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As a world leader of the accountancy and finance profession, we are proud to promote, develop and support over 144,000 chartered accountants worldwide. Our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. They are part of something special, and now, so are you. It’s with our support and dedication that our members, and hopefully yourself, will realise career ambitions, maintain a professional edge and contribute to the profession.

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You are in good company, with a network of over 26,000 students around the world made up of like-minded people; you are all supported by ICAEW. We are here to support you as you progress through your studies and career; we will be with you every step of the way, visit page xi to review the key resources available as you study.

I wish you the best of luck with your studies and look forward to welcoming you to the profession in the future.

Michael Izza
Chief Executive
ICAEW
## Contents

- Introduction vii
- Strategic Business Management viii
- Permitted Texts x
- Key Resources xi

1. Strategic analysis 1
2. Strategic choice 65
3. Strategic implementation 135
4. Strategic performance management 235
5. Strategic marketing and brand management 313
6. Corporate governance 417
7. Business risk management 479
8. Data analysis 543
9. Information strategy 605
10. Human resource management 701
11. Finance awareness 777
12. Business and securities valuation 833
13. Financial instruments and financial markets 895
14. Financial structure and financial reconstruction 989
15. Financial risk management 1065
16. International financial management 1137
17. Investment appraisal 1183
18. Treasury and working capital management 1221
19. Ethics 1253

- Index 1299

Questions within the study manual should be treated as preparation questions, providing you with a firm foundation before you attempt the exam-standard questions. The exam-standard questions are found in the question bank.
1 Introduction

ACA qualification

The ICAEW chartered accountancy qualification, the ACA, is a world-leading professional qualification in accountancy, finance and business.

The ACA has integrated components that give you an in-depth understanding across accountancy, finance and business. Combined, they help build the technical knowledge, professional skills and practical experience needed to become an ICAEW Chartered Accountant.

Each component is designed to complement each other, which means that you can put theory into practice and you can understand and apply what you learn to your day-to-day work. Progression through all the elements of the ACA simultaneously will enable you to be more successful in the workplace and exams.

The components are:

- Professional development
- Ethics and professional scepticism
- 3-5 years practical work experience
- 15 accountancy, finance and business modules

To find out more on the components of the ACA and what is involved in training, visit your dashboard at icaew.com/dashboard
2 Strategic Business Management

The full syllabus and technical knowledge grids can be found within the module study guide. Visit icaew.com/dashboard for this and more resources.

2.1 Module aim

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

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

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

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

2.2 Prior knowledge

This module assumes and develops the knowledge and skills acquired in the Financial Accounting and Reporting module, the Business Strategy module and the Financial Management module.

Background knowledge based upon the strategic elements of the Business Planning: Taxation and the Audit and Assurance module will also be required in evaluating the business and financial risks of reporting entities.

2.3 Ethics

Ethical codes will be those issued by IFAC and the ICAEW. The ethical implications will be at both the organisational level and for individuals, particularly with respect to the accountant in business.
2.4 Method of assessment

The Strategic Business Management module will be examined using a paper-based assessment of 3.5 hours. Each exam will contain questions requiring integration of knowledge and skills, including ethics. Candidates will be allowed to take any written or printed material into the exam hall subject to practical space restriction.

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

2.5 Specification grid

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

<table>
<thead>
<tr>
<th>Syllabus area</th>
<th>Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business strategy and Management</td>
<td>30–40</td>
</tr>
<tr>
<td>Corporate Reporting</td>
<td>15–20</td>
</tr>
<tr>
<td>Assurance</td>
<td>10</td>
</tr>
<tr>
<td>Ethics</td>
<td>5–10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

2.6 Business contexts

The learning outcomes may all be assessed within an integrated business scenario. The following are examples of possible scenarios:

- Developing management information strategies
- Developing management and corporate governance mechanisms
- Business and financial risk management
- Business start-up planning
- Business and security valuations
- Developing policies for sustainability and corporate responsibility
- Raising, structuring and restructuring of finance
- Resource management issues
- Developing performance management strategies
- Developing remuneration and reward packages
- Reorganisation and restructuring of entities, and the management of change
- Financial distress and business recovery
- Developing global financial and business strategies and operations
- Developing global divisional and transfer pricing strategies for tax and performance management
- Appraisal methods for businesses undertaking major projects and/or organisational or process transformation
- Issues arising from use of complex financial instruments in business finance in the context of risk and treasury management
- Ethical issues arising in business and finance.
3 Permitted Texts

At the Professional and Advanced Levels there are specific texts that you are permitted to take into your exams with you. All information for these texts, the editions that are recommended for your examinations and where to order them from, is available on www.icaew.com/permittedtexts.

<table>
<thead>
<tr>
<th>Professional Level Examinations</th>
<th>Permitted Text</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit and Assurance</td>
<td>✓</td>
</tr>
<tr>
<td>Financial Accounting and Reporting</td>
<td>✓</td>
</tr>
<tr>
<td>Tax Compliance</td>
<td>✓</td>
</tr>
<tr>
<td>Business Strategy</td>
<td>✗</td>
</tr>
<tr>
<td>Financial Management</td>
<td>✗</td>
</tr>
<tr>
<td>Business Planning: Banking/Insurance/Taxation</td>
<td>No restrictions</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Advanced Level Examinations</th>
<th>No restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Reporting</td>
<td>No restrictions</td>
</tr>
<tr>
<td>Strategic Business Management</td>
<td>No restrictions</td>
</tr>
<tr>
<td>Case Study</td>
<td>No restrictions</td>
</tr>
</tbody>
</table>

Business Planning: Banking/Insurance/Taxation and the Advanced Level exams have no restrictions so you may take any hard copy materials into these exams that you wish, subject to practical space restrictions.

Although the examiners use the specific editions listed to set the assessment, you may use a different edition of the text at your own risk. If you use a different edition within your exams, you should note this inside your answer booklet, at the beginning of the question.

This information, as well as what to expect and what is and is not permitted in your exams is available in the Instructions to Candidates. You will be sent this with your exam admission details and it is also available on our website; www.icaew.com/exams.
4 Key Resources

Student support team
Our student support team is here to help you as much as possible, providing full support throughout your studies.

T +44 (0)1908 248 250
F +44 (0)1908 248 069
E studentsupport@icaew.com

Student website
The student area of our website provides the latest information, guidance and exclusive resources to help you progress through the ACA. Find everything you need (from sample papers to errata sheets) at icaew.com/dashboard.

Online student community
The online student community provides support and practical advice – wherever you are, whenever you need it. With regular blogs covering a range of work, life and study topics as well as a forum where you can post your questions and share your own tips. Join the conversation at icaew.com/studentcommunity.

Tuition
The ICAEW Partner in Learning scheme recognises tuition providers who comply with our core principles of quality course delivery. If you are receiving structured tuition with an ICAEW Partner in Learning, make sure you know how and when you can contact your tutors for extra help. If you are not receiving structured tuition and are interested in classroom, online or residential learning, take a look at our recognised Partner in Learning tuition providers in your area, on our website icaew.com/dashboard.

Faculties and special interest groups
Faculties and special interest groups support and develop members and students in areas of work and industry sectors that are of particular interest.

Our seven faculties provide knowledge, events and essential technical resources. Register to receive a complimentary e-magazine from one faculty of your choice each year throughout your studies.

Our 12 special interest groups provide practical support, information and representation within a range of industry sectors. Register to receive free provisional membership of one group each year throughout your studies.

Find out more about faculties and special interest groups at icaew.com/facultiesandsigs.

Library & Information Service
The Library & Information Service is ICAEW’s world-leading accountancy and business library.

The library provides access to thousands of resources online and a document delivery service, you’ll be sure to find a useful eBook, relevant article or industry guide to help you. Find out more at icaew.com/library.
CHAPTER 1

Strategic analysis

Introduction

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

Summary and Self-test
Technical reference
Answers to Interactive questions
Answers to Self-test
Introduction

Learning objectives

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

Knowledge brought forward and syllabus links

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

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

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

At a high level, the first three chapters of this Study Manual could be viewed as following the three broad stages of the rational planning model: strategic position; strategic choice; and strategic action (implementation). In this chapter, our focus is entities’ objectives and analysing their strategic position, both in terms of their relationship with the external environment (opportunities and threats) and in terms of their internal resources and capabilities (strengths and weaknesses).

In Chapter 2 we look at the different strategic options which entities can take to help them achieve their objectives and to achieve a sustainable competitive advantage.

