CIMA
Strategic Level – Paper E3
ENTERPRISE STRATEGY
(REVISION SUMMARIES)

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Chapter

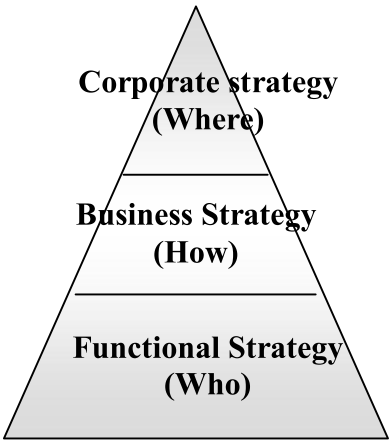
1 Strategic Management

Key summary of chapter

What is strategy?

Strategy
*"A **course of action**, including the **specification of resources** required, to **achieve a specific objective**."*
CIMA: Official Terminology

Levels of strategy - Johnson and Scholes



Arguments in favour of a strategic approach

- ✓ Strategy helps minimise risk
- ✓ Avoids short-term behaviour
- ✓ Improves stakeholder perceptions
- ✓ Encourages environmental analysis e.g. critical to react to change
- ✓ Evidence indicates performance can be improved using strategic approaches
- ✓ Integration and coordination of activities and processes

Arguments against a strategic approach

- ✗ Difficult to plan when environment changing, uncertain or complex
- ✗ Encourages ćconformityôstifling innovation e.g. the corporate straightjacket
- ✗ Infrequently reviewed e.g. chosen long-term strategy may not keep pace with change
- ✗ Implementation often managed poorly
- ✗ Rational planning a complex methodology and costly for small businesses

Comparing and contrasting approaches to strategic formulation

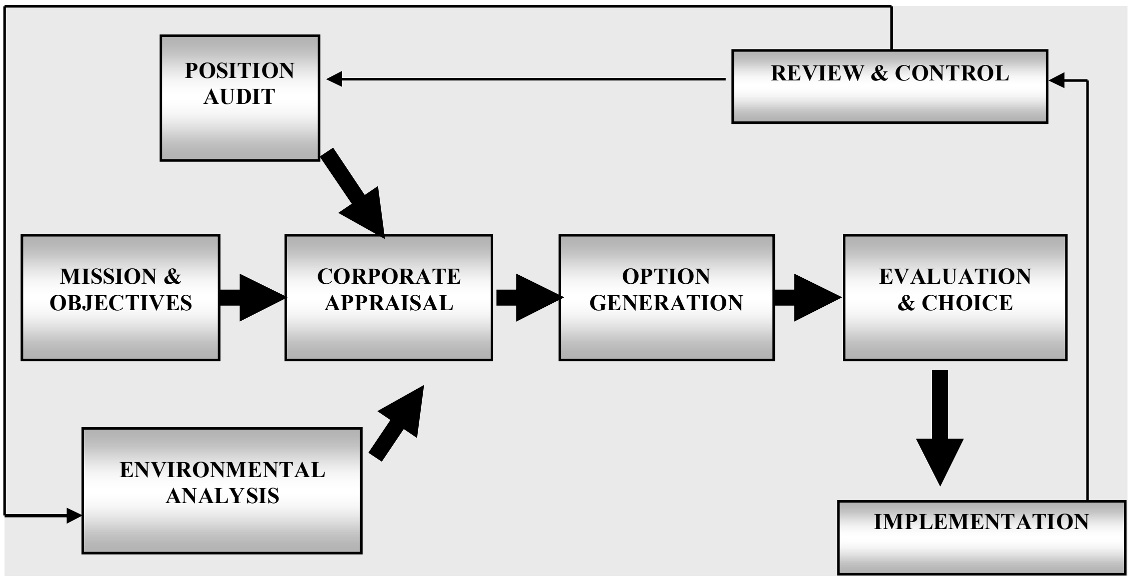
The Rational Planning process	Incremental approaches	Freewheeling Opportunism	Emergent strategies
Top-down and centralised	Top-down and centralised	Top-down and centralised	Bottom-up and decentralised
Time horizon 2-10 years	Time horizon 6 months to 2 years	Time horizon day to day basis	Time horizon indefinite
Formal planning	Less formal planning	Informal planning	Informal planning
Complex and costly	Less complex and costly	Less complex and costly	More complex and less costly
Stable and certain environment.	Dynamic and uncertain environment.	Dynamic and uncertain environment.	Dynamic and uncertain environment.
Inflexible.	Flexible.	Flexible.	Flexible.

