions to formulate and support business strategy

3 Financial implications of making strategic choices and of implementing strategic actions

I People

1 Strategy and people: leadership

2 Strategy and people: performance management

3 Strategy and people: reward management

4 Strategy and people: job design

5 Strategy and people: staff development

Approach to examining the syllabus

The syllabus is assessed by a three-hour paper-based examination.

Section A

This section contains one multi-part question based on a case study scenario. The question is worth 50 marks. The question will be firmly based on capabilities defined in sections A, B and C of the syllabus, supported by capabilities defined in sections H and I of the syllabus. It will occasionally be supported by capabilities defined in sections D, E, F and G of the syllabus. The case study scenario will always include quantitative information, which might be financial data.

Section B

This section of the examination paper will contain three discrete questions, each worth 25 marks. The candidate must answer two questions in this section. **At least** two of the questions in this section will be based on capabilities defined in sections D, E, F, G and I of the syllabus. **At most**, one question in this section will be based on capabilities defined in sections A, B and C of the syllabus. Capabilities defined in section H of the syllabus may be used to support questions in this section.

Examination structure

		Number of marks
Section A:	One compulsory, possibly in several parts	50
Section B:	Choice of 2 from 3 questions (25 marks each)	50
		100

Study guide

This study guide provides more detailed guidance on the syllabus. You should use this as the basis of your studies.

A STRATEGIC POSITION

1 The need for, and purpose of, strategic and business analysis

(a) Recognise the fundamental nature and vocabulary of strategy and strategic decisions.

(b) Discuss how strategy may be formulated at different levels (corporate business level, operational) of an organisation.

(c) Explore the Johnson, Scholes and Whittington model for defining elements of strategic management – the strategic position, strategic choices and strategy into action.

(d) Analyse how strategic management is affected by different organisational contexts.

(e) Compare three different strategy lenses (Johnson, Scholes and Whittington) for viewing and understanding strategy and strategic management.

(f) Explore the scope of business analysis and its relationship to strategy and strategic management in the context of the relational diagram of this syllabus.

2 Environmental issues affecting the strategic position of an organisation

(a) Assess the macro-environment of an organisation using PESTEL.

(b) Highlight the key drivers of change likely to affect the structure of a sector or market.

(c) Explore, using Porter's Diamond, the influence of national competitiveness on the strategic position of an organisation.

(d) Prepare scenarios reflecting different assumptions about the future environment of an organisation.

3 Competitive forces affecting an organisation

(a) Discuss the significance of industry, sector and convergence.

(b) Evaluate the sources of competition in an industry or sector using Porter's five forces framework.

(c) Assess the contribution of the lifecycle model and the cycle of competition to understanding competitive behaviour.

(d) Analyse the influence of strategic groups and market segmentation.

(e) Determine the opportunities and threats posed by the environment of an organisation.

4 Marketing and the value of goods and services

(a) Analyse customers and markets.

(b) Establish appropriate critical success factors for products and services.

(c) Explore the role of the value chain in creating and sustaining competitive advantage.

(d) Advise on the role and influence of value networks.

(e) Assess different approaches to benchmarking an organisation's performance.

5 The internal resources, capabilities and competences of an organisation

(a) Discriminate between strategic capability, threshold resources, threshold competences, unique resources and core competences.

(b) Advise on the continuing need for cost efficiency.

(c) Discuss the capabilities required to sustain competitive advantage.

(d) Explain the impact of new product, process, and service developments and innovation in supporting business strategy.

(e) Discuss the contribution of organisational knowledge to the strategic capability of an organisation.

(f) Identify opportunities for managing the strategic capability of an organisation.

(g) Determine the strengths and weaknesses of an organisation and formulate an appropriate SWOT analysis.

6 The expectations of stakeholders and the influence of ethics and culture

(a) Advise on the implications of corporate governance on organisational purpose and strategy.

(b) Evaluate, through stakeholder mapping, the relative influence of stakeholders on organisational purpose and strategy.

(c) Assess ethical influences on organisational purpose and strategy.

(d) Explore the scope of corporate social responsibility.

(e) Assess the impact of culture on organisational purpose and strategy.

(f) Prepare and evaluate a cultural web of an organisation.

(g) Advise on how organisations can communicate their core values and mission.

B STRATEGIC CHOICES

1 The influence of corporate strategy on an organisation

(a) Explore the relationship between a corporate parent and its business units.

(b) Assess the opportunities and potential problems of pursuing different corporate strategies of product/market diversification from a national, international and global perspective.

(c) Assess the opportunities and potential problems of pursuing a corporate strategy of international diversity, international scale operations and globalisation.

(d) Discuss a range of ways that the corporate parent can create and destroy organisational value.

(e) Explain three corporate rationales for adding value – portfolio managers, synergy managers and parental developers.

(f) Explain and assess a range of portfolio models (the growth/share (BCG) matrix, the public sector portfolio matrix, market attractiveness/ SBU strength matrix, directional policy matrix, Ashridge Portfolio Display) that may assist corporate parents manage their business portfolios.

2 Alternative approaches to achieving competitive advantage

(a) Evaluate, through the strategy clock, generic strategy options available to an organisation.

(b) Advise on how price-based strategies, differentiation and lock-in can help an organisation sustain its competitive advantage.

(c) Explore how organisations can respond to hypercompetitive conditions.

(d) Assess opportunities for improving competitiveness through collaboration.

3 Alternative directions and methods of development

(a) Determine generic development directions (employing an adapted Ansoff matrix and a TOWS matrix) available to an organisation.

(b) Assess how internal development, mergers, acquisitions and strategic alliances can be used as different methods of pursuing a chosen strategic direction.

(c) Establish success criteria to assist in the choice of a strategic direction and method (strategic options).

(d) Assess the suitability of different strategic options to an organisation.

(e) Assess the feasibility of different strategic options to an organisation.

(f) Establish the acceptability of strategic options to an organisation through analysing risk and return on investment.

C STRATEGIC ACTION

1 Organising and enabling success

(a) Advise on how the organisation can be structured to deliver a selected strategy.

(b) Explore generic processes that take place within the structure, with particular emphasis on the planning process.

(c) Discuss how internal relationships can be organised to deliver a selected strategy.

(d) Discuss how external relationships (outsourcing, strategic alliances, networks and the virtual organisation) can be structured to deliver a selected strategy.

(e) Explore (through Mintzberg's organisational configurations) the design of structure, processes and relationships.

2 Managing strategic change

(a) Explore different types of strategic change and their implications.

(b) Determine and diagnose the organisational context of change using Balogun and Hope Hailey's contextual features model and the cultural web

(c) Establish potential blockages and levers of change.

(d) Advise on the style of leadership appropriate to manage strategic change.

(e) Specify organisational roles required to manage strategic change.

(f) Discuss levers that can be employed to manage strategic change.

3 Understanding strategy development

(a) Discriminate between the concepts of intended and emergent strategies.

(b) Explain how organisations attempt to put an intended strategy into place.

(c) Highlight how emergent strategies appear from within an organisation.

(d) Discuss how process redesign, quality initiatives and e-business can contribute to emergent strategies.

(e) Assess the implications of strategic drift and the demand for multiple processes of strategy development.

D BUSINESS PROCESS CHANGE

1 The role of process and process change initiatives

(a) Advise on how an organisation can reconsider the design of its processes to deliver a selected strategy.

(b) Appraise business process change initiatives previously adopted by organisations.

(c) Establish an appropriate scope and focus for business process change using Harmon's process-strategy matrix.

(d) Explore the commoditisation of business process.

(e) Advise on the implications of business process outsourcing.

(f) Recommend a business process redesign methodology for an organisation.

2 Improving the processes of the organisation

(a) Evaluate the effectiveness of a current organisational process.

(b) Describe a range of process redesign patterns.

(c) Establish possible redesign options for improving the current processes of an organisation.
(d) Assess the feasibility of possible redesign options.
(e) Assess the relationship between process redesign and strategy.

3 Software solutions

(a) Establish information system requirements required by business users.
(b) Assess the advantages and disadvantages of using a generic software solution to fulfil those requirements.
(c) Establish a process for evaluating, selecting and implementing a generic software solution.
(d) Explore the relationship between generic software solutions and business process redesign.

E INFORMATION TECHNOLOGY

1 Principles of e-business

(a) Discuss the meaning and scope of e-business.
(b) Advise on the reasons for the adoption of e-business and recognise barriers to its adoption.
(c) Evaluate how e-business changes the relationships between organisations and their customers.
(d) Discuss and evaluate the main business and marketplace models for delivering e-business.
(e) Advise on the hardware and software infrastructure required to support e-business.
(f) Advise on how the organisation can utilise information technology to help it deliver a selected strategy.

2 E-business application: upstream supply chain management

(a) Analyse the main elements of both the push and pull models of the supply chain.
(b) Discuss the relationship of the supply chain to the value chain and the value network.
(c) Assess the potential application of information technology to support and restructure the supply chain.
(d) Advise on how external relationships with suppliers and distributors can be structured to deliver a restructured supply chain.
(e) Discuss the methods, benefits and risks of e-procurement.
(f) Assess different options and models for implementing e-procurement.

3 E-business application: downstream supply chain management

(a) Define the scope and media of e-marketing.
(b) Highlight how the media of e-marketing can be used when developing an effective e-marketing plan.

(c) Explore the characteristics of the media of e-marketing using the '6I's of Interactivity, Intelligence, Individualisation, Integration, Industry structure and Independence of location'.

(d) Evaluate the effect of the media of e-marketing on the traditional marketing mix of product, promotion, price, place, people, processes and physical evidence.

(e) Assess the importance of, on-line branding in e-marketing and compare it with traditional branding.

4 E-business application: customer relationship management

(a) Define the meaning and scope of customer relationship management.

(b) Explore different methods of acquiring customers through exploiting electronic media.

(c) Evaluate different buyer behaviour amongst on-line customers.

(d) Recommend techniques for retaining customers using electronic media.

(e) Recommend how electronic media may be used to increase the activity and value of established, retained customers.

(f) Discuss the scope of a representative software package solution designed to support customer relationship management.

F QUALITY ISSUES

1 Quality control, quality assurance and quality management systems

(a) Discriminate between quality, quality assurance, quality control and a quality management system.

(b) Assess the relationship of quality to the strategy of an organisation.

(c) Appraise quality initiatives previously adopted by organisations.

(d) Advise on the structure and benefits of a quality management system and quality certification.

2 Quality in the information systems development lifecycle

(a) Justify the need and assess the characteristics of quality in computer software and the implications of these characteristics for testing, liability and ownership.

(b) Discuss the stages of systems development through the medium of the V lifecycle model.

(c) Advise on how the V lifecycle model defines and partitions testing and contributes to improved computer software quality.

(d) Discuss how the process of computer software development process might be improved through the application of the Capability Maturity Model Integration (CMMI) process.

3 Quality Initiatives: Six Sigma

(a) Define the scope, principles and objectives of Six Sigma.

(b) Discuss the team roles typically required by Six Sigma.

(c) Outline the Six Sigma problem-solving process (DMAIC).

(d) Discuss the significance and implications of measurement in the Six Sigma problem-solving process.

(e) Explain the application of Six Sigma within e-business, the value chain and process re-design.

G PROJECT MANAGEMENT

1 Identifying and initiating projects

(a) Determine the distinguishing features of projects and the constraints they operate in.

(b) Discuss the relationship between organisational strategy and project management.

(c) Identify and plan to manage risks

(d) Advise on the structures and information that have to be in place to successfully initiate a project.

(e) Assess the importance of developing a project plan and discuss the work required to produce this plan.

(f) Explain the relevance of projects to process re-design, e-business systems development and quality initiatives.

2 Managing and leading projects

(a) Discuss the organisation and implications of project-based team structures.

(b) Establish the role and responsibilities of the project manager and the project sponsor.

(c) Identify and describe typical problems encountered by a project manager when leading a project.

(d) Advise on how these typical problems might be addressed and overcome.

3 Monitoring, controlling and concluding projects

(a) Monitor the status of a project and identify project risks, issues, slippage and changes and the likely achievement of business benefits.

(b) Formulate responses for dealing with project risks, issues, slippage and changes.

(c) Establish mechanisms for successfully concluding a project.

(d) Discuss the meaning and benefits of an end-project review, including benefits realisation.

(e) Evaluate how project management software may support the planning and monitoring of a project.

H FINANCIAL ANALYSIS

1 The link between strategy and finance

(a) Explain the relationship between strategy and finance.
  (i) Managing for value
  (ii) Financial expectations of stakeholders
  (iii) Funding strategies

2 Finance decisions to formulate and support business strategy

(a) Determine the overall investment requirements of the business.

(b) Evaluate alternative sources of finance for these investments and their associated risks.

(c) Efficiently and effectively manage the current and non-current assets of the business from a finance and risk perspective.

3 Financial implications of making strategic choices and of implementing strategic actions

(a) Apply efficiency ratios to assess how efficiently an organisation uses its current resources.

(b) Apply appropriate gearing ratios to assess the risks associated with financing and investment in the organisation.

(c) Apply appropriate liquidity ratios to assess the organisation's short-term commitments to creditors and employees.

(d) Apply appropriate profitability ratios to assess the viability of chosen strategies.

(e) Apply appropriate investment ratios to assist investors and shareholders in evaluating organisational performance and strategy.

I PEOPLE

1 Strategy and people: leadership

(a) Explain the role of visionary leadership and identify the key leadership traits effective in the successful formulation and implementation of strategy and change management.

(b) Apply and compare alternative classical and modern theories of leadership in the effective implementation of strategic objectives.

2 Strategy and people: performance management

(a) Explain how the effective recruitment, management and motivation of people is necessary for enabling strategic and operational success.

(b) Discuss the judgemental and developmental roles of assessment and appraisal.

(c) Evaluate the concept of performance management and explore its relationship with strategic management.

(d) Advise on the relationship of performance management to performance measurement (performance rating) and determine

the implications of performance measurement to quality initiatives and process re-design.

3 Strategy and people: reward management

(a) Explore the meaning and scope of reward management and reward practices.

(b) Discuss and evaluate different methods of reward.

(c) Discuss and evaluate different techniques of reward and their relationship to job design, appraisal and deployment of staff.

(d) Explore the principles and difficulty of aligning reward practices with strategy.

(e) Advise on the relationship of reward management to quality initiatives, process re-design and the harnessing of e-business opportunities.

4 Strategy and people: job design

(a) Assess the contribution of four different approaches to job design (scientific management, job enrichment, Japanese management and re-engineering).

(b) Explain the human resource implications of knowledge work and post- industrial job design.

(c) Discuss the tensions and potential ethical issues related to job design.

(d) Advise on the relationship of job design to quality initiatives, process re-design, project management and the harnessing of e-business opportunities.

5 Strategy and people: staff development

(a) Discuss the emergence and scope of human resource development, succession planning and their relationship to the strategy of the organisation.

(b) Advise and suggest different methods of establishing human resource development.

(c) Advise on the contribution of competency frameworks to human resource development.

(d) Discuss the meaning and contribution of workplace learning, the learning organisation, organisation learning and knowledge management.

CHAPTER 1

The purpose of strategic and business analysis

Contents

1	Definition of strategy and levels of strategy
2	Elements of strategic management and business analysis
3	The process of strategy development

Definition of strategy and levels of strategy

- Definition of strategy
- Levels of strategy
- Corporate strategy
- Business strategy
- Functional strategy
- A note on levels of planning

1 Definition of strategy and levels of strategy

1.1 Definition of strategy

Business analysis is about analysing the strategic position of an entity, making strategic choices and putting the chosen strategies into action.

Chandler (1962) defined strategy as 'the determination of the basic long-term goals and the objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals.'

Strategic management therefore involves deciding answers to questions such as:

- What business or businesses should we be in?
- How can this business activity contribute to the competitive advantage of our enterprise?

Drucker on strategy

Drucker defined strategy as 'a pattern of activities that seek to achieve the objectives of the organisation and adapt its scope, resources and operations to environmental changes in the long term.'

This definition is a bit more complex than the previous one. It contains several elements:

- A strategy consists of organised activities.
- The purpose of these activities (the strategy) is to achieve an objective.
- Strategy is long-term. Formal strategic planning by large companies, for example, might cover five years or ten years into the future, and for some companies even longer.
- The strategic choices that an enterprise makes are strongly influenced by the environment in which the enterprise exists.
- The environment is continually changing, which means that strategies cannot be rigid and unchanging.
- Strategies involve an enterprise in doing different things with different resources over time, as it is forced to adapt to changes in its environment.

A strategic five-year plan for a company will therefore consider questions such as:

- Where are we now?
- Where do we want to be in five years' time?
- How do we get from where we are now to where we want to be?
- How large will the company be?
- What will it be doing?
- Where will it be operating?
- How many employees will it need and what skills will they need?
- What technology should be used?

Johnson, Scholes and Whittington on strategy

Johnson, Scholes and Whittington ('Exploring Corporate Strategy') have defined strategy as 'the direction and scope of an organisation over the long term, which achieves advantage in a changing environment through its configuration of resources and competencies with the aim of fulfilling stakeholder expectations.

This definition has some similarities to the definition by Drucker, but it contains two other aspects of strategic management:

- An enterprise should use its resources and its skills and abilities to achieve a 'competitive advantage' in its business activities. Competitive advantage is achieved by doing something better (and more successfully) than any competitors can do.
- It is often assumed that the main objective of a company should be to maximise the wealth of its shareholders. Johnson, Scholes and Whittington state that the objective of an entity should be to fulfil 'stakeholder' expectations.

Johnson, Scholes and Whittington identified the range or scope of strategic decisions as follows:

- Deciding the scope of the entity's activities. What businesses should we be in?
- Relating the activities of the entity to the environment in which it operates.
- Ensuring that the entity has the 'resource capability' to operate in its selected areas of activity. This means making sure that the entity has enough employees with the right skills, access to sufficient raw materials and other supplies, enough equipment, suitable IT systems, and so on.
- Allocating resources to the different business activities.
- Providing a high-level (strategic) framework for more detailed decision-making at an operational level.
- Reflecting the values and expectations of the individuals in positions of power within the entity.
- Deciding the long-term direction that the entity should take.
- In many cases, implementing change within the entity so that it adapts successfully to its changing environment.

In your examination, you might be expected to assess a business strategy in a case study type of examination question. These are the broad issues that you might need to consider in your answer.

Example

A company that extracts and supplies oil and natural gas is considering its future business direction over the next 10 years. It is aware that these resources are in limited supply, and that there is growing public and political concern about the environment.

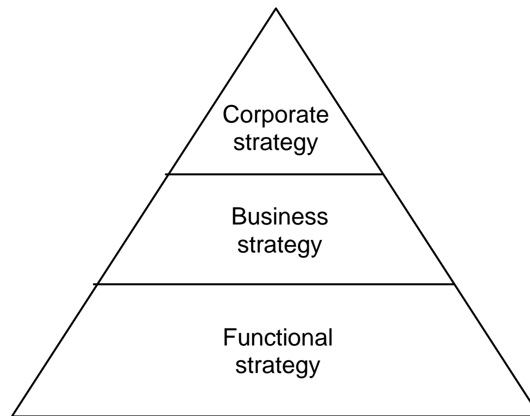
The company's board of directors might agree on the following broad strategy.

- The company will continue to extract oil and natural gas, but it will also invest heavily in production of energy from renewable energy sources, such as wind and sea.
- The move into energy from renewable sources recognises the probability that public and political pressure will grow for restrictions on the use of non-renewable energy sources and for protection of the global environment.
- Change is therefore essential for long-term survival.
- The strategic plan should also provide for the resources required to achieve the company's goals. Important resources for the chosen plan will include exploration rights, access to pipelines and other methods of transporting energy to users, and expertise in wind and wave power technology.
- A decision must be made about how many resources (including money) should be invested in each business activity.
- This will depend partly on the strategic vision of the board of directors, and the direction they think the company should be taking. What proportion if its total energy sources in ten years time will come from wind and wave power, and to what extent will the company still be relying on oil and natural gas?
- The strategic plan also reflects the values of the board of directors. In this example, the company has not included nuclear power in its strategic plan.

1.2 Levels of strategy

It is usual to analyse strategy into a hierarchy of different levels. Johnson, Scholes and Whittington identify three levels of strategy:

- corporate strategy
- business strategy, and
- functional strategy.



Level of strategy	Comment
Corporate strategy	What businesses should we be in?
Business strategy	How should we compete in each selected business?
Functional strategy	For each business function, how can that function contribute to the competitive advantage of the entity?

Consistency of strategies

The strategies in this hierarchy should be consistent with each other.

- The corporate strategy should seek to achieve the overall objective or objectives of the entity.
- Each business strategy should have its own objective, and achieving the objective for a business strategy should contribute towards the achievement of the corporate strategy and overall objective.
- Each functional strategy should have its own objective, and achieving the objective for a functional strategy should contribute towards the achievement of the business strategy that it supports.

1.3 Corporate strategy

Corporate strategy is concerned with deciding which business or businesses an entity should be in, and setting targets for the achievement of the entity's overall objectives.

The elements of corporate strategy are as follows:

- **Deciding the purpose of the entity**. Why is the entity in existence? What is its mission and what is it trying to achieve? Different people have different ideas about what the purpose of an entity should be. For example a company has shareholders, its legal owners, who consider that the purpose of their company is to make profits and pay dividends. However, a company has other stakeholders, such as employees and customers, whose opinion about what the purpose of the company should be might be very different.

- **Deciding the scope of the activities of the entity**. Corporate strategy also involves deciding what businesses the entity should be in, including the range of businesses. For example, the purpose of a transport company is to provide transport services. Its corporate strategy must include a decision about which transport services it will provide (for example, bus travel, train services, air travel, space travel and so on) as well as the geographical areas where it will operate.
- **Matching** the chosen **business activities to the external environment** of the entity **and** also to its **available resources**.
  - The choice of business activities by an entity should be consistent with conditions in its environment. For example, a company should choose to sell products or services that customers want to buy, and for which the technology exists. Its choice of business activities might also be affected by laws or regulations.
  - The choice of business activities should also be consistent with the resources that the entity expects to have available or expects that it will be able to obtain.
- Matching the purpose and activities of the organisation to the expectations of its owners. The chosen corporate strategy, when put into action, should be capable of meeting the expectations of the owners of the entity. For example, a company's objectives for profits over the long term should be consistent with shareholders' long-term profit expectations.
- Matching the purpose and activities of the organisation to the expectations of other stakeholders in the organisation.

Corporate strategy and the expectations of owners and other stakeholders

The corporate strategy of an organisation will be influenced by the expectations of its owners and other stakeholders.

- **Owners' expectations**. In a commercial company, the owners are the shareholders. These might expect the company to provide them over time with investment income or with growth in their wealth. Corporate strategy might therefore aim towards maximisation of the shareholders' wealth. Objectives for corporate strategy might therefore be stated in terms of raising the share price by x% over the next five or ten years. With a state-owned organisation, the owner is the government. The expectations of a government as owner of an entity are different from those of the shareholders in a company. The 'corporate' strategy of a state-owned enterprise will therefore differ from the corporate strategy of a company.
- **Stakeholders' expectations**. The term 'stakeholder' means any individual or group of individuals who have a strong interest (a 'stake') in the organisation and what it does. The chosen corporate strategy should also recognise the rights and expectations of other stakeholders, such as employees, customers, government, suppliers, lenders, local communities and the general public.

1.4 Business strategy

Business strategy, also called **competitive strategy**, is concerned with how each business activity within the entity contributes towards the achievement of the corporate strategy.

- A large group of companies might consist of many subsidiary companies. Subsidiaries might be organised into strategic business units (SBUs) or operational divisions. Each SBU is a different business, and should have its own business strategy.
- In a commercial entity, business strategy focuses on markets and business strategy is concerned with how to compete successfully in the chosen markets with the chosen products.

According to Porter, a successful competitive strategy must be based on either:

- cost leadership, or
- differentiation.

Cost leadership means becoming the lowest-cost producer in the market. A company that can make products or provide services at a lower cost than competitors will succeed, by selling at lower prices and winning the biggest share of the market.

Differentiation means making products or services that are considered by customers to be different from those of competitors, and because they are different they are better. A company that is not the least-cost producer can therefore succeed by offering product or service that customers will pay a higher price (than the least-cost producer's price) to obtain.

Example

In the UK, there is a large consumer market for potato crisps. One company has succeeded by producing a popular and well-advertised product that it makes at a low cost and sells at a low price. It has a dominant share of the total market for potato crisps.

Other producers of potato crisps have succeeded by offering a differentiated product – 'hand cooked' crisps with no artificial ingredients – that are sold in larger packets and at a higher price. Some consumers are happy to pay the higher price to get what they consider to be a distinctive and better-quality product.

1.5 Functional strategy

Functional strategy relates to particular functions within an organisation, such as manufacturing, distribution, marketing and selling, research and development, accounting, IT and so on.

The purpose of functional strategy should be to support the business strategies and corporate strategy of the organisation.

Example

Manufacturing strategy is a functional strategy for a manufacturing company.

The objectives of manufacturing strategy are stated in terms of:

- cost
- quality
- delivery (speed or reliability of delivery), and
- flexibility (the ability to switch between different products or production methods).

There is some 'trade-off' between these objectives. For example, the cost objective might be to minimise costs, but this objective might be affected by a requirement to provide products of a minimum quality. The trade-off between cost and quality should be recognised in the objectives for manufacturing strategy.

To formulate a manufacturing strategy, decisions have to be taken for five aspects of manufacturing operations:

- decisions about plant and equipment
- production planning and control
- labour and staffing
- production design and engineering
- the organisation and management of the manufacturing function.

Manufacturing strategy may therefore be defined as the set of decisions that determine the capability of the manufacturing system and specify how the system will operate to meet a set of manufacturing objectives that are consistent with the overall business objectives.

1.6 A note on levels of planning

This text is concerned with strategy and business analysis. We have seen that strategy (including strategic planning) is a hierarchy of corporate strategy, business strategies and functional strategies.

Planning is also a hierarchical activity, linking strategic planning at the top with detailed operational planning at the bottom. Strategic plans set a framework and guidelines within which more detailed plans, and shorter-term planning decisions, can be made.

R N Anthony identified three levels of planning: within an organisation:

- **Strategic planning**. This involves identifying the objectives of the entity, and plans for achieving those objectives, mostly over the longer term. Strategic plans include corporate strategy plans, business strategy plans and functional strategy plans.
- **Tactical planning**. These are shorter-term plans for achieving medium-term objectives. An example of tactical planning is the annual budget. Budgets and

other tactical plans can be seen as steps towards the achievement of longer-term strategic objectives.

- **Operational planning**. This is detailed planning of activities, often at a supervisor level or junior management level, for the achievement of short-term goals and targets. For example, a supervisor might divide the workload between several employees in order to complete all the work before the end of the day.

Elements of strategic management and business analysis

- Defining elements of strategic management
- Strategic position
- Strategic choices
- Strategy into action
- The scope of business analysis

2 Elements of strategic management and business analysis

2.1 Defining elements of strategic management

Strategic management is a broad-ranging subject. To study strategic management, it is useful to have a logical structure or model as a basis for analysis. An analytical model by Johnson, Scholes and Whittington ('Exploring Corporate Strategy') is used within the syllabus and study guide for the Business Analysis examination. This model will therefore be used here.

Johnson, Scholes and Whittington state that strategic management consists of three elements:

- Strategic position
- Strategic choices
- Strategy into action.

2.2 Strategic position

'Strategic position' means making an analysis or assessment of the strategic position of the entity. The senior management of a company, for example, need to understand the position of the company in its markets: in what ways does the company perform better than its competitors, and in what ways are competitors more successful? In other words, how do rival companies compare with each other in terms of 'competitive advantage'?

Management also need to understand the factors in the 'business environment' that affect their company, and how the company will be affected by changes that are likely to happen in the environment in the future. Could the company be affected by changes in technology, or changes in the state of the economy, or new laws? Even more important, perhaps, will there be changes in what customers want to buy, because of changes in society or life styles? If so, how might this affect what the company produces and sells?

Management have to make a decision about what their company should be doing, and what the company is trying to achieve. Objectives need to be realistic, so

management need to understand where the company stands now in its markets, and where it should be trying to get to a few years in the future.

All these factors must be considered in the analysis of strategic position. Johnson, Scholes and Whittington suggest that there are three aspects to strategic position:

- The environment
- Strategic capability of the entity
- Expectations and purposes.

Environment (threats and opportunities)

An analysis of the business environment involves an analysis of the threats and opportunities that seem to exist, and an assessment of their significance.

- Threats are developments in the environment that could threaten the ability of the entity to achieve its objectives.
- Opportunities are developments that might be exploited, to improve the ability of the entity to achieve its objectives.

Environmental analysis is described more fully in a later chapter.

Strategic capability of the entity (strengths and weaknesses)

The management of an entity should also make an assessment of the strategic capability of the entity. This means reaching an understanding of what the entity is capable of achieving. An assessment of strategic capability involves an analysis of the strengths and weaknesses of the entity.

- What is the entity good at doing? Why? What can be done to improve these strengths?
- What is the entity bad at doing that its rivals can do better? Why? What can be done to reduce or eliminate these weaknesses?

An analysis of internal resources and competences is described in a later chapter.

Expectations and purposes

An analysis of strategic position also requires management to make decisions about the purpose of the entity and what it is trying to achieve.

- Some entities make a formal statement of their purpose and reason for existence in the form of a **mission statement**. For example, a university might have a mission statement that its purpose is to provide a centre for academic and scientific research and first-class tuition for undergraduate and postgraduate students.
- A company might consider that its purpose is to provide returns to its owners, the shareholders. It might therefore state its purpose in terms of maximising shareholder wealth, or increasing shareholder wealth.
- A company might consider that its purpose is to increase shareholder wealth but that it also has a significant responsibility to other stakeholder groups, such as employees and customers. A company might recognise its ethical duty as a

'corporate citizen' in society, and see a part of its purpose as the requirement to protect the environment and achieve a 'sustainable business'.

The purpose of an entity is linked to the expectations that managers, owners and other stakeholders have about it. Management need to understand how successful the entity has been in meeting the expectations of its owners and other stakeholder groups. They also need to make decisions about what the entity should be doing in the future to meet stakeholder expectations more successfully than in the past.

Expectations about what an entity should do are also linked to cultural and ethical influences.

Corporate mission and corporate culture are considered in more detail in a later chapter.

2.3 Strategic choices

The second element in the Johnson, Scholes and Whittington model is strategic choices. This involves identifying different possible strategies that the entity might adopt, and making a choice of the preferred strategies from the different alternatives that are available. There are three aspects to identifying alternative strategies and making strategic choices:

- Corporate level and international
- Business level strategies
- Development directions and methods

Corporate level and international

Strategic choices have to be made at the corporate strategy level. In particular, decisions have to be made about what the entity should be doing. For companies, this means making decisions about which products or services it should be selling, and what markets it should be selling them in.

There could also be an international aspect to strategic choices at this level. A company needs to decide whether it will operate internationally, and if so in what countries.

Business level strategies

Choices must also be made at the business strategy level. For companies, a major strategic choice is between a strategy of cost leadership and a strategy of differentiation.

If a company chooses a strategy of differentiation, it has to decide how it intends to make its products or services different from those of its competitors, so that the company will have a competitive advantage over rival companies and can succeed with its chosen strategy.

Development directions and methods

A choice must be made about the direction or directions in which the business should be directed.

- If a company's management decide on a strategy of growth, and making the business bigger, decisions have to be made about how the company will grow. Will it have a strategy of internal growth, and developing the business gradually using the company's own internal resources? Or will it seek to grow by making acquisitions of other companies? Or will it seek to grow by making strategic alliances with other companies, so that all the companies in the alliance help each other to grow their businesses?
- Senior management must also make strategic choices about its products and markets. One method of analysis (by Ansoff) is that companies can seek to grow in any of four ways:
  - **market penetration**: this is a strategy of trying to increase market share, by selling more of the company's existing products in its existing markets
  - **market development**: this is a strategy of growth by selling the company's existing products to new markets, such as markets in other countries
  - **product development**: this is a growth strategy that involves developing new products or services to sell to the company's existing markets
  - **diversification**: this is a higher risk strategy, which involves selling new products or services to new markets.

Ansoff's strategic analysis is explained in more detail in a later chapter.

The nature of strategic choices

Making a strategic choice is often a fairly simple decision, in the sense that the choices are clear. The problem with making strategic choices, however, is that it is easy to make the wrong choice and select unsuitable strategies.

Here are some of the choices that have to be made, and why management might make a wrong decision.

- What is the best way to make the entity succeed in achieving its objectives?
  - Should strategic decisions be based on the significant changes that are happening in the environment? Or is success achieved by focusing on the strengths of the entity, and stick to doing what it does best?
  - Should the entity choose a cost leadership strategy and sell its products at the lowest prices possible? Or should it seek to add value for the customer by differentiating its products, and charging higher prices?
  - Should the entity specialise in one type of product or one market? Or should it diversify and sell a range of products and in a number of different markets?
- What is the best way to manage the entity, in order to get the best out of its resources? Should the organisation structure be centralised or decentralised? What management style is appropriate? (Management style is explained in a later chapter.)

2.4 Strategy into action

The third element in the Johnson, Scholes and Whittington model of strategic management is 'strategy into action'. This means implementing the chosen strategies. There are three aspects to strategy implementation:

- Organising
- Enabling
- Managing change.

Organising

An organisation structure must be established that will help the entity to implement its strategies effectively in order to achieve its strategic targets. 'Organising' means putting into place a management structure and delegating authority. Individuals should be made responsible and accountable for different aspects of the chosen strategies. Decision-making processes must be established.

Enabling

'Enabling' means enabling the entity to achieve success through the effective use of its resources.

- Each resource must be used to support the achievement of strategic objectives. This calls for efficient management of resources such as people (and labour skills), information, finance and technology.
- Strategies should be based on making full use of the resource strengths of the entity, to achieve competitive advantage.

Managing change

Most entities exist in a rapidly-changing environment and they need to adapt and change in order to survive and succeed.

Implementing strategy always means having to make changes. Managing change successfully is therefore an important aspect of strategic management.

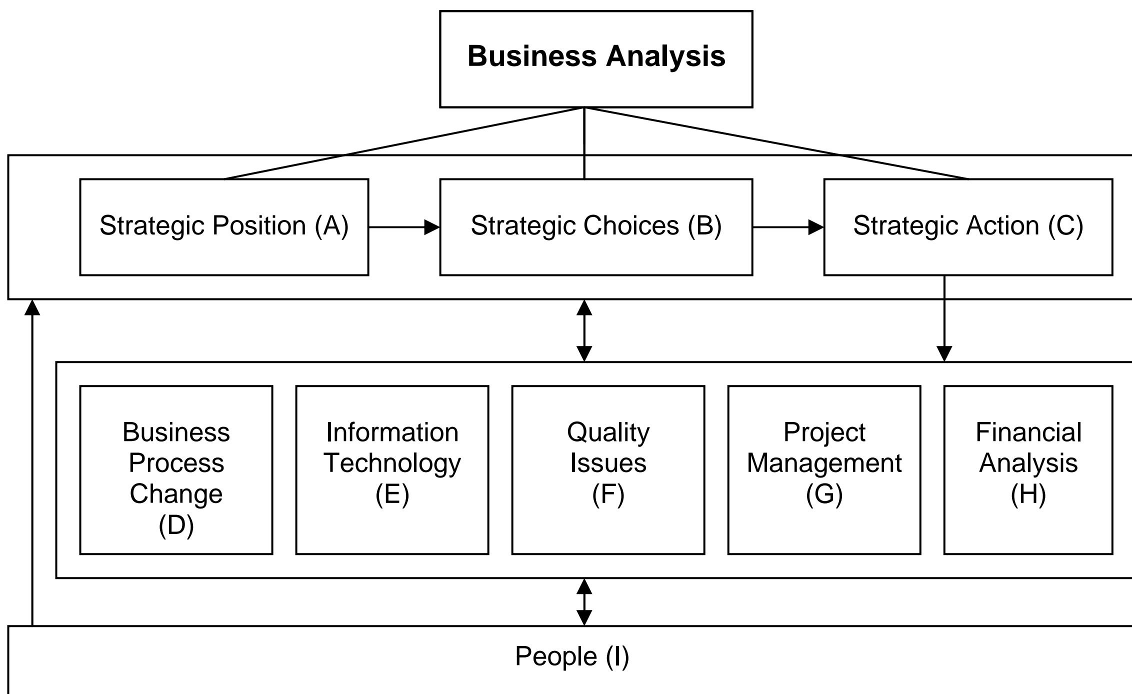
2.5 The scope of business analysis

Strategy is implemented through normal day-to-day work processes and through co-ordinating the efforts of many different individuals and groups. Work processes and relationships need to be managed efficiently, so that the entity is able to achieve its strategic objectives.

- Improvements in business processes are often a significant aspect of strategy implementation. Changing processes can be necessary to improve operational effectiveness.
- Strategies might be implemented as new projects and investments. Project management is therefore another aspect of successful strategy implementation.

- For some companies, the management of quality could be a key aspect of successful strategy implantation, through the implementation of initiatives such as Total Quality Management and Six Sigma.
- Successful strategic management also requires the support of management information systems. The information systems that management require are provided by information technology (IT) systems.
- An important part of management information systems for strategic planning and implementation is financial analysis. Relevant financial analysis is an essential part of strategic management.

The Business Analysis examination syllabus emphasises the relationship between strategic management and supporting business processes. This relationship is shown simply in the following diagram (which also indicates that the management of individuals is also a key to strategic success).



The examination syllabus deals with each of the elements in this diagram in some detail.

The process of strategy development

- Deliberate strategy, emergent strategy and incremental strategy
- Strategy lenses
- Strategy as design: the design lens
- Strategy as experience
- Strategy as ideas
- Using the three strategy lenses
- Mintzberg: 5 Ps for strategy
- Strategic planning frameworks

3 The process of strategy development

3.1 Deliberate strategy, emergent strategy and incremental strategy

Strategies can be developed in different ways. One way of explaining how strategies are developed is to make a distinction between deliberate strategy, emergent strategy and incremental strategy.

Deliberate strategy

Deliberate strategy is also called prescriptive strategy and rationally-planned strategy. It is the outcome from a formal strategic planning process, in which management:

- carry out a strategic position analysis
- identify and evaluates the strategic alternatives
- make strategic choices, and
- implement the chosen strategies, which are set out in a formal business plan or strategic plan.

The business plan is reviewed regularly, and amended if necessary. For example, if a company produces a formal five-year business plan, it might review the plan every year and amend it if necessary. It might also add another year to the end of the plan so that a rolling five-year plan is produced on an annual basis.

Formal strategic planning also involves the use of management aids and planning techniques, such as SWOT analysis and the use of models such as Porter's diamond and Porter's Five Forces model.

Example

For some companies, formal strategic planning and the implementation of deliberate strategy is essential.

In 2007, the UK government announced a new transport policy for the railways, with a strategic objective of increasing the capacity of the UK rail network but without increasing the number of train services.

Implementing this strategy would require the purchase of extra trains by train operating companies.

In addition, the company responsible for managing and maintaining the rail network, Network Rail, undertook to ensure that railway stations would be able to cater for longer trains, with 50% more carriages. To do this would require extending the length of some station platforms, which would involve substantial construction work.

This transport policy, involving the provision of longer trains, could not be implemented without formal (and co-ordinated) strategic planning by the train operating companies and Network Rail.

Emergent strategy

An emergent strategy is a strategy that is not formally planned, but which emerges in response to unforeseen developments and opportunities. Ideas for an emergent strategy might come from employees or fairly junior managers, rather than senior management.

However, once a new strategy has emerged, the entity applies the strategy consistently.

A company might develop both deliberate strategies and emergent strategies. These two methods of strategic development are not inconsistent with each other. There might be a formal business plan, containing deliberate strategies, but the company's management might be willing to develop new strategies whenever unexpected opportunities arise, even though they are not in the formal plan.

A strategy that begins as an emergent strategy might be included in a future formal business plan, so it eventually becomes a part of deliberate strategy.

Incremental strategy

Incremental strategy is strategy that is developed slowly over time, by making small changes to existing strategy. Changes to strategy are not large or far-reaching, because the management of the entity cannot see the need for any substantial changes.

When the entity's business environment is changing, small changes to existing strategies are unlikely to be sufficient to ensure the survival of the entity, and incremental change might be associated with aimlessness and a lack of strategic direction ('**strategic drift**').

Incremental strategy is only 'safe' when an entity operates in a very stable environment, where changes over time are small and gradual.

Example

An example of either incremental strategy or emergent strategy might be the case of international banking group Citigroup. In 2004, Citigroup suffered severe damage to its reputation, and some loss of business, from two sets of incidents.

- In Japan, repeated breaches of regulations by Citigroup staff resulted in the Japanese authorities forcing the bank to shut down its private banking operation in that country.
- In London, a trading strategy by some of its bond traders, who saw an opportunity to make a quick profit at the expense of other bond dealers, disrupted the market for European government bonds, and angered the European governments affected.

In response to the loss of customer goodwill and adverse publicity, Citigroup developed a new strategy aimed at preventing further incidents and damage to reputation and business. The strategy was designed to change the culture and attitudes of employees, based on programmes of training and changes in systems of performance reviews and rewards.

The new strategy emerged out of events, and was not a part of a regular strategic planning process. It was therefore an emergent strategy. It was also an incremental strategy because, in the words of the chief executive of the company, it did not call for a 'sea change' in culture.

3.2 Strategy lenses

Johnson and Scholes have suggested a slightly different approach to understanding strategy development. They have suggested that there are three different ways of looking at strategy development and, depending on circumstances, each approach might be appropriate.

They use the term 'strategy lenses' to describe these three ways of looking at strategy development. Strategy development can be seen:

- as design
- as experience
- as ideas.

3.3 Strategy as design: the design lens

Strategy can be seen as the result of a design process. Strategy development is logical, analytical and planned.

The characteristics of seeing strategy development as a design process are as follows.

- Strategy development is a formal and deliberate process.
- Thinking about strategy, and making strategic choices as an outcome from this thinking process, precedes the implementation of strategy.

- Strategies are logical and clear.
- Strategic choices are made by senior management. Senior managers are the strategic decision makers.

This type of strategic development is well-suited to an entity with a hierarchical management structure, where employees are accustomed to receiving directions from their senior managers.

This approach to strategy development is based on several assumptions and beliefs.

- The quality of strategic decision-making is improved by carefully-planned and systematic thinking, when the business environment is complex and the future is uncertain.
- Strategic development needs formal planning and control.
- The quality of strategic planning is improved by analytical tools and techniques, and business modelling.

'Strategy as design' is similar to deliberate strategy.

3.4 Strategy as experience

When strategic development is seen as the result of experience, future strategies:

- are developed by adapting and changing current strategies, and
- will be fairly small changes from current strategy.

Strategic thinking and strategic choices are strongly influenced by:

- the culture of the entity and the attitudes and beliefs of the people who work in it and
- history.

The 'old ways' have worked in the past, and there is no need to make significant changes to something that has proved itself successful.

The characteristics of seeing strategy development as a design process are as follows.

- the strategic direction of the entity will be strongly influenced by bargaining and negotiation between managers: strategic development is often the outcome of compromises
- strategies will develop incrementally.

'Strategy as experience' is similar to incremental strategy. The weakness with this form of strategic development, as indicated earlier, is **strategic drift**.

Strategic drift

Many entities go through periods of relative continuity, when their strategies are largely unchanged or change incrementally. This situation can go on for a long time – many years.

There is a risk of strategic drift in this type of situation, when strategies are increasingly inappropriate for dealing with the strategic position of the entity. There

are no changes or only minor changes in strategy, when changes in the business environment, even though they are not dramatic, mean that different strategies would now be more suitable. Gradually, the performance of the entity deteriorates.

3.5 Strategy as ideas

'Strategy as design' and 'strategy as experience' do not explain innovation. Formal strategic planning can help an entity to deal with the problems of change in the business environment, but it is not particularly well-suited to innovation and radical new ideas. Incremental strategic development is also inappropriate for encouraging innovation.

If important new strategic ideas do not come from formal planning or an incremental approach, where do they come from?

Johnson and Scholes suggested that innovation is likely to come from the third perspective on strategy; strategy as ideas.

The characteristics of seeing strategy development as a design process are as follows.

- Strategic development should rely on radical new ideas. These do not necessarily come from senior management. Other individuals within the entity might create the new ideas.
- Innovation happens as a result of variety and diversity. A changing and diverse environment encourages major innovation.
- Within an entity that encourages new ideas and innovative thinking, many different ideas compete for the support of management.
- Innovative thinking is unlikely to happen within an organisation with a traditional hierarchical management structure and formal lines of authority and responsibility.

This approach to strategy development is based on several assumptions and beliefs.

- Management must create suitable conditions for the encouragement and development of innovative ideas. There should not be too much management control; neither should there be too little control.
- Top managers are not the creators of new ideas and new strategies. Their role is to create a working environment where innovation is encouraged and to give support and guidance to their staff.
- When strategies are developed from ideas in this way, the entity has to recognise that new ideas will not be perfect. A part of the strategic development process is to make improvements to the weaknesses that are found in new strategies.

'Strategy as ideas' is similar to emergent strategy.

3.6 Using the three strategy lenses

Johnson and Scholes suggested that there is no single 'correct' approach to strategy development. All three strategy lenses provide a different insight into strategy, and

any one lens might be appropriate in a particular situation. Management should therefore be prepared to use all three lenses.

Looking at strategy through just one lens can be risky, because aspects of strategy that are seen and understood using one lens might not be seen if the other lenses are used.

3.7 Mintzberg: 5Ps for strategy

Mintzberg has provided a multiple definition of 'strategy', which also provides a useful analysis of how strategy develops. He suggested that the term 'strategy' is used in different ways and that there are five differing definitions. These are his '5Ps' for strategy. Strategy can be used to mean any of the following:

- plan
- ploy
- pattern
- position
- perspective.

Strategy as a plan. In this definition, strategy is an intended course of action or an intended strategic direction for the entity direction to take. A strategy is made in advance of its implementation and it is consciously developed and implemented. In this meaning, strategy means 'deliberate strategy'. In practice, however, the term 'strategy' is also used in other ways, and not as a conscious and intended plan.

Strategy as a ploy. In a second meaning, a strategy is a manoeuvre that is taken to get the better of a competitor, by taking advantage of an opportunity that arises. It is unplanned and opportunistic. For example, if a competitor raised the prices of its products, a counter-strategy might be to announce a temporary price cut. This might be a temporary ploy to create a distinction in the mind of competitors between the rival's price-raising and the company's own concern for customer interests.

Strategy as a pattern. Mintzberg suggested that it is not sufficient to define strategies as plans or ploys. Strategy must also be considered in terms of strategic outcomes. Strategies might be planned and opportunities taken, but the result might not be what was planned. The outcome of strategic development is a combination of deliberate strategies and emergent strategies. It might be possible to look back at what has happened, and describe a company's strategy in terms of a pattern that has emerged.

Strategy as position. This definition of strategy refers to locating or positioning an entity in its environment, and deciding the position within its environment (e.g. the position within its markets) that the entity should be. For example, an airline company might have a low-cost 'no frills' strategy for providing air travel. It would be positioning itself in the low-cost end of the market for air travel.

Strategy as perspective. Mintzberg also suggested that strategy can be defined in terms of the corporate personality and culture of the entity and its members (e.g.

management and employees). Strategy is a collective way of looking at an entity that is shared by all its members. For example, the teaching staff in a private school might share the view that the strategy of the school should be to offer a broad-ranging and high-quality academic education to pupils and to be one of the top schools in the country for examination results.

3.8 Strategic planning frameworks

Although strategic development in practice might be the outcome from deliberate strategies and emergent strategies (and possibly also some incremental strategies), it is useful to study the subject of business analysis and business strategy as if it were an organised process of planning and implementation. This helps to provide a framework for understanding the issues in strategic management and business analysis.

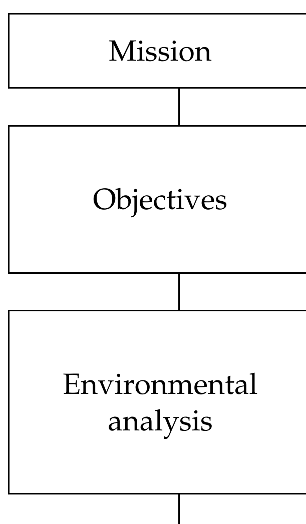
Two strategic planning frameworks that are useful to bear in mind are the rational planning model and strategic gap analysis.

The rational planning model

The 'rational planning model' is a strategic planning framework that:

- sees the purpose of strategy as the achievement of clearly-established objectives
- considers strategic planning to be a formal process, led by senior management
- sees strategic planning as a multi-layered process, with corporate strategy, business strategy and functional strategies.

The rational planning model consists of several elements, and the planning process goes though each of these elements in the following sequence.

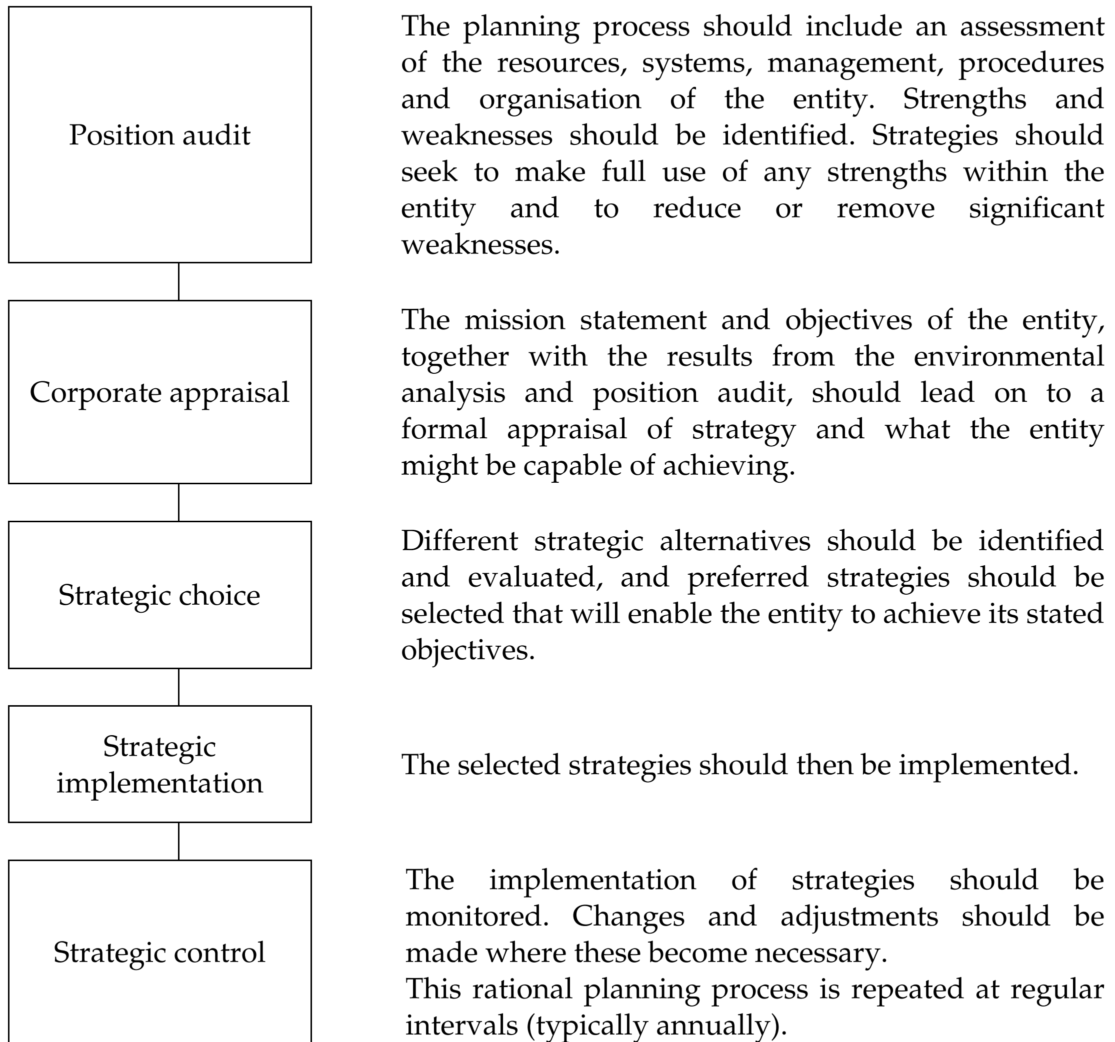


Comment

The entity exists for a purpose, which may be expressed formally in a mission statement.

The entity should also have clear objectives, such as the maximisation of shareholder wealth. Within the planning processes, targets can be established for the achievement of objectives within the planning period.

There are opportunities and threats within the business environment of the entity. These must be identified, and suitable strategic responses should be developed to deal with anticipated change and also unexpected change.



Gap analysis as an approach to strategic development

Gap analysis provides an alternative model for planning and developing strategy in a formal way. This approach consists of the following stages.

- Identifying objectives and setting targets: Where do we want to be?
- Establishing the current position. Where are we now?
- Measuring the difference between where we are and where we want to be as a strategic gap.

The gap might be expressed in a variety of ways. For example, at a corporate strategy level, a gap might be expressed including total annual sales revenue and total profitability, or product-market areas that the company should be operating in.

The purpose of strategy development should be to choose and implement strategies that will fill this strategic gap (or planning gap) so that the objectives can be achieved.

Filling the gap requires:

- an analysis of environmental threats and opportunities, and the internal strengths and weaknesses of the entity
- identifying the competitive advantage that the entity enjoys.
- if necessary, re-stating the business objectives as a result of this strategic appraisal, so that objectives remain realistic and achievable: this will change the size of the strategic gap
- identifying alternative strategies, evaluating them and selecting strategies to fill the strategic gap
- implementing the selected strategies.

CHAPTER 2

Strategic position and the business environment

Contents

1 Models for environmental analysis
2 PESTEL analysis
3 Porter's diamond

Models for environmental analysis

- The nature of environmental analysis
- The purpose of environmental analysis
- Two models for environmental analysis

1 Models for environmental analysis

1.1 The nature of environmental analysis

A business entity cannot exist in isolation from its environment. It inter-relates with its environment, and its survival and strategic success depend on how well it responds to the threats and opportunities that the environment provides.

An entity's environment is anything that is not a part of the entity itself. For a business organisation, the environment includes customers, potential customers, markets, competitors, suppliers, governments and potential sources of new employees. It also includes the social, political and economic environment in which the entity exists and operates.

The term '**macro-environment**' is used to mean general factors in the business environment of an entity, rather than specific customers, suppliers and competitors.

Environmental influences on an organisation vary with the size of the organisation, and the industry and the countries in which it operates.

The importance of environmental factors for strategic management arises because:

- organisations operate within their environment and interact with it
- changes in the environment can be large and significant – and continually happening
- future changes can be very difficult to predict.

1.2 The purpose of environmental analysis

Environmental analysis is a part of the process of assessing strategic position. In order to make strategic choices about the future, the management of an entity need to understand:

- the factors in the environment that have a significant effect on the entity and what it does
- the key drivers of change: these are the factors in the environment that will have the greatest effect on the entity, and force the entity to change its strategies in order to survive and succeed
- the difference in impact that key drivers of change in the environment will have on different industries or different markets, or how changes in the environment might affect one particular entity more or less than other entities.

It is also important to consider the **future impact** of factors in the environment. The future impact might be different from the impact that they have had in the past. Some factors might grow in significance; others might become less significant.

Environmental analysis is the process of:

- studying the environment in which an entity operates
- identifying significant factors in the environment, particularly those that will be significant in the future.

The purpose of the analysis is to assess the environment, to **analyse the position of an entity in relation to its environment** and to judge how the entity's strategies should be developed to take advantage of opportunities and the deal with any potential threats. It is a first step towards formulating a business strategy.

1.3 Two models for environmental analysis

In your examination, you may be required to carry out an environmental analysis. You might be required to use any 'model' of your choice. Alternatively you might be asked specifically to use PESTEL analysis or Porter's Diamond.

- The PESTEL model is used to identify significant factors in the macro-environment of an entity.
- Porter's Diamond model is used to analyse reasons why entities in particular countries, or regions within a country, appear to have a significant competitive advantage over similar entities in the same industry, but operating in other countries or other regions.

PESTEL analysis

- The nature of PESTEL analysis
- Social and cultural environment
- Legal environment
- Economic environment
- Political environment
- Technological environment
- Ecological influences
- Limitations of PESTEL analysis
- PESTEL analysis examples

2 PESTEL analysis

2.1 The nature of PESTEL analysis

PESTEL analysis is a structured approach to analysing the external environment of an entity. The influences (current influences and possible future influences) of the environment on the entity are grouped into categories. For each category of environmental influence, the main influences are identified.

There are six categories of environmental influence:

- P – Political environment
- E – Economic environment
- S – Social and cultural environment
- T – Technological environment
- E – Ecological influences
- L – Legal environment

The purpose of dividing environmental influences into categories is simply to make it easier to organise the environmental analysis and ensure that some key influences are not over-looked. It provides a **useful framework** for analysis.

You might also see reference to SLEPT analysis and PEST analysis. These are similar to PESTEL analysis in concept, but use a smaller number of environmental categories.

- SLEPT analysis uses the same categories of environmental influence as PESTEL analysis, without 'Ecological influences'.
- PEST analysis is the same as SLEPT analysis, but includes 'Political influences' and 'Legal environment' in the same category.

2.2 Social and cultural environment

An entity is affected by social and cultural influences in the countries or regions in which it operates, and by social customs and attitudes. Some influences are more significant than others.

Factors in the social and cultural environment include the following:

- The values, attitudes and beliefs of customers, employees and the general public.
- Patterns of work and leisure, such as the length of the working week and popular views about what to do during leisure time
- The ethnic structure of society
- The influence of religion and religious attitudes in society
- The relative proportions of different age groups in society.

Example

In many countries of Western Europe, the average age of the population is rising. A large number of individuals are reaching retirement age, and (as a proportion of the total population) the number of people in work is declining.

This demographic change will have consequences for many companies in the countries affected. It could be much more difficult in the future to attract and retain employees. In addition, a large part of the population will be older and in retirement from work. This could affect the demand for various goods and services, such as holidays and health products.

Among people of retirement age, two distinct social groupings might emerge: those who have retired because they have a sufficiently large pension, and those who cannot afford to retire because their pension would be inadequate for a reasonable living. An increase in the number of older people continuing to work past normal retirement age will have an impact on human resources planning for employers.

Example

In some countries there has been a growth in the awareness of 'healthy living' and 'healthy eating'. This has affected companies in industries such as health and leisure (the demand for fitness clubs), clothing (the demand for sportswear and running shoes) and food manufacture (the demand for organic food).

As a result, a large number of consumers have been prepared to pay more to obtain goods and services that offer healthier living and healthier foods.

Companies might need to consider whether the trend towards healthy living will continue, and if so, how they should respond to the continuing change in society.

2.3 Legal environment

The legal environment consists of the laws and regulations affecting an entity, and the possibility of major new laws or regulations in the future.

Laws and regulations vary between different countries, although international regulation is accepted in certain areas of commercial activity, such as banking.

Strategic decisions by an entity might be affected by legal considerations. For example:

- an international company might locate some operations, for tax reasons, in a country with a favourable tax system
- decisions to relocate operations from one country to another could be affected by the differences in employment law in the two countries, or by new employment legislation
- in many industries, companies are faced with environmental legislation or health and safety legislation, affecting the ways in which they operate, as well as the design of the products they make and sell.

2.4 Economic environment

The economic environment consists of the economic influences on an entity and the effect of possible changes in economic factors on future business prospects. Factors in the economic environment include:

- the rate of growth in the economy
- the rate of inflation
- the level of interest rates, and whether interest rates may go up or fall
- foreign exchange rates, and whether particular currencies are likely to get weaker or stronger
- unemployment levels and the availability of skilled or unskilled workers
- government tax rates and government subsidies to industry
- the existence or non-existence of free trade between countries, and whether trade barriers may be removed
- the existence of trading blocs of countries, such as the European Community.

Economic factors could affect a decision by a company about where to invest. Tax incentives, the availability of skilled labour, a good transport infrastructure, a stable currency and other factors can all influence strategic choices.

2.5 Political environment

The political environment consists of political factors that can have a strong influence on business entities and other organisations.

Investment decisions by companies will be influenced by factors such as:

- the stability of the political system in particular countries

- the threat of government action to nationalise the industry and seize ownership from private business
- wars and civil unrest
- the threat of terrorist activity.

Political considerations are particularly important for business entities operating in countries with an unstable political regime, or a dictatorship.

2.6 Technological environment

The technological environment consists of the science and technology available to an organisation (and its competitors), and changes and developments in science and technology.

Some aspects of technology and technological change affect virtually all organisations. Developments in IT and computer technology, including the Internet, are the most obvious example. Business entities that do not respond to changes in IT and computerisation risk losing their share of the market to competitors.

However, technological change might also affect particular industries. Scientific developments in food and drugs, for example, are having a continual impact on companies in these industries.

For strategic planning, companies need to be aware of current technological changes and the possible nature of changes in the future. Technology could have an important influence, for example, on investment decisions in research and development, and investment in new technology.

2.7 Ecological influences

For business entities in some industries, environmental factors have an important influence on strategic planning and decision-making. They are particularly important for industries that are:

- subject to strict environmental legislation, or the risk of stricter legislation in the future (for example, legislation to cut levels of atmospheric pollution)
- faced with the risk that their sources of raw materials will be used up (for example, parts of the fishing industry and timber production industry)
- at the leading edge of technological research, such as producers of genetically modified foods.

In some countries, companies have seen a commercial advantage in presenting themselves as 'environment-friendly', by improving their reputation with the general public. Several companies have adopted a policy of becoming 'carbon neutral' so that they remove as much carbon dioxide from the atmosphere as they add to carbon dioxide with emissions from their operating activities. (It was reported in the UK in 2007 that the demand from UK companies to acquire energy from renewable energy sources was far in excess of the capacity of the energy companies to supply energy from those sources.)

Major oil companies are investing in the development of energy from renewable energy sources, such as the sea and wind.

Example

In 2007, PricewaterhouseCoopers announced a business strategy aimed at becoming climate neutral in its business operation and travel. Since 2004, it had reduced carbon emissions by over 40% through measures such as buying renewable energy. It planned to offset its remaining carbon emissions by purchasing carbon credits.

The firm was also increasing the proportion of its waste that would be recycled to over 60%, cutting paper consumption per head of the workforce by 20% and reducing the amount of waste sent to landfill by more than 80%.

2.8 Limitations of PESTEL analysis

PESTEL analysis is a useful framework for identifying environmental influences on an entity. However, there are limitations to the technique.

- It is easier to use PESTEL analysis to identify environmental influences in the past and present. It is not so easy to identify the environmental influences that will have the biggest influence in the future.
- It is a method of identifying environmental influences, by providing a framework for analysis. It does not provide an assessment of environmental influences. It is used for qualitative analysis, but not for quantification. A manager using PESTEL analysis might need to use his (subjective) judgement to decide which environmental factors are more important than others.

2.9 PESTEL analysis examples

In your examination, it is more likely that you will be required to apply PESTEL analysis to a case study or scenario than to write about the method. You should therefore practice with examples, trying to identify which environmental factors could be the most significant for a particular type of entity.

Some examples are given here. Suggestions are provided about what the most significant environmental influences might be, but your opinion might differ from the suggested 'answers' here. You should also bear in mind that when you use PESTEL analysis it is not essential to identify a significant influence in each of the six categories of environmental influence. PESTEL analysis is simply a framework to help you to organise your ideas.

Example

In the UK, rail transport is operated by a number of different transport companies. Rail transport competes with road and air transport systems, for both passenger traffic and also goods traffic. Rail transport companies are awarded a licence to operate train services on particular parts of the rail network, for a specified number of years.

Strategic management of the companies in the industry might need to consider the following PESTEL factors:

- **Social and cultural**
  - More individuals are now working from home rather than travelling into work each day.
  - Even so, the number of people using rail services is increasing.
  - Many individuals prefer to use their car rather than go by train.
- **Legal**
  - Following a number of serious train crashes in recent years, rail transport companies are now probably more alert to the risk of litigation in the event of another serious accident.
- **Economic**
  - Investment decisions will be affected to some extent by expectations of growth in the UK economy and interest costs (= investment costs).
  - An important economic factor for the rail transport industry is the relative cost of rail transport compared with other forms of transport.
- **Political**
  - In the UK, the rail industry is subject to significant government influence. Rail transport companies receive subsidies from the government, and pricing is partially controlled by the government.
  - Rail transport companies must consider the risk that their licence to operate will not be renewed when it comes to an end.
- **Technological**
  - The rail industry is affected to some extent by new technology, such as high-speed trains and safety technology (for example, safe signalling equipment).
  - Rail companies need to consider when and whether they need to replace existing trains and carriages with more modern equipment.
  - The rail network might be reaching capacity. If so, this would restrict the strategic options available for growth in rail traffic unless measures can be found to increase the capacity of the network.
- **Ecological**
  - Rail services are normally regarded as ecologically kind forms of transport, with relatively low greenhouse gas emissions.

Example

The environmental factors that might be affecting the strategic outlook for the recorded music industry include the following:

- **Technology**. The widespread practice of downloading recorded music from the internet.
- **Legal**. The inability of the music industry to enforce copyright laws and prevent illegal downloading of recorded music on the internet.

- **Economic**. Low costs of delivering music to customers over the internet, making it easier for low-cost business operations to offer their music products to the market.
- **Social and cultural**. Growing differences in musical tastes and preferences of customers. Decline of the 'pop music' industry.

This analysis does not identify any significant political or ecological influences on the music industry.

Example

The UK building construction industry is strongly influenced by political/legal factors and ecological/general environmental factors.

- There are political pressures to increase the volume of properties built as residential homes, especially 'affordable homes' for low-income families.
- There are legal restrictions on planning permission to build new homes, especially on land that has been used in the past for other purposes.
- Building regulations are becoming more environment-conscious, and there are likely to be stricter regulations about installing 'environment-friendly' features (for example, energy-saving features such as solar panels and roofing insulation).
- There are likely to be growing restrictions on the sourcing of raw materials (stone or bricks) from quarries.
- There are also likely to be stricter regulations about the disposal of building waste materials.

Porter's Diamond

- National competitive advantage
- The four elements in Porter's Diamond
- Favourable factor conditions
- Related and supporting industries
- Demand conditions in the home market
- Firm strategy, structure and rivalry
- The role of government in creating competitive advantage
- Criticisms of Porter's Diamond
- Using Porter's Diamond

3 Porter's Diamond

3.1 National competitive advantage

Business entities in some countries appear to enjoy a competitive advantage over businesses in other countries in particular industries. For example, the US and Japan appear to enjoy an advantage in global markets for IT and communications products and services; Switzerland and the US enjoy an advantage in pharmaceuticals, the UK appears to have some advantage in investment banking, and so on.

This competitive advantage is **often concentrated in a particular region** of a country.

Clusters

A feature of national or regional competitive advantage is the existence of a 'cluster'. A cluster is a concentration of inter-connected companies in the same geographical region. It consists of companies in the same industry, and also specialised suppliers and service providers to the industry. There may also be firms in related industries: for example, if a region has a competitive advantage in the manufacture of plastics, there may also be a concentration of firms in the electronics, engineering and oil refining industries. A cluster may also contain associated institutions that promote innovation and improvements in the industry such as universities with research departments and trade associations. Many of the firms within a geographical cluster compete, but in many respects they also co-operate with each other to develop their industry.

The reasons for national competitive advantage

Traditional economic theory states that a country 'inherits' a comparative advantage over other countries in particular industries because of the natural resources that it

enjoys. Natural resources include not only land and mineral deposits, but also the labour force and size of the population.

Michael Porter challenged the traditional theory of comparative national advantage in his book **The Competitive Advantage of Nations**. He put forward a different theory of national competitive advantage, known as Porter's Diamond.

The strategic significance of national competitive advantage

Porter argued that the national domestic market plays an important role in creating competitive advantage for companies on a global scale. Companies operating in a strong domestic market can develop competitive strengths. They can then build on the strength of their 'home base' to extend their business operations into other countries, where their competitive advantage will also apply and help them towards success.

3.2 The four elements in Porter's Diamond

Porter argued that a country could create factors that give its firms (business entities) a **comparative competitive advantage** over firms in the same industry in other countries. Comparative competitive advantage for a country (or region) means that business entities in the country (or region) can compete successfully and effectively against business entities in the same industry but operating in another country (or region).

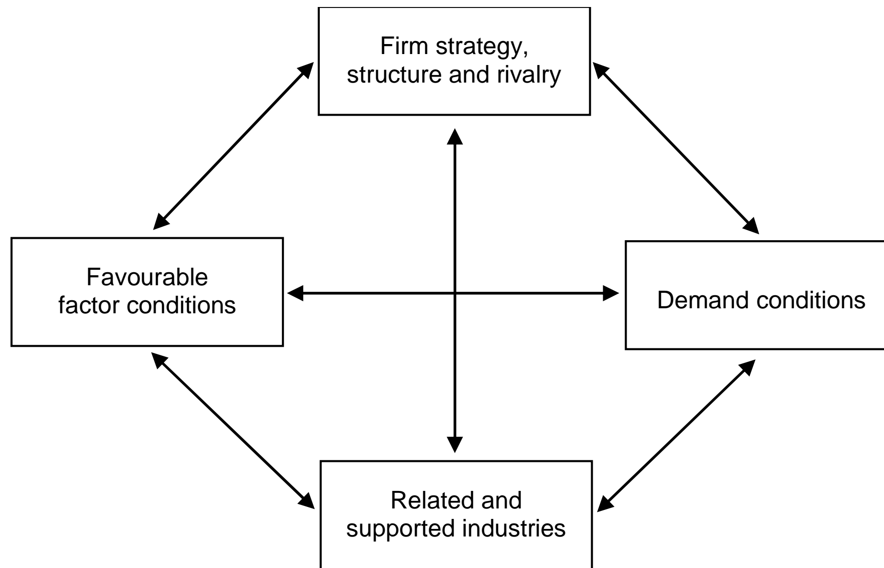
When a country enjoys a comparative competitive advantage in a particular industry, there will be a concentration of businesses in the country operating in the industry or in supporting industries.

Porter's Diamond model provides an analysis of the factors that give a country or region a comparative competitive advantage. Porter argued that a key to national or regional supremacy in a particular industry is the **ability to innovate**. Firms and industries must innovate to remain successful: a country must encourage innovation in order to retain a national comparative advantage.

Porter used a diamond shape to present the factors that create comparative competitive advantage for a country over other countries. There are four inter-related elements:

- Favourable factor conditions
- Related and supporting industries
- Demand conditions in the home market
- Firm strategy, structure and rivalry.

These four elements can be presented in a diagram in a diamond shape, as follows.



3.3 Favourable factor conditions

'Factors' are the economic factors of production – land, labour, capital (equipment) and raw materials. 'Factor conditions' are conditions in a market with regard to one or more of these factors of production.

Some factor conditions in a national market might be favourable for companies operating in a particular industry, and give them a strong national competitive advantage. Factor conditions in a country can be divided into two categories:

- basic factors and
- advanced factors.

Basic factors

Basic factors are factors of production that exist naturally in the country. These might be:

- large amounts of suitable land, such as land for agriculture
- large quantities of natural materials, such as timber, fresh water, and mineral resources such as oil and metals
- a favourable climate.

For example, the basic factor conditions of climate and suitable soil help to explain why countries such as France and Australia are successful at wine-making.

Advanced factors

Advanced factors are factors that are 'created' and developed over time. Unlike basic factors, they are not 'inherited' and do not exist naturally. A country might be successful at developing particular factors that make it easier for companies to compete more successfully.

Examples of advanced factors are:

- **Labour skills and knowledge**. These might be general skills, such as a highly educated workforce with excellent skills in language and mathematics. They might also be skills in a particular industry or type of work. For example, a country might have a working population with high levels of technical skill in computer software writing, or nuclear physics.
- **Technological resources**. A country might benefit, for example, from the existence of scientific research centres.
- **Infrastructure**. A country might benefit from excellent transport networks and telecommunications networks.

Creating favourable factor conditions

A country might suffer from a disadvantage in a factor of production compared with other countries. It can overcome this 'factor disadvantage' by innovating. For example:

- Japan suffers from a shortage of land. Its companies therefore find it difficult to allocate space to the storage of goods and materials. Japanese companies successfully overcame the disadvantage of land shortage by developing the concept of Just-in-Time purchasing and production.
- Japan has employment laws that make it difficult to dismiss employees from their job. As a result, there was extensive use of automation that gave Japan a lead over other countries in the production of high-quality manufactured goods.
- Switzerland has suffered from a comparatively small population. It has a long tradition of excellence in the production of watches, and overcame the problem of labour-intensive watch production by developing innovative high-quality watch designs.
- It has been argued that the success of Switzerland in international banking is due largely to the language skills of its population and the consequent ability of Swiss bankers to establish a good relationship with customers from many different countries.

3.4 Related and supporting industries

A country's industry is made more competitive, compared to other countries, when there is strong competition and innovation in related and supporting industries.

When supporting industries are highly competitive, costs are reduced and innovation occurs continually. Some of the benefits of lower costs and innovation in a supporting industry (or related industry) are passed on to business entities in industries that the supporting industry serves.

For example, many industries in the US have benefited from the competitiveness and innovation of IT firms in Silicon Valley. In Singapore, companies have achieved national competitive advantage in both port services and shipping repairs: port services benefit from the presence of a strong shipping repair industry, and the shipping repair industry benefits from the existence of excellent port facilities.

Porter argued that the competitive benefits of an innovative supporting industry (or related industry) are greater when firms in the supporting industry are themselves strong competitors in global markets.

In many industries, innovation depends on **research and development**. Another feature of national competitive advantage may therefore be the existence of companies with strong R&D departments, and universities that have research departments with specialists in the industry.

3.5 Demand conditions in the home market

Porter argued that strong demand in local markets, particularly when this demand is sophisticated and discerning, can help to make local firms more competitive in global markets.

- When local demand is strong, local firms will give more attention than their foreign competitors to the needs of the local customers.
- This will help to make local firms more innovative and competitive.
- When local firms sell their products in global markets, the innovation and competitiveness created in local markets will help them to succeed internationally.
- Innovation in local markets will help local firms to anticipate changes in global demand.

As an example, it might be argued that strong local demand for wine, and sophisticated local customers, has helped France to maintain its strong competitive position in the global markets for wine.

It has also been argued that in the Japanese market for consumer electrical and electronic goods, customers have very high expectations about the quality of products. Companies are therefore forced to produce products to very high quality standards to satisfy demand in the Japanese market. This creates a competitive advantage for Japanese producers in foreign markets.

3.6 Firm strategy, structure and rivalry

Porter suggested that other factors that create national competitive advantage are the strategy of firms and their owners, the organisation structure of firms and the rivalry between local firms in the industry.

- Firms and their owners might have different ideas about investment strategy. For example, in the US, investors and the management of companies often have a short-term outlook, and expect returns on their investment within a relatively short time. In other countries, investors might expect to invest for longer, to obtain the benefits of long-term returns. This might help to explain, for example, why the US does well in computer industries and Switzerland excels in pharmaceuticals.
- In some countries, the management structure in larger companies is formal and hierarchical. In other countries, many companies are family-run businesses. This might give companies in some countries a competitive advantage in some industries, but not others.

- A country is likely to retain a competitive advantage in industries whose key employees have jobs that give the individual a high status in society. For example, the UK has some comparative strength in investment banking: jobs as investment bankers have a high status in UK society.
- Rivalry between local firms is also an important factor in maintaining national or regional competitive advantage. This is because rivalry forces producers to innovate, and to keep on looking for ways of meeting customer needs better than their competitors.

It has been suggested for example that the international success of beer producing companies in the Netherlands and Belgium is attributable to keen competition between producers in those countries. Similarly, the success of pharmaceuticals companies in Switzerland may be attributable to the rivalry between Swiss firms in the industry.

3.7 The role of government in creating competitive advantage

Porter argued that the four elements in the diamond are all important for creating national competitive advantage, because they create the conditions that result in competitive advantage:

- the availability of suitable resources and skills
- information that firms can use to decide how to invest the resources and skills that are available to them
- goals of individuals and companies
- pressure on companies to innovate and invest.

Governments can help to create suitable conditions for national competitive advantage.

- They can create an education and training system that develops appropriate labour skills and knowledge.
- They can help companies to raise their performance levels by enforcing strict product standards.
- They can create early demand for new and advanced products by purchasing the products themselves.
- They can stimulate rivalry between local firms by enforcing strict anti-trust legislation.

Example

An example that has been used to illustrate Porter's Diamond theory is the success of Japanese companies manufacturing fax machines.

Several factors contributed to the comparative national advantage of Japan in fax machine production.

- Customers in Japan for fax machines were very demanding in their requirements, due to the nature of the Japanese written language.

- Japan had a relatively large number of electrical engineers, providing a source for skilled labour in fax machine technology.
- Japan had strong related and supporting industries, with expertise in miniaturisation and micro-technology. These helped Japanese companies to produce advanced fax machines.
- Strong local rivalry between fax machine producers helped to stimulate innovation in product design and keep costs low.
- There was strong government support: the government eased its own purchasing regulations, making it easier for government departments to buy the new fax machines produced by local firms.

3.8 Criticisms of Porter's Diamond

There are some weaknesses in Porter's Diamond theory. In particular:

- It is more relevant to companies in advanced economies than to companies in countries with developing economies.
- The diamond model does not consider the role of the multinational company, which locates production operations in different countries across the world.

3.9 Using Porter's Diamond

In your examination, you might be required to use Porter's Diamond theory to explain the global success of companies in a particular country. To do this, you would need to consider the four factors in the Diamond, together with the influence of government.

Example

The success of London as a global financial centre can be explained using Porter's Diamond.

- **Favourable factor conditions**
  - In the UK, investment bankers have a high social status. This helps to attract highly-talented individuals into the industry, from other countries as well as the UK.
  - There is a highly-skilled workforce, in investment banking and also related industries.
  - London benefits from its membership of the European Union.
  - London is in a favourable time zone in Europe, between the time zones of the Far East and the US (especially New York).
  - English is the 'language' of international banking, and London benefits from being in an English-speaking country.
- **Related and supporting industries**
  - London's financial companies benefit from the existence of strong related and supporting industries, such as accounting firms, law firms and IT firms.

- **Demand conditions in the home market**
  - Investment institutions such as pension funds and insurance companies are major customers of financial services firms in the UK. They have very high expectations of the quality of service they should receive.
- **Firm strategy, structure and rivalry**
  - Banks in the London market benefit from strong rivalry between firms that helps to maintain standards of service at a high level.

London also benefits from high standards of corporate behaviour/corporate governance, but a regulatory regime that is not too oppressive. The UK government seeks to encourage the success of the UK financial services industry.

CHAPTER 3

Competitive forces

Contents

1	Competition and markets
2	Industry competition: Five Forces model
3	Life cycle model
4	Strategic groups and market segmentation
5	Opportunities and threats

Competition and markets

- Customers and markets
- Industries and sectors
- Convergence

1 Competition and markets

1.1 Customers and markets

A market is a place where buying and selling takes place. A market can be defined in different ways.

- It can be defined by the products or services that are sold, such as the fashion clothes market, the banking market or the market for air travel.
- It can be defined by the customers or potential customers for products or services, such as the consumer market or the 'youth market'.
- Customer markets might also be defined by geographical area, such as the North American market or European market.

Markets can be global or localised.

An important aspect of business strategy for companies is concerned with selling goods or services successfully to targeted markets. (These strategies are 'product-market strategies.')

A similar concept of 'markets' and 'customers' can also be applied to the provision of public services, such as state-owned schools and hospitals. For example, there are 'markets' for education services in which customers are pupils (or their parents).

1.2 Industries and sectors

An industry consists of suppliers who produce similar goods and services. For example, there is an aerospace industry, an automobile manufacturing industry, a construction industry, a travel industry, a leisure industry, an insurance industry, and so on.

Within an industry, there may be different segments. An industry segment is a separately-identifiable part of a larger industry. For example, the automobile industry can be divided into segments for the construction of automobiles and the manufacture of parts. Similarly, the insurance industry has several sectors, including general insurance, life assurance and pensions.

Companies need to make strategic decisions about:

- the industry and industrial segment (or segments) they intend to operate in, and
- the market or markets in which they will sell their goods or services.

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A distinction should be made between products and markets.

- Companies in different industries might sell their goods or services to the same market. For example, small building companies compete with retailers of do-it-yourself tools and other products. Laundry services compete with manufacturers of domestic washing machines.
- Companies in the same industry might not compete because they operate in different markets. For example, a ferry company operating passenger services between the UK and France is in the same industry as a ferry company operating passenger services between the Greek islands, but they are in the same industry.

In their analysis of strategic position, management need to recognise which industries and segments they operate in, and also which markets they are selling to. They also need to recognise changing conditions in industries, segments and markets, in order to decide what their product-market strategies should be in the future.

Generic types of industry

Porter suggested that there are five generic types of industry. The strategic position of a company depends to some extent on the type of industry it is operating in. The five industry types are as follows:

- **Fragmented industries**. In a fragmented industry, firms are small and sell to a small portion of the total market. Examples are dry cleaning services, hairdressing services, shoe repairs.
- **Emerging industries**. These are industries that have only just started to develop, and are likely to become much bigger and much more significant in the future. An example is the space travel industry.
- **Mature industries**. These are industries where products have reached the mature phase of their life cycle. (The product life cycle is described later.) Examples are automobile manufacture and soft drinks manufacture.
- **Declining industries**. These are industries that are going into decline: total sales are falling and the number of competitors in the market is also falling. An example in coal mining in Europe.
- **Global industries**. Some industries operate on a global scale, such as the microprocessor industry and the professional football industry.

1.3 Convergence

Occasionally, two or more industries or industrial segments converge, and become part of the same industry, with the same customer markets. When convergence is happening, or might happen in the future, this can have a major impact on business strategy.

Example

In the past, there were three separate communications industries providing services to consumer households.

- Television broadcasters (such as the BBC and ITV) delivered terrestrial television services to households.
- Telephone service companies delivered voice communications to households through the telephone network.
- More recently, data communications have been provided to households through internet service providers.

A separate mobile telephone industry also developed.

These industries or industrial segments are now converging into a single industry, serving the same customers. Voice, data and entertainment services can be delivered over the same network. They can also be delivered to mobile telephones as well as to households.

As a consequence, these industries have undergone, and continue to undergo, major strategic changes.

- Technology is continuing to develop. It should soon be possible to download high-quality TV pictures over the internet. Customers will be able to receive voice, data and entertainment services through the same hardware, anywhere and at any time.
- New products and new services will emerge and markets for these products will grow – examples are on-demand TV programmes, video conferencing, and narrowcasting (delivering programmes to a targeted audience). Direct advertising services will also be affected.
- Inevitably, some companies will be 'winners' and some will be 'losers'. The companies that survive in the converging industries will be those that are most successful with their strategic management.

Demand-led and supply-led convergence

Convergence can be either demand-led or supply-led.

- With demand-led convergence, the pressure for industry convergence comes from customers. Customers begin to think of two or more products as interchangeable or closely complementary.
- With supply-led convergence suppliers see a link between different industries and decide to bridge the gap between the industries. The convergence of the entertainment, voice communication and data communication industries, discussed in the previous example, is probably supply-led, because suppliers became aware of the technological possibilities before consumers became aware of the convenience.

Industry competition: Five Forces model

- Competition analysis
- The Five Forces
- Threat from potential entrants
- Threat from substitute products
- Bargaining power of suppliers
- Bargaining power of customers
- Competitive rivalry
- The Five Forces model summarised
- Using the Five Forces model

2 Industry competition: Five Forces model

2.1 Competition analysis

Analysing competition is an important part of strategic position analysis.

- It is also important to assess the strength of competition in a market, and try to understand what makes the competition weak or strong.
- A company should also monitor each of its major competitors, because in order to obtain a competitive advantage, it is essential to know about what competitors are doing.

Porter's Five Forces model provides a framework for analysing the strength of competition in a market.

It is not a model for analysing individual competitors, or even what differentiates the performance of different firms in the same market. In other words, it is not used to assess why some firms perform better than others.

Profitability and competition

In addition, the Five Forces model can be used to explain why some industries are more profitable than others, so that companies operating in one industry are able to make bigger profits than companies operating in another industry. Profitability is affected by the strength of competition: the stronger the competition, the lower the profits.

Note: Porter argued that **two factors affect the profitability** of a company:

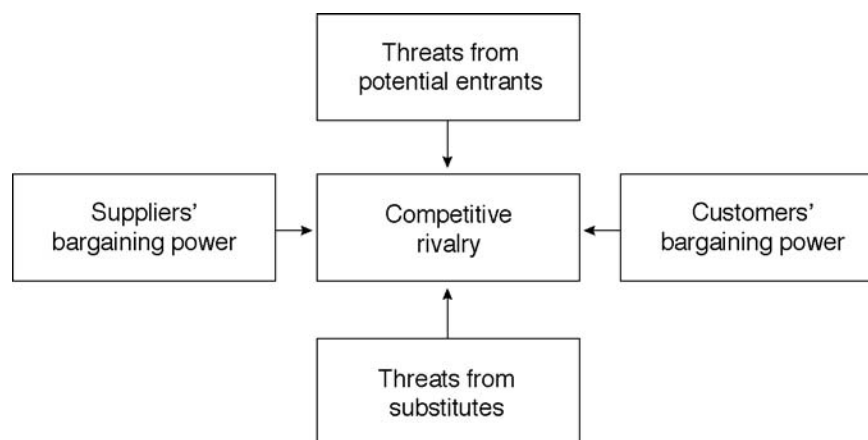
- industry structure and **competition in the industry**, and also
- **sustainable competitive advantage**: this is discussed in detail in a later chapter.

2.2 The Five Forces

Michael Porter ('Competitive Strategy') identified five factors or 'forces' that determine the strength and nature of competition in an industry or market. These are:

- threats from potential entrants
- threats from substitute products or services
- the bargaining power of suppliers
- the bargaining power of customers
- competitive rivalry within the industry or market.

The Five Forces model is set out in the following diagram.



When competition in an industry or market is strong, firms must supply their products or services at a competitive price, and cannot charge excessive prices and make 'supernormal' profits. If they do not charge the lowest prices, firms must compete by offering products that provide extra value to customers, such as higher quality or faster delivery.

When any of the five forces are strong, competition in the market is likely to be strong and profitability will therefore be low. Analysing the five forces in a market might therefore help strategic managers to choose the markets and industries for their firm to operate in.

2.3 Threat from potential entrants

One of the Five Forces is the threat that new competitors will enter the market and add to the competition. New entrants might be attracted by the high profits earned by existing competitors into the market, or by the potential for making high profits. When they enter the market, new entrants will try to establish a share of the market that is large enough to be profitable. One way of gaining market share would be to compete on price and charge lower prices than existing competitors.

The significance of this threat depends on how easy or how difficult it would be for new competitors to enter the market. In some markets, the cost of entering a new

market can be high, with new entrants having to invest in assets and establish production facilities and distribution facilities. In other markets, the cost of entering the market can be fairly low.

The costs and practical difficulties of entering a market are called 'barriers to entry'.

- **When barriers to entry are low**. If new entrants are able to come into the market without much difficulty, firms already in the market are likely to keep prices low and to meet customer needs as effectively as possible. As a result, competition in the market will be strong and there will be no opportunities for high profit margins.
- **When barriers to entry are high**. When it is difficult for new competitors to enter a market, existing competitors are under less pressure to cut their costs and sell their products at low prices.

A number of factors might help to create high barriers to entry:

- **Economies of scale**. Economies of scale are reductions in average costs that are achieved by producing and selling an item in larger quantities. In an industry where economies of scale are large, and the biggest firms can achieve substantially lower costs than smaller producers, it is much more difficult for a new firm to enter the market. This is because it will not be big enough at first to achieve the economies of scale, and its average costs will therefore be higher than those of the existing large-scale producers.
- **Capital investment requirements**. If a new entrant to the market will have to make a large investment in assets, this will act as a barrier to entry, and deter firms from entering the market when they do not want the investment risk.
- **Access to distribution channels**. In some markets, there are only a limited number of distribution outlets or distribution channels. If a new entrant will have difficulty in gaining access to any of these distribution channels, the barriers to entry will be high.
- **Time to become established**. In industries where customers attach great importance to branding, such as the fashion industry, it can take a long time for a new entrant to become well established in the market. When it takes time to become established, the costs of entry are high.
- **Know-how.** This can be time-consuming and expensive for a new entrant to acquire
- **Switching costs**. Switching costs are the costs that a buyer has to incur in switching from one supplier to a new supplier. In some industries, switching costs might be high. For example, the costs for a company of switching from one audit firm to another might be quite high, and deter a company from wanting to change its auditors. When switching costs are high, it can be difficult for new entrants to break into a market.
- **Government regulation**. Regulations within an industry, or the granting of rights, can make it difficult for new entrants to break into a market. For example, it might be necessary to obtain a licence to operate, or to become registered in order to operate within an industry.

2.4 Threat from substitute products

There is a threat from substitute products when customers can switch fairly easily to buying alternative products (substitute products).

The threat from substitutes varies between markets and industries, but a few examples of substitutes are listed below:

- Domestic heating systems. Consumers might switch between gas-fired, oil-fired and electricity-fired heating systems.
- Transport. Customers might switch between air, rail and road transport services.
- Food and drink products. Consumers might switch between similar products, such as coffee and tea.

When there are substitute products that customers might buy, firms must make their products more attractive than the substitutes. Competition within a market or industry will therefore be higher when the threat from substitute products is high.

Threats from substitute products may vary over time. There are many examples in the past of industries that have been significantly affected by the emergence of new substitute products.

- Plastic containers and bottles became a significant substitute for glass containers and bottles.
- Synthetic fibres became a substitute for natural fibres such as wool and cotton.
- Word processors and personal computers became a substitute for typewriters, and the market for typewriters was destroyed.

2.5 Bargaining power of suppliers

In some industries, suppliers have considerable power. When this occurs, they might charge high prices that firms buying from them are unable to pass on to their own customers. As a result, profitability in the industry is low, and the market is competitive.

Porter wrote: 'Suppliers can exert bargaining power over participants in an industry by threatening to raise prices or reduce the quality of purchased goods or services. Powerful suppliers can thereby squeeze profitability out of an industry unable to recover cost increases in its own prices.'

Example

An example of supplier power is possibly evident in the industry for personal computers. Software companies supplying the computer manufacturers (such as Microsoft) have considerable power over the market and seem able to obtain good prices for their products. Computer manufacturers are unable to pass on all the high costs to their own customers for PCs, and as a consequence, profit margins in the market for PC manufacture are fairly low.

Porter suggested that the bargaining power of suppliers might be strong in any of the following situations:

- when there are only a small number of suppliers to the market
- when there are no substitutes for the products that are supplied
- when the products of a supplier are differentiated, and so distinctly 'better' or more suitable than the products of rival suppliers
- when the supplier's product is an important component in the end-products that are made with it
- when the industry supplied is not an important customer for the suppliers
- when the suppliers could easily integrate forward, and enter the market as competitors of their existing customers.

The bargaining power of suppliers also depends on the importance of the product they supply. For example, for a firm that manufactures cars the bargaining power of engine suppliers will be greater than the bargaining power of suppliers of car mirrors.

2.6 Bargaining power of customers

Buyers can reduce the profitability of an industry when they have considerable buying power. Powerful buyers are able to demand lower prices, or improved product specifications, as a condition of buying. Strong buyers also make rival firms compete to supply them with their products.

In the UK, a notable example of buyer power is the power of supermarkets as buyers in the market for many consumer goods. They are able to force down the prices from suppliers of products for re-sale, using the threat of refusing to buy and switching to other suppliers. As a result, profit margins in the manufacturing industries for many consumer goods are very low.

Porter suggested that buyers might be particularly powerful in the following situations:

- when the volume of their purchases is high relative to the size of the supplier
- when the products of rival suppliers are largely the same ('undifferentiated')
- when the costs of switching from one supplier to another are low
- when the cost of purchased item is a significant proportion of the buyer's total costs
- when the profits of the buyer are low
- when the buyer's product is not affected significantly by the quality of the goods that it buys
- when the buyer has full information about suppliers and prices.