Then in Chapters 3 and 4 we look at the issues entities face in implementing their strategies, and measuring how well they are performing against the objectives and targets they have set themselves. Strategy implementation is also underpinned by functional strategies, such as marketing, IS/IT and human resources strategies. We look at these strategies, respectively, in Chapters 5, 9 and 10.
1 Strategic management

Section overview

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

1.1 What is strategy?

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

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

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

1.2 Characteristics of strategic decisions

In addition to defining strategy, Johnson, Scholes and Whittington describe some important characteristics of strategic decisions.

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

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

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

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

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

1.3 Elements of strategic management

Strategic management is concerned with taking and implementing strategic decisions. The ‘strategic’ perspective focuses on an organisation as a **whole**, rather than looking at individual business functions in isolation.

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

- **Analysis** – analysis of current strategic position, including objective setting and the influences on an organisation’s strategy (external environment, internal capabilities, and the expectations of stakeholders)
- **Choice** – formulation and evaluation of agreed strategies
- **Implementation, monitoring and control** – with control information feeding back into the system

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

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

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

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

The structured ‘process’ of strategic management that we have illustrated in section 1.3 is characteristic of the formal, rational model approach to strategic planning. However, there is a marked contrast between this prescriptive approach to strategic planning and the emergent approach.

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

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

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

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

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

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

Section overview

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

2.1 Brought forward knowledge

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

Organisational goals

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

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

2.2 Mission and values

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

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

- **Coca-Cola** – 'To refresh the world … To inspire moments of optimism and happiness … To create value and make a difference.'
- **Google** – 'To organize the world’s information and make it universally accessible and useful.'
- **Starbucks** – 'Our mission: to inspire and nurture the human spirit – one person, one cup and one neighbourhood at a time.'
- **eBay** – 'To provide a global trading platform where practically anyone can trade practically anything.'
- **Microsoft** – 'To help people and businesses throughout the world realise their potential.'

2.3 Goals, objectives and targets

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

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

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

Most people's work is defined in terms of specific and immediate things to be achieved. If these things are related in some way to the wider purpose of the organisation, it will help the organisation to function more effectively.
Loosely speaking, these 'things to be achieved' are the goals, objectives and targets of the various departments, functions and individuals that make up the organisation. In effective organisations, goal congruence will be achieved, such that these disparate goals, objectives and targets will be consistent with one another and will operate together to support progress with the overall mission.

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

2.3.1 A hierarchy of objectives

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

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

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

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

Goals can be related in several ways:

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

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

2.3.2 Management by objectives

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

**Specific**  
**Measurable**  
**Achievable**  
**Relevant**  
**Time-related**

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

There are other variants: achievable may be replaced with attainable, which has an almost identical meaning. Achievable is also sometimes replaced with agreed, denoting that objectives should be agreed with those responsible for achieving them. However, note that whichever version you prefer, a SMART objective corresponds very closely with our description of the way the word target is commonly used.
(a) **Specific:** An objective must be a clear statement, and must be easy to understand. Whereas mission statements tend to be vague, objectives must be specific.

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

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

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

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

### 2.3.3 Primary and secondary objectives

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

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

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

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

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

### Case example: Jaguar Land Rover

In its 2013–4 Annual Report, Jaguar Land Rover summarised its objectives and strategy:

'The Company has a multifaceted strategy to position itself as a leading manufacturer of premium vehicles offering high-quality products tailored to specific markets, and to profitably grow its strong, globally recognised brands. The Company invests substantially to develop new products in new and existing segments with new powertrains(*) and technologies to meet customer aspirations and regulatory requirements. Complementing this, the Company invests in manufacturing capacity in the United Kingdom and internationally to meet customer demand.'

* The 'powertrain' in a motor vehicle describes the main components (like the engine, transmission, drive shaft and wheels) that generate power and deliver it to a road surface.

The focus on 'premium' and high quality is important here, because it shows how Jaguar Land Rover is looking to differentiate itself from the budget and mid-range vehicles.
In its Annual Report, Jaguar Land Rover then goes on to identify five objectives, which it believes are the key steps it needs to take to achieve this strategy:

1. **Grow the business through new products and market expansion** – Jaguar focuses on producing products in the premium performance car and all-terrain vehicle market segments, and aims to grow the business by diversifying its product ranges within those segments. For example, the Range Rover Evoque is designed for the market segment for smaller, lighter and more 'urban' off-road vehicles, complementing the more mature, existing markets for Range Rover, Freelander and Discovery.

   Alongside this product development, the company is also looking to 'expand its global footprint'. On the one hand, this market development has seen Jaguar Land Rover increasing its marketing and dealership network in emerging markets such as China where it had 170 dealerships by 31 March 2014. On the other hand, the company is progressing with new manufacturing facilities, assembly points and suppliers in selected markets. This includes a manufacturing and assembly joint venture in China with Chery Automobile Company Limited, an assembly facility in India, operated by Tata Motors, and a manufacturing facility in Brazil.

2. **Invest in manufacturing** – Over the long term, Jaguar has a capital spending target of between 10–12% of revenue, which is in line with other premium automotive manufacturers. However, in the short and medium term, Jaguar expects capital spending to be higher to allow it to take advantage of the growth opportunities presented.

3. **Invest in R&D, technology and people** – The company aims to maintain and improve its competitive position by developing technologically advanced vehicles, particularly with regard to economy and emissions aspects. Jaguar undertakes extensive in-house R&D, particularly through two advanced engineering and design centres, which centralise capabilities in product design and engineering. However, the company is also involved in a number of advanced research consortia which bring together leading manufacturers, suppliers and academic specialists.

   The company recognises that its workforce is key to its success, and it recruits talent from many sources, as well as engaging in a number of collaborations.

4. **Transform the business structure to deliver sustainable returns** – The company undertakes a range of internal and external benchmarking activities which help to identify cost improvement opportunities for components and systems. This includes sharing components across different designs and models of car in order to reduce engineering costs and to gain economies of scale. The company is also looking to enhance global sourcing and to take advantage of lower-cost bases in countries such as India and China.

5. **Continuing quality improvement and focus on putting the customer first** – Superior vehicle quality is a key element of Jaguar’s competitive advantage, and it has implemented a range of programmes (both internally and at suppliers’ operations) designed to improve the quality of its products, enhance customer satisfaction and reduce future warranty costs.

   Robust procedures are in place in the supply chain to ensure quality control of outsourced components, and products purchased from approved suppliers undergo a supplier quality improvement process.

   Downstream in the supply chain, the extensive sales and service network enables high-quality and timely customer services. Through close co-ordination, supported by IT systems, Jaguar monitors the quality performance of its vehicles and implements corrections on an ongoing basis to minimise any inconvenience to its customers.

---

**Long-term and short-term objectives**

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

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

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

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

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

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

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

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

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

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

2.3.4 Financial objectives

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

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

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

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

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

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

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

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

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

Competitive strategy, financial strategy and investment strategy

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

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

![Figure 1.1: Elements of business strategy](image)

The three types of strategy are described in the following table.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitive strategy</td>
<td>This determines how and where the firm competes in the market (customers, products) in order to achieve a sustainable position, and thereby generate profits and cash flows. The results of competitive strategy determine the level of profits and cash flow available for financial and investment strategies.</td>
</tr>
</tbody>
</table>
| Financial strategy | This is concerned with the way companies raise and deploy their funds. As such it looks at how companies build and maintain relationships with shareholders and other providers of finance. It is also concerned with how companies use the cash and earnings generated by their competitive strategy, and specifically how financial resources are invested for the future of the company. In her text Corporate Financial Strategy, Ruth Bender argues that financial strategy has two key components:  
  (a) Raising the funds needed by an organisation, in the most appropriate manner  
  (b) Managing the ways those funds are used within the organisation |
<table>
<thead>
<tr>
<th>Strategy</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment strategy</td>
<td>This aims to provide the resources (such as non-current assets, working capital, training, marketing, branding, R&amp;D expenditure) for the competitive strategy to be carried out.</td>
</tr>
</tbody>
</table>

The life cycle model

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

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

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

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

Delivering value for shareholders

We can also highlight the importance of the interrelationship between business and financial strategies by reference to the underlying financial objective of companies – which is delivering value for their shareholders.

As we will see in Chapter 12 later in this Study Manual, one of the ways a company can be valued is by discounting its expected future cash flows at an appropriate cost of capital. As such, value arises from creating competitive advantage through successful business strategy, in combination with a successful financial strategy, to increase those cash flows and reduce the cost of capital.

Value drivers

Definitions

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

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

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

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

(a) Increase sales growth
(b) Increase operating profit margin
(c) Reduce cash tax rate
(d) Reduce incremental investment in capital expenditure
(e) Reduce investment in working capital
(f) Increase time period of competitive advantage
(g) Reduce cost of capital
The first five drivers can be used to prepare cash flow forecasts for a suitable period. The length of this period should be defined according to the likely period of a company’s competitive advantage (driver (f)). Discounting these cash flows at the cost of capital (driver (g)) leads to the value of the business’s operations.