The rational planning process

Top-down (centralised) and formalised approach to strategic planning. Originated from the USA e.g. the planning horizon for the organisation could be over 2-10 years.

Advantages	Disadvantages
✓ For transformational or radical change ✓ Copes with the uncertain future by providing long-term plans ✓ Helps integrate and coordinate complex organisations	✘ Rational planning can be too rigid and bureaucratic e.g. no use for the small business ✘ Rational planning can stifle innovation e.g. locked into plans ✘ No use for dynamic or uncertain environments e.g. plans quickly become óout of dateô

The rational planning process



Incremental planning approaches (logical incrementalism)

Top-down (centralised) and less formalised approach to strategic planning. Smaller, gradual and more incremental adjustments to strategic plans e.g. every 6 months up to 2 years maximum.

Advantages

- ✓ Less complex and long winded
- ✓ Better for uncertainty or rapidly changing environments
- ✓ More frequent gradual adjustment e.g. easier to control and manage
- ✓ Greater frequency of planning to adjust plans to environmental change

Disadvantages

- ✘ Too reactive, ‘muddling through’
- ✘ Not suitable for transformational or radical change
- ✘ Lack of long-term direction e.g. ‘strategic drift’ may occur

The entrepreneurial model (or freewheeling opportunism)

Henry Mintzberg referred to ‘**freewheeling opportunism’** as an opportunistic strategy, dominated by the search for new opportunities, with bold and often high risk decisions that need to be made by the entrepreneur him or herself.

Freewheeling opportunism is a top-down (centralised), informal and short-term approach to strategic planning.

Advantages

- ✓ Focus on exploiting product and market opportunities e.g. ‘never miss a good opportunity’
- ✓ Less time consuming and complicated
- ✓ Greater frequency of planning to adjust plans to environmental change
- ✓ Better for uncertainty or rapidly changing environments

Disadvantages

- ✘ Organisation too reactive, ‘muddling through’
- ✘ Not suitable for transformational or radical change
- ✘ Lack of long-term direction.
- ✘ Relies heavily of the judgement and experience of the founder e.g. one single individual

Emergent strategies

Henry Minzberg, described emergent strategies as ópatterns or consistencies realised despite or in the absence of conscious intention by senior managementô
Strategy emerges and is óunanticipatedô

Informal and bottom-up (decentralised approach) allowing strategic courses of action to be developed from both tactical and operational levels within the organisation.

Advantages	Disadvantages
✓ Quicker change or repositioning for the organisation e.g. lower strategic levels ócloser to the customerô ✓ Tactical and operational levels an extensive source of innovative ideas ✓ Greater motivation to other strategic levels ✓ Supports culture of flexibility, learning and enterprise	✗ Chaotic organisation that lacks control over planning ✗ Lack of long-term direction. ✗ Organisation too reactive, ómuddling throughô ✗ Requires entrepreneurial skills from staff which may not exist

Comparing and contrasting RBV to the Positioning Approach

<table>
<tr><th>Resource Based View (RBV)</th><th>Positioning View (PA)</th></tr>
<tr><th colspan="2">Similarities</th></tr>
<tr><td colspan="2">• Both ideas stem from the rational planning process.
• Both can use centralised (rational planning) or decentralised (emergent) approaches.
• Both aim to achieve competitive advantage e.g. ways to compete with rivals.</td></tr>
<tr><th colspan="2">Differences</th></tr>
<tr><td>• Resource based approach
• Inside out e.g. key internal resources for achieving success.
• Organisation focuses on what it does best e.g. óstick to knittingô
• Emphasis on internal appraisal e.g. unique assets or core competences.
• Higher cost and time to exploit but long-term advantage.</td><td>• Market based approach
• Outside in e.g. best external opportunities to exploit.
• Organisation focuses on diversity and innovation.
• Emphasis on external environment e.g. competition and customers
• Less costly to exploit but short-term advantage gained.</td></tr>
</table>

Two contrasting leadership styles generally exist, democratic and autocratic. Democratic is based on democracy and social equality. Autocratic a bossy way and often aggressive and dominating.				
Huneryager and Heckman	Dictatorial	Autocratic	Democratic	Laissez faire

Chapter

2

Mission, Objectives and Stakeholders

Key summary of chapter

> Stakeholders are those organisations or people that have an interest in the organisation, these interests varied and for many reasons. They can be a source of potential conflict for the successful accomplishment of an organisations strategy.