2.7 Competitive rivalry

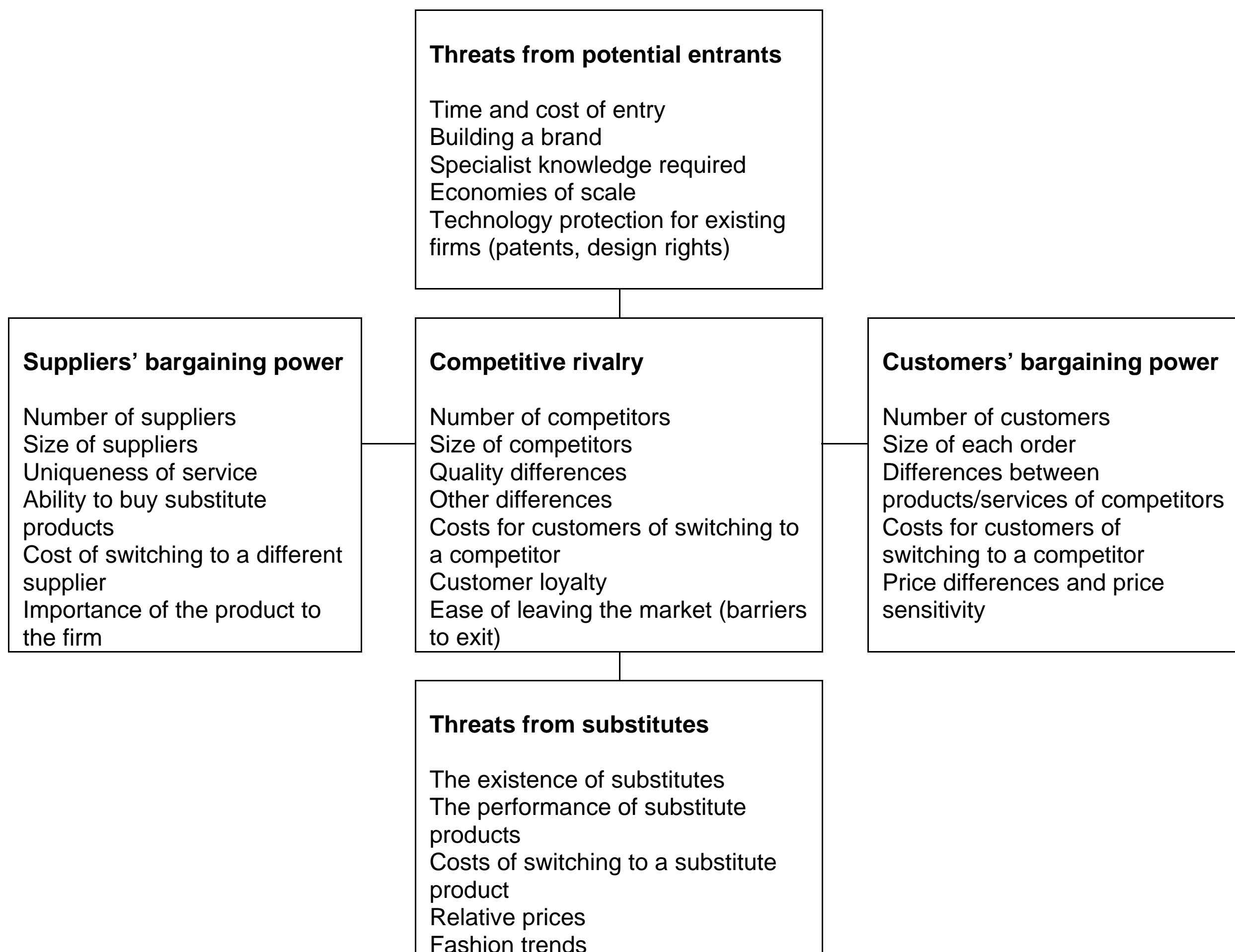
Competition within an industry is obviously also determined by the rivalry between the competitors. Strong competition forces rival firms to offer their products to customers at a low price (relative to the product quality) and this keeps profitability fairly low.

Porter suggested that competitor rivalry might be strong in any of the following circumstances:

- when the rival firms are of roughly the same size and economic strength
- when there are many competitors
- when there is only slow growth in sales demand in the market
- when the products of rival firms are largely the same ('undifferentiated')
- when fixed costs in the industry are high, so that firms still make some contribution to profit even when they cut prices
- when supply capacity can only be increased in large incremental amounts (for example, in electricity supply industry, where increasing total supply to the market might only be possible by opening another power generation unit)
- when the costs of withdrawing from the industry are high, so that even unprofitable companies are reluctant to leave the market.

2.8 The Five Forces model summarised

The Five Forces model is summarised below, showing some of the key factors that help to determine the strength of each of the forces in the industry or market.



2.9 Using the Five Forces model

In your examination, you might be required to use the Five Forces model to analyse the strength of competition in a market or an industry, in a question containing a case study or scenario. To do this, you should take each of the Five Forces in turn and consider how it might apply to the particular case study or scenario.

Here are two simple examples, with suggestions about the strength of competition. Your own views might differ.

Example

The Five Forces model can be used to analyse the market for legal services (the services of firms of solicitors) in a local area, where competition is between small and medium-sized firms.

- **Threat from potential entrants**. This is likely to be fairly low. New entrants must be qualified solicitors, and it could take time to establish a sufficiently large client base.
- **Suppliers' bargaining power**. Solicitors have no significant suppliers; therefore the bargaining power of suppliers is non-existent.
- **Customers' bargaining power**. Most firms of solicitors have a fairly large number of customers. Customers need legal services. The bargaining power of customers is probably low.
- **Threat from substitutes**. There are no substitutes for legal services, except perhaps for some 'do-it-yourself' legal work.
- **Competitive rivalry**. This is likely to be very weak. Firms of competitors will not usually seek to compete with other firms by offering lower fees.

The conclusion is that competition in the market for legal services in a local region is very weak.

Example

The Five Forces model can be used to analyse the competition for Amazon, the company that supplies books, CDs and DVDs through online ordering on its website. It has no direct competitor.

- **Threat from potential entrants**. This is likely to be fairly low, because of the costs of establishing a selling and distribution system and the time it might take a new competitor to create 'brand awareness'.
- **Suppliers' bargaining power**. Amazon obtains its books and other products from a large number of different suppliers. The bargaining power of most suppliers is therefore likely to be weak, with suppliers needing Amazon more than Amazon needs individual suppliers.
- **Customers' bargaining power**. Amazon has a very large customer base, and the bargaining power of customers is non-existent.

- **Threat from substitutes**. Substitutes are bookshops, shops selling CDs and DVDs, internet downloads of films and music, and possibly eBay and other online auction sites as a channel for selling second-hand books. In the longer term electronic books might be another substitute.
- **Competitive rivalry**. Amazon has no direct competitor.

In conclusion, the major competition in the market served by Amazon is probably the threat from substitute products.

Life cycle model

- The 'classical' product life cycle
- Relevance of the product life cycle to strategic management
- Cycle of competition

3 Life cycle model

3.1 The 'classical' product life cycle

A 'life cycle' is the period from birth or creation of an item to the end of its life. Products, companies and industries all have life cycles. A product life cycle begins with its initial development and ends at the time that it is eventually withdrawn from the market at the end of its life.

A life cycle is said to go through several stages. The 'classical' life cycle for a product, or even an entire industry, goes through four stages or phases:

- Introduction
- Growth
- Maturity
- Decline.

Introduction phase. During this stage of a product life cycle, there is some sales demand but total sales are low. Firms that make and sell the product incur investment costs, and start-up costs and running costs are high. The product is not yet profitable.

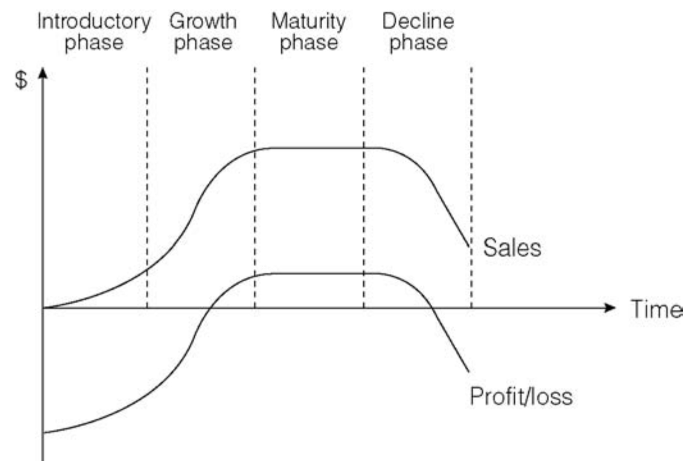
Growth phase. During the growth phase, total sales demand in the market grows at a faster rate. New entrants are attracted into the market by the prospect of high sales and profits. At an early stage during the growth phase, companies in the market begin to earn profits.

Maturity phase. During the maturity phase, total annual sales remain fairly stable. Prices and profits stabilise. The opportunity for more growth no longer exists, although the life of the product might be extended, through product updates.

More companies might seek to improve profits by differentiating their products more from those of competitors, and selling to a 'niche' market segment.

Decline phase. Eventually, total annual sales in the market will start to fall. As sales fall, so too do profits. Companies gradually leave the market. At some point in time, it is no longer possible to produce and sell the product at a profit, and the product is therefore discontinued by the last of the companies that makes it.

A 'classical' product life cycle is shown in the following diagram.



Not all products have a classical life cycle. Unsuccessful products never become profitable. A business entity might be able to 'revitalise' and redesign a product, so that when it enters a decline phase, its sales can be increased again, and it goes into another period of growth and maturity.

The length of a product life cycle can be long or short. A broad type of product, such as a motor car, has a longer life cycle than particular types of the product, such as a Volkswagen Beetle or a Ford Escort.

3.2 Relevance of the product life cycle to strategic management

Strategic management should consider the cash flows and profitability of a product over its entire life cycle.

When a decision is being made about whether or not to develop a new product, management should consider the likely sales and returns over the entire life cycle. For existing products, management need to assess the position of a product in its life cycle, and what the future prospects for the product, in terms of profits and cash returns, might be.

Timing market entry and market exit

The product life cycle concept might help companies to make strategic decisions about when to enter a market and when to leave it.

- Entrepreneurial companies might look for opportunities to enter a new market during the introductory phase, in the expectation that the product will become successful and the company will win a large share of the market by being one of the first companies to enter it.
- More cautious companies, looking for growth opportunities, might delay their entry into the market until the growth phase, when the product is already making a profit for its producers.

- Companies are unlikely to enter a market during the maturity phase unless they see growth opportunities in a particular part of the market, or unless the costs of entry into the market are low.

A company might need to make a strategic decision about leaving a market, when the product is in its decline phase. It should be possible to make profits in a declining market, but better growth opportunities might exist in other markets and a company might benefit from a change in its strategic direction.

Life cycle analysis as a technique for competition analysis

Life cycle analysis is also useful for assessing strategic position and the nature of competition in a market. The number of competitors in the market 'now', and the number of competitors that might exist in the future, will be influenced by the phase that the product has reached during its life cycle.

3.3 Cycle of competition

A cycle of competition is another concept for understanding the behaviour of competitors in a market.

When one company achieves some success in a market, competitors might try to do something even better in order to gain a competitive advantage. A new initiative by one company will result in a counter-measure from another company. Each company in the market tries to do something different and better.

A typical cycle of competition affects prices and quality. If one company has a large share of a profitable market, a rival company might start to sell its product at a lower price. Another rival company might improve the quality of its product, but sell it at the same price as rivals in the market. The first company might respond to these initiatives by its rivals by improving its product quality and reducing the selling price.

The effect of a cycle of competition in a growing market is that prices fall and quality might improve.

In the maturity phase of a product's life cycle, or in the decline phase, it becomes more difficult to lower prices without reducing quality. Competitors might try to gain a bigger share of the market by selling at a lower price, but the product quality might be reduced. This can lead to a 'spiral' of falling prices and falling quality, to the point where the product is no longer profitable, and it is less attractive to customers.

The concept of the cycle of competition is useful for strategic analysis, because it can help to explain the strategies of companies in a market, and to assess what future initiatives by competitors might be.

Example

Products and raw materials related to solar energy are now in a strong growth phase of their life cycle, due to growing demand. World-wide annual sales of global solar equipment were $20 billion in 2006 and were forecast to increase to $90 billion by 2010. Annual production of the high-purity silicon required to make solar cells was forecast to increase ten-fold by 2015. With the growth in demand, the price of silicon rose sharply.

At this stage of the life cycle of solar energy equipment products, companies still felt able to charge high prices, in spite of falling costs. Profit margins were therefore very high.

As the market develops and grows, it is likely that this situation will change, as more competitors enter the market.

Strategic groups and market segmentation

- Strategic groups
- Strategic space
- Product differentiation
- Market segmentation
- Methods of segmenting the market
- Market segmentation and strategic space

4 Strategic groups and market segmentation

4.1 Strategic groups

Another approach to analysing and understanding the competitors in a market is to group them into strategic groups.

A strategic group is a number of entities that operate in the same industry and that have similar strategies or that are competing in their markets in a similar way. Strategic groups have been defined as: 'Clusters of firms within an industry that have common specific assets and thus follow common strategies in key decision variables' (Oster).

When there are only a few competitors in the same industry, the concept of strategic groups has no practical value, because each competitor can be analysed individually. However, when there are many competitors in the industry, it can simplify the analysis to put them into strategic groups of entities with similar resources and similar strategies. For the purpose of competitor analysis, all the entities in the same strategic group can then be treated as if they are a single competitor. Instead of analysing each competitor individually, they can be analysed collectively, in groups.

Example

There are many companies in the industry for brewing and selling beers. To facilitate competitor analysis, they can be grouped into the following strategic groups. (All the companies in each group promote their brand image, so all the products are branded.)

- Companies that operate globally and make and sell a broad range of different beer products. (Carlsberg is an example)
- Companies that operate regionally, for example in Europe only, and make and sell a broad range of different beer products.
- Companies that operate in a national market, and make and sell a broad range of different beer products. (Bass in the UK has been suggested as an example)

- Companies that operate internationally, but offer a relatively limited range of beer products. (Grolsch has been suggested as an example)
- Local specialists that make a small range of products for a local market.

The strategies of all the companies in a strategic group will be similar.

Example

Companies in a manufacturing industry might be grouped according to their strategic priorities.

Three strategic groups might be identified:

- Companies that seek to maintain their position in the market
- Companies that seek to innovate and develop new products
- Companies that consider marketing to be the key to strategic success.

The strategic priorities of the companies in each group might differ as follows.

	Maintain market position	Innovators	Marketing-based strategies
Priority			
1	Cost reduction	Consistent quality	Consistent quality
2	Short lead time for delivery	Rapid product design/change	Dependable delivery
3	Consistent quality	Dependable delivery	Cost reduction
4	Dependable delivery	Improved product performance	Short lead time for delivery

Note: A lead time is the time between a customer placing an order and delivering the product to the customer. When the strategic objective is a short lead time, the aim is to deliver the product as quickly as possible after a customer has ordered it.

Dependable delivery means being able to state when and where a product will be delivered to the customer, and meeting this promise.

The main concerns of all manufacturing companies are broadly similar, but their priorities differ. This means that their strategies are likely to be different, as companies in each strategic group pursue their own priorities.

4.2 Strategic space

When all the companies in an industry are put into strategic groups, and these groupings are analysed, a strategic space might become apparent.

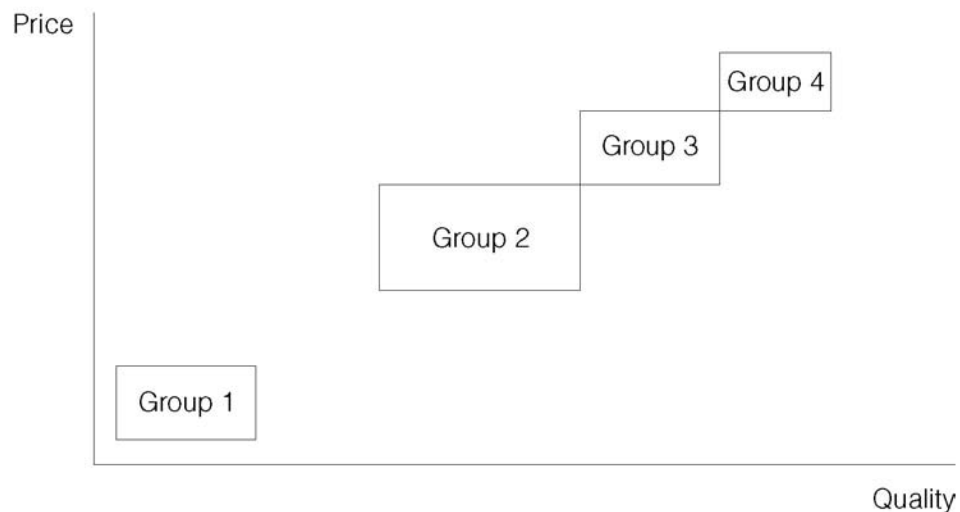
A strategic space is a gap in the market that is not currently filled by any strategic group. The existence of strategic space might provide an opportunity for a company

to make a strategic initiative, and attempt to fill the space that no other rivals occupy.

Example

One way of identifying strategic groups within an entire market is to classify market position in terms of price and quality. Some firms will offer lower-priced products, but their equality is probably not as good. Other firms might offer higher-quality products for a higher price.

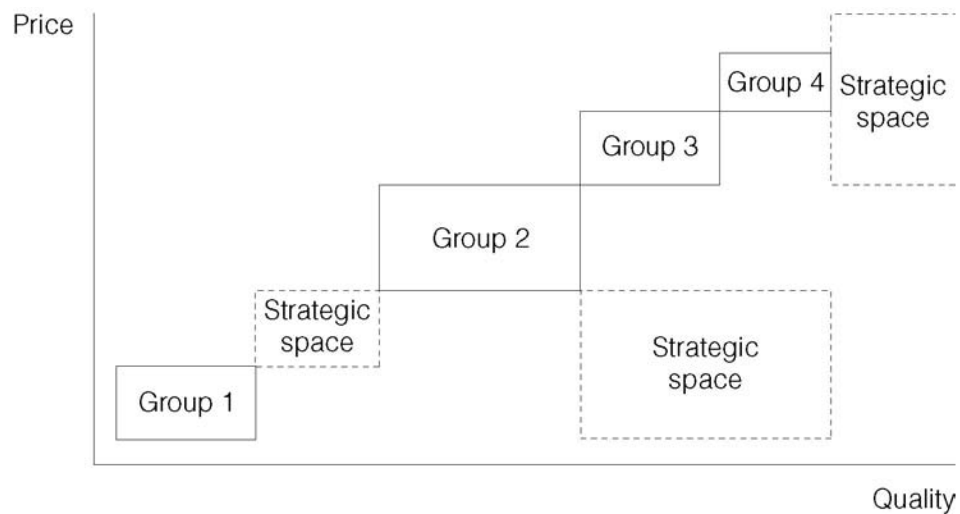
The strategic groups in a market might be mapped according to price and quality as follows:



This map indicates that there are four strategic groups, each in a different market position in relation to price and quality. The largest group, Group 2, sells products with a middle-range price and middle-range quality.

This method of analysis can help an entity to identify possible gaps in the market – strategic space. When there is a perceived gap in the market, an entity might decide on a strategy of filling the empty space by offering a product with the characteristics that are needed to fill the gap.

If the positioning of entities in a market is analysed by price and quality, as above, possible strategic spaces might be identified as follows:



In this example, an entity might decide to target a position in the market where it sells a high-quality product for a low price, because there are no firms yet in this part of the market. Alternatively, there might be a market for even higher-quality products at an even higher price.

4.3 Product differentiation

A market can be identified as a group of customers or potential customers for a particular product or range of related products.

In a very small number of markets, all suppliers provide an identical product that is the same in every respect to the product supplied by its competitors. An example is foreign exchange. Banks selling US dollars in exchange for euros are all trading exactly the same product.

In most markets, products are differentiated in various ways. They are similar, but there are also noticeable differences. Differences in products include differences in:

- product design
- pricing
- branding.

Products might also be differentiated by the way in which they are delivered to customers. For example, banking services might be delivered through a branch network or as an internet service. Similarly, consumers can buy products in shops or through the internet; or they can buy a hot meal by going to a cafeteria or restaurant, or by ordering a home-delivery meal.

Business entities often use differentiation to make their products attractive to customers in the market – so that customers will buy their products rather than those of competitors.

4.4 Market segmentation

A business entity might try to sell its products to all customers in the market. For example, manufacturers of sugar might try to sell their product or products to all customers in the market who buy sugar. Similarly, distributors of petrol (car fuel) might try to sell their products to all car drivers/buyers of petrol.

However, a business entity might choose instead to target its products at a particular section or segment of the market. A **market segment** is a section of the total market in which the potential customers have certain unique and identifiable characteristics and needs.

Instead of trying to sell to all customers in the entire market, an entity might develop products or services that are designed to appeal to customers in a specific market segment.

Market segmentation is the process of dividing the market into separate segments, for the purpose of developing differing products for each segment.

Example

The market for motor cars might be segmented according to the design of the car, for example:

- four-door or two-door family saloon car (with or without hatchback) – and with differing engine sizes
- two-seater sports cars
- estate cars
- people carriers
- 4 × 4 vehicles
- electric-powered cars
- cars that can be powered by ethanol (bio-fuel).

For car dealers, the market for cars can also be segmented into the new cars market and the used cars market.

Each type of car design is intended to appeal to the needs of a different segment of car buyers.

When an entity is selecting a product market strategy, Porter has suggested that it should select from **three generic strategies**:

- **Cost leadership**. This means being the lowest-cost producer in the market. The least-cost producer can compete on price, and can expect to achieve market leadership.

- **Differentiation**. This means offering products or services that are different in some way from those of competitors. By making its products different, an entity might be able to add value for customers, and so justify a higher price (= higher than the lowest price in the market).
- **Focus**. This means selecting a specific market segment for selling a product or service. Having targeted a market segment, an entity must also choose between a strategy of cost leadership or a strategy of differentiation within that market segment.

4.5 Methods of segmenting the market

Market segmentation is important for strategic management for two main reasons:

- It provides a basis for analysing competition in a market or industry.
- It provides a basis or framework for making strategic choices.

There are various ways of segmenting the market, and identifying different groups of customers. Methods of segmenting the market include segmentation by:

- geographical area
- quality and performance
- function (for example, within the market for footwear, there are market segments for running shoes, football boots, hiking boots, riding boots, snow boots, and so on)
- type of customer: for example, consumers and commercial customers
- social status or social group
- age: adults, teenagers and younger children might all buy different types of similar products, such as computer games or music downloaded from the internet
- life style.

Example

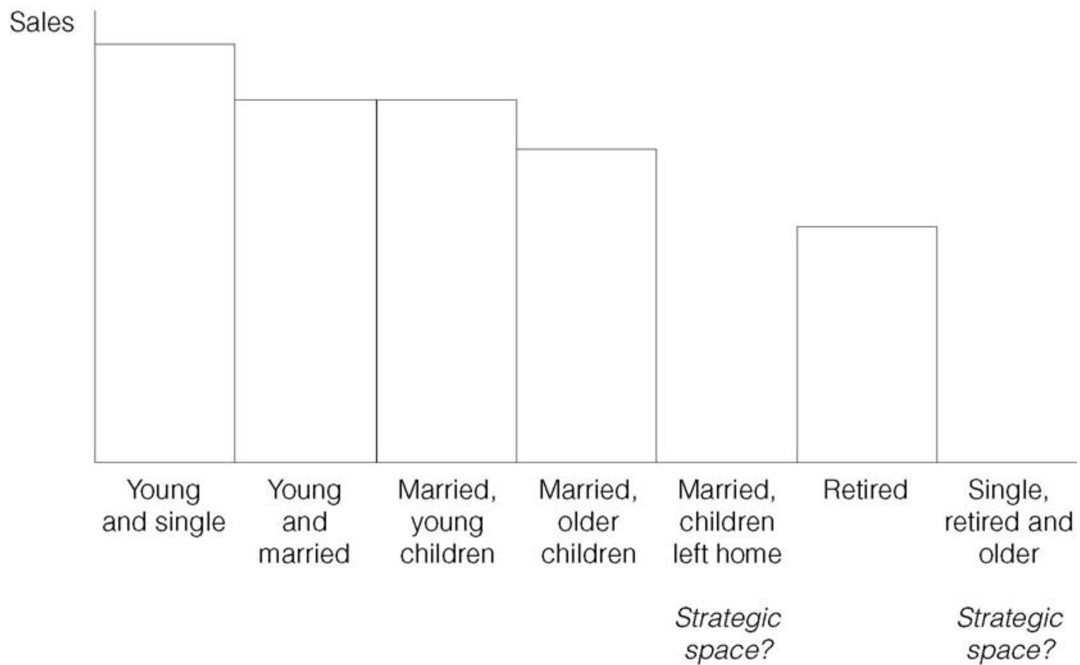
An entity might decide to segment a market according to the life style of customers. Possible life style segments include single people under 30 years of age, newly-married couples with no children, married couples with young children, married couples with teenage children, married couples whose children are grown up and have left home, retired couples, and retired single people.

This form of market segmentation can be useful for certain product so services such as:

- holidays
- motor cars
- some food and drink products
- entertainment products.

4.6 Market segmentation and strategic space

A similar analysis of strategic groups can be made to identify possible target market segments. In the example below, the strategic groups are analysed by life style of customers.



This analysis suggests that there are possibly **gaps in the market** for a product, and that a product is not currently being made and sold that might appeal specifically to individuals whose children have left home or to individuals who have retired from working.

Having analysed the market and identified these strategic spaces, management can go on to assess whether a strategy based on developing an amended product specifically for these gaps in the market might be strategically desirable and financially worthwhile.

Identifying gaps in a market can be a particularly useful method of competition analysis for companies that are considering whether or not to enter into a market for the first time.

Opportunities and threats

- SWOT analysis (TOWS analysis)
- Identifying opportunities and threats

5 Opportunities and threats

5.1 SWOT analysis (TOWS analysis)

SWOT analysis is a technique (or 'model') for identifying key factors that might affect business strategy. It is a simple but useful technique for analysing strategic position.

SWOT analysis is an analysis of strengths, weaknesses, opportunities and threats.

- **S -** Strengths. Strengths are internal strengths that come from the resources of the entity.
- **W** - Weaknesses. Weaknesses are internal weaknesses in the resources of the entity.
- **O** – Opportunities. Opportunities are factors in the external environment that might be exploited, to the entity's strategic advantage.
- **T** – Threats. Threats are factors in the external environment that create an adverse risk for the entity's future prospects.

Strengths and weaknesses are concerned with the internal capabilities and core competencies of an entity. Threats and opportunities are concerned with factors and developments in the environment.

SWOT analysis is sometimes called TOWS analysis (an analysis of Threats, opportunities, Weaknesses and Strengths).

Analysing strengths and weaknesses will be considered in a later chapter. In this chapter, the focus is on using SWOT analysis as a technique for identifying strategic opportunities and threats in the business environment and competitive environment.

5.2 Identifying opportunities and threats

If you are asked to apply SWOT analysis to a case study or scenario in an examination question, part of your analysis will be the identification of opportunities and threats.

The following approach is recommended. Opportunities and threats might exist because of changes, or possible changes, in the business environment. They might also exist because of the nature of competition in the market or the existence of a strategic space.

To identify opportunities and threats in the business environment, you should consider each aspect of the business environment. PESTEL analysis provides a useful framework. However, whereas PESTEL analysis is used to identify significant factors in the environment, SWOT analysis is used to assess these factors and consider how they might create an opportunity or a threat for the entity.

You should then consider the competitive environment.

- What is the strength of the competition? You should consider the Five Forces model. Are any of the Five Forces likely to change in the future, and if so, how might they change? What effect could this have on the nature of competition (and profitability in the market)?
- Does the life cycle model offer a useful insight into the market and competition? Is the market in its introductory phase, its growth phase, its maturity phase or its decline phase? Is it likely to move from one phase to the other? If so what might be the consequences for the business?
- Is the market segmented? What are the existing market segments? Are there gaps in the market, and opportunities for developing new segments? If the market is not segmented now, might it become segmented in the future, and if so what might those market segments be? Is there an opportunity to create a new market segment?

Opportunities should be seen in terms of circumstances (or changes in the environment or in competition) that can be used to increase competitive advantage.

Threats should be seen as circumstances (or changes in the environment or in competition) that will weaken or remove a competitive advantage, or that could give competitors a competitive advantage over you.

It is also worth remembering that some changes in the environment can be both a threat and an opportunity. For example, it can be a threat if competitors of a company take advantage of a change in the environment, but it can be an opportunity if the company takes the initiative itself.

Example

There is intense public concern about 'global warming' and the effect on the world's climate of carbon emissions into the atmosphere. This concern is growing. It is recognised that the consumption of oil products could be having a major impact on the world climate.

The known reserves of oil and natural gas in the world are falling. Consumption is exceeding discoveries of new reserves. Many of the known reserves are in politically unstable countries.

New technology is being developed for the production of fuel out of corn. Corn can be converted into ethanol (a 'bio-fuel') and cars are now being manufactured that

will run on ethanol. However, the technology is in a very early stage of development.

The US government has set a formal target for the production of bio-fuels. The European Union also announced that a minimum of 10% of transport fuel consumed in the EU by 2020 should come from bio-fuels.

You work for a company that specialises in commodity trading. It buys and sells a range of agricultural products such as corn. At the moment, its purchases of corn are resold mainly to food manufacturers. Most of its suppliers are in North America.

Required
Identify opportunities and threats that appear to exist for your company, over the next five years or so.

Answer

There is no 'correct' answer. Strategic managers need to identify threats and opportunities in the environment and the competitive market, but opinions can vary.

PESTEL analysis

There is growing public concern for the environment. Attitudes are changing, and over time it is probable that attitudes towards the consumption of oil products will become more hostile. At the same time, public support for the use of bio-fuels might grow significantly.

Changes to the ecology and social attitudes have already had an impact on political thinking in the US and EU. Formal targets have been set for the production of bio-fuels. Over time, these formal targets might become laws or regulations.

The current situation indicates that over the next ten years, there will be a significant shift towards the consumption of bio-fuels. World demand for the raw materials – corn – will therefore increase, and this means that the total amount of land used for the production of corn will also increase. It is very likely that the increase in demand for corn will exceed the increase in supply, and prices will rise. Opportunities for making profits in agriculture and related industries should increase.

These changes offer opportunities to the commodity trading company. There will be more customers wanting to buy corn. More agricultural producers will make corn. There is an opportunity to develop the company's business by finding the new customers and new suppliers. There is also a threat, because competitors will want to do the same thing.

There might also be an opportunity for the company to become involved in trading in ethanol and other bio-fuels.

There is a problem with technology. It is not yet clear how successful the technology for producing ethanol will be. Improvements will be needed, and it is possible that

other methods of producing bio-fuels, using other natural products, might become more successful.

Competitor analysis

If the above analysis is correct, the market for ethanol is at an introductory phase of the product life cycle. Demand for ethanol – and corn – will increase substantially. Trading in these products will also increase.

If profits from trading increase, new competitors are likely to enter the market.

Five Forces analysis might suggest that competition in the market for trading corn will intensify. This is partly because of the threat from new entrants, and (probably) an increase in competitive rivalry amongst firms that are in the market already. As the demand for corn increases, demand will exceed supply (for some years at least) and the bargaining power of suppliers will increase. The probability of increasing competition might be seen as a threat.

There might be a segmentation of the market for corn and other grain products in the future, with the market dividing between users of corn for fuel production and users of corn for food manufacture. There might be an opportunity for the company to specialise in selling corn to one type of customer, offering specialist knowledge of their particular requirements as a feature of its service (to give the company a competitive advantage over its non-specialist rivals).

Summary

You might agree or disagree with this analysis. The main point to understand, however, is how to use PESTEL analysis and competition analysis to identify opportunities or threats that an entity will be faced with in the future.

CHAPTER 4

Marketing and the value of goods and services

Contents

1	Customer needs
2	Critical success factors for products and services
3	Value chain
4	Value network

Customer needs

- The marketing approach
- What are customer needs?
- The 4Ps of the marketing mix

1 Customer needs

1.1 The marketing approach

As stated earlier, markets can be defined by their customers and potential customers. Companies and other business entities compete with each other in a market to sell goods and services to the customers. The most profitable entities are likely to be those that sell their goods or services most successfully.

- Business success is achieved by providing goods or services to customers in a way that meets customer needs successfully.
- Customers will buy from the business entities that meet their needs most successfully.

Much business strategy is based (partly) on the marketing approach or the marketing concept, which is that the aim of a business entity is to deliver products or services to customers in a way that meets customer needs better than competitors. To do this, the business entity must have a competitive advantage over its competitors, and a strategic aim is to achieve a competitive advantage, and then keep it.

1.2 What are customer needs?

Customers buy products or services for a reason. When they can choose between two or more competing products, there is a reason why they choose one product instead of another.

A major factor in the decision to buy a product is usually price. Many customers choose the product that is the cheapest on offer, particularly when they cannot see any significant difference between the competing products.

If the buying decision is not based entirely on price, the customer must have other needs that the product or service provides. These could be:

- a better-quality product
- better design features
- availability: not having to wait to obtain the product
- convenience of purchase
- the influence of advertising or sales promotions.

There are many different types of customer, each with their own particular needs. A product that meets the needs of one customer successfully might not meet the needs of another customer nearly as well.

Customers may be grouped into three broad types:

- consumers: these buy products and services for their personal benefit or use
- industrial and commercial customers: customers might include other business entities
- government organisations and agencies.

In some markets, most customers are consumers. In industrial markets, all customers are industrial and commercial customers, and possibly some government customers. In some markets, such as the markets for military weapons, the only customers are governments.

As a general rule, the needs of different types of customer vary. Industrial and commercial customers are more likely than consumers to be influenced by price. Consumers will often pay more for a branded product (due to the influence of advertising) or for convenience.

1.3 The 4Ps of the marketing mix

The marketing approach is to identify customer needs and try to meet customer needs more successfully than competitors. To do this, business entities need to offer provide a 'mix' of the four Ps that will appeal to customers. The 4Ps are:

- Product
- Price
- Place
- Promotion.

Product refers to the design features of the product, and the product quality. In addition to the product itself, features such as short lead time for delivery and reliable delivery could be important. Product features also include after-sales service and warranties. For services, the quality of service might depend partly on the technical skills and inter-personal skills of the service provider.

Price is the selling price for the product: some customers might be persuaded to purchase by a low price or by the offer of an attractive discount.

Place refers to the way in which the customer obtains the product or service, or the 'channel of distribution'. Products might be bought in a shop or supermarket, from a specialist supplier, by means of direct delivery to the customer's premises or through the internet.

Promotion refers to the way in which product is advertised and promoted. It includes direct selling by a sales force (including telesales).

Marketing can be analysed at a tactical level, and decisions about the marketing mix might be included within the annual marketing budget. However, marketing issues can also be analysed at a strategic level.

It is important in strategic analysis to understand what customers will want to buy, and why some products or services will be more successful than others.

Critical success factors for products and services

- Definition of a critical success factor
- Marketing and CSFs for products and services
- CSFs and key performance indicators (KPIs)
- Johnson and Scholes: a six-step approach to using CSFs
- Competitor benchmarking
- Methods of competitor benchmarking

2 Critical success factors for products and services

2.1 Definition of a critical success factor

Critical success factors (CSFs) are factors that are essential to the strategic success of a business entity. They have been defined as: 'those components of strategy in which the organisation must excel to out-perform competition' (Johnson and Scholes).

When management are analysing a market and customers in the market, they should try to understand which factors are essential to succeed in business in the market, and which factors are not so important. Strategic success is achieved by identifying the CSFs and setting targets for performance linked to those critical factors.

Example

A firm of accountants has an office in a major UK city. The partners are considering an expansion of the business, by opening another office in another city 50 miles away.

The partners want to expand their business, but they are cautious about investing in a project that might not succeed and might cost them a lot of money. They have a meeting to discuss the factors that would be critical to the success of a new office. They prepare the following list of factors:

- Employing top-quality accountants for the new office.
- Charging lower fees than other accountancy firms in the city.
- Obtaining a minimum number of corporate clients.
- Obtaining a minimum number of private (individual) clients.
- Offering a full range of audit and accountancy services.
- Locating the new office in attractive city-centre premises.

All these factors could be important, and might help the new office to be a success. However, not all of them might be **critical** to the success of the venture.

If the partners can agree which factor or factors are critical to success, they can concentrate on setting reasonable targets for each key factor and making every effort to ensure that those targets are achieved.

2.2 Marketing and CSFs for products and services

The previous example considers the CSFs for a new business venture (a new office for an accounting firm). Strategic planners might want to identify the CSFs for a particular product or service.

These are the features that the product must have if it is to be a success with customers.

The CSFs of a product or service must be related to customer needs. They are the features of a product or service that will have the main influence on the decisions by customers to buy it.

Example

A parcel delivery service (such as DHL or FedEx) might identify critical success factors as:

- collecting parcels from customers quickly, as soon as possible after the customer has asked for a parcel to be delivered
- providing rapid and reliable delivery.

Example

The senior management of a company that manufactures sports cars, competing with producers such as Ferrari and Maserati, need to understand the critical factors that enable their products to compete successfully in the market.

After an analysis of the market and competition, they might decide that the CSFs are:

- building cars that match competitors in performance (top speeds, acceleration, engine capacity), and also
- sell at prices that are about 10% less than those of the main competitors.

Example

In a particular country, about 1,000 accountancy students take the ACCA professional examinations each year. There are two tuition companies that provide training courses for the examination.

Company X has been providing tuition for the ACCA examinations for several years and now trains about 800 students each year. Company Y is a new company that is entering the market for providing ACCA teaching for the first time.

For Company Y, the critical success factor for their training courses is probably the pass rate for its students, and achieving a higher-than-average pass rate. (This is the proportion of its students who pass the examination after attending a course.) For Company X the pass rate is probably less critical because it trains most of the students in the country, so it will not be able to beat the national average pass rate by any significant amount. For Company X, the critical success factor might be providing courses at times and in locations to meet the requirements of customer.

2.3 CSFs and key performance indicators (KPIs)

Critical success factors should be identified at several stages in the strategic planning process.

- CSFs should be identified during the process of assessing strategic position. Management need to understand the main reasons why particular products or services are successful.
- CSFs are important in the process of making strategic choices. A business entity should select strategies that will enable it to achieve a competitive advantage over its competitors. These are strategies where the entity has the ability to achieve the critical success factors for its products or services.
- CSFs are also important for strategy implementation. Performance targets should be set for each CSF. This involves deciding on a measurement of performance, that can be used to assess each CSF, and then setting a quantified target for achievement within a given period of time.

Measured targets for CSFs are called **key performance indicators** (KPIs).

2.4 Johnson and Scholes: a six-step approach to using CSFs

Johnson and Scholes have suggested a six-step approach to achieving competitive advantage through the use of CSFs.

Step 1

Identify the success factors that are critical for profitability (long-term as well as short-term). These might include 'low selling price', and also aspects of service and quality such as 'prompt delivery after receipt of orders' or 'low level of sales returns'. It is useful to think about customer needs and the 4Ps of the marketing mix when trying to identify the CSFs for products or services.

Step 2

Identify what is necessary (the 'critical competencies') in order to achieve a superior performance in the critical success factors. This means identifying what the entity must do to achieve success. For example:

- If a critical success factor is 'low sales price', a critical competence might be 'strict control over costs'.
- If a critical success factor is 'prompt delivery after receipt of orders', a critical competence might be either 'fast production cycle' or 'maintaining adequate inventories'.

- If a critical success factor is 'low level of sales returns', a critical competence might be either 'zero defects in production' or 'identifying 100% of defects on inspection'.

Step 3

The entity should develop the level of critical competence so that it acquires the ability to gain a competitive advantage in the CSF.

Step 4

Identify appropriate key performance indicators for each critical competence. The target KPIs, if achieved, should ensure that the level of critical competence creates a competitive advantage is obtained in the CSF.

Step 5

Give emphasis to developing critical competencies for each aspect of performance, so that competitors will find it difficult to achieve a matching level of competence.

Step 6

Monitor the firm's achievement of its target KPIs, and also monitor the comparative performance of competitors.

2.5 Competitor benchmarking

Benchmarking is a process of comparing your own performance against the performance of someone else, preferably the performance of 'the best'.

The purpose of benchmarking is to identify differences between your performance and the performance of the selected benchmark. Where these differences are significant, methods of closing the gap and raising performance can be considered. One way of improving performance might be to copy the practices of the 'ideal' or benchmark.

In strategic position analysis, benchmarking is useful because it provides an assessment of how well or badly an entity is performing in comparison with competitors.

Methods of benchmarking

There are several methods of benchmarking:

- **Internal benchmarking**. An entity might compare the performance of units within the organisation with the best-performing unit. For example, an organisation with 30 branch offices might compare the performance of 29 of the branches with the best-performing branch.
- **Operational benchmarking**. An entity might compare the performance of a particular operation with the performance of a similar operation in a different business entity in a different industry. For example, a book publishing company might compare its order handling, warehousing and despatch systems with the

similar systems of a company in a different industry that has a reputation for excellence – for example a company in the clothing manufacturing industry.

Operational benchmarking arrangements might be negotiated with another business entity.

- **Competitive benchmarking**. An entity might compare its own performance and its own products with those of its most successful competitors. Unlike internal benchmarking and operational benchmarking, competitive benchmarking must be carried out without the knowledge and co-operation of the selected benchmark.
- **Customer benchmarking**. This is a different type of benchmark. The benchmark is a specification of what customers expect. An entity compares its performance against what its customers expect the performance to be.

Example

Competitive benchmarking originated with the Xerox Corporation in the US in 1982. The company manufactured photocopier machines, but had lost a large part of its market share to Japanese competitors. The corporation set up a team to compare Xerox against its competitors.

The team identified critical success factors and performance indicators is several different areas of operations, such as order fulfilment, the distribution of products to customers, production costs, selling prices and product features. It then compared it's own performance in each area with the performance of the competitors.

The comparison showed that Xerox was seriously under performing in comparison with the competition. Its management therefore went on to consider measures that it should take to improve its performance.

As a result of the measures it took, Xerox was able to reduce its costs, improve customer satisfaction, and regain some of its lost market share. In other words, competitive benchmarking helped the corporation to regain competitiveness.

2.6 Methods of competitor benchmarking

There are no 'standard' methods of competitor benchmarking. In most circumstances, competitors will not provide more information about themselves than they are required to by law or regulations. **Published financial statements** might therefore be an important source of comparative material, particularly where the competitor is required to publish a full set of financial statements each year that comply with international accounting standards.

Some of the methods that might be used by a company to compare performance with its competitors are suggested below.

- The published financial statements of competitors should be studied. These should be analysed to assess the financial performance of the competitor. Segment analysis, showing the performance of business and geographical segments, might be particularly useful.

- Financial ratios obtained from the financial statements of the competitor should be compared with similar ratios for the company. In addition, trends in performance and in the ratios over time should also be monitored. Key performance measures might include:
  - annual sales (by business segment or geographical segment)
  - growth in annual sales (as a percentage increase on the previous year)
  - return on capital employed
  - net profit/sales ratio
  - gross profit/sales ratio.
- Where there are significant differences in performance, the possible reasons for the differences should be considered.
- The products or services of competitors should be analysed in detail. In the case of products, units of the competitor's product might be purchased and taken to a laboratory for scientific or technical analysis.
- Information about competitors can be gathered by talking to customers and potential customers who have had dealings with a competitor, and who are willing to discuss what the competitor is offering as an incentive to make the customer buy its products.
- Sales prices should be compared. Some competitors might sell at higher prices and some at lower prices. Some competitors might sell a variety of similar products across a range of different prices. When there are significant price differences, management should consider whether the price differences are justified by the differences between the products or services.

Competitor analysis should also include an assessment of the critical success factors of all the firms in the market. The CSFs of companies in the same market might differ, and individual companies might succeed in their market for different reasons, particularly when the market is segmented.

Value chain

- Definition of value
- The concept of the value chain
- Primary value chain
- Secondary value chain activities: support activities
- Adding value
- Value creation and strategic management
- Using value chain analysis

3 Value chain

3.1 Definition of value

Value relates to the benefit that a customer obtains from a product or service. Value is provided by the attributes of the product or service. Customers are willing to pay money to obtain goods or services because of the benefits they receive. The price they are willing to pay puts a value on those benefits.

Business entities create added value when they make goods and provide services. For example, if a business entity buys a quantity of leather for $1,000 and converts this into leather belts, which it sells for $10,000, it has created value of $9,000.

In a competitive market, the most successful business entities are those that are most successful in creating value. Porter has suggested that:

- if a firm pursues a cost leadership strategy, its aim is to create the same value as its competitors, but at a lower cost
- if a firm pursues a differentiation strategy, it aims to create more value than its competitors.

The only reason why a customer should be willing to pay a higher price than the lowest price in the market is that he sees additional value in the higher-priced product, and is willing to pay more to obtain the value.

- This extra value might be real or perceived. For example a customer might be willing to pay more for a product with a well-known brand name, assuming that a similar non-branded product is lower in quality. This difference in quality might be imagined rather than real; even so, the customer will pay the extra amount to get the branded product.
- The extra value might relate to the quality or design features of the product. However, other factors in the marketing mix might persuade a customer that a product offers more value. For example, a customer might pay more to buy one product than a lower-priced alternative because it is available immediately (convenience) or because the customer has been attracted to the product by advertising.

3.2 The concept of the value chain

A framework for analysing how value can be added to a product or service has been provided by Porter.

Porter ('Competitive Strategy') grouped the activities of a business entity into a value chain. A value chain is a series of activities, each of which adds value. The total value added by the entity is the sum of the value created by each stage along the chain.

Johnson and Scholes have defined the value chain as: 'the activities within and around an organisation which together create a product or service.'

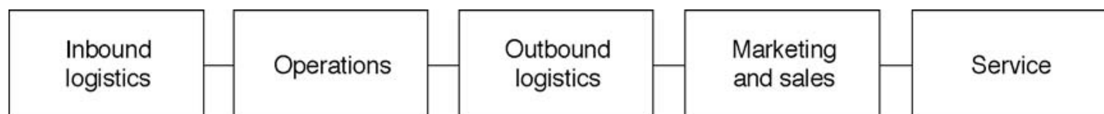
Strategic success depends on the way that an entity as a whole performs, but **competitive advantage**, which is a key to strategic success, comes from each of the individual and specific activities that make up the value chain.

Within an entity:

- there is a primary value chain, and
- there are support activities (also called secondary value chain activities).

3.3 Primary value chain

Porter identified the chain of activities in the primary value chain as follows.



This value chain applies to manufacturing and retailing companies, but can be adapted for companies that sell services rather than products.

Most value is usually created in the primary value chain.

- **Inbound logistics**. These are the activities concerned with receiving and handling purchased materials and components, and storing them until needed. In a manufacturing company, inbound logistics therefore include activities such as materials handling, transport from suppliers and inventory management and inventory control.
- **Operations**. These are the activities concerned with converting the purchased materials into an item that customers will buy. In a manufacturing company, operations might include machining, assembly, packing, testing and equipment maintenance.
- **Outbound logistics**. These are activities concerned with the storage of finished goods before sale, and the distribution and delivery of goods (or services) to the customers. For services, outbound logistics relate to the delivery of a service at the customer's own premises.
- **Marketing and sales**.

- **Service**. These are all the activities that occur after the point of sale, such as installation, warranties, repairs and maintenance, providing training to the employees of customers and after-sales service.

The nature of the activities in the value chain varies from one industry to another, and there are also differences between the value chain of manufacturers, retailers and other service industries. However, the concept of the primary value chain is valid for all types of business entity.

3.4 Secondary value chain activities: support activities

In addition to the primary value chain activities, there are also secondary activities or support activities. Porter identified these as:

- **Procurement**. These are activities concerned with buying the resources for the entity – materials, plant, equipment and other assets.
- **Technology development**. These are activities related to any development in the technological systems of the entity, such as product design (research and development) and IT systems. Technology development is an important activity for innovation. 'Technology' also includes acquired knowledge: in this sense all activities have some technology content, even if this is just acquired knowledge.
- **Human resources management**. These are the activities concerned with recruiting, training, developing and rewarding people in the organisation.
- **Corporate infrastructure**. This relates to the organisation structure and its management systems, including planning and finance management, quality management and information systems management.

Support activities are often seen as necessary 'overheads' to support the primary value chain, but value can also be created by support activities. For example:

- Procurement can add value by identifying a cheaper source of materials or equipment
- Technology development can add value to operations with the introduction of a new IT system
- Human resources management can add value by improving the skills of employees through training.
- Corporate infrastructure can help to create value by providing a better management information system that helps management to make better decisions.

3.5 Adding value

Strategic management should look for ways of adding value, because this improves competitiveness (creates competitive advantage).

- Management should look for ways of adding more value at each stage in the primary value chain.
- Similarly, management should consider ways in which support activities can add more value.

Finding ways of adding value is a key aspect of strategic management. Answers need to be provided to a few basic questions:

- Who is the customer?
- What features of the product or service do they value?
- How do we provide value to the customer in the products or services we provide?
- How can we add to the value that the customer receives?
- How can we add value more successfully than our competitors? Do we have some **core competencies** that we can use to give us a **competitive advantage**?

Methods of adding value

There are different ways of adding value. There is an important link between value and CSFs for products and services.

- One way of adding value is to alter a product design, and include features that might meet the needs of a particular type of customer better than products that are currently in the market. A product might be designed with added features. **Market segmentation** is successful when a group of customers value particular product characteristics, and are willing to pay more for a product that provides them.
- Value can be added by making it easier for the customer to buy a product, for example by providing a website where customers can make purchases. Bookstores can add value to the books they sell by providing sales outlets at places where customers often want to buy books, such as airport terminals.
- Value can be added by promoting a brand name. Successful branding might give customers a sense of buying products or services with a better quality.
- Value can be added by delivering a service or product more quickly. For example, a private hospital might add value by offering treatment to patients more quickly than other hospitals in the region.
- Value can also come from providing a reliable service, so that customers know that they will receive the service on time, at the promised time, to a good standard of performance.

New product design (**innovation**) is also concerned with creating a product that provides an appropriate amount of value to customers.

When a business entity is planning to expand its operations into new markets or new market segments, it should choose markets for expansion where the opportunities for adding value are strong.

It is also important to recognise that value is added by all the activities on the primary value chain, including logistics. Customers might be willing to pay more for a product or a service if it is delivered to them in a more convenient way. For example, customers might be willing to pay more for household shopping items if the items are delivered to their home, so that they do not have to go out to a supermarket or a store to get them.

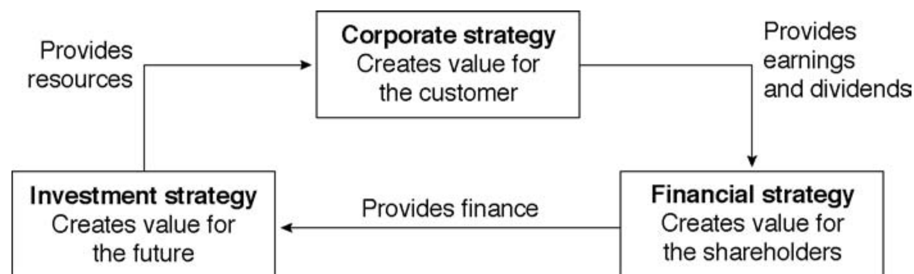
3.6 Value creation and strategic management

By adding value more successfully, a firm will improve its profitability, by reducing costs or improving sales. Some of the extra benefit might be passed on to the customer, in the form of a better-quality product or service or a lower selling price. If so, the business entity shares the benefits of added value with the customers, and gains additional competitive advantage.

Added value does not have to be given immediately to customers (in the form of lower prices) or shareholders (in the form of higher dividends). The benefits can be re-invested to create more competitive advantage in the future.

There is a link between:

- corporate strategy, which should aim to add value for the customer
- financial strategy, which should aim to add value for the shareholders and
- investment strategy, which should aim to ensure that the entity will continue to add more value in the future.



3.7 Using value chain analysis

The value chain model is another useful model for business strategy analysis. It can be argued that in business, the most important objective for success should be to add value better than competitors. Creating value for customers will, over the long term, create more value for shareholders.

Since adding value is critical to the success of a business entity, it should be important to identify how it creates value, where it is creating value and whether it could do better (and create more value). The entity's success in creating value can be compared with the performance of competitors. Who is doing better to create value for customers?

In your examination, **the value chain model can be used to make a strategic assessment of performance**. Each part of the primary value chain and each of the secondary value chain activities should be analysed. For each part of the value chain, providing answers to the following questions can assess performance:

- How is value added by this part of the value chain?
- Has the entity been successful in adding value in this part of the value chain?

- Has the entity been more successful than its competitors in adding value in this part of the value chain?
- Has there been a failure to add value successfully?
- Does the entity have the core competencies in this part of the value chain to add value successfully? (If not, a decision might be taken to out-source the activities.)

Value network

- Difference between a value chain and a value network
- Elements in a value network
- The strategic significance of value networks

4 Value network

4.1 Difference between a value chain and a value network

There is a value chain within every business entity.

There is also a supply chain from the producers of raw materials and equipment through to the entities that sell the end consumer product to customers.

For example, food products might go from the original food producer to a food processor (who makes the processed food item) to a retailer. Here, there are three firms in the supply chain from the original food source to the end consumer. Each firm in the supply chain has its own value chain.

A value network, also called a **value system**, is the sum of the value chains in all the firms in a supply chain.

The value that the end-consumers customers pay for when they buy goods or services comes from the value created by the entire value network.

Definition

A value network can be defined as 'any web of relationships that generates tangible and intangible value through complex, dynamic exchanges between two or more individuals, groups or organisations'.

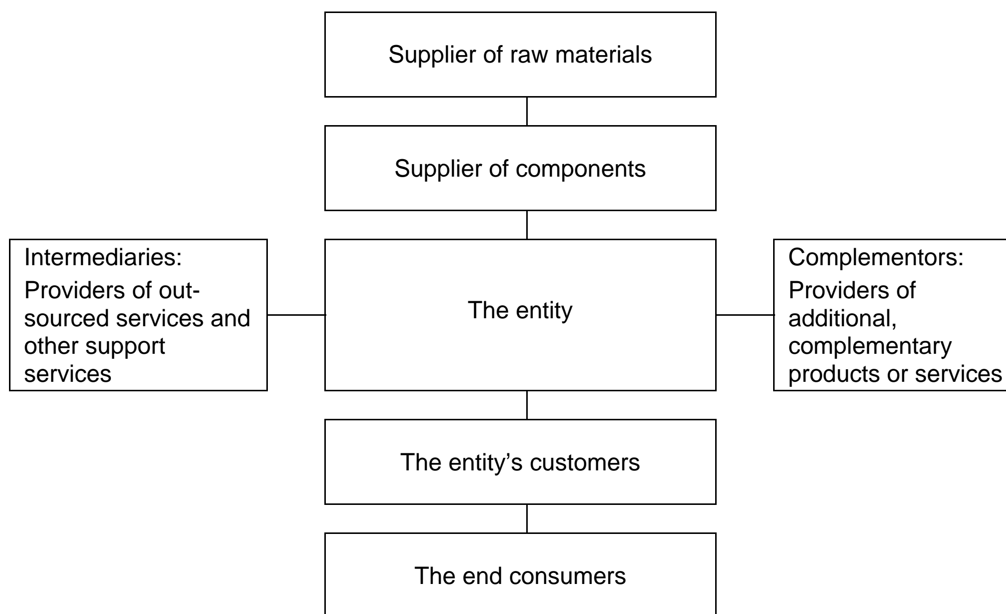
Through networks, a company with a small number of employees can actually have a value network with a large number of different suppliers and customers.

4.2 Elements in a value network

For many business entities, the value network is more complex than a chain of suppliers, from raw materials to end product. Other entities are also included in the value network. These can be categorised as:

- Intermediaries. These are entities that provide outsourced services (such as out-sourced book-keeping or outsourced logistics management) and support services (such as public relations advisers).
- Complementors. These are entities that provide additional and complementary products or services.

The elements in a value network are shown in the diagram below.



Example

A company produces the consoles (handsets) and operating system software for computer games.

- It buys raw materials and components from suppliers for the assembly of the consoles.
- Intermediaries: It sells its products globally, and in some countries it outsources the sales function to other companies. It also outsources some of the software production to specialist software companies.
- Complementors: The success of the company's product depends largely on the availability of computer games that customers can play on the console. Computer games are written and supplied by independent companies, including subsidiaries of film studios.
- The entity's customers. The consoles are supplied to retail organisations in most countries of the world.

All these elements make up a single value network.

4.3 The strategic significance of value networks

The concept of the value network or value system has an important implication for each firm in the supply chain/value network. Value can be created (and lost) in any part of the value network. To achieve competitive advantage, it is often necessary to work with other entities in the value network in order to create extra value.

The concept of a value network is particularly important for value systems that do not consist of a simple chain of suppliers from raw materials through to finished

products. It is very useful, for example, in many service industries where securing and retaining customers or suppliers depends on the activities of other entities.

An entity should try to improve the efficiency and effectiveness of its own activities in creating value within its own value chain.

However, it should also consider the entire value network, and think about how value might be added across the network, not just within its own internal value chain. A value network must operate with the efficiency and effectiveness of a self-contained individual entity. To do this, it is necessary to manage relationships with other entities in the network.

Example

Mobile telephones can deliver a variety of services to users, such as voice telephony, music, entertainment, picture transmission, photography and data transmission. Providing all this value to users requires collaboration between many different companies: manufacturers of mobile handsets, operators of mobile networks, content providers, computer manufacturers, and so on.

Collaboration

Collaboration between business entities and their key suppliers, for example in developing new materials or improving delivery systems, can help to add value across the supply chain, to the benefit of both entities.

The concept of the value network has been introduced by one writer as follows: 'Re-inventing supply chains…From communication to collaboration.' In many industries and markets business entities need to work together to find strategic solutions. It is not sufficient simply to exchange information about what they are planning to do.

CHAPTER 5

Internal resources, capabilities and competences

Contents

1	Strategic capability
2	Resources and competences
3	Capabilities and competitive advantage
4	Analysing strengths and weaknesses

Strategic capability

- The meaning of strategic capability
- Achieving strategic capability

1 Strategic capability

1.1 The meaning of strategic capability

Strategic capability means the ability of an entity to perform and prosper, by achieving strategic objectives. It can also be described as the ability of an organisation to use its core competences to create **competitive advantage**.

Most of the previous chapters have described the environment of an entity, and how an entity can succeed by exploiting opportunities and dealing with threats that emerge in the environment.

However, monitoring the environment for opportunities and threats is not sufficient to provide an entity with competitive advantage. Strategic capability comes from competitive advantage. Competitive advantage comes from the successful management of resources, competences and capabilities.

Definition of strategic capability

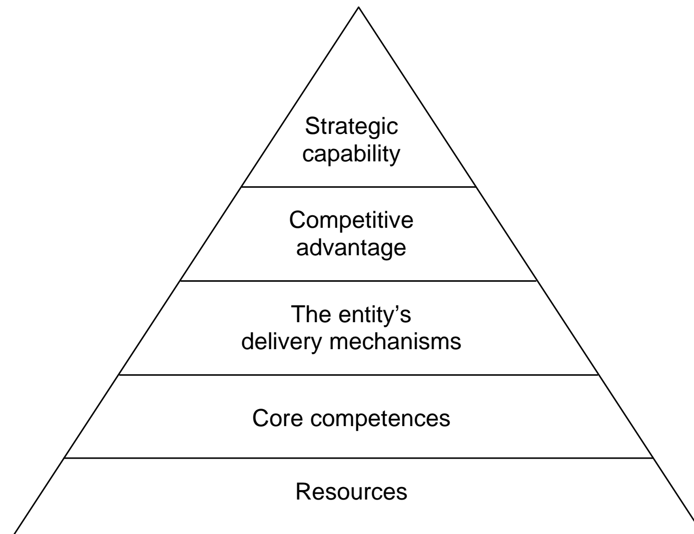
'Strategic capability reflects the ability of [an entity] to use and exploit the resources available to it, through the competences developed in the activities and processes it performs, the ways in which these activities are linked internally and externally, and the overall balance of core competences (capability) across the [entity]. Above all the capability of the [entity] depends upon its ability to exploit and sustain its sources of competitive advantage over time.'

1.2 Achieving strategic capability

A **resource-based view of the firm** is based on the view that strategic capability comes from competitive advantage, which comes in turn from the resources of the firm and the use of those resources (competences and capabilities).

This is illustrated in the following hierarchy of requirements for strategic capability.

Achieving strategic capability



Resources and competences

- Resources
- Competences
- Sustainable core competences
- Core competences and the selection of markets
- Summary: resources and competences

2 Resources and competences

2.1 Resources

An entity uses resources to provide products or services to its customers. A resource is any asset, process, skill or item of knowledge that is controlled by the entity.

Resources can be grouped into categories:

- **Human resources**. These are the leaders, managers and other employees of an entity, and their skills.
- **Physical resources**. These are the tangible assets of an entity, and include property, plant and equipment, and also access to sources of raw materials.
- **Financial resources**. These are the financial assets of the entity, and the ability to acquire additional finance if this is required.
- **Intellectual capital**. This includes resources such as patents, trademarks, brand names and copyrights. It also includes the acquired knowledge and 'know-how' of the entity.

Threshold resources and unique resources

A distinction can be made between threshold resources and unique resources.

- **Threshold resources** are the resources that an entity needs in order to participate in the industry and compete in the market. Without threshold resources, an entity cannot survive in its industry and markets.
- **Unique resources** are resources controlled by the entity that competitors do not have and would have difficulty in acquiring. Unique resources can be a source of competitive advantage.

A **unique resource** is a resource that competitors would have difficulty in acquiring. It might be obtained from:

- ownership of scarce raw materials, such as ownership of exploration rights or mines
- location: for example a hydroelectric power generating company benefits from being located close to a large waterfall or dam, and a bank might benefit from a city centre location

- a special privilege, such as the ownership of patents or a unique franchise.

Unique resources are a source of competitive advantage, but they can change over time. They can lose their uniqueness. For example:

- An investment bank might benefit from employing an exceptionally talented specialist; however, a rival bank might 'poach' him and persuade him to join them.
- A company might have patent rights that prevent competitors from copying a unique feature of a product that the company produces. However, competitors might find an alternative method of making a similar product, without infringing the patent rights.

2.2 Competences

Competences are activities or processes in which an entity uses its resources. They are created by bringing resources together and using them effectively. Competences are used to provide products or services, which offer value to customers.

A competence can be defined as an ability to do something well. A business entity must have competences in key areas in order to compete effectively.

Threshold competencies and core competencies

A distinction can be made between threshold competences and core competences.

- **Threshold competences** are activities, processes and abilities that provide an entity with the capability to provide a product or service with features that are sufficient to meet customer needs (the ability to provide 'threshold' product features).
- **Core competences** are activities, processes and abilities that give the entity a capability of meeting the critical success factors for products or services, and achieving competitive advantage.

Threshold capabilities are the **minimum** capabilities needed for the organisation to be able to compete in a given market. For example, **threshold competencies** are competencies:

- where the entity has the same level of competence as its competitors, or
- that are easy to imitate.

To do really well, however, an entity needs to do more than merely to meet thresholds; it needs capabilities for competitive advantage. Capabilities for competitive advantage consist of **core competences**. These are ways in which an entity uses its resources effectively, better than its competitors, and **in ways that competitors cannot imitate or obtain**.

The concept of core competence was first suggested in the 1990s by Hamel and Pralahad, who defined core competence as: 'Activities and processes through which resources are deployed in such as way as to achieve competitive advantage in ways that others cannot imitate or obtain.'

2.3 Sustainable core competences

Core competences might last for a very short time, in which case they do not provide much competitive advantage.

Competitive advantage is provided by sustainable core competences. These are core competences that can be sustained over a fairly long period of time – over a period of time that is long enough to achieve strategic objectives.

Sustainable competences should be durable and/or difficult to imitate.

- **Durability**. Durability refers to the length of time that a core competence will continue in existence, or the rate at which a competence depreciates or becomes obsolete.
- **Difficulty to imitate**. A sustainable core competence is one that is difficult for competitors to imitate, or that it will take competitors a long time to imitate or copy.

Example of core competences

Sustainable core competences come from unique resources and a unique ability to use resources. The core competences that give firms a competitive advantage vary enormously. Here are just a few examples:

- Providing a good service to customers. Some entities have a particular competence in providing good service that other entities find difficult to imitate.
- Embedded operational routines. Some entities use processes and procedures as part of their normal way of operating, as a result of which they are able to 'make things happen'. This competence is sometimes described in general terms as 'operating efficiency'.
- Management skills. The core competence of an entity might come from the ability of its management team.
- Knowledge. Knowledge can be a key resource, and a core competence is the ability to make use of the knowledge and 'know how' within the entity, to create competitive advantage.

It is a **useful exercise** to think of any company that you would consider successful, and list the unique resources and core competences that you consider to be the main reasons why the company has achieved its success. (You should also think about why the company has been more successful than its main competitors. What makes your chosen company so much better than other companies in the same industry or the same market?)

2.4 Core competences and the selection of markets

A core competence gives a business entity a competitive advantage in a particular market or industry.

Some strategists have taken the idea of core competence further. They argue that if an entity has a particular core competence, the same competence can be extended to

other markets and other industries, where they will be just as effective in creating competitive advantage.

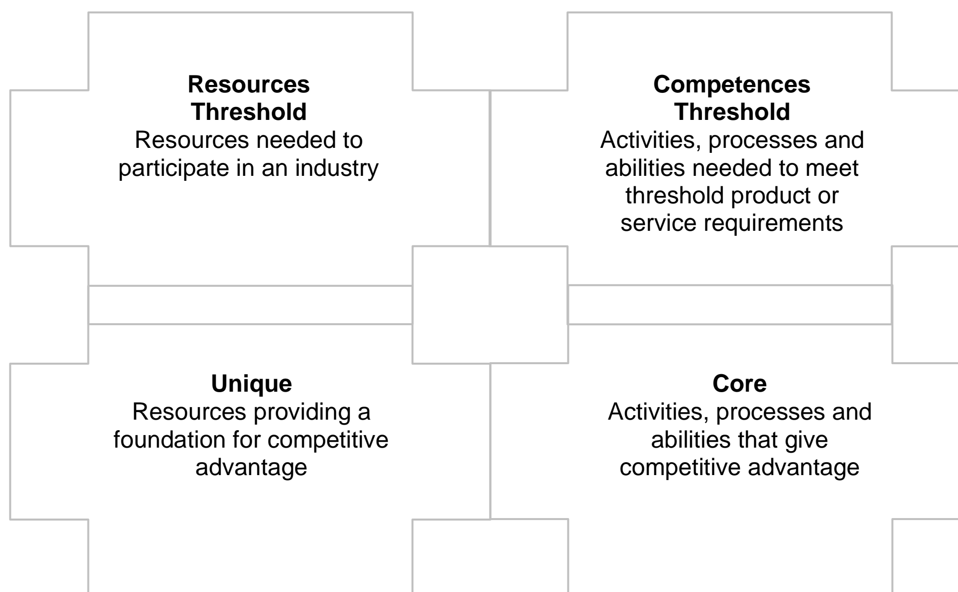
An entity should therefore look for opportunities to expand into other markets where it sees an opportunity to exploit its core competences.

Example

The Marriot group is well known as a chain of hotels. However, the group developed a range of different services based on the core competencies it acquired from operating a chain of hotels. It extended these competencies successfully into markets such as conference organisation, hospitality arrangements at events (for example at sporting events) and facilities management.

2.5 Summary: resources and competences

Resources and competences are necessary to compete in a market and deliver value to the customer. Unique resources and core competences are needed to create competitive advantage.



Threshold resources and competences are necessary, but are not sufficient for achieving strategic success (strategic capability).

Capabilities and competitive advantage

- Competitive advantage
- Capabilities
- Cost efficiency and strategic capability
- Corporate knowlege and strategic capability

3 Capabilities and competitive advantage

3.1 Competitive advantage

Competitive advantage is any advantage that an entity gains over its competitors, that enables it to deliver more value to customers than its competitors. Competitive advantage is essential for sustained strategic success.

The result of competitive advantage should be an ability to:

- create added value in products or services, that customers will pay more to obtain, or
- create the same value for customers, but at a reduced cost.

3.2 Capabilities

Capabilities are the ability to do something. An entity should have capabilities for gaining competitive advantage. These come from using and co-ordinating the resources and competences of the entity to create competitive advantage. Capabilities arise from a complex combination of resources and core competences, and they are unique to each business entity.

Each business entity should have capabilities that rivals cannot copy exactly, because the capabilities are embedded in the entity and its processes and systems.

A resource-based view of the firm is based on the idea that strategic capability comes from the distinctive capability of the entity to use its resources and competences to provide a platform for achieving long-term strategic success.

Dynamic capabilities

'Dynamic capabilities' is a term used to describe the ability of an entity to create new capabilities by adapting to its changing business environment, and:

- renewing its resource base: getting rid of resources that have lost value and acquiring new resources, particularly unique resources
- developing new and improved core competences.

Two definitions of dynamic capabilities are follows:

- Dynamic capabilities are abilities to create, extend and modify ways in which an entity operates and uses its resources, and its ability to develop its resource base, in response to changes in the business environment.
- Dynamic capabilities are the abilities of an entity to adapt and innovate continually in the face of business and environmental change.

The point has been made in earlier chapters that business entities operate in a continually-changing environment. Strategic success is achieved by reacting to changes in the environment more successfully than competitors.

Dynamic capabilities refer to the ability of an entity to respond to environmental change successfully, and recognise the need for change and the **opportunities for innovation**, through new products, processes and services.

3.3 Cost efficiency and strategic capability

Porter has argued that in order to achieve strategic capability, an entity must gain competitive advantage over its rivals, and competitive advantage can be achieved by adding value or by reducing costs.

Cost efficiency to an accountant means minimising costs through control over spending and the efficient use of resources. A firm must achieve a certain level of cost efficiency if it is to be able to compete and survive in the industry. In strategic management, **cost efficiency** refers to the ability not only to minimise costs in current conditions, but to **continually reduce costs over time**.

The ability to reduce costs continually is often a key requirement for strategic success. Cost efficiency has been described as a 'threshold strategic capability'. A cost efficiency capability is the result of both:

- making better use of resources or obtaining lower-cost resources, and
- improving competencies and capabilities (for example, improving the systems of inventory management).

Ways of achieving cost efficiency

There are various ways in which cost efficiency can be achieved, to gain a competitive advantage over rival companies.

- **Economies of scale**. Reductions in cost can be achieved through economies of scale. Economies of scale refer to ways in which the average costs of production can be reduced by producing or operating at a higher volume of output. In simplified terms, operating at a higher volume of output enables a firm to spread its fixed costs over a larger volume of output units, so the average cost per unit falls. Cost efficiency often goes hand-in-hand with size because large entities can make use of economies of scale. Many businesses are therefore very keen on continuous growth as this is one way to keep improving cost efficiency and, therefore, of keeping ahead of the competition.

- **Economies of scope**. In some industries, reductions in costs might be achieved by producing two or more products, so that an entity that makes all the products achieves lower costs per unit than competitors that produce only one of the products.

Examples

Economies of scale
Company A and Company B are building construction companies. Both companies construct residential homes. Company A is much smaller than Company B. Company B has been able to acquire a large share of the housing construction market because it is able to build lower-cost houses than companies such as Company A.

It achieves lower costs by exploiting **economies of scale**. It can buy raw materials (such as bricks and windows) at lower prices by purchasing in bulk. It can make better use of the time of its specialised workers. It can also reduce costs by buying its own construction equipment, instead of having to hire equipment from equipment suppliers at a higher cost (which is what Company A must do).

Economies of scope
Company C produces curtains and carpets for both commercial customers and the retail market. It competes with Company D, which produces curtains only, and Company E, which produces carpets only.

Company D might be able to achieve greater cost efficiencies than either Company D or Company E because it produces both curtains and carpets, and not just one product.

Cost efficiency and strategic capability

Cost efficiency can become a strategic capability, which will give the organisation competitive advantage, for example by achieving 'cost leadership'. A cost leadership strategy is explained in a later chapter.

3.4 Corporate knowlege and strategic capability

Corporate knowledge or organisational knowledge is the knowledge and 'know-how' that is acquired by the entity as a whole. It is created through the interaction between technologies, techniques and people. Within organisations, knowledge comes from a combination of:

- collaboration between people, who share their knowledge and create new knowledge together
- technology, which makes it possible to store and communicate knowledge
- information systems that make use of the technology systems, and
- information analysis techniques.

Knowledge gives a company a competitive advantage. Another important characteristic of corporate knowledge is therefore that it cannot be easily replicated by a competitor. It is something unique to the company that owns it.

Another way of making this point is to say that the premium value of knowledge comes from the fact that it cannot be digitised, codified and easily distributed or easily acquired.

A capability in knowledge management comes from a combination of unique resources and core competences:

- experience in an industry or market, and acquiring knowledge through experience
- the knowledge that employees have or acquire, for example through training
- the management of people, and success in encouraging creativity and new ideas
- the management of IS/IT systems.

Analysing strengths and weaknesses

- Assessing resources and competences
- Techniques for assessing resources and competences
- Resource audit
- SWOT analysis and strengths and weaknesses
- Preparing a SWOT analysis
- Interpretation of a SWOT analysis

4 Analysing strengths and weaknesses

4.1 Assessing resources and competences

In addition to assessing the external environment, including markets and competitors, strategic managers should also assess the internal resources of the entity, its competences and its capabilities.

The following assessment is required:

- What are the resources of the entity?
- Which of these resources are unique or special? What value do they provide? (What competitive advantage do they provide?)
- Will requirements for resources change, as a result of changes in the business environment?
- How are the resources used? Are they used effectively and efficiently? What core competences does the entity have?

4.2 Techniques for assessing resources and competences

There are several techniques that might be used to assess the resources and competences of an entity.

- Management need to understand how value is created, and how value might be lost. An assessment of the value that is created or lost by the entity can be made using **value chain analysis** or **value network analysis**. These were described in the previous chapter.
- Management can prepare a **capability profile** of the entity. This is an assessment of the key strategic processes that are needed to provide consistently superior value to customers. This is an assessment of capabilities and competitive advantage.
- A capability profile might be prepared together with a **SWOT analysis**.

In order to prepare a capability profile or a SWOT analysis, management need a thorough understanding of the resources that the entity has, the value of those resources, and the competences that the entity has acquired in using those resources.

This can be provided by a **resource audit**.

4.3 Resource audit

A resource audit is an initial assessment of the resources of an entity. It is carried out to establish what resources there are, which are unique and how efficiently and effectively they are being used.

A resource audit should identify all the significant resources that are used by an entity. These will vary according to the nature of the entity. In general, however, a resource audit should provide data about the following resources.

Human resources (Part-time and full-time employees, consultants, sub-contractors etc)	▪ Size and composition of the workforce ▪ Efficiency of the workforce ▪ Flexibility of the workforce ▪ Rate of labour wastage/turnover ▪ Labour relations between management and workers ▪ Skills, experience, qualifications ▪ Any particular expertise? ▪ Labour costs: salaries and wages
Management	▪ Size of the management team ▪ Historical performance ▪ Skills of the managers ▪ Nature of management structure, the division of authority and responsibility
Raw materials	▪ Costs as a percentage of total costs ▪ Sources, suppliers ▪ Availability ▪ Future provision. Scarcity? ▪ Wastage rates ▪ Alternative materials and alternative sources of supply
Non-current assets	▪ What are they? ▪ How old are they? What is their expected useful life? ▪ What is their current value? ▪ What is the amount of sales and profit per $1 invested in non-current assets? ▪ Are they technologically advanced or out-of-date? ▪ What condition are they in? How well are they repaired and maintained? ▪ What is the utilisation rate for each group of non-current assets?
Intangible resources	▪ Are there any intellectual rights, such as patent rights and copyrights? ▪ Are there valuable brand names? ▪ Does the organisation have any identifiable goodwill? ▪ What is the reputation of the entity with its customers? How well does it know them? ▪ Is the work force well-motivated?

Financial resources	▪ What is the capital of the entity? ▪ What are its sources of new capital? ▪ What are the cash flows of the entity? ▪ What are its sources of liquidity? ▪ How well does it control trade receivables? ▪ How well does it control other elements of working capital?
Internal controls and organisation	▪ How well does the entity control the use of its resources? ▪ How effective are its controls over the efficient and effective use of assets? ▪ How effective are its controls over accounting and financial reporting? ▪ How effective are its controls over compliance with regulations? ▪ How effective are its risk management systems? ▪ Is the entity organised in an efficient way?

Evaluating resources

Having identified its key resources, management can evaluate them and the entity's ability to use them efficiently and effectively to create value (competences).

A simple framework for evaluating resources is the VIRO framework:

- **V**: Value. Does the resource provide competitive advantage?
- **R**: Rarity. Do competitors own similar resources, or are the resources unique?
- **I**: Imitability. Would it be costly for competitors to imitate the resource or acquire it?
- **O**: Organisation. Is the entity organised to exploit its resources to best advantage?

4.4 SWOT analysis and strengths and weaknesses

SWOT analysis was described in an earlier chapter as a technique for analysing strategic position and identifying key factors that might affect business strategy. These factors are both internal and external to the entity.

In the previous chapter, SWOT analysis was explained in the context of identifying opportunities and threats in the environment. It is also used to identify strengths and weaknesses in the resources, competences and capabilities of the entity.

- **Strengths**. Strengths are resources and competences that an organisation has, and the capabilities it has developed. Strengths in resources, competences and capabilities can be exploited and developed to create sustainable competitive advantage.
- **Weaknesses**. Weaknesses are resources, competences and capabilities that are deficient or lacking. These weaknesses are preventing the entity from developing or sustaining competitive advantage.

Identifying strengths and weaknesses

In your examination, you might be given a question that contains a case study or scenario, and asked to identify the strengths and weaknesses of the entity and the opportunities and threats that it faces.

To identify strengths and weaknesses, you should consider the following:

- **Resources**
  - Consider all the resources of the entity, and identify those that are significant and unique. Include the skills of management and other employees in your assessment. You should also consider the knowledge that the entity has acquired, and its intellectual capital.
  - Consider whether there are key resources that the entity lacks, but a competitor might have.
- **Competences**
  - Consider all the activities and processes of the entity and how it uses its resources. Identify the competences of the entity and consider whether any of these are core competences that provide competitive advantage.
  - Consider the competences that the entity lacks.
- **Capabilities**
  - Consider the capabilities of the entity, and its relative success or failure in delivering value to the customer or in creating cost efficiency.

4.5 Preparing a SWOT analysis

If you are required to use SWOT analysis in your examination, you will probably be required to analyse opportunities and threats as well as strengths and weaknesses in the strategic position.

Strengths and weaknesses are concerned with the internal capabilities and core competencies of an entity. Threats and opportunities are concerned with factors and developments in the environment.

A SWOT analysis might be presented as four lists, in a cruciform chart, as follows. Illustrative items have been inserted, for a small company producing pharmaceuticals.

Note that strengths and weaknesses should include competences and capabilities as well as resources. In this example, the strengths relate to resources and the weaknesses relate to competences and capabilities, suggesting that the entity might not be making the best use of its resources.

Strengths	Weaknesses
Extensive research knowledge Highly-skilled scientists in the workforce High investment in advanced equipment Patents on six products High profit margins	Slow progress with research projects Poor record of converting research projects into new product development Recent increase in labour turnover
Opportunities	**Threats**
Strong growth in total market demand New scientific discoveries have not yet been fully exploited	Recent merger of two major competitors Risk of stricter regulation of new products

In order to prepare a SWOT analysis, it is necessary to:

- analyse the internal resources of the entity, and try to identify strong points and weak points
- analyse the external environment, and try to identify opportunities and threats.

An analysis might be prepared by a team of managers, a think tank, a risk management committee or another group of individuals within the entity.

Using the technique

If you are required to use SWOT analysis in your examination, you may be expected to do so to answer a case study question. The technique is fairly simple to use. You can prepare four lists as 'workings' for your answer, one for each of the SWOT categories (strengths, weaknesses, opportunities and threats). Read through the question carefully, and add to each of the lists as ideas come to your mind. You will need to think 'strategically'. You will also be required to interpret the results of your analysis and consider their strategic implications.

4.6 Interpretation of a SWOT analysis

An initial SWOT analysis is simply a list of strengths, weaknesses, opportunities and threats. The **significance** or **potential value/cost of each item** is not considered in the initial analysis, and the items are not ranked in any order of importance.

A problem with SWOT analysis is that it can encourage very long lists of strengths, weaknesses, opportunities and threats, without any differentiation between those that are significant and those that are fairly immaterial.

Having prepared an initial SWOT analysis, the next step is to interpret it. Interpretation involves identifying those strengths, weaknesses, opportunities and threats (SWOTs) that might be significant, and what their implications might be for the future. The process of interpretation therefore involves ranking the SWOTs in some order of priority or importance.

Another problem with SWOT analysis is that it can be used to identify significant issues, but it cannot be used for evaluation. It cannot be a substitute for a more rigorous strategic analysis.

Having identified the most significant issues facing the organisation, strategic management should then consider:

- how major strengths (for example, core competencies) and opportunities might be exploited, to obtain competitive advantage
- how major weaknesses and threats should be dealt with, in order to reduce the strategic risks for the entity.

CHAPTER 6

Stakeholder expectations. Ethics and culture

Contents

1 Organisational purpose and strategy
2 Implications of corporate governance
3 Stakeholders and stakeholder expectations
4 Ethical influences and corporate social responsibility
5 Corporate culture and business strategy

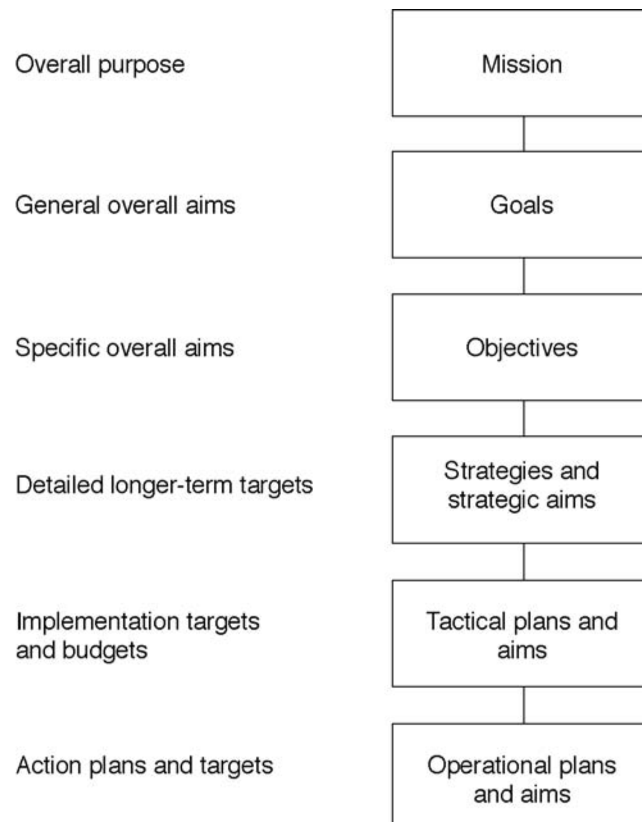
Organisational purpose and strategy

- A hierarchy of objectives and plans
- Mission and mission statement
- The relevance of the mission statement
- Goals and objectives
- Who decides mission, goals and objectives?

1 Organisational purpose and strategy

1.1 A hierarchy of objectives and plans

As a part of a strategic review, management should always re-consider the purpose of the entity that they manage – what it is trying to achieve. In the strategic planning process, goals, objectives and strategies should be decided with the aim of fulfilling the entity's purpose. A business entity should have a hierarchy of aims and plans. A useful way of presenting this is shown below.



1.2 Mission and mission statement

A mission is the purpose of an organisation and the reason for its existence. Many entities give a formal expression to their mission in a mission statement.

'A mission describes the organisation's basic function in society, in terms of the products and services it produces for its customers' (Mintzberg).

A mission statement should be a clear and short statement. Drucker suggested that it should answer the following fundamental questions:

- What is our business?
- What is our value to the customer?
- What will our business be?
- What should our business be?

Some entities include a statement about the role of their employees in their mission statement, or include a statement on the ethics of the entity.

Some examples of mission statements are set out below.

Examples

Mission statements of not-for-profit organisations often stress the ethical aspects of their mission.

The World Bank
'Our dream is a world free of poverty

To fight poverty with passion and professionalism for lasting results.

To help poor people help themselves and their environment, by providing resources, sharing knowledge, building capacity and forging partnerships in the public and private sectors.

To be an excellent institution able to attract, excite and nurture diverse and committed staff with exceptional skills who know how to listen and learn.'

Commercial entities also often emphasise the ethical aspects of their mission, perhaps as a method of motivating employees.

Pfizer Corporation (pharmaceuticals)

'Our mission. We will become the world's most valued company to patients, customers, colleagues, investors, business partners and the communities where we work and live.

Our purpose. We dedicate ourselves to humanity's quest for longer, healthier, happier lives through innovation in pharmaceutical, consumer and animal health products.'

A mission statement might include some reference to competitive position.

Kodak (imaging products)

The Kodak mission statement starts with statements about the corporation's values, and then continues as follows:

'With the above-mentioned values in mind we plan to grow more rapidly than our competitors by providing customers with the solutions they need to capture, store, process, output and communicate images – anywhere, any time. We will derive our competitive advantage by delivering differentiated, cost-effective solutions – including consumables, hardware, software, systems and services – quickly and with flawless quality. All this is thanks to our energetic, results-oriented employees with the world-class talent and skills necessary to sustain Kodak as the world leader in imaging.'

1.3 The relevance of the mission statement

A mission statement can have several different purposes:

- to provide a basis for consistent strategic planning decisions
- to assist with translating broad intentions and purposes into corporate objectives
- to provide a common purpose for all groups and individuals within the organisation
- to inspire employees
- to establish goals and ethics for the organisation
- to improve the understanding and support for the organisation from external stakeholder groups and the public in general.

1.4 Goals and objectives

There is some confusion about the meaning of goals and objectives, and the terms might be used to mean different things.

However, it is useful to think of goals and objectives as follows.

- **Goals** are aims for the entity to achieve, expressed in narrative terms. They are broad intentions. For example, an entity might have the goal of maximising the wealth of its shareholders, or the goal of being the world's leading business entity in one or more markets.
- **Objectives** are derived from the goals of an entity, and are aims expressed in a form that can be measured, and there should be a specific time by which the objectives should be achieved.

The objectives specified by the strategic planners should be SMART:

- **S**pecific/stated clearly
- **M**easurable
- **A**greed
- **R**ealistic
- **T**ime-bound (a time must be set for the achievement of the objective).

Example

A company might have a goal of maximising the wealth of its shareholders. Its objective might therefore be to double the share price within the next ten years.

Objectives might be expressed as a hierarchy of corporate and strategic objectives:

- A **corporate objective** might be to double the share price within the next ten years. This is the overall objective for the entity.
- In order to achieve the corporate objective, it is necessary to set **strategic objectives for key aspects of strategy**. Examples of strategic objectives might be:
  - to increase the annual profit after tax by 125% in the next ten years

- to introduce an average of three new products each year for the next ten years
- to become the market leader in four market segments within the next ten years, an improvement in each case from the current position of second-largest competitor in each of these market segments.

Some strategic objectives are more important than others, and there is a hierarchy of strategic objectives. However, the main strategic objectives might be identified as **critical success factors**, for which there are **key performance indicators**.

Goals and objectives can therefore be used to convert an entity's mission into specific strategies with strategic targets for achievement within a strategic planning period.

Example

Which of the following aims is (or are) an objective? Give your reasons.

(a) A supermarket chain has a target of increasing its market share from 20% to 25% within the next five years.

(b) A fitness and leisure centre has set itself the aim of becoming 'best in the field'.

(c) A chain of cinemas has the aim of increasing its sales revenue by 2% next year.

(d) A telecommunications company has set itself the target of reducing customer complaints in the next 12 months from 1.5% to 1% of its total customer numbers.

Answer

(a) This is an objective. It is clearly stated and measured, and presumably realistic.

(b) This is not an objective, because it is not measured. It is a goal.

(c) This is an objective. It is clearly stated and measured, and presumably realistic.

(d) For the same reasons, this is also an objective.

1.5 Who decides mission, goals and objectives?

When an entity states its mission in a mission statement, the statement is issued by the leaders of the entity. For a company this is the board of directors. Similarly, the formal goals and objectives of an entity are stated by its leaders.

However, the decisions by a board of directors about the goals and objectives of an entity are influenced by the way in which the company is governed and the expectations of other stakeholders in the company.

There are differing views about how a company should be governed. The implications of corporate governance on organisational purpose and strategy are considered in the next section.

Implications of corporate governance

- The meaning of corporate governance
- The traditional view of corporate governance
- Risks from bad corporate governance
- The traditional view of corporate governance: implications for organisational purpose and strategy
- The stakeholder view of corporate governance

2 Implications of corporate governance

2.1 The meaning of corporate governance

Corporate governance is the way in which a company is governed and led.

In countries such as the UK, where there are unitary boards of directors and many directors are also senior executive managers of the company, it is easy to confuse governance and management. Governance is not concerned with detailed management issues, such as planning and operational control. It is about giving direction to the company, and accounting to the owners and other stakeholders of the company for the success or failure of the company in achieving its objectives.

2.2 The traditional view of corporate governance

The traditional view of corporate governance is that the shareholders are the owners of a company, and the company is led by the board of directors. The directors act as agents of the company, and give leadership to the company on behalf of the shareholders.

- The directors should aim to provide maximum benefits for the shareholders. The aim of a company should be to maximise the wealth of the shareholders, and this is achieved by increasing and maximising profitability over the long term.
- Corporate objectives and strategies should be decided with the aim of maximising shareholder wealth.
- The directors should be accountable to the shareholders for the performance of the company, and the success or failure of the company in achieving its objectives.

In small companies, the main shareholders are often the directors. When the shareholders and directors are the same people, there should be no problems with governance. However in larger companies the directors might own some shares, but are not usually major shareholders.

A problem with corporate governance might arise when the shareholders and the directors are different people, because their personal interests will be different.

- The shareholders will be interested in profits, dividends and the share price.

- The directors, as individuals, will be interested in their remuneration and other benefits, and probably also in their status and power.

There is a risk that the directors of a company will make strategic decisions with the aim of adding to their status and remuneration, rather than with the aim of maximising shareholder wealth.

2.3 Risks from bad corporate governance

In most countries that have a stock exchange, there are now voluntary codes or regulations about corporate governance. The development of codes and laws on corporate governance happened as a result of major corporate scandals.

In the UK in the 1980s several large stock market companies collapsed (for example, Maxwell Communication Corporation and Polly Peck International). Investigations in to the collapses found that the directors had deceived the shareholders and presented misleading accounts. The companies were also dominated by a powerful director, usually the CEO and chairman, who had been **running the company for his personal benefit**, without regard to the interests of the other shareholders.

During the 1990s, **remuneration of senior executives** became another governance issue. There was concern about the strategic decisions that directors were sometimes making for their company. Directors were sometimes making decisions that were intended to maximise short-term profits (at the expense of long-term profitability) or were making strategic decisions about growing the company through acquisitions that were not always beneficial for the share price and shareholder wealth. It was argued that the remuneration packages of directors were giving them an incentive to boost short-term profits or increase sales turnover, and there was much less incentive to increase the share price and shareholder returns. It was therefore suggested that the remuneration packages of senior executives should be designed to bring the personal interests of directors (through their remuneration) into line with the interests of the shareholders.

The current view is that directors' personal interests can be made consistent with shareholders' interests if remuneration packages include substantial short-term incentives and long-term incentives, such as annual cash bonuses and the award of shares in the company or share options, which are dependent on the company's performance.

2.4 The traditional view of corporate governance: implications for organisational purpose and strategy

The traditional view of corporate governance has implications for decisions affecting the purpose and strategies of an entity.

- If the traditional view of corporate governance is valid, the aim of a company should be to maximise shareholder wealth.
- However, the board of directors might make strategic decisions for a different purpose. In particular, they might make strategic decisions that will benefit

themselves personally, by increasing their remuneration or adding to their personal status and power.

- The directors might make decisions aimed at maximising short-term profits, when they are rewarded on the basis of short-term profitability rather than long-term performance. When short-term profits are maximised, this is often at the expense of longer-term profits and shareholder value.
- The directors might also make decisions to expand the business, usually through acquisitions, in order to increase their power and status (putting them in charge of a much larger company). A strategy of growth through acquisitions might not be in the best interests of the shareholders.

The problems of bad corporate governance can be reduced through 'good governance practices'. These can be applied either through voluntary codes of practice or law. The aims of codes and regulations should be to encourage a board of directors to make decisions that are in the best interests of the shareholders (for example, by appointing more independent directors to the board of directors, and through careful structuring of remuneration packages for senior executives).

2.5 The stakeholder view of corporate governance

The traditional view of corporate governance is not accepted by everyone. An alternative view is that companies are 'corporate citizens' and have a responsibility to society as a whole, not just to their shareholders.

There are individuals and groups of individuals who are not shareholders in a company but whose welfare is affected by what the company does. It can therefore be argued that the aims and actions of companies should recognise their obligations to these other 'stakeholders'. Decisions by a board of directors should have the purpose of benefiting all significant stakeholder groups, not just the company's shareholders.