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

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

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

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

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

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

2.3.6 Financial management decisions

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

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

Investment decisions

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

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

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

Financing decisions

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

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

Interaction of financing with investment and dividend decisions

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

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

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

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

**Dividend decisions**

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

**Interaction of dividend with investment and financing decisions**

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

### 2.4 Shareholder value and value-based management

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

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

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

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

The statement of cash flows (cash flow statement) may also fail to provide appropriate information. Large positive cash flows are possible when organisations underspend on maintenance, or reduce capital investment in order to increase short-term profits at the expense of long-term success. On the other hand, an organisation can have large negative cash flows for several years and still be profitable; for example, if it has recently invested in a new factory, or in acquiring new plant and machinery.

A shareholder value approach to performance measurement involves a shift in focus away from short-term profits to a longer-term view of value creation, the motivation being that this will help the business stay ahead in an increasingly competitive world.
Individual shareholders have different definitions of shareholder value as different shareholders value different aspects of performance:

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

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

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

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

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

### 2.5 Value-based management

**Definition**

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

VBM consists of three elements:

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

(b) **Metrics** – for measuring value

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

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

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

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

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

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

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

2.5.1 Creating shareholder value

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

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

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

2.5.2 Measurement

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

2.5.3 Managing value

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

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

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

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

2.5.4 Elements of VBM

A comprehensive VBM programme should consider the following:

(a) Strategic planning – Strategies should be evaluated to establish whether they will maximise shareholder value.

(b) Capital allocation – Funds should be allocated to the strategies and divisions that will create most shareholder value.

(c) Operating budgets – Budgets should reflect the strategies the organisation is using to create value.

(d) Performance measurement – The economic performance of the organisation needs to lead to increases in share prices, because these promote the creation of shareholder wealth.

(e) Management remuneration – Rewards should be linked to the value drivers, and how well value-based targets are achieved.

(f) Internal communication – The background to the programme and how VBM will benefit the business need to be explained to staff.
(g) **External communication** – Management decisions, and how they are designed to achieve value, must be communicated to the market. The market's reaction to these decisions will help determine movements in the organisation's share price.

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

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

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

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

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

### 2.5.5 Business strategy and shareholder value

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

![Strategy and shareholder value diagram](image_url)

**Figure 1.2: Strategy and shareholder value**

### 2.6 Stakeholders and objectives

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

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

---

**2.6.1 Stakeholder interests**

Organisations have a variety of stakeholders, each of which is likely to have its own interests:

(a) **Managers and employees** – typically interested in job security, career progression, salaries and benefits, job satisfaction

(b) **Shareholders** – interested in maximising their wealth from holding shares (as measured by profitability, P/E ratios, market capitalisation, dividends and yield)

(c) **Lenders** – interested in the security of loans given, and adherence to loan agreements

(d) **Suppliers** – achieving profitable sales, payment for goods, developing long-term relationships

(e) **Customers** – receiving goods and services as purchased, achieving value for money in their purchases

(f) **Government and regulatory agencies** – jobs created, tax revenues, compliance with laws and regulations, investment and infrastructure, national competitiveness

(g) **Environmental and social bodies, and other non-governmental organisations** – primarily interested in social responsibility

(h) **Industry associations and trades unions** – interested in members’ rights

(i) **Local communities** – interested in local jobs on one hand, but also environmental impact (noise, pollution etc) on the other

When determining its strategy, an organisation needs to consider how well that strategy fits in with the interests of different stakeholders. The organisation should also consider how stakeholders could respond to strategies which do not uphold their interests; for example: shareholders could raise concerns at the company’s AGM, or even sell their shares; banks could refuse to lend money to a company or could demand higher interest charges; customers may choose to purchase goods and services from a competitor; and employees could resign or take part in industrial action (supported by trade unions).

**Focus of stakeholders’ interests**

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

**Economic or social focus**

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

**Local or national focus**

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

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**2.6.2 Stakeholder management**

Conflict is likely between stakeholder groups due to the divergence of their interests. This is further complicated when individuals are members of more than one stakeholder group and when members of the same stakeholder group do not share the same principal interest. For example, if some members of a workforce are also shareholders while others are not, the interests of the two groups may be different.
Different stakeholder groups are likely to have a range of responses to possible business strategies. When an organisation is evaluating a strategy, it should consider what impact that strategy will have on key stakeholder groups.

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

**Figure 1.3: Mendelow’s matrix**

<table>
<thead>
<tr>
<th>Level of interest</th>
<th>Power</th>
</tr>
</thead>
</table>
| Low               | Low   | A
| High              | Low   | B
| Low               | High  | C
| High              | High  | D

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

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

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

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

3 The external business environment

**Section overview**

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

3.1 The external environment

The business environment includes the wider political, economic, social, technological, environmental (green) and legal context in which an organisation operates, as well as the more immediate pressures of the business competition it faces. The business environment is both complex and subject to constant change, to the extent that it is unlikely that a business can ever have a complete understanding of its environment.
However, by analysing the key environmental variables that might affect it, an organisation can identify the **opportunities** which are available to it and the **threats** that it is facing.

### 3.1.1 Environmental analysis

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

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

### 3.2 Environmental and market analysis tools

#### 3.2.1 PESTEL analysis

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

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

**Interactive question 1: Opportunities and threats**

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

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

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

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

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

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

The increase in prices was prompted by narrowing profit margins in the sea services (freight and passenger). Business customers have so far successfully resisted an increase in freight charges. The fruit business on the islands is continuing to grow at a fast rate and it is expected that soon, at some times of the year, one boat will be insufficient to transport all the fruit production from the islands to the mainland.

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

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

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

The developers of the complex have announced that they are considering the negotiation of a 10-year agreement with a transport company for the exclusive rights to transport their customers from the mainland to the island complex.
STF has been very profitable, but the owners have been taking out most of the profits as dividends each year, and the company has only limited capital.

**Requirement**

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

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

### 3.2.2 Porter’s five forces

Porter suggests that the competitive environment and, in turn, competitive strategy is shaped by five forces:

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

These forces influence the strength of the competition in an industry, and consequently also determine the profit potential of that industry as a whole.

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

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

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

**Case example: Telecommunications in Zambia**

The telecommunications market in Zambia is dominated by three operators MTN Zambia, Airtel, and Zamtel (the government-run, Zambia Telecommunications Company). MTN Zambia is the market leader, with just over 50% of the country’s mobile phone market. Airtel is the second largest provider, holding around 35% market share, while Zamtel has approximately 15%.

In 2012 the Zambian Government appeared to have cleared the way for a fourth mobile service provider, and by early 2013 bids had been received from five telecom operators, including Vodacom of South Africa.

The Government believed that the entry of a fourth provider would increase competition in the sector, generate sustainable improvements in the quality of services, reduce tariffs, and extend service outreach to more areas. In particular, the Government was concerned with the high cost of making phone calls, and felt that the increased competition from a fourth mobile service provider could help reduce call tariffs.

However, in August 2013, the Zambian Government announced that plans to award the fourth mobile licence had been put on hold until the completion of the country's digital migration project in 2015. (In
line with the Southern African Development Community's deadline, Zambia plans to migrate to digital television services by 2015.)

In July 2015, ZICTA (the Zambia Information and Communications Technology Authority) noted that the country's mobile phone market had been growing at a faster than expected rate in recent months. The Authority also said that increased competition in the provision of mobile phone services had resulted in the reduction of the tariffs and the growth of the subscriber base. ZICTA highlighted how the liberalisation of the international gateway for the three operators has promoted competition in Zambia’s information and communications technology sector.

Prior to 2010, Zamtel had monopoly rights over the international gateway – the satellite system for making international calls – so the other providers had to pay a gateway fee to Zamtel for using the system. However, in 2010, the Zambian government awarded the private mobile phone operators licences to operate their own international gateways, in order to force down the high costs of communication and thereby to make international calls and international roaming more attractive.

In mid-2010 a majority stake in Zamtel was sold to LAP Green of Libya (although this sale was subsequently challenged, and Zamtel reverted to a State-owned company). One of Zamtel’s key assets is a national fibre optic cable network, because cable networks are required to develop internet usage in the country.

Internet penetration in Zambia is still very low. Market research in 2014 suggested that only 16% of the country’s population had internet access, compared to 91% of them using mobile phones. There is still a perception that data services are the preserve of the elite, and ZICTA has said that there is a need for heavy investment in broadband and cable networks to alleviate the country’s digital divide, and to help Zambian companies to grow and compete on a global level.