Mendelow’s stakeholder mapping model

Mendelows matrix is a way of prioritising stakeholders by ósubjectiveô mapping of them, in order to understand and resolve any issues or conflicts that may exist. This model prioritises by mapping which stakeholders should more likely considered and therefore ósatisfiedô by the organisation.

- **Power** e.g. bargaining power, right or ability to exert influence over the organisations strategic aims and the general way it conducts itself.
- **Interest** e.g. interest in the activities or conduct of the organisation for varied reasons.

Power over the organisation	**Interest in the organisation: Low**	**Interest in the organisation: High**
Low	**Minimal Effort (priority four)**	**Keep Informed (priority three)**
High	**Keep Satisfied (priority two)**	**Key players (priority one)**

Mission statements

Every organisation should have a mission, purpose or reason for being. This can be embedded within a mission statement. A mission statement describes in writing the basic purpose of an organisation and what it is trying to accomplish. A mission statement is a brief description of an organisations fundamental purpose.

Goals and objectives

Goals

What the organisation plans or intends to achieve. Normally converted to objectives which measurability and timescale. Long-term and sufficient to satisfy the mission statement.

Critical success factors (CSFs)

Key organisational goals that if achieved will make the organisation more successful.

Objectives

A measurable goal with a clearly defined timescale to achieve it.
Objectives should ÔSMARTÔ (specific, measurable, agreed, realistic and time bound.

Key performance indicators KPIs (performance measures)

Objectives which have measurability and time scale.

Chapter

3 Environmental Analysis

Key summary of chapter

Environmental (external) analysis

ñA study which considers potential environmental effects during the planning phase before an investment is made or an operation startedò (CIMA)

Environmental analysis tools

- PEST or SLEPT (social, legal, economic, political and technological).
- Porterõs 5-forces (threat of new entrants, competitive rivalry, substitutes, bargaining power of suppliers and bargaining power of customers).
- Porters Diamond (favourable factor conditions, demand conditions, related and supporting industry and firm strategy, structure and rivalry).
- Competitor analysis**.** A systematic comparison of the organisation to competition within the same industry.

Using environmental models such as SLEPT analysis or Porterõs five forces can give a diverse range of environmental information for an organisation. These models can be used to describe both the nature and source of information when conducting environmental analysis. The source of information is where the information can be found or where it originates from e.g. media, customers, websites or companies house. The nature of the information means to describe the information itself.

Game theory

A branch of applied mathematics that can be used in social sciences, in particular it can be applied to the theory of competition in terms of gains and losses amongst opposing rivals. A mathematical framework is used for analysing different choices that rational players can make, when their pay-off depends on the combination of their choices, as well as all other players choices.

Country risk

The financial or other risks of changes in the business environment of a country e.g. changes in the political, ethical, legal, market or economic environment. Such examples include introduction of trade barriers, regulatory changes to employment or competition law, or outbreak of war.

Country risk can also be referred to as political risk, however country risk is a more general term, for the diversity of environmental factors that can influence an organisation other than those which are just political.

Tools for analysing country risk

- **PEST or SLEPT** (social, legal, economic, political and technological).
- **Porter's 5-forces** (threat of new entrants, competitive rivalry, substitutes, bargaining power of suppliers and bargaining power of customers).
- **Porters Diamond** (favourable factor conditions, demand conditions, related and supporting industry and firm strategy, structure and rivalry).

Political risk

Political risk is the risk that political or government action will effect the position and value of an organisation. The financial or other risk that a nations government changes its policies and procedures e.g. potential loss arising from a change in government policy regarding trade barriers such as foreign exchange controls, tariffs or import quotas.