Another view of corporate governance is the '**enlightened shareholder view**'. This is the view that the board of directors should govern their company in the interests of the shareholders, but at the same time must recognise the interests of other stakeholder groups. Strategic decisions should therefore be taken in the interests of significant stakeholders as well as in the interests of the shareholders.

If the stakeholder view of corporate governance, or the enlightened shareholder view, is applied in practice, **strategic decisions by companies will be affected by the interests and the expectations of important stakeholder groups**.

Stakeholders and stakeholder expectations

- Definition of stakeholders
- The expectations of stakeholders
- Stakeholder mapping
- Stakeholder position/importance matrix
- Mendelow's stakeholder power/interest matrix
- Stakeholder influence: the cultural context

3 Stakeholders and stakeholder expectations

3.1 Definition of stakeholders

The stakeholders in an entity are any individuals, groups of individuals or external organisations that have an interest (a 'stake') in what the entity does or is trying to achieve. Some stakeholders have much more influence than others over the strategic decision-making of an entity, and the identity of the main stakeholders varies between different entities.

The stakeholders or stakeholder groups for a business entity usually include most of the following:

- the ordinary shareholders
- the controlling shareholder, if there is one
- other classes of shareholders
- bondholders
- the investment community
- lenders
- suppliers, especially major suppliers
- customers
- the directors
- other senior executive managers
- other managers and employees, or groups of employees
- the government (local or national government)
- pressure groups, such as environmental protection groups and human rights groups
- local communities in which the entity operates
- the general public.

Although large companies have most or all these stakeholder groups, the influence and significance of each stakeholder group will vary. Many stakeholder groups might have very little influence at all on strategic decisions by the company. The relative importance and significance of each stakeholder group will vary with the

company's circumstances, and the attitudes of its shareholders and directors towards corporate governance.

3.2 The expectations of stakeholders

Each stakeholder or stakeholder group has different expectations from a company. They expect to benefit from their association with the company, and the benefits they expect are different.

According to the traditional view of corporate governance, the main stakeholders are the shareholders of the company, its board of directors and probably also its senior managers. These stakeholder groups have different rights and duties, and they also have different expectations of what the company should provide for them.

Company law varies between countries, but the rights, duties and expectations of the main stakeholder groups might be described briefly as follows.

	Rights	Duties	Expectations
Shareholders	Right to vote on certain issues Other rights are set out in the constitution of the company	None	Share price growth Dividends Return on investment Possibly also an expectation of being consulted by the board on major issues
Directors	No rights, but extensive powers are given to the board under the company's constitution	The directors have certain duties in law (for example, a legal duty of due care and skill) The board of directors has a duty to give leadership to the company	Personal advancement – remuneration, status
Senior managers	Employment rights	Senior managers have a duty to carry out their delegated tasks, in accordance with their contract of employment	Personal advancement – remuneration, status Possibly a belief that they should have the power to make key strategic decisions

Expectations of other stakeholder groups

Other stakeholder groups have different expectations from their company.

- Employees expect to receive fair pay for the work that they do. They will often want job security and possibly career progress. They might also expect good working conditions. The expectations of employees might be expressed by trade union representatives.

- Customers have expectations about the nature of the goods or services they receive from a company.
- Suppliers might expect to develop a good business relationship with the company and collaborate on achieving improvements in the value network.
- Communities might expect a company to provide employment and economic prosperity by investing in the local area
- The general public and government might expect a company to show concern for the environment and to reduce pollution and develop environment-friendly ways of operating.

When these stakeholders have some power, they can influence the strategic decisions of a company.

Employees might have considerable power when they possess a high level of skills, and it would be difficult to replace them if they left the company. Employees have much less power and influence in a company with highly-automated operations and where it would be fairly easy to obtain and train replacements if the employees left the company.

The power of communities and the general public could be affected by government policy. For example, the willingness of a company to invest in a particular area could be affected by government policy and whether investment incentives are available. A company's concern for the environment could be affected by the threat of government legislation against polluting companies.

The power or influence of stakeholders might come from a variety of sources.

Stakeholders within an entity include shareholders, senior managers, middle managers and other employees and their trade union or staff association representatives. Their power or influence over decision-making within the entity might come from:

- their control over formal decision-making processes (shareholders, the board of directors, senior executives)
- their position in the management hierarchy (although senior managers should not rely on their formal power alone to exercise influence within the entity)
- their influence (through personal qualities)
- control over strategic resources, such as the work force or key workers in the work force, or the design or research and development department
- knowledge or skills (for example, accountants)
- control over access to the entity's environment (for example, the marketing department often exercises influence because marketing managers can claim to know the customers best)
- their ability to exercise discretion. For example, in a large organisation such as a government department, middle management often has considerable influence over the way in which senior management strategies are implemented.

External stakeholders include lenders, suppliers, customers and the government. The influence of external stakeholders might come from:

- laws and regulations (the government)
- the dependence of the entity on particular suppliers or customers (for example, the bargaining power of suppliers or customers)
- the involvement of an external entity in the implementation of strategy (for example, the importance of distribution networks and organisations)
- the knowledge or skills of an external entity (for example, an important sub-contractor).

3.3 Stakeholder mapping

A business entity should manage its stakeholders, particularly those with the greatest influence. As a part of a review of the strategic position of a company, management should identify its major stakeholder groups, their power and their expectations.

One way of presenting the results of a stakeholder assessment is to prepare a 'stakeholder map'. This is a simple diagram showing the main stakeholders or stakeholder groups, and their relative significance. The purpose of stakeholder mapping is to assist the directors of a company (or the governors of a public sector entity) to obtain an appreciation of who the main stakeholder groups are, and what their real and potential influences are over the entity and the entity's strategies.

One approach to stakeholder mapping is to show the relative significance of stakeholder groups using a 2 × 2 matrix. There are a number of different stakeholder maps. Two matrices are:

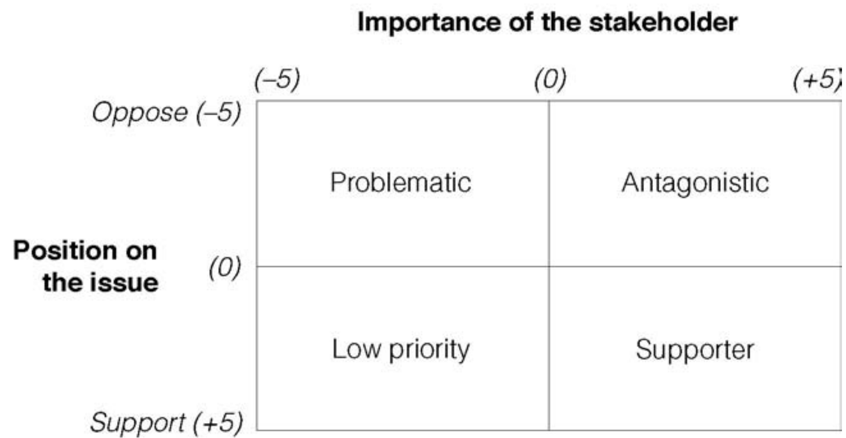
- the stakeholder position/importance matrix
- the stakeholder power/interest matrix.

The power/interest matrix is associated with Mendelow, and might be referred to as a 'Mendelow matrix'.

3.4 Stakeholder position/importance matrix

This matrix compares:

- the position of the stakeholders on a particular issue, on a scale ranging from 'strong opposition' (+5) to 'strong support' (–5), and
- the relative importance of the stakeholders, on a scale from 'not important' (–5) to 'very important' (+5).



The map can be used by the directors to assess the action they should take to try to win the support of each stakeholder group. They should give more attention to the important stakeholders.

In the matrix shown here, the main concern should be to deal with important stakeholders who are strongly opposed to proposed plans of the board of directors and are 'antagonistic'. These would be shown in the top right hand corner of the matrix. The directors should consider what measures should be taken to try to reduce the opposition of these stakeholders. Their decision will be influenced by what the consequences for the company might be if the stakeholders remain antagonistic. The solution might be to find a compromise solution, which reduces their opposition.

Management should also try to win support from the 'problematic' stakeholders, although their opposition is relatively unimportant. They should also try to maintain the goodwill of 'supporters' – important stakeholders who support their plans.

3.5 Mendelow's stakeholder power/interest matrix

This matrix compares:

- the amount of interest of the stakeholders on a particular issue, on a scale ranging from 'not at all interested' (0) to 'very interested' (+10), and
- the relative power of the stakeholders, on a scale from 'very weak' (0) to 'very powerful' (+10).

Interest of the stakeholder

Power of the stakeholder	*Very low (0)*	*(5)*	*Very high (10)*
Weak (0)	Minimal effort		Keep informed
(5)			
Strong (10)	Keep satisfied		Key players

The strength of the interest of a stakeholder group in the strategic decisions by the company will depend on their expectations of the benefits they expect the company to provide.

The recommended course of action for the board of directors is indicated in each quadrant of the matrix. The key stakeholders are those who have considerable power or influence, and also have strong expectations (a keen interest)about the strategic choices that the company makes.

3.6 Stakeholder influence: the cultural context

It is also important to remember that the relative importance of different stakeholder groups for an entity, and the way in which management respond to the interest of different stakeholder groups, will also vary according to culture; the culture of the country or region in which the entity operates, and the culture of the organisation itself and its senior management.

Ethical influences and corporate social responsibility

- Business ethics
- Consequences of unethical behaviour
- Ethical codes
- Corporate social responsibility
- Implications of ethics and CSR for strategy

4 Ethical influences and corporate social responsibility

4.1 Business ethics

Companies should comply with the law. Many companies go further and state that they will act in an ethical way. Ethical behaviour (for most people) involves compliance with the law. However, it is possible to act within the law but behave in an unethical way.

The ethics of doing business are different from the ethics of normal social behaviour. Businesses compete with each other, and many decisions are taken for commercial reasons, regardless of their effect. For example, companies will close down loss-making operations, regardless of the impact on the employees who are made redundant.

The ethics of business conduct by individual companies depends largely on the ethical stance of the company and its leaders.

Ethical issues

Ethics in business is generally associated with the following aspects of behaviour:

- Acting within the law. In international business, ethical behaviour often means compliance with accepted international codes of behaviour, such as a code against bribery by companies seeking to win a major contract from a customer.
- Fair and honest dealing with suppliers and customers.
- Acting fairly towards employees and showing due concern for the welfare of employees.
- Showing respect and concern for the communities in which the business entity operates.
- Showing respect for human rights, and refusing to deal with any entities that do not show concern for human rights. A significant issue for some companies in recent years has been public pressure to avoid dealing with suppliers in developing countries who use child slave labour.
- Showing concern for the environment and the need for sustainable businesses.

Ethical stance

The business ethics of a company can also be described as an ethical stance. An ethical stance is the extent to which an entity will exceed its minimum legal and ethical obligations to stakeholders and society in general.

There is a range of different ethical stances that a company might take, but it is useful to group them into four broad positions on a scale from position 1 to position 4.

- **Position 1**. The company takes the view that its only interests should be the short-term interests of its shareholders. Business decisions should be taken with satisfying shareholder interests as the only objective.
- **Position 2**. The company takes the view that the interests of its shareholders are the most important concern, but that in the long term the company will benefit by showing some concerns for the interests of employees, communities, the general public and the environment. The company therefore acts in its 'enlightened self-interest'.
- **Position 3**. The company recognises an obligation not only to its shareholders, but to other stakeholder groups.
- **Position 4**. The company has an ethical obligation towards society as a whole, and should be a 'shaper of society', creating a fair and just society for everyone. Financial objectives should be of secondary importance.

'Ethical behaviour' by companies is generally associated with an ethical stance around position 2 or position 3.

4.2 Consequences of unethical behaviour

Acting ethically reduces risk. There are several possible consequences of unethical behaviour.

- When business conduct is illegal or in breach of regulations, there is a risk of being 'found out'. The consequences could be the payment of fines to the authorities or compensation to individuals who have suffered as a consequence of the illegal behaviour. In some cases, individual directors might be liable to imprisonment for illegal behaviour.
- When businesses act illegally but in a way that the general public considers 'immoral', there is a risk of action by the government to makes such action illegal.
- Businesses that act in an unethical way are also exposed to reputation risk.

Reputation risk

Many large companies take the view that in a competitive business environment, customer loyalty depends on the general public's perception of the company's behaviour, which establishes a reputation. Reputation comes from business practice, such as providing high quality products at a fair price. It also comes from ethical behaviour.

Companies with a good reputation find it easier to win and keep loyal customers, and also loyal employees. When a business reputation is damaged, there is a risk of losing customers to rival companies.

Although the evidence for the importance of reputation risk is inconclusive, there is no doubt that many large companies are very aware of their reputation and reputation risk, and they invest heavily in trying to maintain their business reputation, through public relations and pursuing 'ethical' business strategies.

Companies that have been exposed to reputation risk include:

- companies accused of buying from suppliers in developing countries that use child labour or slave labour
- companies accused of polluting the environment
- companies in the food and drugs industries accused of selling dangerous food products or dangerous drugs.

4.3 Ethical codes

Many public companies have a published code of business ethics.

- The New York Stock Exchange rules require companies whose shares it trades to have a publicly displayed code of business conduct and ethics.
- In the UK, 90% of the top UK companies have a code of ethics.

If ethical codes are to be effective then:

- They must be strongly endorsed from the top of the company. (Enron, the collapsed US corporation, had an ethical code but the board of directors chose to over-rule it.)
- Training must be given. If not, many employees might not even be aware that it exists, let alone know how to apply it.
- The code must be kept up-to-date.
- The code must be available to all, for example, through the corporate intranet.
- Adherence to the code should be part of employees' contracts and departure from the code should be a disciplinary offence.

Examples

Citigroup, the international banking group, attracted adverse publicity in 2004 following two reported incidents – breaches of regulations in Japan and trading activity in the European bond market that was investigated by the authorities for possible breaches of financial regulations and was also criticised by other bond trading firms as unethical.

Citigroup announced that it was introducing an education programme to make employees aware of their ethical responsibilities.

In 2005, two executives of advertising agency Ogilvy & Mather were found guilty of overcharging the US government. The company announced that its response to the incident included the appointment of an ethics officer and the introduction of a 'hot line' that employees could use to 'blow the whistle' on colleagues, in confidence.

4.4 Corporate social responsibility

Corporate social responsibility (CSR) is the responsibility that companies recognise for acting in a socially responsible way. 'While there is no single commonly-accepted definition of corporate social responsibility or CSR, it generally refers to business decision-making linked to ethical values, compliance with legal requirements, and respect for people, communities and the environment' (Business for Social Responsibility).

CSR usually means that a company goes further than required by law in order to:

- treat employees fairly and with respect
- operate in an ethical way and with integrity, in all its business dealings with customer, suppliers, lenders and others
- respect human rights
- sustain the environment for future generations
- be a responsible neighbour in the community and a good 'corporate citizen'.

CSR is therefore closely linked to ethical behaviour. Many large stock market companies issue reports on corporate social responsibility and their CSR activities.

- These reports might be included in the annual report and accounts. For example, quoted companies in the European Union are now required to provide information on social and environmental issues in a business review within the annual report and accounts.
- Some companies publish a separate corporate social responsibility report. This may be called a 'social and environmental report' or a 'sustainability report'. These describe the company's social and environmental strategies and their progress towards achieving their CSR strategic objectives.

4.5 Implications of ethics and CSR for strategy

Companies that acknowledge their ethical responsibilities and corporate social responsibility need to demonstrate their genuine commitment to these ideals. To do this, they need to consider the implications of ethics and CSR for their strategic planning and objectives.

The growing importance of environmental (ecological) issues was discussed in an earlier chapter on environmental analysis. Many large public companies have adopted formal environmental policies, with objectives for creating a sustainable business and being environment-friendly. For example:

- A company that uses large quantities of timber as a raw material might adopt a policy of re-forestation, to replace trees that they have cut down.

- A company that sells sea fish might adopt a policy of maintaining fish stocks in the seas.

Ethics might also affect a company's policy to its employees. If a company has a formal policy of providing secure employment, fair wages and salaries, and good working conditions to its employees, this policy might affect strategic decisions about re-locating business and making staff redundant.

A policy of ethical business dealing might involve a business decision that all suppliers will be paid promptly.

When companies adopt ethical or CSR policies, they should do so out of a genuine wish to act in an ethical and socially responsible way. There is often a suspicion that many companies claim to have CSR policies, when in reality they fail to implement them. For example, many environmental disasters and many serious fires and explosions at work have been caused by poor safety procedures in companies that have publicised their CSR policies on protection of the environment and employee safety.

CSR and competitive advantage

The significance of CSR probably varies between different countries, but in some countries, particularly Europe and North America, companies are waking up to the strategic possibilities and strategic advantages of being an environmental-friendly company.

Customers might be willing to pay more for environment-friendly and for 'healthy food'. There is growing interest in smaller motor cars and cars driven by bio-fuel or electricity. CSR activities can therefore create value.

Michael Porter (Harvard Business Review, 2006) suggested that companies should not merely be taking corporate social responsibility seriously as an idea. They should also be 'embedding' CSR into their corporate and business strategy, in order to build a competitive advantage.

Corporate culture and business strategy

- Definition of corporate culture
- Edgar Schein: three levels of culture
- Johnson and Scholes: the cultural web
- Implications of the cultural web for business strategy
- Peters and Waterman: the concept of excellence
- Communicating core values

5 Corporate culture and business strategy

5.1 Definition of corporate culture

The culture of an organisation is a broad term for the way in which the people within an organisation act, think and work together. Culture can have a significant influence on strategic planning and implementation and it can both influence and be influenced by organisational structure.

Culture can be defined in various ways.

- Culture is the basic assumptions and beliefs that are shared by individuals within an organisation
- Culture is the philosophy that guides the organisation's attitudes to employees, customers and other stakeholders.

Culture affects what the employees within an organisation believe that the organisation should be doing and what it should be trying to achieve. It affects their attitude to work generally and standards of performance. Culture is therefore a very important factor in whether organisations achieve their objectives, realise their strategies and achieve competitive advantage. For example, the culture in an organisation offering very high quality service to customers is likely to be different to that in organisations offering cheap, basis services.

Within an organisation, there might be one culture. On the other hand, there might be different cultures in different parts of the organisation.

Changing the corporate culture is a very important part of managing change. It can also be the most difficult part, if only because the desired culture is difficult to specify and define.

5.2 Edgar Schein: three levels of culture

Edgar Schein suggested that employees working within a company have shared values, beliefs and ways of thinking: these interact with the policies, organisation structure and politics of the company's management system to create a corporate

culture. Culture affects the expectations of employees within the company about what the company should achieve.

Schein argued that organisation culture is strong because it is regarded as something that helps the company to succeed. An organisation culture is a set of assumptions that a group of people working together have invented, discovered or discovered by learning how to deal with problems that the organisation faces, internally and in its external environment. These assumptions work well enough to be considered valid; they are therefore 'taught' to individuals who join the organisation. New entrants therefore learn the culture of the organisation and become a part of that culture.

According to Schein, there are three levels of culture that members of an organisation acquire.

- **The outer skin**. At one level, the culture of a company is evident in what an observer can see by visiting the company, and in the values that it states. The facilities and surroundings in which employees work help to create culture. So too does the way that employees dress. Culture is also seen in the way that employees talk to each other and interact with each other. A company might have a formal code of ethical behaviour, which is intended to shape the attitudes of all its members. It might have a formal code of ethical behaviour, which is intended to shape the attitudes of all its members. However, stated values and mission statements are often expressed in general terms, such as 'providing a service to the community' and 'providing the best quality of service to customers'.
- **An inner layer**. At this second level, the employees in a company share common views on specific issues. This layer of culture can be seen in the ethical stance that the company takes. Whereas the outer layer of culture is expressed in general terms, this inner layer is expressed in relation to specific issues, such as:
  - Should we trade with companies or governments in politically repressive countries?
  - Should we buy goods from suppliers who use slave labour or child labour?
- **The heart**. The third level of culture is the company's **paradigm**. This is a term for the shared assumptions and attitudes about what really matters, that are taken for granted and rarely discussed. These affect the way that the organisation sees itself and the environment in which it operates, and is the real 'core' culture of the organisation. Unlike mission statements and codes of ethics, a paradigm is not written down, and it is difficult to identify or explain. The 'paradigm' has also been described as the reason why the organisation exists. A police force exists to catch criminals, and a school exists as a place for learning.

Schein argued that changing corporate culture is very difficult. The 'outer skin' can be changed fairly easily, with a determined effort by management, but it is very difficult to change the paradigm.

5.3 Johnson and Scholes: the cultural web

Although Schein's model describes the nature of corporate culture, it does not suggest what causes a particular culture to come into existence and it does not explore the implications of corporate culture for business strategy.

Another approach to analysing corporate culture has been suggested by Johnson and Scholes. They have suggested that there is a cultural web within every organisation, which is responsible for the prevailing culture, which they call the 'paradigm' of the organisation.

The cultural web consists of six inter-related elements of culture within an organisation.

- **Routines and rituals**. Routines are 'the ways things are done around here'. Individuals get used to the established ways of doing things, and behave towards each other and towards 'outsiders' in a particular way. Rituals are special events in the 'life' of the organisation, which are an expression of what is considered important.
- **Stories and myths**. Stories and myths are used to describe the history of an organisation, and to suggest the importance of certain individuals or events. They are passed by word of mouth. They help to create an impression of how the organisation got to where it is, and it can be difficult to challenge established myths and consider a need for a change of direction in the future.
- **Symbols**. Symbols can become a representation of the nature of the organisation. Examples of symbols might be a company car or helicopter, an office or building, a logo or a style of language and the common words and phrases ('jargon') that employees use.
- **Power structure**. The individuals who are in a position of power influence organisations. In many business organisations, power is obtained from management position. However, power can also come from personal influence, or experience and expertise. The most powerful groups within an organisation are most closely associated with the core beliefs and assumptions in its culture.
- **Organisation structure**. The culture of an organisation is affected by its organisation and management structure. Organisation structure indicates the important relationships and so emphasises who and what is the most important parts of it. Hierarchical and bureaucratic organisations might find it particularly difficult to adapt to change.
- **Control systems**. Performance measurement and reward systems within an organisation establish the views about what is important and what is not so important. Individuals will focus on performance that earns rewards.

Together, the cultural web consists of the assumptions that are 'taken for granted' within the organisation as being correct, and also the physical manifestations of the culture.

5.4 Implications of the cultural web for business strategy

Individuals find it difficult to think and act outside the paradigm created by the cultural web of their organisation. As a consequence, they often find it difficult to

accept major changes. As a consequence, organisations often find it difficult to adjust to changes in their environment, and change more slowly than they ought to.

The cultural web is a useful concept for strategic management.

- An analysis of the cultural web can indicate strengths and weaknesses within the entity.
- Analysing the cultural web can also provide an understanding of how people within the entity might resist planned changes, and who the key individuals are (within the power structure and the organisation hierarchy) who might provide the greatest resistance to change.
- Management can use their understanding of the corporate web to plan changes. By identifying the factors that will cause resistance to change, management can devise ways of trying to overcome the resistance by dealing with its causes.

Example

A company has acquired a reputation for achieving high rates of growth in annual profits. Its top executives are paid large annual cash bonuses, based on the rate of profit growth in their division.

However, the board of directors is now concerned that many senior executives are beginning to take high risks in the search for higher profits, and they believe that the company's exposures to business risk is too high. They have decided to pursue lower-risk business strategies in the future, with the aim of achieving steady growth in the business over the long term.

A cultural change is needed to switch from a high risk strategy with a focus on short-term profits to a lower-risk strategy with a focus on long-term growth.

The change will require changes in the cultural web, and overcoming the resistance of the senior managers who have benefited in the past from large cash bonuses for profit performance. Changes in culture might be achieved by:

- changing the reward structure, so that bonuses for executives are not based exclusively on annual profits or profit growth
- changing the organisation structure, possibly by appointing senior managers responsible for risk management, and giving them a high status within the management hierarchy.

5.5 Peters and Waterman: the concept of excellence

Corporate culture can be a strength as well as a potential weakness. In their book **In Search of Excellence** (1982), Peters and Waterman suggested that 'excellent' companies showed certain characteristics of culture. An organisation wanting to become 'excellent' in their field of operations should therefore seek to promote these characteristics.

The aspects of culture they found in excellent companies were as follows.

(1) A **bias for action**. There is a sense of urgency about getting things done, rather than analysing the obstacles to getting things done. There is a positive attitude of 'what can we do now rather than an attitude of 'What might stop us?'

(2) **Hands-on, value driven**. The company is managed in a hands-on, value-driven way. There is a commitment to the values of the organisation. Managers get involved in doing things, and are not remote from the action.

(3) **Close to the customer**. The company is close to its customers and understands what its customers want. Concern for improving quality and meeting customer needs better is a strong motivating force throughout the organisation, affecting all its employees.

(4) **Stick to the knitting**. The company sticks to doing what it does best. It does not seek to diversify into new areas of operation where other companies might do things better.

(5) **Autonomy and entrepreneurship**. The company encourages teams and individuals to establish their own targets for improvement, and for finding ways of innovating in order to do things better.

(6) **Simple form, lean staff**. The organisation structure is simple and uncomplicated. Head office is small, without large numbers of staff.

(7) **Productivity through people**. Greater productivity is achieved through the contribution of motivated individuals. Employees are treated as intelligent individuals who can contribute towards improvements.

(8) **Simultaneous tight-loose properties**. There is a balance between the application of controls and trusting individuals to act responsibly.

5.6 Communicating core values

The culture of an entity includes the ethical stance and ethical values of its individual members. When the directors of a company wish to promote ethical values and recognition of social and environmental responsibilities, they need to introduce these values into the corporate culture.

Changing culture can take a long time particularly in a big organisation with many employees. If the board of directors are serious in their wish to change ethical views and the company's values, they must give the lead to everyone else.

- Cultural values within a company are set by the 'tone at the top' – the leadership and example set by the directors and senior managers.
- There must be a conscious effort to change aspects of the cultural web.
- New cultural values can be communicated to all employees through formal communications, such as a new ethics code or the company in-house magazine.
- The reward structure might be changed, so that rewards are given to employees who accept the new cultural values and achieve performance linked to those values.

CHAPTER 7

Strategic choice: corporate strategy

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The corporate parent and its strategic business units

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- Who makes the strategy choices?
- The role of the parent company
- Three rationales for adding value
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1 The corporate parent and its strategic business units

1.1 The nature of strategic choices for corporate strategy

After making an assessment of the strategic position, decisions have to be made about which strategies to pursue. Strategic choices have to be made at the corporate, business and functional strategy levels.

- A strategic position analysis should inform management about where the business is now.
- Strategic choices have to be made about where management want the business to be in a few years time.
- Having identified 'Where We Are' and made choices about 'Where We Want To Be', plans can be developed for getting to 'Where We Want To Be'.

At the corporate strategy level, the strategic decision process is to:

- establish which businesses the entity is in at the moment
- make choices about which businesses it should be in, and
- decide what needs to be done to get there.

The directors and senior management therefore decide the businesses in which the entity should exit, and which it should enter, during the next few years.

1.2 Portfolio of businesses

Large companies are usually organised as groups, with:

- a parent company, whose management is responsible for the group as a whole, and
- strategic business units, organised as groups of subsidiary companies (or as a single subsidiary) whose management is responsible for the business performance of the strategic business unit (SBU).

A strategic business unit is a part of an organisation for which there is a distinct external market for goods and services. As a general rule, different strategies and marketing approaches will be needed for each SBU.

- Sometimes SBUs are obviously very different, for example a company selling both ethical pharmaceuticals (where doctors' prescriptions are needed) and cosmetics.
- Sometimes, SBUs are harder to distinguish, for example selling the same products to both consumer and business markets.

Each SBU can be seen as a separate business. All the SBUs within a group are a portfolio of businesses. The strategic choice about which businesses the group should be in involves making decisions about:

- which SBUs to retain
- which to shut down or dispose of, and
- which new SBUs to establish or acquire.

1.3 Who makes the strategy choices?

The directors and senior management at 'head office' may take strategic decisions in a large business organisation centrally. Alternatively, strategic decision-making may be delegated to managers at a 'lower level' within the organisation. Management of operating divisions or strategic business units (SBUs) may have the authority to formulate and implement strategy for their own division or SBU. When authority for decision making is delegated, there is usually a need to make sure that decisions taken 'locally' by divisional managers are consistent with the strategic objectives of the organisation as a whole. Head office should therefore (usually) exercise either a controlling or a co-ordinating role.

Four styles of strategic management can be identified:

- **Strategic planning style**. This is a centralised approach to the management of strategy. Strategic decisions are taken at head office, and strategic planning is centralised. This approach to strategy management is appropriate when the divisions or strategic business units in the organisation are highly interdependent, so that planning must be carefully co-ordinated.
- **Financial control style**. This is a decentralised approach to strategy management. Managers of divisions or SBUs are given the authority to formulate their own strategy. Head office limits its involvement to making sure that financial objectives are met, and it therefore exercises financial controls over the divisions or SBUs. Financial controls are applied by means of budgeting and budgetary control and other financial planning and control methods.
- **Strategic control style**. This style of strategic management lies between the strategic planning style and the financial control style. Head office is involved in setting strategic objectives for the entity as a whole. Strategic decision-making is delegated to management of divisions or SBUs, but these decisions must be consistent with the overall strategic objectives for the group as a whole.
- **Holding company style**. This style of strategic management refers to groups in which the parent company is nothing more than a holding company, owning the shares of the other companies in the group. The holding company does not exercise any management functions, and has little or no input to strategic management for the group. Strategic management is therefore highly decentralised, with individual SBUs operating independently.

Decisions about corporate strategy should be taken by the board of directors. Usually, the directors are advised by corporate strategists at head office, and it is therefore convenient to state that corporate strategy decisions – about which businesses the entity should be in – are made by the parent company in the group.

Decisions about business strategy for each individual business unit might be taken by the parent company, or by the management of the SBU, depending on the strategic management style that the entity has adopted.

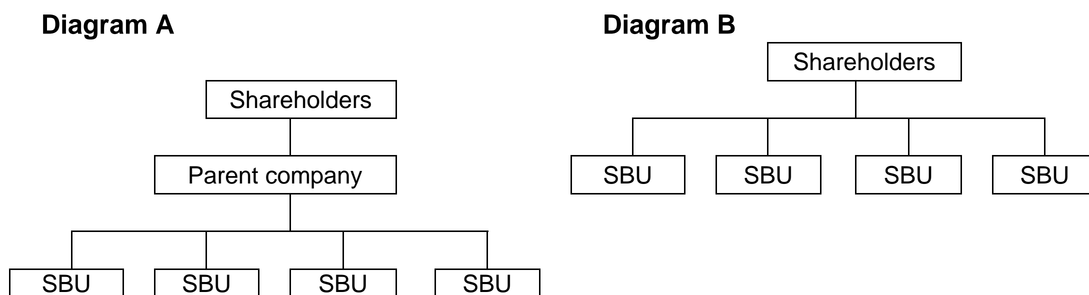
1.4 The role of the parent company

When a group of companies consists of a parent company and a number of strategic business units, it is useful to consider the role of the parent company.

Each SBU has its own products and markets, which means that it should be able to operate as an independent company, with its own independent corporate and business strategies.

The parent company owns 100% (or a majority) of the shares in each SBU, and shares in the parent company are held by the parent company shareholders. This arrangement is shown in Diagram A below.

Another way of organising the shareholding structure would be for the parent company shareholders to own their respective proportion of the shares in each SBU, and do without a parent company. This is shown in Diagram B below.



Logically, it might seem that the arrangement in Diagram B should be better. Total costs should be lower because there is no parent company, so total profits should be higher.

The arrangement in Diagram A can only be better than the arrangement in Diagram B if the parent company serves a purpose, and adds value to the group as a whole.

Since most groups of companies do have an active parent company, making strategic decisions, there must be an acceptance that parent companies can add value.

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1.5 Three rationales for adding value

There are three different ways of arguing that a parent company can add value to a group. Each different argument is based on a different view of the role of the parent company. A parent company can perform any **one** of the following roles for the group:

- portfolio manager
- synergy manager
- parental developer.

Portfolio managers

This view of the role of the parent is that the parent acts as a corporate manager, operating on behalf of the shareholders. In this role, the parent buys and sells SBUs (or discontinues SBUs), depending on the corporate strategy choices that it makes and as opportunities arise. However, the parent company has a 'hands-off' approach to the management of the businesses of the group. Each SBU is managed independently, by its own managers, without any interference or advice from the parent.

When it performs this role, the parent company is managing a portfolio of investments, in much the same way as an investor might manage a portfolio of shares in different companies.

As far as the parent is concerned, it does not matter what businesses the SBUs are in. They can be totally different investments. All that matters is the size of the return provided by each SBU.

In this role, the parent company adds value only if it can manage the portfolio of businesses better than its own shareholders could if they were investing directly in the stock market. It can do this by:

- identifying and acquiring under-valued businesses
- encouraging under-valued businesses to improve their management and performance, so that their value increases: the managers of each SBU might be given financial performance targets that the parent expects the SBU to achieve
- selling off over-valued businesses, and
- selling off under-performing businesses that fail to improve.

The parent should also try to keep its own operating costs as low as possible. Head office will therefore have a very small staff.

Synergy managers

A parent might perform the role of synergy manager, by identifying opportunities for synergies across the group. Synergies might exist when:

- two or more SBUs in the group are able to share the same resources, and so reduce operating costs
- two or more SBUs in the group can share a joint activity, and so reduce operating costs

- two or more SBUs can share skills and competences that exist across their businesses, so that skills and competences that are learned and acquired in one SBU can be taught to other SBUs.

Opportunities for synergy and cost savings can exist only when the SBUs have something in common that they can share. A synergy manager role cannot be performed by a parent company of a widely-diversified group of SBUs.

There are also difficulties for a parent company in performing a synergy manager role successfully, even when opportunities for synergies do exist.

- The costs of operating the parent company might exceed the benefits of the synergies it is able to find.
- The parent might have difficulty in overcoming the self-interest of the managers of the SBUs and persuading them to co-operate with each other.
- There might be cultural differences between the SBUs, which make it very difficult for the SBU managers to co-operate successfully.
- Synergy management cannot be successful unless the management of the parent have the determination to make synergies work. Where necessary, this will mean intervening in the management of the SBUs whenever necessary, and 'forcing' them to co-operate to achieve the synergies.

Parental developers

A parental developer is a corporate parent that brings some of its own skills to bear on SBUs to help them to develop and add value. (This differs from synergy management, where the corporate parent looks at how sub-units might help each other. Here, the corporate parent teaches the SBUs some of its own competences.)

For example, a corporate parent might have very good international marketing skills and these skills can be used to add value to a SBU that is attempting to sell its goods in other countries.

Parental developers must be clear about the distinctive skills, capabilities and resources that it has that can add value for an SBU. A 'parenting opportunity' is a SBU that is not fulfilling its potential and where the parent has particular skills or competences that can help to the SBU to improve.

1.6 Ways in which parents can destroy value

Parent companies can destroy value rather than create it. A parent destroys value when the benefits it provides to the group are less than the costs of operating the parent.

- When a parent company acts as a portfolio manager, its selection of SBUs for the group's business portfolio might be no better – or even worse – than the choices that could have been made by its own shareholders if they had been making the business investments directly.
- When a parent acts as a synergy manager, it may fail to realise enough synergies, for the reasons explained earlier.

- When a parent acts as a parental developer, it might try to use its skills and competences where they bring little or no benefit to the SBU. There has to be a good 'fit' between the parent and the SBU.

Corporate strategy: an international perspective

- Global competition
- Corporate strategies for international business
- International scale operations, international diversity and globalisation
- Multinational organisations and global organisations
- Ethnocentric, polycentric and geocentric orientation
- The geocentric company: Ohmae
- Transnational companies: Bartlett and Ghosal
- Foreign subsidiaries as a portfolio of SBUs

2 Corporate strategy: an international perspective

2.1 Global competition

Many business entities have expanded beyond their national markets and operate in foreign markets. As a result, many markets have become international or global, with competitors from different countries competing with each other in all or most countries. The reasons for the internationalisation of markets and competition can be summarised as follows.

- Business entities succeed by gaining competitive advantage in their markets. One way of achieving competitive advantage is by reducing costs. Costs can be reduced by **economies of scale**. Expanding business operations into the markets of other countries creates a bigger volume of sales, and provides an opportunity for achieving economies of scale and lower unit costs.
- The **markets in many countries are converging**, and national differences might be fairly small. When customer needs and demands are similar in different countries, an entity should be able to sell a fairly standard product in all of those countries.
- Foreign currency volatility and **currency risk**. By setting up operations in other countries or currency blocs, an entity can avoid the currency risk of exporting to those countries. By producing and selling its products within the same country or currency bloc, there is no risk from variations in the exchange rate. In contrast, if products are exported from one country to another country with a different currency, the exporter is exposed to the risk of losses from adverse movements in the exchange rate between the two currencies.
- Porter has suggested (**Porter's diamond**) how some countries obtain a competitive advantage over others in a particular industry. Business entities can use the competitive advantage gained from their own country to compete successfully in other countries.
- Business entities often need to adopt a global strategy simply to compete against rival entities that are pursuing the same strategy.
- In some cases, a company might choose to set up new operations within an **economic trading bloc**, to overcome the difficulties of trying to export goods into the bloc due to import control regulations and other regulations. For

example, a Japanese or US corporation wanting to sell goods into Europe might set up a subsidiary in the eurozone, in order to get round the difficulties of exporting from their home country.

2.2 Corporate strategies for international business

Large companies have developed strategies for growing their business operations internationally.

When an entity starts to sell its products in foreign markets for the first time, it will probably think of the foreign market as an extension of its domestic market. It will not change its product design for the foreign markets, and will sell an identical product in all the countries where it operates. The product will be manufactured in the entity's domestic country, and exported to the foreign markets.

However, as an entity becomes more committed to its foreign markets, and as foreign sales increase, the situation changes. The entity will start to recognise differences between the different foreign markets. Customers in each different market will have slightly different needs and preferences. The entity might therefore alter its products to suit the needs of each local market. As a result, total sales will increase. However, profits will fall. This is because the cost of adapting products to local market needs is high.

2.3 International scale operations, international diversity and globalisation

Corporate strategies for international business can be analysed into three different categories:

- international scale operations
- international diversity
- globalisation.

International scale operations

A company might decide to sell a standard product in many different countries. To do this, it needs to establish operations on an international scale. Production plants might be established in selected countries, each serving a different region of the world. The purpose of selecting a centralised production location in each part of the world is to benefit from economies of scale, by producing the standardised products in large quantities. The products are then distributed to different countries in the region and sold.

International scale operations therefore seek to obtain a cost-minimising balance between production costs and distribution costs.

The operations are usually managed and controlled from a head office in the company's country of origin.

International diversity

A strategy of international diversity is also called multi-domestic strategy. With this type of strategy, the company recognises the differences in customer needs in each different country, and bases its strategy on the view that most or all value-adding activities must be located in the country where the target national market is located. In each country, the product is adapted to suit the unique requirements of the local customers.

It is even possible that the company's products will be sold under different brand names in each country, and the group does not attempt to obtain global recognition for a single global brand name.

Globalisation

A globalisation strategy is similar to an international scale operations strategy, selling a single product under a single global brand name. However, the group operates in every country (or most countries) rather than having centralised regional locations for production.

When it adopts a globalisation strategy, the company will become a global company.

Choosing a suitable international strategy

An entity with international business operations must decide how to develop its business operations and which corporate strategy (or strategies) to adopt. The ideal strategic and marketing solution is to find a balance between:

- selling a standardised product, using the same marketing methods, in every foreign market: in this way, the entity will benefit from economies of scale and lower costs
- adapting its products to the needs of different local markets, in order to achieve higher sales.

Some international companies use a mix of a multi-domestic strategy and an international scale strategy

2.4 Multinational organisations and global organisations

Companies that operate in different countries and many different national markets are called either multinational companies (MNCs) or global companies. Often, the two terms are used with the same meaning.

However, a difference can be identified between MNCs and global companies according to their differences in corporate strategy.

- An **international company** is a company with all or most of its production operations in a single country. Most of its senior managers are nationals of the country. The company sells its products in different companies, through local sales agents or local sales offices in each country, or using international sales representatives.

- A **global company** is a company with operations in a large number of different countries, making a similar range of products or providing a similar range of services. Its senior managers are nationals of a variety of different countries.

When companies expand their business outside their 'home country', they will usually begin as an international company, but may eventually develop into a global company.

Multinational company	Global company
Management make strategic decisions for each foreign market individually.	Management develop worldwide strategies for all their markets.
Products are adapted and designed to the requirements of the local market.	The company produces core products. These are standardised for all markets, with only minimal design changes for individual national markets.
Marketing (for example, advertising) is adapted in each country to suit the local culture.	There is a uniform approach to marketing in all countries, with only small variations.
Countries are selected as a target for production and sales entirely on the basis of their potential for profitability.	Countries are selected for their ability to contribute to the integrated global strategy.
The aim is to optimise the value chain in each country of operation.	The value chain is broken up, and different parts of the value chain are in different countries. The aim is to optimise the value chain globally.
A multinational company often has the culture of the country where its head office is based (for example, the US).	A global company develops a global culture. Its senior managers are likely to come from different countries.

2.5 Ethnocentric, polycentric and geocentric orientation

It was suggested earlier that companies that compete internationally must find a suitable balance between:

- achieving a global integration of their activities and operations, in order to achieve economies of scale, and
- being responsive to the different needs of the individual local market in each country.

In the late 1960s, Perlmutter identified three different approaches to this problem:

- ethnocentric orientation
- polycentric orientation
- geocentric orientation.

Ethnocentric orientation

An entity with ethnocentric orientation is 'home-country' oriented. It emphasises the culture and values of the country of the parent company, and it sees the rest of the world as an area where the home country's values and culture should be copied. This type of entity usually has a traditional hierarchical management structure, and nationals of the parent company hold most or all of the senior management positions throughout the world. Research and development and product innovation are based in the parent company's home country. The strategy of this type of entity is to develop a standardised product for a global market.

Polycentric orientation

An entity with polycentric orientation is 'host-country' oriented. It emphasises the need to adapt its products to the needs of each local national market, and it usually has different systems and ways of doing things in each of the different parts of the world in which it operates. To a large extent, the entity's products are adapted to the needs of the individual local markets.

This type of entity usually has a decentralised organisation structure, with a large amount of authority delegated to local management. The structure is also usually based on geographical divisions. It also recruits and promotes local managers.

Geocentric orientation

An entity with geocentric orientation is 'world oriented'.

Geocentric orientation has been defined as follows: 'A management orientation based upon the assumption that there are similarities and differences in the world that can be understood and recognised in an integrated world strategy. The geocentric orientation or world orientation is a synthesis of the ethnocentric orientation (home country) and the polycentric orientation (host country)' – American Marketing Association.

An entity with geocentric orientation sees the global market place as a single integrated market, and its objective is to identify and implement the best global practices. At the same time, it seeks to balance the need for global integration (and economies of scale) with the economic benefits of responding to local market needs. It does not have a particular preference for home country or host country values; it believes in finding the optimal solutions to all problems.

Senior management appointments are made on the basis of the individual's talent and potential, regardless of the individual's country of origin.

2.6 The geocentric company: Ohmae

Kenichi Ohmae, a Japanese organisation and management theorist ('The Borderless World'), suggested that as a company internationalises its business, and as the volume of its sales in foreign markets increases, it gradually transfers key activities into its main foreign markets from the host country of the parent company. He identified five stages of development in an international organisation. At each progressive level, the organisation becomes more sophisticated.

- **Stage 1**. The firm starts selling its product outside its home market through direct exports to customers in other countries. It will probably use export agents in each of the foreign countries to help it with selling.
- **Stage 2**. With increasing volumes of foreign sales, the company sets up local sales and marketing operations in other countries. The purpose of setting up local sales and marketing units is to get to know customers better (and their needs) and also to sell more effectively. In each country, sales and marketing activities are adapted to the character of the local market.

- **Stage 3**. As international business continues to increase, the firm sets up local manufacturing and service operations in other countries. These produce adapted products to meet the needs of the customers in the local market. In each country, the company now has manufacturing, sales and marketing operations serving the local market.
- **Stage 4**. The **complete insiderisation** stage. At this stage in growth and development of its international business, the firm replicates all its home country activities within each of the countries in which it operates. This allows the subsidiaries in each foreign country to tailor all aspects of their business strategy to the needs of the local market.
- **Stage 5**. A global firm develops. The firm now integrates some activities on a global basis in order to obtain economies of scale (e.g. in production), and also to prevent the fragmentation of the business. However, products are still adapted to the needs of local markets. Even so, the company 'thinks globally and acts globally'. Ohmae called this type of company a 'geocentric' company.

Ohmae argued that if an entity cannot amortise its fixed costs over a large volume of customers, its average costs will be too high and the firm is unlikely to survive in the long term in a competitive international market. An international diversity or multi-domestic strategy of adapting products to the specific needs of each individual foreign market is therefore not sensible. Entities must achieve some economies of scale to compete successfully.

Ohmae therefore suggested that this explains the development of the geocentric company. A geocentric company organises its business operations around specific geographical areas of the world, where the local markets are similar (for example, Europe, North America, South America).

- It centralises its functions within each geographical areas, for functions where localisation is inappropriate. For example, functions such as manufacturing, research and development and product branding are centralised activities). Centralisation enables the entity to benefit from economies of scale.
- It customises other aspects of its operations, to meet the specific demands of a local or national market, where this will provide benefits. For example, advertising might be localised, and some aspects of product design might also be localised.

Ohmae also suggested five reasons why an entity might choose to organise itself as a geocentric company. These reasons were called the 5Cs.

- **Customer**. Customer tastes in different national markets, particularly within a region of the world, are becoming more and more the same. In some segments of some markets, such as the youth markets in countries and regions such as the US, Western Europe and Japan, tastes are becoming the same across different regions.
- **Company**. There is a strategic reason for companies to become geocentric. Organising in this way will help to achieve economies of scale and reduce costs.

- **Competition**. Competitors might be developing into geocentric companies and obtaining the benefits of economies of scale. Other companies need to do the same in order to compete.
- **Currency**. Exchange rates between currencies are volatile, and future movements in exchange rates are difficult to predict. Companies are able to reduce the strategic risk from adverse movements in exchange rates by locating operations in other countries. Foreign currency risk has been a major factor in the strategic decision by many companies to set up production facilities or assembly operations in other countries in or close to foreign markets. It is now rare for a major international company to export all its goods from the same country. It is more appropriate, to minimise the currency risk, to locate production facilities in different countries in different parts of the world.
- **Country**. Locating operations in different countries allows an entity to gain access to cheaper labour, and possibly also cheaper raw materials. In addition, when an international company sets up an operation in another country, it will often receive favourable treatment from the local government. In addition, it will also probably win goodwill from customers in the local market.

2.7 Transnational companies: Bartlett and Ghoshal

Bartlett and Ghoshal have written about the increasing internationalisation of business, and the growth of what they call the 'transnational' corporation – a business entity operating in many different countries (i.e. a global company).

Their research suggested that companies were taking one of two different approaches to market positioning in the world markets:

- Some corporations adopt a 'global' approach and seek to integrate the markets in different countries into a single world market for a standard product.
- Other corporations operate a group of businesses in different countries that are tailored to the local needs of each market.

(These two different types of corporation have been described earlier as the global company and the multinational company.)

As international competition becomes more intense, and as IT systems and communication systems develop, companies are continually looking for new strategies and new forms of organisation structure to support those strategies.

- Production systems, marketing systems and other operations have been made more flexible.
- Lean manufacturing systems have been developed with the aim of improving quality and reducing costs. Lean manufacturing systems, and the search for economies of scale, are benefits that can be obtained from a global organisation of business operations.
- However to deal with uncertainty and volatility in local markets, corporations need to change their organisation structures from vertical bureaucracies to decentralised organisations with team-based management, and greater management responsibility at the local market level. These local operating units become the focus of strategy development for the entity as a whole.

Bartlett and Ghosal therefore suggested that the way in which an international company is organised and structured depends on two factors:

- the benefits obtainable from global organisation, and
- the need for local (national) operations to respond to the demands of the local market, and so the need for 'local independence'.

Their analysis brought them to the conclusion that where the benefits of globalisation are high, but where the need for local independence and responsiveness to local needs is also high, a 'transnational corporation' is the ideal type of organisation.

However, the organisation that is likely to be found in an international company is likely to vary as follows.

		Benefits from global co-ordination	
		Low	High
Need for local independence and responsiveness	Low	International divisions	Global product companies
	High	International subsidiaries	Transnational corporations

1. **International divisions**. International divisions are headed by senior management (mainly from the home country) located in head office in the home country.

2 **International subsidiaries**. These are locally-established subsidiaries that respond more to the needs of the local market. Each subsidiary develops its product variations and local strategies. This type of organisation is vulnerable to competition as global competition intensifies.

3 **Global product companies**. The company sells a standard product globally, with benefits from economies of scale. Differences in customer needs between local markets are ignored. This type of company might become vulnerable to competition from companies that respond more successfully to the needs of local markets.

4 **Transnational corporations**. Companies that are organised as an integrated network of interdependent resources, on a global scale. As international business develops, more companies are becoming transnational.

2.8 Foreign subsidiaries as a portfolio of SBUs

A multi-national company might own a number of different subsidiaries in a number of different countries. They might be seen as a portfolio of different SBUs, and strategic choices should be made by the parent about which SBUs to retain and develop, and which to dispose of.

One approach to analysing foreign subsidiaries in a portfolio of companies is to divide them into four categories:

- **Strategic leaders**. These subsidiaries hold valuable resources and have value-adding competences and capabilities. They are located in countries that are crucial to the competitive success of the parent's international strategy.
- **Contributors**. These are subsidiaries with valuable resources, but they are located in countries that have less strategic significance to the group. Because they have some valuable resources, they contribute value to the group.
- **Implementers**. These subsidiaries do not contribute substantially to the enhancement of the group's competitive advantage. They do not have unique resources or core competences of their own. However, they add financially to the profits of the group.
- **Black holes**. These are subsidiaries that are not yet creating competitive advantage and are losing money for the group. However, they could possibly be developed. They are therefore a strategic problem for the parent company. The problem might be overcome by developing local alliances or by trying to convert unique resources and core competences into competitive advantage.

Corporate strategy selection and portfolio models

- Boston Consulting Group matrix (BCG matrix)
- Weakness in BCG model analysis
- Shell directional policy matrix
- The parenting matrix (Ashridge Portfolio Display)
- Public sector portfolio matrix

3 Corporate strategy selection and portfolio models

Corporate strategy selection involves making decisions about which businesses to invest in, and which businesses to divest, in order to create a suitable portfolio of businesses that should enable the company to achieve its strategic objectives.

A number analytical methods have been developed to help managers assess which SBUs they should have in their business portfolio. Collectively, these methods are known as portfolio analysis models.

Portfolio analysis is simply an approach to analysing:

- markets, and their future potential for growth and profitability, and
- the position of a business entity within those markets.

The purpose of this analysis is to make decisions about the most suitable portfolio of businesses. The selected portfolio should then become the established corporate strategy for the company.

All portfolio models are based on the assumption that the optimal corporate strategy is to invest in a range of different businesses and products. It would be very risky to rely on just one product, or even on a limited range of products, because of the risk that these might be unprofitable or might go into decline at the end of their life cycle.

- With a portfolio of different products, some will be more successful than expected and some will be failures: however, the successes should be sufficient to finance the failures.
- By having a portfolio of products, a company can also achieve a mix of products at different stages of their life cycle. The company can plan for its long-term future, by developing new products that will eventually become major profit-earners in the future.

The portfolio models described in this chapter are:

- the Boston Consulting Group matrix (BCG matrix).
- the directional policy matrix.
- the parenting matrix (Ashridge Portfolio Display)
- the public sector portfolio matrix.

3.1 Boston Consulting Group matrix (BCG matrix)

The Boston Consulting Group developed a product-market portfolio for strategic planning. It allows the strategic planners to select the optimal strategy for individual products or business units, whilst also ensuring that the selected strategies for individual units are consistent with the overall corporate objectives.

The objective of the matrix is to assist with the allocation of funds to different products or business units.

The matrix is a 2 × 2 matrix.

- One side of the matrix represents the rate of market growth for a particular product or business unit.
- The other side of the matrix represents the market share that is held by the product or business unit.

Notes

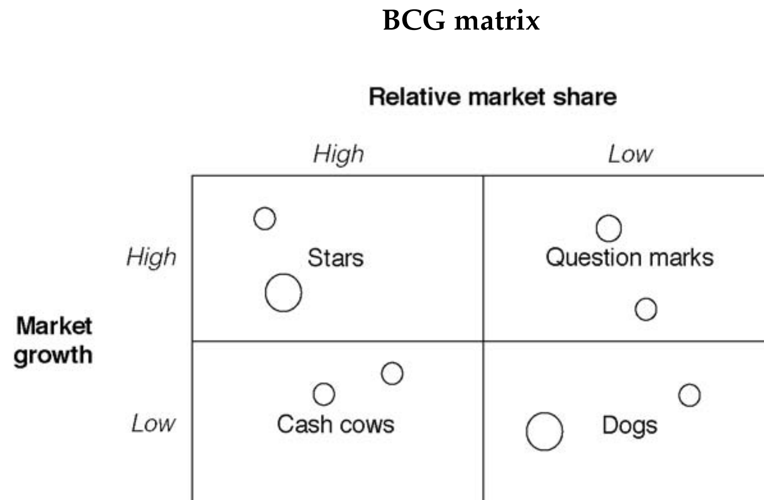
Market growth. The mid-point of the growth side of the matrix is often set at 10% per year. If market growth is higher than this, it is 'high' and if annual growth is lower, it is 'low'. It should be said that 10% is an arbitrary figure.

Market share is usually measured as the annual sales for a particular product or business unit as a proportion of the total annual market sales. For example, if the product of Entity X has annual sales of $100,000 and total annual sales for the market as a whole are $1,000,000, Entity X has a 10% market share.

In the BCG matrix, however, market share is measured as annual sales for the product as a percentage or ratio of the annual sales of the **biggest competitor** in the market. The mid-point of this side of the matrix represents a situation where the sales for the firm's product or business unit are equal to the annual sales of its biggest competitor. If a product or business unit is the market leader, it has a 'high' relative market share. If a product is not the market leader, its relative market share is 'low'.

The BCG matrix is shown as follows. The individual products or business units of the firm can be plotted on the matrix as a circle. The size of the circle shows the relative money value of sales for the product. A large circle therefore represents a product with large annual sales.

BCG matrix



The products or business units are categorised according to which of the four quadrants it is in. The four categories of product (or business unit) are:

- Question mark (also called 'problem child')
- Star
- Cash cow
- Dog.

Question mark

A question mark is a product with a relatively low market share in a high-growth market. Since the market is growing quickly, there is an opportunity to increase market share, but initially it will require a substantial investment of cash to increase or even maintain market share.

A strategic decision that needs to be taken is whether to invest more heavily to increase market share in a growing market, whether to seek a profitable position in the market, but not as market leader, or whether to withdraw from the market because the cash flows from the product are negative.

The BCG analysis states that a firm cannot last long with a small market share, as bigger companies will be able to apply great cost and price pressure as they enjoy economies of scale.

Star

A star has a high relative market share in a high-growth market. It is the market leader. However, a considerable investment of cash is still required to maintain its leading position. Initially, they probably use up more cash than they earn, and at best are cash-neutral. Over time, stars should gradually become self-financing. At some stage in the future, they should start to earn high returns.

Cash cow

A cash cow is a product in a market where market growth is lower, and possibly even negative. It has a high relative market share, and is the market leader. It should be earning substantial net cash inflows, because has high economies of scale and

will have become efficient through experience. Other companies will not mount an attack as they perceive that the market is old and near decline. Cash cows should be providing the business entity with the cash that it needs to invest in question marks and stars.

Dog

A dog is a product in a low-growth market that is not the market leader. It is unlikely that the product will gain a larger market share, because the market leader will defend the position of its cash cow. A dog might be losing money, and using up more cash than it earns. If so, it should be evaluated for potential closure.

However, a dog may be providing positive cash flows. Although the entity has a relatively small market share in a low-growth market (or declining market), the product may be profitable. A strategic decision for the entity may be to choose between immediate withdrawal from the market (and perhaps selling the business to a buyer, for example in a management buyout) or enjoying the cash flows for a few more years before eventually withdrawing from the market.

It would be an unwise decision, however, to invest more capital in 'dogs', in the hope of increasing market share and improving cash flows, because gaining market share in a low-growth market is very difficult to achieve.

Using the BCG matrix

Companies must invest in products and business units for the future. They need to invest in some question marks as well as in stars, and this uses up cash. Much of the cash for investing in other products will come from cash cows. The BCG matrix model can help management to decide on a portfolio of products or business units, for both short-term and longer-term returns.

		Strategy
Low market growth, high market share	Cash cow	Defend and maintain market share. Spending on innovation (R&D) should be limited. The cash generated by a cash cow can be used to develop other products in the portfolio.
Low market growth, low market share	Question mark	The product will need a lot of new investment to increase market share. The strategic choice is between investing a lot of cash to boost market share or to disinvest/ abandon the product
High market growth, high market share	Star	Stars are the cash cows of the future. An entity should market a star product aggressively, to maintain or increase market share. A large continuing investment in new equipment and R&D will probably be needed. Stars should at some stage generate enough cash to be self-sustaining. Until then, the cash from cash cows can finance their development.
High market growth, low market share	Dog	These might generate some cash for the business, and if they do, it might be too early to abandon the product. The product has a limited future, and strategic decisions should focus on its short-term future. There is a danger that the product will use up cash if the firm chooses to spend money to preserve its market share. The firm should avoid risky investment aimed at trying to 'turn the business round'.

Example

A company produces five different products, and sells each product in a different market. The following information is available about market size and market share for each product. It consists of actual data for each of the last three years and forecasts for the next two years.

	Year - 2 Actual	Last year Year -1 Actual	Current year Actual	Next year Year + 1 Forecast	Year + 2 Forecast
Product 1					
Total market size ($ million)	50	58	65	75	84
Product 1 sales	2	2	2.5	3	3.5
Product 2					
Total market size ($ million)	150	152	149	153	154
Product 2 sales	78	77	80	82	82
Product 3					
Total market size ($ million)	40	50	60	70	80
Product 3 sales	3	5	8	10	12
Product 4					
Total market size ($ million)	60	61	61	61	60
Product 4 sales	2	2	2	2	2
Product 5					
Total market size ($ million)	100	112	125	140	150
Product 5 sales	4	5	5.5	6	6.5

In the current year, the market share of the market leader, or the nearest competitor to the company, has been estimated as follows:

	Market share of market leader or the company's nearest competitor
Market for:	%
Product 1	37
Product 2	26
Product 3	12
Product 4	29
Product 5	20

Required

(a) Using the Boston Consulting Group model, how should each of these products be classified?

(b) How might this analysis help the management of the company to make strategic decisions about its future products and markets ('product-market strategy')?

Answer

A **star** is a product in a market that is growing quickly, where the company's product has a large market share or where the market share is increasing. **Product 3** appears to be a star. The total market is expected to double in size between Year – 2 and Year + 2. The expected market share in two years' time is 15%, compared with 7.5% in Year – 2. Its market share in the current year is over 13%, which makes it the current market leader.

A **cash cow** is a product in a market that has little or no growth. The market share, however, is normally quite high, and the product is therefore able to contribute substantially to operational cash flows. **Product 2** appears to be a cash cow. In the current year its market share was over 53%, and it is the market leader.

A **dog** is a product in a market with no growth, and where the product has a low share of the market. Dogs are likely to be loss-making and its cash flows are probably negative. Product 4 appears to be a dog. The total market size is not changing, and the market share for Product 4 is only about 3%. This is much less than the 29% market share of the market leader.

A **question mark** is a product with a fairly low market share in a market that is growing fairly quickly. **Product 1** appears to be a question mark. The total market is growing quite quickly, but the market share of Product 1 is about 4% and this is not expected to change. **Product 5** also appears to be a question mark, for the same reason.

The company should decide on its strategy for the products it will sell.

- It should benefit from the cash flows generated by its only cash cow, Product 2.
- It should invest in its star, Product 3, with the objective that this will eventually become a cash cow.
- It should give serious consideration to abandoning its dog, Product 4, and withdrawing from the market.
- It has to make a decision about its two question marks, Product 1 and Product 5. The main question is whether either of these products can become a star and cash cow. Additional investment and a change of strategy for these products might be necessary, in order to increase market share.

For all the products (with the exception of Product 4, if this is abandoned) the company should also consider ways of making the products more profitable. Techniques such as **value chain analysis** might help to identify cost savings.

3.2 Weaknesses in BCG model analysis

There are several criticisms of the BCG model.

- The BCG model assumes that the competitive strength of a product in its market depends on its market share, and the attractiveness of a market for new investment depends only on the rate of sales growth in the market. Unless a product can achieve a large share of the market, it is not sufficiently competitive. Unless a market is growing quickly enough, it is not worthwhile to invest more money in it. It can be argued that these assumptions are incorrect.
  - A product can have a strong competitive position in its market, even with a low market share. Competitive strength can be provided by factors such as product quality, brand name or brand reputation, or low costs. Porsche earns very high profits but its market share is small compared to bigger car manufacturers such as General Motors, Ford and Toyota.

  - A company might benefit from investing in an industry or market where sales growth is low.
- Other factors, apart from market share and market size will influence what a company should do with a product: strength of competition, cost base and brand strength are all important considerations.
- It might be difficult to define the market.
  - There might be problems with defining the geographical area of the market. A market might be defined in terms of a single country, a region of a country or as an international or global market.
  - It might also be difficult to identify which products are competing with each other. For example the total market for cars may be divided into different categories of car, but there may be problems in deciding which models of car belong to each category.

- It might be the BCG matrix is better for analysing the performance of strategic business units (SBUs) and market segments. It is not so useful for analysing entire markets, which might consist of many different market segments.
- It might be difficult to define what is meant by 'high rate' and 'low rate' of growth in the market. Similarly, it might be difficult to define what is meant by 'high' market share and 'low' market share.
- Care is therefore needed interpreting a BCG analysis. For example, there are major differences in R&D and marketing spend suggested depending on whether a product is a star or a cash cow. It would be wrong to dramatically reduce marketing and R&D simply because the market growth rate fell from 10.1 to 9.9 (if 10 is taken as the low/high cut-off).

3.3 Shell directional policy matrix

The Shell directional policy matrix is another portfolio model. It can also be called the 'attractiveness matrix'.

Like the BCG matrix, the directional policy matrix is used to place products or business units in a grid. It is a 3 × 3 matrix. This allows products to be treated with a more graduated approach than the 2 × 2 BCG matrix.

- **Industry attractiveness**. One side of the grid represents the attractiveness of the business sector or market. Indicators of market attractiveness include:
  - Profitability
  - Growth prospects
  - Strength of competition
  - Market size
  - PESTEL issues (opportunities and threats in the business environment)
  - Customer and supplier pressure
  - Entry barriers
  - Business risk

Industry attractiveness is labelled Low, Medium, and High.

- **Competitive strength**. The other side of the grid represents business sector or market strength compared to the competition. Indicators of competitive strength include:
  - Market share
  - Managerial ability
  - Low cost base
  - Successful innovation
  - Strong finance
  - Know-how
  - Brand

The company's position in the business sector, which is categorised as Strong, Average or Weak

The strategic decision about what to do with the product in the future is guided by the position of the product in the grid.

		Industry or sector attractiveness		
		High	**Medium**	**Low**
Business/ competitive strength	**Strong**	Leader/ investment and growth	Selective growth	Cash generation
	Average	Selective growth/ try harder	Proceed with care	Phased withdrawal/ harvest
	Weak	Double or quit (problem child)	Phased withdrawal/ harvest	Divest

Using the directional policy matrix

The matrix can be used as a guide to the direction of future strategy.

- A strategy of immediate withdrawal from the market is indicated only when the industry or sector attractiveness is low and the entity has a weak position in the market.
- A strategy of phased withdrawal may be appropriate to maintain the entity's reputation with customers. Presumably, the product or business is not cash-negative, which means that there is no need for immediate withdrawal. However, it would be inappropriate to invest further in these products or business sectors.
- When an entity has a strong position in its market, its strategy should be based on maintaining or improving its position. However, if future prospects for the business sector are poor, the entity should probably treat its product as a 'cash cow'.

- When an entity has an average position in a business sector with attractive future prospects, its strategy should be aimed at competing more effectively.
- Strategy selection is more difficult when an entity has a weak position in a sector with strong growth prospects, or an average position in a market with average prospects. The policy guidelines – 'double or quit' and 'proceed with care' should indicate the existence of a strong element of risk in strategy selection.

3.4 The parenting matrix (Ashridge Portfolio Display)

The Ashridge Portfolio Display matrix can be used to assess the role of the parent company in the strategic management of the business units in the group.

If a parent company becomes involved in the management of the business unit, it might add value, through improvements in operating efficiency, providing synergies, building competences in the business unit, providing expertise, managing risks at a group level (e.g. financial risk management) and providing corporate vision.

However, a parent might also create harm and destroy value by adding costs with no benefits, and creating extra bureaucracy and delay.

The matrix is based on the view that there is degree of 'fit' between a parent company and a business unit (subsidiary). When the fit is high, the parent company understands the business unit well.

There is also a degree of opportunity for a parent company to add value to a business unit.

The opportunity for a parent to become involved in a business unit, and add value, therefore depends on:

- the degree of fit between the parent and the business unit (the capacity of the parent to add value) and also on
- the existence of opportunities for the parent to add value.

Opportunities to apply parent skills

Fit between parent and business unit (manageability, ability to add value)	Low	High
High	**Ballast business units**	**Heartland business units**
Low	**Alien business units**	**Value trap business units**

- **Heartland business units**. These are SBUs to which the parent can add value without any danger of doing harm to the SBU. These SBUs should be at the core of the parent's future corporate strategy.
- **Ballast business units**. These are SBUs that the parent company management understand well, but the parent can do very little to add value to the SBU. These SBUs could just as easily operate as an independent company as a business unit within the group, because it obtains no value from being within the group. If they are to be included within the future corporate strategy of the group, they should be managed with a 'light touch' by the parent.
- **Value trap business units**. These are SBUs where there are opportunities for the parent company to add value. However, there is a risk that in trying to add value, the parent might actually do the SBU more harm than good. These business units should only be included in the future corporate strategy of the group if the parent company's management is convinced that the SBU can be moved from the 'value trap' to the 'heartland' category of business units. For this to happen, the parent must be able and willing to gain a better understanding of the business. Sadly, too many parents think they know best, and do harm to the business.
- **Alien business units**. These are SBUs that are 'misfits' within the group. The parent company can do little or nothing to add value for the SBU, and the SBU does not fit in well with the other businesses of the group or the culture of the parent. A exit strategy is advisable for these SBUs and the corporate strategy should be to dispose of them.

You might be wondering how a parent company could add value to an SBU when there is a risk that it could also do harm. An example would be the case of a parent company that has very good international marketing skills. It could use these skills to help an SBU to sell its goods in other countries for the first time. However, a strategy of selling goods to other countries might be the wrong strategy for the SBU. So although the parent would be using its skills to help the SBU, it would also be causing harm.

3.5 Public sector portfolio matrix

The public sector portfolio matrix is a portfolio selection model for public sector services, which can be used by individual public sector entities to choose the projects in which they should invest their available funds. It is a 2 × 2 matrix.

- One axis shows the organisation's ability to serve the public effectively. A high ability to serve effectively means that it is well-funded at the moment.
- The second axis looks at political attractiveness in terms of whether or not the service can gain public support and so whether it should attract funding in the future.

The matrix produces four types of public sector service.

		Ability to serve effectively/ current funding	
		High	**Low**
Public need and support and attractiveness for future funding	**High**	Public sector star	Political hot box
	Low	Golden fleece	Back drawer issue

- **Public sector stars** perform well and are likely to well-funded at the moment. They are also attractive to the public and meet a strong public need. Public sector services in this segment should attract more funding in the future. However, it can be difficult to find examples for this segment, if only because members of the public often have very different experiences of public services and would disagree about how well they perform.
- **Political hot boxes** are very popular but deliver a service that is perceived as poor. They are probably services that are too new and inadequately resourced to be delivered effectively. These services are similar to question marks in the BCG matrix. A strategic decision has to be taken about whether more funding should be given to them in the future. Some national health services might be perceived to fall into this category.
- **Golden fleece services** are well-resourced and are being delivered effectively. However, they are no longer meeting a strong public need. They are likely to be viewed as over-staffed and a drain on the public funds, and could be at risk of budget cuts in the future.
- **Back drawer services** have a low priority with the public, have no political support and are not delivered effectively, possibly because of poor funding. If possible they should be abandoned.

An obvious weakness to this portfolio model is that the assessment of 'meeting the needs of the public' could be subjective. How is a distinction made between services that appear to meet a public need and those that do not? The public need cannot be measured reliably by public opinion, because public opinion is changeable.

Another weakness is that effectiveness in delivering the service often depends on the level of public funding that the service is given. A more effective service is likely when funding is adequate. The only difference between a public sector star and a political hot box might therefore be the current level of funding and its implications for the effectiveness of the service.

CHAPTER 8

Strategic choice: achieving competitive advantage

Contents

1 Competitive advantage
2 The strategic clock
3 Cost leadership, differentiation and lock-in strategies
4 Collaboration

Competitive advantage

- Two factors affecting profitability
- Value and competitive advantage
- Selecting business strategies for competitive advantage

1 Competitive advantage

1.1 Two factors affecting profitability

Porter argued that two factors affect the profitability of companies:

- industry structure and competition within the industry: he used the Five Forces model to explain the factors affecting competition
- at the level of the individual company, achieving a sustainable competitive advantage.

Sustainable competitive advantage is achieved by creating value for customers.

1.2 Value and competitive advantage

Companies and other business entities in a competitive market should seek to gain an advantage over their competitors. As explained in earlier chapters, competitive advantage means doing something better than competitors, and offering customers better value.

Having some competitive advantage over rival firms is essential. Without it, there is no reason why customers should buy the company's products instead of the products of a competitor.

Essentially, competitive advantage arises from the customers' perception of value for money. Value was explained in the chapter on the value chain and value networks. The key point to understand is that value comes from:

- a low price, or
- features of the product (or the way it is made available to customers) – both real and imagined – that make the customer willing to pay a higher price, or
- a combination of price and product features that gives 'best value' to a group of customers in the market.

Note that value is determined by the perception or opinion of customers. A combination of price and product features that gives 'best value' to one customer might not give 'best value' to another, because the customers have different perceptions of value.

1.3 Selecting business strategies for competitive advantage

Since there are different perceptions of value, companies have to make a strategic decision about how they will try to offer value and gain competitive advantage.

- Companies decide their corporate strategy, and the combination or portfolio of businesses ('product-markets') they want to be in.
- They must then select one or more business strategies that will enable them to succeed in their chosen product-markets.

There are several approaches to identifying and choosing business strategies. Some of these are explained in the remainder of this chapter.

The strategic clock

- Purpose of the strategic clock
- Drawing a strategic clock
- Using a strategic clock

2 The strategic clock

2.1 Purpose of the strategic clock

The two key factors in providing value to customers are the price of the product or service and the benefits that customers believe the product or service provides. Competitive advantage comes from offering an attractive combination of price and perceived benefits.

The strategic clock was suggested by Bowman (1996) as a way of looking at combinations of price and perceived benefits. Companies should consider which combination of the two they should try to offer, although to do this they must also understand the perception of customers about the benefits that the product or service provides.

Companies can also use the strategic clock to assess the business strategies of competitors, and the combination of price and benefits that they are offering.

2.2 Drawing a strategic clock

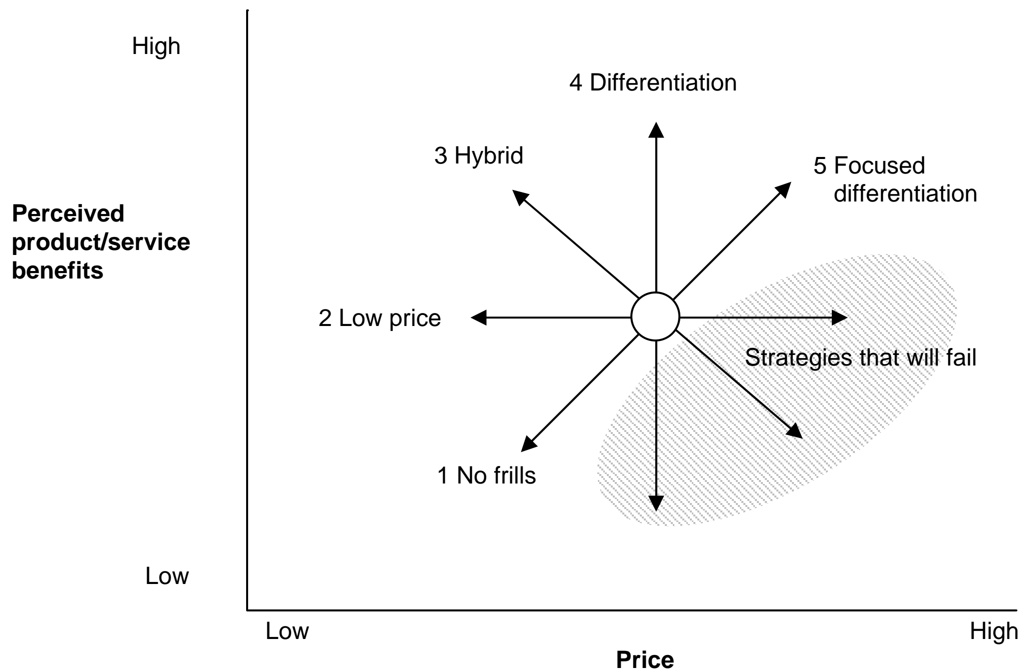
The strategic clock has two dimensions: price and perceived benefits. Price can be shown on a scale ranging from 'low' to 'high'. Similarly, perceived benefits can be shown on a scale from 'low' to 'high'.

The 'clock' consists of a series of business strategies. Each business strategy is shown as the hand of a clock, pointing in the direction of a combination of price and perceived benefits. Each business strategy has a different combination of price and perceived benefits, where customers have different requirements in terms of value for money.

The different positions on the clock also represent a set of generic business strategies for achieving competitive advantage.

There can be any number of different business strategies, each with its own combination of price and perceived benefits. However, the different business strategies can be grouped into:

- five business strategies that might enable a firm to gain a competitive advantage, and
- strategies that will fail because they cannot provide competitive advantage.



2.3 Using a strategic clock

A strategic clock can be used to consider different business strategies for gaining competitive advantage, based on providing a combination of price and perceived benefits.

In your examination, you might be given a case study or scenario and asked to suggest a suitable business strategy for a company. The strategic clock might be a useful basis for making an analysis – looking at the business strategies of competitors, and what a company must do to find an appropriate combination of price and perceived benefits that it should offer to customers.

The five broad groups of business strategy that might succeed are:

- a 'no frills' strategy (position 1 on the clock)
- a low price strategy (position 2)
- a differentiation strategy (position 4)
- a hybrid strategy (position 3)
- a focused differentiation strategy (position 5)

No frills strategy: Position 1

A 'no frills strategy' is to offer a product or service at a low price and with low perceived benefits. It should attract customers who are price-conscious, and are happy to buy a basic product at the lowest possible price.

This strategy has been used by low-cost airlines, which offer a basic service for a low price.

With a 'no frills' strategy, customers understand that they are buying a product or service that gives them fewer benefits than rival products or services in the market.

Low price strategy: Position 2

With a 'low price' strategy, customers perceive that the product or service gives average or normal benefits. It is not regarded as a low-quality product. The price, however, is low compared with similar products in the market.

Only the lowest-cost producer in the market can implement this business strategy successfully. If a company that is not the **least-cost producer** tries to implement a 'low price strategy' there will be a continual threat that the least-cost producer will copy the same strategy, and offer prices that are even lower. Only the least-cost producer could win such a price war.

However, a 'low price' strategy can be applied in segments or sections of the market. For example, supermarkets offer their 'own brand' products at prices that are lower than similar branded goods. Customers shopping in a supermarket might buy the low-price own-brand goods rather than higher-priced branded goods (which might be perceived as offering more benefits to customers).

Differentiation strategy: Position 4

A differentiation strategy is based on making a product or service appear to offer more benefits than rival products or services. Companies try to differentiate their own particular products – make them seem different. There are various ways in which differentiation can be achieved: products or services might have **different features**, so that rival products do not offer exactly the same benefits. Companies might also promote the perception that their products or services are much better in **quality**.

In the strategic clock a strategy of differentiation involves charging average prices for the product or service, or prices that are perhaps only slightly higher than average. The strategy does not involve charging prices that are very much higher than average. Customers therefore believe that they are getting more benefits for every $1 they spend.

Hybrid strategy: Position 3

A hybrid strategy involves selling a product or service that combines:

- higher-than average benefits to customers, and
- a below-average selling price.

To be successful, this business strategy requires low-cost production and also the ability to provide larger benefits. It tries to achieve a mix between a low price strategy and a differentiation strategy.

Focused differentiation strategy: Position 5

A focused differentiation strategy is to sell a product that offers above-average benefits for a higher-than-average price. Products in this category are often strongly branded as premium products so that their high price can be justified. Gourmet restaurants and Ferrari sports cars are examples of products sold using this business strategy.

Business strategies on the clock that will fail

The diagram of the strategic clock shown above indicates some business strategies that will not succeed, because they do not enable the company to gain a competitive advantage. There are other strategies that competitors might adopt that will be more successful.

Strategies in the area that could be described as 'three o'clock' to 'six o'clock' on the strategic clock are clearly inferior to strategies on other parts of the clock.

- Products with perceived benefits that are below-average cannot be sold successfully when there are lower-priced products offering the same perceived benefits. Customers will not pay more for products that, in their opinion, give them nothing extra.
- Similarly products cannot be sold successfully at an above-average price when they have below-average perceived benefits. Customers can pay similar prices for products offering more benefits (which will be sold by companies pursuing a focused differentiation strategy).

Conclusion: strategic clock

Each business strategy is 'market facing', which means that it aims to meet the needs of customers, or a large proportion of potential customers in the market. It is therefore very important to understand the critical success factors (CSFs) for each position on the clock. In particular, what exactly does 'above average' benefits mean?

A useful exercise is to think about any product or service with which you are familiar, and a company that provides the product or service. The market should be competitive. Then try to describe the business strategy that the company has for its product or service, using the strategic clock as a basis for analysing business strategies.

Remember that the benefits of a product or service do not have to be different product design or different product quality. Other features of a product or service could given them better value in the opinion of customers, such as fast speed of delivery, availability in stock, convenience of purchase, a better after-sales service or a product guarantee. Benefits do not have to be real: what matters is whether customers believe that a product offers more benefits. Branding and advertising can create extra benefit in the perception of customers.

Cost leadership, differentiation and lock-in strategies

- Porter's generic strategies for competitive advantage
- Cost leadership strategy
- Differentiation strategy
- Focus strategy
- Porter: six principles of strategic positioning
- Target markets
- Leaders, followers, challengers and nichers
- Product positioning
- Lock-in strategy
- Strategies in conditions of hypercompetition

3 Cost leadership, differentiation and lock-in strategies

3.1 Porter's generic strategies for competitive advantage

Porter has suggested three strategies for sustaining competitive advantage over rival firms and their products or services. These strategies, which are similar to some shown on a strategic clock, are:

- a cost leadership strategy
- a differentiation strategy
- a focus strategy

Porter argues that sustainable competitive advantage is achieved by offering customers a '**value proposition**'. This is a set of benefits that the product or service will provide, that are different from those that any competitors offer. A value proposition can be created in two ways:

- **Operational effectiveness**. This means doing the same things better than competitors, and so providing the same goods or services at a lower cost. Through lower costs, sustainable competitive advantage can be gained through lower selling prices.
- **Strategic positioning**. Strategic positioning means doing things differently from competitors, so that the company offers something unique to customers, so that customers will be prepared to pay a higher price to acquire the unique value combination that the product or service offers.

Operational effectiveness provides the basis for a cost leadership strategy and strategic positioning provides the basis for a differentiation strategy.

3.2 Cost leadership strategy

Cost leadership means being the lowest-cost producer in the market. The least-cost producer is able to compete effectively on price, by offering its products at a lower

price than rival products. It can sell its products more cheaply than competitors and still make a profit.

Companies with a cost leadership strategy must have excellent systems of cost control and should continually plan for further cost reductions (in order to remain the cost leader in the market). The source of their competitive advantage is low cost and they must never lose sight of this fact.

In general, the cost leader in a market is a large company, because large companies can benefit from economies of scale that smaller companies are unable to achieve.

The success of a cost leadership strategy is based on offering products at the lowest price, which means that in order to make a reasonable profit the company must sell large quantities of the product. Total profits usually come from selling large volumes at a low profit margin per unit.

A cost leadership strategy is similar to a 'low price' strategy or a 'no frills' strategy on the strategic clock.

3.3 Differentiation strategy

A differentiation strategy has been explained in relation to the strategic clock. For Porter (and for writers on marketing management) differentiation means making a product different from rival products in a way that customers can recognise. Customers might be willing to pay a higher price for the product, because they value its different features. Companies pursuing a differentiation strategy need to offer products and services that are perceived as better or more suitable than those of their competitors. To deliver better products and services usually requires **investment** and **innovation**.

Companies with a differentiation strategy cannot ignore cost. They should keep costs under control and try to reduce costs, so that they can offer more value to customers and retain their competitive advantage. However, they are not trying to be the least-cost producers. It more important for a successful differentiation strategy that products should give more benefits to the customer, even if this means having to spend more to deliver the product.

3.4 Focus strategy

A cost leadership strategy and a differentiation strategy can be pursued in a market that is not segmented.

However, many consumer markets are segmented, and companies might select one or more particular segments as target markets for their product. This is a focus strategy - concentrating on selling the product to a particular segment of the market and to a particular type of customer.

Within a market segment, a business entity might seek competitive advantage through:

- cost leadership within the market segment, or
- product differentiation within the market segment.

Example

In the market for manufacturing and selling soap, one or two companies might pursue a strategy of being the cost leader in the market, and offer their standard products to customers at the lowest prices.

Other producers of soap might pursue a differentiation strategy, and promote the superior quality of their products, for example by including ingredients that are better for the skin or provide a more attractive aroma.

Some producers of soap might focus on a particular market segment, such as the market for liquid soap. Within this market segment, firms might either seek to be the least-cost producers or to offer a differentiated liquid soap product.

Example

Porter's generic strategies can be used to suggest how airline companies seek competitive advantage.

These are suggestions.

Cost leadership	Low-cost airline. Reduce operating costs, such as: cheaper ticket production (on-line), no free in-flight meals or drinks, use low-cost 'out-of-city' airports, eliminate seat reservations, reduce baggage allowances for passengers. Go for high capacity usage (high % of seats sold on each flight).
Differentiation	Offer extra facilities for customers at airports. Offer extra facilities on flights. Promote the airline through branding/advertising. Fly to major airports. Maintain a modern fleet of aircraft.
Focus	Pursue a cost leadership strategy or a differentiation strategy in a particular geographical region of the world (for example South West United States), or focus on particular high-profit routes (such as London-New York). Possibly focus on a particular type of customer. In the UK an airline might focus on services for business customers in the City of London, offering convenient flights to and from City of London Airport on small planes.

Example

The market in the UK for holiday companies is another example of a segmented market, in which different companies pursue a cost leadership, differentiation or focus strategy.

The main market for holiday companies is probably the package holidays market, where a small number of competitors attempt to be the cost leader, although differences in some features of holiday packages mean that a competitive advantage can be gained from low prices, even if these are not the lowest prices in the market.

Some companies offer a package holiday at a higher price, but with better quality accommodation or additional benefits such as onsite pastimes and entertainment (for example Center Parcs and Club Mediteranée).

There are a number of market segments, such as fly-drive holidays, city breaks and adventure holidays. Within each market segment competitors seek to be the cost leader or differentiate their products.

3.5 Porter: six principles of strategic positioning

It is useful to summarise the views of Porter about how individual firms can achieve sustainable competitive advantage.

- Principle 1. The **strategic goal for a company should be to achieve a superior long-term return on investment**. A company should not select as its strategic goal any other objective, such as maximising sales volume or maximising market share, on the assumption that high profits will result from this. Maximising sales or market share does not necessarily provide a superior return on investment.
- Principle 2. The strategy must offer a **unique value proposition** for the customer. This is a combination of price and benefits that competitors do not (and cannot) offer. The value proposition might be for customers in the entire market, or for customers in a segment or niche of the market.
- Principle 3. There should also be a **distinctive value chain**. A company should perform similar activities to competitors, but in a different way that offers customers more value.
- Principle 4. The selected strategy will involve some **trade-offs**. This means that by selecting one set of strategic options, a company inevitably chooses not to select alternative options. For example, there has to be a trade-off between the selling price of the product and the benefits that it offers. By offering one set of benefits, the firm is choosing not to offer others. (If a company could alter its product or value chain without having to make trade-offs, it cannot be achieving any sustainable competitive advantage, and competitors will be able to copy what the company is doing.)
- Principle 5. All the different elements in the strategy and in the value chain should link together and reinforce each other.
- Principle 6. There should be **continuity of strategic direction**. Having chosen its strategies and the direction it wants to take its businesses, a company should apply the strategy consistently. It should avoid the temptation of changing strategy every time a new threat emerges.

3.6 Target markets

An entity must decide which markets or market segments it should target. It must:

- identify the total market for the products or services that it sells
- recognise the ways in which the market is or might be segmented
- decide whether to sell its products to all customers in the market
- decide whether to try to be the market leader, or whether to pursue a differentiation strategy
- if it chooses a segmentation strategy (focus strategy), select the segments that it will target with its product
- within the targeted market segment (or segments), decide whether to try to be the market leader or whether to pursue a differentiation strategy.

Market niche

A market niche is a small segment of a market. An entity might target a market niche, and expect to achieve its corporate objectives by selling its products or services to the fairly small number of potential customers in that niche.

3.7 Leaders, followers, challengers and nichers

A business entity can be classified as a leader, follower, challenger or nicher in its markets.

- The **leader** is the entity that sells most products in the market. Examples are Microsoft for PC operating software and Coca-Cola for cola drinks.
- A **challenger** is an entity that is not the market leader, but wants to take over as the market leader.
- A **follower** is an entity that does not have any ambition to be the market leader, and so follows the strategic lead provided by the market leader (or challenger). A follower will try to differentiate its product.
- A **nicher** is an entity that targets a particular market segment or market niche for its product, and does not have any strategic ambition to gain a position in the larger market.

3.8 Product positioning

The concept of product positioning is now widely used in marketing. The idea originated with Ries and Trout in the late 1960s.

They defined product positioning as the concept of the product in the mind of the customer. Advertising is an important factor in creating product position.

Ries and Trout argued that consumers receive vast amounts of advertising information, but they will only accept the messages that are consistent with their existing knowledge and experience.

They also argued that the best product position to achieve in the mind of consumers is the position of number 1. The market leader dominates the market for many products and services, and customers will often buy a product because it is the number 1.

Being the number 1

When an entity is the market leader, it should want to maintain its market leadership. To do this, it needs to maintain its position as number 1 in the mind of consumers.

- The most effective way of becoming number 1 in the mind of consumers is to be first into the market at the beginning of the product's life cycle.
- If this is not possible, an entity needs to create a new image for its product, that will enable it to take over as the perceived number 1.

Being the number 2

When an entity is only the number 2 in its market, customers will know this. Unless the entity wants to challenge for the position of number 1, it must do what it can to win customers from its position as number 2. Advertising can help.

In the US, Avis has been the number 2 car-hire company, and Hertz the number 1. Avis achieved a position as an attractive number 2 by recognising its number 2 position, but offering something better than the number 1. Its successful advertising message was: 'Avis is only the number 2 in rent-a-car, so why go with us? **We try harder**.' (It is not clear what trying harder means, but this did not matter!)

Pepsi promoted its 7-Up soft drink against market leader Coca-Cola by advertising it as the 'Uncola'. This recognised that it was not the number one soft drink, but offered customers the attraction of not being cola.

Product positioning for followers and nichers

Ries and Trout argued that entities that are not the number 1 in their market should try to find a way of being number 1 in a particular way. It is much better to be seen as the number 1 in a market segment (or in a special way) than the number 5 in the market as a whole.

To create a product position of number 1 in the mind of customers, entities might devise various marketing strategies.

The approach recommended by Ries and Trout is to be the number 1 for a particular type of customer, such as the number 1 product for women or the number 1 product for professional businessmen. For example:

- a newspaper or magazine might claim to be the number 1 choice for investment bankers or investors)
- a local radio station might claim to be the number 1 commercial station in its geographical area, or the number 1 station for a particular type of music

- Apple Mac PCs were not the number 1 make of personal computer, but it was marketed as the number 1 PC for graphic designers.

3.9 Lock-in strategy

A lock-in strategy is another approach to gaining and keeping competitive advantage. The idea of 'lock-in' is that when a customer has made an initial decision to purchase a company's product, it is committed to making more purchases from the same company in the future. The customer is 'locked in' to the supplier and the supplier's products.

Lock-in strategies are fairly common in the IT industry.

- Microsoft has successfully locked in many customers to its software products. Customers would find it difficult to switch to personal computers that do not have a Microsoft operating system or do not include some of the widely-used application packages such as Word and Excel.
- Apple Computers adopted a lock-in strategy for digital downloading of music from the internet. Its iTunes service cannot (currently) be used on non-Apple MP3 players or on most mobile telephones. Customers buying an Apple iPod are currently locked in to buying digital downloads from Apple.

A successful lock-in strategy often depends on becoming the industry 'leader' or provider of the standard product to the industry (such as the Microsoft operating systems for PCs). Once an organisation has become the industry standard, it is very difficult for other suppliers to break into the market. Indeed, market standard positions tend to be reinforced as time goes on as more and more people turn to that supplier.

Lock-in tends to be achieved early in a product's life cycle when the new supplier achieves an unassailable lead.

However, another type of lock-in strategy is used by companies that make and sell expensive equipment with a long useful life, such as military aircraft. Once a customer has made a decision to buy such products from one supplier, it is committed to buying spare parts and maintenance services from the manufacturer, for many years into the future.

3.10 Strategies in conditions of hypercompetition

Cost advantage is much more difficult to sustain when there is hypercompetition in the market. **Hypercompetition** occurs when 'the frequency, boldness and aggressiveness of dynamic moves by competitors create conditions of consistent disequilibrium and change.'

Organisations are in a hypercompetitive environment when they face fast-changing uncertain and dynamic business environments in which there are aggressive competitors constantly challenging current assumptions and methods. For example, internet sites such as Expedia.com, Lastminute.com and a host of no-frills airlines have radically changed the travel business.

- In a market where competitive conditions are more stable, business strategy is concerned with building and **sustaining** competitive advantage.
- In a hypercompetitive environment it is much more difficult to establish sustained competitive advantage through either cost leadership or differentiation, because any competitive advantage that is gained will be temporary. Competitors in a hypercompetitive environment continually look for ways of competing in different ways, so that no company can sustain competitive advantage for long using the same basis for achieving its advantage. Product and services that were once successful might not be relevant for long. Long-term competitive advantage is achieved only through making a continual sequence of short-term competitive initiatives.

Strategies that might be pursued in a hypercompetitive market are as follows:

- Shorter product life cycles. Seek to introduce new improved products quickly, to compete against established products of competitors. Introducing a 'better' product might allow a company to gain market share, although this advantage will only last until another competitor introduces a new, improved product that is even better.
- Imitate competitors. Imitating competitors might remove the competitive advantage that the competitors currently enjoys.
- Prevent a competitor gaining a strong initial position by responding quickly.
- Concentrate on small market segments that might be overlooked by competitors. Eventually, the market might be divided into many small market segments.
- Unpredictability. Companies should continually strive for radical solutions. Be prepared to abandon current approaches.
- In some situations, it might be possible to compete by building alliances with some smaller competitors to compete with larger companies that are financially stronger and currently are the market leaders.

Collaboration

- The nature of collaboration
- Collaboration and strategic alliances
- Collaboration and joint ventures
- Franchising
- Licensing
- Possible problems with collaboration: restricting competition

4 Collaboration

4.1 The nature of collaboration

In a competitive market, companies need to achieve a competitive advantage over competitors in order to succeed (and survive).

In some situations, companies might be able to achieve competitive advantage through collaboration with:

- suppliers or customers in the value network/value system
- other business entities in the value network
- some other competitors.

Collaboration with suppliers and customers can create additional value, in areas such as:

- product design: suppliers and customers might collaborate to improve the product design, by improving the design of product components or providing better raw materials
- delivery times: suppliers and customers might collaborate to improve the reliability and speed of delivery, for example through a just-in-time purchasing arrangement.