**Five forces**

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

**Threat of new entrants** – Two main barriers to entry into the telecoms industry can be distinguished.

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

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

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

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

**Threat of substitutes** – The threat of multiple products and services from non-traditional telecoms industries has raised serious challenges to telecommunications players. For example, the development of the Voice over Internet Protocol (VoIP) has meant that the internet has become a way of making cut-price (and in some cases, free) phone calls, to the detriment of the more traditional phone business (delivered by telecoms companies).

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

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

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

Key questions for competitor analysis

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

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

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

What is the competitor doing and what can it do?
- What strategies is the competitor currently pursuing?
- What are the competitor’s strengths and weaknesses? What key resources and capabilities does the competitor have (or not have)?

Competitor response profiles

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

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

Interactive question 2: Competitor analysis

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

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

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

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

See Answer at the end of this chapter.
4 Internal factors and strategic capability

Section overview

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

4.1 Resource-based approaches to strategy

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

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

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

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

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

4.2 Resources and competences

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

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

Resources are the assets that an organisation has (eg staff, equipment) or can call on (eg partners and suppliers); while competences are the ways an organisation used or deploys those assets effectively.

Resources, on their own, are not productive. Therefore organisational capability – an organisation’s capacity to successfully deploy its resources to achieve a desired end result – is vital as a basis for achieving competitive advantage. These organisational capabilities could be in a range of different areas:

- Corporate functions (financial control; multinational co-ordination)
- R&D, or innovative and adaptive capability
- Product design
- Operations (operational efficiency; continuous improvement; flexibility)
- Marketing
- People and talent management
- Sales and distribution
Johnson, Scholes and Whittington highlight this point in their text *Exploring Strategy* when they note:

*There would be no point in having state-of-the-art equipment if it were not used effectively. The efficiency and effectiveness of physical or financial resources, or the people in an organisation, depend, not just on their existence, but on the systems and processes by which they are managed, the relationships and co-operation between people, their adaptability, their innovatory capacity, the relationship with customers and suppliers, and the experience and learning about what works well and what does not.*

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

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

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

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

**Case example: Huawei smartphones**

Although sales of smartphones have been increasing in recent years, not all phone makers have shared this success.

In the three months to July 2012, Nokia made losses of £1.1bn as it has battled to remain competitive in a smartphone market dominated by Apple and Samsung, which between them had over 50% of global market share.

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

However, another big winner has emerged in the smartphone market: Huawei Technologies. Although Huawei was only the seventh largest smartphone maker in 2011, by the fourth quarter of 2012 it had become the third largest smartphone maker, although its sales were still much lower than Samsung and Apple’s.

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

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

Huawei sold 27 million smartphones in 2012 (an increase of 74% compared to 2011), partly as a result of gaining a larger market share of the US market. In 2013, sales again increased by over 70%, to a total of 46.7 million units sold.

Prior to 2012, Huawei sold handsets costing less than US$200 to providers such as MetroPCS and Cricket that offer pay as you go plans, mostly to lower-income consumers.

In November 2011, it landed a deal with a top-tier US provider when AT&T started selling Huawei’s Impulse phone for $29. And in July 2012, T-Mobile announced that Huawei would be building two models in the mobile phone operator’s MyTouch line of handsets.
'We essentially made the market for affordable smartphones,' says William Plummer, Huawei's US vice president for external affairs. 'We're in a good position because we've established ourselves as a trusted partner to carriers.'

However, succeeding in smartphones is vital for Huawei if it wants to remain a fast-growing company. Its US$23bn-a-year telecom equipment business grew by only 3.5% in 2011, before declining in 2012 due to the slowdown in China's economy this year.

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

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

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

Moreover, by 2013, sales of handsets in mature regions (the US; Western Europe) began to slow, with emerging markets – in particular India and China – providing the engine for growth. This again would seem to favour manufacturers of cheaper handsets, compared with Samsung and Apple.

Analysis by the technology research firm, Gartner, showed that Samsung's share of the global mobile phone market fell from 31.1% in the fourth quarter of 2012, to 29.5% in the fourth quarter of 2013, and Gartner attributed this dip to the saturated high-end markets in the developed regions which had previously been the engines for growth in the global market. Over the same period, Apple also saw its market share drop from 20.9% to 17.8% while Huawei's share increased from 4.2% to 5.7%.

In response to changing patterns in demand across the global market, Gartner said it expected an increasing number of manufacturers to refocus their product portfolios on lower-end devices.


4.3 Core competences and strategic capabilities

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

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

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

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

4.3.1 Strategic capabilities and competitive advantage

Resources and competences are clearly important in creating and sustaining competitive advantage. However, if an organisation’s strategic capabilities are going to deliver competitive advantage for it, then those capabilities must have four qualities:

(a) **Valuable to buyers** – They must produce effects or benefits that are valuable to buyers.

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

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

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

4.4 Position audit

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

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

The elements of the position audit are:

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

4.5 Resource audit

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

**Competitive resources**

Richard Lynch’s text *Strategic Management* provides a useful checklist for analysing whether an organisation’s internal ‘resources’ can be construed as strengths or weaknesses:

<table>
<thead>
<tr>
<th>Aspect of resources</th>
<th>Questions to ask</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market share</td>
<td>How does the company’s market share compare to competitors?</td>
</tr>
<tr>
<td></td>
<td>Are there any particular areas in which the company dominates or has a strong market share?</td>
</tr>
<tr>
<td></td>
<td>How does the level and quality of the company’s marketing activity compare to competitors?</td>
</tr>
<tr>
<td>Market growth</td>
<td>Is the company involved in growth markets, or is it involved primarily in mature/declining markets?</td>
</tr>
<tr>
<td>Aspect of resources</td>
<td>Questions to ask</td>
</tr>
<tr>
<td>---------------------</td>
<td>------------------</td>
</tr>
<tr>
<td>Product quality</td>
<td>Do the company’s products and services offer good value for money for customers? Does the company have a good quality record in relation to the price of its goods or services? How many customer complaints does it receive?</td>
</tr>
<tr>
<td>Leadership</td>
<td>How effective is the company leadership? Is it risk taking or risk averse? Is it ethical?</td>
</tr>
<tr>
<td>Purpose and objectives</td>
<td>Are the company’s purpose and objectives clearly stated? Are the objectives known to the people responsible for delivering them? Is performance against key objectives measured?</td>
</tr>
<tr>
<td>Management and workers</td>
<td>Does the company have a good industrial relations record? How does staff turnover compare to competitors? How does the quality or experience of management resource compare to competitors?</td>
</tr>
<tr>
<td>Financial position</td>
<td>Is the company financially sound or are its financial resources stretched? What has been its profit record and earnings per share record over the past few years? Are there any ‘difficult’ shareholders?</td>
</tr>
<tr>
<td>Profit performance</td>
<td>How does the company’s profit record compare to competitors? How do products and distribution costs compare to competitors? Could production and distribution costs be reduced?</td>
</tr>
<tr>
<td>Investment practice</td>
<td>How much does the company invest in capital investment? How does this compare to the level of competitors’ investment?</td>
</tr>
<tr>
<td>R&amp;D; Innovation</td>
<td>How important are R&amp;D and innovation in the industry? How does the company’s record in these areas compare to competitors? Does the company support innovation and knowledge management?</td>
</tr>
</tbody>
</table>

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

4.6 Strategic capability

An organisation’s ability to survive and prosper, and to deliver future value, depends on its strategic capability.

**Definition**

**Strategic capability**: The adequacy and suitability of an organisation’s resources and competences to contribute to its long-term survival or competitive advantage.
When evaluating an organisation's strategic capability, the following questions are important:

(a) Does the organisation have a **suitable business model** to deliver future success, based on an understanding of the sources of competitive advantage that contribute to profitability and growth across the value system of the organisation?

(b) Does it have the **people, processes and resources** it needs to be able to deliver this success?

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

These 'external' resources can include:

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

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

### 4.6.1 Dynamic capabilities

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

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

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

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

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

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

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

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

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

Case example: GlaxoSmithKline

Since the 1950s, a key resource for large pharmaceutical companies has been patented drugs with regulatory approval. This resource has been continually refreshed through R&D activity which has involved testing large numbers of prototype drugs for their effectiveness in treating different illnesses. Pharmaceutical companies built up dynamic learning capabilities through establishing and developing teams of specialist researchers, and other groups which were skilled in the extensive phases of testing required to gain regulatory approval for new drugs.

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

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

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

Similarly, in 2007, GSK bolstered its biopharmaceuticals portfolio with the purchase of the UK-based speciality antibody company, Domantis. The acquisition cost £230m, but Domantis has become a key part of GSK's Biopharmaceuticals Centre of Excellence for Drug Discovery, and helped catapult GSK into the arena of next-generation antibody drugs by more than doubling the number of projects it had in this area.