Examples of political risk within Countries

- Outbreak of national war, civil war, unrest or riot.
- Nationalisation of industries
- Enforcement of international trade barriers
- New regulations or legislation introduced
- Restrictions on dividends or expropriation of assets out of a country.
- Political instability

Ways an organisation can influence a government

- Political donations
- Employment of lobbyists
- Appointment of civil servants or politicians as internal directors
- Attendance at annual conferences or political meetings
- Good relations with government upheld
- Advertising or promotion to influence legislation change or sway public opinion
- Unite with pressure groups that have common aims to the organisation

Chapter

4

The Position Audit and Corporate Appraisal

Key summary of chapter

Position audit

A position audit is a systematic assessment of the current strengths and weaknesses of an organisation and is a prerequisite for strategic planning and implementation.

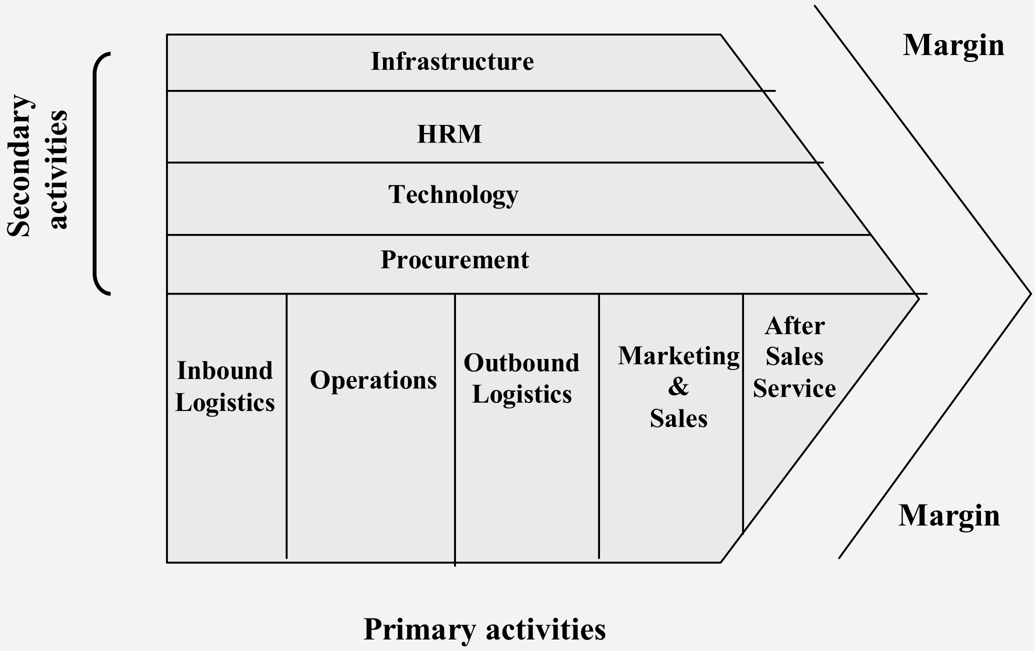
- Resources
- Products, brands and markets
- Operating systems
- Internal organisation
- Current Results
- Returns to equity and debt holders

The 9Ms resource audit

- Men and women
- Management
- Money
- Make-up
- Machinery
- Methods
- Markets
- Material
- Management information

Value chain analysis

A value chain is ‘the sequence of business activities by which, in the perspective of the end user, value is added to the products or services produced by an organisation’ **(CIMA)**.



The value shop is an alternative representation of value chain analysis and can be used more applicably for the professional firm or service organisation. Rather than just creating value by producing output from an input of raw materials in a uniform or standard way each client problem maybe unique, value is created by mobilising resources and deploying them for to solve specific problems. Within a service organisation the value creation process may deal with unique situations and the links between the primary activities may not be so visible.