For example, if a supplier and purchaser collaborate on the supply of goods by allowing their IT systems to communicate, then the costs of ordering and supply will be reduced. Both parties can share in those savings and, additionally, switching costs are created which safeguard the supplier against competition.

The development of high definition (HD) television has not been possible without co-operation between the manufacturers of televisions and media companies who will supply the programme content.

Finding ways of increasing value in the value network, through collaboration with other entities, has been discussed in an earlier chapter.

4.2 Collaboration and strategic alliances

Another way of trying to increase competitive advantage is to collaborate with other companies in the same industry, who might possibly be regarded as competitors. One form of collaboration is to create a strategic alliance.

A **strategic alliance** is an arrangement in which a number of separate companies share their resources and activities to pursue a joint strategy. By collaborating, all the companies in the alliance are able to offer a better product or service to their customers.

Examples of strategic alliances are in the airline industry where groups of airlines might form alliances in order to offer travellers a better selection of routes and facilities than any single airline could offer on its own. Strategic alliances have included Oneworld (British Airways, American Airlines and others) and Star Alliance (Lufthansa, BMI and others).

The success of a strategic alliance depends on the members of the alliance not being in direct competition with each other. They are in the same industry, but serve different markets or market segments.

Example

A strategic alliance of airlines enables the combined alliance to offer customers the ability to arrange journeys by air to and from most parts of the world with a single booking; however, the airlines do not compete on most routes.

A UK-based international airline might want to offer its customers linked flights from anywhere in the UK to anywhere in the US. Since it does not have a US flight network, it might enter into a strategic alliance with a domestic US airline. As a result of the alliance, it expects to be in a better position to compete against larger US airlines for transatlantic air traffic.

A US domestic airline might want to offer its customers an all-in-one flight service from anywhere in the US to the UK. It can achieve this aim by forming a strategic alliance with the UK airline.

For example, a customer in the UK wanting to arrange a flight to a city in the US not serviced by British Airways might be able to book the journey through British Airways: the customer would then fly to the US on British Airways to New York and then switch to American Airlines for onward travel to the US city destination.

4.3 Collaboration and joint ventures

A joint venture is a formal venture by two or more separate entities to develop a business or an activity jointly. Many joint ventures are established in the form of a separate company which is jointly owned by the joint venture partners. No single partner being able to dominate and dictate the way that the company is run.

Joint ventures are frequently used for investing in a new business venture where:

- there is considerable risk
- large amounts of capital are needed
- a mix of skills is essential.

The joint venture allows the business risk and financing to be shared by the joint venture partners. The partners might be companies that compete in some markets of the world, but have agreed to collaborate in a particular venture. Alternatively the joint venture partners might be companies in different markets, and do not compete with each other directly; however each partner brings special skills to the venture that will help to give it a competitive advantage.

When multinational companies are seeking to expand by investing in a different country, they might seek to do so by establishing a joint venture with a local company. There are several advantages in entering a foreign market in an alliance with a 'local' company.

- It might be a legal requirement for foreign companies setting up business in the country to operate as a joint venture with a local company.
- The local company management should have a better knowledge of business conditions and practices in the country.
- It is probably easier to succeed by forming an alliance with a local company than in competition with local companies. For example, the government might be a major customer, and it might have a policy of favouring domestic companies when it makes its purchase decisions.
- The local company might already have customers to which the new joint venture can sell its products.

Difficulties can arise with joint ventures, and lead to the eventual break-up of the partnership. This can happen when:

- one joint venture partner is perceived (by the other partners) not to be contributing adequately
- one joint venture partner wants to withdraw from the venture, or
- the joint-venture companies start to compete with each other instead of collaborating.

4.4 Franchising

Some business entities have been able to grow through franchising. This is another form of collaboration. The basic idea of a franchise is that a company develops a product with the following features:

- It is a standard product (or range of products), delivered to customers in a standard way.
- It has brand recognition, achieved through advertising and other sales promotion.

- Systems for delivering the product to customers are standardised (using standard equipment, and standard work practices.
- Customers want to buy it.

The most well known examples of franchise operations are some of the fast-food restaurant chains, such as McDonalds. The company that originates the product, the franchisor, protects its patent rights or intellectual property rights over the product. It then sells the concept to franchisees who pay for the right to open their own store and sell the branded product.

- The franchisor supplies the product 'design' and the right to sell the product. It also provides a centralised marketing service, which includes extensive advertising and brand promotion. It also supplies other support services, such as business advice to franchisees.
- The franchisee pays for the franchise, and in addition pays a royalty based on the value of its sales or the size of its profits.

By buying into a successful franchise, a franchisee suffers much less risk than would be experienced setting up a business from scratch and can benefit from extensive marketing by the franchisor.

The franchisor receives a constant inflow of cash from new franchisees, as the operation expands, and is therefore able to grow by selling its business concept to a large number of other businesses, sometimes worldwide. Additionally, their head office is kept small because there is considerable delegation of day-to-day management to the franchisee.

However, the franchisor will always want to protect its brand name and to present a consistent appearance to its customers. This means that franchise agreements have very extensive rules governing franchisees' behaviour and they will also supply the products. Many franchisees find these rules and the monopoly supply of products very restrictive and frustrating.

4.5 Licensing

In a typical licensing agreement, a licensee is given permission by the licenser to make goods, normally making use of a patented process, and to use the appropriate trademark on those goods. In return the licenser receives a royalty. The licensee is exposed to relatively little risk and goods can be made wherever the licensee is located.

4.6 Possible problems with collaboration: restricting competition

The purpose of collaboration should be to gain competitive advantage in a market. However, it should not seek to create unfair restrictions on competition.

Governments in countries with advanced economies are generally in favour of 'free' competition in their national markets (and in international trade), although there are many exceptions to this general rule. When it has a policy of encouraging competition in markets, a government will seek to discourage actions by companies

that will distort or reduce competition in their industry and markets. They might do this by making some forms of anti-competitive behaviour illegal.

In the UK, the government seeks to ensure that there is sufficient competition in domestic markets so that consumers get a 'fair deal'. Some industries have special regulatory bodies, whose responsibilities include ensuring that the consumer is protected. For industries generally, the Office of Fair Trading is responsible for identifying cases where fair competition might be at risk, and referring cases to a Competition Commission for investigation.

The UK's Competition Commission might be asked to investigate:

- a market, where the Office of Fair Trading suspects that competition is being prevented or restricted by anti-competitive behaviour
- a proposed merger or takeover (or merger that has already occurred), where it is suspected that a consequence of the merger will be a significant reduction in competition
- competition in a regulated industry, such as electricity, gas, water, telecommunications, postal services, broadcasting, airports and air traffic.

Firms within an industry might seek to reduce the strength of the competition, in order to increase their profitability. There are several ways of reducing competition; some of them illegal.

Cartels

A cartel is an arrangement between the rival firms in an industry to operate the same policies on pricing. By operating a price cartel, the firms are able to charge higher prices than if they competed with each other, and as a result make higher profits. Provided that the cartel includes all the firms in the industry (or at least all the major firms), they are able to exercise supplier power.

Price cartels are often illegal within a country, although an example of a successful major price cartel is the powerful Organisation of Oil Producing Countries (OPEC).

CHAPTER 9

Strategic direction and strategy development

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Strategic direction: introduction

- PIMS analysis
- Product-based and resource-based strategies
- Four key areas for successful strategy development
- Product-based strategies and strategic direction

1 Strategic direction: introduction

1.1 PIMS analysis

PIMS analysis stands for **P**rofit **I**mpact of **M**arketing **S**trategy analysis.

It originated in the 1960s at General Electric in the US, but the PIMS database is now maintained by the Strategic Planning Institute.

The PIMS database contains data provided by several thousand strategic business units (SBUs) of major corporations. The data consists of details about the activities and performance of the SBUs, and the database can be used to analyse the factors that appear to make some strategies more successful than others.

The database can be used, for example, to relate the success of a SBU to factors such as market share, diversification strategy, investment intensity, product or service quality or labour productivity.

The PIMS database appears to show a link between profitability and relative market share. The higher the market share, the higher the return on investment will be.

This connection between market share and investment return or profitability is probably due to economies of scale for a large firm in its markets, arising perhaps from the following factors.

- The purchasing benefits of being a large buyer (the ability to obtain better terms from suppliers; for example bulk purchase discounts).
- The advantage of selling in large volumes. (In an industry where profit margins are low, it is vital to have the ability to sell in large quantities in order to make a reasonable-sized profit).
- Scale of advertising. Large firms can obtain greater benefits from advertising; for example by advertising nationally.
- More efficient use of equipment and other non-current assets.
- For retailing firms, the advantages of a large market share also include:
  - easier access to new products from suppliers
  - easier access to retail property: for example, large retail firms are more likely than smaller firms to obtain valuable out-of-town retail space in a new shopping centre.

PIMS analysis would therefore suggest that an appropriate product-market strategy should be to seek a large share of a chosen market (or market segment)

Other findings of PIMS analysis

PIMS analysis has also produced several other conclusions, which appear to have remained consistent over time.

- Relative quality of a product or service is an important factor in obtaining high investment returns. 'Relative quality' means 'value for money' for the customer.
- Although high market share reduces costs and so should improve profitability and return, the benefits of high market share can be lost due to poor relative quality.
- High investment in capital equipment seems to reduce profitability. This is often a characteristic of an industry as a whole, but can also apply to individual companies within an industry. The most successful companies get better asset utilisation (more sales per $1 invested).
- Acquisition strategies are not successful at increasing return on investment for shareholders. The main beneficiaries of acquisitions are usually the shareholders in the acquired company.
- Diversification is not a particularly successful strategy in terms of return on investment.

1.2 Product-based and resource-based strategies

Here are two different approaches to the selection of product-market strategies:

- a product-based strategy, and
- a resource-based strategy.

With a product-based strategy, a firm should identify the products that it wants to sell and the markets or market segments in which it should sell them. The focus of attention is on which products are likely to be the most successful in their market, and so the most profitable.

Hamel and Prahalad suggested that instead of a product-based strategy approach, entities should use a resource-based approach. Instead of looking for the most profitable products, an entity looks instead at the strengths and competencies in its internal resources. The entity should then look for product-market opportunities that will enable it to exploit its core competencies. By choosing products and markets in this way, the entity should have a competitive advantage over its competitors.

Hamel and Prahalad argued that a resource-based approach to strategy selection:

- provides a basis for deciding which new product-market areas to enter, and
- is a more flexible approach to strategic planning than the selection of target products and markets as part of a formal, long-term business plan.

Example

Amazon.com was originally a specialist online seller of books via the internet. Over time, it develop several core competencies

- a user-friendly website for online purchasing
- an efficient delivery service for small packages to customer addresses
- a recognised name and reputation.

The company has been able to use these core competencies to develop its business outside the sale of books. The same competencies that sell books successfully can be applied to similar products that are easily warehoused and can be despatched in small parcels, such as CDs and DVDs.

1.3 Four key areas for successful strategy development

An entity should give clear signals, to outsiders and to its own management, about:

- **Product-market scope (strategic scope)**. The entity should make clear the product-market areas in which it expects to operate. This aspect of strategic choice (corporate strategy selection) was discussed in a previous chapter.
- **Competitive advantage**. The entity should identify those properties of the product-market areas in which it intends to operate that will give the entity a strong competitive advantage over its rivals. Making strategic choices about competitive advantage was discussed in the previous chapter.
- **Growth vector**. A growth vector is the direction in which the entity is moving from its current product-market position. It indicates where the entity sees its future growth. The growth vector might be a new product area, a new market, or both.
- **Synergy**. An entity should also indicate how it might expect to benefit from synergy by moving into new product-market areas. Synergy is perhaps best described as the '2 + 2 = 5 effect'.

Examples of synergy include:

- Instead of making just one product, making two different products with the same equipment and getting better utilisation of the equipment as a result.
- Selling two products with the same sales force, instead of selling just one product.

Synergy can therefore provide extra benefits from making and selling two products instead of one, or making and selling a product in two different markets instead of one.

1.4 Product-based strategies and strategic direction

Strategic choices must be made about the direction that the entity should take. For companies, **strategic direction** is often expressed in terms of:

- the products or services that the company wants to sell
- the markets or market segments it wants to sell them in, and
- how to move into these product areas and market areas, if the entity is not there already.

To achieve growth in the business, an entity must:

- sell more in its existing markets (try to make its existing markets bigger)
- sell new products in its existing markets
- sell existing products in new markets or new market segments (for example in other countries)
- sell new products in new markets.

These are strategic directions that Ansoff described in a growth sector matrix.

Strategic direction: Ansoff's growth matrix

- Growth vector analysis: Ansoff
- Market penetration strategy
- Market development strategy
- Product development strategy
- Diversification strategy
- Gap analysis
- Withdrawal strategy
- Consolidation and corrective strategies

2 Strategic direction: Ansoff's growth matrix

2.1 Growth vector analysis: Ansoff

Ansoff (1957) argued that when a firm is planning its growth strategies, there should be a link between its current products and markets and its future products and markets. This link is necessary so that outsiders (for example, investors) can see in which direction the entity is moving. It also provides guidance to the entity's own management.

As indicated earlier, the strategic direction a company can take is to move into new markets for its products or to develop new products.

Ansoff summarised the potential strategies for product-market development with a 2 × 2 matrix. It sometimes referred to as Ansoff's growth vector matrix or product mission matrix.

		Product: Existing products	Product: New products
Market	Existing market	**Market penetration strategy**	**Product development strategy** **(or innovation strategy)**
Market	New market	**Market development strategy**	**Diversification strategy**

A market penetration strategy is sometimes called a 'protect and build' strategy.

2.2 Market penetration strategy

With a market penetration strategy, an entity seeks to sell more of its current products in its existing markets. This strategy is a sensible choice in a market that is growing fast. With fast growth, all the companies competing in the same market can expect to benefit from the rising sales demand.

A market penetration strategy is more difficult to implement when the market has reached maturity, or is growing only slowly.

Kotler suggested that market penetration calls for aggressive marketing, and that there are three ways in which this strategy might be successful:

- Persuade existing customers to use more of the product or service, and so buy more. This is a strategy based on trying to increase total market sales demand.
- Persuade individuals who have not bought the product in the past to start buying and using the product. Marketing tactics for attracting new users might include advertising or special promotional offers. This is another strategy based on trying to increase total market sales demand.
- Persuade individuals to switch from buying the products of competitors. This is a competitive strategy based on winning a bigger market share. This strategy has the obvious risk, however, that competitors will retaliate with their own marketing initiatives to win customers.

Example

A manufacturer of shower gel might decide on a market penetration strategy, by trying to persuade existing customers to take showers more often. One way of encouraging a change in the rate of usage would be to have a special promotional offer for a short period of time, such as 'Buy one, get one free'.

However, offers such as 'buy one, get one free' can only be short-term marketing initiatives. If this tactic were turned into a longer-term strategy, the effect would be to reduce the selling price by 50% and the company would be pursuing a low price strategy. To succeed with this strategy it would need to become the least-cost producer in the market.

A market penetration strategy is a low-risk product-market strategy for growth, because unless the market is growing fast, it should require the least amount of new investment. However, there are some risks with this strategy.

- If the company fails to increase sales, its business will have no strategic direction, and will suffer from 'strategic drift'.
- A strategic choice of 'doing nothing new' is a high-risk choice, because competitors are likely to be much more innovative and competitive.
- The strategies selected by major competitors might be a threat, particularly if there is a 'war' to win customers from each other.

2.3 Market development strategy

Market development involves opening up new markets for existing products. Kotler suggested that there are two ways of pursuing this strategy:

- The entity can start to sell its products in new geographical markets (through regional, national or international expansion).
- The entity can try to attract customers in new market segments, by offering slightly differentiated versions of its existing products, or by making them available through different distribution channels.

Example

A business entity specialising in making and selling a branded type of chocolate bar might develop its markets by offering the same product in new sizes:

- a small size, to attract purchases by diet-conscious customers
- a large size, to attract customers who might buy a chocolate bar as their lunch.

In this example, the target new market segments are segments differentiated by the 'life style' of the customer.

Example

Many farmers in the US who grow corn are starting to sell their produce to energy companies, which are making bio-fuels out of the corn to fuel motor engines.

The energy market is a new market segment for these farmers, who also continue to sell corn to food product manufacturers.

2.4 Product development strategy

Product development is a strategy of producing new products for an existing market. There are several reasons for choosing this strategy.

- The business entity might have a strong brand name for its products, and it can extend the goodwill of the brand name to new products.
- The entity might have a strong research and development department or a strong product design team.
- The entity has to react to new technological developments by producing a new range of products or product designs.
- The market has growth potential provided that new products are developed.
- The entity wants to respond to a strategic initiative by a major competitor, when the competitor has developed a new product.
- Customer needs might be changing, so that new product development is essential for the survival of the business.

Disadvantages of a product development strategy are that:

- developing new products can be expensive
- a large proportion of new products are unsuccessful.

Example

Many food and drinks companies have adopted a strategy in recent years of developing 'healthy foods' and 'diet' drinks or 'health drinks'.

They have often been able to use the strength of their existing brand name to persuade customers to buy their new products.

Example

In the UK, Tesco is the leading supermarket company. Its successful growth in the UK has been based partly on a product penetration strategy. The company has extended the range of goods it sells in its stores to include items such as clothing and domestic electrical equipment.

2.5 Diversification strategy

Diversification is a strategy of selling new products in new markets. A distinction can be made between:

- **concentric diversification** (also called **related or horizontal diversification**), which means that the new product-market area is related in some way to the entity's existing products and markets
- **conglomerate diversification**, which means that the new product-market area is not related in any way to the entity's existing products and markets.

Both forms of diversification are normally achieved in practice by means of an acquisition strategy (in other words, buying companies that already operate in the new product-market areas).

Concentric diversification

The aim of concentric diversification might be to use the entity's existing technological know-how and experience is a related but different product-market area. Here are some examples.

- A manufacturer of vacuum cleaners (e.g. Dyson in the UK) might diversify into the manufacture of washing machines.
- An airline company might acquire an international chain of hotels. There could be obvious benefits from co-operation in providing good services to passengers and from cross marketing. Both are in the people/travel business so many corporate values could be shared and the brand strengthened.
- A company selling men's clothes by mail order might diversify into selling women's clothes.

- A company that provides driving lessons for learner drivers might expand into the market for providing driving lessons for advanced drivers.

Some concentric diversification strategies have a lower amount of business risk than others.

Conglomerate diversification

The aim of conglomerate diversification is to build a portfolio of different businesses. The reasoning behind this strategy might be as follows.

- Diversification reduces risk. Some businesses might perform badly, but others will perform well. Taking the businesses as a diversified portfolio, the overall risk should be less than if the entity focused on just one business. However, this view is rejected by some business analysts, who argue that shareholders can themselves reduce risk if they want to, by spreading their investments in shares over different companies in different industry sectors. For a company in car manufacturing, diversifying into supermarkets is unlikely to be popular with shareholders who have carefully constructed a portfolio that suits their needs.
- Diversification will save costs and generate ‘synergy’. (Synergy is the idea that 2+2 = 5.) But synergy can only occur if costs can be saved (for example by economies of scale) or there is some other beneficial linkage between the companies. However, if the companies are truly unrelated then it is not easy to see how synergy can be created. Purchases, manufacturing, customers and management will all be radically different.
- An entrepreneurial management team should be able to succeed in any markets, and the entity therefore seizes different business opportunities whenever and wherever they arise. This is the only potentially valid argument for unrelated diversification, but it is only valid if the company taken over is not being managed well, or it holds undervalued assets that could be sold at a profit. If it is already well-managed, holds no under-valued assets and is taken over at a fair price, it is not clear where shareholder value can be added. All too often, new owners destroy value by meddling with an already successful business

Example

Management must select a strategy that they believe is best suited to the needs of the entity. The strategy they choose might differ from the strategy of close competitors. When two rival companies select different strategies, it will not necessarily be clear whose strategy is the most successful, particularly over the longer term.

An interesting example is the product-market strategy of PepsiCo compared with Coca-Cola. In 1996, Pepsico was struggling in its competition with Coca-Cola. Since then, PepsiCo has turned round its business and is currently larger than Coca-Cola.

Coca-Cola remains predominantly a drinks business. Its strategy in recent years has been to expand its range of products for existing markets, and to develop more

geographical markets. Coca-Cola has stronger markets outside the US than Pepsi for its carbonated drinks products.

In contrast, PepsiCo pursued a strategy of concentric diversification, in addition to product and market development within its existing drinks business. It successfully developed its existing snack foods business (Frito-Lay) and also purchased two businesses with strong nutritional food ranges – Quaker Oats and Tropicana juices.

2.6 Gap analysis

Gap analysis is a technique that might be used in strategic planning.

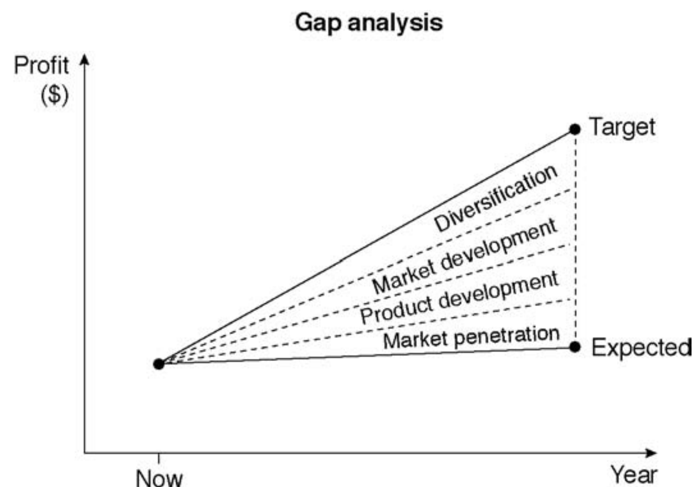
A gap is the difference between:

- the position a business entity wants to be in by the end of the planning period, in order to meet its overall objectives, and
- the position the entity is likely to be in if it does not have any new strategy or change in strategy.

The strategies selected for the planning period should be sufficient to close this strategic gap.

In the following diagram, the forecast of where the entity will be without any new strategies might be estimated by statistical forecasting methods, such as regression analysis. For simplicity, the forecast is a forecast of annual profit.

The corporate objectives are expressed in the same terms (in this example, profit). The strategic gap might be closed by a combination of product-market strategies.



Example

Fine China is a manufacturer of high-quality dinner services (plates, saucers, bowls, cups, saucers etc) and has a dominant position at the high-quality end of its national market. The market is in a slow decline.

Management is considering its strategies for the future. The aim is to achieve a 5% average annual growth in the entity's share price over the next five years.

Required

Suggest briefly a strategy that the entity might adopt if its strategic direction is:

- market penetration
- product development
- market development
- diversification.

Answer

Here is a suggested answer.

Market penetration	Aim to win more share of the existing market, possibly by means of a takeover (acquisition of a competitor's business).
Product development	Aim to develop new products for the same market. This might be achieved by developing lower-quality and lower-priced products, under a new brand name, for sale through the same outlets as the existing products.
Market development	Try to sell the company's existing products in new geographical markets – in selected other countries.
Diversification	The company might be able to diversify into related products and markets (concentric diversification) by developing household ornaments made from china.

2.7 Withdrawal strategy

As the name suggests, a withdrawal strategy is a strategy for withdrawing from a particular product-market area. This might be appropriate, for example, when:

- the entity can no longer compete effectively, or
- the entity wishes to use its limited funds and resources in a different product-market area.

A withdrawal strategy might be adopted as a deliberate policy by deciding to:

- reduce the range of products offered to the market
- reduce the number of markets or market segments (for example, pulling out of a market in one or more regions of the world)
- withdrawing entirely from the market, and no longer operating in the market.

The reasons leading to a withdrawal from a product-market area might be any of the following:

- A decline in the size of the market or market segment, for example because the product is becoming obsolete. (For example, due to technological change, videotape and music cassettes are becoming obsolete).
- More effective and successful competition from rival firms.
- Poor financial results; for example, the product might be loss-making.
- A decision by the entity that the product is no longer a 'core product' and the entity therefore does not intend to continue making and selling it.

2.8 Consolidation and corrective strategies

A business entity might decide that it does not need to grow. A **consolidation strategy** is a strategy for maintaining market share, but not increasing it.

There are several reasons why a entity might choose a non-growth strategy.

- The entity might be managed by their owner, who does not want the business to get any larger.
- Management might take the view that if the entity gets any bigger, there will be serious problems in managing the enlarged entity. They might prefer to avoid the problems by remaining the same size.

However, a strategy of non-growth does not mean a strategy of doing nothing. Business entities must continue to innovate even to 'stand still'. If a business entity does not have clear strategies for its products and markets, it will lose its market share to competitors.

A **corrective strategy** is a strategy for making corrections and adjustments to current strategy, to counter threats from competitors or to respond to changes in customer needs.

Corrective strategies might be necessary as a part of a consolidation strategy.

Example

In the UK, the British Broadcasting Corporation (BBC) does not have a growth strategy, and is not particularly looking for more viewers or listeners for its television and radio programmes. However, it recognises the significance of digital broadcasting. A corrective strategy in recent years has therefore been to develop digital television and radio broadcasting. The BBC launched several digital television and radio channels, designed to attract existing customers to the new technology.

Business entities in a competitive market should seek to obtain an advantage over their competitors. Competitive advantage means doing something better than competitors, and offering customers better value. Competitive advantage is

essential; otherwise there is no reason why customers should buy the entity's products instead of the products of a competitor.

Methods of strategic development

- Growth through internal development
- Greiner's growth model
- Mergers and acquisitions
- Diversification and integration
- Forward and backward integration

3 Methods of strategic development

Whatever product-market strategies are selected, an entity must also decide how to develop the chosen strategies.

There are three main approaches to developing a product-market strategy for growth:

- internal growth
- growth through acquisitions or mergers
- joint ventures and strategic alliances: these were discussed in the previous chapter.

3.1 Growth through internal development

An entity might grow its business with its own resources, seeking to increase sales and profits each year.

There are several **advantages** of internal development over other forms of strategy for growth:

- Management can control the rate of growth more easily, and ensure that the entity has sufficient resources to grow successfully. The entity might not have sufficient resources to meet the growing sales demand. However, it will only make and sell as much as it can, efficiently and effectively, with the resources at its disposal.
- The entity should be able to focus on its core competencies, and develop these in order to grow successfully.
- If the entity finds that it is short of a key labour skill, it can buy the labour skills it needs by recruiting new staff.

There are some **disadvantages** with growth through internal development.

- The biggest disadvantage is probably that there is a limit to the rate of growth a business entity can achieve with its internal resources. Rival firms might be able to grow much more quickly by means of mergers, acquisitions and joint ventures.
- In order to expand a business beyond the limits of its current capacity, it is necessary to invest in new capacity. For a production company, this means investing in new production facilities. The lead time between taking a decision

to invest and the opening date for the new production facilities (possibly in another country) can be long. Until the new production facilities are opened, the entity may be unable to meet customer demand, and it might therefore lose business to competitors. After the new production facilities are opened, production capacity will probably exceed demand, and for a time (until demand grows further) there will be some unused capacity and idle resources.

- If there is an element of diversification, then internal growth presents some risks because the organisation will have to learn new skills. Mistakes are almost inevitable.
- Another disadvantage is that even with internal growth, the entity will eventually need to change its organisation and management structures, in order to handle the growth in its business. Unless an organisation does change, it will become inefficient. Unfortunately, introducing change to the organisation structure and management style is by no means simple and easy to accomplish.

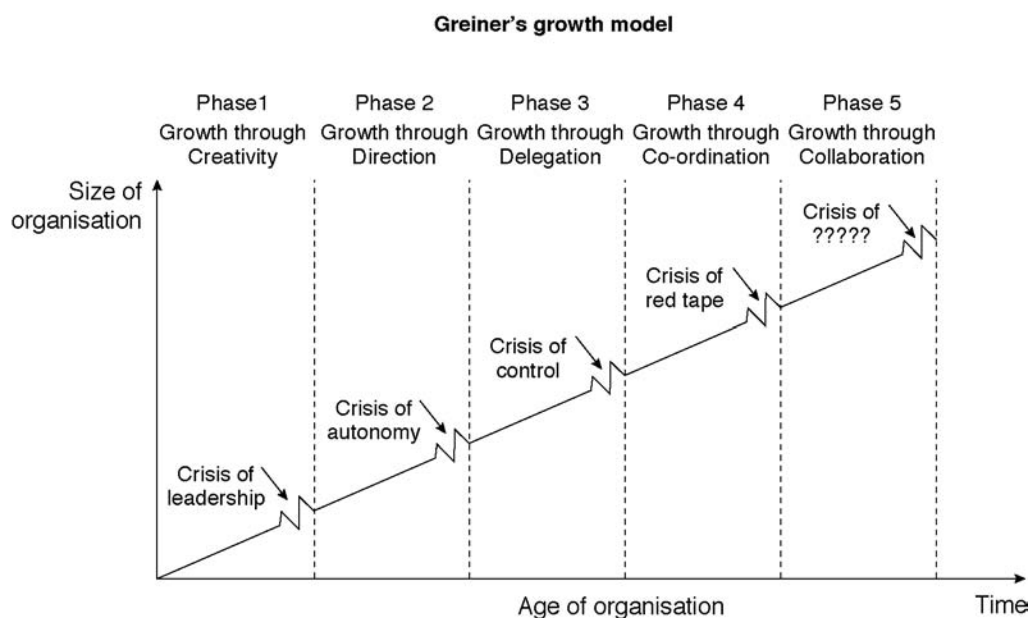
Greiner's growth model provides an analysis of how organisation and management structures might need to change as a business grows.

3.2 Greiner's growth model

In the 1970s, Greiner suggested that an entity that grows in size goes through a series of changes as it gets bigger. Each change occurs in response to a 'crisis', when the existing organisation and management structure is no longer capable of handling a business as large as it has now become.

According to Greiner, there are five phases in the life of an entity. These phases, and the crisis that starts each new phase, are set out in the diagram below.

Greiner's growth model



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Phase 1: Period of growth through creativity

The early years of a successful business entity are a period of creativity and innovation. The entity is probably managed in an entrepreneurial way, and it is producing new products that appeal to customers and is developing new markets.

Over time, production becomes more organised. As the entity grows, the entrepreneurial method of management and the existing organisation structure both become inefficient. The organisation needs organisation and planning and control systems.

There is a **crisis of leadership**. Management must become more 'professional'. The entity therefore introduces professional management, and it enters its next phase of growth.

Phase 2: Period of growth through direction

The entity is now more structured, with a 'traditional' management hierarchy. Formal systems are introduced, such as planning and control systems (budgeting and budgetary control), accounting systems, inventory control, production scheduling, communication and IT systems, etcetera.

However, as the entity grows, the hierarchical management structure becomes inefficient. The control systems and reporting systems are designed for close control from the top by senior management. However, management control from the top is not as effective as it used to be. Top management are far away from actual operations, and 'local' managers know much more about how the business functions in their area of operations.

There is a **crisis of autonomy**. The 'tensions' between senior management and local management grow. Until local managers are given more authority to take decisions for themselves, the entity will be managed inefficiently from the top.

Phase 3: Period of growth through delegation

In order to survive, the entity is reorganised, with much more authority delegated to 'local' managers. The entity is organised in divisions, which might be profit centres. Central management receive reports from the divisions, but divisional managers take most of the decisions about how the division should be run. Central management concentrate much more on strategy and business expansion.

However, as the business continues to grow, central management realise that they are losing most of their own authority, and that the local managers are becoming perhaps too powerful and unaccountable.

This leads to a **crisis of control**. Central/senior management must change the organisation and management structure, to avoid losing control.

This leads the entity into its next phase of development, a period of growth through co-ordination.

Phase 4: Period of growth through co-ordination

In this phase of growth, central management monitor their local managers carefully, using sophisticated reporting systems. Local managers are more accountable, although they have delegated authority to make decisions.

The focus is now on:

- co-ordinating the activities of all the different local operating divisions within the entity and
- consolidating the business.

However, as the entity continues to grow, the reporting systems start to create a bureaucratic culture at head office. Local managers become angry at having to provide so many reports, and explain so much to head office, when they feel that their time would be better spent in managing operations. This leads to a **crisis of red tape** – with too much form-filling, report-writing and bureaucracy.

Phase 5: Period of growth through collaboration

Greiner suggested that the crisis of red tape leads to a further change. To overcome the problems of red tape, head office management and local managers find ways to collaborate more constructively. There is a greater emphasis on teamwork and problem-solving, and less emphasis on formal reporting systems and accountability. Participation in decision-making by more individuals is encouraged.

Since no entity has gone beyond Phase 5 of its development Greiner suggested that it was too early to tell whether there is a crisis the end of Phase 5, leading perhaps to even more change.

If entities continue to grow, they will have to go through the phases of transformation. If they do not, they will become inefficient and will fail to survive. (For example, they might become a takeover target).

3.3 Mergers and acquisitions

An entity can grow quickly by means of mergers or acquisitions. Both mergers and acquisitions involve the creation of a single entity from two separate entities.

- With a merger, the two entities that come together are approximately the same size.
- With an acquisition, one entity is usually larger than the other and acquires ownership (control) by purchasing a majority of the equity shares.

Acquisitions are more common than mergers, but large mergers are possibly more significant, because they can create market leaders in their industry. Examples of large mergers have been:

- pharmaceuticals firms SmithKline Beecham and Glaxo to form Glaxo SmithKline.
- the merger of media giant Time Warner with AOL

- the merger of consumer products manufacturers Proctor & Gamble with Gillette.

Advantages of acquisitions and mergers

Acquisitions and mergers have several advantages as a strategy for growth, compared with a strategy of internal development.

- Growth by acquisition or merger is much faster than growth through internal development.
- An acquisition can give the buyer immediate ownership of new products, new markets and new customers, that would be difficult to obtain through internal development.
- An acquisition enables an entity to enter new market where the barriers to entry are high, so that it would be very difficult to set up a new business in competition.
- An acquisition prevents a competitor from making the acquisition instead.
- It might result in cost savings and higher profits ('synergy'). This point is discussed in more detail later.

Disadvantages of acquisitions and mergers

- An acquisition might be expensive. The bid price has to be high enough to make the shareholders of the target company willing to sell their shares. The return on investment for the entity making the acquisition might therefore be very low.
- A merger or acquisition can result in a loss of proportional ownership of the entity. For example, if two entities with an equal total value are merged together, a shareholder who held say 10% of one of the companies before the merger might only own 5% of the merged company. (The actual change in proportional ownership will depend on the structure of the merger or acquisition, and how it is financed.)
- The two entities will have different organisation structures, different management styles, different cultures, different systems of salaries and wages. Bringing them together into a single entity will be extremely difficult. Naturally, many employees will feel threatened, as often takeovers are followed by the company seeking cost efficiencies (including redundancies). Many good employees could leave. Generally, the period of disruption following a takeover or merger will last around a year.
- When individuals from different 'cultures' are brought together into a single organisation, there will probably be a 'clash of cultures', and it may be difficult for individuals from the different cultures to work together easily. They will have a different outlook on business, and will have different ideas about the way that work should get done. The problems of a clash of cultures are particularly severe when companies merge, or when one company takes over another. There have been several well-publicised examples of a clash of cultures in the banking industry, when a commercial bank (a traditional 'lending bank') merges with an investment bank.

Mergers and acquisitions: will there be synergy?

Synergy is often a key reason for a merger or acquisition. Synergy will occur when, as a result of a merger or acquisition, there are operational or financial benefits.

- There might be over-capacity of equipment and property, so that the surplus assets can be sold off.
- It might be possible to make operational changes to save resources In particular, an acquisition often results in redundancies for large numbers of employees. Running costs are reduced.
- Two Research and Development departments can be combined into just one, and savings in running costs should be possible.

However, it has been found in practice that a very large proportion of acquisitions and mergers fail to achieve the expected synergy.

The difficulties with bringing together two different organisations, management styles, management structures and cultures mean that there is often a high risk of a loss in efficiency and higher operating costs.

Acquisitions: the need for financial strength

A successful strategy of growth through acquisition requires financial strength. A company needs one or more of the following.

- A large amount of cash that is available for long-term investment. Some acquisitive companies have a 'war chest' of cash that they use to buy target companies.
- Access to additional funding, in the form of new equity (from new share issues) or borrowing (bond issues or loans).
- Highly-regarded shares. Many acquisitions are negotiated as a share-for-share exchange, with shareholders in the target company agreeing to accept shares in the acquiring company as payment for their shares. To succeed with acquisitions financed by a share-for-share exchange, a company's shares must be well-regarded by investors, so that shareholders in a target company are willing to accept shares as payment.

3.4 Diversification and integration

Diversification and risk

Diversification has already been described as a strategy for growth. Entities that grow by diversification usually do so by means of merger or acquisitions.

It has also been stated that diversification is a high-risk growth strategy, because the entity is moving into both new product areas and new markets at the same time, and it does not have experience in either.

Conglomerate diversification is a greater risk than concentric diversification, because with concentric diversification, the entity is moving into related product-

market areas, where it might be able to use its experience and core competencies more effectively.

Integration

Integration is a term that means extending a business. There are two main types of integration:

- horizontal integration
- vertical integration.

Horizontal integration. With horizontal integration, an entity extends its business by obtaining a larger share of its existing product markets. Typically, an entity might acquire one or more of its competitors.

Vertical integration. With vertical integration, an entity extends its business by acquiring (or merging with) another entity at a different stage in the supply chain. A strategy of vertical integration is usually a form of concentric diversification.

3.5 Forward and backward integration

Vertical integration might be:

- forward, or
- backward.

With **forward vertical integration**, also called 'downstream' integration, an entity enters the product markets of its customers. For example:

- a manufacturer of tyres might go into the production of motor cars or motor cycles
- a wholesaler (selling goods for resale to retailers) might go into the business of retailing itself
- an entity specialising in oil and gas exploration might move into the market for oil and gas extraction.

With **backward vertical integration**, also called 'upstream' integration an entity enters the product markets of its suppliers. For example:

- an entity specialising in oil and gas extraction might move into the market for oil and gas exploration
- an entity operating a chain of cinemas might go into the market for film production
- a shoe manufacturer might enter the market for leather production.

Arguments for vertical integration

Integration can give an entity a position of strength in the supply chain, particularly if it a major competitor in its market.

The reasons given for forward or backward vertical integration might be as follows.

- Backward integration gives an entity control over its source of supply.
- Forward integration can give an entity control over its channels of distribution.
- Vertical integration allows an entity to extend its expertise and skills into related product markets.
- Vertical integration makes it easier to find ways of reducing costs in the supply chain, and adding value.
- Vertical integration can help to differentiate the product. Backwards integration could aid designing and making unique components; forwards integration could help to sell products in a unique environment.

However, it might not be certain how customers or suppliers might react. For example, if a wholesaler goes into the business of retailing, will its other retailer customers stop buying its goods and switch to buying from a different wholesaler who is not also a competitor?

There is also a risk that integration might reduce the competitiveness of the entity.

Arguments against vertical integration

- Avoiding the discipline of the market. A cosy, relaxed relationship is likely to grow between, say, an in-house component manufacturer and producer of the finished product. The component manufacturer knows that the group company will almost certainly buy its components, and so there is little pressure for cost efficiency and innovation.
- Other companies might turn out to be more successful than the one bought in by the group. For example, a rival component manufacturer makes a technical breakthrough so that their components are better and cheaper. It might be better on each purchasing occasion to have the pick of all manufacturers so that the best and most suitable cost effective components can be bought.
- Different managements skills. If a manufacturer takes over a distribution chain, the skills needed to manage that will be quite different, and the company could easily mess things up.
- Core business. The company should examine its value chain and distinctive competences. These must be protected, and buying another company can mean that management pays less attention to the areas of its business that really matter.
- Use of capital. Is buying, or setting up, a supplier or distributor really the best way for a company to use its capital?

Example

Several companies that manufacture high-quality goods have adopted a strategy of acquiring their own retail outlets to sell their products and to project a sophisticated brand image. These companies include Louis Vuitton (luggage) and Apple (computers).

Another example is Nespresso, a subsidiary of Nestlé. This company originally (1986) sold coffee capsules for espresso machines, and then expanded its business into selling coffee machines that were manufactured by other companies but sold under the Nespresso brand name.

More recently, the company has opened a small number of 'coffee boutiques' in prestigious locations such as Madison Avenue in New York and Beauchamp Place in London, selling high-priced coffee in luxurious surroundings. The aim of this strategic development, however, is not to sell more Nespresso coffee or become an upmarket chain of coffee shops. The concept is to make customers more aware of Nespresso coffee machines and to persuade more customers to buy the machines.

Assessment of business strategies

- The basis for assessing business strategy
- Suitability of a strategy
- Suitability: life cycle analysis and the life cycle portfolio matrix
- Suitability: assess resources and competencies
- Suitability: business profile analysis
- Feasibility of a strategy
- Acceptability of a strategy
- Selecting individual investments: strategic fit

4 Assessment of business strategies

4.1 The basis for assessing business strategy

Before deciding whether or not to choose a particular business strategy, an assessment should be carried out to judge whether the strategy is acceptable. Johnson and Scholes suggested that when judging the strengths or weaknesses of a proposed strategy, the strategy should be evaluated for its:

- **suitability**: does it address the strategic requirements, given the circumstances and the situation?
- **acceptability**: does it address the strategic requirements in a way that will be acceptable to significant stakeholders?
- **feasibility**: is it practical?

Included within an assessment of acceptability or feasibility should be a financial analysis of the proposed strategy. Strategies might be suitable, and they might succeed in achieving their business objectives. However, if the expected financial return is too low, or if the strategy could only be implemented at a loss, it should not be undertaken.

An assessment of strategy **must always consider the financial aspects**. In your examination, you should bear this in mind. If you are given a case study and asked to recommend a business strategy, you should not recommend anything that is financially unacceptable!

4.2 Suitability of a strategy

A strategy is suitable if it would achieve the strategic objective for which it is intended.

- If the purpose of the strategy is to gain competitive advantage, it is necessary to assess how the strategy might do this, and how effective the strategy might be. Will the strategy succeed in reducing costs, if this is its purpose? Will the strategy succeed in adding value, if adding value is the purpose?

- If the purpose of the strategy is market development, how successful might the strategy be?
- Similarly, how suitable are the chosen strategies for market development, product development or diversification?
- Is the business risk in the strategy acceptable, or might the risk be too high?

Several techniques might be used to assess the suitability of a strategy. These include:

- life cycle analysis and the life cycle portfolio matrix
- an assessment of resources and competencies
- business profile analysis.

4.3 Suitability: life cycle analysis and the life cycle portfolio matrix

The life cycle portfolio matrix can be used to assess the suitability of a particular strategy in relation to the stage of its life cycle that the entity's product has reached.

A choice from several different strategies might be appropriate for a product in a particular stage of its life cycle, but some strategies are more appropriate than others. For example, a strategy that might be appropriate for the growth stage of the life cycle might not be appropriate during its decline stage.

The life cycle portfolio matrix suggests what the appropriate strategies might be, in view of both:

- the stage of the life cycle, and
- the entity's competitive position in the market.

A version of a life cycle portfolio matrix is shown on the next page. This suggests which business strategies might be appropriate at each stage of the life cycle, depending on the company's position in the market. Some of the terms used in the table are explained below:

- 'Fast grow' means 'grow the company's business at a faster rate than the rate of growth in the market as a whole'.
- 'Grow with the industry' means 'grow the company's business at the same rate as the average rate of growth in the market as a whole'.
- 'Find niche' means try to develop a market niche for the product.
- 'Retrench' means cut expenditure and reduce investment: usually this means accepting a reduction in market share.
- 'Renew' means give the product new 'life' by introducing new and improved features.
- 'Harvest profits' means treat the product as a 'cash cow': take the money from profits but do not invest further.

One version of a life cycle portfolio matrix is set out below.

		Stage of product life cycle			
		Introduction	**Growth**	**Maturity**	**Decline**
Competitive position	**Dominant**	Fast grow Start-up	Fast grow Achieve cost leadership Renew product Defend position	Defend position Achieve cost leadership Fast grow	Defend position Focus Renew Grow with the industry
	Strong	Start-up Differentiate Fast grow	Fast grow Catch up Achieve cost leadership Differentiate	Achieve cost leadership Renew Focus Differentiate Grow with the industry	Find niche market Hold niche Hang in Grow with the industry Harvest profits
	Favourable	Start up Differentiate Focus Fast grow	Differentiate Focus Catch up Grow with the industry	Harvest Hang in Find niche Hold niche Renew Turnaround Differentiate Focus	Retrench Turnaround
	Weak	Find niche Catch up Grow with the industry	Turnaround Retrench	Withdraw Divest	Withdraw

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4.4 Suitability: assess resources and competencies

Another approach to strategy evaluate is to consider the strategy in relation to:

- the resources that the strategy will need, to carry it out, and
- the competencies of the entity, and in particular its core competencies.

Unless the strategy will enable the entity to take advantage of its core competencies, it will be difficult – or impossible – for the entity to gain a competitive advantage by pursuing the strategy.

A strategy should not be considered suitable **unless** it is expected to make use of the entity's core competencies.

4.5 Suitability: business profile analysis

A strategy can also be evaluated by comparing:

- the features of the marketing strategy that appear to make it successful and profitable, with
- whether the strategy under consideration will have these features, and if so, to what extent.

For example, a product could be positioned in the market as being up-market and exclusive and could have a brand name associated with luxury. A strategy to sell the product in supermarkets might not therefore be suitable.

4.6 Feasibility of a strategy

The feasibility of a strategy is concerned with whether it will work. A strategy is feasible if it can be implemented successfully. Assessing whether or not a strategy is feasible will require some judgement by management.

Some of the questions to consider are as follows:

- Is there sufficient finance for the strategy? Can we afford it?
- Can we achieve the necessary level of quality that the strategy will require?
- Do we have the marketing skills to reach the market position that the strategy will expect us to achieve?
- Do we have enough employees with the necessary skills to implement this strategy successfully?
- Can we obtain the raw materials that will be needed to implement this strategy?
- Will our technology be sufficient to implement the strategy successfully? For example, will our IT systems be good enough?

If there are serious doubts about the feasibility of a strategy, it should not be selected.

An important aspect of strategy evaluation is the financial assessment.

- Will the strategy provide a satisfactory return on investment?
- Is the risk acceptable for the level of expected return?
- What will be the expected costs and benefits of the strategy? How will it affect profitability?
- What effect is the strategy likely to have on the share price?

4.7 Acceptability of a strategy

The acceptability of a strategy is concerned with whether it will be acceptable to key stakeholders. If it is not acceptable to a key stakeholder, the stakeholder will oppose the strategy. Management should then consider whether a strategy that is not acceptable to a key stakeholder should be undertaken or not.

In most cases, management are likely to reject a strategy that will not be acceptable to a key stakeholder.

There are several aspects of 'acceptability'.

- Management will not regard a strategy as acceptable if the expected returns on investment are too low, or if the risk is too high in relation to the expected return.
- Investors might regard a strategy as unacceptable if they will be expected to provide a large amount of additional investment finance.
- Employees and investors might consider a strategy unacceptable if they regard it as unethical.

Example

In 2005, the company that owns the German stock exchange, the Deutsche Borse, made a takeover bid for the London Stock Exchange. Under German law, the company's management did not have to consult its shareholders about the bid.

However, a large number of shareholders formally expressed their hostility to the bid, and opposed management's strategy. They stated their preference for the company to use its large amounts of cash to increase dividends.

In spite of the stated objection of the shareholders to the management strategy, however, the management team continued with the takeover bid.

4.8 Selecting individual investments: strategic fit

When an entity has decided its business strategies, it might make new investments or undertake new business initiatives in order to put the strategy into practice. In principle, all new investment decisions:

- should be expected to provide a minimum acceptable financial return (in other words, should have a positive net present value when its cash flows are discounted at an appropriate cost of capital), and also
- should be consistent with the chosen strategies, and there should be a 'strategic fit' between strategy and investments.

However, an investment opportunity might be identified that will provide high financial returns, but is not a good strategic fit. Even though the investment is not consistent with agreed strategy, it would probably be undertaken – provided that the expected financial returns were high in relation to the investment risk. This would possibly be an example of emergent strategy, which was described in an earlier chapter. (Alternatively, it would be a one-off investment with the sole aim of making money!)

In other situations, an entity may decide to undertake an investment with low financial returns, because it is an excellent 'strategic fit'.

Strategy selection

- Formal evaluation
- Enforced choice
- Learning and experience

5 Strategy selection

The process of strategy evaluation provides an assessment of the suitability, feasibility and acceptability of different strategies. Strategy proposals that are not suitable, not feasible or not acceptable can be rejected. This might still leave several different alternative strategies to consider. If so, the preferred strategies must be selected from the strategy options that are available.

5.1 Formal evaluation

Where there is a free choice from several available strategies, the selection might be based on a formal financial evaluation and strategic evaluation of the expected returns and the risks, over the long term as well as the short term.

5.2 Enforced choice

In some cases, management might take the view that they have no real choice, and that they are 'forced' to adopt a particular strategy. The reasons for having to select an enforced strategy might be that:

- a key stakeholder, such as a major shareholder, is insisting on a particular strategy, or
- every competitor is doing the same thing.

However, it is probably a sign of weak management that a strategy is considered necessary or unavoidable. Strategy selection should be positive. Management should be looking for the strategies that are most likely to achieve the corporate objectives.

5.3 Learning and experience

A distinction can be made in strategy selection between experience and learning.

- **Experience** is acquired over time. With experience, an entity should develop skills and competencies. Strategic opportunities should arise that enable the entity to use its skills and experience to develop its businesses. Using acquired skills to develop and grow is consistent with the logical incremental model of strategic management.
- **Learning** is the acquisition of new ideas. An entity might select a strategy that forces it to learn something new. This might require a significant change in behaviour as well as skills. Although the learning process can be rapid, strategies based on new learning are likely to introduce change more suddenly. This type of strategy might therefore be fairly risky.

CHAPTER 10

Strategic action

Contents

1	Organising for success
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3	The most appropriate organisation structure
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Organising for success

- Strategy implementation
- Organisation structure
- Entrepreneurial organisation
- Functional organisation structure
- Divisional organisation structure
- Matrix organisation structure
- Project-based and team-based structures
- Span of control
- Organisational processes

1 Organising for success

1.1 Strategy implementation

After a strategic position analysis has been undertaken, available strategies have been evaluated and the preferred strategies have been selected, the selected strategies must be implemented. Achieving strategic objectives requires successful strategy implementation.

Strategy implementation takes the form of day-to-day actions and relationships. Three aspects of strategy implementation are specified in the syllabus for the Business Analysis paper:

- organisation structure, including the organisation of processes and relationships
- managing strategic change
- implementing strategy through a combination of intended strategy and emergent strategy.

1.2 Organisation structure

Organisation structure is an aspect of strategy implementation. Strategy is implemented through actions, and actions are planned and controlled through the management and decision-making structure within the entity.

Organisation structures differ between entities. The organisation structure for an entity should be appropriate for the size of the entity, the nature of its operations, and what it is trying to achieve. Most important, the organisation must enable the entity to develop plans and implement them effectively.

There are several different types of organisation structure. Within a single entity, particularly a large entity, there might be a mixture of different organisation structures, with different structures in different parts of the entity.

From a strategic perspective, however, the key question is: 'What is the most appropriate structure for a particular entity that will help it to achieve its strategic objectives in the most efficient way?'

Organisation structures for multinational and global entities were described in an earlier chapter. You should also be familiar with the following basic structures that might exist within any entity or part of an entity:

- an entrepreneurial organisation structure
- a functional structure
- a divisional structure
- a matrix organisation.

1.3 Entrepreneurial organisation

An entrepreneurial organisation is an entity that is managed by its entrepreneurial owner. The main features of an entrepreneurial organisation are usually that:

- the entrepreneur takes all the main decisions, and does not delegate decision-making to anyone else
- the entity is therefore organised around the entrepreneur and there is no formal management structure
- operations and processes are likely to be simple, and the entity will probably sell just a small number of products or services.

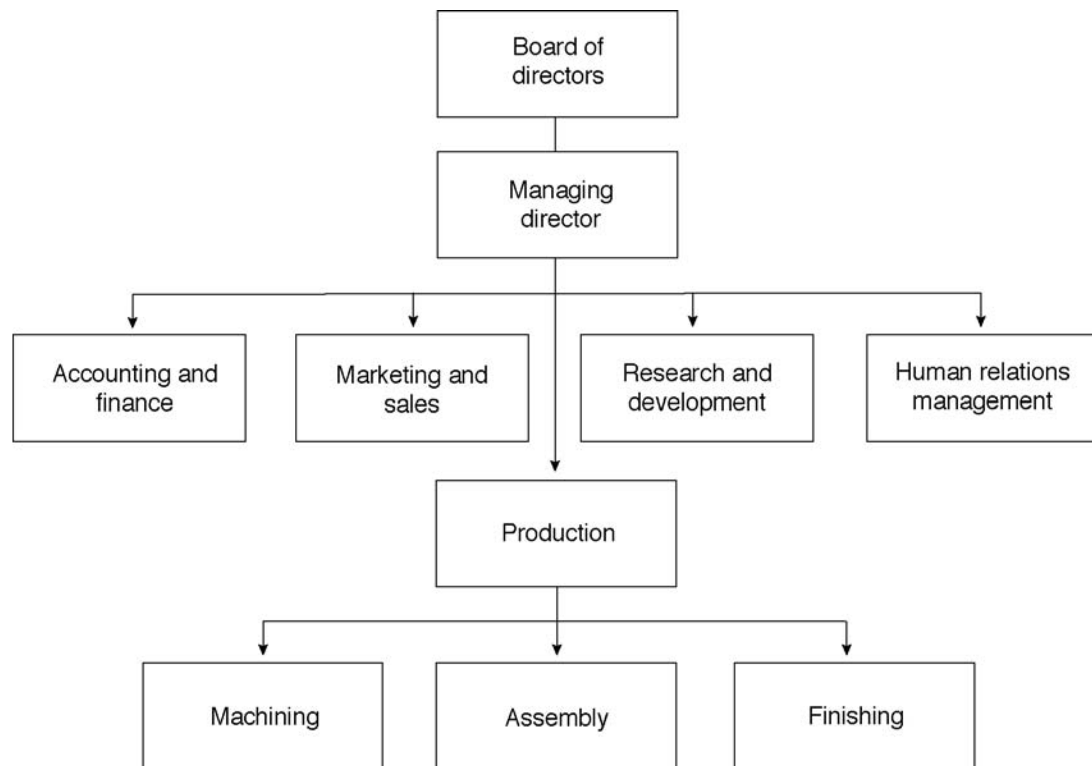
An entrepreneurial structure is appropriate when an entity is in the early phase of its life. As it grows larger, however, an entrepreneurial structure will become inefficient, and a formal management structure is needed.

1.4 Functional organisation structure

A functional structure is usually the next stage in the development of the organisation structure of a growing entity. In a functional organisation structure, decision-making authority is delegated in a formal arrangement, and responsibilities are divided between the managers of different activities or functions. Typically, functions in a manufacturing entity include production (or operations), marketing and sales, and finance and accounting. There might also be a human relations function, an IT function, a research and development function, and so on.

Each function has its own management structure and its own staff.

An organisation chart showing a simple functional structure is shown below.



1.5 Divisional organisation structure

As entities grow still further, and develop their business operations into different product-markets, a divisional structure might become appropriate. A division is an area of operations, defined by:

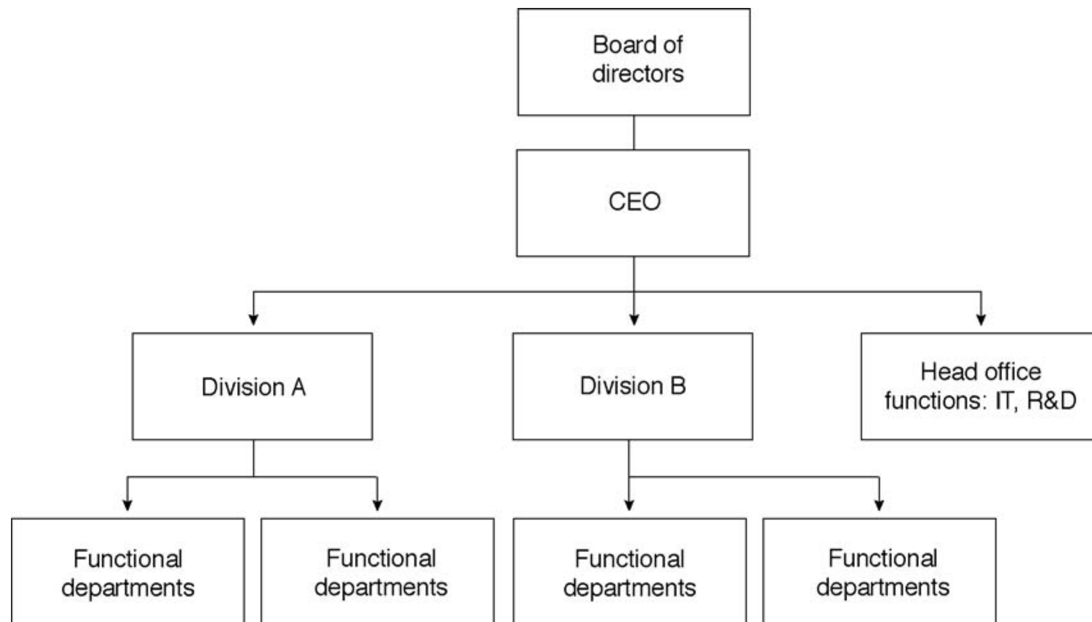
- markets in different geographical areas (for example, the European and the North American divisions).
- different products (for example the bus division and the rail division of a transport company).
- different customers (for example, industrial products and consumer products).

A division might be a strategic business unit of the entity (group). Each division has its own functional departments, such as marketing and sales, operations (production), accounting and finance, and so on.

Authority is delegated from head office to the divisional management (led perhaps by a divisional managing director), and responsibility for the implementation of product-market strategy is mainly at divisional level.

Head office retains overall control, and there may be some head office functions providing support services to all the divisions, such as corporate strategy, IT and research and development.

The simple organisation chart below shows the organisation structure for a divisionalised organisation with two divisions, where IT and research and development are head office support functions.



1.6 Matrix organisation structure

Some entities have developed a matrix organisation structure for some of their activities. The matrix organisation originated in the 1950s and 1960s, in entities where it was recognised that different functions within the entity needed to work closely together. Horizontal relationships across different functions were as important as the 'traditional' reporting relationship within functions.

Matrix organisations and project organisation structures were both first used in the defence and aerospace industries, where companies were required to carry out major projects for customers, such as building a quantity of aircraft for a government customer.

The challenge was to complete projects on time and on budget. However, the traditional functional structure within the construction companies meant that no one was responsible for the project as a whole. A matrix organisation or project management organisation was introduced to overcome the problem.

- Project managers were appointed with overall responsibility for individual projects. Project managers had to organise the efforts of individuals in all the different functions.
- At the same time, functional managers such as management of engineering, production and sales and marketing, retained their decision-making authority.

In this way, a dual command structure was created. In a matrix organisation, the traditional vertical command structure has an overlay of horizontal authority or influence.

A matrix organisation has been defined as: 'any organisation that employs a multiple command system that includes not only a multiple command structure but also related support mechanisms and an associated organisational culture and behaviour pattern' (Davis and Lawrence 1977).

The difference between a matrix organisation structure and a project organisation is that with a project organisation, the project management comes to an end when the project ends. With matrix organisation, the matrix structure of authority and command is permanent.

Functional managers	→	**Production**	**Quality control**	**Design**
Project managers ↓			↑ Responsible to quality control manager	
Project A				
Project B	← Responsible to Project Manager B		Quality control expert	
Project C				

In the diagram above, the person shown is a quality control expert and is responsible to the quality control manager for technical aspects of the job, maintaining quality systems and so on.

The person is also responsible to the manager of Project B. That manager will be concerned with completing the project on time, within the cost budget and to the proper standard.

Obviously conflicts can arise: the project manager might want to skip some tests to make up time, but the quality control department won't want to do that. Both can put the employee under some pressure. However the matrix structure should allow the employee to ask the two managers to discuss the problem, as it is plain that they are both involved.

Overall, matrix structures should:

- encourage communication
- place emphasis on 'getting the job done' rather then each manager defending his or her own position.

Examples

Examples of matrix organisations are as follows.

- A large company in which there are:
  - divisional managers responsible for a geographical market or a particular product, and for the profitability of the market or the product, and in addition
  - functional managers at head office responsible for the major functions across the entire entity – for production marketing and sales, human resources management and so on.
- A university in which there is a traditional command structure based on heads of faculty and heads of department, but in addition a course-based management

structure in which individual lecturers are responsible for all aspects of particular courses or degree programmes (for example, obtaining and managing the teachers from different faculties or departments, finding the lecture rooms, marking the examinations, and so on).

1.7 Project-based and team-based structures

In addition to having a formal management structure, entities might also used project teams and other management teams to implement some activities.

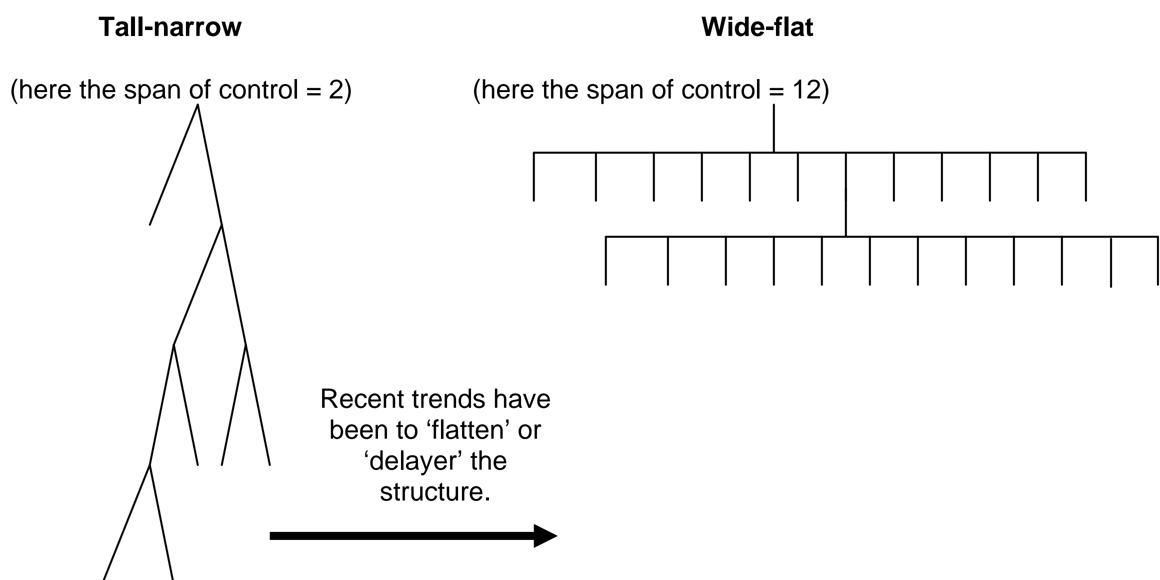
Project teams are usually assembled to accomplish a specific task, such as introducing a new system or a new process. The project team should consist of members from different disciplines or functions, so that a wide range of skills is assembled to implement the project.

Project teams might be used for implementing planned strategic changes.

1.8 Span of control

The span of control refers to the number of people who directly report to a manager in a hierarchical management 'command' structure. There are two extreme shapes:

- **Tall-narrow**. In this type of structure, each manager has a small number of subordinates reporting directly to him. As a result, in a large organisation, there are many layers of management from the top down to supervisor level. The span of control is narrow, and the shape of the organisation structure is tall, because of the many layers of management.
- **Wide-flat**. In this type of structure each manager has a large number of subordinates reporting directly to him. As a result, even in a large organisation, there are only a few layers of management from the top down to supervisor level. The span of control is wide, and the shape of the organisation structure is flat, because of the small number o f management levels.



The tall-narrow structure often has the following characteristics.

- Formality in relationships between managers and subordinates.
- Close supervision, with managers spending much of their time monitoring the work of subordinates and giving them directions.
- Task specialisation, with a small group of manager and subordinates specialising in a very narrow aspect of the entity's operations.
- A strong cultural and procedural emphasis on formal roles, job titles and job descriptions.
- Slow vertical communication. Because of the many levels of management, it can take a long time for information to get from top to bottom of the management hierarchy, and from bottom to top. As a result, tall-narrow organisations can be slow to react to change.

The wide-flat organisation structure often shows the following characteristics, where the work is **fairly complex** and **non-routine**.

- Greater egalitarianism. 'Bosses' and 'subordinates' will often respect each other for their skills and experience, and will treat each other as equals.
- Team-work and co-operation.
- Greater delegation of responsibility to subordinates. Managers have too many subordinates to apply close control. Managers must therefore trust subordinates to get on with their work, with relatively little supervision.
- Flexibility. There is less emphasis on roles and job descriptions, and individuals are more willing to switch from doing one type of task to another, as the demands of the work change.
- There is rapid vertical communication and decision-making. Information travels quickly from top to bottom of the organisation structure and from bottom to top.

Wider and flatter organisation structures have replaced tall bureaucratic structures in many organisations. The reasons why wide-flat organisations are often preferred are as follows.

- Wide-flat structures are more suitable to rapidly-changing business environments, where entities must respond to changes quickly and with flexibility. An organisation in which information travels quickly and decisions can be made quickly is more appropriate in these circumstances that a structure that is more formal and hierarchical.
- Cost savings. It has been argued that in a tall-narrow organisation, managers spend too much time managing each other, instead of adding value. If middle managers do not add value, they should be eliminated from the organisation structure.

1.9 Organisational processes

Actions are implemented within an entity through established processes. The processes that are used within an entity vary. As explained above, they differ between tall-narrow organisation structures and wide-flat organisations.

Processes affect the way that plans are made and implemented, and activities are controlled. The nature of planning and control can differ widely between different entities.

- At one extreme, actions are controlled through direct and close supervision of the work of individuals by their supervisor or superior manager.
- At the other extreme, there is minimal supervision, and control is exercised mainly by the individual himself.

Example

Some investment banks have developed very complex financial products which they sell to customers or trade for profit.

Due to their complexity, senior management do not understand the products in any great detail. They rely on small investment management teams to use and develop new products that are consistent with the bank's strategic intent.

Supervision is therefore minimal, and control is often exercised through self-control by the individual product experts.

Internal and external relationships

- Organisational relationships and implementing strategy
- Internal relationships: centralisation versus decentralisation
- External relationships
- Outsourcing
- The virtual organisation

2 Internal and external relationships

2.1 Organisational relationships and implementing strategy

Plans are put into action by the co-ordinated efforts of many individuals and groups within the entity. The way in which plans are implemented depends on:

- the nature of internal relationships: these are relationships between different parts of the organisation
- the nature of external relationships: in many entities a significant amount of work is done by other entities and individuals who are external to the entity and not a part of it.

2.2 Internal relationships: centralisation versus decentralisation

An important aspect of internal relationships is the extent to which decision-making is centralised, so that major planning decisions are made (and implemented) by 'head office', or decentralised.

- In a centralised organisation, senior management retain most (or all) of the authority to make the important decisions.
- In a decentralised organisation, the authority to take major decisions is delegated to the management of units at lower levels in the organisation structure, such as SBU managers, and divisional managers.

The choice between a centralised and a decentralised organisation depends to some extent on the preference of senior management. However, the size and complexity of the entity also influence the extent to which decision-making, planning and control are centralised or decentralise ('devolved'). It is difficult to control a large and complex entity from head office, without delegating substantial amounts of authority to divisional managers.

Advantages of centralisation

Advantages of centralisation are as follows.

- Decisions by management are more likely to be taken with regard for the corporate objectives of the entity as a whole. There is a very strong argument in favour of making strategic decisions centrally.

- Decisions by management should be co-ordinated more effectively if all the key decisions are taken centrally.
- In a crisis, it is easier to make important decisions centrally.

Advantages of decentralisation/devolution of authority

Advantages of decentralisation are as follows.

- In many situations, junior ('local') managers have much better knowledge than senior management about operational conditions. Tactical and operational decisions are probably better when taken by local management, particularly in a large organisation.
- Giving authority to managers at divisional level and below helps to motivate the management team.
- Decisions can be taken more quickly at a local level, because they do not have to be referred to head office.
- In a large and complex organisation, many decisions have to be made – probably too many for senior management at head office.

The appropriate amount of centralisation or decentralisation for an entity will depend on the circumstances.

It has already been suggested (**Greiner's growth model**) that as it gets larger, an entity might go through periods of centralisation, decentralisation and co-ordination between local management and head office.

2.3 External relationships

An entity might use external relationships to deliver a particular strategy. These are relationships with other entities, or with individuals who are not a part of the entity but are external to it. External relationships may take the form of:

- strategic alliances
- value networks
- outsourcing of functions
- virtual organisation

Strategic alliances (including joint ventures) and value networks have been described in earlier chapters.

2.4 Outsourcing

An entity does not need to carry out operations itself. Instead, it can outsource work to a sub-contractor.

Outsourcing is common in certain industries, such as the construction industry. It is also common to outsource 'non-core' activities, such as the management of the entity's fleet of motor vehicles, security services, some IT work and some accountancy work (for example, payroll operations).

The size of an entity, and its organisation structure, will depend to some extent on how much of its operational activities it chooses to outsource.

The reasons for outsourcing

Outsourcing is consistent with the view that an entity achieves competitive advantage by concentrating on its core competencies. It does not achieve competitive advantage doing work that can be done just as well – if not much better – by another entity.

- The entity should therefore focus activities within the entity on core competencies, with the aim of gaining more competitive advantage in these core areas.
- The entity should outsource work to entities that have core competencies in these areas of work. They should be able to add value more effectively than the entity would if it were to carry out the work internally instead of outsourcing it.
- The outsourced work might require specialist skills that the entity cannot employ internally, because it cannot offer enough work or a career structure to full-time specialists. It therefore outsources its specialist work to specialist firms.

Problems with outsourcing

The nature of the relationship with suppliers of outsourced work is critical to the successful implementation of strategy.

A potential problem with outsourcing is the loss of control over the outsourced activities. This can be significant when something goes wrong, and action performance does not meet expectations.

For example a company might outsource its IT work and might commission a software company to write some new software. The software, when written, might not function properly. The problem is then to manage the external relationship with the software company, to find a satisfactory solution to the problem.

2.5 The virtual organisation

The virtual company or virtual organisation does not have an identifiable physical existence, in the sense that it does not have a head office or operational premises. It might not have any employees.

A virtual organisation is operated by means of:

- IT systems and communications networks – normally telephone and e-mail
- business contacts for outsourcing all operations.

Many small businesses operate as virtual organisations. For example, a house builder might operate his business from his home. When asked to build a new house, he can hire all the labour – skilled and unskilled – that he needs to do the work, supervise it and check it. He can employ a firm of accountants to deal with the invoicing and payments. The builder does not need an office, or full-time

employees. His core competence is his personal skill and experience, which he should use to give his firm its competitive advantage over rival house builders.

In the same way, there is no reason why a larger business should not be operated as a virtual company. For example, a company that sells branded footwear could operate as a virtual company, using its brand name as its major core competence. It could outsource all its value chain and support activities. Manufacture could be outsourced to producers in developing countries, warehousing companies could be used to hold inventories. A network of self-employed sales representatives might be used to sell the footwear into retail organisations, and marketing activities might be outsourced to an external agency.

One person, or a small number of individuals, can operate a virtual organisation and indirectly control the actions of many 'external' entities and individuals.

A key to a successful virtual organisation is the successful management of all the different external relationships, and successful co-ordination of their activities.

The most appropriate organisation structure

- Contingency theory of organisation structure
- Burns and Stalker: mechanistic and organic structures
- Mintzberg's five building blocks for organisational configurations
- Mintzberg's six organisational configurations
- Conclusion: the most appropriate organisation structure

3 The most appropriate organisation structure

3.1 Contingency theory of organisation structure

Contingency theory of organisation structure is that the most effective organisation structure for an entity depends on the circumstances. An entity should use the organisation structure that is best suited to its size, complexity and strategies. Organisation structure will vary according to differences in organisational processes and internal and external relationships.

3.2 Burns and Stalker: mechanistic and organic structures

An example of contingency theory is the management study of Burns and Stalker. They identified two categories of organisation structure, a mechanistic structure and an organic structure.

The differences between the two types of structure are set out in the table below.

Mechanistic organisation	Organic organisation
Authority is delegated through a hierarchical management structure. Power over decision-making is obtained from a person's position in the management hierarchy.	There is a network structure of control. Individuals influence decisions on the basis of their knowledge and skills, regardless of their position in the organisation.
A bureaucracy.	Control is cultural, not bureaucratic.
Communication is vertical, up and down the chain of command.	There is much more horizontal communication and free-flow of information.
Jobs are specialised, and individuals concentrate on their specialist area. Doing the job is the main priority.	Specialist knowledge and expertise are shared, and contribute to the 'common task' of the entity. Contributing to the common task is the main priority.
Job descriptions are precise.	Job descriptions are less precise.
Tasks and operations are governed by instructions from a superior manager.	Communications consist of information and advice, rather than decisions and instructions from a manager.

Burns and Stalker found from their research that one type of organisation is not necessarily better than the other. However, they did find that:

- an organic structure is better-suited to an entity that needs to be responsive to change in its products and markets, and in its environment
- a mechanistic structure is better suited to an entity in a stable environment, where change is gradual.

Burns and Stalker also found that entities with an organisation structure better suited to their environment perform better than entities whose structure is not well suited to their environment. For example an entity with a mechanistic structure performs better in a stable market than an entity with an organic structure.

Example

It is important to recognise that the most suitable organisation structure depends partly on circumstances and partly on management preference. Organisation structures can also be changed.

An example is Nestlé. In an article in the Financial Times newspaper (22 February 2005), the CEO of Nestlé explained that in the past he had been frustrated by the minor role played by the marketing function in the company. He had also disliked the matrix organisation structure used by the company, where 'local' managers were responsible for the profitability of their local markets, and functions such as marketing had responsibility for their functions, but not for markets. The marketing management were responsible for some innovation, but not for country performance. Marketing managers had targets for returns on investment in advertising, rather than responsibility for returns on business investment.

This organisation structure was changed. The head of marketing was made responsible for the company's seven strategic business units – dairy, confectionery, beverages, ice cream, food, pet care and food services. These units established the global business strategy for the company's product markets. They were responsible for research and development, production expertise and systems control.

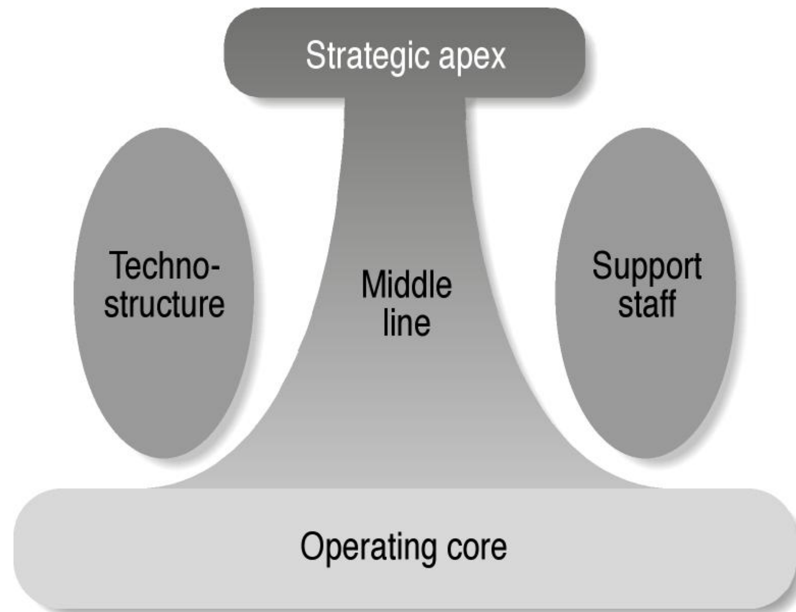
Regional business strategy was developed from the business strategies for each of the SBUs. Local market strategy was developed from the regional business strategies. In this way, the head of marketing became a key figure in strategic management. He had to authorise every new factory opening by guaranteeing the capacity utilisation of the factory and the return on investment.

The change in organisation structure, giving much more responsibility to the marketing function, was the result of management preference rather than strategic necessity. Clearly, however, the CEO believed that the new structure would be more effective.

3.3 Mintzberg's five building blocks for organisational configurations

Mintzberg argues that an organisation structure exists to co-ordinate the activities of different individuals and work processes, and to implement plans into action. The nature of the organisation structure varies with differences in processes and internal and external relationships. He suggested that there are five elements or 'building blocks' in an organisation. The way in which an entity is organised most effectively depends on which of these elements is dominant.

These five elements are shown in the diagram below.



- **Strategic apex**. This is the top management in the organisation.
- **Operating core**. This represents the basic work of the organisation, and the individuals who carry out this work.
- **Middle line**. These are the managers and the management structure between the strategic apex and the operating core.
- **Support staff**. These are the staff who provide support for the operating core, such as secretarial staff, cleaning staff, repair and maintenance staff, IT staff and so on.
- **Technostructure**. These are staff without direct line management responsibilities, but who seek to standardise the way the organisation works. They produce procedures and systems manuals that others are expected to follow.

Mintzberg argued that the group that has the greatest influence determines the way in which the entity is organised, and the way that its processes and its relationships operate.

- When the strategic apex is powerful, the organisation is entrepreneurial. The leaders give the organisation its sense of direction and take most of the decisions.

- When the technostructure is dominant, the organisation often has the characteristics of a bureaucracy, with organising, planning and controlling prominent activities. The organisation continually seeks greater efficiency.
- When the organisation is divisionalised and local managers are given extensive authority to run their own division in the way that they consider best, the middle line is dominant.
- Some organisations are dominated by their operating core, where the basic 'workers' are highly-skilled and seek to achieve proficiency in the work that they do. Examples might be schools, universities, and hospitals, where the teachers and doctors can have an exceptionally strong influence.
- In a professional bureaucracy, such as a firm of accountants or lawyers, the middle line tends to be short (close contact between the partners and staff). Unexpectedly, in view of the amount of standardised audit documentation, the technostructure is small. This is because, although the documentation is extensive, the use of the documentation is unique for each client. No two audits or law cases are the same, so standardisation must be limited.

3.4 Mintzberg's six organisational configurations

Mintzberg identified six different organisational configurations, each having a different mix of the five building blocks. He suggested that the most suitable organisational configuration would depend on the type and complexity of the work done by the entity. The six configurations are:

- simple structure
- machine bureaucracy
- professional bureaucracy
- divisionalised form
- adhocracy
- missionary organisation

Simple structure

This is found in an entrepreneurial company. The strategic apex exercises direct control over the operating core, and there is no middle line. There is also little or no support staff or technostructure. The strategic apex might be an owner-director of the company. This type of structure is very flexible, and can react quickly to changes in the environment, because the strategic apex controls the operating core directly.

Machine bureaucracy

In a machine bureaucracy, the technostructure is the dominant element in the organisation. The entity is controlled and regulated by a bureaucracy and the emphasis is on control through regulation. It is difficult for an entity with this type of organisation to react quickly to environmental change. This structure is therefore more suitable for entities that operate in a stable business environment.

Professional bureaucracy

In this type of structure, the operating core is the dominant element. Mintzberg gave the name 'professional bureaucracy' to this type of structure because it is often found in entities where the operating core consists of highly-skilled professional individuals (such as investment bankers in a bank, programmers in a software firm, doctors in a hospital, accountants and lawyers in a professional practice, and so on).

Divisionalised form

In this type of structure, the middle line is the dominant element. There is a large group of powerful executive managers, and the organisation structure is a divisionalised structure, each led by a divisional manager. In some divisionalised structures, divisional managers are very powerful, and are able to restrict the influence of the strategic apex on decision-making.

Adhocracy

Mintzberg identified a type of organisation that he called an 'adhocracy'. This is an organisation with a complex and disordered structure, making extensive use of teamwork and project-based work. This type of organisation will be found in a complex and dynamic business environment, where innovation is essential for success. These organisations might establish working relationships with external consultancies and experts. The 'support staff' element can therefore be very important.

Missionary organisations

In this type of organisation, all the members share a common set of beliefs and values. There is usually an unwillingness to compromise or accept change. This type of organisation is only appropriate for small entities that operate in simple and fairly static business environments.

Differences between the six organisational configurations

The differences between the six organisational configurations are summarised below. Note in particular how each configuration is likely to be suitable for different types of business environment and different types of organisational relationships. The main controlling and co-ordinating factor within each type of configuration also differs.

	Business environment	**Internal features**	**Key organisational element**	**Main co-ordinating factor**
Simple structure	Simple and dynamic	Small entity Simple tasks	Strategic apex	Direct control by strategic apex
Machine bureaucracy	Simple and static	Large and well-established. Regulated processes and systems	Technostructure	Standardised procedures

Table continued

Professional bureaucracy	Complex but static	Simple processes. Control by the professionals	Operating core	Standardisation of skills
Divisionalised form	Fairly static Diverse activities	Large and well-established. Divided activities	Middle line	Standardisation of outputs
Adhocracy	Complex and dynamic	Complex tasks. Young entity	Support staff or operating core	Flexibility and adaptation
Missionary organisation	Simple and static	Simple systems. Fairly well established (not young)	-	Standard beliefs and values

3.5 Conclusion: the most appropriate organisation structure

The organisational configurations suggested by Mintzberg, or the idea of Burns and Stalker, can be used to consider whether the organisation structure of an entity is well-suited to its circumstances and situation. The key point to note is that the organisation structure should be designed to enable the entity to implement its strategies successfully.

Johnson, Scholes and Whittington have commented: 'Poor performance might be the result of an inappropriate configuration for the situation or inconsistency between structure, processes and relationships.'

Strategic change

- The nature of change
- Triggers for change
- Consequences of change
- Attitudes to change

4 Strategic change

4.1 The nature of change

Change happens continually within organisations and their markets. Strategic development inevitably results in some change, which needs careful management. Change is either planned or unplanned.

- **Planned change** (or **proactive change**) is deliberate and intended. The entity makes the change to move from an existing situation (or way of doing things) to a new situation.
- **Unplanned change** (or **reactive change**) happens in response to developments, events and new circumstances that have arisen. The change is not intended in advance.

With planned change, the entity might see an opportunity to develop. Unplanned change is often seen as a reaction to a threat or an adverse event.

Change is either incremental or transformational.

- **Incremental change**is a fairly small change. This type of change happens without the need for a major reorganisation or restructuring of the organisation and its systems and procedures. The entity should be able to adapt easily to the change.
- **Transformational change** is a big change. A transformational change requires a major reorganisation or a restructuring of the organisation and its systems and procedures. The change has a big impact on the entity, and also on the people working in it.

Transformational change requires change management skills from the managers who are responsible for introducing the change (the 'change managers').

Change is also either:

- a 'one-off' event, so that the entity moves quickly from the old state of affairs to a new state of affairs, or
- a continuing process of development and change over a long period of time.

4.2 Triggers for change

Triggers for change are the reasons for making a change, or the reasons for the motivation to change. A trigger for change might come from either outside or inside the entity.

External triggers for change

External triggers for change are caused by changes in the environment. The PESTEL analysis of the external environment provides a useful framework for analysing external reasons for change.

Political reasons for change

- Changes in strategy might be caused by an unexpected political crisis – such as a civil war or major civil unrest – in a country that is either a major source of supply or a major export market.

Economic reasons for change

- Unexpected developments in the economies of various countries might result in a change of strategy on foreign sales or expansion into foreign markets.

Social and cultural reasons for change

- Changing public attitudes and opinions might persuade an entity to alter its strategy. For example, changing public attitudes to food safety following a 'health scare' about a food product might persuade a food manufacturer to change its strategy to the design and production of its products.
- Changing public attitudes to retirement age might persuade an entity to change its retirement policy for employees, and its human resource plan.

Technological reasons for change

- The significance of technological development has been mentioned earlier.

Ecological/environmental reasons for change

- Change might be driven by ecological change, such as diminishing supplies of fresh water, diminishing supplies of energy or factors related to climate change. These changes might force a company to consider how its businesses will continue to survive in the future, and what changes will be needed to make the business sustainable.

Legal reasons for change

- New laws on health and safety at work, laws against pollution and laws to protect the environment might have an impact on strategy and procedures.

Internal triggers for change

Change might be motivated or caused by developments within the organisation.

- **Change of senior management**. When there is a new senior manager, such as a new chief executive officer or managing director, the new person in charge might want to introduce change because he has his own ideas about how things should be done.
- **Acquisitions and mergers**. When there is a large acquisition or a merger, major changes will probably be required to integrate the two separate firms into a single entity.
- **Demergers and divestments**. Similarly, when an entity is split up into two separate entities (a demerger) or when a large part of the entity is sold off (a divestment), changes in organisation, management and systems will be necessary.
- **Reorganisation, downsizing and rationalisation**. Change might be necessary because the current organisation and systems are no longer appropriate and change is needed. This might happen when a loss-making entity needs to close down an operating division, or needs to reduce the size of its total workforce. Current operational systems might need to change because they are no longer appropriate and have become inefficient or ineffective.

4.3 Consequences of change

Transformational change must be managed carefully. It is extremely difficult to introduce major changes without causing disruption. Many changes fail to achieve the planned benefits because of the difficulties experienced with implementing the change.

Change management requires:

- identification of the strategic changes that should be made
- recognising the need to change systems and organisation structures to make the changes work successfully
- recognising the effect of change on employees: this aspect of change management is often overlooked, but is probably the most common reason why attempts to make major changes are unsuccessful
- careful planning and implementation of the change
- making sure that the changes 'stick' and remain in place, after they have been made.

There are several strategic models for the management of change. All models for change management recognise the importance of people and attitudes to change.

4.4 Attitudes to change

Some employees might welcome change and support the changes. More often, however, employees fear change and resist change. Attitudes and culture may therefore act as **blockages to change**. Here are several reasons for opposing change:

Reasons related to the job

- Employees might believe that the change will put their job at risk, and make them redundant.
- Employees might believe that their existing skills will no longer be required. This is why employees often resist major technological changes.
- Employees might fear that their working conditions will change for the worse.

Personal reasons and fears

- Employees might fear that the change will make them less important to their employer.
- They might believe that the call for a change is a criticism of the way they have been working.
- They might think that after the change, their work will be less interesting. They might be reluctant to learn new ways of working.
- They might fear the unknown.

Social reasons

- Employees might resist change because they believe it will break up their work group, and separate them from the people they enjoy working with.
- They might think that after the change, they will be forced to work on their own more, and there will be less interaction with colleagues.
- They might dislike the manager who is forcing through the change.
- They might dislike the way that the change is being introduced, without consultation with the employees affected.

Change and organisation culture

Some entities are more capable of adapting to change than others. The reasons listed above, and the earlier description of the cultural web, might suggest reasons why resistance to major changes could be strong. Some entities, however, are better at adapting to change than others, and in some entities, change might be seen as a 'good thing'.

The management writer Elizabeth Ross Kanter suggested that there are cultural reasons why an organisation might be more change-adept than others. According to Kanter, change-adept organisations have three key attributes:

- The **imagination to innovate**. This comes from a leadership that seeks new ideas for positive change.
- The **professionalism to perform**. The management of the entity are competent at introducing change. In addition, the workforce has been suitably trained and developed, and has the ability to support its management in introducing change.
- The **openness to collaborate**. Change-adept entities share ideas with other entities, such as suppliers and joint venture partners, and are able to work well with other entities in making changes.

Kanter argued that change should be accepted by entities as something that is natural, desirable and welcome. When change occurs as a defensive reaction, in response to a threat, it is not welcomed. However, it is more appropriate to see change as an opportunity for the successful implementation of business strategies.

Entities that welcome change are most likely to be the first to innovate and adapt to new technology, or entities with an ability to create sustainable competitive advantage by creating extra value for its customers. Kanter argued that entities that are change-adept are 'fast, agile, intuitive and innovative'.

Managing strategic change

- Guidelines for change management: change levers and management skills
- Lewin: force field analysis
- Lewin: unfreeze, change, re-freeze
- The change agent
- The Gemini 4Rs
- The 7S approach

5 Managing strategic change

5.1 Guidelines for change management: change levers and management skills

A general guideline for managing strategic change is as follows:

- When change is planned, managing the change involves deciding how to get from where we are to where we want to be, and recognising the changes that are necessary to get there.
- The change process consists of planning the changes, implementing them and then maintaining the change, so that there is no 'going back' to former ways and methods of operating.
- There are several requirements for successful change. These are often referred to as **levers of change**.

Levers of change

The following requirements are needed for successful implementation of change.

- A clear understanding of the need for change, and what will be the desired result of the change.
- The commitment of the entity's leaders to the change.
- Effective communication with everyone affected by the change. This should be two-way communication. Management should listen as well as explain.
- Management should have the required qualities to implement change successfully. Leadership qualities for managing change are described later.
- The organisation structure and relationships within the organisation should be adapted to meet the requirements of change.
- Reward systems should be amended, so that rewards to managers and other employees are based on performance targets that are consistent with the requirements of the change.
- Critical success factors and key performance indicators should be revised, so that they are consistent with the requirements of the change.
- Employees should be given education in the purpose of change and training to meet the operational requirements of the change.

Skills for managing change

Rosabeth Moss Kanter suggested that a manager in a change-adept entity should have the following skills.

- **Tuning in to the environment**. Managers need to be aware of changes in the environment that will make change by the entity necessary or desirable. Kanter suggested that managers should create a network of 'listening posts' that they should use to monitor environmental change. She commented: 'Pay special attention to customer complaints, which are often your best source of information about an operational weakness or unmet need. Also search out broader signs of change – a competitor doing something differently or a customer using your product or service in unexpected ways.'
- **Challenging the prevailing organisational wisdom**. Change managers should be prepared to challenge the 'conventional wisdom' and question accepted views about what is necessary or the way that things should be done.
- **Communicating a compelling aspiration**. A change manager should have a clear idea of what he wants to achieve and should communicate this 'vision' to everyone he deals with. The manager must have personal conviction that the change is necessary. Without this sense of purpose, he will not be able to 'sell' the need for change to others.
- **Building coalitions**. Managers cannot make change happen through personal effort alone. They need to win the support and co-operation of all the individuals with the knowledge, influence or resources to make change happen. Making change happen is therefore a process of building alliances and support.
- **Learning to persevere**. Managers should continue with the process of change even though there are likely to be setbacks and 'defeats' on the way.
- **Making everyone a hero**. The manager should give full credit to everyone who helps to introduce change successfully, and should make them feel that their efforts are fully appreciated. If possible, individuals who help to introduce changes successfully should be rewarded.

Models for managing change

There have been several different suggestions about how transformational change might be managed. Several of these 'models' for change are described in the remainder of this section.

5.2 Lewin: force field analysis

Kurt Lewin was a social psychologist. He developed a theory, which he called force field analysis, to describe the forces that came into conflict over planned changes. He suggested that there are two opposing forces:

- the **driving forces** that support the need for change, and
- the **restraining forces** that oppose and resist the change.

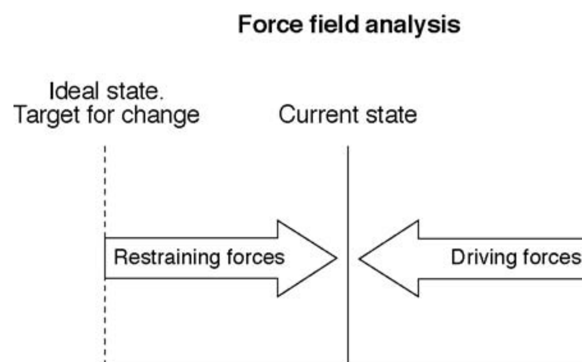
Any of the following factors might be a driving force or a restraining force:

- the people involved in the change, and what they want for themselves

- the habits and customs of the individuals
- their attitudes
- the relationships between the people involved
- organisation structures within the entity
- vested interests
- the entity's policies
- the resources available to make the change
- regulations
- events (happenings).

Lewin argued that each driving force or restraining force has a strength, which might be measured on a scale of 1 to 5. The strength of the total driving forces and the strength of the total restraining forces can therefore be measured.

Force field analysis



Lewin also argued that:

- Change will not occur if the forces resisting the change are stronger than the driving forces for change.
- Change is only possible when the driving forces for change are stronger than the restraining forces against change.

A key task of the change manager is therefore to ensure that the strength of the driving forces is stronger than the strength of the restraining forces. There are two ways that this might be done:

- **Strengthen the driving forces for change**

  It might seem that the best answer is to strengthen the driving forces for change. However, Lewin argued that by increasing the driving forces, management run the risk that the restraining forces against the change will also grow stronger.
- The best approach is therefore to try to **reduce the restraining forces against change**. Management should therefore:
  - identify the main restraining forces against change and
  - consider ways of reducing their strength, for example by discussing the issues and difficulties with the individuals concerned, or by trying to win the support of key individuals who currently oppose the change.