However, as well as making acquisitions, GSK has divested (or outsourced) activities traditionally performed in-house. Pharmaceutical giants were not immune to the global economic downturn in 2008 and 2009, and they were forced to adopt cost-saving strategies, like companies in many other industries. However, GSK looked towards more sophisticated approaches beyond simply cutting jobs and shelving expensive projects.

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

This arrangement was specifically engineered to reduce the overhead costs involved with R&D, while simultaneously allowing GSK to benefit from any breakthroughs that Convergence Pharmaceuticals might develop and go on to market.

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

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

1 Although Convergence initially traded as an independent company, it was subsequently acquired by Biogen Idec in February 2015.
(Note: We will look at ethical issues – including allegations of bribery against GSK in China – in more detail in Chapter 19 of this Study Manual.)

As the drugs industry contends with healthcare spending cuts and increased generic competition, companies will continue to find new ways of strengthening their positions and generating value for their shareholders.

More recently, in 2015, GSK completed a three-part transaction with Novartis which combined elements of both acquisition and disposal (divestment), and which was seen as a key element in reshaping the company into a simpler, stronger and more balanced platform for long-term growth.

Under the deal, GSK acquired Novartis's vaccine business, formed a joint Consumer Healthcare business with Novartis, and sold its cancer drugs to Novartis.

Analysts noted that the deal had the potential to change the way companies look to expand – with asset swaps becoming a more focused alternative to acquiring a whole company. The GSK–Novartis deal enabled both companies to strengthen their product portfolios, with each offloading one of its weaker divisions and strengthening one of its core areas. GSK is the world’s leading vaccine manufacturer, while Novartis has a substantial cancer drugs business.

The deal also gave substantial global scale to the joint Consumer Healthcare business, which became the market leader in more than 30 countries.


5 Analysing strategic position and performance

Section overview

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

5.1 Product life cycle

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

The stages in a product’s life cycle are:
- Introduction
- Development and growth
- Maturity
- Decline
During strategic planning, products should be assessed in three ways:

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

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

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

Case example: Apple

In its Annual Report, the consumer electronics and software giant Apple identifies the risk factors which could affect its business.

One of the factors identified in the 2014 Report is that the markets for the company’s products and services are highly competitive and are subject to rapid technological change:

“The Company’s products and services compete in highly competitive global markets characterized by aggressive price cutting and resulting downward pressure on gross margins, frequent introduction of new products, short product life cycles, evolving industry standards, continual improvement in product price/performance characteristics, rapid adoption of technological and product advancements by competitors, and price sensitivity on the part of consumers.

“The Company’s ability to compete successfully depends heavily on its ability to ensure a continuing and timely introduction of innovative new products and technologies to the marketplace… As a result, the Company must make significant investments in R&D. The Company currently holds a significant number of patents and copyrights and has registered and/or has applied to register numerous patents, trademarks and service marks. In contrast, many of the Company’s competitors seek to compete primarily through aggressive pricing and very low cost structures, and emulating the Company’s products and infringing on its intellectual property. If the Company is unable to continue to develop and sell innovative new products with attractive margins or if competitors infringe on the Company’s intellectual property, the Company’s ability to maintain a competitive advantage could be adversely affected.”

The 2014 Annual Report showed that the company’s R&D expenditure for the fiscal year 2014 was $6.0 billion; up from $4.5 billion in 2013. However, the Report noted that Apple expects to continue making further investments in R&D in the future to remain competitive.

Net sales rose 7% during 2014 compared to 2013, due in part to the successful launch of iPhone 6 and 6 Plus, and strong demand for MacBook Air and MacBook Pro which were updated in 2014 with faster processors and offered at lower prices.

During the first quarter of 2014, the company introduced iPad Air – its fifth generation iPad, with Retina display (for improved viewing quality).

In October 2014, the company launched Apple Pay in the US (enabling shoppers to make payments using some of the latest Apple products, such as the iPhone 6), and also previewed Apple Watch, its first new product category for five years.

However, although Apple has continued to generate impressive profits, some analysts are concerned that the company’s performance is too heavily dependent on the iPhone.

www.apple.com
Case example: Diet Coke

Coca-Cola’s results for the second quarter of 2015 showed that global sales of Diet Coke had fallen 7% compared to the same quarter in 2014, continuing a decline which began in 2008.

The president of Coca-Cola North America said that declining sales of Diet Coke are linked to the increasing trend for fresh food and drink, and consumers look for healthier food and drink options.

However, an alternative explanation for the decline is that the number of different soft drinks available to customers may have resulted in cannibalisation of sales within the same brand. A survey by Euromonitor reported that, between 2007 and 2012, sales of Diet Coke declined in France and the US, but sales of Coke Zero increased over the same period.

In 2013, the company also launched a new product – Coca-Cola Life – a lower calorie drink sweetened with a blend of sugar and stevia leaf extract (a natural, plant-based sweetener).

Although Diet Coke and Coke Zero contain no sugars at all, they do contain artificial sweeteners such as aspartame. Therefore, Coca-Cola have argued that by adding Coca-Cola Life to their portfolio of drinks they are giving people an extra option that’s lower in sugar and calories, and whose sweetness comes from natural sources.

However, in doing so, they may also be contributing to the decline of Diet Coke.

Interactive question 3: Product life cycle

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

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

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

- Epsilon is a drug used in the treatment of heart disease. It has been available for eight months and has achieved significant success. Sales of this drug are not expected to increase from their current level.
- Alpha is a painkiller. It was launched more than 10 years ago, and has become one of the leading drugs in its class. In a few months the patent on this drug will expire, and other manufacturers will be allowed to produce generic copies of it. Alpha is expected to survive a further 12 months after it loses its patent, and will then be withdrawn.
- Beta is used in the hospital treatment of serious infections. It is a very specialised drug, and cannot be obtained from a doctor or pharmacist for use outside the hospital environment. It was launched only three months ago, and has yet to generate a significant sales volume.

Requirement

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

See Answer at the end of this chapter.

5.2 Boston Consulting Group (BCG) matrix

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

<table>
<thead>
<tr>
<th>Market growth</th>
<th>Relative market share</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High</td>
</tr>
<tr>
<td>High</td>
<td>Stars</td>
</tr>
<tr>
<td>Low</td>
<td>Cash cows</td>
</tr>
</tbody>
</table>

**Figure 1.4: BCG matrix**

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

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

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

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

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

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

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

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

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

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

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

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

**The strategies**

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

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

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

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

**Divest.** Disposal of a poorly performing business unit or product. Divestment stems the flow of cash to a poorly performing area of the business and releases resources for use elsewhere.
Interactive question 4: BCG matrix

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

CPH plc's total revenue for the last financial year was $12.9bn, split across the group's four trading companies as follows:

<table>
<thead>
<tr>
<th>Business Unit</th>
<th>Revenue (bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>5.4</td>
</tr>
<tr>
<td>Engineering</td>
<td>3.5</td>
</tr>
<tr>
<td>Transport</td>
<td>2.8</td>
</tr>
<tr>
<td>Gaming</td>
<td>1.2</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Business Unit</th>
<th>Market Growth</th>
<th>T/O of Nearest Rival</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>2%</td>
<td>$3.8bn</td>
</tr>
<tr>
<td>Engineering</td>
<td>4%</td>
<td>$8.7bn</td>
</tr>
<tr>
<td>Transport</td>
<td>11%</td>
<td>$4.7bn</td>
</tr>
<tr>
<td>Gaming</td>
<td>13%</td>
<td>$0.7bn</td>
</tr>
</tbody>
</table>

Requirement

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

See Answer at the end of this chapter.

5.2.1 Shell Directional Policy Matrix

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

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

<table>
<thead>
<tr>
<th>Business Strengths</th>
<th>High</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Attractiveness</td>
<td>High</td>
<td>Invest</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Harvest</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Grow</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Divest</td>
</tr>
</tbody>
</table>

Figure 1.5: Shell Directional Policy Matrix

5.3 Value chain analysis

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

The value chain describes those activities of the organisation that add value to purchased inputs. Primary activities are involved in the production of goods and services; support activities provide necessary assistance to support the primary activities; and linkages are the relationships between activities.
As well as using the value chain to establish where it creates value for the customer, an organisation can use the model in other strategically beneficial ways, including the identification of critical success factors and opportunities to use information strategically. For example, an organisation can use the value chain to contribute towards competitive advantage by:

(a) Inventing new or better ways to perform activities

(b) Combining activities in new or better ways

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

(d) Managing the linkages in the value system

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

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

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

**Interactive question 5: Value chain**

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

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

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

Courses at the ABC college are administered by well-qualified and trained non-teaching staff who provide non-academic (that is, non learning related) support to the lecturers and students.
The college has had no difficulty in filling its courses. The college has also noted a significant increase in the number of students transferring from other training providers in the last year.