Stabell and Fjeldstad (1998), five generic activities (primary activities) carried out by a value shop

1. Problem finding and acquisition
2. Problem solving
3. Choice of problem solution
4. Execution of solution
5. Control and evaluation

Benchmarking

ñA continuous, systematic process for evaluating the products, services and work processes of an organisation that are recognised as representing best practice, for the purpose of organisational improvement.ò

(Michael Spendolini)

Types of benchmarking

- Internal
- Best practice or functional
- Competitive
- Strategic

The process

- Selecting what you want to benchmark
- Consider benefits against the cost of doing it
- Assign responsibilities to a team
- Identify potential partners/known leaders
- Breakdown processes to complete
- Test and measure e.g. observation, experimentation or investigation/interview
- Gather information
- Gap analysis
- Implement changes/programmes/communicate
- Monitor and control
- Repeat regularly

Business process re-engineering (BPR)

Hammer & Champy (1993) defined the process of reengineering as "the fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical, contemporary measures of performance, such as cost, quality, service and speed."

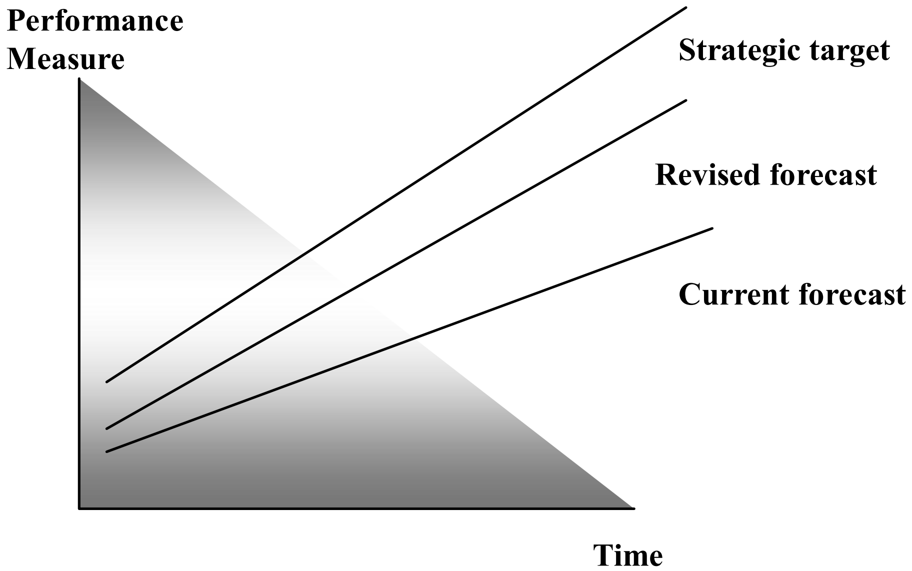
The stages in a BPR exercise

1. Identify processes to be re-engineered
2. Understand, break down and analyse the process
3. Identify óchange leversô
4. Rationalise or eliminate process
5. Redesign process to operate in the most cost effective and efficient way
6. Reassemble, implement and manage change
7. Monitor and review

Gap analysis

Gap analysis is a long range and quantifiable planning technique

- Where the organisation is now
- Where the organisation will be
- Where the organisation wants to be



Process of gap analysis

1. Set long-term strategic objectives
2. Forecast likely performance given its current state of affairs
3. Current forecasts are frequently updated
4. Periodically compare revised performance to target performance and identify measurable gaps.
5. Further strategic development required when a ógapô exists

Scenario planning

A strategic planning method for the preparation of flexible long-term plans. Scenario planning involves testing business strategies against ‘alternative futures’ in an attempt to build plausible views, when operating in conditions of high uncertainty.

Process developed by Schoemaker

1. Develop scenarios e.g. examine environment, key trends and uncertainties.
2. Develop strategies to match each scenario.
3. Identify core competences that are required for each scenario.
4. Use of strategies developed if key trends and uncertainties turn out to be true.

The concept of foresight

Foresight has been described as the art and science of anticipating the future and planning prudently for it.