5.3 Lewin: unfreeze, change, re-freeze

Lewin also suggested an approach to introducing planned transformational change, which is sometimes called 'prescriptive planned change theory'.

He suggested that a planned process for change should begin with:

- identifying the cause of the problems, and the reasons why change is needed, and
- identifying the opportunities of making improvements through transformational change.

The change process then needs to go through three stages:

- unfreeze
- movement (change)
- re-freeze.

Unfreeze

The process of 'unfreezing' is persuading employees that change is necessary. Individuals will not want to change anything if they think that the current situation is acceptable. Employees should therefore be encouraged to recognise what is wrong with the current system or current situation and management should encourage employees to feel dissatisfaction. Employees should be 'unfrozen' out of their acceptance of the current situation

However, this is not enough. It is also necessary to offer employees an attractive alternative for the future that can be reached by changing the current situation.

Management must therefore have a clear vision about what changes they want to make, and they should encourage employees to want these changes to happen.

Management must therefore discuss the problems with the employees affected, and communicate their ideas.

Unfreezing is therefore the process not only of making employees dissatisfied with the current situation, but also persuading them about the nature of the changes that should be made.

Movement (change)

The changes should then be made.

To introduce change successfully, the support for change must be strong enough to overcome the opposition. This is consistent with Lewin's force field analysis.

Management should be given sufficient resources to implement the changes. (Having sufficient resources to make a change can be a driving force for change.)

The change managers should try to involve the employees affected and get them to participate in making the changes. Participation in making changes helps to reduce the resistance to change.

Re-freeze

Lewin argued that even if change is implemented, there is a risk that before long, employees will go back to their old ways of doing things, and the benefits of the change might be lost.

It is therefore essential that once change has happened, employees should be encouraged to carry on with the new way of doing things.

One way of doing this might be to reward employees for performance based on the desired behaviour and results.

The process of getting employees to carry on with the new system is called re-freezing.

5.4 The 'change agent'

When a transformational change is implemented, there has to be a 'change agent' who drives the change and is responsible for its successful implementation. Often the change agent is an outside consultant. This individual must have certain skills.

- He must explain the reasons for the change, and provide employees with reliable information. This will help to reduce the risk of false rumours spreading.
- As far as possible, he should involve the individuals affected, and get them to participate in making the changes. When individuals are involved in the change process, they are less likely to resist it.
- He should maintain communications with employees at all time, monitoring the progress of the change and providing information to others about the progress.
- Where appropriate, he should provide training to the employees affected.
- He should emphasise the benefits of the change to the individuals affected.

A consultant is often used because:

- An outside consultant is perceived to be independent and fair.
- The consultant will have experience in managing the change process.
- The consultant will have experience of many organisations and should be able to advise on which changes are desirable
- Large-scale changes can easily go wrong. Management will want all the help and advice available.

5.5 The Gemini 4Rs

Another model for introducing transformational change was promoted by Gemini Consultants. This is known as the 4Rs model.

The elements of the model are as follows.

Re-frame	Create the desire for change. Create a vision of what the entity is trying to achieve. Create a measurement system to set targets for change and measure performance.
Re-structure	Examine the organisation structure, and create an economic model showing how value is created by the entity, and therefore where resources should be used. Re-design the processes so that they work better to create more value.
Revitalise	This is the entity's commitment to the future. Find new products and new markets that fit well with the entity's environment. Invent new businesses. Change the rules of competition by making use of new technology.
Renew	Develop individuals within the organisation. Make sure that employees have the skills that are needed and that they support the change process. Create a reward system to motivate individuals to seek change. Develop individual learning and creativity within the entity.

5.6 The 7S approach

The 7S Framework was first published in 1981 and was subsequently adopted by the consultancy firm McKinsey. It is therefore sometimes known as the McKinsey 7S model. It is a model for the successful implementation of strategic change.

The 7S model consists of seven factors that contribute to the effectiveness of an entity. It is based on the view that in order to introduce strategic change, managers must take into consideration all seven of the following factors (the 7Ss)

These seven factors consist of three 'hard' factors and four 'soft' factors.

Hard factors

Strategy	This consists of the formally stated goals and objectives of the entity, and a plan for allocating the entity's resources to activities in order to achieve those goals.
Structure	This is the formal organisation structure of the entity. It is concerned with the division of responsibilities and the allocation of authority for the achievement of the strategic goals.

Systems	These are the systems that operate within the organisation, including manufacturing systems, procedures and information systems.
Soft factors	
Staff	These are the people who work for the organisation, and their attributes – numbers, motivation, loyalty, pay rates, working conditions, career advancement, and so on.
Skills	These are the skills of key personnel. What can they do well, and what do they do badly?
Style	Style refers to the cultural characteristics of the entity and the people who work in it, and also the leadership style of its managers.
Shared values	These are the guiding beliefs about the purpose of the entity and why it exists, shared by the individuals who work in it. These might be, for example: 'providing customer service and satisfaction', or 'making profits', or 'providing a service to the community'.

The hard factors are so-called because they are relatively easy to define: strategy can be recorded in a strategic plan, structure on an organisation chart and systems in a procedures manual.

The soft factors are harder to identify and define. Of course there are elements of these factors that are relatively easy to define (such as wage rates) but there are factors that are more difficult to pin down (such as staff motivation and loyalty).

All seven factors are inter-related. The 7S model is therefore often depicted as a molecule with seven atoms (balls) all joined to each other by molecular bonds (= the 'managerial molecule')

When making strategic change, a failure to take any one of the seven factors into consideration could have adverse implications for the other six factors, and the change will not be successful. All seven factors must therefore be given consideration when change is planned and implemented.

- When the model was first devised, research showed that in many US corporations managers tended to focus on those factors that they felt they could change – structure, strategy and systems, i.e. the **hard variables**.
- However they tended to ignore the other four factors (skills, style, staff and shared values) – i.e. the **soft variables**.
- According to McKinsey, this is why attempts at strategic change often fail.

The 7S model and change management

The 7S can be used to carry out an internal assessment of the capabilities or competencies of an entity. However, the model has other applications, and in particular it can be used to assess the possible implications of change within an organisation.

A change in any one of the S factors will have a knock-on effect, so that there might need to be changes in the other S factors too. Changes in 'hard factors' such as

operational systems or the management structure will have an impact on 'soft factors'. Problems with the soft factors could mean that changes to hard factors are difficult to implement successfully.

Example

- A company recognises that it has a weakness in its after-sales service to customers. It therefore decides to establish a new customer services department, in order to improve customer goodwill. (= Change in Strategy).
- It will need to recruit staff and organise them into customer service teams (= Change in Structure).
- The entity might recruit new staff who will have the confidence to use their initiative in dealing with individual customers (= Change in Staff)
- The staff will need suitable training in customer service skills (= Change in Skills).
- Senior management will need to promote an awareness of the need for better quality throughout the organisation (= Change in Shared values).
- New procedures need to be developed for guiding employees in how to handle customer complaints and queries (= Change in Systems).
- Although there will be procedures for handling standard problems, management and supervisors might need to learn to 'empower' their employees and allow them to use their initiative in dealing with unusual cases (= Change in Style).

Strategic changes should therefore be considered from all seven perspectives. A failure to deal with any one factor could result in a new weakness.

Using 7S model analysis

One way of using the 7S model to analyse the possible consequences of change is to take each pair of factors and consider the possible implications of a change in one factor on the other.

For example, the connections between 'structure' and 'skills' might be considered. An entity might be planning to increase the skills of a group of employees by giving them training towards a professional qualification. A possible implication of the change in skills could be that the employees, once they are trained, might expect greater responsibility for decision-making and less supervision. The change in skills would therefore have implications for the organisation and management structure.

By analysing the implications of change in this way, it should be possible to plan for the change, so that the change is carried out successfully. In the example above, the strategy to raise skills levels might be accompanied by a plan to restructure the management hierarchy, and gradually reduce the number of front-line supervisors.

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The organisational context of change

- Two models for diagnosing the organisational context of change
- Balogun and Hope Hailey: contextual features model
- Using the cultural web to analyse the context of change

6 The organisational context of change

6.1 Two models for diagnosing the organisational context of change

To achieve any substantial change in an organisation, it is essential to get the individuals involved in the change to accept it. This means:

- getting people to recognise the need for change and understand why change is necessary
- then to get them to understand what changes are needed and learn what they have to do in the changed operations or process.

The 'change agents' who are responsible for introducing the change need to:

- recognise the current situation and the readiness of individuals to accept change or their reluctance to change
- identify a suitable approach to making the change that will be successful, given the current situation
- recognise what they need to do as change agents to bring about the change and gain the acceptance of the individuals involved.

The approach to managing change should depend on the circumstances, or the context in which the change should be made. The approach should differ according to the context in which the change has to take place.

In your examination you might be required to consider a case study involving the management of strategic change, and to consider the organisational context of the change. In other words, you might be required to consider the circumstances or context in which the change will be made, and how this might affect the approach to managing the change.

There are two models that can be used for making such an analysis or diagnosis:

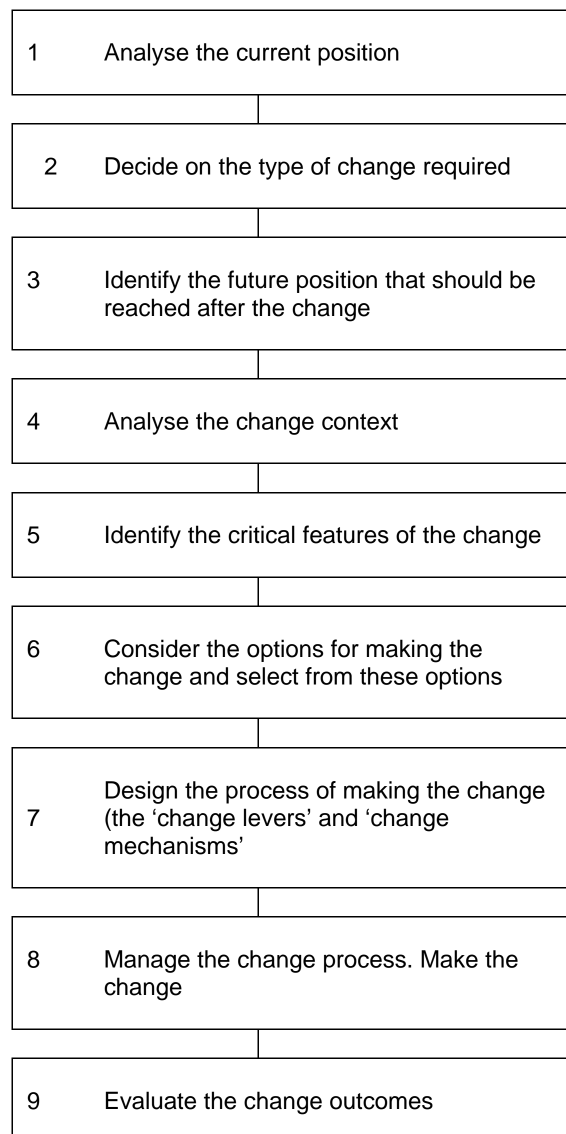
- Balogun and Hope Hailey's contextual features model
- the cultural web.

The cultural web has been described in an earlier chapter on corporate culture. This section shows how the cultural web can be used to consider the problems that might be faced in making change.

6.2 Balogun and Hope Hailey: contextual features model

Creating lasting change in an organisation can be a difficult and complex process. In order to introduce strategic change successfully, there has to be a clear plan of action. In addition, the entity must have the capacity to achieve the desired end-result.

Julia Balogun and Veronica Hope Hailey have suggested a model for change. The management of organisational change can be seen as a process with the following steps.



The nature of the change and the end result of the change (Steps 1 – 3)

The nature of the change might be gradual, or the change might be introduced suddenly, all in one go. Change can therefore be described as either:

- gradual or incremental, or
- a 'big bang': this is change that happens all at once and quickly.

The desired end-result of the change might be either:

- a transformation: this is a fundamental change in the organisation, or
- a realignment: this type of change is less fundamental than a transformation, but is still a major change.

Transformational change calls for a change in aspects of the culture of the entity, and so is more difficult to introduce successfully. A realignment does not require any cultural change, and so is more easily accepted by the individuals affected.

The nature and extent of the change can therefore be defined by a combination of two issues:

- Whether the change will be gradual or a 'big bang' and
- Whether the nature of the change will be transformational or a realignment.

Balogun and Hope-Hailey were therefore able to identify four categories of change.

		End result	
		Transformation	**Realignment**
Nature of the change	**Incremental**	Evolution	Adaptation
	'Big bang'	Revolution	Reconstruction

Realignment, whether introduced incrementally or all at once, does not alter the fundamental beliefs and culture of the organisation. Realignment is therefore usually much easier to achieve successfully than transformation. It might be either:

- incremental, and introduced gradually ('adaptation'), or
- introduced all at once (a 'reconstruction').

Evolution, which is the incremental introduction of a transformational change, can take long time to accomplish.

Revolution is the introduction of transformational change quickly and all at once. This calls for several simultaneous measures by the change managers in order to introduce the change successfully. It is the most difficult type of change to accomplish successfully.

The managers responsible for making the change need to be aware of the implications of the type of change they are trying to achieve (adaptation, reconstruction, evolution, revolution).

Analysing the context within which the change will occur (Steps 4 and 5)

Balogun and Hope-Hailey suggested that the following features can be used to assess the context, and identify the crucial features of the change situation:

1	**Time scale**	How quickly is the change needed? Will the change be incremental or 'big bang'?

2	**Scope of change**	How extensive is the change? Is it a transformation or a realignment?
3	**Preservation**	What resources and characteristics of the organisation need to be preserved? What do we want to keep maintained, unaffected by the change?
4	**Diversity**	Are the employees affected by the change a homogeneous group of similar people with similar views and culture, or are there diverse groups who will be affected?
5	**Capability**	What is the capability of the entity's management and employees for implementing the change? Do they have the capability to make the change?
6	**Capacity**	What resources are available for making the change? What resources – money, staff time – can be invested in making the change work?
7	**Readiness**	How ready for change are the employees who will be affected by it? Are they aware of the need for change? Do they agree with the proposed change? Are they motivated to make the change?
8	**Power**	What power do the managers responsible for the change have? Do they have the power to make the change? Or does someone else have power over the ability of the entity to make the change?

The design choices for making change (Steps 6 and 7)

When the organisational context of the change has been analysed, management can move on to consider the 'design for change', and how the change should be introduced. Management can consider whether the context might be improved by providing training for staff, a restructuring of the organisation, or recruiting new staff with the skills required to make the change.

Balogun and Hope have suggested that there are six key aspects of making the design choices for change:

1	**Change path**	What type of change is required: transformation or realignment, and incremental or 'big bang'?
2	**Change start point**	How is the change initiated: top-down (imposed by senior management) or bottom-up (as a result of employee initiatives)
3	**Change style**	What management style will be used for implementing the change?
4	**Change targets**	What are the targets to focus on for achieving change? Are changes in the outputs from the process needed? Are changes in attitudes and culture needed?
5	**Change levers**	What measures must be taken to implement the change to achieve the change targets?
6	**Change roles**	Who has the responsibility for managing and implementing the change?

Example

A government department wishing to introduce significant changes into the operations of the department. Its design for the change might be as follows:

1	**Change path**	Incremental, transformational change
2	**Change start point**	Top-down, to be imposed by senior management
3	**Change style**	Directive rather than collaborative. Management will impose the changes they want.

4	**Change targets**	Change targets might be specified in terms of changes in the outputs of the department, and changes in attitudes and culture
5	**Change levers**	The measures for implementing the change should be specified.
6	**Change roles**	Senior management assisted by eternal management consultants will be responsible for implementing the change.

Balogun and Hope-Hailey suggested that in order to design an appropriate change process, the change agents/managers responsible for the change need to analyse how ready the organisation is for change and how great is its capacity for making change. The change agent therefore needs:

- an ability to analyse the change context and to judge the key contextual features of the change (as described earlier)
- to design an appropriate approach to making the change
- an ability to take action to implement the change
- an ability to handle complex issues and to be sensitive about the impact of change on the individuals affected
- have good skills at influencing other people
- have an awareness of the possible impact on the design choices they make of their own personal preferences for change.

Key success factors for change are:

- a compelling vision for action and desired change
- leadership who are committed to the change
- rigorous project management, where the implementation of change is organised as a project (with detailed plans, milestones for achievement, project managers, and so on)
- securing the support of everyone affected 9the 'stakeholders')
- effective communication
- infrastructure realignment, such as making sure that sufficient staff with the necessary skills are in place for making the change, that sufficient IT resources and HR policies are in place, that budgets for the change are provided, and so on).

Making the change and moniitoring the change (Steps 8 and 9)

Balogun and Hope Hailey have suggested three levels of interaction or communication that are required by change agents with the individuals affected by change. They linked these three levels of interaction to Lewin's unfreeze, move re-freeze model for change, and also to another model for change, a transition curve suggested by Adams, Hayes and Hopson.

Their ideas are set out in the following table.

Lewin: change status	Unfreeze	Move	Re-freeze
Adams and others: state of transition	Shock then Denial	Awareness then Acceptance then Search	Integration
Requirements:	Try to minimise the shock Expect resistance Communicate early	Help individuals: give support Educate and train	Encourage reflection Support individuals in their new roles Celebrate success
Balogun and Hope Hailey: communication needs	**Create readiness** Communication must be designed to **create readiness** for change	**Provide explanations** Communication must be designed to **provide explanations**	**Provide updates** Communication must **provide updates** for all staff
	Rich communication needed	Rich communication needed	Routine communication should be sufficient
	Aims:	Aims:	Aims:
	Un-freeze employees	Reduce uncertainty	Keep staff informed
	Challenge the existing state of affairs	Provide employees with information to fulfil their roles during the change	Prevent anxiety and uncertainty
	Spread understanding of the need for change	Enable staff to undertake the needed change	

6.3 Using the cultural web to analyse the context of change

Johnson and Scholes' cultural web can also be used to analyse the organisational context of change. Significant change, particularly transformational change, requires some change to the culture of the organisation.

It is important to recognise that unless the need to change culture is recognised, the organisation and its employees will continue to be driven by the existing culture instead of the desired new ways of operating.

The cultural web can be used to analyse which aspects of the current culture need to be changed (and by how much) and which aspects of culture should be preserved and retained. Analysing the cultural web can help the managers responsible for the change to consider the following questions:

- To what extent does the existing corporate culture support the changes that need to be made? And to what extent does the existing culture act as a hindrance or obstacle to the desired change?
- To what extent does the existing corporate culture need to be changed so that the desired organisational change can be introduced successfully?

- To what extent does the existing corporate culture need to be preserved because it supports essential competencies of the entity that need to be maintained?

Six aspects of the cultural web can be studied, so that the desired change can be seen in the context of the current organisational culture and what needs to change.

Symbols	Are the outward symbols of culture – such as logos and uniforms – helpful for making the change? Or are they a barrier to change?
	Does the language used by various groups of employees assist with making the change? Or does the language used by some groups exclude other groups from involvement?
Power structures	The individuals who believe in the vision for change need to be the most 'powerful' people within the corporate culture. Is this actually the case at the moment? Who holds the power over change? Is this the right person or group? Does the current power structure help or hinder change?
Organisation structure	The organisation structure is an expression of the behaviour that is expected from each person working within it. Is the current organisation structure appropriate for the change that is needed?
Control systems	All systems within the entity need to contribute to making the change and achieving the strategic vision. This includes communication, information and performance management systems. Are these systems appropriate? Are they efficient and do they promote the desired change?
Routines and rituals	Do the existing routines and rituals that are widely used help or hinder the entity in achieving the vision for change?
Stories	Are the stories that are used to communicate the culture of the entity appropriate for explaining the current strategy and vision? Do the stories represent the 'reality' that management wants to achieve?

Example

Outward symbols can act as a barrier to change. For example, a manufacturing company that wants to introduce changes to the organisation of production processes, in which more responsibility and 'power' is given to production workers. This would require a more collaborative approach between managers and employees. The current 'culture' of managers wearing formal suits and other employees wearing factory uniforms might be a barrier to change.

Example

A company might have an established ritual whereby work groups meet regularly every Monday morning to discuss progress made during the previous week and plans for the current week. These work group meetings start at 8.30 and go on for about one hour.

It might be that in planning to introduce major changes to operations within the company, this ritual of Monday morning meetings would hinder the change, by using up the time of individuals who now need to be somewhere else and doing other things on Monday mornings. A change in culture is therefore needed, and employees need to be persuaded of the need to change the Monday morning ritual.

Understanding strategy development

- A mix of intended strategy and emergent strategy
- Intended strategy
- Emergent strategy
- The process of strategy development: a summary

7 Understanding strategy development

7.1 A mix of intended strategy and emergent strategy

Strategy development has been described in an earlier chapter as either intended strategy (or deliberate strategy), emergent strategy or incremental strategy. Mintzberg has argued that strategy development should be a mixture of intended strategy and emergent strategy. He commented (1987) that strategy is shaped as much by the capacity of individuals throughout the entity to respond to or create opportunities, as it is by the strategic intentions of the senior managers at the top.

Management need to understand that strategic developments can occur in either of these ways. However new strategic developments, both intended and emergent strategy, must all be consistent and must all fit in with the same strategic objectives.

7.2 Intended strategy

Intended strategy is a strategy that is planned in advance through a formal planning process. The choice of strategy is a conscious decision by senior management.

The board of directors of a company might approve a formal business plan. For example, the directors of a company might approve a rolling five-year business plan each year.

The formal plan should not be taken as a commitment to specific planning targets, particularly if the entity operates in a continually changing business environment. As changes occur, for example as new threats and opportunities emerge, an entity should adapt its strategies and should not be committed to formal targets if these no longer seem appropriate.

It is therefore necessary for managers to understand that:

- intended strategy is a formally-approved choice about the strategic direction that the entity should be taking, and
- this choice was considered valid and appropriate at the time that it was approved. However, strategy should be flexible.

7.3 Emergent strategy

Emergent strategy is new strategy that develops or 'emerges' without formal approval being given in advance. It is the result of reaction to changes in the environment and might be a response to changes as they occur.

For example, many companies in the past few years have developed an e-business for selling their products on the internet. This development for most companies was in response to an unexpected growth in customer orders or enquiries in their website. An emergent strategy, selling goods by e-commerce, therefore came into existence without formal planning or formal approval. It was a natural response to a major environmental change – customer use of the internet.

Emergent strategy has been defined as an 'organisation-wide process of incremental adjustment to environmental states that cannot be discerned or anticipated through the prior analysis of data' (Boisot 1995). This definition stresses the point that intended strategy on its own can never be an adequate approach to strategy development, because some environmental changes cannot be anticipated or foreseen in advance.

- Emergent strategy may be developed at different levels within an entity, in response to events as and when they occur.
- When environmental change or 'turbulence' is high, the responsibility for emergent strategy might have to be decentralised entirely and intended strategy becomes irrelevant due to the inability of managers at head office to understand the changes that are happening. The ability of individuals within the entity to innovate and be entrepreneurial can be extremely important.

Strategic intent

An intended strategy is also a statement of strategic intent. It indicates the strategic direction that the entity is taking. Although detailed strategies might change, strategic intent should be consistent. All new strategies and strategy changes should be consistent with where the entity is trying to get to, and the objectives it wishes to achieve.

When new, emergent strategies are adopted, these should also be consistent with the entity's strategic intent. The entity should not continually change its mind about what it is trying to achieve.

7.4 The process of strategy development: a summary

Intended strategy and emergent strategy are developed in different ways. The table below indicates the main differences.

Intended strategy	Emergent strategy
The outcome from a strategic planning process.	Emergent strategy becomes evident from changes in the allocation of resources to activities.
The implementation of change might be given to specially-formed project groups.	Change is a cultural process.
Strategy consultants might be hired to advise on strategy.	Organisational 'power politics' might affect the strategic choices that are made.

Entities should accept the need for strategic development and change. Reference has already been made to the dangers of 'strategic drift' and reluctance to make necessary developments.

CHAPTER 11

Modelling and redesigning business processes

Contents

1 Business processes
2 Modelling an organisation and its processes
3 Analysing activities
4 Software solutions

Business processes

- What is a business process?
- Process redesign as an aspect of strategy in action
- Technological change and process change
- The scope and focus of process change: Harmon's process-strategy matrix
- The business process redesign patterns
- Methodology of business process redesign
- Business process re-engineering

1 Business processes

1.1 What is a business process?

A business process is a set of linked tasks or activities performed by individuals, groups, departments or other organisational units within a business entity. A business process:

- consumes inputs/resources
- adds value, and
- produces an output that has value to either an 'internal customer' within the entity or to an external customer.

High-level business processes (and many lower-level processes) involve activities by more than one department or more than one business function.

Business processes make up the value chain of an entity. The operations of most business entities can be defined as a small number of processes, typically somewhere between 6 and 12. Typical high-level processes might include:

- product development
- distribution
- manufacturing
- order processing
- customer service
- procurement.

High-level processes can be divided into a number of sub-processes, perhaps about 30–40 in number. It may also be useful to sub-divide the sub-processes into sub-sub-processes. Processes at a 'lower level' contribute to the value chain by producing output which becomes the input to another process.

For example, in a manufacturing company, there are processes of procurement and managing inventory, and these add value to the manufacturing process (which uses the output from the procurement and warehouse management processes).

1.2 Process redesign as an aspect of strategy in action

Processes might be changed or introduced as a result of implementing a strategy.

- New processes might be needed for new work.
- Existing processes might be improved. The purpose of improving processes is to make them more efficient or make them add more value. It is useful to think of process redesign adding to value in the value chain.

Process change exists at various levels:

- **Automation** – This means making existing operations more efficient by automating work or computerising work previously done by hand. For example, using a computer system to calculate wages and producing payslips. Computer systems usually play a large part in automation. Automation might also be improved by replacing an 'old' computer system with a 'new' one.
- **Rationalisation** – This involves streamlining standard operating procedures, so that procedures become more efficient. For example, using electronic data interchange to place orders with suppliers.
- **Business process redesign or design** – This is the major redesign of business processes. It might combine radical changes in processes to cut waste, and eliminating repetitive paper-intensive tasks in order to improve costs, quality and service. The aim is to make major changes to a process in order to achieve improvement in critical measures of performance such as cost, quality, service and speed. An example of major change is allowing suppliers access to your inventory records so that the suppliers become responsible for your inventory management and decide when items should be repurchased and resupplied. (Note that the term 'business process re-engineering' has fallen out of favour, being replaced by 'business process redesign'.).

1.3 Technological change and process change

Technological change, particularly new IT systems and methods of communication and processing, often contribute to business process redesign. Here are some examples:

Old methods and assumptions	Disruptive technology (IT developments that led to process redesign)	New methods and options
Sales representatives spend most of their time away from the office, visiting customers. However, they need offices where they can receive, store and deliver information	E-mails and attachments can be sent by mobile phone to and from laptop computers.	Sales representatives do not need an office of their own. They can receive and send information anywhere.
Information can only be in one place at a time and can only be used by one person at a time	Shared databases, group ware and networks	People can share data and work collaboratively.
Businesses need high levels of inventory to produce a reliable service to customers that avoids 'stock-outs'	EPOS, extranets, electronic data interchange.	Just-in-time purchasing and inventory management. High inventory levels are no longer needed.

Old methods and assumptions	Disruptive technology (IT developments that led to process redesign)	New methods and options
Only a limited range of standard products can be made available economically (at a cost that is low enough to provide a profit)	Ordering and product specification over the internet. Automated manufacturing techniques	Customers can 'design' their own products, and these can be manufactured economically.
Only managers have the information, skills and judgement to make decisions	Decisions support systems, expert systems, shared information and networks	Decision-making is a part of the job of many employees, not just managers.

1.4 The scope and focus of process change: Harmon's process-strategy matrix

In order to make changes to business processes, decisions have to be made about:

- which processes to change (the focus of change), and
- how radical or extensive the process redesign should be (the scope of the change).

The **Harmon process-strategy matrix** provides a useful framework to help managers decide what type of process change or redesign might be appropriate in the circumstances.

Harmon suggested that two factors should be considered:

- the complexity of the process (a complex process cannot be subject to a high degree of automation, whereas a simple process can be largely automated)
- the strategic importance of the process to the company: a process has strategic importance when it provides competitive advantage.

Processes can be placed in a 2 × 2 matrix according to the complexity of the process and their strategic importance to the entity.

- 'Process complexity and dynamics' is measured on the vertical axis. This ranges from low complexity/dynamics to high complexity/dynamics. Dynamics refers to how often the process changes. (A dynamic process can be compared with a stable process, which does not change.)
- 'Strategic importance of the process to the entity' is measured on the horizontal axis. This ranges from low to high strategic importance.

A highly complex process which changes frequently will be difficult to perform competently and could be subject to high error rates. The process is likely to require employees with specialist or expert knowledge to do the work efficiently. A complex process cannot be extensively automated.

The strategic importance of the process can be assessed by asking how much the process adds value to the products or services sold. Is the process a necessary administration-type task (low strategic importance) or is it a process in which the entity has a core competence and so can provide competitive advantage (high strategic importance)?

A Harmon process-strategy matrix is shown below. The four quartiles of the matrix indicate the type of process and the scope of process change that might be required if it is redesigned.

Strategic importance (Low → High); **Process complexity and dynamism** (High → Low)

Process complexity and dynamism	Strategic importance: Low	Strategic importance: High
High	Complex and dynamic processes, but of low strategic importance Might be better to outsource	Complex and dynamic processes that provide competitive advantage Business process redesign and improvement
Low	Simple, stable, routine, ordinary processes Should be capable of a high degree of automation	Processes that are simple and stable, but provide competitive advantage Should be capable of high degrees of automation to improve efficiency/add value

Analysing the matrix

The matrix can be used to assess the scope and focus for process redesign.

- Processes in the bottom left quadrant are simple and stable. These are just the conditions needed for automation of the process. The process is a 'necessary evil': it has to be performed but it does not add value or provide competitive advantage. The company should aim to make it as efficient as possible. An example of a routine administrative process in this quadrant is the payment of wages and salaries.
- Processes in the bottom right quadrant are also simple and stable. These qualities make them suitable for automation. However, the process is strategically important. An example of a process in this quadrant might be the assembly work in a manufacturing process. Quality initiatives might be important here also to ensure that the strategically important long-term process is carried out to a very high standard.
- Processes in the top left quadrant are complex and change rapidly. However, they are not strategically important and so they are not part of the company's core competences. An example might be the process of calculating the company's tax liability, or the process of writing some bespoke software. It would make sense to outsource these activities to experts (assuming, of course, that the company is not a firm of software engineers or a firm of tax consultants, in which case these processes would be part of their core competences).
- Processes in the top right quadrant are complex and dynamic. They are also important and provide the entity with a core competence. They cannot be automated because they are too complex and dynamic. They should not be outsourced because they are part of the firm's core competences and are crucial for adding value and making profit. These processes should be carefully investigated and analysed. Where necessary, they should be redesigned to create even more value.

1.5 Business process redesign patterns

Business process redesign can be classified into a number of patterns. The basic process redesign patterns are:

- **Re-engineering**. This is a radical redesign of the process.
- **Simplification**. This is redesign that simplifies the processes, for example by removing unnecessary activities.
- **Value-added analysis**. This is process redesign that focuses on adding value in the process and removing activities that do not add value.
- **Gaps and disconnects analysis**. This analyses a process with a view to identifying parts of the process where there are gaps in the activities or where there are inefficiencies or breakdowns in the transfer of output from one department or function to another.

Pattern	Driver	Description
Re-engineering	Major reorganisation is needed. New technology is to be introduced	Design process from scratch. This will take much time and effort and is a high risk/high return pattern.
Simplification	Remove unnecessary activities and duplication	Ask if each step in a process is needed and what it achieves. This pattern can achieve relatively modest improvements, but is relatively low risk.
Value-added analysis	Eliminate activities that do not add value	Ask how each activity adds value to the product or service. What does it do for the customer? Does it transform the product or service? This pattern usually achieves modest improvements.
Gaps and disconnects	Information or materials are not passed correctly between departments	Look at each interface between processes and analyse what needs to pass and what needs to happen. This pattern usually achieves modest improvements. Process diagrams (see later) should help in identifying potential gaps and disconnects.

Example

A supermarket chain has the following processes and sub-processes. Place these processes on a Harmon process-strategy matrix.

(a) Calculation and payment of wages and salaries for staff.

(b) Running of the company's own-name credit card operations.

(c) Developing products, predicting demand, monitoring competitors.

(d) Sourcing and ordering and receiving goods.

Answer

		Strategic importance: Low	Strategic importance: High
Process complexity and dynamism	High	Credit card operations	Developing products, predicting demand, monitoring competitors
	Low	Processing wages and salaries	Sourcing, ordering, receiving (procurement and inward logistics)

(a) Calculation and payment of wages and salaries for staff. Simple, stable, not of strategic importance.

(b) Running the company's own-name credit card operations. Fairly complex process, but routine and possibly not strategically important. (You might disagree with this view!) Probably should be sub-contracted to a bank.

(c) Developing products, predicting demand, monitoring competitors. Dynamic and complex process. Also of great strategic importance.

(d) Sourcing and ordering and receiving goods. Stable routine process, but it is strategically important that shelves in supermarkets are filled with the correct goods.

Decisions about process redesign can be made using this analysis as a basic framework.

1.6 Methodology of business process redesign

The approach to business process redesign advocated by Harmon and others is as follows.

There must be a **clear strategic goal** for the process and for the process redesign. This goal must be identified and understood. For example the goal of a process might be to meet the needs of customers and the goal of the redesign might then be to meet customer needs better. The goal of a process might be to complete a set of tasks efficiently, and the goal of the redesign might be to reduce costs and/or improve efficiency.

The focus for process redesign should be on the **value chain** rather than on functional (departmental) activities. Processes are often multifunctional. For example, process redesign might focus on processing customer orders, rather than on the functions of the warehousing and delivery department).

The **value chain should be analysed** into lower-level processes, and lower-level processes further analysed etc, down to the level of individual activities.

A **measure must be established for the outputs of the process**. This measure is for comparison with the objectives of the process or process redesign. For example if the objective of the customer order handling process is speed of completion, the process output measure should be the time taken to process orders.

The methodology of business process redesign includes the use of process diagrams, also called process maps. Process maps are used to create a 'model' or description of the process:

- 'is' diagrams or 'is' maps show the current process (= the process that 'is' now)
- 'could' diagrams or 'could' maps should a possible new way of performing the process (= a process that 'could' be used)
- 'should' diagrams or 'should' maps show the process redesign that has been selected (= the process as it 'should' be).

The purpose of 'is' diagrams is to provide an easy-to-understand description of the process that exists at the moment, and they can be used to analyse weaknesses and inefficiencies in the current process that should be removed by the process redesign. Business process redesign is not simply a matter of changing activities. It might involve human reorganisation and IT systems changes. (It is useful to think of the 7S model.)

1.7 Business process re-engineering

The term 'business process re-engineering' was first mentioned in an article by Michael Hammer in the Harvard Business Review in 1990. Hammer and Champy went on to define business process re-engineering as 'the fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical, contemporary measures of performance, such as cost, quality, service and speed.'

There are three important elements in their definition:

- **Fundamental**. The redesign of a process should be fundamental, and old assumptions about the way things are done must be questioned.
- **Radical**. The redesign of the process results in a completely different way of doing things.
- **Dramatic**. The improvements resulting from process change are not small. They are dramatic, in terms of lower cost, better quality, better service or improved speed.

The BPR approach is based on the view that value for a customer is created by the total process, not by individual operational functions that contribute to the overall process. To make improvements in operations, the appropriate approach is to look for ways of improving the entire process and not to focus on individual functional areas or individual parts of the process separately. By considering changes to the entire process, BPR can result in a radical business process redesign

The main principles of BPR have been described (by Hammer 1990) as follows:

- There must be a complete re-think of business processes in a cross-functional manner. The work should be organised around the natural flow of information, or materials or customers (in other words, around the natural flow of the transformed inputs). The work should be organised around the outcomes from the process, not around the tasks that go into it.

- The objective should be to achieve dramatic improvements in performance through a radical re-design of the process.
- Where possible, the number of links in the chain of activities should be reduced. 'Internal customers' within a process should be required to act as their own suppliers, rather than depending on someone else to do the work for them. If an internal customer can be its own internal supplier, this will simplify and speed up the process. (For example, the routine maintenance of equipment might be carried out by a specialist team of maintenance engineers. These maintenance engineers would be an internal supplier to the equipment users, the internal customers. A suggestion for re-engineering the equipment maintenance process might be for the equipment users to carry out their own maintenance work, at times to suit their own convenience. The internal customer would become its own supplier.)
- The decision points for controlling the process should be located where the work is done. There should not be a division or separation between the people who do the work and the people who manage and control it.
- In a BPR process, there should be a review of critical success factors for the organisation and a re-engineering of the critical processes so as to achieve targets for the CSFs and improve customer satisfaction.

Example

An example of business process re-engineering is a computer manufacturing company that used to sell hardware through sales representatives. Customers wishing to buy a computer might ask for financing arrangements and the company would provide credit subject to a satisfactory credit check.

The request for credit went to the credit department. If the decision was to approve the financing terms, a financing agreement would be drawn up by a person in another department. The agreement then went to yet another department for pricing – to decide the interest rate to charge on the finance. The administration department then set out the offer of finance in a formal letter to the customer.

The entire process of receiving a request for finance and sending out an offer took six days on average.

An analysis of the process found that although it took six days, the actual amount of work done took about one to two hours. The rest of the time was caused by delays in sending the transaction from one department to another.

The BPR solution was to give the entire responsibility to one individual for checking credit, drawing up the agreement, pricing the finance and sending a formal letter to the customer. The new process time became four hours instead of six days.

Modelling an organisation and its processes

- Using models for process redesign
- Organisation structure: a functional view and a process view
- Process diagrams: swim lane diagrams
- Improving processes

2 Modelling an organisation and its processes

2.1 Using models for process redesign

When a process is redesigned:

- the current process should be defined
- the current process should be analysed for weaknesses, and for ways in which it could be improved
- the process should be redesigned, to include improvements that make it more efficient or value-adding.

Modelling can be very useful to help with redesign. The current process can be modelled and a model can be developed for the new process.

A 'model' might consist of an organisation diagram or a process diagram, drawn on paper or a computer screen.

2.2 Organisation structure: a functional view and a process view

A 'traditional' method of presenting the way in which work is done within an entity is an organisation chart. This presents the different functions (departments) within the organisation structure, and the different levels of management within each function.

This approach to presenting an organisation structure is based on the view that work should be organised by grouping together individuals who do the same sort of work, in an accounting department or a purchasing department or an IT department, and so on.

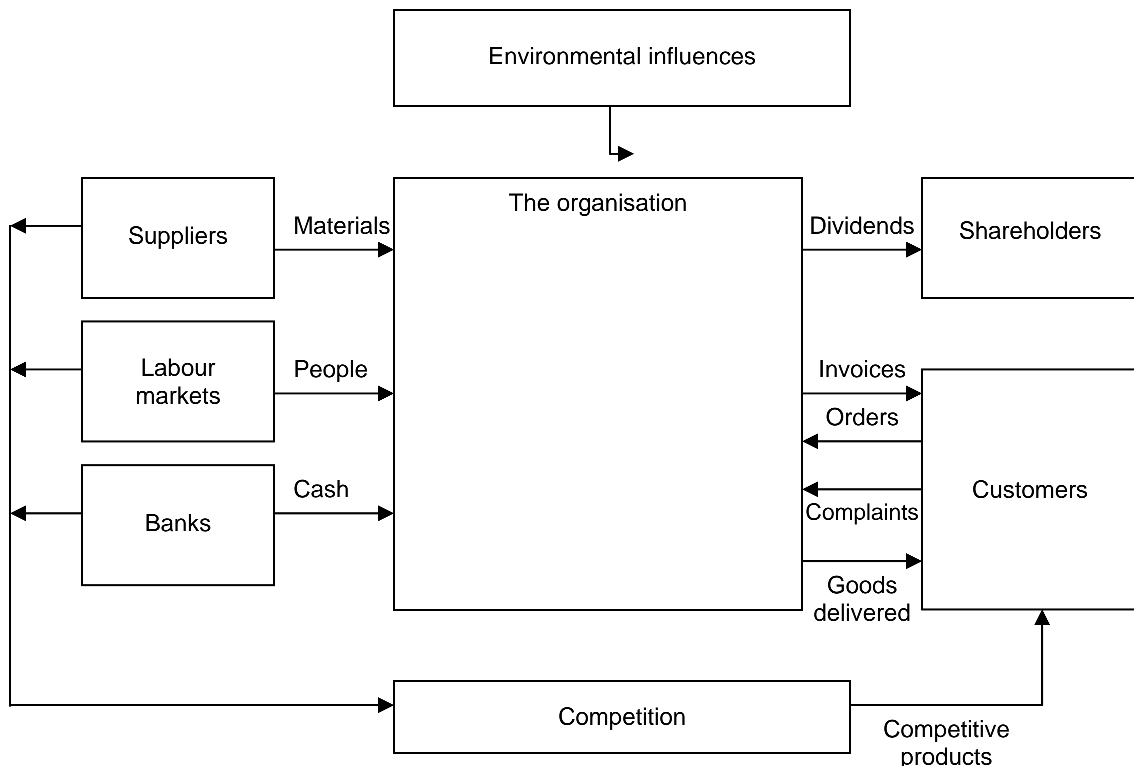
A traditional organisation chart based on functions does not show how business processes are performed. Many processes, especially high level processes, involve several different functions. For example, new product development involves the marketing department, research and development, finance and accounting, sales and engineering and production.

It is not possible to re-engineer a functional department. Re-engineering applies to processes. For the purpose of process redesign, it is therefore much more useful to

use an organisation diagram as a model for an entity rather than an organisation chart.

An organisation diagram shows the processes within the organisation, the relationships between the different processes, and the relationships between the entity's processes and external entities (customers, suppliers). It is a process diagram for the organisation as a whole (and so it is a model at a very high level, without much detail).

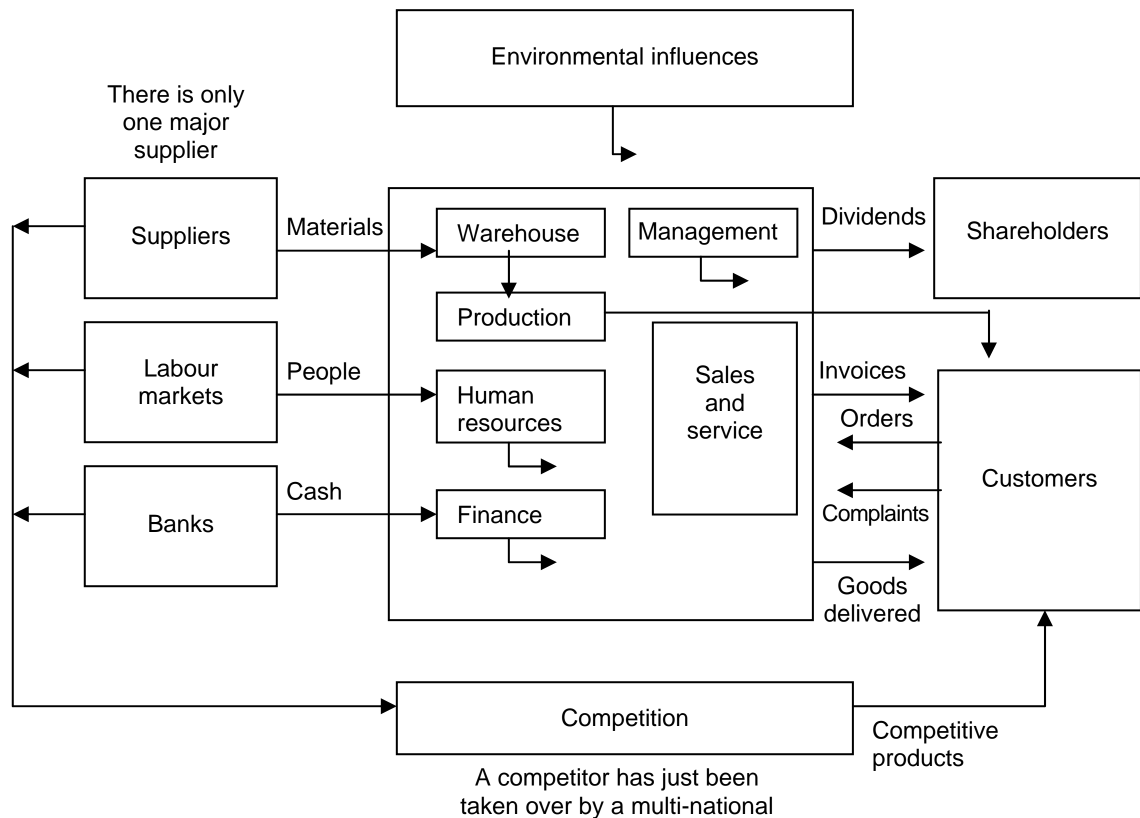
An example is shown below, at a very high level of detail.



This shows that the organisation receives material, people and cash from outside sources. It delivers dividends to its shareholders and has various transactions with customers. Competitors also make use of resources and can deliver goods to customers.

Environmental influences will affect every process within the entity. Instead of drawing a large number of arrowed lines to each function within the entity (which would make the diagram confusing), a 'right-handed arrow' is drawn. This indicates that the environment has a complex effect on all the items in the other boxes in the diagram.

Organisation diagrams can be drawn at different levels of detail. The next stage is therefore to provide more detail about what happens within the organisation. It is also possible to include other information within the diagram. In the example below there are some notes about competitive forces.



It is most unlikely that you will be asked to draw an organisation diagram in your examination. However, you should be prepared to understand what an organisation diagram shows, and to comment on the advantages of using organisation diagrams compared with traditional organisation charts for the purpose of modelling and understanding organisations.

2.3 Process diagrams: swim lane diagrams

Process modelling (also called **process mapping**) means defining a process. A common method of process modelling is to draw a process diagram.

There are different methods of drawing process diagrams. For your examination, you need to know about swim lane diagrams. These are diagrams that can be used to model processes where the activities involve more than one function or department, or more than one individual, or more than one organisational unit.

The features of a swim lane diagram

The main features of a swim lane diagram are as follows.

- A swim lane diagram shows the activities that are performed in order to complete a process. **Each separate activity is shown in a box** in the diagram.
- **Arrowed lines are used to indicate the movement of information, documents or goods** from one function to another, or from one person to another, or from one organisation unit to another (for example a project team).
- The **diagram shows who performs each activity**. Activities are performed by functions (departments), individuals, teams or other organisation unit.

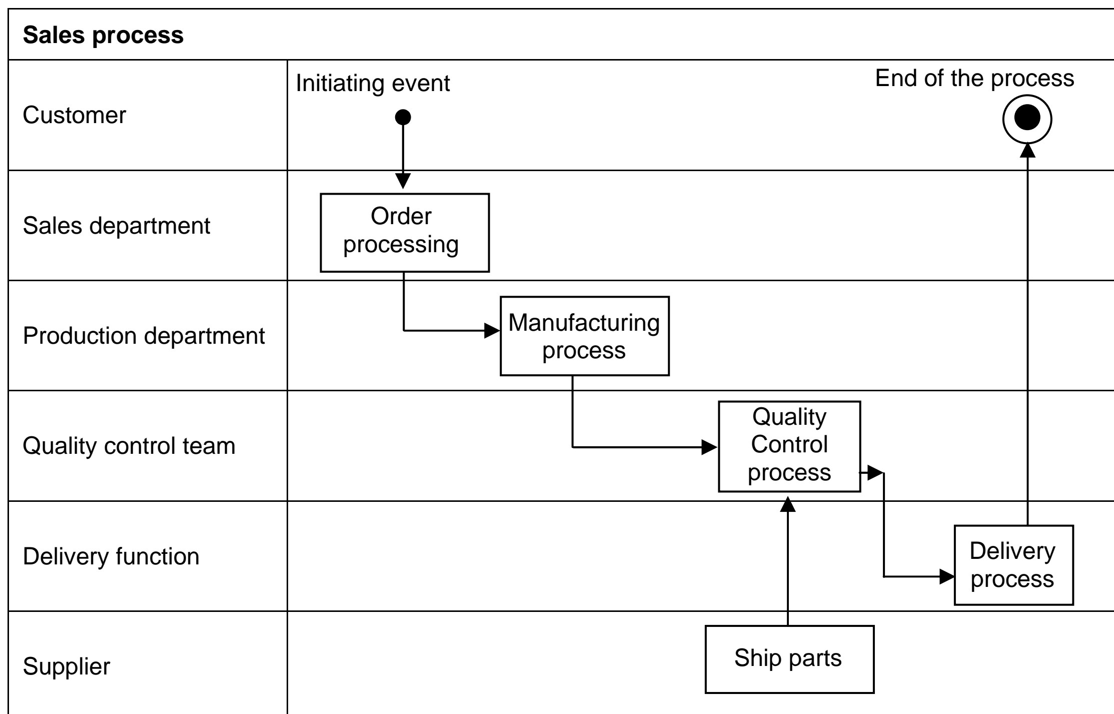
- **There is a 'swim lane' for each function, individual, team or other organisation unit**. The activities performed by a department, for example, are shown in the swim lane for that department

A swim lane can be drawn vertically or horizontally.

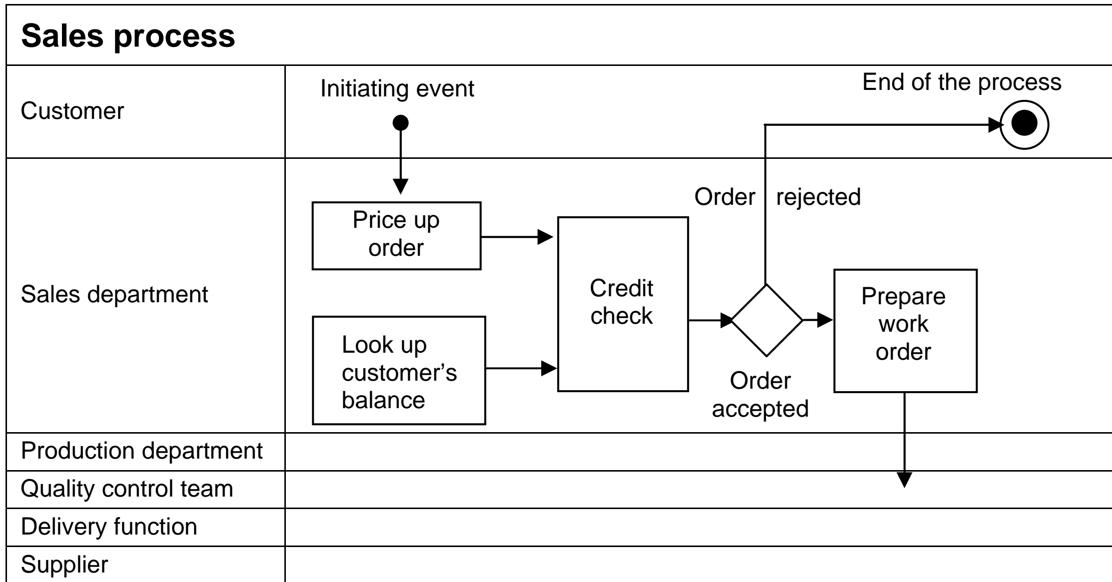
- When they are drawn vertically, the swim lanes go from top to bottom in the diagram. The movement from top to bottom of the chart also indicates movement in time, and activities are shown in the sequence in which they occur. The name 'swim lane' comes from the fact that the diagram looks similar to a swimming pool with a separate lane marked for each swimmer. The individual or function that initiates the process is always shown in the left-hand swim lane, and the initiating action is shown at the top of this lane.
- When a swim lane diagram is drawn horizontally, the swim lanes run from left to right, and the movement from left to right also indicates the sequence of activities in time. The individual or function that initiates the process is always shown in the top swim lane, and the initiating action is shown on the left hand side of this lane.

Example

Swim lane diagrams can be drawn at different levels of detail. The example below is a simple high-level swim lane diagram, drawn horizontally.

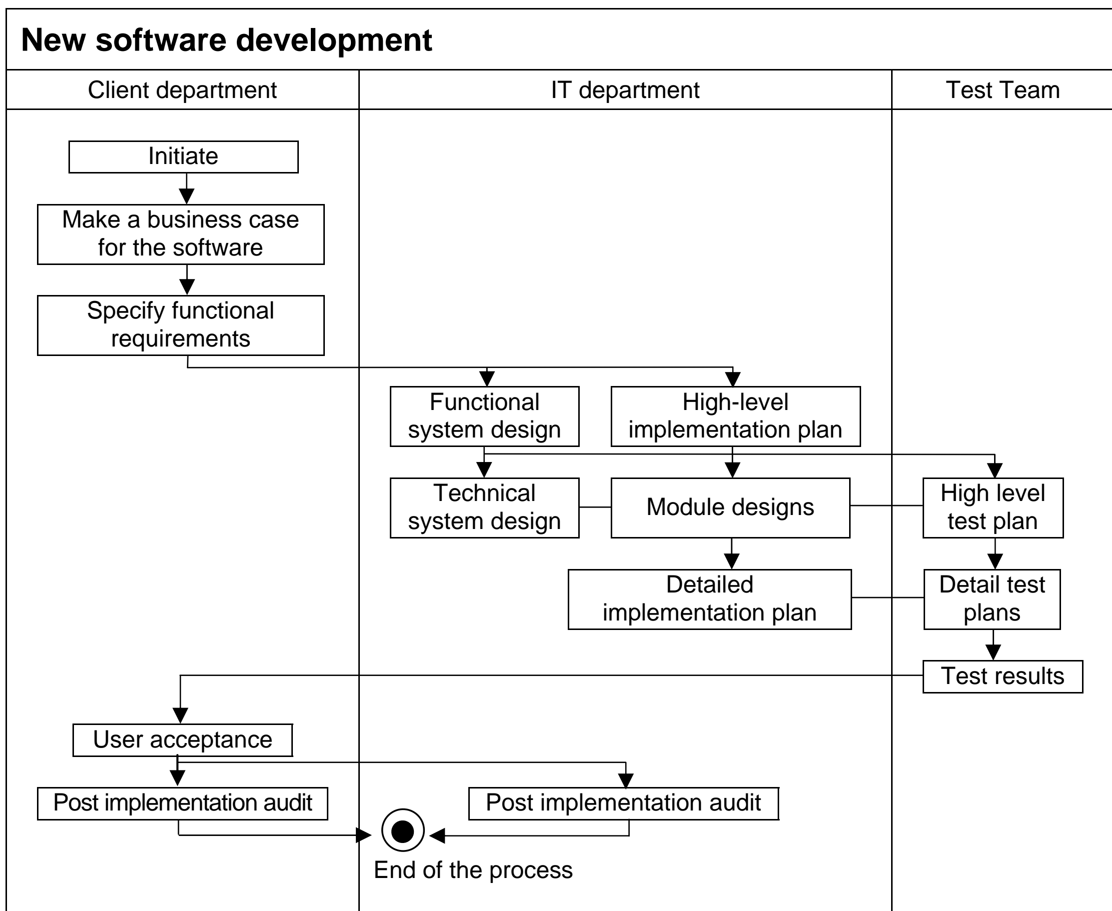


More process diagrams can be drawn which 'drill down' to more detailed levels of each process. For example, it is not clear from the high-level diagram exactly what processes occur within the process called 'order processing. More detail has been added to that sub-process in the diagram below. This diagram also includes a decision point, shown as a diamond shape. This indicates that a decision is made at this point and the subsequent activities depend on the outcome from that decision.



Example

Here's another example that illustrates the cross-functional nature of a process more clearly. The process shown here is the process for designing new software for an IT system. It is drawn at a high level, and the swim lane diagram this time is drawn vertically.



2.4 Improving processes

The purpose of process redesign is to improve the efficiency of processes or to add value for the customer.

In practice, processes are often slow, expensive, full of mistakes, inflexible and not as effective as they should be. There are several reasons for this.

- Individuals in one department who are involved in a process are not aware how the work they do (or fail to do) affects people in other departments. In other words, individuals often do not understand the process that they are a part of.
- Processes may be slow and expensive because they include activities that take time but add no value. Nothing would be lost if these activities did not happen.
- Processes may be slow and expensive because some of the work is duplicated by two or more people.
- Processes may be inefficient because they use the wrong people to do the work, using the time of valuable employees to do work that is routine and adds little value.
- There may be mistakes in a process because important checks and controls have been omitted, or because important activities are overlooked and are not carried out.
- Processes may be slow because there are 'bottlenecks' in the process, and some departments are expected to do too much work with insufficient resources.

An analysis of process models, such as process diagrams, can help to identify these process weaknesses, and to redesign a process in which the weaknesses are removed.

If you are asked in your examination to identify weaknesses in a process by studying a process diagram, the key weaknesses you should look for are:

- Duplication of activities
- Activities carried out by an inappropriate person
- Gaps in activities: activities that should be performed but are not currently performed
- Activities that do not add value (and might delay completion of the process).

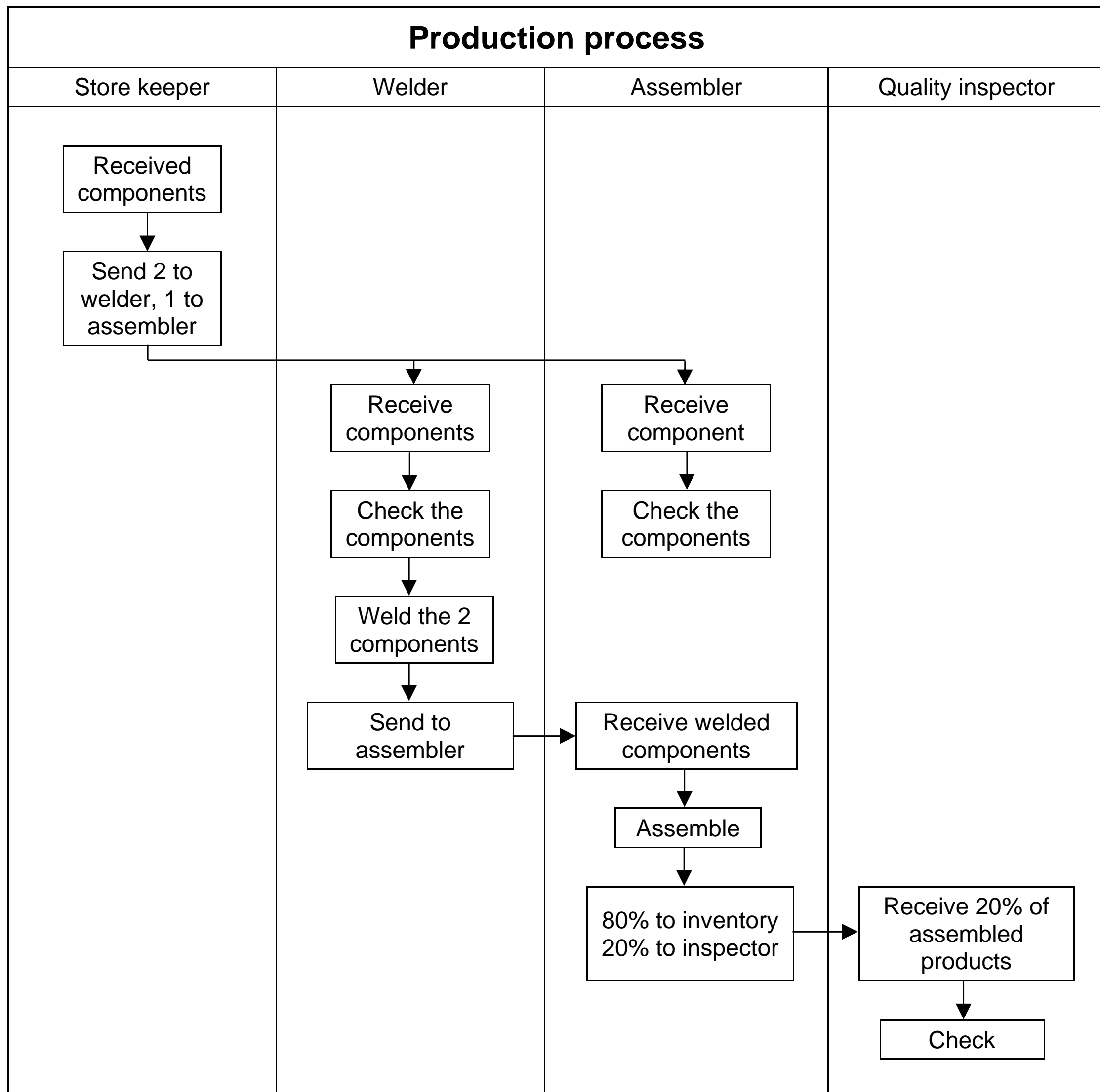
Example

Here's an example of a simple process diagram at a low level of detail, where there are one or two weaknesses in the process.

The process is the assembly of a standard product that consists of three components. These components are purchased from external suppliers, and must be inspected before use because experience shows that some components are faulty or damaged on delivery from the supplier.

Two of the components are welded together by a welder in the production department. These two welded units are then transferred to an assembler, who joins together the welded units and the third unit to make the finished product.

Here's a simple example of how a process diagram might help a business to become more efficient:



An analysis of this diagram might suggest one or two weaknesses in the process.

- It might be more efficient and would save time if the inspection of components is made by the storekeeper when the components are received. Inspecting components when they are ready for use means that faulty components are identified later than necessary. It might also make better use of the time of the welder and assembler if they are not required to check components before using them.
- It might not be necessary to inspect as many as 20% of finished units. A lower percentage might be checked without loss of value in the process.

Analysing activities

- Activity analysis worksheet
- Finding reasons for poor performance
- Process measures for selected activities

3 Analysing activities

3.1 Activity analysis worksheet

Process diagrams show the sub-processes within a process or (in a process diagram at a low level of detail) the activities that are performed within a process. However, they do not specify in detail what each activity consists of, or the rules that have to be followed when carrying out that activity. They also do not indicate how the performance of an activity should be measured, to assess whether the activity has been performed well or badly.

When a process is redesigned, the structure of the process and the process activities can be specified in a process model (process diagram). In addition, the individual activities within the process must be specified in detail.

Preparing an activity analysis worksheet is a useful method of analysing a current activity or specifying the contents of a new or redesigned activity. An example of one of these worksheets is shown on the next page. This is for a credit checking activity, which leads to a decision about whether a customer should be given credit for a particular order. (The outcome decision is to give credit or refuse credit.)

Points to note about the worksheet

You will not be expected to prepare an activity analysis worksheet in your examination. However, you do need to understand that process redesign involves analysing the specific content of current activities, and specifying the content of activities for the redesigned process.

You should also note the following points.

- The purpose of the activity is specified as the major output from the activity. In this example, the major output is a rejected or an accepted order for a customer. The purpose of the activity can be assessed, to determine whether it is necessary. Its significance should also be assessed in terms of whether it improves efficiency or adds value to the process. (In this example, the activity should add value by reducing bad debts.)
- It is also important to identify the key measures of performance for the activity, which should be used to assess whether the activity is performed well or badly. In this example there are three key measures of performance:
  - the level of bad debts (which should not exceed a target level)
  - the number of major sales orders that are rejected as a result of the credit check (which should not be high, because this might indicate that

opportunities for making higher profits are lost as a consequence of strict credit assessments)

- customer relations, measured perhaps by the number of customer complaints of unreasonable treatment in the credit checking process.

- The worksheet specifies in detail the actions that are carried out to perform the activity.
- The worksheet also specifies the rules that are applied to make decisions. In process redesign, these decision rules might be changed.

Activity Analysis Worksheet

Activity:	Credit check	**Process:**	Sales process
Performed by:	Employee X Software		
Major output:	Accepted/rejected orders		
Measures of output:	Few bad debts, good customer relations, major sales not rejected		

Steps in the activity	Responsibility	Decision/rules	Opportunities for improvement
1. Order received 2. Price list consulted and order priced-up 3. Priced order added to current receivables balance 4. Credit limit compared to potential balance	Credit control assistant in the sales department	1. If potential balance is below credit limit mark order as 'Credit approved' 2. If credit limit would be exceeded and customer is not a key customer, mark order as 'Not approved' 3. If credit limit would be exceeded and the customer is a key customer, refer order to supervisor	

3.2 Finding reasons for poor performance

If an activity is not being performed well or correctly, the reasons should be investigated to find out what is going wrong. There are five factors that could be causing poor performance:

- **Activity standards.** The activity requirements and standards of performance might not be clearly defined? If they have not, then it should be no surprise that the activity is not being performed well or correctly.
- **Activity support.** There might be inadequate resources available to perform the activity properly. Resources include adequate relevant information to make appropriate decisions. In the example above, the decision of the credit control assistant depends partly on whether or not the customer is a major customer. This suggests that a list of major customers should be available to the credit

control assistant. If such a list does not exist, then it will be difficult for the assistant to make the right decision.

- **Consequences.** There should be a connection between rewards for employees and good performance. Poor performance might be partly due to the fact that the employee does not receive any reward or benefit for performing the activity well. Financial rewards linked to suitable performance targets might encourage better performance. This can be a problem when an individual is responsible for many different activities. How should key performance measures be identified and suitable performance targets established?
- **Feedback.** It is important to tell people whether or not their performance is good or bad. How else would they know whether their performance should be improved? Poor performance might be due to the fact that individuals are not informed about their performance of a particular activity. Without any information about performance, there is no incentive at all to improve.
- **Skill, knowledge and capability.** Poor performance might be caused by a lack of skill or understanding. More training might solve the problem. Ideally training programmes should be carefully targeted at the specific performance problems.

3.3 Process measures for selected activities

An important aspect of process design (or redesign) is deciding the measures of performance for each activity that should be used to assess whether the activity is performed well or badly.

In broad terms, the success of a process should be measured in terms of its contribution to efficiency or the extra value that it creates. For individual activities within a process, however, it is often difficult to link performance in the activity to added value or competitive advantage.

The performance of individual activities is often measured in practice by 'traditional' measurements such as efficiency, cost and volume produced. Functional measures of performance are used in nearly all business entities, often as by-products of the budgeting, accounting and reporting functions.

However, these traditional measures of activity performance might not be suitable measures of process performance, because traditional performance measurements might disregard the strategic purpose of the process.

For example, a company could keep costs down by purchasing cheaper raw materials. However if cheaper materials mean that the quality of finished goods is lower, value to the customer is lost. A decision to reduce product quality in order to reduce costs should be a strategic decision to change the value proposition to the customer. Unless the decision to buy cheaper materials is a part of such a strategic decision, the cost savings have probably not been a success. Cost savings would therefore be an inappropriate measure of performance for the procurement process.

Functional measures are, of course, important but they need to be balanced against process measures and process measures should normally win any 'conflict'. Cost savings in purchasing are desirable, provided that value is not lost due to lower quality.

Process measures worksheet

A useful way of specifying the key performance measures for a process is to record them on a process measures worksheet. An example is shown below, continuing the previous example of the credit checking process.

This example shows that process measures might be specified as both an external measure and an internal measure. Targets can be set as external and internal targets, and activities should be designed in a way that makes these targets realistic and achievable. In this example:

- An external measure of the process is that customer dissatisfaction with the credit checking process should be avoided, and complaints from customers who have been refused credit should not exceed 0.1% of all orders. This is an external measure because performance depends on attitudes or actions of external entities or individuals.
- To achieve this level of satisfaction in the process, the activities to carry out the process must be performed to certain standards, which can be measured by functional measures of performance – functional measures.
- Internal (functional) measures of process performance can be used to set targets for employee performance and reward employees for good performance. In this example, it is assumed that customer complaints will remain below the target maximum if credit checking procedures are carried out correctly and no mistakes are made in processing credit applications.
- The internal performance target of not making any errors can be analysed into more detail, by measuring errors in pricing an order, errors in calculating the customer's receivables balance, and so on. Actual performance can be measured in these functional terms. (Rewards to employees should be based on achieving targets of performance for each functional measure.)

Process Measures Worksheet

Process: Sales process **Activity:** Credit check

External measure: Customer complaints arising from credit refusal <0.1% of all orders

Internal measure: All orders approved/rejected correctly

Pricing of order and calculation of potential balance	Comparison of credit limit and potential balance	Identification of major customers
1. 96% of orders priced correctly 2. 95% of potential balances are correctly calculated	1. 98% comparisons correctly carried out	1. 100% correctly identified

Note: the percentages entered on this form represent measurements made of actual performance. The performance target in this example is 100% for each functional measure.

Software solutions

- Software for process re-design
- Generic software or tailor-made solutions?
- The commoditisation of business processes
- Outsourcing business processes

4 Software solutions

4.1 Software for process redesign

Business entities will often use software and IT solutions to re-design processes. Standard software packages are available to businesses (even small and medium-sized businesses) that will help them to improve efficiency in their processes. As a general rule, software and automation of processes improves efficiency in several ways:

- It can speed up the process.
- It should reduce the error rate, compared to a 'manual' process.
- Through the use of databases, software enables all functions to have access to the same data and information.
- An entity-wide system can improve the integration of work where the process involves several different departments, and co-ordination of their efforts will improve process performance.

SAP and Oracle are leading providers of 'business process solutions' software. Oracle for example offers software systems under the J D Edwards and PeopleSoft brand names.

J D Edwards software, for example, includes packages for distribution management, human relations management, financial management and manufacturing management. PeopleSoft packages include packages for customer relationship management, supplier relationship management (procurement), supply chain management, project management, asset life cycle management and financial management.

Within each major package, there are modules for sub-processes. For example:

- a distribution management package might include modules for inventory management, procurement management, sales order management, requirements planning and warehouse management
- a human relations management package might include modules for work force planning, employee development and for monitoring head-count spending.

4.2 Generic software or tailor-made solutions?

When an entity decides to introduce a software system to improve a business process, a decision has to be made between:

- buying a generic package from a company such as SAP or Oracle, and
- creating a tailor-made software system, designed and written either by the entity's own IT department or by an external software company.

There are several advantages in buying a generic software package.

- It should be less expensive than a tailor-made (bespoke) IT system. Small and medium-sized companies might not be able to afford the cost of a specially-designed system for their specific requirements.
- A generic system can be introduced into operational use much more quickly. With a tailor-made system, the design, writing and testing of the system can take a long time (depending on the size and complexity of the system).
- Software packages are available that enable users to introduce new processes within weeks. The 'flows' in a process can be designed and amended by management themselves, simply by drawing or re-drawing them on a computer screen. This allows business entities to design or change process flows quickly and easily without the need for assistance from external (and often expensive) IT specialists.
- A generic software package has been used by other entities, and the package should have gone through modifications and improvements as a result of the experience gained by the software companies.

A tailor-made (bespoke) IT system has advantages over a generic system.

- It is designed for the specific processing requirements of the entity. (In contrast, a generic software package establishes standard processing methods that users must adopt in order to use the package. An entity might therefore be obliged to make changes to its processes because the software package requires them, not because they are appropriate for the entity.)
- A generic package cannot add sustainable competitive advantage, because if it did give its user a competitive advantage, other competitors would buy the same system and the competitive advantage would be lost.
- A tailor-made IT system can provide sustainable competitive advantage because the entity has exclusive ownership of the software. Competitors cannot copy it easily or cheaply.
- However, a tailor-made IT system is probably only ever preferable to a generic software package when it does provide sustainable competitive advantage, so that the extra cost of the tailor-made system is justified by the strategic benefits that it provides.

4.3 The commoditisation of business processes

There are two differing views about the strategic impact of business processes and business process redesign.

- One view is that a well-designed business process can give a business entity a sustainable competitive advantage over its rivals, by delivering more value. To provide competitive advantage, the process must be different and in some way superior to the comparable processes used by competitors. It should also be difficult for competitors to copy the process and introduce it themselves within a fairly short time; otherwise the competitive advantage is not sustainable and is quickly lost.
- Another view is that developments in process design software and process software mean that business processes have become 'commodities'. They are easily available in software packages, standardised and relatively inexpensive to introduce. If processes are standardised commodities, they cannot be used to achieve a sustainable competitive advantage. IT systems for business processes are a utility – they are vital for the business entity but do not add value. Companies need to buy business process packages from software providers such as oracle and PeopleSoft for doing repetitive common activities: this improves the efficiency of the process, saving time and money. However, all rival companies should be doing the same thing.

These two different views are not inconsistent with each other. It can be argued that there are two types of business process:

- Processes that enable a business entity to develop its core competencies and achieve a sustainable competitive advantage.
- Commodity processes or standard processes, where business entities should seek to improve efficiency and reduce costs, but where strategic advantage cannot be obtained. These processes represent a set of activities performed by business entities that are relatively standard across the entire industry, or even across different industries.

Core competencies can be protected and developed with generic software system. Commoditised processes or peripheral processes can be performed using off-the-shelf packages, or by outsourcing the process to an external entity.

A problem with this analysis, however, is that it is not always easy to decide which processes are processes that provide core competencies, and which processes are commodity processes.

- In the computer manufacturing industry, IBM regards the process of assembling PCs as a commodity process that is outsourced to another company. In contrast, Dell regards assembly as a core competence that they perform in-house.
- The example of a wake-up call in the hotel industry has been used (by Gilmore and Pine, 2002) to show how a commodity process can be developed into a process that provides a competitive advantage. Wake-up calls might seem in theory to be a standardised process. However, some hotels at Walt Disney World introduced a wake-up call service where recorded voices of Disney characters were used. By doing this, the hotels were able to increase the value of the service to customers, by making a routine process a much more unforgettable event.

4.4 Outsourcing business processes

Many business entities outsource some processes. A survey by the UK government in 2006 found that over 50% of UK organisations outsourced some processes to an external service provider.

There are several reasons why entities might choose to outsource processes to a service provider.

- The entity itself might have no particular skill in performing the process itself, and it does not create any sustainable competitive advantage by doing the process itself. (This would apply to 'commodity' processes in particular.)
- The entity might have difficulty in obtaining enough skilled staff to do the work in-house, especially where IT skills are needed or where the process has to be performed 24 hours each day and seven days each week. The process can be performed more efficiently and effectively by external specialists, who have the necessary skills and experience.
- Because external providers have the resources and skills to perform the process more efficiently and effectively, outsourcing a process can result in significant cost savings.
- When a business entity wants to alter a business process, it might be easier to alter the process using an external service provider rather than introducing the new process internally (where resistance to change from existing employees might be strong).

The main reasons for outsourcing business processes seem to be cost reduction and changing the 'infrastructure' for a business process.

There is probably a link between outsourcing processes and the commoditisation of business processes. External service providers are able to offer a cheaper operation by providing a fairly standardised process that can be adapted easily to meet the needs of different clients.

Example

A supplier of timber to companies in the building construction industry has 20 branches across the country. It delivers timber from its branches to building sites throughout the country, using its own fleet of 200 trucks.

An investigation by management found several operational problems with the trucks. On many occasions, drivers got lost delivering timber and could not find the destination. This led to delays in delivery, and extra costs of drivers' time and wasted journeys. Vehicles were also being used improperly for private use.

The company therefore decided to introduce a new global positioning system for its trucks. The system would enable the company to monitor the position of every truck at any time, and its movements, on computer screens at each branch. It would also enable the office to give directions to drivers who got lost.

Instead of operating the system itself, it outsourced its operation and management to an external company. The timber company management took the view that they should concentrate on the core competencies of the company – selling timber – and should give this non-core operation to an external service provider.

The new system, and outsourcing its management, proved successful. The costs of operating the timber company's fleet of trucks was reduced (lower fuel costs, lower drivers' wages) and customer satisfaction improved.

CHAPTER 12

Information technology solutions

Contents

1	Principles of e-business
2	The infrastructure required to support e-business
3	E-business and the supply chain
4	Marketing concepts: the 7Ps
5	E-marketing
6	Customer relationship management

Principles of e-business

- Definition of e-business
- E-business and its implications for business strategy
- The impact of the internet on business strategy and competition
- Main business and marketplace models for delivering e-business
- E-commerce and the globalisation of business
- A stage model of e-business
- Barriers to e-business

1 Principles of e-business

1.1 Definition of e-business

The purpose of this chapter is to look at how e-business methods might be used to implement business strategy. There are two commonly-used terms: e-commerce and e-business.

E-commerce can be defined as: 'all electronically mediated information exchanges between an organisation and its external stakeholders. E-commerce is sell-side if it is between an organisation and its customers and is buy-side if it is between an organisation and its suppliers' (Chaffey: 'E-business and E-Commerce Management').

E-business includes all aspects of e-commerce, but also includes work flows and movements of information within an entity, for example between departments or functions. Internal processes are driven by e-business methods as well as external relationships with customers, suppliers and other external stakeholders.

Here are two broader definitions of e-business:

- E-business is 'automated business processes (both intra- and inter-firm) over computer mediated networks' (OECD).
- E-business is 'the exchange of information across electronic networks, at any stage in the supply chain, whether paid or unpaid.'

E-business and information flow

E-business transactions do not necessarily involve a payment for goods or services. Transactions with customers and suppliers might involve the transfer of information rather than a transfer of money. For example, a major aspect of e-marketing is concerned with providing information to customers or exchanging information with customers or potential customers.

It is usual to associate e-business with the internet. However, it is better to think of the communication networks for e-business as:

- the internet and corporate websites
- company intranets
- telecommunications networks, including mobile telephony
- interactive television (especially in consumer markets).

1.2 E-business and its implications for business strategy

The objective of e-business is to increase the competitiveness and efficiency of an entity by using electronic information exchanges to improve processes. E-business does not simply involve automating existing processes. Processes should be radically redesigned by e-business methods so that they become more efficient and create added value. E-business opportunities can alter the strategic position of an entity, and provide different strategic choices.

- E-business can change the nature of the market place in which goods and services are bought and sold. For example, it encourages the globalisation of markets and the buying and selling of items in the internet.
- E-business also changes the nature of the relationships with suppliers and customers.

1.3 The impact of the internet on business strategy and competition

An article in *Student Accountant* (March 2007, 'Strategy challenge: the internet') provides a very useful assessment of the impact that the internet has had on business strategy and competitive advantage. The analysis is based on Porter's views on strategy.

Porter has argued that the two main factors that determine the profitability of a business entity are the structure of the industry in which it competes, and the ability of the entity to achieve a sustainable competitive advantage.

The internet and industry structure

The internet has led to the development of some new industries, such as online auctions. However, it has had a much more significant impact on existing industries and the nature of competition within those industries. (Remember that when an industry becomes more competitive, prices are lower and profitability for all companies in the industry is lower.)

The impact of the internet on competition in many industries can be analysed within the framework of Porter's Five Forces model.

- **Competitive rivalry** with existing competitors. The internet encourages greater competition. Companies provide a large amount of information about themselves and their products on their websites. This makes it easier for competitors to copy what they are doing. As a result of the stronger competition, selling prices are depressed.

- **Threat of new entrants**. In many industries, the barriers to entry have been lowered. By using the internet, new competitors can enter the market more quickly and more cheaply. Companies are able to enter the market using the internet to market their products or services. They do not need to employ an expensive full-time sales force, or distribute their products through (expensive) traditional retail networks.
- **Bargaining power of suppliers**. Suppliers are able to use the internet to increase the number of clients or customers for their products. As a result, the bargaining power of suppliers is likely to increase.
- **Bargaining power of customers**. The internet has increased the bargaining power of customers substantially. Customers are able to obtain information about the rival products of many different competitors, by using search engines such as Google and visiting many different websites. 'The reality is that customers using the internet are finding it easier to switch suppliers, and the openness of the internet and its standards makes it difficult for a customer to maintain its customer network intact.'

Porter has argued (Harvard Business Review 2001) that the overall effect of e-business decisions taken by many companies has been to make competition much more price-driven and to reduce profitability.

Individual firms and competitive advantage

At the level of the individual firm, the internet has also had an effect on the ability of companies to sustain competitive advantage. Competitive advantage is achieved through operational effectiveness (reducing costs) and strategic positioning (differentiation).

- Porter has argued that the internet affects operational effectiveness, because it allows companies to exchange information in real time across its entire value network. However, the internet also makes it difficult for companies to use this improved operational effectiveness as a sustainable competitive advantage. Methods of using the internet devised by a company are fairly easy to copy. 'Companies converge on the same applications with the same benefits – benchmarking and copying best practice make any operational advantage difficult to sustain.'
- Porter also argues that it is possible for firms to gain sustainable competitive advantage using the internet, but only from superior strategic positioning. They need to link the IT platform provided by the internet to 'critical corporate assets' such as skilled personnel, a proprietary product or a very efficient delivery (logistical) system. In practice, not many companies have yet done this.

1.4 Main business and marketplace models for delivering e-business

E-business is based on the exchange of information in real-time, between entities and their suppliers, customers and potential customers. The internet has given companies an opportunity to sell their goods or services to a larger number of customers, and to find new suppliers. The main types of 'model' for delivering e-business are probably familiar to you.

- **Selling goods and services**. 'E-shopping' is a term for consumers buying goods or services by placing orders on a company's website.
  - When physical goods or services are purchased, the company must have a delivery system in place that fulfils the customer's order efficiently. Companies use different delivery systems for goods purchased on the internet, such as direct delivery in the company's own vehicles (for example as Tesco home shopping in the UK) or delivery through a parcel delivery service.
  - The purchase of information, such as education packages and software products, can be delivered directly to the customer's computer by internet (e-mail).
- **Providing electronic auctions**. These are websites where customers can auction goods for sale, and put in bids for auctioned items. eBay is perhaps the most well-known example.
- **New intermediary companies**. One of the problems with the internet is the enormous number of different websites. This can make it difficult for customers to know which website to visit where they can buy goods or services that they are looking for, and obtain the 'best deals'. Search engines on their own would not be efficient in helping a customer to find a suitable holiday in Australia, for example, or a fashionable pair of shoes. As a result, a large number of intermediary companies have established themselves in business. Their business is based on acting as agents for selling the (similar) products or services of a large number of different companies, and attracting customers to their website. Customers visiting the intermediary's website they can select an item that meets their requirements from the many different items on offer. An example is lastminute.com, which sells holidays, travel, theatre tickets and similar items on behalf of a large number of different holiday companies, travel companies, theatres and so on.
- **Alliances of suppliers**. In some markets, businesses have created alliances with shared websites for selling their products to customers over a wider geographical area. For example, companies selling residential property (such as estate agents) can join with similar companies in other regions and towns in order to advertise their properties to customers throughout the country, not just in their local area.
- **E-procurement**. As well as creating larger markets for consumer goods and services, communications networks and computer systems have created new opportunities for business-to-business purchasing ('e-procurement'), by linking up the computer systems of companies with those of their main suppliers.
- **Advertising**. The internet has also created new opportunities for advertising and marketing. Companies can advertise their products or services on search engines such as Google, or on the websites of other companies. They can also use their own websites to provide product information to customers; for example publishers are able to display extensive information about their books. Companies with popular websites, and companies that provide search engines, can sell advertising space and earn revenue for their business in this way.
- **Marketing**. Marketing opportunities are provided by the chance to send marketing messages by e-mail to potential customers (although this form of marketing is affected by the very large number of 'spam' marketing e-mails).

- **Customer relationships**. The internet provides opportunities for companies to build customer relationships, for example by providing support, user forums and FAQ (frequently asked questions) pages. The internet can also be used to analyse customer interests and preferences, and so learn more about what customers want and value. Customer relationship management is explained in more detail later.

1.5 E-commerce and the globalisation of business

E-commerce has been a major factor in the globalisation of business. Geographical distance can still be a barrier to the globalisation of markets, but e-commerce reduces those barriers, and can even remove them.

- The internet and e-mail in particular have made it much easier for suppliers to make contact with customers in geographically-distant countries.
- The internet and e-mail have also made it easier for customers to search for suppliers in other countries of the world.
- Suppliers and customers can communicate with each other much more quickly and easily, in spite of differences in time zones.

Customers can search the internet to find suppliers who are able to provide what they want at a competitive price. They can compare rival products or services, and can compare prices.

Suppliers can try to attract more customers from wider geographical markets by advertising their goods or services on their website (or other information websites or on search engines).

The implications of globalisation of markets

An important implication of the globalisation of markets is that the size of the market increases, but competition is more international. The main rivals are no longer local suppliers to a domestic market, but international or global companies competing for market share in countries around the world.

Efficiency in global markets depends on information and communication. Companies may need to become international or global in order to compete successfully, and this means having to establish operations in other countries of the world, typically be setting up foreign subsidiaries. International groups need management control, and computer networks and IS/IT systems help to provide management with the information they require to apply suitable control to the group.

1.6 A stage model of e-business

Companies that do not use the internet might start to develop their e-business in stages. The following 'stage model' for the development of e-business might be useful in helping the management of a company to understand their business strategy – where it is and where it is hoping to get to. There are four broad stages of development to a full e-business model.

Stage	Characteristics
1 **Web presence**	The company sets up a website that it uses to display product information and catalogues. There is nothing innovative in this strategy, since most competitors will do the same or more on their websites. Providing product information electronically is not much more than the replacement of paper catalogues and brochures.
2 **E-commerce**	The company uses its website to sell its products or services. (It might also buy through the internet from some suppliers.) There is no fundamental change in strategy: the company is simply using its website to create an additional market place.
3 **Integrated e-commerce**	The company now uses the internet to obtain more information about its customers and their buying preferences. Attempts are made to improve communications with customers, for example by trying to establish two-way communication ('dialogue'). Selling on the internet is therefore linked to the analysis of customer information, and the company uses the information to identify ways in which value might be added to its products and services.
4 **E-business**	If a company achieves this stage of e-business development, its e-business has become closely integrated with its business strategy. E-business might drive the business strategy, and determine the strategic direction in which the business should be taken. E-business is no longer an additional way of doing business: it is fundamental to the company's way of operating.

Example

In the UK, the Zara chain of fashion retail shops is an example of fully integrated e-business.

This company produces and distributes new fashions within about six weeks. It makes relatively small numbers of each garment so that inventory in shops changes rapidly. This encourages shoppers to visit frequently to see what's new, and it they see something they like, they buy it there and then as it might not be in stock tomorrow.

The design, manufacture and distribution of the goods depend fundamentally on e-business, with fast information exchange and decision-making.

In traditional fashion retail businesses, by comparison, design and approval of new fashion items is much slower, and new items are produced in large quantities in order to keep down the unit costs.

1.7 Barriers to e-business

Although many companies engage in some form of e-business, there are barriers to setting up e-business activities and maintaining them so that they remain an effective way of developing the business. The difficulties with e-business can include the following.

- **Set-up costs**. It can be fairly expensive for a small company to establish a website for selling its products and taking payment by credit card or debit card. For example, it will be expensive for a small company to set up a website showing an online catalogue with photographs, keeping records of inventory balances, and with the facility to debit customer credit cards.
- **Type of business**. Some products and services are easier to sell on the internet than others. For example, computer firms sell products very successfully over the internet as their products can be perfectly specified in writing. However, it is much more difficult to sell items of clothing. No matter how much detail about clothing items is provided on the website or how many photographs are provided, there are difficulties with selling goods 'by catalogue'. Companies that do sell clothing by internet have to budget for large amounts of sales returns.
- **On-going operating costs**. A website has to be updated frequently, to keep it interesting (and accurate), and it might be necessary to keep making special offers to encourage customers to revisit the site.
- **Time to establish the system**. It takes time to establish a website that customers know about and want to visit.
- **No in-house skills**. A company might not employee individuals with the knowledge or skills to maintain a website. However, this should not be a serious barrier to e-business, especially if the employer is prepared to give suitable training to staff.

The infrastructure required to support e-business

- Layers of infrastructure
- The internet
- Intranets and extranets
- Designing a website for e-commerce

2 The infrastructure required to support e-business

2.1 Layers of infrastructure

To operate e-business activities, a company needs to be able to communicate with its customers or suppliers electronically, usually by the internet. The infrastructure necessary to support e-business is a combination of computer hardware, software, data files and communication networks.

- Each website is located on a 'host computer' which gives it access to the internet.
- System software requirements include a web browser and a database management system, which are used to display and locate the information on the website.
- Content and customer information is held on data files.
- The communication network is provided by the internet. In addition, many companies operate their own intranet (or extranet).
- Some companies use additional software applications, such as customer relationship management software.

2.2 The internet

Most e-businesses use the internet. The internet is a network of computer networks. To link to the internet you need the following.

- An internet service provider (ISP), such as AOL, MSN and BTinternet. Users are connected to the internet through their ISP, which provides e-mail facilities as well as internet access.
- A browser, such as Microsoft's Internet Explorer.
- A communication link such as ordinary telephone or ISDN. Increasingly users are subscribing to broadband (ADSL or DSL), which provides very high transmission speeds. Wireless technology is also increasing rapidly for communication.
- A modem to enable the computer to transmit over the communications link.

The **World Wide Web (WWW)** is a network of large internet computers (servers). However the WWW is only one part of the internet, though the terms 'World Wide Web' and 'internet' are often used interchangeably.

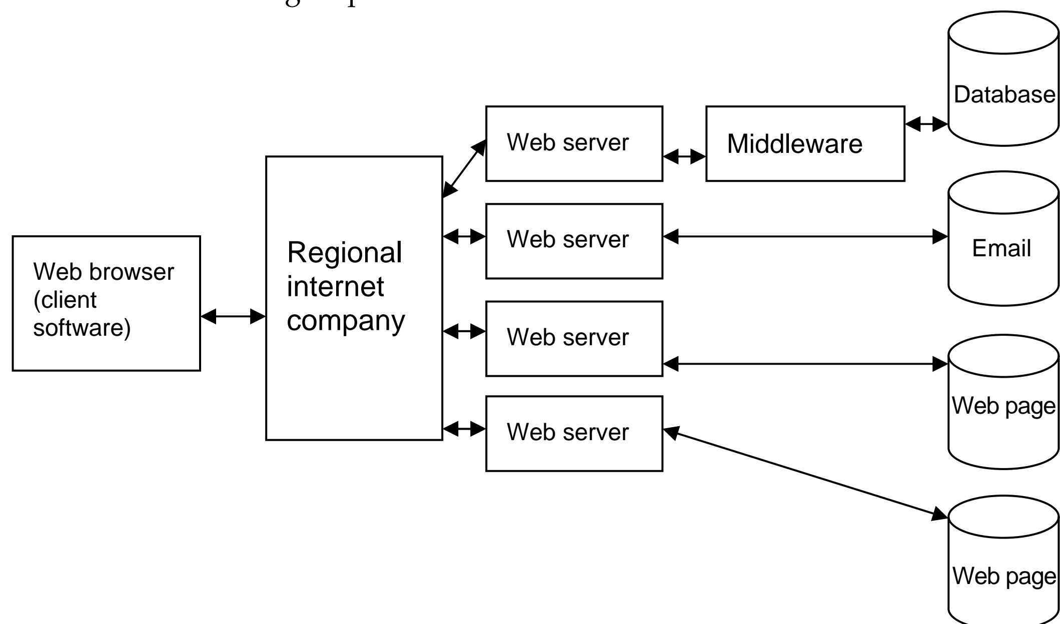
A **website** is a presence on the internet. Each website is hosted on a computer which has permanent access to the internet.

- Each website has a unique address called a **Uniform Resource Locator** or **URL** which allows other internet users to locate and access the information on the website (for example, www.emilewoolfpublishing.com). Each URL has to be registered as a domain name to ensure it is unique.
- Websites designers can choose certain key words, meta tags, which summarise or indicate what the site is about. Search engines, such as Google, can then provide users with lists of relevant sites addresses by searching for relevant meta tags.

The internet is based on client-server technology. **Web browsers**, such as Internet Explorer, are the client applications. The server, which may be a distant computer, holds e-mails and web pages.

Websites are usually arranged in a **hierarchical pattern**, starting with a home page. The client requests information from the server, at first by specifying a URL. Once the home page of the site is delivered to the user from the server, links on the page can be clicked to access other pages on other sites.

Some **web pages** are static, always showing the same information, rather like a printed sheet. Other web pages are dynamic, which means that they are updated in real time. Current information for a database can be incorporated and shown on the web page. For example, in a site which offers online ordering, it would be possible to link to the inventory database to show up-to-date inventory balances. Linking to a database is done through a piece of software called middleware.



All information flows for computers attached to the internet are two-way. If a customer can access the internet, potentially the internet can access the customer's computer, mobile phone or television. Unauthorised access to a user's computer from the internet can be prevented by installing a piece of software called a **firewall**. (Firewall hardware can also be installed, to improve the user's security against unauthorised access to his computer system from other internet users.)

2.3 Intranets and extranets

An **intranet** is the use of internet technology within one entity. For example, a company can set up its own intranet, which allows its employees to exchange and share information with each other. Customer information and product information are usually available on intranets, together with other shared data files, newsletters, company procedures, and so on.

- An intranet uses the public communications network to provide this in-house communications network. In this respect it is the same as the internet. It also creates a risk of unauthorised access into the intranet by users of the internet.
- Users of an intranet can access the external internet as well as the in-house intranet files and software.
- Security for an intranet against unauthorised access by external internet users is provided by firewall hardware and software.