Requirement

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

See Answer at the end of this chapter.

5.3.1 Value system

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

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

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

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

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

5.3.2 Strategic value analysis

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

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

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

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

SVA prompts companies to ask four key questions:

(a) Are there any new or emerging players in the industry (in any portion of the value chain) that may be more successful than existing players?

(b) Are these companies positioned in the value chain differently from existing players? (In particular, are companies emerging which specialise in single activities within the value chain, eg marketing and logistics, rather than trying to cover all activities?)

(c) Are new market prices emerging across segments of the value chain?

(d) If we used these market prices as transfer prices within our company, would it fundamentally change the way any of the operating units behave?
SVA is particularly relevant to vertically integrated companies, because it encourages them to consider whether it would be more profitable for them to outsource certain functions or activities rather than continuing to perform them all in-house. We will discuss outsourcing in more detail in Chapter 3 of this Study Manual.

5.4 **Gap analysis**

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

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

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

```
PRODUCT
<table>
<thead>
<tr>
<th>Present</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present</td>
<td>Market penetration</td>
</tr>
</tbody>
</table>
| New     | Market development | Diversification
         |                  | • related
         |                  | • unrelated
```

*Figure 1.7: Ansoff's product-market matrix*

5.5 **Benchmarking**

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

5.5.1 **Benchmarking and strategic position**

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

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

5.5.2 **Benchmarking and competitive strategy**

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

The same logic applies to differentiation. Whatever an organisation wants its differentiating factor to be, it needs to measure its performance in that area against its competitors before deciding whether or not to use it as the basis for its competitive strategy.
When carrying out benchmarking exercises, you should be asking such questions as:

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

### 5.6 Business process analysis

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

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

### 5.7 Strategic risk analysis

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

**Case example: Tesco – Principal risks**

In its Annual Report and Accounts, Tesco provides a summary of the principal risks it faces, and for each risk it identifies key controls and mitigating factors.

The Annual Report also highlights that, in September 2014, Tesco identified an overstatement in its commercial income in its expected financial results, after it emerged that the supermarket had incorrectly recorded the payments it receives from suppliers for stocking their products. The overstatement was estimated to be £263 million. A number of directors were suspended as a result of this and the Chairman announced he was stepping down. At the same time, Tesco hired two new non-executive directors in response to criticism that its existing board did not have sufficient retail experience.

In addition to the accounting scandal, Tesco’s like for like sales fell 4.6% for the first half of its 2014/5 financial year, and it acknowledged it faced a tough trading environment, with supermarkets facing continuing pressure from discount retailers such as Aldi and Lidl.

Bear these events in mind, as you read through the principal risks which Tesco had identified in its Annual Report.

**Customer** – If Tesco does not meet customer needs and compete on price, product range, quality and service in competitive markets, then it will lose its share of customer purchases.

If the Group does not consider customers at the heart of its decision-making processes, this will have an adverse impact on its relationship with customers.

**Financial strategy** – There is a risk that financial strategy is unclear or unsustainable.

Weak performance could put further pressure on free cash flow, and affect Tesco’s ability to improve its credit rating.

Investor support is likely to be affected if it takes longer than expected for the current strategy to achieve the turnaround required.

Future legal and regulatory changes to the pension scheme could introduce more onerous requirements and increase the Group’s financial liability, while the deficit on the existing scheme could also increase due to change in key assumptions about inflation, mortality and discount rates.

**Brand, reputation and trust** – Tesco’s brand will suffer if it does not rebuild trust and transparency in its business.

Similarly, the Group’s reputation (among customers, staff, suppliers, local communities and investors) may be damaged if it does not remain firm in the face of ethical, legal, moral or operational challenges.
**Data security and privacy** – The increasing risks of cyber-attack threaten the security of customer, employee and supplier data. (In response to this risk, Tesco has established a CyberSecurity team to investigate and mitigate the risks of cyber-attack.)

Tesco also needs to ensure it understands the types of data that it holds and secures it adequately to manage the risk of data breaches.

**Transformation** – If the scale of change being experienced across the business disrupts its focus, there is a risk that the business will not be transformed to where it needs to be.

Associated with this, there is a risk that Tesco underestimates the wider impacts of the changes it is making.

**Competition and markets** – If Tesco fails to address the differing challenges of the budget retailers, the premium retailer, and online entrants, its market share and profitability are likely to be adversely impacted.

**Performance** – If the Group’s strategy is not effectively communicated or implemented, the business could underperform against its plan and against its competitors.

The delivery of long-term plans may be adversely affected if the business focuses on short-term targets only.

(To address these issues, all the businesses have targets based on a balanced scorecard of performance against KPIs and financial targets.)

**Political and regulatory** – As a multinational business, Tesco could be affected by legal and regulatory changes, or political changes that affect the retail market, in each country in which it operates.

The regulatory landscape is becoming more restrictive in many markets, which could also affect its trading.

**Product** – Tesco’s business may suffer if it fails to work with its suppliers to ensure that products are designed and delivered to a high standard, and so that Tesco can trace their provenance.

If Tesco does not build mutual and trusting relationships with suppliers this could adversely affect its product range and price proposition.

If Tesco does not manage its supply chain effectively, it risks not being able to ensure the quality and security of product supply for its customers.

**Technology** – Any significant failure in the IT processes of the Group’s retail operations in store, online, or in its supply chain, could affect its ability to trade. (To address this risk, Tesco has business continuity plans in place for key business processes.)

If Tesco does not invest enough, does not invest efficiently, or invests in the wrong areas, it may not be able to deliver its customer proposition which, in turn, could affect its competitiveness.

As Tesco develops new technologies, it also needs to maintain the controls over its existing technology platforms because disruption to them could affect systems availability and security.

**People** – Failure to attract, retain, develop and motivate the best people with the right capabilities across all areas and levels of the business could limit its ability to succeed.

There is also a risk that Tesco’s leaders may not play their critical role in shaping the organisation that its stakeholders want it to be, and that they do not inspire great performance from their teams.

**Safety, fraud, control and compliance** – If Tesco does not implement safety standards effectively, this could endanger customers or colleagues. (To address this risk, health and safety standards are defined for all sites, and processes are in place to monitor them. Product safety standards are also communicated to suppliers and are tested through audit programmes.)

The size, geographical scope and complexity of the Group also increases the potential for fraud and dishonest activity by suppliers, customers and employees.

If the compliance monitoring to Group standards and policies is not sufficient, Tesco could fail to identify weaknesses or breaches.
Tesco Bank – The continually changing regulatory environment could affect the levels of capital and liquidity the Bank expects to hold, and could affect the earnings profile as a result of a cap being placed on the handling fees the Bank can charge for debit and credit card transactions.

Financial risks

In addition to identifying the business risks it faces, Tesco separately identifies the financial risks it faces. The main financial risks the Group faces relate to: the availability of funds to meet business needs (funding and liquidity risks), interest rate risk, foreign currency risk, credit risk and insurance risk (being inadequately protected against liabilities arising from unforeseen events).

Tutorial note

Although Tesco’s Annual Report is only an example, a number of the risk areas identified here correspond to the key themes we will discuss in later chapters in this Study Manual. So, as you are working through the chapters, try to think how the issues covered in them could affect an organisation’s performance, and what implications they have on how an organisation might be managed.

Risk appetite

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

5.8 Balanced scorecard

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

The balanced scorecard focuses on four different perspectives.

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

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

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

5.8.1 Financial indicators and ratios

As the balanced scorecard illustrates, it is important for companies to monitor non-financial performance metrics as well as financial ones.
Nonetheless, financial performance measures are still important, and the measures used should cover a balanced range of perspectives:

- Growth
- Profitability
- Liquidity
- Gearing

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

**Competitor financial information that could be obtained**

- Total profits, sales and capital employed
- ROCE, profit/sales ratio, cost/sales ratios and asset turnover ratios
- The increase in profits and sales over the course of the past 12 months and prospects for the future, which will probably be mentioned in the chairman’s statement in the report and accounts
- Sales and profits in each major business segment that the competitor operates in
- Dividend per share and earnings per share
- Gearing and interest rates on debt
- Share price, and P/E ratio (stock exchange information)

### 5.9 SWOT analysis

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

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

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

<table>
<thead>
<tr>
<th>Internal to the company</th>
<th>Exist independently of the company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strengths</strong></td>
<td><strong>Weaknesses</strong></td>
</tr>
<tr>
<td>Conversion</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Matching</strong></td>
</tr>
<tr>
<td></td>
<td>Conversion</td>
</tr>
<tr>
<td><strong>Opportunities</strong></td>
<td><strong>Threats</strong></td>
</tr>
</tbody>
</table>

*Figure 1.8: SWOT analysis*

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

The organisation should look to match strengths with opportunities, neutralise threats and overcome weaknesses. This ‘matching’ is expressed in the TOWS matrix.
However, an organisation also needs to consider whether its strengths, resources and capabilities support its strategy and provide it with a source of competitive advantage. For example, if an organisation aims to be a cost leader, do its processes provide it with cost advantages over its competitors?