- Think tanks
- The Delphi model
- Scenario planning
- Brainstorming
- Visioning
- Morphological analysis

Corporate appraisal (SWOT analysis)

A corporate appraisal is a ‘critical assessment of the strengths and weaknesses, opportunities and threats (SWOT analysis) in relation to the internal and environmental factors affecting an entity in order to establish its condition prior to the preparation of the long-term plan.’ **(CIMA)**

- Strengths and weaknesses are normally internal (within the organization)
- Opportunities and threats are normally external (outside the organisation)

The TOWS approach

- **SO** Strategies e.g. match core competences or **S**trengths to **O**pportunities
- **ST** Strategies e.g. use **S**trengths to avoid **T**hreats
- **WO** strategies e.g. take advantage of **O**pportunities by addressing **W**eaknesses
- **WT** strategies e.g. minimise **W**eaknesses and avoid **T**hreats

Chapter

5 Strategic Options

Key summary of chapter

Michael Porter's competitive generic strategies

Competitive Scope	Competitive advantage: Low cost	Competitive advantage: Differentiation
Broad Target	**Cost Leadership** Offering a product or service at the lowest price due to having the lowest cost per unit in the industry.	**Differentiation** Offering a product or service with certain characteristics or features that are unique and distinct relative to the competition.
Narrow Target	**Cost Focus** Market segmentation and cost leadership strategy pursued.	**Differentiation Focus** Market segmentation and differentiation strategy pursued.

The Ansoff matrix

	Existing Product	**New Product**
Existing Market	Market Penetration	Product Development
New Market	Market Development	Diversification

Types of integration (merger or acquisition)

Related diversification

- Horizontal integration
- Backwards vertical integration
- Forwards vertical integration

Unrelated diversification

- Lateral integration or conglomerate diversification

Strategic options

- Internal development or ‘organic growth’
- Acquisition (takeover) or merger
- Joint venture
- Strategic alliance
- Franchise (licensing)
- Sales agents
- Manufacturing overseas
- Exporting
- Outsourcing
- Turnkey operations
- Do nothing
- Withdraw
- Consolidate

Divestment

- Liquidate assets
- Sell off products or brands as a going concern
- Management buy out (MBO)
- Management buy in (MBI)
- Demerger (sale)
- Rationalisation

Business process outsourcing (BPO)

A form of outsourcing, the contracting of operations and responsibilities of a specific business function (process) to a third-party service provider. Commonly referred to as ‘back office outsourcing’ because it involves the outsourcing of internal business functions e.g. finance, human resource management, legal, information technology, even the ‘offshore outsourcing’ of call centers by companies today.

Benefits of BPO

- ✓ Economies of scale
- ✓ Reduces the complexity of internal management
- ✓ Management can focus on its core competencies
- ✓ Greater flexibility of using the outsourcer
- ✓ Increase speed, improve efficiency and cut cost

Limitations of BPO

- ✘ Loss of strategic control
- ✘ Organisation more vulnerable due to over reliance
- ✘ Loss of competitive advantage
- ✘ Internal redundancy
- ✘ Risk to the security of information
- ✘ Failure of outsourcer to meet service levels

Offshore outsourcing

Offshore outsourcing is BPO contracted outside the company's country. Examples from the UK and US, have included overseas development of information technology e.g. programming or software development, customer call centers, processing insurance claims, and even research and development. In either case the process is performed in another country to where the product or service is actually developed or manufactured.

Offshoring is a similar term used when a process is performed in another country, but instead of a third party used, the process is provided by a foreign subsidiary.

Supply chain management

Strategies to achieve greater integration of the supply chain from raw material to the ultimate final sale and disposal of a finished product or service. Effective supply chain management can be crucial for an organisation to gain competitive advantage e.g. higher quality, lower cost, quicker delivery etc. A supply chain is an example of a supply network, raw materials, components, finished goods and services, are procured as a product passes through a chain of processes that supply one another and at each stage ćadds valueô to the customer in some way.

Strategic supply chain management

The **strategic supply wheel** illustrated by Cousinôs

- **Portfolio of relationships** e.g. high collaboration with suppliers
- **Skills and competences** e g. develop skills internally
- **Strategic performance measures** e.g. monitor and control supply chain
- **Cost-benefit analysis** e.g. over strategic approaches
- **Organisational structure** e.g. support effective supply chain management

Supplier sourcing strategies

- **Single sourcing** e.g. source from one supplier only.
- **Multiple sourcing** e.g. source service from many suppliers simultaneously.
- **Delegated sourcing** e.g. purchasing decisions are outsourced.
- **Parallel sourcing** e.g. a combination of two or more of the above.