The benefits of an intranet are:

- better communication within the organisation
- access to more information and better information within the organisation for senior management
- Internet access (access to external information on other websites) and e-mail.

An **extranet** is a network in which the intranet of one company can connect with the intranet of another company, usually a supplier or customer. An example of an extranet is a buyer's purchasing system communicating electronically with a seller's sales order system, through their intranets, to generate a purchase order and order delivery.

2.4 Designing a website for e-commerce

The design of a website is extremely important, for persuading customers to use the site and buy from it.

- The website must be easy to use. The user must be able to navigate though the site easily. Icons must be clear. Users should be able to select goods for purchasing without any difficulty or possible confusion. Any forms must be easy to fill in.
- Screens should also be visually attractive, to encourage users to browse through the site.
- Design features such as the ability to enlarge images of products, or obtain additional information about a product, may also be very useful.
- The system must allow users to interact with it, so that the users can choose their own route through the website easily.
- The website must be kept up to date. For example, the availability of products must be kept up to date, so that buyers know whether a product is available for purchase or not. If a website is not kept up to date, users will lose confidence in it.

- The website is an advertising medium as well as an electronic store. It can be designed in such a way that the user's attention is drawn to additional products that he or she might be interested in buying.
- The website must be available 'all the time' to users. Downtime must be kept to an absolute minimum.
- The system must integrate with the company's other transaction processing systems, such as its customer database, accounting system and inventory control system.
- The system must be able to reassure users that it is secure. The website should be designed with security in mind, and also with providing reassurance to users that it is a secure site.

E-business and the supply chain

- The supply chain and the value network
- The push and pull models of the supply chain
- E-procurement
- Benefits of e-procurement
- E-procurement and collaboration with major suppliers

3 E-business and the supply chain

3.1 The supply chain and the value network

E-commerce involves making agreements to buy and sell goods and services through electronic dealing. E-commerce transactions can occur at any stage of the supply chain, from the supplier of raw materials to the end consumer of the finished consumer goods.

E-business is a method of increasing value by reducing costs, and also by improving the value of benefits offered to customers.

- Added value can be created at any stage in the supply chain and at any link in the supply chain between a company and a supplier.
- The value chain and value network have been described in an earlier chapter. E-business provides opportunities for improvements throughout a company's own value chain and within its entire value network.

The virtual supply chain

A virtual supply chain consists of electronic communications links between suppliers and customers in the supply chain. The links may be made via websites, extranet links or electronic data interchange (EDI) links. The role of a virtual supply chain may be either to:

- improve information flows with suppliers and customers, and so improve the efficiency and effectiveness of the physical supply chain, or
- replace some of the 'traditional' links in the supply chain, to provide a more efficient and effective supply chain.

A virtual supply chain makes use of web-based technology and facilities such as the internet, intranets and extranets, e-mail, e-purchasing and electronic order-tracking systems.

A virtual supply chain can improve the efficiency and effectiveness of the physical supply chain, by improving the information flow from customers back through the supply chain to suppliers.

Creating a virtual supply chain might be essential for a manufacturer, in order to remain competitive. To be competitive, a manufacturing company must try to reduce the cycle times or lead times that:

- cost money at all stages in the supply chain, and
- may persuade customers to buy what they want somewhere else.

Improving the responsiveness of a supply chain to the demands (and changing requirements) of customers should be a key strategic target for many businesses. To do this, they need an interactive and collaborative approach between all the main suppliers in the supply chain and the end-customer.

Information about changes in demand or supply conditions should be communicated along the virtual supply chain. Customers and suppliers at each link in the chain should then collaborate to respond to the new supply or demand conditions.

For example, suppose that a business customer places an order for a new item of machinery with a manufacturer. If the manufacturer has an EDI or extranet link with its key suppliers, details of the materials and components requirements can be transmitted back through the supply chain immediately. This will speed up the delivery time to the customer.

3.2 The push and pull models of the supply chain

There are two methods or models for selling through the supply chain: a push model and a pull model.

- With a **push model**, a company markets its goods and services to potential customers, and tries to persuade customers about the merits of its products compared with those of competitors. For example, a manufacturer of tyres can try to sell its goods to motor car manufacturers by persuading them that their tyres offer the best value. Similarly a producer of canned beans can try selling its goods to companies operating supermarket chains, by persuading them that their product offers better value to the supermarkets than other brands of canned beans.
- With a **pull model**, a company tries to sell its products to its own customers by encouraging the customers at the end of the supply chain to demand their products. The company's customers are persuaded to buy the company's products because their own customers want them. For example, the manufacturers of Michelin tyres or Bridgestone tyres could (if they wished) try to sell their tyres to car manufacturers by encouraging the buyers of cars to demand their branded tyres on the cars that they buy. Car manufacturers would be persuaded to buy tyres from a particular manufacturer because their own customers want those tyres. Similarly, the manufacturer of a particular brand of canned beans could persuade supermarkets to buy their product because of demand from shoppers in the supermarkets to buy it.

Advertising and sales promotion can be important in a pull strategy by creating demand for a product from the consumer at the end of the supply chain.

In practice, manufacturers of consumer products normally use a combination of a push strategy and a pull strategy in its sales and marketing strategy.

E-business and push and pull strategies

A push strategy or a pull strategy can also be used for e-commerce, but in a slightly different way.

- With a push strategy, a company uses the internet to try to persuade customers to buy its products or services. To use a push strategy, a company needs to identify customers or potential customers, and send out a marketing communication. Typically, companies acquire a customer list and send out e-mail marketing messages to the e-mail addresses on the list.
- Selling goods through the internet, particularly to consumers, is largely a pull strategy. This is because a company relies on customers coming to its website (or to the websites of intermediaries) and asking for product information and/or placing an order.

For companies that are used to selling through sales representatives and sales agents, selling through the internet can require a major re-think of the supply chain.

3.3 E-procurement

The term 'procurement' refers to all the activities involved in purchasing items from a supplier. Procurement activities include:

- Identifying the need to purchase a quantity of an item (initiating a request to purchase or a 'materials requisition')
- Identifying one or more possible suppliers for the materials
- Negotiating a price and other contract details with one or more suppliers
- Placing the purchase order with the chosen supplier
- Receiving and checking the goods on delivery
- Recording receipts of purchased items in inventory records
- Storing the items
- Paying the supplier.

Procurement can also be summarised as the 'five rights of purchasing':

- right price
- right quality
- right quantity
- right time
- right place.

Components of e-procurement

E-procurement is a term used to describe the electronic methods used in any stage of the procurement process, from identification of the requirement to purchase

through to the payment to the supplier. There are three areas in particular where e-procurement methods can improve efficiency in the supply chain:

- e-sourcing
- e-purchasing
- e-payment.

E-sourcing

E-sourcing is the use of electronic methods for finding new suppliers and negotiating terms for purchase agreements. The internet can be used to identify potential new suppliers, and to find out more about the business of potential suppliers by visiting their websites.

Communications can be established, initially perhaps by telephone or letter, but subsequently by e-mail. Negotiations about the terms of purchase agreements can be conducted electronically, through e-mail.

E-purchasing

E-purchasing is the process of making purchase orders electronically. The process of making a purchase might involve:

- submitting requests for quotations to suppliers, inviting them to submit a quotation for the supply of goods or services
- receiving quotations/tenders from potential suppliers
- placing the order electronically.

E-payment

E-payment is **the use of electronic methods for payment**, such as electronic invoicing and self-billing. Many companies also arrange to pay suppliers by sending electronic payment instructions to their bank. In the UK, electronic payments are made through BACS (the Bankers Automated Clearing Services).

3.4 Benefits of e-procurement

The ability to source products and services electronically can be extremely cost effective, saving time and money. These improvements in efficiency can be shared between suppliers and customers, adding value to the supply chain.

Benefits of e-sourcing

E-sourcing enables companies to purchase more easily from other countries or new suppliers that they have not considered previously. It might be possible to find suppliers who can offer better value, in terms of lower prices or better-quality products.

Benefits of e-purchasing

Electronic purchasing methods reduce the time for suppliers to respond and a purchase to be made. Savings in time and the use of electronic communications can save costs and improves efficiency in the purchasing process.

Purchasing efficiency is improved still further if suppliers link their purchasing system to a computerised order fulfilment and delivery system.

Some form of e-purchasing arrangements are needed to make a system of **just-in-time purchasing** feasible.

Benefits of e-payment

E-payment can streamline the payment processes for both the purchaser and supplier, reducing costs and errors that can occur as a result of information being transferred manually from and into their respective accounting systems. These efficiency savings can translate into cost reductions that can be shared by both parties.

3.5 E-procurement and collaboration with major suppliers

As well as providing opportunities to choose from a larger number of different suppliers, e-procurement methods can also provide opportunities for achieving a competitive advantage through collaboration with suppliers.

Effective collaboration with major suppliers involves the joint design of new materials and components, and new product design. It can also include collaboration between a company and key suppliers for improving efficiency in purchasing.

One method of improving purchasing efficiency is to exchange information directly between the computer system of a company and its supplier. The electronic exchange of information with a supplier might simply involve sending e-mails with documents attached. Close collaboration with a supplier, however, goes much further, because the output from the supplier's computer system can be fed directly into the company's computer system, without human intervention. Similarly, information output automatically from a company's computer system can be read directly by the supplier's computer system, without human intervention.

There are several benefits of direct communication between computer systems. Removing the need for human input to computer systems saves time and reduces the risk of error. Purchase orders sent by a company can be read and processed by the supplier's system. Similarly delivery notices and purchase invoices from the supplier can be read directly into the company's own system and processed automatically.

Any of the following methods can be used for linking computer systems of a company and a supplier:

- **Extranets** (described earlier)

- **Electronic data interchange** or **EDI**, which is a system for the electronic translation of data from one computer system so that it can be read by a different system. EDI is fairly expensive and is only used by large companies.
- **A supplier can be given direct access to a company's intranet**. It can use this access to obtain information about inventory levels, and recognise when a re-supply of materials will be required. Taking this arrangement to its extreme possibility, it would be possible to give a supplier the responsibility for deciding when to re-supply an item to the company, and the quantity to supply.

Example

The US stores group WalMart has provided an excellent example of EDI. WalMart set up EDI arrangements with its key suppliers that allowed the suppliers to access its inventory control system. When inventory levels fell to a pre-set level, the supplier had to provide a fresh delivery of the item automatically, without the need for a formal order from WalMart. The responsibility for supply therefore passed from the customer (WalMart) to the supplier, but for the benefit of both organisations.

Marketing concepts: the 7Ps

- Marketing and e-marketing: the marketing mix
- Product strategy
- Price strategy
- Place strategy
- Promotion strategy
- Physical environment strategy
- People strategy
- Processes strategy

4 Marketing concepts: the 7Ps

4.1 Marketing and e-marketing: the marketing mix

Marketing is concerned with persuading customers to buy products or services by offering them a unique value proposition that meets their needs better than the products or services offered by any other competitor. Marketing strategy is concerned with the methods that should be used to do this.

E-marketing is the use of electronic methods for marketing. The general concepts of marketing apply to all methods of marketing, including e-marketing. Marketing strategy is based on the '4 Ps'. These have been described in an earlier chapter, in the context of providing value to customers by meeting their needs effectively.

With the growth in service industries, the 4Ps have been extended to the 7Ps:

- Product
- Price
- Place
- Promotion
- Physical environment
- People
- Processes

Together, these aspects of marketing are called the **marketing mix**. These basic concepts of marketing strategy will be explained in some detail, because an understanding of marketing generally is needed for a proper understanding of e-marketing.

4.2 Product strategy

'Product' is a key element in the marketing mix. Value is provided to a customer by the product or service itself. Value comes from a combination of different factors, such as:

- The **features** of the product or service. What is it used for? What does it do? Does it do what customers want it to do? It is also important to remember that the product is more than just the actual physical product itself. It also includes other factors such as warranties and guarantees, and after-sales service.
- **Accessories**. Customers might be attracted by the accessories that are available with a product. For example, customers wanting to buy a personal computer might be attracted by the software that is provided with the computer (within the purchase price).
- **Convenience of use**. How is it used? For example, a mobile telephone that fits into a pocket or a small handbag has the attribute of convenience. Ready-to-cook meals are convenient for people who do not want to cook meals themselves, or who do not have time to cook.
- **Design**. Is the design attractive? Does the design make the product easy to use?
- **Quality**. How reliable is the product or service. What standard of performance does it achieve? Quality can be assessed by the components elements of a product: for example gold is valued more than silver in jewellery products and diamonds are valued more than gold. Quality can also be assessed by the frequency of break-down or expected useful life. In service industries, some business entities develop a reputation for quality and professional service.
- **Packaging**. Is the packaging attractive and convenient? Is the packaging suitable for the way in which the product will be used?
- **Brand name**. The value of a product to the consumer can be enhanced by a recognised brand name, which is an intangible product feature or quality.
- **Safety features**. With some products, health and safety issues might be important - for example, some consumers are concerned about the healthiness of food products.
- **Uniqueness**. Some customers will buy an entirely new product or a low-volume production item, for the prestige of being one of the few owners.

Within a marketing mix strategy, product strategy is concerned with:

- designing new products
- designing new variations of existing products, to sell to a different market segment, or to renew customer interest in a product (if demand is falling), or to create new demand.

For marketing purposes, product design should be related to what customers want and need. The starting point for designing a new product or a new design of an existing product is therefore to assess customer needs and preferences, to establish what aspects of a product are valued more than others, by customers in each segment of the total market.

Differentiation and product strategy

Product design can be used as a part of marketing strategy to create a differentiated product, even if the measure provides only a short-term advantage. For example a manufacturer might offer special versions of a product, a new edition or a change in packaging as a way of creating differentiation.

4.3 Price strategy

Customers choose to buy products that offer a unique combination of price and other benefits. Pricing is therefore an important element of the marketing mix, although some customers are more price-conscious than others, and some products are more price-sensitive than others.

Pricing can also be used as a means of improving the value on offer to customers. For example:

- commercial customers might be attracted by good credit terms and bulk purchase price discounts
- consumers might be attracted by money-back coupons, two-for-the-price-of-one offers, or short-term price discounts in supermarkets and stores
- for products such as cars that are often bought with a personal loan, the terms of the finance deal might be important in obtaining sales.

When a company launches a **new product** on the market, and there are not yet any rival products on sale, it can choose either of the following pricing strategies:

- To set a '**market penetration price**' for the product. This is a low price (or fairly low price). The aim of penetration pricing is to build customer demand quickly by offering an attractive price, so that sales volume is high and the company 'penetrates the market' and wins a large share of the potential market.
- To set a '**market skimming price**'. This is a high price (or fairly high price). The aim of market skimming is to maximise the gross profit per unit sold. Gradually, the price will be reduced and market demand will rise slowly as the price falls. Early customers for a product will often be willing to pay a high price simply because it is 'new' and 'different'. Much of the product's value for the early customers comes from its uniqueness and the fact that most other people do not have a similar product.

When using the internet to market products or services, low price could be an important part of the value proposition to customers. This is partly the reason why the development of e-business has led to a general lowering of prices in many markets.

4.4 Place strategy

Place strategy is concerned with getting products to the places where customers want to buy them.

- For many consumer products, customers expect to find the products whenever they visit a supermarket. A key element of marketing for supermarkets is to ensure that the products are always available on its shelves. However, in some countries the internet has led to a growth in the market for ordering supermarket goods online and having them delivered to the customer's home.
- For consumer goods manufacturers, place strategy will involve developing an adequate distribution network for its products, so that customers can easily find a retail outlet that sells its products. (This is important, for example, in the case

of motor car manufacturers, and manufacturers of consumer durable goods such as washing machines).

- Some manufacturers might base their place strategy on delivery of the product to the customer's home or office. For example, Dell computers will deliver and, if required, install PCs at the customer's address.
- In recent years, there has been a substantial growth in internet banking and online share dealing, where the customer receives a service conveniently on his own computer.
- The development of the internet has made it easier to deliver products to the customer, where the product can be delivered by electronic means. The sale of software products is an obvious example, but music and film can be downloaded from the internet, and customers are able to purchase tickets for travel or entertainment on line.

The choice of distribution network can be particularly important for entities that rely on export sales, but do not have foreign subsidiaries or foreign branches. They will rely on agents and distributors in other countries, and the control over the distribution and availability of its products might therefore be restricted.

A 'place strategy' might be used to gain a foothold in a market. A business entity might seek to sell its product by offering it in a place (through a distribution channel) that rival companies do not use. An example is the development of the market for music, and the use of the internet by consumers for purchasing and downloading selected music. Bands that are unable to get the backing of established music publishers are able to reach customers directly through the internet.

4.5 Promotion strategy

Promotion is concerned with making the customer conscious of a product and wanting to buy it. There are several different aspects to promotion:

- **Advertising**. Advertising can be by several different media, such as television, radio, magazines, newspapers, and billboards. Brochures are another form of advertising. Brochures and advertising messages might be delivered to consumers by direct mail, or electronically as pop-up ads or advertisements with search engine providers such as Google or Yahoo!
- **Sales promotions**. Sales promotions are activities other than advertising that are designed to prompt customers into buying a product. In supermarkets, promotions are often placed at the end of a line of shelves, or at the checkout counter. Some aspects of price marketing (for example, buy one, get one free) are also sales promotions.
- **Direct selling (personal selling)**. Some entities use direct selling for their products. Direct selling is particularly common for selling to industrial/commercial customers, where the potential value of individual sales orders might be very high.

  Some entities use telephone selling, rather than face-to-face selling by sales representatives.
- **Sponsorship**. Some entities use sponsorship to increase public awareness of their product, and improve their general image. For example, many sporting

events and sporting teams are sponsored. In addition, entities might use sponsorship of television programmes to ensure that their name appears on television at the same time as a popular television programme that large numbers of viewers will be watching.

- **Public relations**. Public relations (PR) are concerned with attracting favourable media attention to an entity and its products. For some companies, PR is a valuable way of developing a favourable reputation with consumers. Many news agencies, for example, now obtain their 'news' from information providers who themselves obtain their information from public relations departments and PR agencies.

4.6 Physical environment strategy

Physical environment can be an important element in the marketing mix for services, including retail services. Customers can be attracted to a sales location by the qualities of the environment – for example, a store that is easy to get around and easy for finding products, the comfort and luxury of the surroundings, 'mood music' and so on.

With internet shopping, the design and layout of the seller's website can be a crucial factor in persuading visitors to the site to make a purchase. This is because a well-designed and constructed website provides a suitable environment for selling.

4.7 People strategy

'People' is an important element in the sale of services and also some products. Customers will be loyal to companies that serve them well and efficiently – in face-to-face dealings or in dealing with telephone queries by call centre staff.

The quality of a service often depends on the people who provide it: the way they deal with customers, the friendliness or concern that they show, and the promptness in dealing with customer requests.

As a part of its marketing strategy, companies might train employees in providing good service and some companies have based advertising campaigns on the message that they are a 'people-friendly' business.

4.8 Processes strategy

Processes are an element in the marketing mix for services. A customer might be attracted or deterred by the processes that he must go through to obtain service. Efficient processes can help to win business.

Processes involved in obtaining service might include receiving reminders, having to register, annual subscriptions and form filling. Internet technology can help to make these processes much more efficient and convenient for the customer.

E-marketing

- E-marketing and the 7Ps of the marketing mix
- The 6Is of the e-marketing mix
- E-marketing: promotion strategy
- E-mail marketing (direct mail and the internet)
- E-branding

5 E-marketing

5.1 E-marketing and the 7Ps of the marketing mix

E-marketing is marketing using electronic technology, particularly the internet. The 7Ps of the marketing mix apply to e-marketing just as much as they do to other forms of marketing, although the relative importance of each item in the mix might vary with e-marketing. Here are some examples of e-marketing.

- Product. Some products sold on the internet can be customised so that they are constructed to the customer's specifications. For example, customers of Dell Computers can order a computer on the internet, and specify the features of the computer they want. Dell then assemble a computer to the customer's specifications. Products can be customised. Remember the Dell example. Additionally, products can be bundled, so that related products can be bought at the same time, perhaps at reduced prices. For example, many airline sites offer accommodation, car hire and travel insurance.
- Price. This is more transparent on the internet and users can often compare prices easily. Some websites are specifically designed to compare prices (for example www.dooyou.com.) Pricing can also be dynamic so that prices change frequently according to demand and availability. Airlines are a good example of this approach, as the prices they offer on the internet might change continually.
- Place. Some goods, such as music, video and software can be delivered over the internet.
- Promotion. Websites and e-mail are new ways of advertising goods and services. Buying space on the websites of other companies or on search engines such as Google can provide an opportunity for targeted promotion. Traditional media are currently suffering from a loss of mass audience, as the market for entertainment becomes much more segmented. As television, radio, magazines and newspapers become less attractive for advertisers, the internet has created new advertising possibilities for reaching a wider (and often younger) audience.
- Physical evidence/environment. In terms of e-marketing, the design of a website is important, because visitors will not stay on a website if it is not attractive, difficult to navigate or fails to provide the information that visitors are looking for.
- People. The internet does not involve 'people' in marketing, in the sense that customers are communicating by computer with a website.

- Processes. Buying goods or services by internet is a process, and the quality of this process is another element in the marketing mix for e-business. A sale must be followed up by an efficient delivery service. Many companies send a confirmation of order to the customer immediately after website purchase is made, to reassure the customer that the order is being dealt with promptly.

Example: Electronic marketing and hotels

You may be very familiar with many examples of advertising and selling via the internet. From a strategic perspective, a notable success has been the use of electronic marketing by the hotels and travel industries.

Electronic marketing changed hotel sales and marketing dramatically, and the internet became a low-cost (affordable) global market place for large and small hotels around the world.

Initially, the internet was used by many hotels as a cheap way of selling accommodation. However, as internet marketing techniques improved and search engine technology evolved, website design had to become more sophisticated. Websites had to be designed to follow search engine rules, in order to attract 'traffic' to the site. An understanding of how and why consumers select accommodation is also essential to the design of a site.

Knowledge of how search engines find and rank websites is essential. There is much more to website design than what you see online. This internal construction has much to do with the eventual popularity of the site. Increased popularity relates to increased reservations.

Hotels have also benefited from internet marketing by 'third party aggregators'. These are companies that package air travel, car rental and hotel rooms. Many travellers are attracted by the idea of being able to purchase an all-in-one travel package – flight, car hire and hotel – all in one transaction. Although marketing data is not exact, it has been estimated that perhaps as much as 80% of hotel reservations are first researched on the internet but only about 20% of web searches for hotels are brand-specific and searches for a particular hotel 'chain'.

5.2 The 6Is of the e-marketing mix

In addition to planning e-marketing strategy in terms of the 7Ps of the marketing mix, an e-marketing mix can also be considered in terms of the '6Is'. These are:

- Interactivity
- Intelligence
- Individualisation
- Integration,
- Industry structure
- Independence of location.

Interactivity

Traditional advertising media are 'push media', in the sense that the flow of information is all one way, from the advertiser to the customers, and the advertiser is trying to persuade the customers to buy its products.

A website is a pull medium, because the aim is to attract interest from customers and make them want to visit the site.

The internet can also be used to establish interactivity with customers, and create a dialogue. Interactivity is a very powerful marketing device. Interactivity takes several forms, such as:

- getting visitors to the site to provide details about themselves (and agree to receive e-mails from the website owner in the future), perhaps in exchange for additional information or a free service
- getting visitors to buy a product or service and pay for it using the internet.

Having obtained the e-mail address of an individual, opportunities exist for the continuation of the dialogue in the future, through e-mail marketing messages and 'information updates'. This connection with the customer helps to establish a long-term relationship, which companies can try to benefit from.

Intelligence

The internet can be used as a relatively low-cost method of collecting market research data and data about customers and other visitors to a website. This data can be analysed to produce marketing information about what customers buy, and what information on a website interests them most.

'Clickstream analysis' of data on a website log file can be used to build up a picture of customer preferences, and possibly also to identify different market segments.

Individualisation

In traditional media the same message tends to be broadcast to everyone. Communication via the internet can sometimes be tailored or 'personalised' to the individual. For example, the activities of every customer who visits a site can be recorded and whenever a customer next visits the site, relevant information will be retrieved from the data files and used to produce an individualised message. (In contrast, advertising messages in media such as television are 'one-to-many' messages, and the same marketing message is sent to every potential customer.)

This can be done even if a visitor has not registered with the website as 'cookies' can be sent and stored on visitors' machines. Cookies are small pieces of information, which are used to customise visitors' experiences on subsequent visits to the website.

Integration

The internet provides scope for integrated marketing communications: how can the internet complement other marketing channels to deliver customer service? Many companies are now considering how they integrate e-mail response and website call-back into their existing call-centre or customer service operation. This may require a substantial investment in training and new software.

Some practical examples of how the internet can be used as an integrated communications tool are as follows:

- The website can have a call-back facility built into it. For example, a customer service representative can contact a customer by telephone when the customer provides his name, phone number and gives a suitable time for calling. Similarly when a customer logs on to the website of his bank and looks at information about personal loans or mortgages mortgage information, this can be notified to one of the bank's mortgage advisers or loans advisers, who can then telephone the customer.
- The internet can be used to support the buying decision even if the purchase does not take place on the website. For example, the website might provide a telephone number to call in order to speak to a sales representative and make an order. (This might be necessary for companies that sell non-standard products or services.)
- The internet can be used to support customer service, for example, by encouraging users to check a list of frequently asked questions (FAQ) compiled from previous customer enquiries before contacting customer support via phone.

Industry restructuring

The internet can lead to a re-structuring of the industry supply chain. Disintermediation is the removal of intermediaries such as distributors or agents: this occurs for example when a company starts selling directly to end-consumers through its website, and reduces or abandons its use of sales agents, distributors and sales representatives. In other markets there has been re-intermediation, where new intermediary companies sell the products of other suppliers, when the suppliers had previously sold direct to customers. An example, mentioned earlier, is the use of intermediaries such as lastminute.com to sell holidays, travel arrangements, book hotel accommodation and buy theatre tickets and tickets to other entertainment events.

Independence of location

The internet introduces the possibility of increasing the impact of an entity on a global market. Users of a website cannot easily tell from the website whether it is owned by a small local company or a large multinational or global company. This gives small companies opportunities to sell into global markets.

The internet also makes it possible to sell to a country without a local sales force. In the UK, the internet is used extensively to advertise residential property in other European countries, for purchase or rental.

5.3 E-marketing: promotion strategy

The objectives of e-marketing with a website should be to:

- Get as many potential customers as possible to visit the website. The first task is to get as many potential customers to visit the website, using a mix of traditional advertising media and e-business methods (such as advertising on other websites or search engine optimisation).
- Keep visitors at the website long enough to make a marketing proposal to them. The website must be designed and used so that it delivers a powerful marketing message.
- Achieve a successful marketing outcome, so that the marketing process can continue. A successful marketing outcome from a visit to a website might not be an immediate sale. It might be persuading the customer to give his e-mail address and agree to receive future messages from the website owner. As mentioned earlier, all forms of advertising, on line and off line, should be used to achieve marketing objectives, and usually to support 'mixed mode' buying (in other words, buying through all available distribution channels for the product, not just buying on the internet).

Advertising: traditional media and the internet compared

Using a website to advertise products and services is very different from the traditional media of television, newspapers, magazines and radio. Differences are summarised in the following table.

	Traditional media	**Internet**
Advertising space	An expensive commodity	Cheap and virtually unlimited
Time consumed	Expensive for the advertisers	Expensive for the internet users
Advertising image	Creating an image is usually more important than the content of the advertising message	The content of the message is usually more important than creating an image.
Communication	Push, one-way from advertiser to customers	Pull, drawing the customers to the website. Or interactive.
How are customers persuaded to act?	Provide an incentive	Offer them information (and possibly incentives) Information is the main currency of the internet.

Electronic marketing has become much more sophisticated in recent years, and we can expect more changes in the future. The changes are happening for a combination of reasons.

- Individuals (customers and potential customers) are spending a substantial amount of their time on the internet. Many people now spend more time on the internet than they do watching TV.
- Many more people have started to make regular use of the internet to obtain information about products and services, or even to buy online. Advertising on

the internet has therefore become an important alternative to advertising on television or in newspapers and other media. 'Readership of newspapers is declining, and every day the internet steals more and more attention away from other traditional ways for businesses to advertise.'

- Individuals are also much more familiar with the internet and confident about using it to find suppliers of goods or services.
- As confidence in using the internet has grown, users have come to expect more from websites – more information, ease of finding information, ease of use, a two-way 'dialogue' with the website (using on-screen prompts that ask the user to provide responses).

Customers are increasingly using the internet as their first-choice method of finding suppliers. Companies are increasingly using the internet to market and sell their products and services.

Users expect websites to provide them with much more than they did in the past. Basic websites (with pages of text and a few photographs, for example) might therefore disappoint users. A poor website could put could put a company at a serious competitive disadvantage to its competitors. Companies with the 'best' websites can gain a very useful marketing advantage, attracting more visitors (and so potential customers) and obtaining more online sales.

5.4 E-mail marketing (direct mail and the internet)

Interactivity with the customer allows a company to build up a relationship with the customer through the internet. An important feature of interactivity (after obtaining the customer's e-mail address and agreement to receive messages) is the delivery of e-mail marketing messages. These might simply provide updating information to the customer, in order to maintain the relationship. Or it might include advertising material or a sales offer.

Companies wanting to use e-mail marketing as apart of their marketing strategy should acquire customer lists – a list of actual or potential customers and their e-mail addresses. These can be built up 'in house' over time, by collecting e-mail addresses from visitors to the website. Alternatively, they can be purchased from 'list owners' or 'list brokers' who have acquired customer lists with customer agreements to receive marketing messages by e-mail.

The great disadvantage of e-mail advertising is that since it is so cheap, many businesses – even very small ones – can use it for direct mail, often to internet users who do not want to receive the mail.

Spam

'Spam' has become a significant problem for electronic marketing, and has helped to give direct mail advertising through the internet a 'bad name'.

Spam is unsolicited and unwanted e-mail. Although many consumers receive 'junk mail' through the post, spam is more of a problem simply because of the very high volumes of mail received. Unless software is installed for detecting and blocking

spam messages, the likelihood is that by far the greatest number of e-mail messages received by an internet user will be spam.
From the perspective of internet users, spam is wasteful of their time and resources. It takes time to work through e-mail messages where wanted messages are mixed with spam.

Regulation of direct mailing by e-mail

The problem of unwanted e-mail advertising has already gone beyond the point where legislation and regulation are required. Companies planning to use electronic direct mailing need to be aware of what those regulations are and what must be done to comply with them.

In the UK for example, there are regulations controlling electronic communications. Businesses or individuals sending marketing messages by e-mail must not conceal their identity and must provide recipients with a valid address to send 'opt out messages' to prevent further mail. In addition, unsolicited marketing messages must not be sent to individual subscribers unless the individual has previously given his or her permission, allowing any such messages from the sender.

5.5 E-branding

A brand image can be defined as a collection of perceptions in the mind of the consumer. (These perceptions can be positive or negative.)

A strong brand is important because it immediately confers a certain amount of recognition when consumers are choosing products and services. To make their choice easier, consumers will choose a brand that they have been happy with in the past.

Brand identity can be defined as the elements that are used by a customer to recognise a brand: logos, symbols, colours, packaging etc. For example, part of Coca Cola's brand identity in the past has been the distinctive shape of their glass bottles.

When an established company is planning to market its products by internet for the first time, it has to consider what to do about its brand identity. There are four choices:

- Duplicate its existing brand identity online. However, if the quality of the internet site is poor, the brand could be damaged.
- Extend the traditional brand by creating a slightly different version of the brand. For example, in the UK the BBC extended its name image to its online services, giving the new services the slightly different name of BBC Online. This allowed the useful associations of the BBC brand name to be retained, but also suggested to the customer that the services offered by BBC Online might be different.
- Partner with an existing e-brand. For example, a chain of hotels could market itself online through an airline website and so associate the hotels with the airline brand name.
- Create a new brand for the web. Financial institutions provide good examples of this approach. For example in the UK Cahoot.com is the online banking division

of Abbey. Smile.co.uk is the online bank of The Co-operative Financial Services and is kept distinct from the traditional Co-operative Bank. The new brand name allows an entity to break free from the perceptions associated with the old brand name. The old brand might be perceived by customers as too traditional and if there is going to be a successful, dynamic presence on the web, a new brand is needed without associations of tradition and conservatism.

Customer relationship management

- Definition and scope of customer relationship management
- CRM software solutions

6 Customer relationship management

6.1 Definition and scope of customer relationship management

A feature of the internet is that it can be very difficult to retain customers and build up customer loyalty over time. This is because customers can visit the websites of other suppliers whenever they are dissatisfied with the products or services of a company they have bought from in the past.

Retaining existing customers, as well as attracting new customers, is an important challenge for companies using the internet for e-business.

The purpose of customer relationship management (CRM) is to help companies to understand better the behaviour of their customers, and modify their marketing operations to service customers in the best way possible. Its objectives are to:

- find out more about the purchasing habits and preferences of customers
- profile the characteristics and needs of individuals customers and groups of customers more effectively
- change the way the company operates, in order to improve its service to customers and the marketing of its products.

Customer relationship management is associated with computer software. This is because companies that take CRM seriously will use CRM software.

The Business Link website states that customer relationship management 'is not just the application of technology, but is a strategy to learn more about customers needs and behaviours in order to develop strong relationships with them. As such it is more of a business philosophy than a technical solution to assist in dealing with customers effectively and efficiently. Nevertheless successful CRM relies on the use of technology.'

6.2 CRM software solutions

A CRM software system is available as an off-the-shelf application package. This is the cheapest software solution for companies, although off-the-shelf packages are not always ideally suited to the specific requirements of the individual company.

Some companies have developed or purchased bespoke (tailored) CRM systems.

The main functions of a CRM system are to:

- Collect information for identifying individual customers and categorising their behaviour. (Different categories of customer might be treated as different market segments, and a different marketing approach might be used for each segment of customers.)
- Store the customer information and keep it up-to-date.
- Access the information, often instantly, whenever it is needed.
- Analyse customer behaviour.
- Use the analysis of customer behaviour to develop a more effective marketing strategy.
- Provide customers with a better 'experience' when they contact the company. Customers often feel that they receive better service when they deal with a person who knows about their previous dealings with the company. Customer service staff are able to provide this type of experience because they have access to the customer's CRM record.
- Monitor key customer management performance indicators, such as the number of customer complaints.

Example

Here is how a typical CRM would work for handling telephone queries from a customer.

1. A customer phones up. The telephone system recognises the incoming number and the customer's record on the CRM is displayed on the screen of the call operator.
2. The customer's record will typically contain the following information:
   - Customer name
   - Address and telephone number
   - Contact name
   - Contact job title
   - Contact purchasing authority
   - Personal notes about the contact, such as interests, likes, dislikes
   - Products previously purchased
   - A log summarising recent conversations and other dealings with the customer
   - An alarm/reminder so that customers are contacted or goods despatched when promised.
3. After the conversation ends, the log is brought up to date with details of the conversation.

The CRM allows the company to offer customers a much better service. It does not matter who deals with the telephone call: full information about the customer is available for use by anyone. In particular, having details of previous conversations will save customers from having to explain, yet again, what might have happened in the past.

CHAPTER 13

Business strategy and quality initiatives

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1 Quality and quality management
2 Total Quality Management (TQM)
3 Quality management systems and certification
4 Quality in the development of information systems
5 Six Sigma

Quality and quality management

- Quality
- The connection between quality and business strategy
- Quality control
- Quality assurance
- Benchmarking and quality management

1 Quality and quality management

1.1 Quality

Quality has several different meanings.

- Quality is often associated with the design or features of a product or service. The quality of similar products might be compared by the raw materials content or the workmanship that has gone into the making of the product. Quality might also be associated with the reliability of a product or superior design.
- Product quality is also assessed in relation to price. Better quality helps to enhance the value of a product to customers. Companies try to offer a unique value proposition to customers that will make them want to buy their product and not the products of competitors. Product quality is one of the factors that help to provide value to customers through product differentiation.
- Quality is also concerned with quality of processes and operations. High-quality processes deliver products to customers more efficiently and at lower cost. Quality management is concerned largely with quality in systems and processes, rather than quality in the product itself.
- Quality in operations could mean producing and delivering goods or services to customers that are free from errors and faults, and that meet their design specifications exactly. In this respect, high quality means avoiding waste and inefficiency.
- In more general terms, the quality of operations, processes, systems and products might be defined in terms of providing goods or services that meet the requirements of customers.

The following definitions of quality are all based on the concept of meeting customer needs efficiently and without errors or waste.

- 'Quality is fitness for use' (Juran, 1988).
- 'Quality means getting everyone to do what they have agreed to do; and to do it right the first time is the skeletal structure of an organisation….' (Crosby, 1992).
- Japanese companies found the old definition of quality 'the degree of conformance to a standard' too narrow and introduced a new definition of quality as 'user satisfaction'.

- Quality is 'the totality of characteristics of an entity that bear on its ability to satisfy [customers'] stated or implied needs' (ISO9000 Handbook).
- Quality denotes an excellence in goods and services, especially to the degree they conform to requirements and satisfy customers' (American Society for Quality (ASQ)).

It is useful to be aware of two aspects of quality, conformance quality and perceived quality. Quality management involves managing both types of quality.

- **Conformance quality** means compliance with technical specifications, and ensuring that operations and processes are efficient, eliminating waste, inefficiencies and errors, and so reducing costs.
- **Perceived quality** relates to the expectations of customers about the product, and whether the product succeeds in meeting those expectations.

Reasons for quality failure

When customers are disappointed with the quality of a product or service, the reason for the 'quality failure' could be any of the following:

- A gap between the product concept and the detailed product specification. There might be a concept for a product, but the detailed design might fail to deliver the concept. The idea might be good, but the detail might fail to match the idea.
- A gap between the product design and customer expectations. The product design might succeed in delivering the concept, but the design might nevertheless fail to meet customer needs and expectations.
- A gap between the actual product and its design specification. For some reason the actual product that is made fails to meet its design specifications. This might result in a high level of defective and rejected items.
- A gap between what the entity promises that the product will do and what it actually does. For example the advertised features of the product or service might not actually exist. Poor quality might therefore arise from false promises.

1.2 The connection between quality and business strategy

Satisfying the needs and expectations of customers is the main factor in all these definitions. Therefore it is essential for a company to identify such needs early in the product/service development cycle. The ability to define accurately customer needs in relation to design, performance, price, safety, delivery, and other business activities and processes give a company a competitive advantage through quality.

The importance of quality in gaining a sustainable competitive advantage, and the importance of quality for business strategy, varies with conditions in the industry and market. It is probably more important in some industries and markets than in others.

- Attention to quality and quality management has been a key factor in the great success of Japanese manufacturing companies in the markets for cars, motor cycles and many electrical and electronic domestic appliances.

- However, there is always the possibility that competitors will copy quality initiatives, and unless quality is improved continually, a competitive advantage through better quality might be difficult to sustain.

1.3 Quality control

Quality control is a method of managing the quality of products, services, systems and processes. The purpose of quality control is to ensure that actual quality conforms to a target or standard level of quality, by:

- measuring actual quality and comparing this with the target or standard
- reporting quality performance to the managers responsible
- requiring managers to take corrective measures when actual quality fails to meet the target or standard.

Quality can be measured in a variety of ways, including the number of items rejected in a manufacturing process on inspection/testing, or the number of customer complaints.

Quality control is concerned with maintaining quality at a target or standard level, rather than improving quality standards. It usually involves:

- procedures for checking and inspecting bought-in materials and components, and output from production processes, and
- some form of statistical quality control.

Measuring quality

Typically, measures of quality performance should relate to the key performance objectives of quality, speed, dependability, flexibility and cost. Several quality performance measures that might be used are listed below.

Performance objective	Performance measure
Quality	Percentage rate of defective items The average number of fault or defects per unit produced The number of customer complaints Customer satisfaction ratings The number or cost of warranty claims The average time between failures or breakdowns in a process
Speed	Lead time for processing orders Throughput cycle time (production cycle time) Actual throughput time compared with budgeted throughput time
Dependability	Percentage of customer orders met from inventory Percentage of items delivered late
Flexibility	Range of products New product development time

Cost	Actual cost versus expected cost Cost per operating hour/per machine hour Labour productivity Added value

Statistical process control (SPC)

Statistical process control (SPC) is a system of monitoring the quality of an entire process. This may be the process of manufacturing a product and delivering it to the customer. It may be the process of delivering a service to a customer.

- Quality standards might be measured and tested at various stages in the process, through inspection of a sample of items.
- Quality standards can also be monitored over time, through statistical quality control charts. The quality in a system might be judged 'out of control' when the quality of the process is consistently below standard or falls outside acceptable variation limits (control limits).

1.4 Quality assurance

Quality control is concerned with measuring quality and comparing actual quality with the target or standard quality level. Quality assurance is concerned with:

- defining quality objectives, and
- ensuring that systems and processes are in place to ensure that these objectives are achieved.

Quality assurance includes quality control processes, but is much broader in scope than quality control. It is a planned and systematic approach to ensuring that all the necessary procedures are implemented and the actions are taken to be confident that the product or service fulfils customers' expectations. A quality assurance system should therefore provide reasonable assurance that a product or service is problem-free and performs the task or purpose that it was designed for.

Quality assurance involves the overall surveillance of everything to do with quality throughout an organisation. It is a method of guaranteeing a standard of quality. Standard procedures and processes are established, together with quality standards. Quality assurance then involves procedures for confirming and checking that all the standard procedures and processes have been performed correctly, and that appropriate tests have also been carried out.

The following definitions of quality assurance might be useful:

- Quality assurance is 'all those planned or systematic actions necessary to provide adequate confidence that a product or service is of the type and quality needed and expected by the customer.' (However, quality assurance applies to all internal systems and processes, such as project development and process redesign.)
- Quality assurance means 'providing confidence that requirements will be met'.

1.5 Benchmarking and quality management

Benchmarking has been explained in an earlier chapter, in the context of competitive analysis. It is also relevant to quality management, since quality provides competitive advantage.

Benchmarking is a method of comparing the operational performance of a company with other companies, often competitors, that are considered the 'best in class'.

Benchmarking is said to have originated with the Xerox Corporation in the US in 1982. The company was a manufacturer of photocopiers. It was in serious difficulties, operating with a costly and inefficient bureaucratic management structure and losing market share to competitors. A multi-functional project team was set up to look into the nature of the company's problems. This team:
identified quality standards that were important in areas such as order fulfilment, distribution, production costs, retail selling prices and product features, and
ranked the company's performance in each of these areas against those of its main competitors.

The exercise revealed that Xerox was seriously under-performing in comparison with its competitors. The company then tried to apply what it had learned from the benchmarking process and identify areas for improvement. As a result of this initiative, costs were reduced dramatically, customer satisfaction improved and Xerox again became a major competitor in its market.

There are different types of benchmarking.

- **Internal benchmarking**. Internal benchmarking involves a comparison of performance in key area in one part of an organisation with the performance in one or more other parts of the same organisation. This might be useful, for example, when:
  - an organisation consists of several different regional or area operations, and some regions appear to perform better than others
  - one company takes over another, and the practices in each company are compared to decide which are better.

- **Competitive benchmarking**. Competitive benchmarking involves a comparison of performance in key areas with the performance of the most successful competitors. A problem with competitive benchmarking is that it can be difficult to obtain much information about competitor performance and standards. Competitors' products can be analysed for design features, but superior processes can be the cause of superior performance, and these are difficult to study in detail.

- **Process benchmarking (activity benchmarking)**. This involves identifying and making comparisons of similar processes, activities, products or services in other organisations in a different industry. The aim of this type of benchmarking is to identify best practice anywhere, and look at organisations that have acquired a

reputation for excellence in particular areas of operation, such as fleet management or customer order handling.

An example in the past of process benchmarking is the collaboration between Xerox and Bean, a catalogue retailer specialising in outdoor clothing. After a wide-ranging search, Xerox identified Bean as an outstanding leader in its industry in order fulfilment and processing activities, and obtained the agreement of Bean to collaborate in a benchmarking exercise. Xerox managers visited Bean to learn about its warehousing and order fulfilment processes, and as a result, Xerox was able to improve order picking in its own warehouse.

Total Quality Management (TQM)

- The nature and origins of Total Quality Management
- Quality management and the views of W Edwards Deming
- Quality management and the views of Juran
- Quality management and the views of Crosby
- Summary of the main features of TQM

2 Total Quality Management (TQM)

2.1 The nature and origins of Total Quality Management

Total Quality Management (TQM) is an approach to improving quality in processes and products that originated in Japan in the 1950s. Manufacturing methods and quality management are credited with giving Japanese manufacturers the leading position in many global industries that many of them still enjoy today.

- TQM is 'an effective system for integrating the quality development, quality maintenance and quality improvement efforts of various groups in an organisation so as to enable production and service at the most economical levels which allow for full customer satisfaction' (Feigenbaum).
- TQM is 'the continuous improvement in quality, productivity and effectiveness obtained by establishing management responsibility for processes as well as outputs. In this every process has an identified process owner and every person in an entity operates within a process and contributes to its improvement' (CIMA).

Many of the concepts of TQM are applicable to all business entities. Some of these concepts are explained below, by describing the views of some of the management 'theorists' who helped to develop TQM.

2.2 Quality management and the views of W Edwards Deming

Deming (1900 – 1993) introduced concepts of quality management into Japanese manufacturing in the 1950s. Much of his work was based on the introduction of statistical quality measurement and statistical quality control.

He is also associated with the concept that companies should seek continuous improvement in their processes and methods of working. Continuous improvement ('kaizen') is a key aspect of Total Quality Management. Deming is perhaps most well known for his fourteen points for achieving quality.

1 **Constancy of purpose**. An entity should establish a constant purpose of achieving continual improvements in systems and processes. The long-term purpose of improving quality should have priority over short-term profit requirements.

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2 **A new philosophy**. Companies outside Japan should adopt the new philosophy of quality that Japanese manufacturers apply. Delays, mistakes and defects in materials and workmanship that some companies consider 'acceptable' should not be tolerated.

3 **Cease dependence on mass inspection to achieve quality**. Quality should be built into products and processes in the first place, so that defects do not happen. It is inappropriate to rely on quality checks and inspections to achieve target standards of output quality.

4 **End lowest tender contracts**. Companies should not always buy from the supplier who quotes the lowest prices. The quality of supplied items is important, and the purchasing decision should be based on factors other than cost.

5 **Improve every process**. Every process should be improved. There should be a continual search for ways of introducing further improvements into processes. Improvements should never end.

6 **Institute training on the job**. On-the-job training should be used to improve the skills levels of employees.

7 **Institute leadership**. Managers should provide leadership that helps everyone to do their job better. Managements should be responsible for quality, not just larger volumes of output.

8 **Drive out fear**. Two-way communications between manager s and employees should be developed, so that communications are open and honest. This mans driving out the fear of blame for making mistakes.

9 **Break down barriers**. The barriers between different functions and departments within the entity should be removed. Individuals in different functions and departments should learn to co-operate with each other, working in teams where necessary to deal with problems that arise.

10 **Eliminate exhortations**. Management should eliminate the use of slogans that urge individuals to do better. Slogans such as 'Avoid waste!' or 'Keep on doing better!' are more likely to arouse hostility than obedience.

11 **Eliminate arbitrary numerical targets**. Quantifiable targets should not be used of they are arbitrary. (Deming was a supporter of the concept of statistical quality control, but this does not require arbitrary quality standards: quality standards can be set objectively through statistical methods.)

12 **Permit pride of workmanship**. Employees should be given the opportunity to take pride in their quality performance. This could mean avoiding reward systems that reward employees for 'good performance', because 'good performance' usually means a high volume of production or sales rather than better quality.

13 **Encourage education**. Employees should be encouraged to improve their education, because the knowledge built up within an entity is a way of achieving competitive advantage.

14 **Top management commitment and action**. The success of quality management initiatives depends on the total support and commitment of top management.

Deming's views can be applied to business strategy development, where quality is considered an important strategic objective. Deming would have argued that in order to achieve continuous quality improvements, it is essential to remain committed to the objective of better quality, even if this means some loss of profits and benefits in the short term.

2.3 Quality management and the views of Juran

Juran is another quality management 'theorist' whose ideas originated in the 1950s. He argued that improvements in quality must be planning, and quality planning is a crucial aspect of successful business management. A system of quality management should have the following elements.

- Identify the needs of customers.
- Establish optimal quality objectives that will meet these customer needs.
- Establish measurements for quality, so that quality can be planned and monitored.
- Plan processes that are capable of meeting the quality objectives under normal operating conditions.
- Continually plan for further improvements in quality.

Juran developed a 'quality road map', which is a way to achieving better quality through planning.

- Having identified customer needs, develop a product that meets those needs.
- Optimise the features of the product so that the needs of the company are met as well as the needs of customers.
- Develop a process for making the product.
- Optimise the process.
- Prove that the process sis capable of making the product to the required quality standard under normal operating conditions.
- Make the process operational.

2.4 Quality management and the views of Crosby

Crosby (1926 – 2001) developed ideas on quality management during the 1950s, when he worked on the Pershing missile project in the US. He found that it was normal practice in industry to consider that a certain level of errors or defects in quality was acceptable. He argued that if management are willing to work with 'acceptable quality levels' that allows for defects, they will get the defects that they plan for.

Defects can accumulate throughout the production process. As a result, tolerating a low level of defects at each stage In the production process could mean that the end product contains an unacceptably high defect level. For example if a product contains 100 components and an acceptable level of 1% defects is tolerated for each component, Crosby argued that only 36.5% of finished products would be free from defects.

He therefore argued that the objective in all processes should be 'zero defects'. There should be a continual search for improvements in processes and methods that reduce defect levels and make progress towards the ideal 'zero defect' quality standard.

Crosby specified 'Four Absolutes of Quality Management'.

- Quality means '**conformance to requirements**'. This is not the same as 'being good'.
- Quality is achieved through **preventing defects** in processes and products, not through inspection to find defects.
- The performance standard for quality should be **zero defects**.
- Quality should be measured by **the price of non-conformance** (which is the cost of failing to achieve a zero defects standard).

2.5 Summary of the main features of TQM

The main features of TQM can be summarised as follows:

- The aim should be to meet the needs and expectations of customers. Quality should be defined as meeting the needs and expectations of customers.
- TQM should be applied to every process within the organisation.
- TQM is achieved by involving all employees. This requires a culture of quality within the entity. Every employee contributes to one or more processes, and so has an effect on quality. It is the responsibility of every employee to get quality right. They will accept this responsibility, but only if they are empowered to make some decisions themselves, about how they organise and perform their work. The concept of **empowerment of employees** is closely associated with TQM.
- All costs relating to quality should be measured and controlled.
- In the long term it costs less to prevent defects than to discover defects after they have occurred. The costs of putting errors right (for example, dealing with customer complaints) can be very costly, especially over the long term. Customer perceptions of the quality of a company's products or services could have a long-term strategic impact.
- The aim should be to avoid mistakes, and 'get things right the first time'.
- Systems for improving quality (quality assurance) should be established. These include systems for planning quality, setting objective quality standards and quality control systems.

There should be a search for continual improvement. The ISO 9004 quality standard describes continuous improvement as an eight-step method:

1. Involve the entire organisation
2. Initiate quality improvement projects or activities
3. Investigate possible causes of quality problems
4. Establish cause-and-effect relationships
5. Take preventative or corrective action to improve quality
6. Confirm the improvement
7. Sustain the gains
8. Continue the improvement.

It is not important that each successive improvement is usually small. The key to success with continuous improvement is that it should happen all the time. There should always be a momentum for change and improvement.

Quality chains

The TQM approach recognises the importance of quality chains. The concept of a quality chain is similar to the idea of the supply chain or a value chain. Within a total operation, there are many inter-linking smaller operations. For each of these small operations within the total operation, there is an internal supplier and an internal customer. Quality can only be achieved if every internal supplier within the quality chain meets the needs and expectations of its internal customer.

The strength of the total quality chain throughout an operation is only as strong as its weakest link. It only takes one person in the chain to produce work which is below the quality required for the whole chain to be broken.

For example in a top-class restaurant customers expect a high quality mean with high quality service. Workers in the kitchen are internal suppliers for the head chef, who acts as internal supplier for the waiters. The quality of the end-product to the customer depends on this entire quality chain, and a weakness in any part of the chain will affect the customer's perception of value received.

Quality management systems and certification

- Quality standards
- ISO9000 quality standards
- ISO9000 and the eight principles of quality management
- ISO9000 and certification
- Benefits of ISO9000 compliance

3 Quality management systems and certification

3.1 Quality standards

Total Quality Management is a philosophy of management. It includes statistical quality measurement and control, but it does not provide a specific statement of what an entity should do to achieve an acceptable quality standard in its processes and products or services.

The recognition of quality as an important factor in business planning and performance has led to the development of specific quality management standards.

Companies and other entities might establish their own quality standards. However, external quality standards have been developed for a wide range of business activities, including:

- quality standards in specific industries or products, and
- more general quality standards for management

3.2 ISO9000 quality standards

External quality standards were developed in the UK by the British Standards Institute, now called the BSI Group. There are also some organisations in the EU that establish external standards.

Standards produced by the BSI influenced the development of international quality standards by the **International Organisation for Standardisation (ISO)** which is based in Switzerland.

Like the BSI, ISO has a range of quality standards for specific industries and products, but also has a series of standards for quality management. This is called the ISO9000 series, or sometimes the ISO9000:2000 series, because the standards were revised in 2000.

The ISO9000 series includes:

- ISO9000:2000 'Quality management systems: fundamentals and vocabulary'. This provides definitions for the terms used in the ISO9000 series.

- ISO9001:2000 'Quality management system – requirements'. This specifies the requirements that must be met by an entity wishing to meet the ISO9000 quality standards and obtain certification for having done so.
- ISO9004:2000 'Quality management systems – guidelines for performance improvements'. As the title indicates, this provides guidelines on how an entity can continue to improve its quality management system.

The purpose of the ISO9000 series

The International Organisation for Standardisation has stated that the ISO9000 series is concerned with quality management, and what an entity should do to:

- meet the quality requirements of its customers
- meet applicable regulatory requirements for quality, and at the same time
- enhance customer satisfaction, and
- achieve continued improvement in performance in pursuit of these quality objectives.

The ISO9000 series specifies the requirements for a generic management system, and the same standards can be applied to all types of entity, large and small, business and non-business.

Definition of a quality management system

A management system is defined as the organisation structure for managing processes and activities. A **quality management system** is a management system that produces consistent standards of quality.

The approach set out in the ISO9000 series specifies what management must do to:

- specify the quality that is to be achieved
- achieve the quality specified
- prove that this quality standard has been achieved in practice.

'Quality management' refers to what the entity does to ensure that its products or services satisfy the customer's quality requirements and comply with any regulations applicable to those products or services. It concerns **processes and systems**, and not products. ISO9000 is *not* a product quality standard. The management system standards in ISO 9000 state requirements for what the organisation must do to manage processes influencing quality.

3.3 ISO9000 and the eight principles of quality management

The ISO9000 series is based on eight quality management principles.

- **Customer focus**. Entities depend on their customers. They should therefore understand the current and future needs of their customers, and should meet these requirements and should try to exceed customer expectations. The benefits of meeting this requirement are:
  - more sales revenue and a bigger market share achieved through flexible responses to market opportunities

  - increased effectiveness in using the resources of the entity to increase customer satisfaction
  - improved customer loyalty, leading to repeat business in the future.
- **Leadership**. The leaders of an entity provide purpose and a sense of direction. Leaders should create and maintain an 'internal environment' in which individuals can become fully involved in achieving the entity's objectives. The benefits of meeting this requirement are:
  - motivating individuals towards the entity's goals and objectives
  - improved communications between different levels of the organisation structure.
- **Involvement of people**. Individuals at all levels within the organisation are the 'essence' of the organisation. Getting them fully involved will enable the entity to make the best use of their abilities. The benefits of meeting this requirement are:
  - a motivated and committed work force
  - the encouragement of innovation and creativity
  - individuals willing to be accountable for their own performance
  - individuals wanting to participate and find ways of achieving continual improvement.
- **Process approach**. A desired result is achieved more efficiently when activities and related resources are managed as a process. The benefits of meeting this requirement are:
  - lower costs and shorter cycle times through the more efficient use of resources
  - improved and consistent results
  - an ability to focus on and prioritise opportunities for improvement.
- **System approach to management**. Interrelated processes should be identified, understood and managed as an integrated system. This will improve the efficiency and effectiveness of the entity in achieving its objectives.
- **Continual improvement**. Continual improvement in performance should be a permanent objective of the entity.
- **Factual approach to decision-making**. Effective decisions are based on the analysis of data and information – facts, not opinions or guesswork. The key benefits are (1) informed decision-making, (2) an ability to question the rationale for decisions and (3) change opinions and decisions if appropriate.
- **Mutually beneficial supplier relationships**. An entity and its suppliers are interdependent. A mutually beneficial relationship helps both to create value. The benefits of meeting this requirement are:
  - a better ability to improve value in the supply chain
  - more flexibility and speed of joint response to changing markets and customer needs and expectations
  - better uses of resources and lower costs.

3.4 ISO9000 and certification

The ISO9000 quality management standards are voluntary standards. However, entities may apply for ISO9000 certification if they believe that they comply with the ISO9000 standards.

Certification means obtaining a certificate of compliance from an external auditing/inspecting body. An independent, external body (recognised by ISO) audits the entity's quality management system and verifies that it conforms to the requirements specified in the standard.

The auditing body then records the certification in its client register. The entity's management system is therefore both certified and registered.

3.5 Benefits of ISO9000 compliance

If an entity complies with the requirements of ISO9000, it will benefit from a high standard of quality management. Many of the benefits are set out in the eight principles of quality management.

In addition, if an entity is certified under ISO9000, this provides independent 'evidence' that the entity has an excellent system of quality management, and so is in control of its processes and is focussed on customer satisfaction. This can have marketing benefits.

Some large companies and governments insist that their suppliers should have ISO9000 certification. This provides a specific commercial reason for achieving – and maintaining – ISO9000 certification.

Quality in the development of information systems

- Why good quality software is important for IS systems
- The quality triangle for new information systems
- Software quality assurance
- Quality assurance and quality control in IS/IT system development
- The V life cycle model
- Advantages of using the V life cycle model
- The Capability Maturity Model

4 Quality in the development of information systems

4.1 Why good quality software is important for IS systems

The term 'IS/IT system' is used to mean an information system that is provided through a computer system or computer network. IS/IT systems can be extremely important for business strategy.

- Important new strategic developments might depend on the development and implementation of a major new IS/IT system.
- IS/IT systems can deliver significant added value, through greater efficiency and lower costs, of improved service standards (such as speed and reliability).
- Successful IS/IT systems can give an entity a sustainable competitive advantage over competitors, when the IS/IT system is developed internally as a 'bespoke' or 'tailor-made' system. It might take competitors a long time, and cost them a lot of money, to copy a rival's bespoke system.

Developing a major new IS/IT system can expose an entity to considerable risk, in the event that the new system development goes wrong. A new system might be implemented late or might cost more than expected. More significantly, a new system might fail to do what it was designed for. Instead of providing competitive advantage, a failed IS/IT system might reduce the quality of products or services to customers. This could put the entity at a serious competitive disadvantage to its rivals.

Quality features of software

When a new system is developed, the user wants the software to be of a high quality. Software can be assessed according to several quality characteristics.

- It should **function correctly**. The software should function in the way specified in the user requirements for the system. If software does not function as intended, the user may have an inefficient or an ineffective system that fails to achieve all its objectives.
- It should be **robust**. Software is robust if it operates without faults, and the system does not 'crash' continually. A system may crash, for example, because it

cannot handle the work load. When a system 'crashes' (or when 'the system is down') the user's operations come to a halt.

- It should be **fairly free from 'bugs'**. Software may contain 'bugs' that do not cause a system crash, but that result in data being processed incorrectly, or input being rejected. It is virtually impossible to write software for a bespoke system that is 'bug-free', but in good quality software, the bugs are relatively few in number and not serious.
- It should be **user-friendly**. User-friendliness has been described in an earlier chapter. If software is not user-friendly, the user may be reluctant to use it, and some of its useful functions may not be used at all.

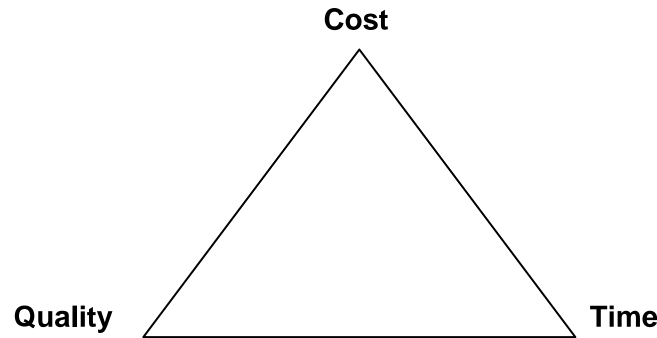
The quality of software can also be assessed in terms of conformity to requirements, reliability, usability and degree of excellence.

- **Conformity to requirements**. Software should do what it is supposed to do, and conform to the user's requirements. What the user requires from the IS/IT system and what is formally specified are not always the same, because there might be weaknesses in the formal specification for the new system. A good quality IS/IT system is therefore one that meets user requirements, so that the user does not have to ask for amendments and changes to the system after it has been introduced. The problem of failure to meet user requirements can be reduced through suitable user acceptance testing (explained later).
- **Reliability**. The IS/IT system should be reliable. This is not simply a matter of eliminating errors in programs. Systems might suffer in practice from excessive 'down time' and insufficient availability to the user. Excessive system downtime might possibly be due to the fact that it was not properly designed to handle such a large volume of processing.
- **Usability**. As explained above, good quality in software can also be measured by its user-friendliness and the ease with which users are able to use it.
- **Degree of excellence**. The quality of an IS/IT system can also be judged by factors such as:
  - whether it is relatively **easy to maintain**
  - whether it is **flexible** and can be adapted for other uses, and
  - **whether it can be expanded** to handle a larger volume of 'traffic' or transactions.

4.2 The quality triangle for new information systems

In view of the importance of many bespoke IS/IT systems for business strategy, quality management is a key issue in IS/IT system development. New system development projects must meet certain targets or standards. Quality in IS development relates to three factors:

- cost
- time
- performance.



Cost

'Cost' as a quality factor in systems development means developing a new IS/IT system on budget, without overspending. If costs exceed budget, there is a risk that the system will fail to provide the required return on investment.

Time

'Time' in new system development means that the system should be developed and implemented on time (on schedule). Delays can be expensive, especially when there is a competitive advantage in implementing a new system ahead of similar systems that competitors might be developing.

Quality

'Quality' here means that a system should meet its design specifications, and perform to the standards that are expected of it.

Compromise between cost, time and performance quality

When new IS/IT systems are designed and developed, a compromise must usually be made between cost, time and performance specifications. However, once the specifications for a new system have been agreed, with an associated budget for expenditure and time schedule for completion, management should try to ensure that the system is designed and implemented within budget and on schedule and that it meets its performance specifications.

4.3 Software quality assurance

Software Quality Assurance (SQA) can be defined as a planned and systematic approach to achieving quality in software development, by means of adherence to standards:

- for software products, and in software development processes and procedures, and
- for the evaluation and testing of software.

SQA includes ensuring obtaining assurance that standards are established and applied throughout the life cycle for software development or acquisition.

Standards provide a framework for developing new software, and they provide established criteria or benchmarks for comparison with actual development and control processes.

There should be quality assurance 'approval points' at certain stages throughout an IS/IT development project, where an SQA evaluation of the project is made in relation to the applicable standards.

New software should be both validated and verified before it is implemented.

- Validation means ensuring that the software is designed to do what the user requires it to do.
- Verification means ensuring that the software conforms to its design.

4.4 Quality assurance and quality control in IS/IT system development

There are external quality standards for software development. As indicated above, standard procedures and processes are an important part of quality assurance. The benefits of IT Standards are:

- to ensure conformity to best IT practice throughout the organisation and in the industry (quality assurance): this will ensure that the desired quality of software and IS system is achieved
- to control computer system operations and practices, and to encourage continuous improvement.

The application of IS standards means that:

- well-established industry-wide procedure standards are applied
- standard documentation is produced for system design and program design
- program coding is developed in accordance with standards
- testing is carried out in accordance with recognised standards.

IT Standards cover all aspects of IT development and operations, including:

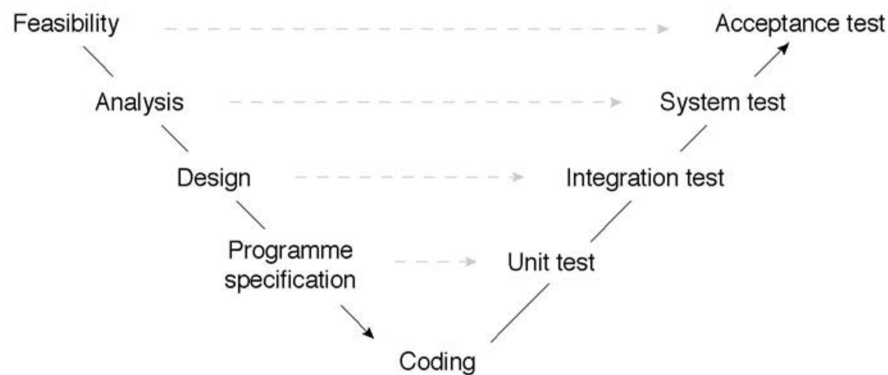
- hardware and software procurement
- control and security procedures
- systems development and implementation, including testing
- documentation.

Whereas quality assurance is concerned with the application of suitable procedures and methods to achieve quality, quality control is concerned with testing.

- **Quality control** in IS/IT system development involves regular testing software and systems against the desired quality standards, design specifications and user requirements. It involves a formal use of testing and acting on the results of the tests.
- **Quality assurance** in IS/IT system development goes beyond quality control. It is concerned with the application of processes, methods and documentation standards, whereas quality control focuses on what comes out of the process.

4.5 The V life cycle model

The V life cycle model for IS/IT system development is commonly used to ensure that appropriate quality assurance is exercised at each stage of a new IS/IT system development project. The model gets its name because the stages of design and testing for a bespoke IS/IT system can be shown in a 'V' model, as follows.



(The name 'V' model comes from the shape.)

The V model shows the stages of system development, and the associated (dynamic) testing for each of those stages. (**Dynamic tests** are tests on the software itself. They involve tests of individual programs or the system as a whole, to check whether these meet the specifications. Unit testing, systems testing and acceptance testing are all examples of dynamic testing.)

- The stages in developing a new system are shown on the left hand side of the V, starting at the top left hand side and moving down to the bottom of the V.
- The stages in testing and implementation are shown on the right hand side, starting at the bottom of the V and moving up to the top right hand side.

Feasibility study

A feasibility study is carried out into the potential benefits of a new IS/IT system. The purpose of the study is to assess whether a new IS/IT system is feasible, what it would do, the benefits that it would provide and the time required for implementation. The study should include a financial evaluation of the proposed information system. A report is prepared for the department or business unit that will be responsible for the new system, and a decision is taken to go ahead with the system development (or decide not to go ahead).

Analysis

The next stage in the system development is the preparation of an outline specification for the new system. This outline design specification states in greater detail than the feasibility study report what the system should be capable of doing, and what it should cost to develop and operate.

Design

After a system has been defined by an outline specification, it is then planned in greater detail, by systems analysts. The total system is divided into units (programs), and specifications are prepared for how the units should integrate to produce the required output for the system as a whole. For example, the design of a bespoke accounts system might be prepared with separate programs or modules for the main ledger, receivables ledger, payables ledger, cost accounting, payroll, management information and so on. The output from this stage of the development is a detailed system specification.

Program specification

When the system has been specified in detail, and divided into separate programs or modules, a specification must be prepared for each individual program. This specification is used by the software programmers to write each program.

Coding

When the individual program specifications have been prepared and approved, the next stage is to write the programs. Coding is the activity at the bottom of the V.

The activities that follow on the right-hand side of the V are all testing activities.

Unit testing

Unit testing is the first stage of testing. Each individual program ('unit' of the total system) is tested in isolation. Unit testing of individual programs is also called program testing. The purpose of unit testing is to test whether the program as written meets the requirements set out in the program specification. (The program specification is on the same line of the model as unit testing, on the left-hand side of the V.)

Dynamic testing on a program is carried out by creating test input data for the program and comparing the actual output from the tests against the expected output.

Example

A simple example of planning a test on software would be a test on a field of data input for the month of the year. The program may specify that the month must be two digits, between 01 and 12. The person testing the program may decide to carry out several tests to confirm that the program will process input into this field of data correctly. He might do this by devising a test with six test items, as follows.

Test item: Entry in the 'month' field of data	Expected output	Actual test output
04	Entry accepted.	
11	Entry accepted.	
01	Entry accepted.	
00	'Invalid entry' message on screen. Entry not accepted.	
7	'Invalid entry' message on screen. Entry not accepted.	
14	'Invalid entry' message on screen. Entry not accepted.	

Devising suitable and comprehensive tests is difficult, because very large quantities of test data would be required to test a program comprehensively. However, the tester should try to devise specific tests that are as comprehensive as possible.

Successful program tests are unlikely to provide a complete assurance that a system will function according to specifications. There are several reasons for this.

- Program tests are tests on individual programs. They do not test how individual programs within the system interact with each other. Integration tests/system tests (including performance tests) are needed to check whether the system as a whole functions according to specifications.
- It is usually impossible to devise test items for every logical combination of possible inputs, because there will be too many to test. Since testing cannot cover 100% of all possible situations, there will always be a risk that the software will not perform properly to specifications. This is a major reason why software errors are commonly found after a system has been implemented operationally (after systems tests and user acceptance tests, although these tests may uncover some errors that the program testing failed to identify.)
- The user may eventually try to use the system in a way that was not predicted, and may input data or instructions that cause the system to fail.

Integration testing

Integration testing follows after unit testing. Integration tests are tests to check whether the program modules or units are fully integrated with each other. A program might work as specified in isolation, but it might not work when it is operating with other programs in the system. The testing aims at trying to ensure that:

- The individual programs in the system integrate with each other properly. For example, the tests should show that data transferred from one program to another is not lost or corrupted in the transfer process.
- The system interfaces correctly with other systems, if this is a user requirement.
- The system performs as required.

The tests should include devising items of test data to process through the system, and checking whether the input has been processed correctly, that the data files are correct and that output from the system is also as expected.

Integration testing can also be defined as a test that the system software as written meets the detailed design specifications prepared by the systems analysts. (The design specification is on the same line of the model as integration testing, on the left-hand side of the V.)

System testing

System testing may be carried out at the same time as integration testing. System testing is concerned with making sure that the system meets its performance objectives and that it will perform to the user's expectations, does what it is supposed to do, is user-friendly and robust. Taken together, integration testing and

systems testing provide a check that the system that was specified has been delivered.

Load testing or **stress testing** might be an element of system testing. This type of test is carried out to see how the system performs when it is required to process large amounts of transactions or handle large numbers of terminals concurrently. The system is tested under extreme conditions (conditions of 'stress'). The purpose of stress testing is to check that the system is capable of handling an unusually large volume of transactions within a short period of time, without performance being adversely affected. For example, a network system with 50 terminals might be tested to see how it performs if all 50 terminals are demanding access to a central server at the same time. Stress testing is also called load testing.

Tests might find, for example, that processing times deteriorate significantly when the system has to process large volumes of data, or response times might become much longer when the system is responding to inputs from a large number of terminals. In some cases, tests might find that the system crashes during load testing/performance testing.

At the end of successful system testing, the system is handed over to the user for testing.

Acceptance testing

Systems tests check whether a system meets the specifications for the system that have been developed by the systems analysts. The system specifications are based on what the systems designers consider to be the user's requirements.

Acceptance testing, in contrast, provides an opportunity for the user to test whether the system meets the original business objectives for the system. These may differ from the formal system specifications, where the design is flawed or where the user specifications were inexact.

Acceptance testing is the final stage of testing. The tests are carried out by the user's staff, using the hardware for the system when it becomes operational.

In other words, the purpose of acceptance testing is to test whether the system successfully delivers what was requested in the feasibility study. (The feasibility study is on the same line of the model as acceptance testing, on the left-hand side of the V.)

At the end of successful acceptance testing, the new system is ready for implementation.

There are two main aspects to user acceptance testing:

- functionality testing. This is testing by the user to ensure that the system performs all the functions that it is supposed to, as specified in the system requirements.
- usability testing. This is testing to see how easy the system is to learn and use.

In addition, since acceptance testing usually involves testing the system with large amounts of test data, it also provides an opportunity to:

- identify more errors in the software or system design that were not discovered during program tests or system tests, and
- train the staff of the computer user in how to operate the system.

Acceptance testing may discover errors and weaknesses in the system that are not identified by system testing:

- Users may input data or commands in ways that the systems designers did not anticipate, and error conditions may be found that had not been provided for by systems testing.
- The user's staff may test for 'real world problems ' - conditions and situations that the systems designers did not anticipate in the system design.
- Acceptance testing may test the system with larger volumes of data that systems testing. This increases the likelihood that some software errors will be found that the program and systems testing did not find.
- Testing with larger volumes of test data may also provide useful performance testing of the system (processing speeds, response times, ability to handle processing loads without crashing).
- Acceptance testing on the actual hardware that the system will use may find that there is incompatibility between the software and the hardware, that earlier tests were unable to check.
- The user is able to test the 'usability' of the system, and identify features that should be made more user-friendly.

4.6 Advantages of using the V life cycle model

The V model therefore maps each stage of 'dynamic testing' on the right-hand side of the V to a corresponding stage of system development on the left-hand side of the V. The advantages of the V model are as follows:

- Tests are performed against specifications that are pre-determined at each stage of the IS/IT project development.
- It specifies who is responsible for testing at each stage. For example, users will carry out acceptance testing; programmers will carry out unit testing.
- It sets out coherent and consistent stages for the testing process.
- It defines the testing that must be done at each stage before development can progress. There's no point jumping to an integration test if the units do not work properly.
- Testing is high on the agenda from the start of the project. It becomes much more expensive to correct software as projects progress, so testing should start at the earliest stages possible.
- The V model, if properly applied, therefore helps to ensure system quality.

The importance of planning and documenting each test

All tests should be planned. The test plans, and the results of the tests, should be documented.

Tests on software and systems must be planned for several reasons:

- The person carrying out the tests has to make sure that the program or system meets its specifications. To do this, specific tests must be devised. Each part of the specification must be tested. In software testing, all logical combinations of input or processing conditions must be tested. Planning is needed to make sure that nothing is overlooked.
- A test is a check on whether a program or the system will work in the way that should be expected. A program or system works properly only if it processes data in the way that it is expected. To carry out the check, it is necessary to compare the actual output from a program or system, and compare it with the output that should be expected.
- Test plans can be documented, and the results of each test recorded to confirm that the software or system passed each test successfully. Errors that are found in the tests should also be recorded, and further tests should be planned and recorded after the error has been corrected. The documentation of testing provides a record that the testing has been successfully completed.
- Planning tests provides a system for control over testing procedures and systems. If an error is found after testing has been completed, the test plans and results can be checked to find out why the error was not identified in testing. Presumably, when errors are not found in testing, the tests were not thorough.

4.7 The Capability Maturity Model

The Capability Maturity Model (CMM) was developed by the Software Engineering Institute (SEI) of Carnegie Mellon University. It describes how entities develop software. The model recognises five stages that entities progress through as they become more sophisticated in their use of IT.

The CMM concentrates on evaluating an entity's ability to perform its software development processes successfully and it gives guidance on how to improve these capabilities. The model is therefore often referred to as the Capability Maturity Model Integration (CMMI) process.

The CMM identifies 5 levels of capability in processes. This applies to all processes, but in particular to the development of new software (IS/IT systems). Entities are encouraged to move up to a higher level, and the model provides guidance for an entity that is at one level on the best way of moving up to the next level.

The objective of SEI was to bring discipline to the development of software. This should result in better-quality software that could be developed in a more predictable way so that there is a greater chance of staying within the cost, quality time constraints. The approach relies on:

- Identifying current capability level.
- Identifying required or desired capabilities of the next level.

- Plan the move from current to desired levels.

The five capability/maturity levels

The five levels and their characteristics are as follows:

Level		Characteristics
1	The process is 'performed'	A performed process is one that meets the objective of the process. For system development, Level 1 capability means that the entity is capable of developing a new system. However, the process is performed informally, without following a documented standard specification. The rigour and success in performing the process often depends on the special efforts of individuals ('heroes'). There is no consistent project management and the quality of performance in the process is variable.
2	The process is 'managed'	A managed process is a performed process that is also planned and implemented in accordance with defined procedures. The process is planned, and management control is applied through comparison of actual performance against the plan. Corrective measures are taken when actual performance differs significantly from the plan. In terms of ISD/IT system development, capability at Level 2 will involve the use of a planned project management methodology and records are taken of time, cost and quality. Problems are identified and dealt with as they occur, but problems are not anticipated in advance.
3	The process is 'defined'	The main distinction between a managed process (Level 2) and a defined process (Level 3) is that at Level 3 there are many more process standards and procedures. In terms of IS/IT development, all aspects of software development (not just the project management) are standardised and consistent. The entity uses well-established standard processes for system development that produce savings in terms of time and cost. Problems are anticipated. Data collected about one project is shared across others.

Table continued

4	The process is 'quantitatively managed'	A process at Level 4 is a defined process that is also controlled using statistical control measures and other quantitative control techniques. Quantitative targets are established for quality and process performance, and these targets are used in the assessment of process performance. At Level 3 a process is managed and controlled only in qualitative terms. At Level 4 statistical analysis is used to identify areas for process improvement. The measurement of quality is therefore a key aspect of Level 4 process capability.
5	The process is 'optimising'	An optimising process is a qualitatively managed process that is continuously improved and adapted to meet developing business objectives. The process sis continually improved by identifying causes of process defects or process variation, and the process is then changed to eliminate the defect or variation. There is strong teamwork with all staff involved in process improvement

Using the CMMI process for IS/IT system development

The CMMI process can be used by entities that wish to improve their process of developing new IS/IT systems, and introducing change successfully. Each level of capability represents a different ability to manage and control the IS/IT development process. An entity should try to improve their process by focussing on how to move from their current level to the next level.

- The CMM describes the practices that an entity must perform in order to improve their IS/IT development process.
- The CMM also provides a benchmark for measuring improvements in the process.
- The CMM also provides a framework within which efforts to improve the process can be planned

Six Sigma

- Seeking 'near perfection'
- The basic approach in Six Sigma
- Process improvement and process design
- Process improvement: DMAIC
- New process design or radical improvement: DMADV
- Six Sigma roles
- The significance of Six Sigma for process re-design

5 Six Sigma

5.1 Seeking 'near perfection'

Six Sigma is an approach to eliminating defects from products and operations, and achieving near perfection. Although it was originally applied to manufacturing operations and defects in products, it can also be applied to any product, process or transaction.

The term 'Six Sigma' comes from statistical analysis, but it is now generally accepted as meaning that there should be no more than 3.4 defects in every 1 million items, for any product or process to which the Six Sigma methodology is applied. The limit of 3.4 defects per 1 million items can be seen as a target, and improvements in existing products and processes and designs of new products and processes should aim towards this target.

Six Sigma was originated in the US the 1980s, by Motorola. (Although the term 'Six Sigma' is widely used, it is a registered trademark of Motorola.). Modern technology was becoming more complex, and it was becoming apparent in some manufacturing industries that old ideas about quality standards and quality control no longer applied. Unless quality standards could be improved in component production, for example, the quality of complex end-products would be much lower than customers had a right to expect. In 1989, having experimented for several years with its approach to quality y improvements, Motorola announced that within five years it intended to achieve a defect rate of no more than 3.4 parts per million in its products.

Example

A company might establish target specifications for the manufacture of a product, and products should be manufactured to this exact specification, or within acceptable tolerance limits. A Six Sigma approach should be to ensure that no more than 3.4 items per 1 million produced will fail to meet the specification, or will be manufactured outside the acceptable tolerance limits.

The IT department of a company that writes software for other departments might set a target for the programs that it writes of no more than 3.4 coding errors per 1 million lines of software code.

5.2 The basic approach in Six Sigma

A definition of Six Sigma will help to explain its key features. Six Sigma has been defined as 'a data-driven method for achieving near-perfect quality. Six Sigma analysis can focus on any element of production or service, and has a strong emphasis on statistical analysis in design, manufacturing and customer-oriented activities' (UK Department of Trade and Industry).

The basic objective with Six Sigma is to focus on improvements in processes and a reduction in variations. **Perfection is achieved by reducing the amount of variations in processes**. For example, if a product is designed with a length of exactly one metre, Six Sigma improvements might be aimed at reducing the variation in the length of products actually manufactured to acceptable tolerance limits of, say, plus or minus one millimetre.

The aim of Six Sigma is to improve customer satisfaction. Its approach is to apply a standard approach (a structured methodology) to reduce and control the causes of variation in a process, and to focus on reducing the standard deviation of actual performance from the target specification.

The Six Sigma approach relies heavily on **statistical measurements**. Actual performance is measured and compared with the target, and the number of 'defects' – products or processes that fail to meet acceptable standards – can be established, to see whether the required quality standards have been achieved.

Another feature of Six Sigma is that **project teams** are established to achieve the required improvements in processes or products. These project teams should consist of representatives from every department or aspect of operations that might contribute towards making the required improvements. The projects teams should be led by individuals who are specially trained in Six Sigma methods, who are commonly called Master Black Belts, Black Belts and Green Belts, according to their level of skill and knowledge of Six Sigma.

General Electric Company, another US company that adopted Six Sigma methods, has stated that Six Sigma is based on the following key concepts:

- **'Critical to quality'**. These are attributes or characteristics of a product or service that are the most important to customers.
- **Defect**. This is failing to deliver what the customer wants.
- **Process capability**. This is the level of quality or performance that a process is capable of achieving.
- **Variation**. This refers to variations in quality that the customer can see or feel in a product or service.
- **Stable operations**. This means consistent and predictable processes and operations that improve what customers see and feel.

- **Design for Six Sigma**. This refers to designing a product or process that meets customer needs and achieves the level of process capability for doing this.

5.3 Process improvement and process design

Rather than the arbitrary application of a quality measure, some companies see Six Sigma as the basis of a campaign to achieve 'best-in-class' status. As a long-term business strategy:

- waste and costs are reduced as quality improves, and
- customer satisfaction is increased through the continuous improvement in quality.

The Six Sigma approach differs slightly between:

- making improvements in existing processes, where the required changes in the process are fairly small ('incremental improvements'), and
- the design of a new process, or major re-design of an existing process.

Process improvements

The Six Sigma approach to making incremental improvements in existing processes is in five steps, known as DMAIC.

- **D**efine an opportunity
- **M**easure performance
- **A**nalyse the opportunity
- **I**mprove performance
- **C**ontrol performance.

New process design/process re-design

The Six Sigma approach to designing a new process or the major re-design of an existing process is also in five steps, known as DMADV.

- **D**efine the goals for the new process
- **M**atch performance requirements with these goals
- **A**nalyse these performance requirements and produce an outline design (a design, but not in detail) of a new process that will meet these requirements
- **D**esign and implement the process
- **V**erify performance.

5.4 Process improvement: DMAIC

The five steps in process improvement using the Six Sigma method are explained in more detail below.

Define

A serious problem with quality is identified.

- A **problem statement** is prepared. This describes the nature of the problem, which must be defined specific, measurable terms. What is the visible evidence of the problem? What are the **symptoms** of the problem? (A 'symptom' is something that is going wrong in the process, expressed as a quantified measurement of **output** from the process).
- A **'mission statement'** is then prepared. This is a statement of what will be done to deal with the problem. The mission statement should also be expressed as a quantified measurement, using the same units of measurement or symptoms that are used in the problem statement. For example, the problem statement may be that the number of defects in a particular process is 1 in 1,000. The mission statement may then be that the aim should be to reduce the number of defects to no more than 1 in 100,000
- A **project team is set up**. This team is given the responsibility and the resources to solve the problem and make an improvement. It should be a 'cross-functional' team consisting of members from all the departments or functions that will be affected by the improvement project.

Measure

Data is obtained about the current process, and the 'symptoms' of the problem are measured in detail. At this stage in the project, the project team should measure how the process is working, and obtain data that can be analysed in order to identify what seems to be causing the problem. Where there are several causes of a 'symptom', the project team should concentrate on those problems that are the main causes.

- This is a preliminary analysis. The project team will not make a final decision about the main causes of the problem until it has carried out a more extensive analysis.
- Measures of process performance are critical to the success of a Six Sigma programme.

Analyse

The preliminary ideas about what might be causing the problem are investigated in more detail. Different theories are tested, until the project team believes that it has discovered the main cause (or causes) of the problem.

- The project team formulate different theories about the main causes of the problem, and documents these theories.
- Each theory is then tested, to establish whether it might be correct. Theories are rejected when it is decided that they cannot be correct.
- The 'root' cause (or causes) of the problem is identified when the testing of the theories has been completed.

Improve

The cause (or causes) of the problem are removed by means of re-designing and improving the process that is causing the problem.

- Several different alternative methods of improving the process should be evaluated, to decide which will be the most effective in achieving the 'mission statement' for the project.
- The chosen improvement is then designed in detail.
- If the improvements are likely to meet resistance to change from some employees, plans should be developed for overcoming the expected resistance.
- Before the improvement is implemented, it should be tested to prove that it will be effective.
- The improvement is then implemented.

Control

New controls are designed and implemented to prevent the problem from returning and to make sure that the improvements are sustained.

Controls will include regular measurements of output from the process, and a comparison of actual performance with the target.

The controls should be audited from time to time, to make sure that they are effective.

5.5 New process design or radical improvement: DMADV

Sometimes, making improvements in existing processes is not sufficient to achieve the required quality standard, and a completely different process must be designed. The five steps in new process design using the Six Sigma method are explained in more detail below.

- **Define**. The goals and target quality standards of the new process must be defined. Customer requirements and expectations should be taken into consideration when defining these goals.
- **Match**. The next step is to develop a set of performance measurements (quantified performance targets) that will enable the goals for the process to be achieved.
- **Analyse**. These performance standards for the new process must be analysed. Based on this analysis, a preliminary design for a new process is developed.
- **Design**. The preliminary design for the new process is developed into a more detailed design, and the new process is then implemented.
- **Verify**. After the new process has been implemented, controls and checks should be introduced to confirm that the required performance targets are met, and that the goals of the process are successfully achieved.

5.6 Six Sigma roles

Because a Six Sigma programme means seeking excellence, implementation requires more than simply explaining to employees what Six Sigma means, and expecting everyone to know what to do to achieve it. It is essential for entities to invest in training selected staff in the appropriate methods, tools and techniques, and then to enable them to manage the Six Sigma programme and guide improvement projects. These selected and trained individuals, particularly those commonly referred to as 'master black belts', 'black belts' and 'green belts', are the core of the Six Sigma programme.

Six Sigma identifies five key roles for its successful implementation.

- **Executive leadership**. This includes the chief executive (CEO) and other key top management team members. They are responsible for setting up a vision for Six Sigma implementation and for allocating resources to the programme.
- **Champions** are responsible for the Six Sigma implementation across the entity in an integrated manner. They are senior managers in the organisation. Champions also act as mentor to Black Belts.
- **Master Black Belts** are identified act as the entity's in-house expert coaches for Six Sigma. They devote 100% of their time to Six Sigma. They assist champions and guide Black Belts and Green Belts.
- **Black Belts** operate under Master Black Belts to apply Six Sigma methodology to specific projects. They devote 100% of their time to Six Sigma. They primarily focus on Six Sigma project execution, whereas Champions and Master Black Belts focus on identifying projects/functions for Six Sigma.
- **Green Belts** are the employees who take up Six Sigma implementation along with their other job responsibilities. They operate under the guidance of Black Belts and support them in achieving the overall results.

5.7 The significance of Six Sigma for process redesign

A key feature of Six Sigma is the search for excellence and near-perfection. In practice many processes fail to provide perfect quality and the scope for improvements is enormous. However, to achieve near-perfection, it might be necessary to introduce radical changes to systems and business methods.

Six Sigma improvements might be targeted for example at:

- the replacement of traditional business methods with e-business methods
- the replacement of traditional organisation structures with virtual organisations
- introducing changes throughout the value chain
- radical process re-design.

CHAPTER 14

Project management

Contents

1 Identifying and initiating projects
2 Managing and leading projects
3 Monitoring, controlling and concluding projects

Identifying and initiating projects

- The nature of projects in business
- Project constraints
- Identifying projects
- Project definition and initiation
- Project plan
- Project risk
- User resistance to new systems and change

1 Identifying and initiating projects

1.1 The nature of projects in business

A project is a process with a clearly-defined start and a clearly-defined finish. It consists of a set of tasks to achieve a goal or objective. Once the goal has been achieved, the project is completed.

For example, an entity might have a project to develop and implement a new IT system, or to develop and launch a new product. The project ends when the IT system is operational or the product has been launched in the market. In some industries, such as construction and IT systems, business entities undertake projects to make their profits; good project management is essential to make sure that projects are completed on time and to budget, and to the customer's satisfaction.

The characteristics of a project are as follows.

- A project has a specific purpose or goal which can be defined.
- A project is unique, and will not be repeated again in exactly the same way as before.
- It has a beginning and a definable end.
- It consists of a series of linked activities that contribute towards the desired goal.
- A project has time constraints, with a target date for completion.
- A project is often complex, bringing together a team of individuals with different skills and from different functional backgrounds or departments. The project team is led by a **project manager** who is responsible for ensuring that the objectives of the project are achieved and the project reaches a successful conclusion. The project manager should be accountable to the project sponsor.

Projects are often initiated with the purpose of achieving a specific end-result. Typical projects involve:

- introducing major changes to processes and systems (process re-design)
- developing a new IS/IT system
- introducing a new e-business initiative

- introducing a new quality initiative (such as a Six Sigma project).

A project should have a **sponsor**. The sponsor is the department or entity that finances the project.

A project may also have a **customer**. In an IS/IT development project, the customer is the department or other unit within the entity that will use the new IS/IT system when it is implemented.

1.2 Project constraints

Projects are usually initiated and carried out within certain constraints.

- **Time constraints**. There is often a scheduled date or latest date for completion of the project.
- **Cost constraints**. There is often a limit to the amount of expenditure that a project is allowed, and projects are expected to be completed within the budgeted expenditure limit.
- **Other resource constraints**. There may be other resource constraints, such as the lack of an individual on the project team with particular knowledge, skills or experience that is needed to improve the quality of the work on the project.

1.3 Identifying projects

The first stage in a project is to identify a requirement. Major projects are intended to achieve a business objective, but someone must first:

- identify how a particular change or initiative might help an entity to achieve its business objectives, and
- decide that the best way of introducing the change or initiative is by establishing a project with a specific objective.

Projects should have a purpose that is consistent with the strategic objectives of the entity, and might be used as a way of implementing particular strategies.

The purpose of project identification and project initiation (described below) is to:

- make sure that the project will achieve identifiable and measurable business benefits and
- the nature of the project is fully understood before it begins.

Experience has shown that many projects fail because of weaknesses in project identification and initiation:

- The nature of the project and its implications for the business are not properly understood.
- The structures are not in place for successful initiation. For example, a project budget and timetable for completion is not specified, inadequate resources are set aside for the project or the project team is inadequate for the purposes of the project.

1.4 Project definition and initiation

Project initiation means setting up and starting a project. The project might be initiated by the Board of Directors or the project sponsor.

Business case

However before a project is initiated, a **business case** must be developed and approved. A business case is the commercial justification for the project.

- It must consider the reasons why a new project is desirable and what it will be expected to achieve.
- It must evaluate the benefits and the costs, and provie a financial justification for the project.
- It must also provide some evidence that the project goals are achievable within an acceptable time frame.

A project needs a sponsor. This is the 'person' (often a department, but it might be the board of directors for a major project) that will agree to finance the project.

The decision by the project sponsor to go ahead and initiate the project will be based on the business case that is presented.

Project initiation document

The goals and objectives of a project should be established before the project begins. These can be set out in a **project initiation document (PID)**. The PID is used to develop and clarify the **terms of reference** for the project.

Typically, a project initiation document will contain the following information:

- Terms of reference (see below)
- Objectives. There should be a clearly defined set of measurable objectives against which project success can be measured.
- The sponsor and the user (customer) for the project should be identified. The PID should state who has the ultimate authority to approve the project on completion, and who has the authority to resolve any arguments or disagreements that may arise during the course of the project.
- The PID should also specify the resources that will be made available to the project, in terms of staff, technical resources and budgeted expenditure limit.
- Milestones. These are key stages of the project development process. Milestones are critical to keeping the project on course.
- The project manager should be identified, and the size and composition of the project team may also be specified.
- There may also be a policy statement on purchasing and procurement, specifying the type of equipment that must be used for the project. (This may be necessary, for example, in a new IS/IT system development project where the entity has a policy of using compatible IT equipment for all its IT systems.)
- The PID may also include an outline project plan, although this may not be produced until later (by the project manager, after his or her appointment).