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

### 5.10 Corporate reporting and management commentary

**Definition**

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

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

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

In this respect, the strategic report (or ‘management commentary’ under IFRSs) in an entity’s annual report is important.

As the IFRS Practice Statement notes:

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

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

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

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

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

- **The nature of the business** (and of the markets and external environment in which it operates).
- Management’s objectives and their strategies for meeting those objectives (for example, how management intends to address market trends and the opportunities and threats presented by those trends).
- The entity’s most significant resources (financial and non-financial), risks and relationships (with key stakeholders).
• The entity’s **results and prospects**. The commentary should include a description of the entity’s financial and non-financial performance, and the extent to which that performance may be indicative of future performance.

• The **critical performance measures** and indicators that management uses to evaluate its performance against its objectives and in relation to its critical success factors. Again, the commentary should refer to both financial and non-financial performance measures that are used.

The ideas of communicating a company’s strategies and prospects to stakeholders – and explaining how a company is creating value – are also important aspects of **Integrated Reporting**, which we look at in more detail in Chapter 4 of this Study Manual.

### 5.11 Preparing to tackle a case study

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

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

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

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

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

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

Also, remember that although the main focus of this chapter (Chapter 1) has been on business strategy, in your exam you may also have to evaluate the relationships between business and financial strategies in the context of the case study scenario.

Key questions here could be:

• Is the business generating value for its shareholders?
• Will the company’s strategies, or the products it is investing in, generate value for its shareholders?

Ruth Bender, in *Corporate Financial Strategy*, suggests there are four different types of factor which could affect the value which a company generates for its shareholders:
• **Product** – Does the company have a good product? (A good product is one that is fit for purpose.)

• **Business** – However, it is possible to have a good product that is not in a good business. For example, there are many social networking companies, with millions of users, which have yet to work out a model for generating an income stream from their assets.

• **Company** – It is possible to have a good business, but not a good company. For example, a sound business can be crippled by the wrong financial strategy. Eurotunnel was an example of a good business in a bad company: it took on too much gearing in its early years, and consequently struggled until its financial strategy was changed in a reconstruction that swapped debt for equity.

• **Investment** – Finally, it is possible to have a good company that is a bad investment. Shareholders invest in order to make a return (from dividends and share price growth) which adequately rewards their perceived risk from the investment. If a share is already overvalued, however, such growth is unlikely.

5.12 **Assurance issues**

**Narrative information**

Our discussion of Management Commentaries earlier in this section has highlighted that a company’s annual report should now contain non-financial and forward-looking information about its objectives and strategies, as well as providing readers with historical information about its financial performance. (In the UK, companies that are not small companies have to prepare a strategic report as part of their annual report, providing shareholders with an overview of the company’s business model, strategy, performance, position and future prospects.)

However, as the ICAEW Audit and Assurance Faculty’s (2013) paper *The journey: assuring all of the annual report?* highlights, the scope of financial audit is limited to the financial statements. This gives rise to an assurance gap in relation to the non-financial, strategic information in an annual report.

Nonetheless, in order for the information in the annual report about an entity’s business model, strategy and future prospects to be valuable to investors, analysts, lenders, regulators or any other users, they need to know it is trustworthy. As such, there could be scope for professional accountants to provide assurance reports to add credibility to the non-financial information provided in companies’ annual reports.

The UK Corporate Governance Code (2012) already requires the directors to include a statement in the annual report confirming that they consider the annual report and accounts, taken as a whole, are fair, balanced and understandable, and provide the information necessary for shareholders to assess the company’s performance, business model and strategy. However, as the Faculty’s paper suggests:

> ‘In the wake of the global financial crisis, trust in business and in the financial world has been severely damaged. Many people are asking what can be done to make business information more trustworthy. We believe that assurance on the annual report, going beyond the audit of the financial statements, is a vital part of the practical solution to this problem.’

**Risk disclosures**

A second paper by ICAEW’s Audit and Assurance Faculty (2014) – *The journey milestone 2: assurance over risk disclosures* – also addresses the issue of providing an assurance opinion over the risk disclosures in an entity’s annual report (such as the Tesco example we have referred to earlier).

In doing so, the paper highlights two different sets of issues over which an assurance opinion may be sought:

• The **risk disclosures** themselves – Are the right risks included? Are enough risks disclosed? Or has the business disclosed too many risks and in doing so obscured the most important ones?

• The **risk reporting process** – If the purpose of risk assurance is to provide investors with confidence in a company’s risk management procedures, then obtaining assurance over the process of compiling the risk report may be more appropriate than assurance over the disclosures themselves.

In relation to the risk reporting process, an assurance engagement would need to focus on the design and effectiveness of the systems and procedures put in place to identify, quantify and report risks. It would also need to consider the design and operating effectiveness of the processes to...
collate and organise risks, and risk management information, in order to provide a materially complete, fair and balanced view of the risks affecting the future operations of an entity.

6 Levels of strategy in an organisation

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

6.1 Levels of strategy

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

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

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

Operational (or functional) strategy is concerned with how the components of an organisation actually deliver the corporate-level or business-level strategies, in terms of resources, processes and people. Typical functional strategies are:
- R&D
- Operations – including purchasing, procurement and supply chain management; capacity management; production; quality management
- Marketing – including marketing mix, market segmentation and customer relationship management
- Human resources – including recruitment and selection; remuneration and reward; appraisal
- Finance
- Information systems and information technology (IS/IT)

In most businesses, successful business strategies ultimately depend, to a large extent, on decisions that are taken, or activities that occur, at operational level. Operational decisions are therefore vital to successful strategy implementation. (We will look at operational strategies and operations management in more detail in Chapter 3 of this Study Manual.)

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

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

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

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

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

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

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

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

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

There are three interrelated elements to a business strategy: competitive strategy, financial strategy, and investment strategy.

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

As part of its strategic planning, an organisation needs to develop an understanding of the external environment and the opportunities and threats that environment presents (e.g., by using PESTEL analysis, Porter’s five forces, and competitor analysis).

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

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

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

Self-test question 1

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

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

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

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

Requirements

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

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

Self-test question 2

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

DDD has offered retail banking services in country X since 2008. DDD decided to invest in X because, at the time, X had a rapidly growing economy, and DDD considered there to be good retail banking opportunities, as only 50% of the population of X had a bank account. DDD initially invested $200m in entering X, and it established a network of its own branches there. DDD also purchased a local bank in X for $150m, just after the start of the global financial crisis in 2007.

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

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

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

There are a number of foreign banks which have been established in X for over 15 years and these are all profitable. Together, they account for 35% of X’s retail banking market.
In the last two years, DDD has identified two foreign banks that entered X at the same time as it did but which have now withdrawn from the country. One of the foreign banks has stated its reason for withdrawal as being, 'Our operations in X have reduced group profitability.'

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

At the meeting, the directors also discussed the principal risks that DDD faces, and how these risks are managed. The CFO and the CEO are keen to improve the quality of the information provided in the bank’s annual report about the principal risks it faces and its risk reporting process. Several of DDD’s major investors have requested this information, due to the importance of effective risk management in sustaining the bank’s performance and value.

The CFO also recommended that DDD should ask its auditors to undertake an assurance engagement on the bank’s risk reporting process in order to provide its investors with increased confidence in the bank’s risk management. Several of the other directors questioned why the focus of the engagement should be on the risk reporting process rather than on the disclosures DDD makes in its annual report about its principal risks.

Requirements

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

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

(c) Briefly evaluate the suitability of the assurance engagement which the CFO is proposing, compared to one focusing on risk disclosures.