The three elements of supply chain management

- Responsiveness
- Reliability
- Relationships

IT to facilitate greater integration of supply chain

- Bar coding
- Electronic tagging
- Materials Requirement Planning (MRP I)
- Route masters
- Electronic Data Interchange (EDI)
- Extranet e.g. internet based EDI.
- Computer Aided Design (CAD)
- Electronic Funds Transfer (EFT) systems.

Business strategies to facilitate greater integration of supply chain

- Vertical integration
- Strategic alliances or joint ventures

Evaluating strategic options

The SFA (or FSA) criteria

- **Suitability** e.g. SWOT analyses and mission statement.
- **Feasibility** e.g. skills, core competences, finance and resources to achieve option
- **Acceptability** e.g. level of risk and financial return acceptable to stakeholders

RACES

- Resources
- Acceptably
- Coherence
- Effectiveness
- Sustainability

Chapter

6 Marketing

Key summary of chapter

The marketing concept

Marketing The management process responsible for identifying anticipating and satisfying customer requirements profitably. Chartered Institute of Marketing (CIM)

The marketing mix (4 Ps) A set of controllable variables an organisation has to influence a customers purchase decision for a good or service.
Product The ópackage of benefitsô including guarantees, warranties and after sales service.
Price The pricing element includes price promotions, discounts, and periods of credit, interest free credit and payment terms.
Promotion The promotional mix or promotional plan is comprised of four subcategories: advertising, personal (or direct) selling, sales promotion and public relations.
Place Place is where the product can be purchased from e.g. distribution channels.
People Often referred to as the 5th P in the marketing mix, because staffs are the essential óhuman assetô to support the marketing concept.
Process How the service is delivered or how the sale of the good is managed.
Physical evidence The tangible evidence that exists and that can be identified to the organisation.

Market research

óA systematic investigation of markets and accumulation of relevant dataô

A process for market research

1. **Problem recognition**
2. **Define scope of data and information needs**
3. **Collect data and information** e.g. sampling, surveys, observation, interview etc
4. **Analyse and understand information** e.g. databases, summarise trends and results
5. **Report and conclude** for new marketing strategies

Sales forecasting methods

Market forecasting methods for estimating current demand

- Total market or industry potential
- Area market potential
- Market share
- Relative market share (RMS)

Market forecasting methods for estimating future demand

- Survey or sample of buyers intentions
- Composite of sales force opinions
- Expert opinions
- Past-sales analysis
- Market test methods

Relationship marketing

Relationship marketing is about devoting marketing resources to the maintenance of the existing customer base, as well as trying to attract new customers. Customer loyalty and retention has become critical to the long-term survival of organisations, relationship marketing aims to build excellent relationships with customers in order to retain their loyalty.

Payne's 6 markets model for relationship management

Payne advocated that an organisation has six markets not just the ócustomerô market when it comes to relationship marketing.

1. Customer market
2. Referral market
3. Supplier market.
4. Recruitment market
5. Influence market
6. Internal market

Market Segmentation

The grouping of customers, with each sub-group or segment of customer having a common need, want or value. Each sub-group or segment will be affected by different targeting strategies; they would behave differently and respond differently to different ‘tailored’ marketing mixes.

Advantages of market segmentation

- ✓ Match closer the features of a product to customer groups.
- ✓ Higher customer satisfaction or delight
- ✓ Brand loyalty and customer retention.
- ✓ More efficient use of marketing resources

Guidance for effective market segmentation (Kotler)

- **Substantial** e.g. segment sizeable enough to be profitable
- **Accessible** e.g. segment can be efficiently and effectively reached
- **Measurable** e.g. segment can be measured
- **Actionable** e.g. effective strategies are available to attract segment
- **Differentiable** e.g. the segment behaves and responds differently

Reasons not to engage in market segmentation

- The number of customers not big enough to earn a profit.
- Effective promotion mediums do not exist to create awareness economically.
- The size or strength of competition that already exists.
- Segment too subjective, complex and therefore difficult to measure.
- The firm lacks the core competences to compete.
- The market segment identified has no long-term future.

The strategic marketing process

The primary goal of any marketing strategy is to satisfy the strategic goals of the organisation e.g. competitive strategy must support the corporate strategy, mission and goals.