- Cost and time estimates.

Terms of reference

The terms of reference are a formal statement of what the project is expected to achieve. They will usually contain the following items.

- A **statement of the business objectives** of the entity, and how the project is intended to contribute to those objectives. In other words, how does the new project fit into the overall plans and objectives of the entity?
- A **statement of the specific objectives of the project**. The terms of reference should state what the new project should achieve.
- A statement of the **scope of the project**. The project should have a stated scope. For example, will it be specific to a particular department or region, or will it be used by the entire entity? Which operations will be affected by the new project?
- A statement of any **constraints or restrictions** for the project. For example, it might be decided that the project should use in-house staff only, and that none of the work should be outsourced.
- A target **date for completion**.

1.5 Project plan

Every project should be planned. A project plan should be developed from the project initiation document, although it might be subsequently reviewed and amended, and additional details will be added.

A plan is essential to ensure that the project manager and the project sponsor understand what the re-designed process or new system is intended to achieve, how much it should cost and when the project should be completed.

The plan will therefore include the same items as the project initiation document, except that it will be set out in much more detail.

- The project might be divided into a series of related tasks, each with an estimated time for completion and a latest date for completion.
- A detailed budget for the project should be prepared, so that actual costs can be compared with budgeted costs as the project progresses.
- The objectives of the project should be specified in some detail, so that the success of the project in achieving its objectives can be measured objectively.

Typically, a project plan contains the following information:

Introduction	Purpose scope and objectives
	Deliverables
	Schedule and budget summary
Project organisation	Management and control structure
	Team organisation
	Roles and responsibilities
	Key contact directory

Project budget	Staff cost estimates Subcontractor cost estimates Fixed asset cost estimates Other costs
Managerial process plans	Project plan – schedules Project resources allocated to each major step Quality management plan Project monitoring and control – schedule, costs, quality. Reporting. Risk management plan – identification, prioritising and mitigation of risk.
Technical process plans	Methods, tools techniques Infrastructure Relationship between major activities Product acceptance – criteria for acceptance
Supporting process plans	Documentation Review and audit plan Problem resolution Management of sub-contractors
Additional plans	Installation plans Training plans Changeover plans Maintenance plans

1.6 Project risk

All major projects involve risks. These include risks that:

- the objectives of the project will cease to be relevant because of unforeseen developments in the business environment
- implementation of the project will have adverse consequences that were not foreseen and anticipated
- the project will fail to achieve its objectives, for a variety of reasons including poor management, resistance from employees within the entity or from other stakeholders, a shortage of money or an inability to complete the work on time
- the risk that the project will fail to deliver the expected benefits.

Risks should be identified and understood before the project is initiated. A decision to go ahead with a project should be based on considerations of acceptable risk, as well as expected benefits and financial returns.

Project success factors

Pinto and Slevin (1987) identified nine key factors for success of an IS/IT system development project. These factors apply equally to other projects.

Aims:

1 The project should be clearly defined.

Organisation:

2 The project should have sufficient resources.

3 Control mechanisms should be in place and used.

4 The project must have the support of top management.

5 Communication channels should be adequate.

6 There should be capability for feedback, and comparing actual progress with the budget or target.

7 The project team should be fully accountable to the project sponsor.

People:

8 The project manager should be competent

9 The project team should be competent.

The nature of project failure

Failure is the opposite of success. The factors that determine whether a project is a success also determine whether it is a failure. A project may be described as a failure when any of the following outcomes occurs:

- The project is abandoned before the work is completed, or before the change or the new system is implemented.
- The project costs much more to develop than expected (and/or costs much more to operate than expected).
- The new system is implemented, but meets strong user resistance, and the system is not used as much as expected.
- The system is implemented but fails to meet all the user's requirements.
- The system functions inefficiently.
- The project is completed much later than planned.

These reasons for failure are also potential risks that should be considered before a project is initiated.

Example

A brief example of a project failure is a computerised command and control service introduced by the London Ambulance Service (LAS) in the 1990s. The new system failed badly, and ambulances sometimes took very long times to reach the scene of an accident. The system cost a large amount of public money, and was claimed to have cost a number of patients their lives.

The failure of the project could be explained in terms of environmental factors. A study the following factors as reasons for the failure of the system.

- **Political factors**. The government had published targets for achieving goals in the health service, in the form of a 'Patients' Charter'. In order to meet the targets in the Charter, deadlines for completion of the LAS project were far too short.

- **Economic factors**. Sixteen companies tendered for the contract to develop the new IT system. The contract was given to the software company that submitted the lowest bid, even though it has a limited track record in developing IT systems.
- **Sociological factors**. Ambulance staff were not given enough training in how the new system operated.
- **Technological factors**. The system did not work as well as it should have done. The system operated slowly, and some telephone calls were lost.

Other project risks

Other factors may affect the risk of unsuccessful completion of a project.

- **Size of the project**. As a general rule, the risk of failure is greater for projects that are:
  - large, in terms of the amount of people and other resources required to complete it
  - complex
  - expected to take a long time to complete
  - costly (there is a large budget for the project).

  With a large project, there are more things that can go wrong. There are more activities to plan, monitor and control. The individuals involved in the project may not co-operate properly and so fail to work as an effective team. When a large project fails, the cost is usually high.

  In contrast, small projects usually involve only a small number of people and a small budget. Even if they go wrong, the consequences are not as great.

- **Structure of the project**. The risk of failure is relatively low if the project has a clear structure. A clear structure depends on having clear user requirements, so that the project can be planned and scheduled with reasonable confidence that the objectives of the system are properly understood. The progress of the project can then be monitored, using project management software and techniques such as critical path analysis and budgetary control.

  In contrast, there is a high risk of project failure if the requirements of the user are not properly understood when the project begins, and the user changes the requirements as the project developments.

- **Experience with the technology**. The project development risk is much lower when the project involves technology that the project team knows well. Experience with using a technology brings a better understanding of its capabilities.

  In contrast, when a new system involves new technology that the project team is dealing with for the first time, the technology will be new and unfamiliar. The risk of failure is higher because technical problems may arise for which the project team cannot find a satisfactory answer.

1.7 User resistance to new systems and change

Another risk factor with a project is strong resistance by employees to major changes. For example, users are often resistant to new information systems. They

are reluctant to use a new system and criticise it strongly. When users are opposed to a new system, they are likely to want it to fail.

There are three general theories about the nature of user resistance. These are:

- People-oriented theory
- System-oriented theory
- Interaction theory.

People-oriented theory

This theory concentrates on resistance to a new system because it is seen by individuals or groups of individuals as a threat to something that matters to them, such as their way of working or their social relationships at work.

For example, resistance to a new system may arise from the fact that the system will call for more shift working and 'unsociable' hours of work. A system that allows users to work from home may be resisted by individuals who enjoy going to work because of the people they work with and the camaraderie. Managers may resist a new system for teleconferencing because they prefer the 'old way' of travelling to meet people face-to-face.

System-oriented theory

This theory concentrates on resistance to a new system because of dissatisfaction with the system design. The user interface with the system may be difficult to understand and use, or the users may have difficulty making the system work.

Clearly, if a new system fails to meet requirements, users will criticise it and will not want to use it.

Interaction theory

This theory is based on the view that even if a new system or changed process is well-designed, it could meet resistance from employees who are concerned for the effect of the new system on their status or importance at work.

- A new system or change in work practices may be seen as a threat to a person's job – for example, a new robotics system may threaten the jobs of production workers, and new transaction processing systems may threaten the jobs of office workers.
- A new system may be seen as a threat to the status or importance of someone in their job. Skills that individuals used before the system was introduced may be replaced by automated processing – for example, an expert system may take away some of the 'status' of the experts who use it.
- A new system may result in changes to bonus pay arrangements, and users of the system may be worried that their bonus payments will fall as a result of introducing the new system.

Managing and leading projects

- The project manager
- The project team
- The skills of the project manager
- Problems that arise in project management

2 Managing and leading projects

2.1 The project manager

A project manager is appointed to lead the project team. He or she is responsible for achieving the objectives for the project, as specified in the terms of reference.

Tasks of the project manager

The tasks of the project manager are to:

- agree the scope of the project (as specified in the terms of reference for the project)
- produce a project plan, setting out the different stages of the project and times for completion of each stage, and also the resources required during each stage
- initiate the work on the project, agreeing individual responsibilities with each member of the project team
- liaise with the sponsor and the customer for the project, and discuss the progress of the work and any problems that have arisen
- motivate the project team
- monitor the progress of the work
- ensure that the project meets certain quality standards
- report on progress to the project steering committee, project sponsor and customer for the project
- deal with any slippage in the work that threatens a delay to completion
- ensure that the new system is properly tested and meets its specifications
- deliver the completed the project to the project sponsor.

2.2 The project team

The project team must include individuals with the necessary skills and expertise, collectively, to achieve the project objectives.

A team is assembled for each project, and the size of the team will depend on the nature and size of the project. Individuals for the project team are brought together for the purpose of contributing to the project, and after they have made their contribution (or after the project is completed) they return to their normal job. The

composition of the team may change during the course of the project, as the work progresses and new skills are required for the next stages of the work.

When the project begins, the team members may not have worked with each other before. Since they come from different departments within the entity (and some team members may be recruited temporarily from outside the entity) their culture and attitudes may differ, as well as their skills and work experience. A task of the project manager is to build a successful team out of these different individuals.

The team-building efforts of the project manager will be helped if the project team is given adequate resources to do its work (such as adequate administrative support) and if the project team members share the same office. Team-building is much more difficult if project team members are assigned to a project for only a part of their time, and the rest of their time is spent doing their normal job in a different office location.

2.3 The skills of the project manager

According to **Adair** ('Action Centred Leadership') an effective project manager must satisfy three overlapping needs:

These three needs are:

- **Task needs**: the need to get the task done. The project manager is responsible for ensuring that the objectives of the project are achieved. This role involves planning the work, allocating tasks to individuals or groups within the project team and controlling the progress of the project and project quality. The project leader must also resolve problems that arise during the course of the project.
- **Team needs**: the need to create an effective project team. Until the project is completed, the project team has to be held together and the team members must work with each other and co-ordinate their efforts. The project manager is responsible for creating a sense of team identity, building team morale and co-ordinating the efforts of all the team members.
- **Individual needs**: the need to encourage every individual in the team to give commitment to the project. Individuals within the project team need to be motivated. The project manager must provide support and guidance for each

individual within the team, and should try to get the best out of each team member.

Adair's 'model' shows that these three areas of responsibility for a project leader are inter-linked, and they cannot always be dealt with in isolation. A successful manager gives sufficient attention to all three needs to ensure that the project is completed successfully.

Yeates and Cadle have suggested that a project manager requires the following **core skills**:

- Leadership skills
- Understanding of technology
- Skills in making assessments and decision-making
- People management
- Communication skills
- Planning skills
- Control skills
- Financial awareness
- Procurement skills
- Negotiation skills
- Skills in negotiating contracts
- An awareness of legal issues.

2.4 Problems that arise in project management

During the course of a project, difficulties and problems will arise. In many ways, this is no different from any other business activity. A function of management is to resolve problems.

The Adair model is useful in categorising the type of problems that may arise.

- There may be difficulties in relation to the task, and achieving the objectives of the project. Technical and practical difficulties might have to be dealt with.
- There may be problems in relation to communication and co-ordination of efforts within the team.
- There may be problems with individual team members, because they lack motivation or are not doing their project tasks as well as they should.

With project work, difficulties in managing the project team and individual team members may arise from the fact that:

- the team members are assigned to the project for a limited time and will go back to their normal work when the project is completed
- the project manager does not have 'line management' responsibility and authority over the project team members.

The project manager does not usually have the power to reward project team members. Responsibility for the appraisal, development and rewarding of the individuals in a project team remain with their line manager in the department from which they have come.

Project team members have a dual loyalty. The project manager should try to develop a team identity, so that the individuals assigned to the project feel that they are members of a team and so develop a loyalty to the team. At the same time, individuals in the project team remain aware of the views and attitudes of their managers in the departments from which they come.

The project manager and the project sponsor

When a project manager is having difficulties with individual team members, and difficulty in developing the project team into an effective unit, it might be possible to resolve the difficulties through 'people management', using team leadership skills, or negotiating with the line managers of project team members.

In some situations, however, the cause of a problem might be a lack of resources for the project, or inadequate support from the project sponsor. The project manager has to work within constraints that are unique to the project. These include a limited number of team members, who might also be expected to do their normal work. There are also constraints of time and cost: the project manager is expected to complete the project on time and on budget.

If a problem cannot be resolved because the constraints on the project are too great, the responsibility for finding a solution lies with the project sponsor rather than the project manager.

Monitoring, controlling and concluding projects

- Project management
- Project management software
- Scope management
- Work breakdown structure
- Project time management
- Project cost management
- Project quality management
- Project risk management
- Requests for changes
- Project completion

3 Monitoring, controlling and concluding projects

3.1 Project management

The main tasks of project management are to ensure that the goals of the project are achieved:

- on time
- within budget, and
- to the required standard of quality or to the required specifications.

The project manager has to plan the project in detail and allocate tasks to individuals.

- In planning the work, he needs to identify all the tasks that will have to be done and estimate how long each task will take to complete. He must also understand which tasks cannot begin until others have been completed, and which tasks can be carried on at the same time.
- Having planned the work, the project manager assigns the tasks to individuals or groups of individuals.

When the work on the project is in progress, the project manager must monitor progress, and try to ensure that the tasks are completed on schedule and that the project remains within budget. When there are slippages in time or cost over-runs, the project manager should take corrective measures of possible to catch up the lost time (or prevent further delays) or control expenditure more effectively.

Kathy Schwalbe ('Project Management', 2006) has identified nine areas of knowledge that project managers must show:

- **Integration management**. The project manager is responsible for integrating the efforts of everyone connected with the project, including the project team

members, so that all the work on the project is directed towards the same objectives.

- **Scope management**. Scope management is concerned with establishing the scope of the project, and the work that needs to be done to meet the project specification. There is a risk that the scope of the project will fail to match the project specification, so that either not enough work is planned to meet the project specification, or too much unnecessary work is planned. Scope management also involves breaking down the total project into individual tasks ('work breakdown').
- **Time management**. The project manager has to manage work on each task and the time taken on each task, so that the project is completed on time. Tasks that are not time-critical can be deferred or delayed, without affecting the final completion date for the entire project. However, tasks that are time-critical must be completed at the earliest possible time, and the project manager should give special attention to the prompt completion of these tasks.
- **Cost management**. The expected financial returns from a project should have been estimated when the project was first initiated. Financial returns might be expressed in terms of net present value (NPV) and payback, or internal rate of return on investment (IRR). However, during the progress of the project, the main concern of the project manager should be to ensure that costs remain within budget, and that significant controllable cost over-runs do not occur.
- **Project quality management**. Projects must be managed to achieve the required standards of quality. For IS/IT development projects, this means compliance with IT project development standards, for example standards for design, testing and documentation.
- **Human resource management**. The role of the project manager as a motivator of the project team members, and as a team-builder, has already been described.
- **Communication management**. The project manager is also a communicator. He must ensure that information flows freely between the project team members, and that everyone in the team knows what is happening and what the other team members are doing. The project manager must also prepare periodic status reports on the progress of the project, and report to the project sponsor. He must also try to resolve any conflicts that arise, between project team members, or between the project team and others inside or outside the entity.
- **Risk management**. The project manager is responsible for identifying and monitoring risks in the project, and taking appropriate action to deal with them.
- **Procurement management**. The project manager is responsible for the procurement of materials, services and assets for the project. He may therefore become involved in supplier selection, negotiating contracts with suppliers, and deciding whether work should be done 'in house' or out-sourced to an external supplier (the 'make-or-buy' decision).

Some of these aspects of project management are discussed in more detail later.

3.2 Project management software

Software packages are available for project management, providing the project manager with a variety of tools and systems for recording, monitoring and

controlling progress with the project. The software enables project managers to use project management techniques with the assistance of a PC or laptop computer. (An example of project management software is Microsoft Project).

Features of project management software

Typically, project management software helps project managers to:

- create a list of tasks for the project and their expected duration
- construct a schedule for the completion of the project, perhaps in the form of a critical path chart
- assign resources to each task
- prepare a budget for the project
- track the progress of tasks
- record and monitor actual costs
- manage the documents for the project
- prepare progress reports or status reports.

Software helps the project managers to amend plans more quickly, and prepare revised critical path charts, and revised budgets.

It also helps managers to prepare better and more comprehensive project documentation.

3.3 Scope management

Scope management is concerned with trying to ensure that the work on a project meets the specifications for the project and the needs of the project customer. The tasks that are performed by the project team should be sufficient to meet the project specifications, but should not exceed what is required.

Scope creep

Problems can arise when the project specification fails to describe properly what the project sponsor requires. The project team is therefore being asked to achieve objectives that the customer does not want.

Incorrect or inexact project specifications are common with IS/IT projects. All too often, the project specifications omit important requirements or specify some requirements incorrectly.

'Scope creep' is a term that describes a situation in which the project specification does not properly describe what is required, but the project team carries out the project work to meet these specifications. However, during the course of the project uncontrolled scope changes are made to the project so that the finished project eventually meets the sponsor's and user's requirements. As a result, the project is much wider in scope than it should have been, and it takes longer and costs more than necessary to complete.

Scope creep can be summarised as follows:

- The project specifications ask for X.
- The project sponsor and project user actually want Y.
- The project team therefore does X and also, through uncontrolled changes to specifications, also does Y.
- The project therefore results in the achievement of (X + Y) when only Y was actually required.

3.4 Work breakdown structure

Splitting a project into phases

In order to plan and schedule the work for the project, it is necessary to identify all the tasks that have to be completed. A first step in the identification of tasks is to identify the main stages of the project. Each stage should have an identifiable beginning and an identifiable end (a 'milestone'). In a typical IS/IT development project the main stages of the project may include the following.

Stage	Starting point	Completion point (milestone)
Project planning	Project initiation document/terms of reference	Project quality plan
System analysis and design	Project quality plan	Detailed system specification
Programming	Detailed system specification	Completion of system testing
Database design	Detailed system specification	Database design specifications and construction of database
Implementation	Completed system tests and database construction	Handover of system to the user/customer

Breakdown of work into lower-level tasks

When the project has been divided into stages, each with its own identifiable beginning and end (milestone for achievement), the next step is to break down each stage into more detailed tasks, or 'lower level tasks.

For example, the systems analysis and design phase of an IS/IT development project might include, as lower-level tasks:

- systems analysis and the production of an outline system specification
- design of system input
- design of system output
- design requirements for individual programs (processing requirements)
- file design.

A large number of lower-level tasks may be identified, although the number of tasks should be restricted. This is because the project manager will need to plan each task, and monitor its progress. Identifying too many tasks could make the job of the project manager too complex.

For each task, the project manager needs to:

- estimate how much time will be needed to complete the task (measured, perhaps, in man-days or man-months), and
- allocate each task to specific individuals or small groups.

Prince 2

A work breakdown structure (WBS) is a tool or technique for breaking the total work on a project into smaller and smaller parts, such as:

- the main stages of a project stages
- the lower-level tasks within each stage, and
- work packages, which are items of work within each lower-level task.

Work for each small part of the project can then be allocated to an individual or team. This helps managers to plan the work for the project and allocate each item of work to individual members of the project team.

In the UK, a WBS system in common use for project planning is Prince 2. Prince stands for '**Pr**ojects **in** **C**ontrolled **E**nvironments'. It was first developed in 1989 by the UK government.

PRINCE 2 provides 'product breakdown structure' (PBS) for a project development. The project, which is seen as consisting of a number of 'products', is broken down from the top-down into smaller and smaller work packages. This enables the project activities to be identified within the context of work packages. Work packages are allocated to individuals and teams. The project manager can then monitor the completion of each work package to control the project deliverables (including cost, time and quality).

3.5 Project time management

Controlling time to completion

A problem with the scheduling of tasks and allocation of tasks to individual project team members is to prepare realistic estimates of how long each task might take to complete. There will be some uncertainty in the estimates.

Another problem is that many tasks in a project are inter-dependent. This means that some tasks cannot be started until other tasks have been completed. For example, program software cannot be written until the system has been specified. Programs cannot be tested until they have been written. A system cannot be implemented by the user until the files in the old system have been converted into files for the new system.

Some tasks can be carried out at the same time, in parallel with each other. For example, programming and database design may happen side-by-side. New equipment for the IT system can be procured whilst the system is being programmed and tested.

In order to schedule a project efficiently, so that it is completed in the shortest time possible (or by a target completion date), the project manager needs to identify the inter-dependencies between certain tasks.

Having specified the tasks to be completed, the resources required for each task, the estimated time to complete each task and the inter-dependencies between them, the project manager can prepare a schedule for the project. It is common to use planning tools or techniques to prepare this schedule. A common planning tool is **network analysis** (also called **critical path analysis**).

Project network and critical path

A **network** is a schedule of the work for a project, showing all the tasks that have to be completed, the inter-dependencies between them and the time-scale for completing them. A network is shown as a diagram or chart.

The network chart will also indicate the tasks that must be started and completed at the earliest time possible, in order for the project to be completed in the earliest possible time. There is a chain of 'critical' activities, one following immediately after the other, that must all be started and finished at the earliest possible time in order to complete the total project within the minimum time. This chain of time-critical activities is the **critical path**.

Network analysis or critical path analysis is a technique that is widely used to plan the timing and scheduling of a project, by drawing the project network and identifying the activities on the critical path and the total duration of the critical path. Identifying these time-critical activities will help management to allocate resources to those activities where serious delays to the entire project might otherwise occur.

In order to prepare a network chart, or critical path analysis (CPA) chart, the following information is required:

- the individual tasks to be completed
- the estimated time to complete each task
- the inter-dependencies between tasks: in other words, which activities must be completed before another activity can begin.

Monitoring completion times: slippage

A CPA chart can be used by the project manager to:

- check whether the time-critical activities are being completed on schedule
- recognise by how much non-critical activities can be delayed without risking the completion time for the project as a whole
- recognise when the completion time for an activity has over-run the schedule (and there is 'slippage' in the timetable for completion) and analyse what the consequences of the slippage will be for the completion time for the entire project

- allocate extra resources to time-critical activities if there is a risk of delay, or if the expected slippage is unacceptable.

3.6 Project cost management

As indicated earlier, one way of controlling costs of a project is to compare actual costs to date with budgeted costs, and report variances between actual and budgeted costs. When variances seem to be too high, they should be investigated and appropriate control measures should be taken where necessary to control excess spending.

A problem with this method of budgetary control is that differences between actual and budgeted cost to date will be due to two factors:

- actual spending on activities is higher than planned
- the amount of work done to date is more or less than scheduled.

An analysis of costs should allow for these two variances: expenditure variances and schedule variances.

Example

A project was scheduled to last for one year and to cost $4,000,000. Actual spending after three months was $1,150,000. It was expected that after three months, 20% of the total project work would be completed. However, the actual amount of work completed was 25% of the total work required to complete the project.

After three months, it was expected that 20% of the work would be completed, at a cost of (20%) $800,000. Only 25% of the work was completed, therefore the cost to date should be $1,000,000 (= 25% × $4,000,000). This means that $200,000 of the overspending can be attributed to faster-than-expected completion of the work.

However, 25% of the project should cost only $1,000,000 (= 25% × $4,000,000) and the actual expenditure was $1,150,000. This difference of $150,000 is due to excess spending on the activities. The activities actually performed to date have cost $250,000 more than budgeted.

A summary of the situation after three months is therefore as follows:

	$		$	
Costs of work scheduled to date			800,000	
Variances				
Schedule variance:				
Extra cost because work is ahead of schedule	200,000	(A)		
Expenditure variance:				
excess spending on actual work to date	150,000	(A)		
			350,000	(A)
Actual spending to date			1,150,000	

This method of analysis provides a better analysis of spending than traditional budgetary control, because it provides an analysis of differences between actual and budgeted costs due to:

- differences between scheduled work to date and actual work to date, and
- differences between actual and budgeted costs for the work actually done so far.

This method of analysis is the basis of earned value analysis.

Earned value analysis

Earned value analysis is a method of providing regular periodic reports on the costs to date of a project. The information provided by earned value analysis reports helps the project manager to:

- identify the excess spending on a project, by comparing the actual and budgeted costs of the work done to date
- provide a measurement of progress on the project, by comparing the budgeted cost of the scheduled work to date and the budgeted cost of the actual work to date.

As shown in the previous example, these two variances together explain the difference between the scheduled cost to date and the actual expenditure to date on the project.

With earned value analysis, the comparison of scheduled work and actual work done, and actual and budgeted expenditure, is done on an activity-by-activity basis. Project management software may include a facility that allows project managers to make this type of analysis.

Example

A project has just been started. At the end of May, it had been scheduled that four activities would have been started, and one of these would have been finished. By the end of May, only three activities had been started but two of these had been finished. An analysis is shown below.

Activity	Scheduled completion by the end of May	Actual completion by the end of May	Budgeted cost for entire activity	Actual cost to date
			$	$
A	100%	100%	20,000	22,000
B	50%	25%	18,000	6,000
C	75%	100%	40,000	43,000
D	10%	0%	25,000	0
				71,000

An earned value analysis can be made, as follows.

Activity	Scheduled cost by the end of May	Budgeted cost of actual work done	Actual cost to date
	$	$	$
A	20,000	20,000	22,000
B	9,000	4,500	6,000
C	30,000	40,000	43,000
D	2,500	0	0
	61,500	64,500	71,000

	$		$	
Costs of work scheduled to date			61,500	
Variances				
Schedule variance:				
Extra cost because work is ahead of schedule	3,000	(A)		
Expenditure variance:				
excess spending on actual work to date	6,500	(A)		
			9,500	(A)
Actual spending to date			71,000	

3.7 Project quality management

Controlling quality

There should also be systems for ensuring that the project work is achieving the required standards of quality, or meeting the project specifications. One method of controlling quality is to establish '**gates**' that the project must pass through on the way to completion. To pass through a gate, the project must succeed in passing a test of quality.

Depending on the nature of the project, it might also be possible to use statistical quality control methods for monitoring and controlling quality.

Project quality plan

A project quality plan might be prepared, providing specifications for various aspects of the project, in order to ensure that the required project quality standards are achieved.

The project quality plan may contain the following items:

- **Project overview**. This gives a broad description of the project and its objectives, and identifies the project user/customer. This section of the project quality plan should be consistent with the project initiation document (terms of reference).
- **Project organisation**. This section of the quality plan specifies the management and organisation structure for the project, and the management responsibilities. It includes, for example, the names of:
  - the members of the project steering committee
  - the project sponsor
  - the person to contact in each user or customer department

- the project manager
- the project team members.

It should also specify the formal reporting procedures, the methods to be used for monitoring and controlling the project, and the decision-making responsibilities.

For example, the quality plan may specify that the progress on the project should be monitored by a project assurance team (with named members) which should meet regularly to consider progress reports from the project manager.

- **Project requirements**. This section of the project quality plan specifies the requirements for the project, in terms of what must be delivered. The project work may be divided into phases, with each phase ending when a recognisable 'milestone' is achieved. Target dates will be set for reaching each milestone. (The new project may be introduced in stages.)

  The project specifications might include performance specifications for the new system or process, security specifications, the required standards and any legal specifications.

  The completed project will be tested against these specifications, to make sure that they have been met successfully.

- **Project development**. This section of the quality plan specifies the methods to be used to develop the new system, and the testing requirements. The different phases of the development work should be identified, with target completion dates for each phase.

- **Quality assurance**. This section of the plan specifies how the work on the project should be reviewed as it progresses, to ensure that it is being performed to the required standards and specifications. The methods that will be used to carry out quality assurance checks should be specified.

- **Change control management**. This is concerned with requests for changes to the detailed specifications for the IS/IT system as the project progresses. When changes are requested, there should be a formal system for documenting the requests – including the reason why the change is needed and why it is desirable. There should be a system for approving requests for changes, and for ensuring that they are made correctly (with suitable changes to all system specifications and programming documentation, and suitable testing to make sure that the change has been made correctly).

- **Testing methods**. The quality plan should specify the testing methods to be used on the new system or process before it is implemented.

- **Documentation standards**. A section of the quality plan should specify the documentation that should be produced for the new system or process. For example, the requirements specification for a project might be drawn up using a standard format in order to ensure that nothing is omitted from the statement of requirements and that the requirements should be comprehensible.

- **Procurement**. A section in the quality plan should specify quality standards for the procurement of materials (and in the case of IS/IT development projects) hardware and any off-the-shelf software. For example, the quality plan should state that a specified **Invitation to Tender procedure** must be followed for the procurement of major hardware items such as computer equipment and communications link rentals.

- The **work performance of sub-contractors** must also be subject to specified performance quality standards.
- **Risk management**. The project quality plan should also specify requirements for risk management for the project. For example, the plan might specify that there should be a review of risks at each stage of the project (by the project team or project assurance team), and that significant risks should be recorded, together with details of the measures taken to eliminate or mitigate the risks.

3.8 Project risk management

Project risks have been described earlier. The project manager is responsible for monitoring risks. A record should be kept of the significant project risks that have been identified, and the measures that have been taken to reduce or control them.

Risk register

A risk register can be used as a record of identified risks and control action.

A risk register lists all significant identified risks and the results the evaluation of the risks by the project team. Information on the current status of the risk is also recorded. The risk register should be continuously updated and reviewed throughout the course of a project.

A risk register should contain the following information:

- Category of risk
- Individual who identified the risk
- Date the risk was identified
- Date the register was most recently updated for this risk
- Description of the risk
- Probability that an adverse event will occur
- Expected impact if an adverse event does occur
- Measures taken to deal with the risk
- Current status of the risk/control measures.

3.9 Requests for changes

With large projects that take a long time to complete, it is common for the project sponsor to ask for changes to the project specifications. Changes might arise because:

- the project sponsor realises that the original project specifications were incorrect, and wants to change them so that they specify requirements correctly
- there might be changes in the business environment that alter the strategic situation, and the project sponsor's requirements are changed by these developments

- the project sponsor keeps thinking of extra requirements that would be 'useful' or 'desirable'. (This is a form of 'scope creep'.)

The project manager must react to requests for changes in an appropriate way.

- The first step should be to consider the changes that have been requested, and decide whether they are feasible.
- If the requested changes are feasible, an estimate should be made of the effect on time to completion of the project and the project's cost. The project sponsor should be informed about the expected effects of cost and completion time.
- The project sponsor should be asked to agree to the delay to completion and the additional cost. (The project sponsor might be reluctant to agree.)
- The request for the change should be documented. 'Unofficial' or 'uncontrolled' changes to specifications should be avoided, because the individual or group responsible for changing the specifications should be formally identified. This individual or group should then be responsible for the consequences of the changed specification (for example, for any delay or extra cost, or reduction in process/system quality).
- The new project specification should be analysed, and amendments should be made to the project design, scheduling, budget, resource requirements, and so on.

3.10 Project completion

There should be formal procedures for the conclusion of a project. On completion of a project, the 'end result' is handed over to the project sponsor or project client for implementation. The 'end result' might be a new process or a new IS/IT system.

The procedures in project completion should include the following:

- Acceptance testing by the project 'client'. Before a new process is implemented or a new IS/IT system is introduced, thorough tests should be carried out to ensure that the outputs from the project meet:
  - the project specifications and
  - the requirements of the project client.

  At this stage, the project client might identify problems with using the new process or system, and changes might be requested at this late stage to improve the process quality or system performance.
- On successful completion of acceptance testing, the process or system is handed over to the project client for implementation. The project manager might prepare a project completion report for the project sponsor.
- The project team is disbanded.
- There should be a post-completion audit of the new process or system, some time after its implementation.

Post-completion audit (post-implementation review)

The purpose of a post-completion audit of a new process or system is to assess the success (or failure) of the project in meeting its intended objectives.

The audit or review should be carried out by a person or a team that is considered 'independent'. Members of the project team and the project client should not be the auditors.

The review should assess the project in terms of:

- whether the objectives of the project have been achieved, and the re-designed process or new system has achieved the expected benefits, and
- in terms of quality, time and cost.

Review of the benefits achieved from the project

Projects are usually undertaken to introduce changes into an organisation, and the purpose of a project is therefore to implement business strategy. If the project has failed to achieve the benefits that were expected, the implications for the entity's business strategy should be assessed. A failure in one project to achieve the expected benefits could mean that the business strategy must be reviewed, and new initiatives must be considered.

The assessments from the post-completion audit of projects should be included within the next general strategic review and position analysis.

Review of cost, time and quality

A post-completion audit should also review the cost of the project, the time it took to complete and the quality of the output from the project – the new process or system.

For example, a post-completion audit of a new IS/IT system should assess:

- whether the project client is satisfied with the new process or system
- whether the system is easy to use or the new process is trouble-free
- the problems that have occurred with the implementation of the process or system, why they happened and whether they have been resolved
- the ability of the process or system to handle the actual volume of transactions, and whether it will be able to handle the expected growth in transaction volume.

The post-completion audit might find that lessons can be learned for the future, so that mistakes that were made with the project are not made again with future projects.

Metrics for post-completion review

The assessment of a project in a post-completion review should ideally be based on quantified measures of performance or achievement ('metrics'). Actual measured

performance should be compared against targets or objectives that were established in the feasibility study for the project.

For example, the feasibility study should include specific measures for the expected benefits from the project, and the expected costs of developing the project and operating the new system or process. The actual benefits and costs should be assessed in the post-audit, and compared with the expected benefits and costs.

Quantified measurements of performance should help management to assess whether the financial objectives of the project have been achieved, as well as the strategic objectives.

CHAPTER 15

Finance and business strategy

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1 The link between finance and business strategy
2 Financial analysis for business strategy

The link between finance and business strategy

- Role of the accountant in business strategy
- Financial objective
- Funding strategy

1 The link between finance and business strategy

This is a short chapter, but financial aspects of business strategy are an important aspect of the examination syllabus for Business Strategy.

The reason why this chapter is short is that you should already have acquired a technical understanding of financial issues from your earlier studies. In the examination, you might be required to apply your understanding of finance and accounting to the development and analysis of business and corporate strategy.

Finance issues are relevant to strategic planning in three ways.

- A finance objective is normally the main corporate objective of a business entity. Even for a not-for-profit entity, its main objective will be limited by the availability of finance.
- An entity must have a financing strategy. It must be able to finance its planned strategies. If it does not expect to have enough financial resources to pay for its planned product-market strategies, it must develop strategies for how it should obtain the additional finance required.
- Accountants should be able to provide valuable management information to management about business strategy, to help management to make strategic decisions.

1.1 Role of the accountant in business strategy

Accountants and the accounting function have some role in business strategy, but the extent of their involvement will depend to some extent on the attitude of the accountants within a business organisation to strategy development and business growth.

- Traditionally, accountants have been associated with a culture of taking the safe option and avoiding risk, whereas successful business strategy depends on being entrepreneurial and taking risks.
- Traditionally, accountants have been associated with judging the merits of any investment on the basis of financial return and (often) short-term profitability and cash flow, without taking non-financial factors into consideration. If accountants are to be involved in business strategy, they need to accept the long-term nature of many strategic decisions, and the difficulty of making reliable financial assessments.
- Accountants are often reluctant to innovate themselves. Their reporting systems are often based on analysing profits of products, services and business sectors. For the purpose of business strategy, reporting systems are needed for analysing

customer profitability and the profitability of distribution channels, and for measuring the effectiveness of marketing strategy. Accountants will not be closely involved in the management of business strategy unless they are able to be innovative with their financial reporting systems, and work closely with colleagues in other disciplines, especially marketing.

The role of the accounting function in corporate strategy will include:

- Providing systems for recording financial transactions and preparing annual financial reports and accounts.
- Providing management information systems and procedures for decision-making (budgets and budgetary control, capital investment appraisal and DCF analysis, and so on).

The role of the accounting function in corporate strategy might also include (and ideally should include):

- Assisting colleagues in R&D and marketing with new product screening, and decisions about whether to develop and market a product.
- Strategic investment appraisal, which involves a strategic assessment as well as a financial assessment of proposed new investment projects.
- Providing a reporting system for the marketing function, by providing management information on customer profitability and channel of distribution profitability, as well as product profitability.
- Working with marketing colleagues to assess the effectiveness of marketing initiatives and the marketing mix.
- Helping colleagues to identify and measure added value throughout the value chain.

1.2 Financial objective

It is important to remember that a business entity has a financial objective, which might be stated in terms of providing a return to the shareholders. In selecting and implementing its product-market strategies, an entity should not lose sight of its financial aims.

In preparing a business plan, senior management should assess the expected return for shareholders, in both the short term and the long term, from the planned corporate and business strategies.

The financial objectives might be measured in terms of annual profit growth or return on shareholder capital over the period of the business plan. Other measurements of financial return might be used.

Example

UK company William Hill is a listed company specialising in gambling, with a chain of betting shops and a business for on-line betting through the Internet.

A UK government policy was announced indicating that a large number of gambling casinos would be allowed to open up and operate. William Hill decided that it should follow a strategy of concentric diversification by entering into this new area of operations. Its intention was to expand into casino operations by means of an acquisition, and it began to accumulate cash to finance it.

However, the UK government changed its policy and chose to restrict the number of casinos it would allow in the country. This change of policy dramatically altered the strategic outlook for William Hill, which now saw 'fewer synergies' between betting and casino operators.

Instead of using its cash to fund other acquisitions, the company recognised its primary objective, to provide a return to its shareholders, and in 2005 it announced an additional dividend of over £450 million.

Having a strong cash position, and no longer expecting to make a takeover bid, it felt that it could support a much higher level of debt finance if necessary, and had no need for the cash to finance growth.

The company still intended to pursue strategies for growth, but these were now expected to be:

- Increasing the number of point-of-sale machines in its betting shops
- Buying and opening more betting shops
- Expanding its on-line betting business.

1.3 Funding strategy

The main objective of a company is to achieve a financial return for its shareholders. In addition, a company should have finance strategies that support the overall business objectives.

An important aspect of finance strategy is funding. An entity needs to plan its funding requirements in advance, so that it is able to obtain the funding required:

- when it is needed
- at an acceptable cost and
- without exposing the entity to unacceptable financial risks.

The funding gap

The major source of additional funding for companies is retained profits. The amount of funding available to a company from retained profits depends on:

- profits after tax, and
- dividend payment policy.

Estimates can be made about the expected profits that will be made each year over the business planning period, and the amount of dividends that the company

intends to pay to its shareholders (which depends on the company's dividend policy).

Estimates can also be made about the amount of funding required for capital investments, including investments in additional working capital.

For each year of the planning period:	$
Total investment requirements	X
Funding available from retained profits	Y
Funding shortfall (or surplus)	(X – Y)

The finance and accounting function will normally prepare the estimates of both investment requirements each year, and also estimates of retained profits.

Filling the funding gap

A funding shortfall is a funding gap that has to be closed. The funding gap might accumulate over the period of the business plan. For example, if there is a funding shortfall of $4 million in Year 1, $2 million in Year 2 and $5 million in Year 3, there is a total funding gap of $11 million over the three-year period. The gap might be closed by raising additional finance of $11 million in Year 1. Alternatively, the entity might raise $4 million in Year 1 and $7 million in Year 2.

A funding strategy should be developed, to decide how the funding gap can be closed. There are two ways of closing the funding gap:

- changing business strategies, so that the capital investment requirement is reduced, or
- obtaining additional funds.

Financial gearing

The main external sources of funding are:

- equity finance (issuing new shares)
- debt finance (bank borrowing or issuing bonds)
- leasing finance.

A company should not use short-term finance (credit from suppliers and a bank overdraft) to finance long-term capital requirements.

You should already be aware that debt capital is usually cheaper than equity capital. Equity shareholders should expect a higher return than providers of debt capital, because their investment risk is higher. Companies also receive tax relief on interest payments on debt, but do not get tax relief on dividend payments to shareholders.

Since debt capital is cheaper than equity, companies might be expected to prefer borrowing to issuing new shares.

However, with high levels of financial gearing (a high ratio of debt capital to equity capital) the financial risk for the company is higher. There is a greater is that the

company will be unable to meet its obligations to pay interest on the debt and repay the debt capital on schedule.

- High gearing may therefore increase the risk of legal action by lenders and insolvency.
- A highly-geared company may also have difficulty in raising additional debt finance, except at a much higher interest cost.

Funding strategy may therefore be based on achieving or maintaining a suitable level of financial gearing, by obtaining required funds through a mixture of retained profits and external funding (equity, debt and lease finance). There are no 'rules' about the maximum level of financial gearing that is safe or desirable.

Example

A company has estimated that it will need an additional $40 million of capital in the next three years. Of this total, it is expected that $10 million will come from retained profits.

The market value of its equity is currently $80 million and its total long-term debt is $60 million.

The board has agreed the following finance strategy:

- At least one third of its total capital value should be in the form of equity and at least one-third should be in the form of debt capital.
- The remaining one-third of capital value may be either equity or debt.
- The choice between debt and equity for external funding should comply with this strategy requirement, and should also seek to minimise the company's cost of capital.

Other influences on funding strategy

There might be other factors that affect a company's choice between equity and debt as a source of new finance. Small and medium-sized enterprises (SMEs) whose shares are not traded on a stock market often have difficulty in obtaining new equity finance, and they are usually unable to raise debt finance by issuing bonds. These companies must therefore rely for long-term funding mainly on retained earnings, bank loans and lease finance.

- In your examination, if you are asked to discuss funding strategy for a **private company**, do not write an answer that discusses funding options that are available to a public company but not a private company. The examiner has commented: 'In our experience, candidates too readily associate funding opportunities and stakeholder expectations of a plc [public company] with a case study scenario which is clearly describing a private limited company.
- A private company might choose a strategy of **becoming** a public company so that it will be able to issue new shares on a stock market and improve its access to external equity funding.

You should also try to be aware of the current financial markets, and how conditions in the financial markets might affect funding decisions. At the time of writing this text:

- **Borrowing costs are fairly low**, and many companies have increased their financial gearing in order to benefit from low costs of borrowing. A typical strategy for public companies has been to borrow long-term funds and use the money to buy back (and cancel) shares. Shareholders have generally welcomed this strategy because it returns capital to them, often at a favourable price for their shares.
- **Private equity** companies have taken advantage of low costs of debt to buy up public companies and 'take them private'. A private equity company, or consortium of private equity companies, make a takeover bid for a targeted public company, ad they acquire all its shares. The purchase is financed largely with debt capital. The company is then converted into a private company, and specialist managers are appointed to run it. Within the next few years, the appointed managers are expected to improve the financial returns from the acquired company. In most cases, the acquired company takes on much higher levels of debt. After about five years, the private equity firm often plans to turn the company into a public company again, and bring it back to the stock market at a much higher price than its original purchase cost.

Financial analysis for business strategy

- The nature of financial analysis for business strategy
- Assessing the financial implications of strategic choices
- Financial analysis and the Business Analysis examination

2 Financial analysis for business strategy

2.1 The nature of financial analysis for business strategy

The finance and accounting function provides financial information to senior management that helps them to evaluate the current strategic position and make financial projections and forecasts for the future.

- Financial analysis of historical performance and the current position. An analysis of financial performance and financial position contributes to a strategic position analysis. Management need to understand the financial strengths and weaknesses of the entity.
- Financial analysis can also be used to assess whether the objectives of a business strategy are realistic. For example, suppose that in the past three years, the gross profit ratio (ratio of gross profit to sales) has been 10%, and the business plan for the next three years predicts a gross profit ratio of 15% in Year 1, 20% in Year 2 and 25% in Year 3. This scale of improvement in the gross profit ratio is likely to be unrealistic, and management should re-assess the expected benefits of their proposed business strategies.
- Business plans are often expressed in financial terms, and senior management need financial forecasts or projections.
- There should be financial assessments of proposed new business strategies. Will a particular strategy provide an adequate return on investment? The anticipated benefits should be measured in financial terms, and compared with the expected costs.
- A financial analysis of the actual benefits obtained should be prepared as part of the post-completion audit of projects.

2.2 Assessing the financial implications of strategic choices

The techniques for assessing the financial implications of business strategies should be familiar to you. In your examination, you might be given a case study or scenario and where you are required to apply financial ratio analysis to a current strategic situation or to a proposed business strategy.

Any of the following aspects of financial analysis might be appropriate.

Efficiency ratios

Efficiency ratios can be used to assess how efficiently resources are used. Business strategies might be based on achieving realistic improvements in resource utilisation.

Efficiency ratios are usually calculated for:

- labour: the entire work force or particular groups of employees
- the use of equipment and machinery

Examples of efficiency measurements are:

- output per man per hour
- output per machine hour
- annual sales revenue per employee
- percentage of time spent idle or 'downtime' for equipment and machines

Improvements in efficiency add value to the value chain because they reduce costs.

Gearing ratios

Financial gearing has already been discussed in terms of funding strategy. Gearing ratios might be used to assess the amount of funding risk in a business strategy.

For example, suppose that a company has a plan for growth that will be funded mainly from external sources, in particular bank loans. The financial gearing (ratio of debt to equity capital) might increase as a result of the new funding from, say, 50% to 125%. The ability of the company to support such a large increase in gearing might be questioned, and the funding strategy might therefore be re-assessed.

Liquidity ratios

Liquidity refers to the ability of an entity to pay its liabilities when these fall due for settlement. An entity needs cash (or access to additional cash) to pay its employees and suppliers.

Financial analysis might show that a company could have cash flow problems, and insufficient liquidity, when:

- it is consistently making losses and its operating cash flows are negative, or
- the size of the business is growing, and the company is financing the growth by increasing trade payables and its bank overdraft, instead of obtaining additional long-term funds.

Companies that finance business growth mainly through short-term finance (bank overdrafts and trade payables) are **overtrading**. Overtrading exposes a company to the risk that it will run out of cash (will not have sufficient liquidity), because:

- suppliers are demanding payment for overdue debts, or
- a bank removes the company's overdraft facility.

An analysis of liquidity might show that a company has an inappropriate funding strategy, which is inconsistent with its business strategy for growth.

Liquidity can be measured by cash flow forecasts, or with liquidity ratios such as the current ratio and quick ratio.

Profitability ratios

Profitability ratios can be used to assess the viability of chosen business strategies. Gross profit ratios and net profit ratios might both be used for an analysis.

- Profitability must be sufficient to provide a suitable financial return on investment.
- Each business strategy should be expected to provide a suitable financial return.
- Historical profit margins can be compared with planned profit margins, to assess whether the planned profits are realistic.
- Actual profit margins can be compared with the planned profits for a strategy, to assess whether the expected benefits were actually achieved and whether costs were properly controlled.

Investment ratios

Investment ratios can be used by shareholders and other investors to assess whether a company is providing attractive returns, in comparison with competitors and with companies in other industries. Investors might compare the financial performance of different companies in terms of:

- growth in earnings per share each year
- accounting return on capital employed
- price/earnings ratio (ratio of market price to earnings per share)
- dividend yield
- annual dividend growth.

2.3 Financial analysis and the Business Analysis examination

If you are required to carry out a financial analysis for a case study in your examination, you must remember that the analysis should be made from a strategic perspective. In particular:

- Look at trends and changes over time. Compare the situation now with the financial position several years earlier.
- If you are given estimated figures for the next year or the next several years, calculate whether historical trends are expected to continue into the future. If historical trends are not expected to continue, you should ask why. Could the estimate for the future be over-optimistic?
- Consider the possible implications of any trend or change that you have identified.

Example

You are given the following information about sales of a product.

	Year 1	Year 2	Year 3	Year 4 (estimate for next year)
Sales revenue	$12 million	$14 million	$15 million	$16.5 million
Sales volume index	100	115	130	150

This information can be analysed as follows:

	Year 2	Year 3	Year 4 (estimate for next year)
Increase in sales revenue	16.7%	7.1%	10%
Increase in sales volume	15%	13%	15.4%
Therefore increase/(decrease) in prices	1.5%	(5.2%)	(4.7%)
(Workings)	[(1.167/1.15) – 1]	[(1.071/1.13) – 1]	[(1.10/1.154) – 1]

The above information shows that although sales revenue is growing each year, sales volume is growing at an even higher rate. This shows that unit prices for products are falling. This could be the consequence of a market skimming price strategy for a new product: prices will be reduced over time. Alternatively, the falling prices could indicate strong competition in the market from rival business entities. A consequence of the falling prices, unless unit costs are also falling, is that the gross profit margin (and probably the net profit margin) will be expected to fall.

Financial analysis and strategic analysis

You should also try to put your financial analysis into the context of business strategy. In particular, you should try to assess what the trends in the financial ratios might indicate. For example:

- Falling unit prices might be a part of a strategy to increase market share. If so, do the sales figures suggest that the strategy is succeeding?
- The rate of growth in sales volume, profitability and investment in R&D can all be indications of the current position of a product in its life cycle. For example, little or no growth in annual sales and a high net profit margin could indicate a product that is in the 'maturity' phase of its life cycle (and a product that is a 'cash cow'). It may be possible to link the financial analysis to the **BCG matrix**, especially if you are also given figures for **market share**.

CHAPTER 16

Leadership and human resources management

Contents

1 Leadership
2 Human resources management
3 Selection and performance appraisal
4 Reward management
5 Job design
6 Development and training

Leadership

- Human resources and Human Resource Development (HRD)
- A brief history of leadership theory
- Transactional and transformational leadership
- The leader as a strategic visionary

1 Leadership

1.1 Human resources and Human Resource Development (HRD)

Business entities need to develop new business strategies to remain competitive in their industries and markets. In a complex and continually-changing environment, it is not sufficient to keep business strategies the same, making only minor incremental changes. New strategies inevitably involve change, which may be substantial.

An earlier chapter explained that new business strategies are developed as a combination of:

- intended strategies (planned strategies) and
- emergent strategies.

Intended strategies can be decided and introduced by senior management, but the successful implementation of these strategies depends on the willingness of employees to accept the change and adapt to new processes or systems, and new business strategy objectives.

Emergent strategies are developed by employees themselves, and 'emerge' from the way in which the entity responds to developments in its environment. For an entity to develop and implement successful emergent strategies:

- it must be innovative
- its employees must have the skills, knowledge and motivation to be innovative
- employees must be given effective leadership by management, and should be encouraged to innovate
- the entity should use the knowledge of its employees to find ways of developing business strategy.

The leadership given to employees, and the ability of an entity to develop and the knowledge of its employees, are now seen as key aspects of successful business strategy development.

Human Resource Development (HRD) is an aspect of the resource-based view of strategy development. This is the view that entities should develop business strategies in a way that seeks to obtain sustainable competitive advantage from the strengths of the entity's resources. Employees are a key resource, and should be

seen as an investment, not a cost. Johnson, Scholes and Whittington have commented: 'Since the early 1990s, the resource-based view of strategy has become highly influential.'

They also comment that entities should make full use of employees' knowledge in order to develop emergent strategies. 'If employers can only see strategies in terms of deliberate planning, they not only risk that such strategies go unrealised, but they also waste the learning that can emerge from their employees.'

Leadership and the management and development of human resources affect all aspects of business s strategy. The examiner for Business Strategy has commented: 'People issues will be inevitable in most questions set in this examination. Candidates must remember to explore … this perspective.'

Human Resource Development and change management

Business strategy development calls for change. The culture of an entity might resist change, or there might be a culture of welcoming change in order to move the business forward.

Change management was discussed in an earlier chapter. You should be aware of the close link between the management and development of employees and other human resources is related to the management of change.

1.2 A brief history of leadership theory

Leadership is an important management skill. It can be defined as an inter-personal influence directed towards the achievements of a goal or objective. An effective leader is someone who leads other people towards the achievement of a goal. An effective manager is therefore a person who is able to lead other people towards the successful achievement of the entity's objectives. He or she gets other people to do whatever helps the entity to achieve its objectives.

'Other people' are the individuals that the leader works with, including his or her 'subordinates' in an entity with a hierarchical authority structure. However, 'other people' may also be members of a project team, individuals to whom work is outsourced, and individuals in other parts of the entity.

Leadership theory is concerned with the qualities that make someone an effective leader. There have been different views about leadership and the qualities of an effective leader, especially for managing change and implementing business strategies. 'Whoever is in the position of managing change needs to consider the style of management they adopt' (Johnson, Scholes and Whittington).

There are several theories about what makes a good leader:

- Trait theory
- Style based theory
- Contingency based theory
- Activity based theory
- Strategic visionary leadership.

Trait theory

Trait theory assumes that there are certain qualities or traits in an individual that makes him (or her) a 'born leader'. Leaders are born, not made. The theory takes the view that if a person possesses the traits required for leadership, he or she will be able to provide effective leadership in any type of situation.

The traits required for good leadership might be physical, intellectual or personal qualities. They might include physical vitality, skill in dealing with people, an eager ness to accept responsibility, an ability to motivate people, courage and resolution, a need for achievement, decisiveness, self-confidence, trustworthiness, assertiveness and an ability to adapt and show flexibility.

The list of traits can be very long. A problem with trait theory is that not many individuals show all the traits of effective leadership, so how many are needed to be effective? It is also recognised that some leadership traits are more relevant in some situations than in others.

Trait theory is therefore of only limited value in identifying what is needed to provide effective business leadership.

Style theory (behavioural theory)

Style theory or behavioural theory is based on an analysis of how leaders behave rather than the traits or qualities they possess. It is suggested that the effectiveness of a leader depends on the style of leadership and how the leader behaves, especially towards subordinates or team members. It is the style of management that matters.

Early theorists who put forward a behavioural theory of leadership identified some or all of the following styles:

- **Concern for the task**. These leaders focus on the achievement of specific objectives. They concentrate on the successful achievement of goals, and organising people to achieve a high level of productivity.
- **Concern for people**. These leaders treat their subordinates or team members as people, show concern for their interests and problems and try to develop them in the work that they do. People are not simply units of resource that are paid to achieve a business purpose. By showing concern for people, it should be possible to develop them into more effective and efficient workers.
- **Directive leadership**. This style of leadership is based on telling people what to do and making decisions for other people to act on. Subordinates or team members are expected to do what they are told.
- **Participative leadership**. These leaders try to encourage participation in decision-making by subordinates or team members. The view is that by involving others on decision-making, they will be motivated more effectively and will therefore perform better in their work. Motivated individuals are much more likely to work harder to achieve clear work objectives.

A leader might be autocratic or democratic, participative or bureaucratic, people-orientated or task orientated. There is an appropriate style for each work situation.

Behavioural theory suggests that leaders can be trained in the appropriate style to use.

Situational theory (contingency theory)

Situational theory or contingency theory is a development from behavioural theory. It considers the situation in which leadership is exercised. The theory is that the most suitable form of leadership differs according to the situation. The most effective form of leadership in one situation is not the most effective form in a different situation.

Situational theory or contingency theory suggests that there is no single set of characteristics that make a good leader. If a manager is in charge of people who expect to be closely managed, then an autocratic style might be appropriate. With other employees that style would not work and a more participative style would need to be adopted.

For example, a leader may need to be more directive in situations where a quick decision is needed and where people are used to being told what to do. (The armed forces are an obvious example where such situations arise regularly.)

Hersey and Blanchard (1977) identified four different leadership styles, and suggested that one style was more appropriate than the others for a given situation. The four styles they identified were as follows.

- **Telling**. This style gives high emphasis to the task and getting the task done, and gives low emphasis to relationships and people. This style is characterised by giving directions to subordinates and defining the roles of subordinates and the goals that the work group should achieve. This style might be appropriate for dealing with new staff, or where the work must be completed quickly or urgently, or where the work is manual or repetitive (and employee skills are not so important).
- **Selling**. This style gives high emphasis to the task and getting the task done, and also gives high emphasis to relationships and people. The leader gives most of the directions, but also makes an attempt to get subordinates to 'buy into' the task. The leader acts as a 'coach', similar to a sports coach. This style might be appropriate where employees are motivated and willing to do well, but lack the ability or maturity, and therefore need guidance from the leader.
- **Participating**. This style gives low emphasis to the task and getting the task done, but gives high emphasis to relationships and people. The leadership style is focused on facilitating and communicating. Subordinates are given a great deal of encouragement, and use their abilities to get the work done. This style might be appropriate when subordinates have the ability to get the work done, but are insecure or unwilling.
- **Delegating**. This style gives low emphasis to the task and getting the task done, and low emphasis to relationships and people. The leader identifies the problem or objective, but the subordinates are given the responsibility for carrying out their tasks so that the problem is resolved or the objective is achieved. This form of leadership style is well-suited to employees with a high degree of competence. They know what to do and have the motivation to do it.

Critics of situational theory argue that not enough attention is given to cultural differences, and how the culture of the work group also affects the most suitable leadership style. Another criticism, which is also a criticism of trait theory, is that no allowance is made for differences in the gender of leaders. Some theorists argue that successful female leaders are often more caring and sensitive than successful male leaders. The situation alone does not determine what leadership style is best.

Activity based leadership theories

These theories state that it is what a manager does that makes him (or her) a good leader. Adair's action-centred leadership theory suggests that a leader has to give attention to task needs, individual needs and group needs. An effective leader is one who can give appropriate attention to each of the three factors – which might be in conflict.

1.3 Transactional and transformational leadership

Burns (1977) made a distinction between transactional and transformational leadership.

- Transactional leaders 'approach their followers with an eye to trading one thing for another.'
- Transformational leaders seek to appeal to the better nature of their followers, change them for the better and 'move them toward higher and more universal needs and purposes'. A transformational leader is an individual who seeks to change people

The main differences between transactional and transformational leaders are set out below.

Transactional leader	Transformational leader
Recognises what an employee wants from work and tries to ensure that the employee gets what he wants provided that his performance justifies it.	Raises the level of awareness of an employee about the significance of what the employee's work should be trying to achieve, and also makes the employee more aware of ways of how these achievements should be reached.
Exchanges rewards for the employee's effort (and performance).	Encourages the individual to put self-interest to one side for the sake of the team and the entity as a whole.
Responds to the employee's immediate self-interests, if this will ensure that the work gets done.	The leader transforms the employee into someone who wants more from work. The employee is encouraged to move towards the highest levels of the Maslow hierarchy of needs.

1.4 The leader as a strategic visionary

Some writers on management and leadership have argued that the traditional views on effective leadership are not appropriate for 'learning organisations'.

A learning organisation is an entity in which individuals are continually learning and finding new ways to help the entity achieve its objectives. Individuals in a learning organisation are capable of innovative thinking. They are also able to see the 'bigger picture' and understand what the entity is trying to achieve.

Their ability to innovate and change comes from their commitment to perform well in their work and to continue learning.

Peter Senge (1990) has argued that leaders in a learning organisation are 'strategic visionaries'. They have a clear vision about what the entity is trying to achieve, and they are able to convey their vision to the people that they work with. Leaders who are strategic visionaries are able to get other people to 'understand complexity, clarify vision and improve shared mental models – that is, they are responsible for learning.'

A leader with strategic vision:

- helps other people to understand the purpose of their work and gives them a vision of what they are trying to achieve
- enables others to improve their learning continually so that they can deal constructively with all the problems they face in their work
- encourages other people to share the vision, and work towards its achievement.

Human resources management

- The importance of human resource management
- The objectives of human resource strategy
- Human resource planning

2 Human resources management

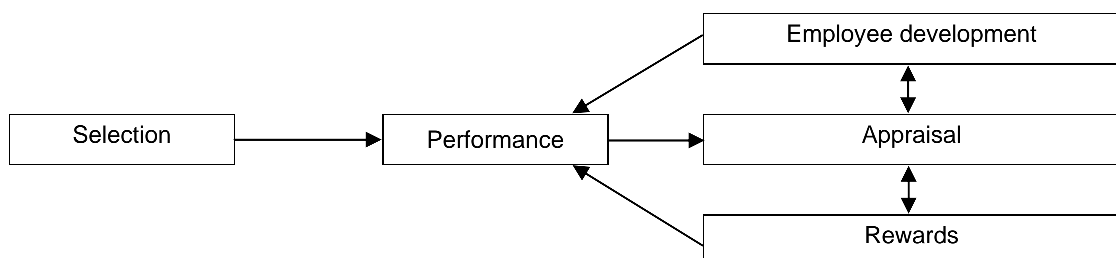
2.1 The importance of human resource management

Human resources are a key resource. The success of a business entity depends on the skills and experience of its human resources. A critical success factor for a business entity is to have sufficient human resources with the necessary skills. Top-quality performance comes from recruiting the best people, using them effectively and giving them an interest in their work performance. Operational and strategic success therefore depends on:

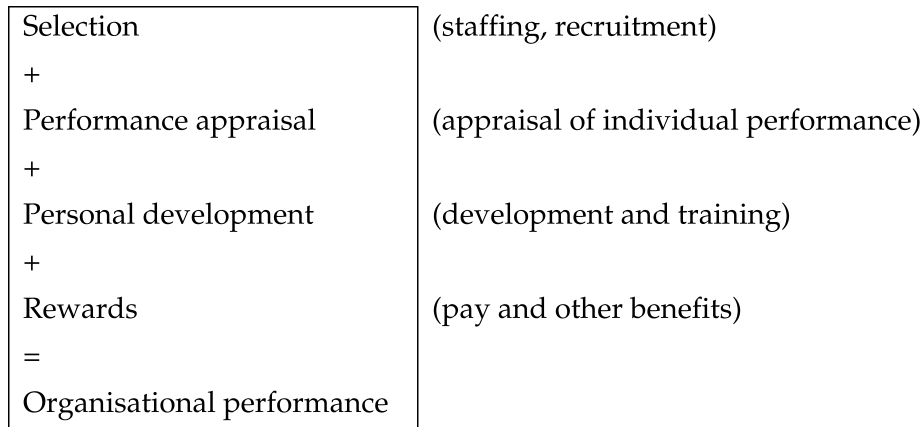
- recruiting suitable employees and developing their skills and knowledge
- managing employees effectively, and
- motivating employees to perform well, and better.

The following diagram shows how five aspects of human resource management are closely related:

- Recruitment and selection procedures should ensure that enough individuals are employed by an entity and that these individuals have the actual or potential skills and knowledge to perform well.
- The performance of employees in their work is monitored and measured through performance appraisal.
- Performance appraisal should be used to assess what is required to improve the individual's performance, through training, new work experiences or other forms of personal development.
- Performance appraisal might also be used as a basis for rewarding employees. Rewarding good performance is seen as one way of motivating employees to achieve planning targets or improve their work performance.
- Taken together, recruitment and selection, training and development and reward systems should all result in better performance from the entity's human resources.



This diagram is based on a model for human resources management that was developed by Fombrun, Tichy and Devanna (1984).



Selection	(staffing, recruitment)
+	
Performance appraisal	(appraisal of individual performance)
+	
Personal development	(development and training)
+	
Rewards	(pay and other benefits)
=	
Organisational performance	

2.2 The objectives of human resource strategy

A responsibility of the human resource management function is to:

- assess the quantity and quality of human resources currently available, including numbers and skills
- estimate the quantity and quality of human resources that will be needed in the future, including numbers and skills
- consider ways of 'filling the gap' and ensuring that the entity has the human resources that it needs.

The objective of a human resources strategy is to ensure that the human resources are available, as required. (In some cases, it might also be necessary to consider reducing the numbers of employees whose skills are declining in importance, through programmes of **redundancy** or **re-training** and **re-location**).

2.3 Human resource planning

A human resource plan consists of a forecast of the human resources that will be required at a given time in the future, and plans for ensuring that the required numbers and skills will be available. A plan will typically look forward about three to five years. Beyond five years, it might be difficult to forecast requirements with any accuracy or reliability.

There are four main stages in the planning process:

- Studying the **corporate objectives** of the entity and the strategic objectives of each division and department. This analysis should then be used to estimate the likely total size and organisation structure of the entity. Total human resource numbers should be consistent with the corporate and divisional strategies.
- **Demand forecasting**. The required numbers and skills of human resources should be estimated. Estimates of requirements should allow for any expected changes in technology, including the introduction of labour-saving equipment.
- **Assessing current resources**. An assessment should be made of the current human resources, and what might happen to these existing resources each year

over the forecast period. The assessment should allow for expected 'wastage rates' or labour turnover rates. For some employees, such as trainee accountants, the estimate might allow for the expected numbers who will pass their professional examinations and obtain a professional qualification during the period.

- **Preparing policies and plans**. The final stage in the planning cycle is to develop policies and plans to fill the gap between the required numbers and current forecasts of future human resources.

These plans will include plans for:

- recruitment of new staff
- training and development to improve skills
- performance appraisal, to monitor and control the development of skills
- promotion
- redundancies, where some employees will be surplus to requirements, or re-training.

The plans should be realistic, and should therefore take into consideration environmental factors such as:

- changes in population trends, and the total size of the work force in each country where the entity has its operations
- changes in government policy, such as changes in the retirement age of workers
- changes in the educational system, and the numbers of students going from school into further education
- the availability of individuals who are trained in a particular skill or vocation
- changing patterns of employment, possibly with increasing numbers of part-time workers or home workers
- competition for human resources from competitors and other businesses
- trends in sub-contracting and outsourcing
- trends in IT and other technological changes that might affect labour requirements.

Example

A basic requirement of a human resources plan is to estimate the future number of employees required for each type of work within the organisation over the planning period. For each year of the planning period, or taking the planning period as a whole, estimates for each type of job can be made as follows:

	Number	Number
Number of employees needed by the end of Year [ ]		1,400
Current number of employees		1,200
Net increase in numbers		200
Estimate of staff turnover in the period		
Employees leaving employment (resignation, retirement etc)	(300)	
Employees moving to another job in the organisation	(150)	
Turnover of employees		(450)
Numbers required (total)		650
Fill from internal promotion or training		350
External recruitment (full-time equivalent)		300

Plans must then be developed to ensure that sufficient numbers of existing staff are given suitable training or personal development for promotion, and for the external recruitment of new full-time and part-time employees to fill the remaining gap.

Selection and performance appraisal

- Performance management
- Recruitment and selection
- Performance appraisal
- Performance measurement

3 Selection and performance appraisal

3.1 Performance management

Performance management is the process of creating a work environment in which people are enabled to perform to the best of their abilities. It begins when a job is defined and ends when the employee leaves an organisation.

A performance management system includes the following:

- Clear job descriptions, related to the objectives of the organisation.
- Appropriate selection
- Establishing and agreeing performance standards and measures
- Providing the necessary training
- Providing regular feedback on performance and coaching
- Rewarding people for doing well
- Providing a career structure.

3.2 Recruitment and selection

At a strategic level, the plan for recruitment and selection requirements should be based on the needs of the entity for human resources in order to implement the entity's corporate and business strategies. It should recognise the changes in the mix of skills and experience that will be required from the work force in the future.

Human resource planning has increased in importance for many businesses over the past two decades because, in some countries (including the UK):

- birth rates have fallen so there is more competition for new people joining the job market
- individuals are expected to work longer
- jobs are more technically complex, so better people and more training are needed.
- employees change jobs more frequently, which means that more vacancies have to be filled
- an increasing proportion of the work force want to work at home and/or part-time.

3.3 Performance appraisal

Performance appraisal is a formal process for reviewing and assessing the performance of:

- individual employees, and
- possibly work groups.

The appraisal process involves an interview or discussion between the employee and a manager. Usually, staff appraisals are between the employee and his or her immediate manager. However, a more senior manager may carry out the interview.

Appraisal interviews should be carried out within a formal appraisal system. In many organisations, there are **annual appraisal interviews** for every individual.

The aim of an appraisal interview should be to have a discussion between the employee and his or her manager, in which the following matters are discussed:

- How are things going?
- What has gone well?
- What has gone badly?
- What have been the problems and difficulties?
- What is needed to develop the employee and improve his or her competence?
- What can be done to meet these needs?

Two aspects of assessment and performance appraisal: judgement and development

There are two different aspects to performance appraisal:

- Appraisal is a judgement by management on the individual. Performance appraisal is a form of judgement, carried out on the individual employee by another person who is usually in a position to decide what rewards the individual will receive for his performance. An individual might be criticised for performing badly, and rewards are often based on success or failure in achieving specific performance targets.
- Appraisal systems are also used to discuss ways in which an individual can improve performance and acquire new skills and knowledge.

The main components of staff appraisal

A staff appraisal may have three different components.

- **A reward review**. The annual appraisal interview may be seen as an opportunity for the employee and his or her manager to discuss pay and other rewards. The employee may have an opportunity to ask for more pay, or express a wish for promotion. The manager might use the appraisal interview to say what the individual's pay will be for the next 12 months.

  However, although rewards will be discussed in an appraisal interview, it is normally inappropriate to combine the annual appraisal interview with the annual pay review. This is because the interview will then focus on pay to the

virtual exclusion of everything else. The annual pay review – telling the employee what his pay and bonuses will be – should be a separate process.

Even so, if a separate pay review is used to discuss annual cash bonuses and other rewards, rewards are still an important part of the performance review process.

- **A performance review**. An appraisal system might be used to assess the performance of the employee since the previous performance appraisal. One way of doing this is to agree a target or objective for the individual, and to compare the individual's actual performance against this objective or target at subsequent appraisal interviews. The target that is set for an individual may be a target to complete a particular task. Alternatively, it might be a more general target, such as getting on better with colleagues in the work team. For a trainee accountant, the target might be to get through a particular examination within the next 12 months.
- **Potential review**. Staff appraisal interviews can also be used to discuss the employee's potential for career development and promotion. However, to make this discussion meaningful, there has to be a system of reporting to senior management and making recommendations that particular employees:
  - should be considered for promotion, or
  - should be considered for development, with a view eventually to promotion.

The benefits of staff appraisal

There are several possible benefits of staff appraisal for the employer.

- It provides a formal system for assessing the performance and potential of employees, with a view to identifying candidates for promotion.
- It provides a system for identifying ways of improving the competence of employees, in order to raise the general level of efficiency and effectiveness of the work force.
- In a large organisation, it is therefore a valuable system for human resource planning, and ensuring that employees are ready for promotion, to fill management job vacancies that arise.
- If it is well-managed, it can improve communications between managers and their employees, and so improve working relationships.

Staff appraisal also offers benefits to the employee.

- The employee gets feedback about his performance at work, and an assessment of his competence.
- A formal appraisal system offers the employee an opportunity to discuss his future prospects and ambitions.
- An appraisal interview may be used as a basis for considering pay and rewards.
- Appraisal can be used to identify and agree measures for further training and development, to improve the employee's competence.

Barriers to effective staff appraisal

At an operational level, potential barriers to an effective appraisal system are as follows:

- **It has no purpose**. Employees see the appraisal interview as nothing more than an informal chat with the manager. Nothing happens as a result of the interview, which is badly organised. The entire process is seen as a waste of time and a pointless exercise.
- **Confrontation**. Employees see the appraisal interview as an occasion for criticism from the manager. The manager (interviewer) might use the interview as an opportunity to tell the employee about his weaknesses and failures. When this is the attitude, the appraisal interview will a confrontation, and the employee will either be on the defensive throughout the interview, or will use the interview to argue back and to accuse the manager of failure. These interviews will not have a constructive outcome.
- **The interview is one-sided**. Staff appraisals might be one-sided, with the manager telling the employee about his strengths and weaknesses, and giving him an assessment of his competence. Employees will often resist a system of appraisal in which they do not have an opportunity to answer back and give their own opinions.
- **Annual event**. The appraisal process might be seen as an annual event, that happens every 12 months, and nothing more happens afterwards until 12 months later. To have any purpose, appraisal systems must include:
  - follow-up action after the appraisal interviews and
  - procedures for monitoring results.
- **Lack of a records system**. There must be formal records for an appraisal system. Records should be kept of each appraisal interview, and what was agreed in the interview. If the employee and interviewer agree on targets or objectives for the employee, these should be recorded so that they can be discussed at the next appraisal interview. Similarly, a record should be made of any agreement about training that the employee needs or about work that the employee should be given to encourage his development. Records provide a basis for follow-up action and feedback.
- Performance management is about directing and supporting employees to work as effectively and efficiently as possible in line with the needs of the organisation. (Walters 1995)
- A systematic approach to improving individual and team performance in order to achieve organisational goals. (Hendry, Bradley and Perkins 1997)

3.4 Performance measurement

In order to assess the performance of individuals, there should be a benchmark, target or standard that the employee is expected to achieve. Actual performance can then be measured and compared with the benchmark.

Measures of performance should ideally be capable of objective assessment, and should not rely on the judgement and opinion of the person making the appraisal. Objective measures include:

- Milestones for achievement. When an employee is expected to make progress toward a longer-term objective, performance can be measured in terms of whether or not the individual has reached agreed 'milestones' or targets on the way to the final objective.
- Accomplishment of agreed tasks. An employee might have been given tasks to complete. Performance can be judged in terms of whether or not the tasks were completed successfully.
- Performance might also be measured in terms of quantitative outputs. For example, a salesman might have been given the target of making annual sales of $X, and annual performance can be measured against this target.

Individuals might have more than one target for achievement. Performance might therefore be measured against several different targets.

The purpose of performance measurement is to provide an objective basis for performance appraisal, and the objective of performance appraisal is to improve the performance of individuals so that the entity implements its business strategies successfully. It is therefore important that the measures that are used to assess individual performance are consistent with the strategic objectives of the entity.

In practice this does not always happen. A lack of consistence between performance measurements and strategic objectives is a major problem for many reward systems that are based on performance appraisal.

Reward management

- The scope of reward management
- Methods of reward
- Rewards as incentives

4 Reward management

4.1 The scope of reward management

Reward management refers to all the monetary, non-monetary and psychological payments that an organisation provides employees in exchange for the work they perform.

- For the employee, rewards are the benefits that are received in exchange for doing the work.
- The employer must reward employees, but reward systems and methods of rewarding employees can be used to improve performance – provided that employees are motivated to perform better by the prospect of more rewards.

Bratton developed a five-stage model of reward management, which sets out the objectives and scope of a reward management system.

Perspective	Aim	Comment
Strategic	Cost leadership or Differentiation	Organisations pursuing a cost leadership strategy are likely to be interested in relatively 'cheap' employees. A differentiation strategy needs employees who are capable of designing, producing and delivering differentiated products and services. Those employees are likely to have higher skills and will be more expensive
Providing a reward system	Performance improvement Improve the commitment of staff to their work and their motivation. Recruit and retain staff	Suitable employees have to be attracted and retained. Then their performance must be directed towards desired behaviour and standards. Commitment and motivation do not necessarily depend on financial rewards.

Perspective	Aim	Comment
Selecting the methods of reward	Basic pay Performance-related pay Other benefits	Basic pay is a constant amount per hour, week, month or year. Performance-related pay includes cash bonuses and the award of shares or share options. Other benefits include health insurance, a company car, a pension entitlement, and so on
Deciding the amount of rewards to pay	Job analysis Job evaluation Appraisal	Job analysis is the process of collecting and evaluating information about the tasks, responsibilities and context of a specific job. It answers the question "What is the job?" Job evaluation determines the relative worth of jobs. Note that this is very important in some anti-discrimination legislation that states that there should be equal pay for work of equal value. Appraisal determines individuals' performance.
Making rewards competitive, compared with other employers	Reflect conditions in the labour market	The going rate of pay in the labour market is an inescapable constraint on reward levels. If pay is set too low, then it will be difficult to recruit and retain. If it is set (or becomes too high after a number of years of pay increases), it will make the organisation uncompetitive with respect to… Competitive forces (which put pressure on profits) constrain the amount that employers can afford to pay. Some countries have minimum pay and maximum working week legislation. Many larger companies have ranges of pay linked to grades and this can constrain managers' freedom to pay employees what they think is necessary and fair.

4.2 Methods of reward

Rewards for an employee might be both extrinsic and intrinsic.

- Extrinsic rewards are rewards provided to the employee by the employer, such as salary and promotion.
- Intrinsic rewards are the rewards that an individual feels personally as a result of doing the work, such as job satisfaction.

Extrinsic rewards include items such as status and promotion, and benefits such as a company car or free medical insurance. However, the main element of extrinsic rewards is money, and possibly also company shares.

The structure of reward systems varies between different entities.

- Employees might be paid a high basic salary or wage, to attract and retain them. However, high salaries are not performance-related, and competitors are able (if they want to) to offer matching salaries.
- There might also be a cash bonus payment, possibly paid annually. The payment of a cash bonus depends on meeting or exceeding agreed performance targets for the period. In some reward systems, a cash bonus is a fixed amount for achieving the target. In many organisations, the size of a cash bonus increases as performance improves. For example a sales representative might receive a sales commission based on the value of sales he makes during the year: the total commission payable increases with sales revenue.
- A cash bonus might be paid to individuals for individual performance. Alternatively, a cash bonus might be paid to a work group for the collective performance of the group members. The group bonus is then divided between the members of the group on an agreed basis, such as an equal share of the total bonus for each member of the group.
- Cash bonuses are usually linked to short-term performance, often annual performance, and are paid annually.
- For senior managers, there might also be rewards in the form of the granting of shares or share options in the company. The purpose of awarding shares and share options is to give the manager a personal interest in the company's share price and long-term performance, not just short-term sales and profits. These longer-term incentive schemes usually contain conditions that the manager will not receive the shares or will not be allowed to exercise the share options for at least a minimum number of years (typically three years).

Many senior executives in large companies therefore receive a reward package that includes a high basic salary, pension rights, annual cash bonuses and shares or share options in the company.

4.3 Rewards as incentives

The purpose of cash bonuses, or the grant of shares and share options, is to give employees an incentive to perform well.

In principle, employees perform well when they contribute to the successful achievement of the entity's strategic objectives.

Unfortunately, there are practical difficulties in establishing suitable performance targets that are closely linked to strategic objectives.

- Most cash bonus systems are based on annual performance, such as the profitability of the company or business unit. Strategic objectives are more long-term. There might be occasions when maximising short-term performance damages long-term performance. For example, a company might maximise profits in the current year, but only by taking measures that will damage profitability in the longer term – such as deferring important new capital investment projects.
- Bonus systems might be based on financial performance targets. However, the successful achievement of strategic objectives depends on non-financial as well as financial performance. Examples of non-financial performance include achieving better product quality, successful implementation of a new IS/IT system, successful implementation of a new process, improving the knowledge and skills of a work team, and so on. If rewards are based on financial performance only, non-financial performance will be given 'second class' status.
- If rewards are based on non-financial performance measures, there may be difficulty in deciding which performance measures to use. There are many to choose from, but some will be more consistent with strategy objectives.

All reward systems have faults, because they fail to link rewards to strategic objectives, or because they fail to provide a sufficient incentive to employees. For example, if a cash bonus is small relative to the size of an employee's basic pay, the bonus might not provide an incentive to the employee to perform better in order to earn the extra money.

Reward systems can de-motivate employees when they are seen to be unfair. For example, when senior managers earn bonuses but other employees do not, the other employees might consider the system unfair, and react to senior management with hostility.

Job design

- Different approaches to job design
- Scientific management and job design
- Job enrichment and job design: Herzberg
- The Japanese management approach
- Job re-engineering
- 'Post-industrial' job design

5 Job design

5.1 Different approaches to job design

There are differing views about the extent to which performance can be improved through 'better' job design. Job design is concerned with the structure of individual jobs, and the roles and responsibilities of the individual holding that job.

Four different approaches to job design and work performance are:

- scientific management
- job enrichment
- the Japanese management approach
- job re-engineering.

5.2 Scientific management and job design

F W Taylor (1856 – 1915) was a US engineer who is considered the founder of 'scientific management'. Scientific management is concerned with applying scientific techniques of analysis and experimentation to improve the efficiency of work.

Taylor studied the relationship between people and the tasks that they perform. His approach was to analyse the tasks that individuals perform at work, and break them down into smaller units of work. Each small unit of work was then analysed to find ways in which they could be performed with the greatest efficiency (in the shortest time). Experimentation was used to find ways of improving efficiency for each small unit of work, and Taylor measured the time that it took to carry out each small task.

Taylor is considered the originator of 'time and motion study'. Scientific management resulted in:

- dividing larger tasks into much smaller units,
- employing individuals to specialise in each small unit of work, and therefore
- increasing efficiency through the division of work and specialisation.

Jobs should therefore be designed by dividing the work into many specialised activities, and appointing individuals to do each job as specialists.

Taylor is probably best known for the experiments he carried out into shovelling coal at the Bethlehem Steel Works in the US. Taylor succeeded in improving productivity through:

- analysing the tasks involved in shovelling coal
- experimenting with different types of shovel (for example, different sizes of shovel and shovels with different lengths of handle) and the amount of coal that should be shovelled in a single action, and
- introducing work specialisation within shovelling operations.

5.3 Job enrichment and job design: Herzberg

A criticism of scientific management is that the jobs designed using scientific management methods are repetitive and boring, and they de-motivate employees.

An alternative approach to job design is to create jobs that are more varied and interesting, and with more responsibility, so that the employee gets greater satisfaction from doing the work. Greater satisfaction, it might be argued, will lead to better work performance.

The concept of job enrichment to motivate employees is associated with theorists such as Frederick Herzberg.

In the 1950s, Herzberg carried out some research into the factors that motivate individuals in their work, by interviewing 200 engineers and accountants. He developed a two-factor theory of motivation, which he set out in his book *The Motivation to Work* (1959).

Herzberg identified two groups or categories of factors: those causing dissatisfaction with work and those causing satisfaction. He called these:

- hygiene factors (= the factors causing dissatisfaction) and
- motivator factors (= the factors causing satisfaction).

The most significant hygiene and motivator factors were as follows:

Factors causing dissatisfaction	Factors causing satisfaction
Hygiene factors	*Motivator factors*
Company policy	Achievement
Supervision	Recognition
Relationship with the boss	The work itself
Working conditions	Responsibility
Salary	Advancement
Relationship with colleagues	Growth

It might be supposed that factors causing dissatisfaction and factors causing satisfaction are opposites. However, Herzberg argued that this is not the case.

- The opposite of dissatisfaction is not satisfaction: it is not being dissatisfied.
- The opposite of satisfaction is not dissatisfaction: it is not being satisfied.

The conclusion from Herzberg's analysis is that management need to deal with two different categories of factors affecting the concerns of employees in their work.

- Management need to make sure that hygiene factors are given proper attention. If employees are content with their hygiene factors, they will not be dissatisfied. For example, employees need to feel that they are being paid well enough in order to prevent them from being dissatisfied. However, satisfying the hygiene factors only prevents dissatisfaction, it does not create satisfaction.
- In order to motivate individuals, the motivator factors need to be satisfied. Creating motivation therefore means providing conditions at work that will make individuals feel a sense of achievement and recognition. According to Herzberg, a key factor in creating motivation is job enrichment – making the work itself more interesting and fulfilling.

A criticism of job enrichment is that although it probably makes employees more satisfied with their work, it does not necessarily improve work performance.

Example

An editor in a small publishing company may be responsible for preparing the 'final copy' artwork for a book, to send to the printer. The editor might also be responsible for sending the artwork to the printer and checking the delivery date for receiving the printed books from the printer.

This job might be enriched by giving the editor the additional responsibilities for:

- negotiating printing prices with the printer, to obtain the best prices, and
- ensuring that the printer meets the agreed dates for delivery of the printed books.

The additional responsibilities might enrich the job by giving the job holder a higher level of authority, that the job did not have before.

5.4 The Japanese management approach

The Japanese management approach to job design emerged from the competitive success of Japanese manufacturing companies in global markets. Management approaches such as Total Quality Management and lean manufacturing were seen as reasons for the success of Japanese industry.

It was therefore suggested that the approach to job design in other countries (such as the US) should copy Japanese practice. Three aspects of job design in the Japanese system are:

- **Job rotation**. Individuals within a work group should be moved from one job to another within the group so that they gain experience of all the jobs within the

group. This broader knowledge of the work done by the group as a whole helps them to perform better and to contribute more effectively to improvements in group performance.

- **Group working and collective decision-making**. Individuals within a group have their own jobs, but also work as a team. If necessary, they switch from one task to another. In addition, management consults the work group before making decisions, so that there is some collective decision-making. This helps the group as a whole to understand what they are trying to achieve, and group performance is improved.
- **Quality circles**. Quality circles are a feature of Total Quality Management. Workers are put into quality circles, which discuss the details of work operations and try to identify ways of improving the way in which the operations are performed, however small the improvement may be. Quality circles are an aspect of group working, and the collective sharing of knowledge and experience.

5.5 Job re-engineering

Job re-engineering is another approach to job design. It is based on the view that improvements in performance are achieved by radical re-design and restructuring of jobs.

Specific processes and operations are studied and the nature of the work is analysed. Jobs are then restructured, so that the individual performing the job is able to achieve the objectives of the work more effectively and efficiently.

Job re-engineering occurs whenever a process is radically re-designed.

5.6 'Post-industrial' job design

The methods of job design described so far are all based on the assumption that jobs are performed by employees of the entity. For some business entities, this assumption is not necessarily valid.

A virtual organisation, for example, is an organisation structure in which individuals are located in different places and linked to each other by telecommunications networks and computers. Jobs are not formally structured, and individuals might contribute to the organisation on a part-time basis, or periodically.

It might be questioned whether job design can contribute significantly to achieving better performance in this type of organisation

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Development and training

- Learning in the workplace
- Methods of personal development
- Succession planning
- Competency frameworks
- The learning organisation
- Senge's views on the learning organisation
- Organisation learning
- Knowledge management
- Knowledge management functions
- Advantages of knowledge management

6 Development and training

6.1 Learning in the workplace

Well-motivated individuals learn about doing their work, and get better at what they do over time. Organisations benefit from learning by individuals, because employees become more efficient and more effective as they learn.

Well-motivated individuals also learn through training and development.

- Training is a process in which individuals are taught something specific. A training programme should have a particular objective, to teach the individual some theoretical or practical knowledge, or to give the individual a new insight into an aspect of their work.
- Development is a process of learning through experience and doing work. Individuals learn as they develop by doing different things at work and gaining new experiences.

Organisations benefit from the learning process, because it produces a better work force, and there should be programmes of training and development for their employees. A well-designed programme of training and development will:

- give employees the knowledge, ability or insight that they need to do their work better
- in a way that is the most effective.

6.2 Methods of personal development

Development improves the skills, knowledge and abilities of an individual through experience in working. Unlike on-the-job training, however, development is not so much concerned with teaching the individual how to do a particular task or job. It is

more concerned with giving the individual more experience and responsibilities, so that he or she is able to improve and become a more valuable employee.

Development programmes are commonly associated with managers. They benefit from development to become better managers, capable of moving on to more senior positions.

Methods of development include the following:

- **Job rotation**. Job rotation means moving an individual from one job to another at fairly regular intervals, so that the individual gains familiarity with the work done in each job. For example, a trainee accountant in the accounts department might be given a job for three months or six months in the payables ledger section, before being moved to the receivables ledger, then to the payroll department, then to the costing department, and so on. Job rotation gives the individual a broad range of experience in the activities of the organisation. This should be useful when he or she is eventually ready for promotion to a more senior position.
- **Secondment**. An individual might be 'seconded' to work somewhere else for a period of time. Secondments are periods of time spent away from the normal working environment, in another department or as part of a project team. For example, an accountant might be seconded from the accounts department to work with the sales team for a while. Similarly, an accountant might be seconded to join a project team that has been set up to design and implement a new computer system. Individuals benefit from secondments because they gain experience from working with people from different parts of the organisation, or with external consultants.
- **Deputising for a manager or supervisor**. An individual may be given the opportunity to deputise for his or her boss when the boss is absent from work for an extended period, on holiday or due to illness. The individual gains experience by doing the job of the boss for a period of time.
- **Delegation**. A boss who wants to develop individuals will give the individuals additional responsibilities, and delegate authority to the individual to make their own decisions. Individuals will gain experience from their additional authority and responsibility, and will be accountable to their boss for how they have carried out their additional responsibilities.
- **Mentoring**. An individual might be given a 'mentor'. The mentor provides guidance and assistance to the individual, and may occasionally discuss the individual's work and work problems.
- **Appraisals**. Formal appraisals are a part of a system of development, as explained earlier in this chapter.

Career development

Training and individual development programmes can provide a basis for a policy of career development and promotions, so that there are individuals within the entity who have the ability and experience to move to a more senior position, whenever a vacancy arises.

Career development should be a key part of the human resources plan.

6.3 Succession planning

At the top levels of management, there should be a plan for the eventual replacement of senior managers, and in particular the chief executive officer. Top managers do not stay in their job forever. They might move on to another company, or might retire. In some cases, top managers are dismissed for poor performance.

When there is change at the top, there should be a plan in place for appointing a successor. In the UK, the nominations committee of the board of directors has the responsibility for succession planning for the CEO, under the corporate governance guidelines for listed companies. A board of directors might therefore announce an intention to appoint a particular individual as the new CEO when the existing CEO retires or moves on.

A change in CEO can often lead to a complete change in strategy, particularly when the CEO is a forceful personality with strong views. The purpose of succession planning, however, is to try to ensure some continuity in strategy when a change in leadership occurs.

6.4 Competency frameworks

Some entities use competency frameworks to assist with performance management. A competency framework is a system for assessing the competences required to do a particular job or task.

A number of different competences are identified. Typically, competences are grouped into two or three categories:

- **Core competences**. These are competences that all employees are expected to have, in any job
- **Technical competences**. These are competences that are of a more technical nature and are specific to a particular type of job.
- **Management competences**. An entity might also identify various competences that managers are expected to have. However, not all competency frameworks include management competences.

A well-known competency framework is the system for academic and vocational training, where competences that students might be required to show include knowledge and understanding, an ability to analyse, an ability to evaluate, an ability to communicate, and so on.

For each competency, there are several levels of achievement. There might be four of five different levels of competence.

A competency framework can be used to analyse the **specific competences** required for each job within an organisation, and the **level of competence** required. The competences required for a job can be compared with the competences of individual employees (as assessed by performance appraisal and other assessment methods).

This approach to analysing performance can be used:

- **For the development of employees**. The current competences of an employee can be compared with the competences required to do the employee's current job, or the competences that will be required for another job if the employee is transferred or promoted. This comparison can be used to assess how the competences of the employee might be improved through training or development.
- **For performance appraisal**. The competences shown by the employee can be compared with the competences required to do his job, as a basis for performance appraisal.
- **For recruitment and selection**. The recruitment and selection of applicants for jobs in the organisation can be based on a comparison of the competences required for the job (and for career progression within the entity) and the competences that the applicant shows.

6.5 The learning organisation

An entity is more likely to sustain its competitive advantage if it is able to adapt and change ahead of its competitors.

A learning organisation is an entity that recognises the importance of its employees in the processes of innovation and change. To remain competitive, and organisation needs elements of a learning organisation.

A learning organisation has been defined as:

- 'an organisation that facilitates the learning of all its members and continually transforms itself' (**the Learning company: a Strategy for Sustainable Development**, Pedler, Burgoyne and Boydell)
- an organisation 'where people continually expand their capacity to create the results they truly desire, where new and expansive patterns of thinking are nurtured, where collective aspiration is set free and where people are continually learning to see the whole together' (Senge).

Pedler, Burgoyne and Boydell identified the following characteristics in a learning organisation:

- **A learning approach to strategy**. Strategy development is based in experimentation and feedback, and learning from the experimenting and testing.
- **Participative policy-making**. All members of a learning organisation have the opportunity to contribute to policy-making, as part of the learning process.
- **Information**. Using information, not as a method of management control, but as a resource for the entire organisation to use.
- **Formative accounting and control**. Accounting systems are designed so that they assist learning. In particular accounting systems provide information about how cash, the key resource, is generated and used.
- **Internal exchange**. The concept of the 'internal customer' is encouraged. Work done for someone else within the organisation is work for an internal customer. An internal customer should be given the same consideration and customer care

that would be given to an external customer. The needs of the internal customer should be recognised and satisfied.

- **Rewarding flexibility**. Members of the organisation should be encouraged to see the various rewards they get from doing their job, not just their money rewards (pay). There is also openness about why some individuals are paid more than others.
- **Enabling structures**. Structures within the organisation, including management structures and physical structures (such as the layout of an office and its desks) should be seen as temporary arrangement. The structure can be changed at any time in response to changing needs.
- **Boundary workers as environment scanners**. Members of the organisation who come into contact with the external environment (sales representatives, customer service staff, buyers and so on) should pass on to others within the organisation all the information they gather from the environment.
- **Inter-company learning**. The organisation learns from other organisations, for example through benchmarking.

Learning climate. The organisation has a learning culture. Members understand that a part of their task is to keep on improving their knowledge and to share their knowledge with other members of the organisation.

6.6 Senge's views on the learning organisation

The concept of the learning organisation are closely associated with the views of Peter Senge in the 1990s. He argued that in a business environment that is continually changing, an organisation will excel only if it is flexible, adaptive and productive. In order to this, an organisation needs to 'discover how to tap people's commitment and capacity to learn at *all* levels' (Senge). It needs to be a learning organisation.