Self-test question 3

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

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

The table below provides a comparison of the Verdant Eco-Plus model with a similar-sized car that has a petrol-driven engine and a hybrid car that is driven by petrol with assistance from an electric motor.
<table>
<thead>
<tr>
<th></th>
<th>Verdant Eco-Plus</th>
<th>Petrol-driven car</th>
<th>Petrol-driven car with assistance from electric motor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing cost</td>
<td>$15,000</td>
<td>$12,000</td>
<td>$14,000</td>
</tr>
<tr>
<td>CO₂ emissions</td>
<td>Zero</td>
<td>180 grams/kilometre</td>
<td>90 grams/kilometre</td>
</tr>
<tr>
<td>Performance</td>
<td>0–100 kilometres per hour (kph): 18 seconds</td>
<td>0–100 kilometres per hour (kph): 10 seconds</td>
<td>0–100 kilometres per hour (kph): 12 seconds</td>
</tr>
<tr>
<td></td>
<td>Maximum speed 120 kph</td>
<td>Maximum speed 180 kph</td>
<td>Maximum speed 170 kph</td>
</tr>
<tr>
<td>Economy</td>
<td>$0.08 per kilometre, electricity cost</td>
<td>$4 per kilometre</td>
<td>$2.50 per kilometre</td>
</tr>
<tr>
<td>Range</td>
<td>175 kilometres before recharging</td>
<td>550 kilometres on a full tank of petrol</td>
<td>1,200 kilometres on a full tank of petrol</td>
</tr>
</tbody>
</table>

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

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

The Government has taken some measures to encourage the use of electric cars. It offers tax incentives to businesses for using them and imposes high taxes on petrol and also on cars with large engines (because they emit more CO₂ than smaller cars).

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

**Requirement**

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

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

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

**Business Strategy texts**

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


Answers to Interactive questions

Answer to Interactive question 1

Opportunities

There are clear opportunities for business growth. The tourist business on the islands is growing. Two new hotel complexes have opened and a new complex is planned for an uninhabited island. The complex on the uninhabited island will require transport services for its customers and also for its staff, who will have to travel from the other islands by sea. This complex intends to negotiate a 10-year agreement with a transport company.

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

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

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

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

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

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

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

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

Threats

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

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

There is a rumour that a global company in the tourism business may establish an operation in the islands, but it is not clear what activities they would undertake. The global company would only create a threat to STF if it decided to fly tourists direct from other countries to the islands (which may reduce passenger traffic between the islands and the mainland) or if it decided to establish its own transport facilities to take people between the mainland and the islands.
Since STF will have to increase the numbers of its ships or aircraft, its lack of capital is likely to be a significant weakness that could affect STF’s ability to respond to the opportunities and threats. Without finance it cannot pay for new transport, and banks may be unwilling to lend the money.

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

Answer to Interactive question 2

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

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

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

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

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

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

Establishing competitors’ assumptions about the industry is essential, as this will play a large part in determining their future activity. For example, a competitor that strongly believed that the industry was reaching overcapacity might consider leaving the industry altogether. This is linked to the relative importance of the industry to competitors’ overall strategy. If movie and theatre cosmetics are only a sideline, the competitor may be more inclined to ‘walk away’ and concentrate its resources elsewhere. As such, assumptions exist mainly in the heads of senior managers, this kind of information may be difficult to obtain, and LBG may have to rely on opportunistic behaviour to gather details.
In a specialist industry such as the one that LBG operates in, competitive advantage depends largely on the possession of unique competences and assets. Establishing the extent to which competitors have these is the next stage in the investigation. In the movie and theatre cosmetics industry, the use of new technologies to develop and bring new and improved products to market is particularly important. The ability to work closely with companies responsible for new cinematic techniques is also essential, to allow knowledge-building of how new techniques can affect the effectiveness of the cosmetics.

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

Answer to Interactive question 3

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

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

![Product Life Cycle Diagram]

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

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

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

As with any portfolio analysis technique, it is important to look for balance in relation to the PLC. Specifically, this means that a portfolio should include products at several stages in their life cycles, so that as one declines, another is emerging to take its place.
3C's current portfolio seems adequate in this respect, in that while Alpha is expected to enter a rapid decline phase, Epsilon is generating high sales in its maturity phase as an acceptable 'cash cow', and Beta has been launched and still has potential for growth.

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

**Answer to Interactive question 4**

<table>
<thead>
<tr>
<th>Company</th>
<th>Mkt growth</th>
<th>Mkt share</th>
<th>Mkt share value</th>
<th>Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>2% – Low</td>
<td>5.4 / 3.8 = 1.42 High</td>
<td>Cash cow</td>
<td></td>
</tr>
<tr>
<td>Engineering</td>
<td>4% – Low</td>
<td>3.5 / 8.7 = 0.40 Low</td>
<td>Dog</td>
<td></td>
</tr>
<tr>
<td>Transport</td>
<td>11% – High</td>
<td>2.8 / 4.7 = 0.60 Low</td>
<td>Question mark</td>
<td></td>
</tr>
<tr>
<td>Gaming</td>
<td>13% – High</td>
<td>1.2 / 0.7 = 1.71 High</td>
<td>Star</td>
<td></td>
</tr>
</tbody>
</table>

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

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

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

**Answer to Interactive question 5**

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

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

**Usefulness of the model**

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

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

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

### SECONDARY ACTIVITIES

<table>
<thead>
<tr>
<th>Procurement</th>
<th>Technology</th>
<th>HRM</th>
<th>Infrastructure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Printed materials</td>
<td>Availability</td>
<td>Staff selection processes</td>
<td>Culture</td>
</tr>
<tr>
<td>Building work</td>
<td>Ease of use</td>
<td>Staff turnover rates</td>
<td>Layout of premises</td>
</tr>
<tr>
<td>Support staff</td>
<td>Training</td>
<td>Staff training</td>
<td>Organisational structure</td>
</tr>
<tr>
<td>Students and staff</td>
<td>Innovation (eg online learning)</td>
<td>Admin and staff processes</td>
<td>Facilities</td>
</tr>
<tr>
<td></td>
<td>Knowledge sharing</td>
<td></td>
<td>Planning systems</td>
</tr>
</tbody>
</table>

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

Answer to Self-test question 1

Part (a)

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

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

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

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

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

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

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

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

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

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

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

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

Shareholders as new stakeholders

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

Importance of customers

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

Impact on objectives

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

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

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

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

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

Corporate governance

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

Overall, the objectives of ZTC will need to change to focus on profitability and shareholder reward, as well as customer satisfaction, all of which becomes increasingly important in a deregulated market. Alongside this, the directors will need to ensure the business's controls and governance are adequate to comply with its new regulatory requirements.
Answer to Self-test question 2

Part (a)

Threat of new entrants

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

**Capital investment** – In this case, the main barrier to entry is the capital investment required to enter the banking market. In total, DDD spent $350m to enter the market ($200m to establish its own branch network, and $150m to acquire a local bank).

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

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

Competitive rivalry

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

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

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

**Bargaining power of consumers**

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

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

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

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

Threat of substitute products

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

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

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

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

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

Potential for future profits

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

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

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

**Part (b)**

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

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

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

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

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

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

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

**Part (c)**

Although the investors have requested improvements to the information provided about the risks DDD faces and its risk reporting process, it seems that their underlying interest is in the quality of DDD’s risk management process.

As such, the purpose of the risk assurance should be to increase investors’ confidence in DDD’s risk management. Therefore, assurance over the process of compiling the risk report will be more appropriate than assurance simply over the risk disclosures themselves.

Ultimately, the investors want to be confident that DDD has a robust approach to identifying, quantifying, management and reporting risks. Therefore they need assurance over the whole process, not just the output of the process.

The assurance engagement which the CFO is proposing appears to be consistent with this. By contrast, the alternative engagement would focus only on the output – that is, the risk disclosures themselves. For example, are the right risks included? Is the quantity of risks disclosed sufficient, or have too few (or too many) risks been disclosed?
Nonetheless, the assurance procedures included within the engagement the CFO has proposed could still include an evaluation of the quality of the disclosures, and the extent to which they accurately reflect DDD’s key risks and the way they are managed.

As such, the engagement proposed by the CFO appears to adequately reflect the shareholders’ interests.

Answer to Self-test question 3

The strategic strengths of VCC seem to be as follows.

- The batteries for powering the electric motors of VCC’s cars are protected by patent. Competitors wanting to enter the market to produce electric cars will have to develop their own technology or will have to pay VCC for a licence to use its patented technology.
- The company currently benefits from low rental costs for its premises and low wages costs, which both help to keep unit costs of production lower than they otherwise would be. It is not clear whether this advantage for the company is expected to continue for the foreseeable future.
- The use of common components for the three models should reduce the company’s inventory requirements and may also reduce unit costs of purchase, since the company can buy in larger volumes for all three models.
- VCC’s cars are relatively cheap to run, compared with fuel-driven cars. This is a strength that has implications for potential market demand for the cars.
- The technology is ‘cleaner’ than for competitive cars. This is another strength that has marketing implications.

The company has several weaknesses.

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

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

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

There are also threats to VCC’s business.

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