All people have the capacity to learn, but the organisations in which they work often do encourage learning. In addition, individuals might lack the techniques people and guiding ideas to respond well to changing business conditions. People need to be encouraged to learn ,and by learning they will help to create a successful organisation.

Senge made a distinction between 'survival learning' and 'generative learning'.

- Survival learning, also called adaptive learning, means adapting to changing environmental conditions and finding ways to survive the change.
- Generative learning is learning that improves the ability of an organisation to innovate in response to change. A learning organisation must be capable of survival learning, but it must also have a capacity for generative learning.

There are five factors that differentiate learning organisations from other organisations.

- Systems thinking
- Personal mastery
- Mental models
- Building shared vision

- Team learning.

Systems thinking. Individuals must be able to see and understand systems as a whole, and how sub-systems interlink and inter-relate with each other. In other words, they should have an ability to 'see the whole picture'. Senge argued that in practice, most individuals tend to focus on the parts rather than seeing the whole, and do not see organisation as a dynamic process.

A particular weakness of individuals is to think in the short term. They fail to think about longer term consequences of current decisions. When faced with a problem, many people will look for a solution that seems to provide desired results in the short term, with little or no regard for the longer term.

However, short-term solutions often involve result in significant long-term costs. For example, cutting back on research and development spending or on product design can result in immediate cost savings, but could also threaten the long-term viability and survival of the organisation.

Similarly, a company might cut its advertising budgets, and in the short term there will be clear benefits in terms of reduced expenditure and higher profits. This improvement might even encourage managers to cut the advertising budgets even further. In the short run there may be little impact on customer demands for the entity's goods and services, but in the longer term the entity might suffer from the decline in market visibility that cutbacks in advertising will cause.

Senge has recommended the use of 'systems maps'. These are diagrams that show the key elements of systems and how they connect. However, individuals often have difficulty in 'seeing' systems, and it can take some effort to teach them to apply the concepts of 'system theory' to the organisation in which they work. (You might see some similarity between these ideas of Senge and the business process redesign approach to process change.)

Personal mastery. Senge also argued that organisations learn only through individuals who learn. If there is larning by individuals, this does not guarantee organisation learning. However, unless individuals within an organisation learn, the organisation itself, as a whole, will not learn. Individuals therefore need to show 'personal mastery'. This means 'continually clarifying and deepening our personal vision, focusing our energies, developing patience, and seeing reality objectively' (Senge). People with a high level of personal mastery 'live in a continual learning mode'.

Mental models. Mental models are 'deeply ingrained assumptions, generalisations, or even pictures and images that influence how we understand the world and how we take action' (Senge). In a learning organisation, there is a discipline of mental models which involves learning to understand the internal picture of the world that we hold in order to subject them to rigorous scrutiny and questioning. Individuals clarify and explain their own thinking and make that thinking open to the influence of colleagues and others.

Entrenched mental models create resistance to change and resistance to systems thinking. The mental models discipline should overcome this reluctance to challenge ingrained assumptions and attitudes.

Building a shared vision. Senge suggested that a role of the business leader is to create a vision that everyone in the organisation can share. This vision should have the power to be uplifting, and to encourage experimentation and innovation. When there is a genuine vision, individuals excel and learn, not because they are told to, but because they want to.

Team learning. Senge defined team learning as 'the process of aligning and developing the capacities of a team to create the results its members truly desire.' People need to be able to think and act together.

6.7 Organisation learning

A successful business entity in a complex and changing business environment needs to ensure that its employees are acquiring the knowledge they need to do their job and are continually developing better ways of working.

To do this, employees need support systems in which information and best practices are disseminated through the organisation and communicated to the individuals who need to know.

Organisation learning refers to the process by which employees acquire knowledge. Three key elements of organisation learning are:

- access to knowledge
- communication of learning, and
- the development and dissemination of best practice.

This should be an ongoing process.

6.8 Knowledge management

Knowledge management is a concept that emerged in the 1990s. It is based on the idea that:

- organisations are stores of knowledge, and knowledge accumulates within organisations
- the knowledge that accumulates in companies is a source of sustainable competitive advantage: knowledge can be used to achieve competitive advantage
- in theory, knowledge is infinite.

Since knowledge has so much potential value, it should be managed properly.

Data workers and knowledge workers

A distinction can be made between:

- **Data workers**, who are involved in processing data and providing information to management from processed data
- **Knowledge workers**, who are involved in developing knowledge within an organisation.

Knowledge workers have much more strategic significance for an organisation than data workers.

Where does knowledge come from?

Corporate knowledge or organisational knowledge is formed through the interaction between technologies, techniques and people. Within organisations, knowledge comes from a combination of:

- collaboration between people, who share their knowledge and create new knowledge together
- technology, which makes it possible to store and communicate knowledge, and
- information systems that make use of the technology systems, and
- information analysis techniques.

Knowledge gives a company a competitive advantage. Another important characteristic of corporate knowledge is therefore that it cannot be easily replicated by a competitor. It is something unique to the company that owns it.

Another way of making this point is to say that the premium value of knowledge comes from the fact that it cannot be digitised, codified and easily distributed.

Knowledge management is therefore concerned with:

- the management of people, and encouraging creativity and new ideas
- the management of IS/IT systems.

6.9 Knowledge management functions

The process of knowledge management can be described as several different functions. Knowledge management can be described as the process of:

- knowledge creation
- knowledge validation
- knowledge presentation
- knowledge distribution, and
- knowledge application.

Creation of knowledge

Knowledge has to be created. People need to be involved in this process, and knowledge management is partly concerned with encouraging individuals to work together to create knowledge. IS/IT systems can assist the process. For example:

- computer assisted design/computer-assisted manufacture (CAD/CAM) systems can help to create knowledge in processes such as three-dimensional machining, tool-making, three-dimensional designing and modelling
- virtual reality systems can help users to acquire understanding and knowledge.

Knowledge validation

Some accumulated knowledge becomes obsolete over time, and loses its value. The validity of current knowledge should therefore be tested to make sure that it is still valid. Knowledge validation is therefore a process of continually monitoring, testing and refining the accumulated knowledge base of the organisation, to make sure that it is still relevant.

Knowledge presentation

Knowledge presentation is concerned with the way that knowledge is displayed to individuals within the organisation. It may come from different information systems, and these may present comparable data in different ways. Some knowledge may be provided in print or in optical form.

When individuals receive information in different forms and from different sources, it can be difficult to interpret what they have been shown, and to give it meaning.

A function of knowledge management should therefore be to ensure that information and knowledge are presented in a form that users will find easier to assimilate.

For example, a company may decide to apply similar coding systems, standards, programming schemes and templates throughout the organisation, for presenting information and knowledge.

Knowledge distribution

Knowledge accumulates more when ideas are shared and when individuals collaborate. Knowledge distribution is concerned with encouraging debate, discussion and interpretation through individuals sharing their different ideas and bringing their own perspective to the analysis of problems.

The distribution of knowledge can be improved through the use of intranets, bulletin boards and newsgroups, and through the use of office automation generally.

Other systems for distributing knowledge include word processing, e-mail, voice mail and imaging systems that can be used by office workers to communicate and transmit information and knowledge.

Knowledge application

Knowledge application is concerned with making knowledge active, by using it to create added value.

Organisations should develop a culture of knowledge-sharing between employees in order to expand collective knowledge.

6.10 Advantages of knowledge management

Knowledge management is the process of creating, sharing and using knowledge. The strategic benefit from knowledge management is competitive advantage acquired through knowledge that rivals do not have.

IS/IT systems can help organisations to build up a knowledge base.

Some examples of the strategic benefits of knowledge management are:

Industry	Success depends on…	Application of knowledge management
Professional services (law, tax, medicine)	Reliable technical advice	Expert systems to raise the standard of professional advice.
Manufacturing	Performing complex tasks well and at a competitive cost	CAD/CAM, robotics and other systems to improve performance in key areas throughout the value chain.
Retailing	Relationships with customers	Use of data warehousing and data mining to learn more about customers.
Entertainment	Creativity	Groupware to enable teams of writers to work together.

Q&A

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1 Excellence

The table below lists the aspects of culture that Peters and Waterman identified in the most successful and 'excellent' companies. Describe each of these characteristics of excellence, in your own words.

A bias for action	
Hands-on, value-driven	
Close to the customer	
Stick to the knitting	
Autonomy and entrepreneurship	
Simple form, lean staff	
Productivity through people	
Simultaneous tight-loose properties	

2 PESTEL

(a) Identify a model that can be used to carry out a strategic position analysis of the industry in which an entity operates.

(b) PESTEL is a model for carrying out a position analysis of the environment within which an entity operates. What does 'PESTEL' stand for?

(c) There are several global oil companies, such as Exxon and BP Amoco. Use the PESTEL model to identify environmental factors that will affect the strategic planning of such companies.

3 Air travel

Use PESTEL analysis to identify the environmental factors that might affect the strategic planning for a major international airline.

4 Diamond

Porter's diamond is used to analyse regional and national competitiveness.

(a) In the context of regional and national competitiveness, explain the meaning of a 'cluster'.

(b) Describe **five** determinants of regional or national competitiveness in Porter's diamond model.

(c) A region in Country X has strong international competitiveness in environmental industries. These are industries specialising in environmental technology, such as air pollution control, water and waste water management, waste management and recycling, energy management and renewable energy, cleaner technologies and processes, and environmental consulting services.

Required

Using the determinants of regional competitiveness in Porter's diamond model as general headings, list **15 factors** that might be contributing to the international competitive advantage in environmental industries that this region of Country X enjoys.

5 Five forces

(a) Explain the purpose of using Porter's five forces model.

(b) List the five forces in the model.

(c) For each of these five forces, list **four factors** that could affect the strength of the force.

6 Niche

The Eastern Isles Tourist Board is a government-funded body responsible for promoting and developing tourism in its region of the country. The tourism industry has been restricted in the past by unpredictable weather in the summer and cold winters. The Board governors have agreed that in order to increase the number of tourists coming to the region, it is essential to attract businesses that will provide services and facilities, such as activity centres and hotels.

To create interest in tourism-related businesses, the Board has decided that it should identify niche markets in the tourism industry that might be developed in the Eastern Isles. By identifying niche markets, the Board governors hope that they will start to attract more businesses that will specialise in catering for particular types of tourist.

Required

Suggest the market niches that might exist for tourism businesses in the region.

7 Product life cycles

(a) A typical product life cycle has four main phases: introduction, growth, maturity and decline. Twelve products are listed below. Match these products to the stage they have probably reached in their life cycle, by filling in the following table. (In the suggested answer, there are three products at each of the life cycle stages.)

Products:

- Portable DVD players
- Fax messaging
- (Hand-written) postcards
- Personal identity cards using 'iris-based' technology
- E-mails
- Credit cards
- Personal computers
- Third generation (3G) mobile telephones
- Cheque books
- Typewriters
- Smart cards (in banking)
- E-conferencing

Introduction	Growth	Maturity	Decline

(b) Identify a product or service whose life cycle has **not** conformed to the traditional pattern of introduction, growth, maturity and decline.

8 Railway company

The purpose of market segmentation is to divide a market into different sections, each with a distinctive group of potential customers. A segmentation strategy is then developed, and a different marketing mix is used to market a product to each segment.

Typically a different price is charged for the product in each segment, but it may be necessary to vary the product offered to each segment of the market, in order to meet the needs of customers in that segment.

Required

Suggest ways in which a railway company might segment its market for rail travel.

9 Tuition company

A tuition company provides a range of tuition services and educational publications to students preparing for professional accountancy examinations.

Required

Suggest ways in which the tuition company might segment its market for teaching services and products.

10 Benchmarking

(a) What is the purpose of benchmarking?

(b) Describe the nature of:

(i) Internal benchmarking

(ii) Competitor benchmarking (or competitive benchmarking)

(iii) Operational benchmarking (also called process benchmarking and activity benchmarking)

(iv) Customer benchmarking

11 Added value

(a) Define added value.

(b) Suggest how a strategy for adding value might be developed, using the following concepts:

(i) Core competencies

(ii) Competitive advantage

(iii) Innovation

(iv) Reputation

(v) Organisational structure

12 Value chain

(a) List the primary activities and secondary activities in a value chain.

(b) Explain the significance of the value chain for business strategy.

(c) Identify the primary activities in the value chain for a publisher of educational text books.

(d) Identify the primary activities in the value chain for a company selling insurance policies (such as car insurance) by telephone.

13 Dairy farm

About ten years ago, the owners of a small dairy farm producing milk and cream switched to organic farming methods and making organic dairy products – milk, cream, cheese, yoghurt and ice cream. They sell their branded products through three distributors in the region. In addition, they use direct marketing to sell some cheeses as expensively-packaged gift products. Catalogues are sent to potential customers by e-mail, customers buy the products online and they are then delivered direct to the customer.

The owners of the farm believe that their success has been due to their ability to add value for their customers.

Required

Suggest how the farm may have succeeded in adding value for its customers.

14 Marketing mix

(a) List the '4Ps' of the marketing mix.

(b) Suggest how the 4Ps of the marketing mix might differ for a consumer product in each of the first three stages of the product's life cycle. (For your answer, you should therefore complete the following table.)

Stage of life cycle	Suitable marketing mix
Introduction	
Growth	
Maturity	

15 Modelling, measuring, targeting

(a) Identify a model or techniques that you might use to carry out:

(i) an analysis of an entity and its activities

(ii) an environmental analysis

(iii) an industry analysis

(iv) a strategic position analysis

(v) an analysis of a strategy for change

(b) What measures might you use to assess the effectiveness of marketing?

(c) The Mayor of Capital City wants to improve the road traffic situation in the city by reducing traffic congestion. At the moment, there are frequent traffic jams and transport times through the city are very slow. The Mayor is particularly concerned about delays to public transport services (buses) and taxis.

He is discussing with his Road Management Committee a strategy to reduce traffic congestion in the city.

Required

(1) Suggest two **critical success factors** (CSFs) that might be used for developing the strategies to reduce road congestion.

(2) Suggest two **strategies** for achieving success in these areas.

(3) For each critical success factor, suggest a **key performance indicator** (KPI) for setting a measurable target of performance, and comparing actual results against the target.

16 Core competencies

(a) Define a core competence, and describe the factors that create a core competence.

(b) For any two successful major companies that you know, state what you consider to be their core competence (or core competencies).

(c) Explain the significance of core competencies for product-market business strategy.

17 SWOT

The Righton Supermarkets Group is the largest supermarket group in the country. In spite of a decline in total consumer spending in the national economy last year, spending in the supermarket sector as a whole increased, and Righton also increased its market share. It now has over 20% of the market for food-and-drink shopping in the country. It is also enjoying strong growth in the sale of non-food products such as clothing (it has its own brand of fashion clothes) and domestic electrical goods.

The group has just announced record annual profits, and investors expect the growth in profitability to continue, in spite of signs of weakness in the national economy.

Rival supermarket groups have been attempting to regain lost market share. Two rival groups merged a year ago. Another competitor was acquired a few years ago by a major US supermarket group and is pursuing an aggressive competitive strategy.

Righton's success is due partly to its reputation for low prices and reasonable-quality products, and its efficient in-store service.

The group continues to acquire land and to purchase retail property with the intention of building more out-of-town stores and smaller in-town convenience stores. It does not have any business operations outside the country. There is some concern about the possibility of government action to prevent the group from exploiting its 'near-monopoly' position in the market.

Required

(a) What is the purpose of SWOT analysis?

(b) Using the information provided, carry out a SWOT analysis for the Righton Supermarket Group.

18 More SWOT

The AZ Group is one of the world's leading pharmaceuticals companies. It was created five years ago by the merger of Entity A with Entity Z. The group's operations are based mainly in Western Europe and North America. The North American market currently accounts for 50% of world sales for pharmaceutical companies.

In the past two or three years, AZ has been involved in clinical trials in countries in South America and Asia, aimed at developing new medicinal drugs. These countries were selected because regulatory controls over medical research are less stringent than in the US, Canada or Western Europe.

The group has suffered some setbacks in its business in the past twelve months:

(1) There have been serious concerns among the public and the medical profession about the safety of one of AZ's most successful drugs, Carora.

(2) A new drug developed by AZ failed to obtain regulatory approval in the US. Approval is needed from the national regulator before it can be sold in the market.

(3) Another new drug that AZ has been developing has had disappointing clinical trials. Clinical trials are carried out before further testing and application to the national regulators for approval.

R&D spending accounts for a substantial proportion of total annual expenditure of the AZ Group (and other pharmaceutical companies).

Required

(a) Using the information provided, carry out a SWOT analysis for the AZ Group.

(b) Suggest a strategy that the AZ Group might pursue as a way of developing and growing its business in the future.

19 Cultural web: culture and strategy

(a) Describe the six elements in the cultural web, as identified by Johnson and Scholes, and explain how an understanding of the cultural web in an entity can be useful for strategic planning.

(b) List **two** situations in which cultural factors should affect the planning and implementation of strategy.

20 Mendelow

(a) Describe Mendelow's power-interest matrix.

(b) Identify factors that may give substantial power to a stakeholder or a group of stakeholders in an entity, who are either inside or external to the entity.

(c) Suggest how the power-interest matrix may be used by the management of an entity as an aid to implementing a strategic change.

21 CSR and environmental strategy

(a) List the main issues commonly associated with corporate social responsibility (CSR).

(b) What is an environmental strategy?

(c) What might be the benefits to a company of developing and implementing an environmental strategy?

(d) What environmental standards might a company adopt?

(e) What is the relevance of environmental strategy to risk and corporate governance?

22 Ken Day

Ken Day is the CEO and chairman of Highwater, a private company specialising in the supply of sailing and boating equipment. The company plans to enter the second-tier London stock market (AIM) in the next few months.

Ken Day currently owns 24% of the equity shares in the company.

The board of directors of Highwater consists of Ken Day, four other executive directors and three non-executive directors, one of whom is an old family friend of the Lay family and has been on the board for over ten years.

In view of the company's plans to gain acceptance to AIM, its banking advisers have been trying to arrange meetings between Ken Day and some institutional investors. However, several such meetings have been cancelled at short notice by Ken, who claimed pressure of work and lack of time. He feels that he will tell investors about his plans for the future when he is ready to do so, and not before then.

The board of directors meets each year to approve the annual report and accounts, and decide on the annual dividend payment. It meets two or three other times each year, to discuss Ken Day's strategic plan for the company, which he formulates with two of his executive director colleagues, the finance director and the operations director.

Required

(a) Using the information provided, explain how the leadership and management of Highwater are inconsistent with best practice in corporate governance.

(b) Explain the roles that non-executive directors should play in the governance of their company.

23 BCG

(a) Describe the Boston Consulting Group (BCG) matrix.

(b) Explain the product-market strategy that might be chosen for products in each quadrant of the matrix.

(c) Identify two weaknesses of the BCG matrix as a model for strategic analysis.

24 Matrices

(a) What are the similarities and differences between the BCG matrix and the Shell directional policy matrix?

(b) Why might these matrices be used for strategic analysis and planning?

25 Global

(a) Explain the meaning or significance of the following terms, in the context of developing a global business.

- Market convergence
- Cost advantage
- Government pressure
- Currency volatility
- Trade barriers
- Emergence of global competition

(b) List **three** methods of entering a market for goods in another country.

(c) With reference to organising and managing a global company, explain the difference between ethnocentric, polycentric and geocentric management structures.

26 Collaboration

Rival firms may sometimes collaborate with each other, or might choose to avoid being strongly competitive.

Describe **three ways** in which rival firms may collaborate.

27 Sustainable competitive advantage

Suggest how a company might seek to achieve a sustainable competitive advantage in its markets.

28 Generic strategies

For each of the three generic strategies identified by Porter, give an example of a company (or companies) that pursue such a strategy.

29 Mission

(a) A low-cost airline fastPlane has published its mission statement on its website:

'To provide our customers with safe, good value, point-to-point services. To effect and to offer reliable and consistent product and fares agreeable to business and leisure markets on a range of European routes. To achieve this, we will develop our staff and establish long-term relationships with our key suppliers.'

Required

State the purpose of a mission statement, and suggest how the mission statement of fastPlane meets this purpose.

(b) The Royal Institute of British Cake-makers (RIBC) is a professional association for cake makers in the UK. Its mission statement is as follows:

'To advance cake making by demonstrating benefit to society and promoting excellence in the profession.'

The RIBC was concerned about the lack of understanding amongst the general public about the benefits of good cake making. It was also concerned that the standards of professional ability amongst chefs might not be as high as it should be, and that public criticisms of some new types of cake were possibly justified.

The RIBC identified a number of strategic objectives, consistent with its mission statement.

Required

On the basis of this information, suggest three strategic objectives that the RIBC might have identified, that are consistent with its mission statement.

30 Product-market strategy

Red Tile Company specialises in roof repairs and new roofing. It operates in the North Town area of a major city. The company has been successful. The success is due largely to growing market demand for new and better roofing, due to the increasing regularity of strong winds and gales at various times of the year.

The company has two owner-managers, Stan and Oliver, who want to grow the business organically. They are considering several strategies for doing this.

The following information is relevant to their strategic thinking:

(1) The company's market share of the business for new roofs and roof repairs in North Town is estimated to be 25%.

(2) There is a strong local demand for the installation of new, improved satellite dishes that have recently been introduced to the market. These are attached to roofs of houses and other buildings.

(3) Stan's sister works for the company. She has been talking to a friend, who has told her about a severe shortage of firms that provide office cleaning services in the North Town area. She used to work as an administration manager in an office cleaning firm in a different part of the city.

Required

Four different product-market strategies are market penetration, product penetration, market development and diversification. Suggest a product-market strategy for each of these four categories that Red Tile Company could select as a way of developing its business.

31 Growth strategy

List the types of strategy a company might select as a means of growing its business, especially in other countries.

32 Suitability, acceptability and feasibility

When an entity is considering its strategic options, it may be faced with a choice between several alternative options. These options should be compared and evaluated, in order to select the one that seems the most suitable. Johnson and Scholes suggest that alternative strategies should be compared according to their:

(a) suitability

(b) acceptability and

(c) feasibility.

Required

Explain the meaning of the suitability, acceptability and feasibility of strategies.

33 Strategy selection

Entity X is the world's only producer of a sugar sweetener called sucralose, which it sells under a well-established brand name. Entity X has maintained its monopoly in the market for sucralose by enforcing its patents over the production process for the product. These patents have about 15 years left before they expire.

There is a rapid growth in the demand for sucralose. Demand grew by over 60% last year, and the entity currently has insufficient production capacity to meet all the demand. Supplies to customers are therefore rationed. Entity X is investing in an increase in its production capacity, by expanding facilities in its existing production plant and opening a new production facility in another country where labour costs are lower.

The huge success of sucralose is caused by the growing concerns of the public about obesity, and the preference of many consumers for sweeteners rather than sugar. In addition unlike other sweeteners, sucralose is a versatile product that can be used in the production of other consumer items, such as soft drinks, cakes, yoghurts and cereals.

A US competitor has announced that it is exploring the possibility of developing a rival sucralose product that would not breach the patent rights of Entity X, and that it will hope to have a product on the market in about five years' time.

Required

(a) Identify the stage in the product life cycle that sucralose has reached.

(b) Assuming that the US competitor does not enter the market sooner, suggest what will happen in the market for sucralose when the patents of Entity X eventually expire.

(c) Suggest strategies that Entity X should pursue in order to maintain its dominance of the highly-profitable market for sucralose.

34 R&D strategy

Some companies invest heavily in research and development. What are the difficulties in carrying out a financial assessment of R&D strategy?

35 Rational strategic plans

Explain the arguments **against** the following statement.

"A company should make rational strategic plans with the aim of maximising the wealth of its equity shareholders."

36 Emergent strategy

(a) The strategic management process is sometimes described as having three stages: strategy analysis, strategy formulation and strategy implementation.

Required

Describe the nature or purpose of each of these three stages.

(b) Mintzberg argued that the process of strategy analysis, formulation and implementation does not provide a realistic description of strategic management. He argued that the strategies implemented by an entity are a combination of deliberate and emergent strategies.

Required

Explain the difference between a deliberate strategy and an emergent strategy. Give an example of an emergent strategy.

37 Stage in development

A company has been established for many years, and is now a large organisation producing a range of food products and household goods. It is organised into a number of investment centres, with each centre producing a different category of product. Each investment centre manager has considerable delegated power over decision-making for his/her business. However, head office uses sophisticated IS/IT reporting systems, and head office management maintain their control by monitoring closely and regularly the performance of each investment centre.

Many of the investment centre managers are now complaining strongly about the amount of time they have to spend in dealing with demands for information from head office – filling in forms, preparing and revising budgets and preparing returns. They argue that all this work is taking them away from their real job, which is to develop the business of their investment centres.

The relationship between head office managers and investment centre managers is generally very poor, and this is affecting the quality of communications between them.

The CEO has recognised the problem, and has decided that it is time for a change. He believes that the current problem is almost inevitable for any organisation as it grows. His plan is to improve the working relationship between head office management and investment centre management, by reducing substantially the amount of reports and returns that are required, but encouraging more collaboration between them in discussing problems and solutions.

Required

Identify a model that might be used to analyse the situation that the company is in, and the need for a change in its organisation and management structure.

38 Business processes

When employees need to have expenses reimbursed, they complete an expense claim form and submit this to their managers. Each manager reviews the claim and either approves it or rejects it. If the claim is approved it is passed to the accounts department who enter post the ledgers and raise a payment request. The payment request goes to the cashier, who sets up the payment and sends a statement to the employee showing the amount of the payment and when it will be made. The payment details are also sent to the company's bank.

(a) Draw the Harmon process strategy matrix and suggest which quadrant the expenses claim process would be in.

(b) Draw a process diagram (swim lane diagram) depicting the above process.

39 Features of organisational change

Huczynski and Buchanan identified four basic features of organisational change. Describe them.

40 Change

A manufacturing company produces engineering items to the specifications of its customers, and each customer order is treated as a unique job. A customer order is taken by a sales representative. It is then processed in an order processing department. Each job goes through three stages of manufacturing: cutting, grinding and assembly. The despatch department is then responsible for delivering the finished item to the customer.

The company's management were aware that the company was losing a large amount of potential business to rival companies, who were able to achieve a much shorter lead time in processing orders, manufacture and delivery to customers.

The company therefore called in some BPR consultants, who recommended that the company should restructure its order fulfilment process. The manufacturing

operations should be restructured. Instead of having three separate departments for cutting, grinding and assembly, workers should be grouped into multi-skilled teams, each equipped with its own machines and tools for all three stages of production. Customer orders should be assigned to a team whose leader would be responsible for completing the job to the required quality standards in the fastest time possible. In addition, order processing and delivery should be combined into an order fulfilment operation. The individual responsible for processing a customer order should remain responsible for arranging the production work, chasing progress of the job and arranging delivery of the finished item to the customer.

The company's management have accepted the recommendations of the consultants. However, they are aware that the changes will meet strong resistance from many employees, especially production workers who will be required to become multi-skilled. There may also be resistance from employees who will become order fulfilment managers and made responsible for the lead times for jobs.

Required

(a) Explain the nature of business process re-engineering (BPR).

(b) Using a model of your choice, suggest how a firm of change consultants might assist the company in planning and implementing the changes.

(c) Explain the meaning of 'internal marketing' and its relevance to change management.

41 Channel for marketing and distribution

The internet and e-commerce have become important channels for marketing and selling, and the internet can also be a distribution channel for electronic products.

Required

List the potential benefits of the internet and e-commerce for:

(a) suppliers

(b) customers.

42 Stefan Lund

Stefan Lund recently graduated from the College of Fashion. Until he has established his own business, he is working in the offices of a supermarket group, where he is highly regarded by his managers. Stefan is keen to exploit a market opportunity that he has identified for making fashionable hats. He believes that there is a strong potential demand for fashionable headwear, and he believes that he has the ability to design and manufacture a successful range of products. He has been given capital by his family to set up the business, and he is confident that he has the financial resources to establish the design and manufacturing side of the business.

He is aware that in order to establish the business, he must find a 'route to market' for his products. He is considering three possibilities:

(1) Reaching an agreement with the supermarket group where he works to sell the products through its supermarkets, using the own-label clothing brand of the supermarket group.

(2) Creating a brand for the products, and selling them through a number of independent fashion stores in the area.

(3) Creating a brand for the products, and marketing and selling them through a website and the internet.

Stefan can choose only one of these options.

Required

(a) What are the advantages and disadvantages of each channel of distribution, and what might be the implications of using each channel for Stefan's business?

(b) Explain briefly how the marketing mix will probably differ for each of the marketing and distribution channels that Stefan is considering.

43 Travel goods firm

ABC is a multinational company specialising in travel goods such as suitcases and travel bags. It has a strong position in the 'luxury goods' section of the market, and its brand is well-known and highly-regarded.

It has manufacturing facilities and distribution centres located around the world. Its IS/IT systems strategy has been to allow decentralisation of systems. Each division of the company has been allowed to develop and use its own IS/IT systems.

The company has been successful in using developments in information technology. It has EDI links with many of its major suppliers, and it was one of the first companies in the industry to develop a website for advertising and selling its goods directly to consumers. However, the popularity of the website has been falling, and the number of 'hits' per day is now down to a third of its peak level about three years ago.

Although the company has EDI links with suppliers, it does not yet have similar arrangements with its major customers. However, some customers have recently suggested that improvements could be made in their supply chain by establishing extranet links.

The company is in a highly-competitive market, and rival companies have been successful in taking market share by offering well-designed products at lower prices.

The directors of ABC are aware that some managers have ideas for improving competitiveness, but these ideas are spread out throughout the company, and it has been difficult for different divisions in different countries to exchange their ideas. It has been suggested that a new intranet system could be introduced to improve the interchange of ideas within the group.

The directors are also aware that they do not have as much information as they would like about their competitors. Travel goods are a type of fashion accessory for many customers, and ABC would probably benefit from learning much faster about the initiatives that its competitors are taking in the market. It has been suggested that an information system should be developed for senior managers, giving them access to information about competitors, including easy access to their internet sites.

Required

Construct a simple SWOT analysis (strengths, weaknesses, opportunities and threats analysis) for ABC.

44 Electronic marketing

Suggest briefly how electronic marketing is used by theatre companies.

45 Leek and Flood

Leek and Flood is a firm of plumbers. The firm employs 20 full-time qualified plumbers. Each plumber has a van that is equipped with a wide range of replacement parts and plumbing items.

Management believes that the success of the company is due to several reasons. It has marketed its services actively, through door-to-door advertising (leaflets), building a user-friendly website and advertising in local telephone directories. It also benefits from 'word-of-mouth' recommendations from satisfied customers.

The company expects a high quality of service delivery by its plumbers, who are given additional training regularly in new skills and technologies and in customer service skills.

To reduce time lost in obtaining replacement parts for plumbing repairs, the plumbers' vans are stocked with a wide variety of different parts. The company also has a good relationship with a local supplier of parts, from which it buys exclusively.

The company offers a warranty on all the work done by its plumbers and promises a quick response to any complaints that it receives. However, the level of complaints is very low.

Required

(a) Suggest a model that you might use to assess the quality of the plumbing services that the company provides.

(b) Explain how you would use this model to make your analysis.

46 Business case

List the sections in a report that presents a business case to senior management for a new IS/IT project.

47 Risk management process

Many project managers are asked to apply a risk management process to their project.

Explain the purpose, meaning and content of a risk management process.

48 Project manager

(a) A feasibility study could be described as a project within a project. Explain why a feasibility study has the characteristics of a project.

(b) List six general responsibilities of a project manager for a project to develop an IS/IT system.

49 Project management software

A project manager may use special project management software to help him (or her) with the management of an IS/IT development project.

List three main features of a project management software package.

50 Requirements creep

What is requirements creep in the development of a bespoke IS/IT system? How can it be controlled?

51 Balanced scorecard

(a) What is the purpose of the balanced scorecard?

(b) What are the four areas of a balanced scorecard?

(c) What types of organisation might benefit most from using a balanced scorecard, or might be most interested in adopting a balanced scorecard approach?

(d) A university wishes to adopt a balanced scorecard approach. Suggest some targets of performance that it might select for its scorecard.

52 Key success factors

In recent years, some low-cost airline companies have achieved commercial success and have developed a large network of passenger air routes. One such airline uses a balanced scorecard approach to setting strategic performance objectives.

Required

(a) Suggest **three factors** that might have been key factors contributing to the success of the airline company.

(b) For each of the four areas of the balanced scorecard, suggest **three performance targets** that might be used by the airline company.

53 Entity P: financial performance

The financial performance of Entity P is summarised below. 'Now' is the end of Year 3.

	Year 1	Year 2	Year 3	Year 4 (forecast)
	$000	$000	$000	$000
Sales	9,000	13,700	19,600	29,300
Cost of sales	5,670	9,320	13,720	20,600
Marketing costs	800	1,000	1,160	1,400
Distribution costs	1,200	1,500	1,610	1,880
Administration costs	200	220	390	580
Interest charges	0	300	750	2,150
Operating profit	1,130	1,360	1,970	2,690
Inventory	900	1,500	2,700	5,400
Non-current assets	1,900	5,700	10,300	24,000
Loans	0	3,300	9,400	19,600
Number of employees	15	18	19	33
Range of products sold	32	74	106	125
Number of suppliers	12	18	27	45

Required

Evaluate the financial performance of Entity P, and highlight any strategic issues that you consider should be brought to the attention of senior management.

54 ABC Group: financial analysis

It is now the end of Year 2. ABC Group has three divisions, each producing and selling a different group of products. Information about the financial performance of each division/product group is as follows.

Division A	Year 1	Year 2	Year 3 (forecast)
	$000	$000	$000
Sales	8,000	8,323	8,741
Cost of sales	4,400	4,520	4,610
Gross profit	3,600	3,803	4,131
Transport costs	400	415	430
R&D expenditure	low	low	Low
Market share	11%	10%	8%
Sales volume index	100	102	104

Division B	Year 1	Year 2	Year 3 (forecast)
	$000	$000	$000
Sales	10,000	11,220	12,600
Cost of sales	6,000	6,480	7,000
Gross profit	4,000	4,740	5,600
Transport costs	350	390	450
R&D expenditure	high	high	high
Market share	27%	27%	27%
Sales volume index	100	110	121

Division C	Year 1	Year 2	Year 3 (forecast)
	$000	$000	$000
Sales	6,000	5,600	5,400
Cost of sales	3,900	4,080	4,210
Gross profit	2,100	1,520	1,190
Transport costs	360	476	540
R&D expenditure	medium	medium	medium
Market share	20%	20%	20%
Sales volume index	100	107	114

Required

Use this information to evaluate the performance of the three product groups. You should try to use an analytical model to support your financial analysis.

55 Role of the accountant

(a) What are the roles of the accounting function within the corporate strategy of a company?

(b) What should be the role of accountants in the formulation and evaluation of business and marketing strategies?

56 HR plan

You have been asked to prepare a human resources plan for your company as part of a strategic review. The company currently employs 2,000 people. In five years, it is estimated that the workforce will be 2,500, with more qualified engineers and accountants, and fewer IT specialists.

Required

Explain how you would prepare the HR plan for the next five years.

57 Strategic management styles

Goold and Campbell (1987) identified three strategic management styles in large organisations:

(a) strategic planning style

(b) financial control style

(c) strategic control style.

A fourth style, the 'holding company style' can be added.

Required

Describe briefly the nature of each of these strategic management styles.

Q&A

Answers to practice questions

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1 Excellence

A bias for action	Decision-makers think about what they need to do, rather than worry about what might stop them from succeeding.
Hands-on, value-driven	Managers get involved in the operations of the business and are not distant figures. They also have a commitment to the values of the entity.
Close to the customer	The entity is close to its customers and seeks to understand and meet the needs of its customers.
Stick to the knitting	The entity concentrates on its core competencies, and stick to doing what it does best.
Autonomy and entrepreneurship	Teams and individuals are empowered to make decisions and to act in an entrepreneurial way.
Simple form, lean staff	The organisation structure is simple, and staff numbers (especially head office numbers) are kept small.
Productivity through people	The entity achieved greater productivity by motivating its employees and recognising their capabilities.
Simultaneous tight-loose properties	Controls are applied but individuals are trusted to do what is expected of them. There is an effective balance between 'freedom of action' and 'accountability and control'.

2 PESTEL

(a) Porter's 5-force model.

(b) (i) Political environment

(ii) Economic environment

(iii) Social and cultural environment

(iv) Technological environment

(v) Environmental/sociological influences

(vi) Legal environment

(c) (i) **Political environment**. Oil companies are affected by the politics of many of the oil-producing nations, and the use of oil supply and oil prices by the governments of some of these countries to exert pressure in world politics. There are also political disputes about the ownership by nations of rights to drill offshore in some parts of the world.

(ii) **Economic environment**. Oil companies, like all other commercial economies, are affected by the current and expected state of the world economy and national economies. However, the importance of oil is such that the decisions and activities of oil companies can have a significant effect on the world economy.

(iii) **Social and cultural environment**. Oil companies need to consider the attitudes of societies towards the consumption of oil. The 'green' movement is strong in some countries, and there is an increasing willingness among people to consider using alternative (non-oil) sources of energy.

(iv) **Technological environment**. Oil companies are affected by developments in technology, particularly developments in the

technology for using alternative energy sources, and R&D into more fuel-efficient technology that uses oil.

(v) **Environmental/sociological influences**. Oil is at the centre of concerns about greenhouse gases. Oil companies are also affected by concerns for the protection of the environment and the ecology (for example, concerns about pollution from oil spillages). There are also concerns about how long supplies of oil will last.

(vi) **Legal environment**. Oil companies will be affected by continuing legislation to protect the environment and to punish companies found guilty of environmental pollution.

3 Air travel

These are suggestions.

General environmental issues (ecological issues)	Pollution and global warming will inevitably affect airlines, through cultural, economic, legal and/or technological change.
Social and cultural issues	Growing demand for international travel in many parts of the world, both developed and developing nations. On the other hand, the demand for air travel may fall if the cost of air travel rises due to higher taxation on aviation fuel.
Legal issues	Risks of legal restrictions, for example restrictions on pollution levels. Possibility of increasing security regulations to deal with the threats from terrorism.
Economic issues	The business prospects of airlines will depend on the condition of the world economy. Also risks from higher operating costs, for example higher fuel costs, partly due to shortages in supply and partly due to higher taxation.
Political issues	Threats from terrorist attacks, making air travel more dangerous. Risk of higher taxation on aviation fuel.
Technological issues	Need to reduce carbon emissions. Possibility of using larger aircraft, but with limited numbers of airports able to accommodate them.

4 Diamond

(a) A cluster is a geographic concentration of inter-connected companies, specialised suppliers and service providers, firms in related industries and associated institutions (for example universities, standards agencies and trade associations), all of which operate in a particular industry. These entities compete, but in many respects they also co-operated with each other to develop their industry.

The OECD has defined clusters as: 'Networks of strongly interdependent firms, knowledge-producing agents (universities, research institutes, engineering companies), bridging institutions (brokers, consultants) and customers linked to each other in a value-added production chain.'

(b) According to Porter's diamond model, the six determinants of regional/national competitiveness in a particular industry are as follows:

(i) **Factor conditions**. The presence of a pool of highly-specialised labour skills, technology and infrastructure, tailored to the needs of particular businesses and industries. 'Factors' are resources – human resources, physical resources, knowledge resources and infrastructure.

(ii) **Demand conditions**. The presence of sophisticated and demanding local buyers/customers.

(iii) **Related and supporting industries**. The presence of a critical mass of capable local suppliers and specialised entities that are critical to innovation (such as research universities).

(iv) **Firm strategy, structure and rivalry**. The presence of capable and fiercely-competitive local firms whose strategies drive continual innovation in the industry.

(v) **Government**. The existence of strong government policies, and government initiatives, that support the development of the industry and also help to create market demand.

A sixth factor is 'chance'.

(c) Some ideas are listed below. You might have other items in your list.

Determinant of regional competitiveness	
Factor conditions	Specialised pools of labour with skills in the industry Local universities and R&D laboratories that carry on research into industry-related matters A waste management infrastructure (for example, the existence of local facilities for materials reprocessing) Specialist investors/venture capitalists in the industry
Demand conditions	Strong demand from industrial customers (for example water companies) that drives innovation Heavy demand for waste recycling from local government authorities Public sector organisations with 'green' procurement policies Strong demand for cleaning up of former industrial sites
Related and supporting industries	The existence of a large number of related manufacturing industries (in engineering, electronics, plastics and metals) High quality academic R&D with strong links with firms in the industry A strong network of advisers, consultants and components suppliers
Firm strategy, structure and rivalry	Many competing local suppliers of environmental services Strong competition that drives innovation Firms with strong capabilities in the manufacture of environmental technology Local firms include leading international companies in the industry.
Government	Government support for environmental industries Government policy targets for recycling and renewable energy Public investment in environmental projects, such as flood prevention measures

5 Five forces

(a) The five forces model provides a framework for the analysis of an industry in which an entity operates. It is an aid to the development of strategies for the future.

(b) (i) Threat from new market entrants

(ii) Competitive rivalry

(iii) Bargaining power of suppliers

(iv) Bargaining power of customers

(v) Threat of substitutes (also described as threats from product and technology development)

(c) Some suggestions are given below.

Force	Factor affecting its strength
Threat from new market entrants	Ease of entry into the market/strength of barriers to entry The cost of investing in the industry The cost of acquiring the knowledge needed to compete successfully The availability of routes to market Geographical factors
Competitive rivalry	The number and size of firms in the industry The size of the industry and growth trends The fixed and variable cost structures of firms in the industry The range of products/services offered The existence/absence of effective product differentiation strategies
Bargaining power of suppliers	The number of available suppliers The brand reputation of suppliers The geographical area covered by a supplier The importance of product quality/service level quality The bidding capabilities of suppliers and the bidding processes used Relationships with suppliers
Bargaining power of customers	The number and size of customers The frequency of changing suppliers The cost to a buyer of changing supplier The importance of product quality/service level quality Relationships with suppliers; for example just-in-time supply arrangements
Threat of substitutes	The existence of substitute products and their price/quality Fashions and trends in customer demand The strength of patents Changes in market distribution Possible consequences of legislation

6 Niche

In the tourism industry, a market niche might be identified according to the type of holiday preferred by particular groups of customer. If so, niche markets in tourism could be (for example):

(1) City break holidays

(2) Golfing holidays

(3) Walking holidays

(4) Sailing holidays

(5) Sight-seeing holidays/culture holidays

(6) Skiing holidays

7 Product life cycles

(a) Suggested answer:

Introduction	Growth	Maturity	Decline
Personal identity cards using 'iris-based' technology	Smart cards (in banking)	Credit cards	Cheque books
Third generation (3G) mobile telephones	Portable DVD players	Personal computers	Typewriters
E-conferencing	E-mails	Fax messaging	Postcards

(b) Suggested answer: radio

'Basic' products have a long-life, and go through periods of regeneration. At one time, radio was expected to go into permanent decline following the arrival of television. However, it has been regenerated at various times, by factors such as radios in cars, local radio stations, digital radio and so on.

Television is another example. Whereas the specific product 'black-and-white television' is probably in decline, televisions themselves are still in the maturity phase of their life cycle, and might be regenerated more in the future by flat-screen technology, digital television and so on.

8 Railway company

Possible methods of market segmentation.

(a) Passenger facilities: first class and second class travel

(b) Time: peak time travel, off-peak travel, week-end travel

(c) Freight transport and passenger transport

(d) Commuter travel, business travel, holiday travel

(e) Long-distance travel, short journeys, international journeys

9 Tuition company

Possible methods of market segmentation.

(a) By professional accountancy body

(b) By level or stage in the examinations

(c) By examination paper

(d) Full time student, revision course student, evening class student, weekend course student

(e) Learning method: courses, distance learning, other home study method

10 Benchmarking

(a) The purpose of benchmarking is to compare the performance of an entity (or a product, operation or business unit) against 'the best in the business' or against expectations. Benchmarking helps to identify weaknesses that need to be improved.

(b) **Internal benchmarking**. An entity compares the performance of its business units (for example, its area offices) against the performance of the business unit that is considered the best.

Competitive benchmarking. An entity compares its performance and its products against the best and most successful of its competitors.

Operational benchmarking. An entity compares the performance of a particular operation, such as handling customer enquiries, or warehousing and despatch, against the performance of a similar operation in a different entity. This different entity is not a competitor; this means that the benchmarking often involves collaboration between the two entities.

Customer benchmarking. A slightly different type of comparison. An entity compares its performance against what its customers expect the performance to be.

11 Added value

(a) Added value is the net extra benefit obtained from doing something or by adding an extra feature to a product or service. Ideally, it should be measured as a money value, which is the extra sales value from the item minus the extra costs of doing it or providing it (although 'value' cannot always be measured easily in money terms).

Value is added – or should be added – in all parts of the value chain.

The writer John Kay has argued that adding value is the central purpose of business activity.

(b) Value is added by:

(i) developing core competencies

(ii) that provide an entity with a competitive advantage.

Competitive advantage is achieved through innovation, reputation and organisational structure.

12 Value chain

(a) Value chain activities

Primary activities	Secondary activities
Inbound logistics	Procurement
Operations	Human resource management
Outbound logistics	Technological development
Marketing and sales	Infrastructure (general management, accounting etc)
Service (after sales)	

(b) Companies compete with each other, and their relative success depends on their ability to add value throughout their value chain.

Companies should try to develop strategies that add value. They should look at each activity in the value chain and consider whether it can be improved to add more value.

A company can also assess its performance by looking at its ability to add value in each part of the value chain (each primary activity and each secondary activity).

(c) Primary activities:

(i) Publisher or author thinks of the idea for a book. The material is written or assembled.

(ii) The publisher edits what the author has prepared.

(iii) The text is prepared for printing

(iv) Printing

(v) Warehousing and distribution of books

(vi) Sale of books to intermediaries (bookshops) or direct (schools, colleges and universities

(vii) After-sales service: taking back returned (unsold) copies

(d) **Primary activities**

Inbound logistics	Operations	Marketing and sales	After-sales service
Managing incoming calls: call systems	Taking calls	Obtaining customer information	Handling claims
	Providing price quotations quickly	Targeting customers	Detecting fraudulent claims
	Cheap prices for insurance policies	Advertising and other forms of marketing	Settlement of successful claims

13 Dairy farm

The farm appears to have added value in the following ways:

(a) It has switched to organic farming. Some customers are prepared to pay more for organically-produced items, partly because organic products may be considered 'more healthy' and partly because customers may want to buy produce of animals that have been well-treated.

(b) It has increased the range of products that it makes and sells.

(c) It has created a brand for their product: branding can add value.

(d) It has developed a direct marketing capability, which presumably includes a potential customer database and an e-commerce facility.

(e) It has developed a direct mail gift product.

14 Marketing mix

(a) Product

Place

Price

Promotion

(b)

Stage of life cycle	Marketing mix (suggested)
Introduction	Build product awareness
	If possible, obtain protection for intellectual property rights (patents, copyrights, etc)
	Establish the brand and the quality to be associated with the brand
	Develop the market and distribution channels
	Pricing: possibly choose a market penetration pricing strategy, or a 'price skimming' (high price) market strategy
	Promotions should be aimed at innovators and early adopters in the customer population: develop product awareness
Growth	Build the brand
	Maintain product quality, but add additional features to create product differentiation
	Add distribution channels
	Keep prices unchanged: sales growth is rising therefore there is no need yet to change pricing strategy
	Promotion should aim now at a broader audience of potential customers
Maturity	Continue to enhance the product, adding features to strengthen product differentiation
	Focus on competition in distribution channels, to maintain a share of the routes to market
	Reduce prices due to growing competition
	Promotion: emphasise product differentiation
	Aim – to maintain market share and maximise profits in the face of more intense competition
Decline	There are several options, and a different marketing mix would be developed to go with each. The strategic options are: maintain the product and try to prolong its life, 'harvest' the product to obtain as much cash as possible in the short term, or disinvest immediately

15 Modelling, measuring, targeting

(1) (i) Value chain analysis

(ii) PESTEL analysis

(iii) Five forces model

(iv) SWOT analysis

(v) Lewin's three-step change model (or Gemini 4Rs or 7S model)

(2)

- Growth in sales or total sales
- Market share or change in market share
- Sales revenue per $1 of marketing spending
- Sales revenue per $1 of advertising spending
- Sales revenue per $1 of sales promotion spending

However, marketing activity is not always aimed at achieved more sales. In the early stages of a product's life, marketing is necessary to create awareness of the product.

It may therefore be appropriate to assess the effectiveness of marketing by trying to measure changes in customer awareness, for example using customer surveys and market research.

For marketing by website, the effectiveness might be assessed by measuring the number of 'hits' on the website every week or every day.

(3) Critical success factors might be:

- reducing the number of cars coming into the city during the day
- increasing the amount of bus and taxi lanes.

Strategies for achieving success

- introduce a 'congestion charge' on all private vehicles entering the city at certain times of the day
- increasing the number and length of 'bus and taxi only' lanes.

Key performance indicators might therefore be:

- a target for a reduction in the number of cars entering the city during the day
- a target for an increase in the number/length of bus and taxi lanes.

Other answers might be equally acceptable. This answer is based on the experience of London.

16 Core competencies

(a) A core competence is 'something a company does especially well [in comparison with] its competitors… A core competence refers to a set of skills or experience in some activity, rather than physical or financial assets.'

Strong core competencies come from:

(i) well-organised special skills, knowledge, expertise, ownership or use of technologies, processes or abilities

(ii) which are typically achieved or acquired through long-term development and experience.

A core competence creates value for the customer because the customer considers it to be unique and distinguishable, and something that rival suppliers cannot provide.

A core competence is difficult for competitors to imitate.

An important strategic consideration is that a company should be able to transfer its core competencies to other products and markets.

(b) Suggestions

(i) Sony has a core competence in miniaturisation.

(ii) Microsoft has a core competence in developing user-friendly software products.

(iii) Federal Express has core competencies in logistics and customer service.

(iv) Honda has core competencies in small engine design and manufacture.

(*Note*: These core competencies do not specify particular products. The competencies could be transferred to a range of different products and markets.)

(c) The significance of core competencies is that they can be used by a company to achieve long-term (sustainable) competitive advantage in ever-changing markets.

17 SWOT

(a) The purpose of SWOT analysis is to carry out an analysis of the strategic position of an entity, through an assessment of its internal strengths and weaknesses, and the threats and opportunities in its environment. It can be used as a basis for developing strategies for dealing with risks or exploiting opportunities and strengths.

However, it is not a tool for evaluating and prioritising strengths, opportunities, weaknesses and threats.

(b) Suggested answer

Strengths	Weaknesses
Profitability Growth in non-food business Large and increasing market share Reputation for low prices and reasonable quality Reputation for good service	No weaknesses are apparent in the information provided.
Opportunities	**Threats**
Continuing growth in the size of the market Further out-of-town and in-town expansion	High investor expectations about future performance Activities of competitors Possibility of government action against monopoly position

18 More SWOT

(a) Suggested answer

Strengths	Weaknesses
Large continuing investment in R&D	Operations are based in Western Europe and North America: high labour costs compared to competitor companies? Clinical failure of new drug
Opportunities	**Threats**
Opportunities for growth in the market for pharmaceutical products outside North America and Western Europe? Establish operations in other countries: lower labour costs, but are the skills available?	Public concerns about the safety of new drugs Concerns about the regulation of drugs and about regulatory decisions by national authorities

(b) AZ Group could perhaps look for future growth in its markets outside North America. If these markets grow, there will be opportunities for switching production facilities to these countries to reduce costs.

19 Cultural web: culture and strategy

(a) The six elements in the cultural web are:

(i) Routines and rituals. These are the established ways in which things get done.

(ii) Stories and myths. These are established tales about how the entity got to where it is today, that have become embedded in the way that individuals view the entity and what it should be doing.

(iii) Symbols. These are accepted signs that represent the character of the entity and what it represents.

(iv) Power structure. This refers to the sources of power within the entity. In many cases, power is in the hands of management, who control the resources of the entity. Sometimes, other individuals can wield power and influence, even when they are not in an official position.

(v) Organisation structure. Culture is affected by organisation structure. For example, large bureaucracies have a very different culture from small entrepreneurial businesses with a flexible organisation structure.

(vi) Control systems. Control systems, particularly systems of rewarding employees, help to establish a sense of what is important. Individuals will focus on what they regard as important.

An understanding of all the elements in the cultural web in an entity can help management to consider the obstacles to change. The cultural web is therefore a useful concept for planning strategies for change.

(b) Here are three suggestions.

(i) Takeovers, especially in the service sector, where employees from two different cultures will be combined into a unified group.

(ii) Any major change in policies or processes, such as implementing recommendations for business process re-engineering (BPR).

(iii) Adopting a new strategy for growth and development in other countries.

20 Mendelow

(a) The power/interest matrix can be used by an entity to 'map':

- the relative interest of various stakeholders in the decisions of the entity, and
- the power of each of these stakeholder groups to affect the outcome of those decisions.

Power is rated on a scale of 0 to 10 (low to high) on one side of the matrix and interest is also rated on a scale of 0 to 10 (low to high) on the other side of the matrix.

(b) Sources of the power of individual stakeholders or stakeholder groups include the following:

Internal stakeholders: sources of power	External stakeholders: sources of power
Position in the management hierarchy	Control over key supplies
Control over strategic resources	Involvement in the implementation of the decision
Relevant knowledge/skills	Relevant knowledge/skills
Personal influence	
Ability to block a proposal (e.g. shareholders may be able to vote down a management proposal)	When the government is a stakeholder: power to regulate

(c) The matrix may be used when a change is planned. It can be used to identify, for each stakeholder or stakeholder group, the strength of their interest in the change and their power to influence its outcome.

Measures can then be taken to satisfy each stakeholder, and reduce the risk of their opposition to the planned change. In general terms the matrix provides the following recommendations:

Power	Interest	Tactic
Low	Low	Minimal effort required
Low	High	Keep these stakeholders informed about plans and developments
High	Low	Make sure that these stakeholders are kept satisfied
High	High	Key players: these stakeholders must be given the most attention and consideration.

21 CSR and environmental strategy

(a)

- Business ethics and ethical conduct
- Concern for the environment
- Concern for the sustainability of business
- Concern for human rights
- Concern for employees
- Concern for societies and communities

(b) An environmental strategy is a strategy to achieve specified objectives for environmental standards. It is usually associated with ecological issues, such as reducing pollution and waste, and sustainable development (such as the preservation of forests and fishing stocks).

(c) In the longer term, a company may benefit from an environmental strategy for several reasons.

- Its reputation as an environment-friendly company might improve its reputation with potential customers. The general public is increasingly aware of 'green' issues.
- The strategy should force the company to develop environmental-friendly processes and products at an acceptable cost.
- The strategy might help the company to anticipate future changes in the law or environmental regulations.
- The strategy could therefore help the company to develop and sustain its business over the longer term.

(d) Environmental standards are measurable targets for achievement in relation to environmental issues, such as measures of pollution (carbon dioxide emissions, toxic chemical content of waste and so on). Standards may be set by individual companies, by industries or more generally for all industries.

(e) **Risk management:**

Management may need to consider the risks from environmental issues:

- to its reputation
- from additional regulation

- from costs of breaching regulations
- from costs of complying with regulations
- from costs of clean-up in the event of pollution

Corporate governance:

Many shareholders now expect to be informed of environmental issues by their companies. Many companies produce a social and environment report annually. In the UK, quoted companies are required by legislation to produce an annual business review, which will normally be expected to consider environmental risks.

22 Ken Day

(a) Highwater is not yet a stock market company, and it is planning to gain acceptance for trading on the second-tier market in London, not the main market. The UK's voluntary Combined Code on corporate governance does not apply to Highwater, and Highwater is not in breach of any corporate governance regulations.

However, the company does not apply best practice in corporate governance, for several reasons.

- Ken holds the positions of both CEO and chairman. This is considered bad governance practice, because it puts too much power (leadership of the executive management team and leadership of the board of directors) into the hands of one person.
- The board is dominated by executive directors. One of the NEDs is not independent (being a family friend of Ken Day and also having been on the board for over nine years). In the UK, the Combined Code recommends that at least 50% of the board should consist of independent non-executive directors, to give it balance.
- The board appears to have few responsibilities, or does not take its responsibilities seriously. It is generally recognised that the board should be responsible for deciding and agreeing strategy. In Highwater, the board appears to accept, with little or no question, the strategic plans produced by a small executive team led by Ken Day.
- The company does not appear to have an audit committee (of independent NEDs), a remuneration committee (of independent NEDs), or a nominations committee.
- There would appear to be inadequate communication between the company and its shareholders. The evidence for this is the unwillingness of Ken Day to meet with institutional investors, who might soon be asked to invest in the company when it seeks entry to AIM.

(b) In a company that adopts best practice in corporate governance, the role of NEDs (and in particular independent NEDs) should be to:

- Provide members for the audit committee, remuneration committee and some (or all) of the nomination committee.

- Check that best practice in corporate governance is actually adopted (for example, by ensuring that the annual review of the adequacy of internal control and risk management systems is carried out).
- Contribute to board decision-making, particularly in the area of strategy. NEDs should be able to bring the benefits of their experience outside the company to the discussions about strategy.
- Provide balance and objectivity to decision-making by the board of directors.

23 BCG

(a) The BCG matrix is not drawn here, but can be found in the text. It is a 2 × 2 matrix, with one side of the matrix representing the rate of growth in the market (high or low) and the other side representing the relative share of the market enjoyed by a firm's product/service.

(b)

		Strategy
Low market growth, high market share	**Cash cow**	Defend and maintain market share. Possibly low spend on R&D. Use cash from this product to invest in other business units/products.
High market growth, low market share	**Question mark**	The product will need a lot of cash to increase market share. The strategic choice is between investing a lot of cash to boost market share or to disinvest/ abandon the product.
High market growth, high market share	**Star**	Promote aggressively. Invest in R&D. Stars should generate enough cash to be self-sustaining.
Low market growth, low market share	**Dog**	These might generate some cash for the business, and if they do, it might be too early to abandon the product. The product has a limited future, and strategic decisions should focus on its short-term future. There is a danger that the product will use up cash if the firm chooses to spend money to preserve its market share. The firm should avoid risky investment aimed at trying to 'turn the business round'.

(c) (i) A high market share is not the only factor that determines the success of a product.

(ii) The growth rate in the market is not the only indicator of the attractiveness of a market.

(There is an assumption in the BCG matrix that these are the two key factors for making strategic decisions about products.)

24 Matrices

(a) Both matrices are used by firms to 'map' their products or business according to the strength of the market and the current position of the product/business in its market. The BCG matrix is a 2 × 2 matrix with its two sides representing the rate of market growth and the product's share of the market. The Shell directional policy matrix is very similar: it is a 3 × 3 matrix, with its two sides representing the prospects for the business sector/market and the company's position in the sector.

The main difference is that the BCG matrix considers products and markets, whereas the Shell directional policy matrix considers business sectors.

(b) Both matrices can be used as an aid to deciding strategies. The BCG matrix can be used to help with a decision about the portfolio of products or business units that a company should invest in. The Shell directional policy matrix can be used to decide the strategic direction for its products or business units (for example decisions about whether to invest or withdraw from a market)

25 Global

(a) Global firms often develop out of companies that initially try to market their products internationally, but produce them domestically for export. Companies become global when they establish operations in many other countries, and are no longer based in a single country.

- **Market convergence**. This describes a situation where the markets in different countries become much more similar (converge), and the needs of customers in the different markets converge. For example, markets in the US and Western Europe might converge. Market convergence creates opportunities for a global business to develop.
- **Cost advantage**. Producers in one country might have a cost advantage over producers in another country, which means that they can produce the same goods more cheaply. Low labour costs or high investment in technology can create cost advantage. The existence of cost advantage means that production costs can be reduced by switching production facilities to low-cost countries. This encourages the development of global companies.
- **Government pressure**. Governments might put pressure on foreign companies to invest more in their country. (The government might be a large buyer of the company's product, or might threaten to restrict imports. Alternatively a government might offer tax incentives for inward investment.) In order to gain access to the markets in another country, it might therefore be necessary to make some investment in that country, for example by investing in a manufacturing or assembly plant. This type of government pressure encourages the development of global companies.
- **Currency volatility**. Currency volatility refers to the way in which exchange rates between currencies vary up and down in unpredictable ways. Currency volatility affects companies exporting goods or importing goods, because the transaction has to be in a foreign currency for at least one of the parties to the transaction. When exchange rates are volatile, there is more risk in transactions of this type: movements in an exchange rate can even eliminate expected profits. Currency volatility can be

reduced by matching the currencies of income with the currencies of expenditure. Global companies are able to do this much more than companies that are based in a single country.

- **Trade barriers**. Trade barriers are government measures to restrict international trade (or the free movement of currencies). They are usually created by charging duties on imports, or placing a ban or quota on the volume of imports. To overcome trade barriers, companies have to set up operations within the country concerned. This encourages the development of global companies.
- **Emergence of global competition**. The creation of global companies, with a global brand, and with production facilities in the low-cost countries leads to a response from rival companies that need to remain competitive. An effective response to a global competitor is to become a global company yourself.

(b)

- Export goods produced domestically and sell them in another country through an agent.
- Give manufacturers in other countries a licence to produce and sell your goods.
- Set up production (and marketing) facilities in other countries – possibly in a joint venture with another company
- Acquisitions: buy the existing business of a foreign company

(c)

- **Ethnocentric management structure**. The company has the culture of its country of origin, and most or all senior managers come from that country. For example, a US company might have operations in many countries of the world, all managed by US managers.
- **Polycentric management structure**. The company operates in different countries, and most or all senior managers in each country are 'local' (nationals of the country). For example, a US company with operations in other countries will use French managers to manage its subsidiary in France, Japanese managers to manage its subsidiary in Japan, and so on. Each subsidiary acquires the culture of its host nation.
- **Geocentric management structure**. This is used by a truly global company. The company builds its own ethos and culture, which cannot be identified with any country in particular. Its management team is international, and top management positions are filled by the best person for the job, regardless of his or her country of origin.

26 Collaboration

Rival firms may collaborate in any of the following ways.

(a) Firms may form a price cartel, to sell their products to the market at the same price. Cartels may be illegal.

(b) Firms may co-operate to promote the interests of their industry as a whole; for example firms may collaborate through trade associations or professional associations.

(c) Rival firms may form a joint venture to undertake a high-risk project.

(d) When there are only two firms in an industry (when there is an **oligopoly**), the firms may avoid competing with each other, particularly on price, and are content to hold on to their existing share of the market. Non-competition allows oligopolies to maximise their profitability.

27 Sustainable competitive advantage

A company can achieve sustainable competitive advantage by:

(1) choosing a suitable strategy – cost leadership, differentiation or focus

(2) sustaining the strategy by

- building up core competencies (special skills, experience, and so on)
- marketing expertise and
- new investment.

28 Generic strategies

(a) **Cost leadership**. Trying to gain competitive advantage by being the cheapest producer in the market may be found in business-to-business markets, such as the supply of raw materials and component parts. The customer tries to buy cheaply in order to keeps its own production costs down. However, in theory, only one firm in any market (or niche market) can be the least-cost producer: other companies need to adopt product differentiation strategies.

(b) **Differentiation**. Forms often compete in a market by differentiating their products from the similar products of competitors. The basis for differentiation is often **product design** (television sets, items of furniture, clothing, mobile telephones and so on). Other product features or marketing methods (advertising, or the selection of a different channel of distribution) might also be used to create differentiation.

(c) **Focus**. Many companies focus on a particular niche of a market. Within its chosen niche, the company needs to pursue a cost leadership or a product differentiation strategy. For example, within the broader market for hi-fi systems and sound systems, a company might specialise in providing headphones and speaker systems.

29 Mission

(a)

Purpose of mission statement	In the fastPlane mission statement
To state the purpose of the entity and the business it is in (and will be in)	Providing safe, good value point-to-point services, at attractive prices, for business and leisure passengers within Europe.
To express the values and beliefs of the entity, to influence the views of key stakeholder groups inside and outside the firm	Safe, good value, consistent and reliable services
To provide a guide for strategic decisions	Develop employees
	Establish good relationships with suppliers
	Limit services to Europe
	Leisure and business passengers
	Safety standards
	Reliability standards

Mission statements should be re-visited regularly, to make sure that they remain relevant. For example, fastPlane would need to reconsider its mission statement if it were to consider the possibility of providing non-air transport services, or to open routes outside Europe.

(b) The RIBC developed five strategic objectives from its mission statement. You can check your ideas against them. The RIBC strategic objectives were:

(i) To demonstrate the benefits of good cake-making, for the economy, community and individuals

(ii) To promote and enhance these benefits, in collaboration with industry and partners.

(iii) To facilitate the delivery of good cake-making – raising the average through professional training and development

(iv) To provide high-quality support services to its members, clients, industry associations and the public

(v) To develop its own capabilities to deliver these strategies.

These strategic objectives were then used to formulate strategies to achieve the objectives.

30 Product-market strategy

Market penetration	Increase market share
Product development	Market the installation of satellite dishes to the existing customer base
Market development	Expand the business into another area of the city
Diversification	Start up a new business operation by offering office cleaning services

31 Growth strategies

Organic/internal growth

(1) Expand existing production facilities and market the product in new markets

(2) Build a new production facility in a different location. Possibly establish a foreign subsidiary.

(3) Use agents in other countries to sell the product

(4) Set up a franchise operation and sell franchises

(5) Grant licences to other producers in other countries

External growth

(1) Takeovers (acquisitions of other companies)

(2) Joint ventures

32 Suitability, acceptability and feasibility

Suitability	Does the strategy deal with the position or circumstances the entity is facing.
	Does the strategy make sense in these circumstances?
	Does it deal with the problem?
	Alternative strategies can be raked according to their suitability. Some will deal with the problem more effectively than others.
Acceptability	Is the strategy acceptable in terms of its expected outcome (for example, is the risk/reward pay-off acceptable to shareholders?)
Feasibility	Does the entity have the competencies and the resources to deliver the strategy and make it work?

33 Strategy selection

(a) The product is in the growth stage of its life cycle.

(b) When the patents expire, competitors will inevitably enter the market, and the ability of Entity X to charge monopoly prices will end. Profitability will fall dramatically

(c) Entity X should make every effort to enforce its patents, and must not allow the US competitor to breach its patent rights.

However, it is not clear whether the patent rights will be sufficient to prevent the US competitor from entering the market in a few years' time. Entity X must therefore develop alternative strategies, to give it a competitive advantage over competitors when they eventually get into the market. These strategies should include:

(i) improving the efficiency of operations

(ii) developing the brand name for its product

(iii) investing in larger and more efficient production facilities

(iv) make sure that supply can meet demand.

34 R&D strategy

Some companies must invest in R&D to survive and grow. The main financial problems associated with R&D are likely to be as follows:

- Deciding how much in total to invest in R&D each year.
- Dividing the total spending between pure research, applied research and development.
- Recognising the probability of failure of many research projects and some development projects. Returns are therefore extremely difficult to predict.
- Even so, recognising the need to innovate. There is a risk that the 'accounting mentality' will persuade companies to invest more in products they have already developed, and avoid R&D.
- Companies that do not spend enough on R&D will fail to innovate. They must therefore copy new products that rival companies develop and bring to market. However, these new products may be protected by patents.
- There has to be a system for planning, monitoring and controlling spending on R&D.

35 Rational strategic plans

The question gives a statement of the 'rational model' of strategic planning.

If we accept that the overall objective is to maximise the wealth of its shareholders, there are several weaknesses with the rational model.

(a) There is a very large element of risk and uncertainty in long-term planning. At best, management can only develop strategies that they think are likely to increase shareholder wealth.

(b) Management is often under pressure to achieve a good performance (profits, dividends and so on) in the short term. They may therefore prefer strategies that provide good short-term results, without giving proper thought to the long-term. Good short-term results are often achieved at the expense of longer-term benefits. (For example, short-term profits can be increased by choosing not to invest in new equipment.)

(c) Shareholders and other stakeholders often have conflicting interests, and it is not possible to develop strategies that optimise the benefits of all groups.

(d) Management do not have perfect knowledge. The information available to them is limited, and their ability to absorb and understand it all is also limited. Managers therefore make strategic plans within the limits of what they know and understand. This is the concept of 'bounded rationality' in strategic planning.

(e) Managers may simply choose strategies that will provide results that are acceptable and 'good enough' for shareholders and other stakeholders. This is the concept of 'satisficing' (rather than 'optimising' to achieve the best results possible).

36 Emergent strategy

(a) **Strategy analysis** is the process of assessing the strategic situation (perhaps using techniques such as SWOT analysis) and identifying different alternative strategies that might be chosen to pursue the entity's objectives. The preferred strategy is then selected.

Strategy formulation is the process of developing plans and establishing targets for achieving the selected strategy.

Strategy implementation is putting the strategic plans into operation, and monitoring actual progress by comparing actual achievements against the targets.

(b) Mintzberg argued that some strategic plans might be developed and implemented in this rational way. These are deliberate strategies.

More usually, planned strategies often do not go according to plan, because unexpected developments occur that alter the situation. As a result, some of the planned strategies might be abandoned, and new strategies selected in response to the new circumstances. A strategy adopted in order to take advantage of an unexpected opportunity is an emergent strategy. Mintzberg argued that the strategies of entities are a combination of deliberate and emergent strategies.

37 Stage in development

The situation can be analysed using Greiner's growth model.
The company appears to have reached a 'crisis of red tape', and the way forward in its development is 'growth through collaboration' between head office and investment centre management. The collaboration should be based on team-work and problem-solving, to replace the old systems of control through reporting and accounting.

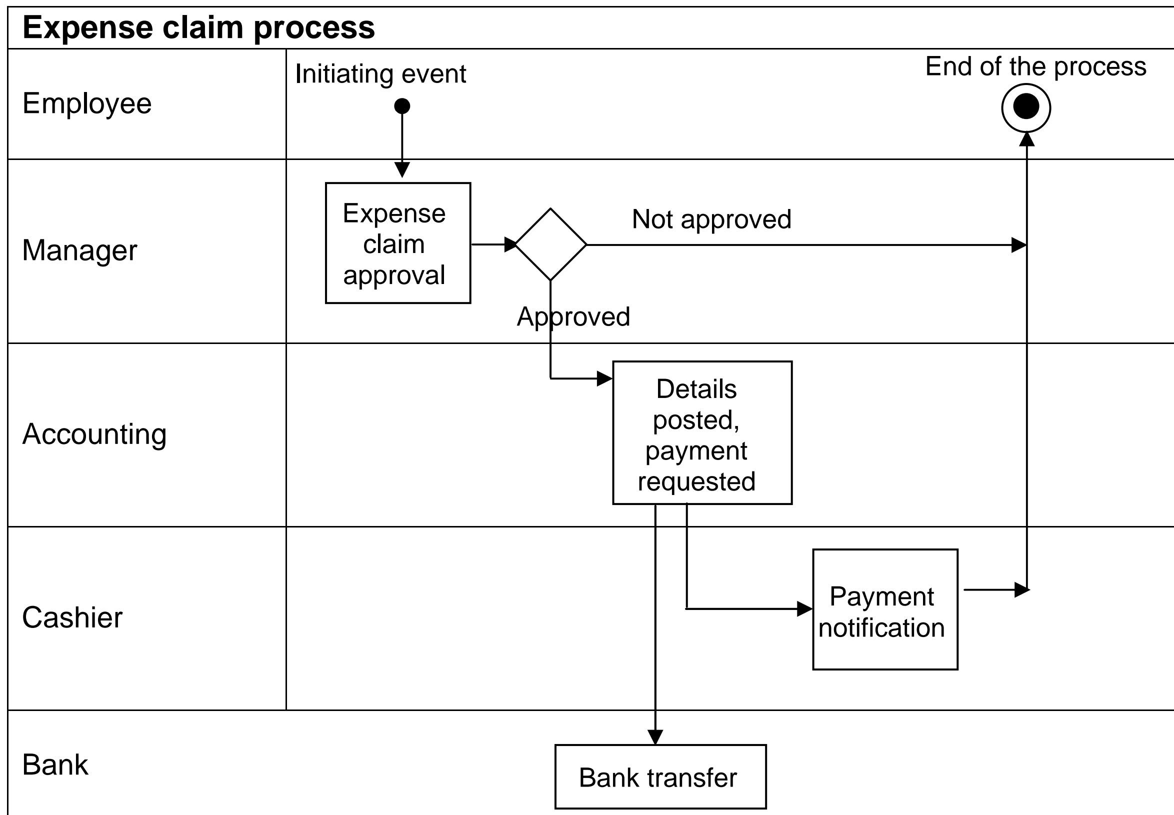
38 Business processes

(a) The Harmon process-strategy matrix is as follows:

Process complexity and dynamism	Strategic importance: Low	Strategic importance: High
High	Complex, dynamic, ordinary processes. Might be better to outsource	Complex, dynamic, valuable processes. Business process redesign and improvement
Low	Simple, stable, routine, ordinary processes. Should be capable of high degrees of automation	Simple, stable, but valuable processes. Should be capable of high degrees of automation to gain efficiency

It is likely that the expense claim process would be in the bottom left-hand quadrant: simple, stable, routine and not of great strategic importance.

(b)



39 Features of organisational change

Huczynski and Buchanan identified four basic features of organisational change, that management should recognise

- **Triggers of change**. These are developments, internal or external to the entity, that point to the need for change. An entity should have surveillance or scanning mechanisms in place to identify these triggers when they arise.
- **Interdependencies**. Changes in one part of an organisation or in some aspect of an organisation's structure or operations will inevitably have a knock-on effect. Other people within the organisation, and other processes and operations will also be affected. (This is similar to the concepts in the McKinsey 7S model.)
- **Conflicts and frustrations**. Change brings conflict and frustrations. Some want the change to happen, and others resist it. People wanting change become frustrated at the lack of change, or slow progress towards change. This leads to conflict.
- **Time lags**. There are time lags in the change process. Planned changes rarely go according to plan or according to the planned timetable. People accept change at different rates, and systems and processes might change at different rates too. Change can therefore be messy.

40 Change

(a) BPR is an approach to introducing a transformational change within an organisation. An entire business process is re-designed and re-organised ('re-engineered'). BPR usually involves reorganising work around a system, instead of organising work by departmental functions. As a result, processes are operated by multi-disciplinary teams.

(b) A suitable model might be the Lewin's three-step change model, supported by Lewin's force field analysis.

(i) The three-step change process is unfreeze, move (change) and re-freeze. The 'unfreeze' step is to develop a recognition amongst the people affected that change is needed and is desirable, and obtaining agreement about the nature of the changes that are required. The 'move' step is making the change. Once a change has been made, there is a risk that employees will go back into their former habits and ways of doing things: 're-freeze' means taking measures to ensure that the change becomes established and the new 'accepted way of doing things'.

(ii) Force field analysis can be used to assess the strength of resistance to change, and the nature of the forces driving change. Lewin recommended that the most effective approach t gaining acceptance of change is to find ways of reducing the forces of resistance to change.

(c) Internal marketing involves establishing the views and opinions of people inside the organisation and trying to 'market' an idea to them – for example, trying to persuade them of the need for change. In the context of change management, internal marketing means finding out the views of employees towards a proposed change and trying to promote the change as 'a good thing'. In external marketing, the customer is the main consideration. In internal marketing, the employee is the 'customer' whose views and opinions must be taken into consideration: plans for change should be amended where appropriate, in response to the views of employees.

41 Channel for marketing and distribution

For suppliers

- A marketing and sales channel available to users 24 hours a day, 7 days a week.
- Products can be sold to customers anywhere in the world, provided that there is a reliable distribution channel.
- Ability to respond immediately to customer requests.
- Customers can access up-to-date information about products on the supplier's web site.
- Direct mailing by e-mail is cheaper and more efficient that direct mail marketing by post.
- It is cheaper to operate an on-line marketing and sales operation than to open a retail outlet.

- Electronic products can be delivered immediately to customers anywhere in the world.
- Can be linked easily to a system for recording management information about sales.

For customers

- A convenient 24/7 method of shopping.
- Easy access to a large number of potential suppliers
- Ability to shop around for the best deal (for example, the lowest price)
- Fast service
- Convenience of immediate delivery for electronic products

42 Stefan Lund

(a)

Selling through the supermarket group

Advantages	Disadvantages
Access to a large number of potential customers	Possibly large sales volumes: this could act as a drain on cash in the early stages of the business.
Potential for large sales volumes	Single customer: risk of losing the customer if sales are disappointing or there are problems with supply.
The supermarket will probably sell the hats as a fairly narrow product range of; therefore less design requirements	Stefan cannot use his own brand for the products.
Probably easily-managed distribution arrangements	There may be pressure from the supermarket group to reduce prices.
	Sales prices for Stefan will be lower than the prices charged by the supermarkets.

Selling through independent fashion shops

Advantages	Disadvantages
Shops specialise in selling fashion goods.	Possibly low sales volumes
Access to customers looking to buy fashion goods.	Shops will probably want a wide range of differentiated products.
Stefan can use his own brand for the products.	Need for high quality
Shops will probably want to sell products at high prices, therefore potential for high gross profit margins	Possibly higher costs of distribution (to the shops)
	Using some of the shops might be unprofitable.
	Sales prices for Stefan will be much lower than the retail prices charged by the shops.

Selling through web site and Internet

Advantages	Disadvantages
Products can be made to order.	Problem of attracting potential customers to the web site.
Product quality may not be such an important issue.	Distribution will be more expensive and time-consuming: products must be delivered to customer addresses
Stefan can use his own brand for the products.	Order-handling will be more complex due to the larger volume of small orders to handle.
Ability to be flexible with design: new designs can be varied to meet customer preferences.	
Direct contact with users of the product	
Higher prices and gross profit margins	

(b)

	Supermarkets	Fashion shops	Internet
Product	Small product range Large volumes Quality important	Wide product range Small volumes Quality important	Wide product range Volume difficult to predict Quality probably less important
Place	Supermarkets	Specialist shops	Internet, web site, e-commerce
Price	Pricing probably critical: low prices	Prices to the customer will be high	Prices probably neither high nor low.
Promotion	Through the supermarket's own brand	Need for brand development	Need for brand development. Success of web site in attracting 'hits' will be critically important

43 Travel goods firm

Tutorial note: A suggested answer is given here. Your answer may differ in some details.

Strengths

- Strong brand and reputation
- Worldwide facilities for manufacture and distribution
- Managers with ideas for improving the business
- Successful experience with EDI
- Successful experience with web site and e-commerce.

Weaknesses

- Poor communications between divisions within the company
- Little or no access to information about competitors
- Possibly the decentralisation of IS/IT systems is a weakness.

Opportunities

- Possible use of intranet to improve internal communications and interchange of ideas
- Possible use of extranets to improve communications with customers
- Possible use of an executive information system to provide more information about competitors and the market.

Threats

- Strong competition in the market. Competitors have made some successful initiatives.
- Significant fall in number of 'hits' on the web site.

44 Electronic marketing

(a) To provide information about theatres on their web site. Theatres may have linked web sites, or a joint web site for theatres in the same commercial group. The information will relate partly to the theatres themselves (and their location) but will provide details of what is on.

(b) To allow customers to buy tickets on line, choosing the date and time of the performance, reserving the seats and paying for the tickets.

(c) To monitor traffic ('hits' at each web site) and so assess customer interest.

(d) To register customers who are interested in receiving information about future shows, and e-mail information to these customers who are willing to receive it (direct marketing).

(e) Perhaps also obtain customer feedback about performances.

There are other opportunities for electronic marketing. For example, theatres could link with travel firms, hotels and restaurants to offer holiday breaks to customers as a joint package of services and entertainment.

45 Leek and Flood

(b) Value chain analysis is a model for assessing performance. Each activity in the value chain can be investigated, to establish whether it adds value successfully.

(c) The activities in the value chain are the primary and secondary activities. In this case study, the identifiable activities in the value chain are inbound logistics (delivery of parts to the plumbers' vans), operations (plumbing services), marketing (door-to-door marketing, directory advertising, web site, word of mouth), after-sales service (warranties and response to complaints) and procurement (buying parts from the single supplier). There is also some reference to human resource management, since plumbers are given regular training. There is no information relating to infrastructure and technological development.

46 Business case

A report presenting a business case for a new IS/IT system should be presented clearly. The report should have a logical structure, and it should present the necessary information. Appendices should be used to show details, and the main body of the report should be kept reasonably short.

A logical structure for a report would be as follows:

(1) Introduction. Explain the purpose of the report and the terms of reference for the report writer.

(2) Current position. Explain the current position. Indicate the nature of the current problem or opportunity.

(3) Where we want to be. Explain the business objective, and what the business is trying or should be trying to achieve.

(4) Where we are. Compare 'where we want to be' with 'where we are' or 'where we will be if nothing is done'.

(5) Gap analysis. The comparison of 'where we are' and 'where we want to be' should be assessed, to establish the need for movement to get from 'here to there'.

(6) Options for closing the gap should be described in broad outline. There may be several different ways of trying to close the gap.

(7) For each 'realistic' option there should be an estimate of the costs and benefits. Benefits may not be measurable in financial terms, and a comparison of financial costs with intangible benefits may be appropriate.

(8) Summary. A brief summary of each option should be given, with a comparison of their 'net benefits'.

(9) Recommendation. The report should conclude with a recommendation. If a business case for a new system has been made successfully, the report's recommendation should be to develop the preferred option.

47 Risk management process

All projects have risks. The risk management process involves identifying and assessing these risks, and taking measures to avoid or control them. The effectiveness of risk control measures should be monitored. The process should be repeated regularly, as a risk management control cycle.

The process involves:

(a) Risk identification. Risks must be identified, perhaps by a special risk management committee, or by the project team.

(b) Risk assessment. Each risk must be assessed. The aim is to decide how significant the risk may be. The reason for assessing significance is to make a decision about the risk avoidance or control action that might be appropriate, in view of the size of the risk.

(c) Typically, a risk is assessed by estimating the probability that an adverse event will happen, and the impact it would have if it did happen. (The expected value of the cost of a risk is its probability multiplied by its impact.)

(d) Having assessed each risk, management must decide on appropriate measures to deal with it. Risks that would have an unacceptable impact should be avoided. For example, the risk of damage from a natural disaster can be avoided through insurance. For some risks, control measures may be taken to reduce the risks. For example, the risks of errors in writing new software for a system can be reduced by means of extensive testing.

(e) Control measures should be implemented.

(f) The effectiveness of control measures should be monitored.

(g) In cases where control measures fail to work, management should investigate the reason for the control failure, and try to learn lessons for the future. If the risk remains, more effective control measures should be devised and implemented.

48 Project manager

(a) A project has number of characteristics:

(i) The project should have a specific objective. The objective of a feasibility study is to produce a feasibility report with a recommendation.

(ii) A project team is assembled to carry out the work. A feasibility study is carried out by a specially-assembled study team.

(iii) A project should have a schedule and a time scale for completion. A feasibility study has a target date for submitting the feasibility report.

(iv) A project should have a customer. For a feasibility study, this is the steering committee (or similar decision-making body).

(v) A project should have a budget. A feasibility study ought to be given a budget.

(b) Seven general responsibilities of a project manager include:

1 Selecting and organising the project team.

2 Agreement of the terms of reference with the project sponsor/computer system user.

3 Planning the schedule of project activities.

4 Agreement of the project milestones and deliverables with the project sponsor/senior management.

5 Control over the progress of the project

6 Control over the project budget

7 Conducting an end-of-project review meeting.

49 Project management software

1 The package can be used to produce charts and graphs, such as critical path charts and Gantt charts

2 The package can be used to record budgeted and actual costs of the project, and produce budgetary control reports.

3 The package can be used to schedule resources for the various tasks in a project.

50 Requirements creep

Requirements creep is a term used to describe gradual changes made by the user to the user requirements for a new system. If the user continually makes changes to the requirements, completion of the project may be delayed.

There are two approaches to controlling requirements creep.

(a) Accept that requirements creep is inevitable, and use a Spiral method approach to system development. Prototypes of the new system can be introduced, and the system can be made operational, before the final prototype is developed. This avoids delay in implementing the new system.

The user also has the opportunity to make changes to the user requirements, because new prototypes can be developed to include the new requirements.

(b) Establish a formal system for agreeing and authorising changes to user requirements. The user will then need to justify changes, and get them formally approved by management (at a suitable level of seniority). A formal procedure could include:

- A formal document including a request for a change to the user requirements
- A formal assessment of the impact the change will have (on the project costs and completion time, and on the user's costs and benefits from the system)
- A discussion of the proposed change and its impact, between the user and the project team
- Formal authorisation of the change in requirements
- Recording the change and its justification in the documentation for the project.

51 Balanced scorecard

(a) To set a number of performance targets in each of four key areas, with the aim of achieving strategic objectives if all the performance targets are met.

(b) Financial targets

- Customer satisfaction targets
- Targets for the enhancement of internal processes
- Targets for learning and growth (creating capabilities in employees and systems).

(c) A balanced scorecard approach might be suitable for not-for-profit organisations, where financial objectives are not as dominant as in commercial organisations. Financial objectives in these organisations are often aimed at achieving revenue targets or controlling costs, rather than making profits.

Profit-making entities might also choose a balanced scorecard approach when they recognise the need to establish longer-term strategic objectives and not concentrate exclusively on short-term profitability. The achievement of longer-term objectives is often measured better by performance relating to non-financial targets than by using financial targets (which tend to focus on the short term).

(d) Suggested answer

Financial targets	Customer satisfaction targets
% of total income from corporate sources, or from foreign students Administration costs as a % of total costs Academic costs as a % of total costs, or target for the average annual cost of a full-time member of the academic staff. Targets for fund-raising or annual growth in fund-raising	(Customers = students and employers of students on completion of their courses, or the government as a provider of funds) Targets for % of students obtaining 1st class honours degree % of students from state schools Target prices for student accommodation Availability of student accommodation

Targets for the enhancement of internal processes	Targets for learning and growth
Targets for room utilisation Target for the average number of full-time students per computer terminal	Number of applications made for research grants each year, per member of the academic staff

52 Key success factors

(a) (i) Low-cost operations (allowing the airline to offer low-cost flights to passengers)

(ii) The development of a route network (using 'secondary airports), avoiding direct competition with other low-cost airlines

(iii) Brand development and successful marketing (for example, selling direct to the customer and avoiding the cost of the 'middle man' such as travel agents).

(b) *Suggestions for an answer*

Financial targets	Customer satisfaction targets
Return on capital employed Financial gearing Average revenue per seat/kilometre Gross profit margin per seat/kilometre	Number of complaints Amount of compensation payments % of customers who are repeat customers

Targets for the enhancement of internal processes	Targets for learning and growth
Targets for aeroplane load factor Punctuality targets Targets for avoidable delays Targets for the conversion ratio of enquiries into sales E-commerce performance targets	Route network development targets Average time for anew route to break even Career progression rates for employees in the company

53 Entity P: financial performance

Note: If you were given similar financial numbers to analyse in an examination, there might only be time to make the more important calculations. The answer provided here misses out the analysis of Year 2 figures, on the assumption that Year 1 (the starting point), Year 3 (now) and Year 4 (next year's forecast) are more important figures to analyse.

	Year 1	Year 3	Year 4 (forecast)
Cost of sales/Sales	63%	70%	70%
Marketing costs/sales	9%	6%	5%
Distribution costs/sales	13%	8%	6%
Administration costs/sales	2%	2%	2%
Interest charges/Sales	0%	4%	8%
Operating profit/sales	13%	10%	9%
Loans/Sales revenue	0%	50%	67%
Inventory/Sales	10%	14%	18%
Sales/Non-current assets	4.7 times	1.9 times	1.2 times
	$	$	$
Average sales per employee	600,000	1,032,000	888,000
Average sales per product	281,000	185,000	234,000
Average sales per supplier	750,000	726,000	651,000

Analysis

- The decline in operating profit margin is a key issue.
- Higher costs of sales (63% in Year 1 to 70% now) and interest charges are clearly a problem.
- The fall in marketing and distribution costs as a percentage of sales is very substantial: does this mean that the entity is putting fewer resources into these operations? If so, what might be the consequences?
- The large increase in borrowing must be a matter for concern. High interest costs are reducing profit margins.
- Why is the large increase in investment in non-current assets and inventory necessary? These increases seem to explain the need to increase borrowing.
- The projected increase in employee numbers next year is large, but possibly reasonable if employees are currently over-worked (see the average sales per employee figures).
- The growth in the product range is not unreasonable (see the average sales per product figures) but the number of suppliers is increasing at a faster rate, and this may eventually lead to operating difficulties in the value chain (procurement and inbound logistics).

54 ABC Group: financial analysis

Workings

Division A	**Year 1**	**Year 2**	**Year 3 (forecast)**
Sales revenue growth		4%	5%
Volume growth		2%	2%
Cost of sales growth		2.7%	2%
Gross profit/Sales	45%	46%	47%
Transport costs/Sales	5%	5%	5%

Division B	**Year 1**	**Year 2**	**Year 3 (forecast)**
Sales revenue growth		12.2%	12.3%
Volume growth		10%	10%
Cost of sales growth		8%	8%
Gross profit/Sales	40%	42%	44%
Transport costs/Sales	3.5%	3.5%	3.6%

Division C	**Year 1**	**Year 2**	**Year 3 (forecast)**
Sales revenue growth		- 9.3%	- 3.6%
Volume growth		+ 7%	+ 6.5%
Cost of sales growth		+ 4.6%	+ 3.2%
Gross profit/Sales	35%	27%	22%
Transport costs/Sales	6%	8.5%	10%

Analysis

Division A

- Good financial performance, but market share falling in spite of a small increase in volume.
- R&D spending low
- This product group may well be reaching the maturity stage of its life cycle, and is a 'cash cow' for the group.

Division B

- Strong growth in volume and sales prices.
- Cost of sales as a percentage of sales revenue is falling, presumably because of the effect of fixed costs in the cost structure.
- R&D spending high.
- Market share unchanged in a fast-growing market.
- This product group may well be a 'star' for the group, and the high R&D spending would therefore be justified.

Division C

- Still profitable, but sales revenue is falling.
- Costs are rising as a percentage of sales revenue.
- R&D spending is moderate.
- Market share still fairly high.
- However, this product group may well be a 'dog' in the terminology of the BCG matrix. The group should beware of investing heavily in risky attempts to sustain the products of Division C.

55 Role of the accountant

(a) (i) Accountants provide support activities for the entity: invoicing, debt collection, provision of management information, and so on).

(ii) Accountants also act as a regulator of management decisions, by establishing a financial framework within which management decisions should be made (investment appraisal systems, budgetary control systems).

(iii) In some entities, they are involved in developing business strategy (see below).

(iv) In some entities, they may act as an agent for change, through their understanding of acquisitions and mergers and franchising as strategic options.

(b) **Involvement in business and marketing strategies**

Accountants ought to be involved (although they are not always involved) in business strategy:

- Provide support to line management in screening new products for development. However, to perform this role successfully, accountants must share the innovative and entrepreneurial culture of their colleagues, and must not be excessively cautious and risk-averse.
- Accountants should also be involved in strategic investment appraisal. This involves assessing not just the potential financial returns from strategic investments, but whether the investments would be a good 'strategic fit' for the entity. (Investments should be undertaken if they offer a high financial return and are a good strategic fit. Decisions about investments with a lower return but good strategic fit, or a high return but a poor strategic fit, should be a 'tactical choice' for management.)
- Accountants should also be involved in the evaluation of marketing decisions (price review, marketing sales budget analysis, product differentiation decisions, evaluation of the effectiveness of advertising). Accountants should provide management information relating to market segments and distribution channels, not just profitability by product and product group.

56 HR plan

- The current work force and the expected work force in five years' time should be analysed. The work force should be divided into employees with different skills and at each level of seniority within the management hierarchy.
- For each category of employee currently employed, an estimate should be prepared of how many will leave each year, and how many are likely to be promoted or transferred to a different job within the company.
- An estimate can therefore be made of the likely numbers of employees in each type of job (= current numbers minus leavers plus numbers promoted or transferred into the job), assuming that there is no external recruitment.
- The difference each year between these employee numbers and the number of employees required will give us a 'gap' to be filled with external recruitment or faster internal promotion.
- In the case of IT staff, where staff numbers will fall, the analysis may show that some staff may have to be made redundant.

The HR plan can then be used to formulate strategies or plans for recruitment, transfers, re-training and redundancies.

57 Strategic management styles

Strategic planning style	Head office is involved in formulating strategy for the organisation. Long-term planning for the organisation is therefore centralised. This style is appropriate when the activities of the organisation are highly-interdependent, and it would therefore be difficult to decentralise strategic planning decisions to business units.
Financial control style	Head office allows divisions/business units to formulate their own independent commercial strategies. However, these strategies must conform to budget targets. Head office exercises control over business units through short-term financial controls (for example, budgets).
Strategic control style	Head office attempts to strike a balance between the strategic planning style and the financial control style. Business units are given the independence to develop their own commercial strategies, but these must be consistent with the overall strategic objectives for the group as a whole.
Holding company style	There is little or no input to strategic management from head office, which is simply a holding company for investments in the different subsidiaries.

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