1. The mission statement and corporate objectives reviewed
2. Conduct a marketing audit
    - Review strategy and objectives of the organisation
    - Audit external marketing environment e.g. PEST or SLEPT analysis
    - Market analysis and segmentation for different customer needs and values
    - Competitive benchmarking of ómarketing mixô practices
3. Evaluation and reporting of all market research and intelligence
4. Determine and evaluate competitive strategies
5. Detailed action plan created
6. Review and obtain feedback periodically
7. Regularly undertake marketing audit

The marketing environment

Environmental analysis is a process strongly linked to the creation of the marketing strategic plan for an organisation. Models such as PEST or SLEPT analysis and other derivatives of these e.g. PESTLE or SLEEPT or STEEPLE can be used for analysing the general or industry environment.

- **S** societal factors
- **L** legal factors
- **E** economic factors
- **P** political factors
- **T** technological factors

Two extra Es could include ethical and ecological factors. Other considerations to the above for a more comprehensive study of the environment would include a full analysis of customers, competition and markets.

Product positioning

Competitive positioning is about the organisation's role in the competitive market place.

- **Undifferentiated (or homogenous) positioning** is the targeting of an entire market with a single marketing mix.
- **Differentiated targeting** is the targeting of different market segments and a specific marketing mix for each segment.
- **Concentrated positioning** is the targeting of a single market segment only with a single marketing mix e.g. single segment focus.

Michael Porter's competitive generic strategies

		Competitive advantage	
		Low cost	**Differentiation**
Competitive Scope	**Broad Target**	**Cost Leadership** Offering a product or service at the lowest price due to having the lowest cost per unit in the industry.	**Differentiation** Offering a product or service with certain characteristics or features that are unique and distinct relative to the competition.
	Narrow Target	**Cost Focus** Market segmentation and cost leadership strategy pursued.	**Differentiation Focus** Market segmentation and differentiation strategy pursued.

The characteristics of services

- **Intangibility** e.g. no material substance or physical existence
- **Legal ownership** e.g. difficult to return if faulty
- **Instant perishability** e.g. cannot be stored for future use
- **Heterogeneity** e.g. performed different each time
- **Inseparability** e.g. cannot be separated from the person who provides it

Product (customer) portfolios and the product mix

Product mix means the different products that the organisation makes or sells. The product portfolio can be managed using tools such as the product life cycle (PLC) theory and the Boston Consulting Group (BCG) matrix.

Product or industry life cycle

The product life cycle illustrates the succession of stages that a product goes through in terms of its sales or market share. The market environment in which a product is sold is always changing and therefore must be managed as it moves through a succession of different stages.

- Introduction
- Growth
- Maturity
- Decline

The Customer Life Cycle (CLC)

The Customer Life Cycle (CLC) is similar in theory to the Product Life Cycle (PLC), however, CLC focuses upon the creation and delivery of lifetime value to the customer (not product) during different óstagesô of their life cycle e.g. identifying products or services that customers need, want or value throughout their life cycle stages. A customer lifecycle value (CLV) estimates the present value of the net cash flows likely to be received during a customers life time.

The Boston Consulting Group matrix

- Problem Child e.g. new product that poorly competes.
- Star e.g. new product that competes well.
- Cash Cow e.g. mature and established product that competes well.
- Dog e.g. mature and established product that poorly competes.

Product portfolio theory states that an organisation should have a ówell diversified portfolio of productsô e.g. stars are essential for future success, cash-cows to óharvestô and support stars, the absence of question marks or dogs if possible.

Customer profitability analysis (CPA)
Relating specific costs to serving customers or groups of customers, so that their relative profitability can be assessed. Customer profitability analysis (CPA) focuses on cost reduction by understanding how customers consume different support resources e.g. processing, delivery, sales visits, telephone support, internet support etc. It allows an organisation to concentrate on the most profitable of its customers.
Direct product profitability (DPP)
DPP is a decision making tool that helps a food merchandiser by providing a better indication of the profitability of products on the supermarket shelves. DPP allocates direct product costs to individual products. These costs are subtracted from gross profit to derive at DPP for each product. The normal indirect costs attributed to products would be distribution, warehousing and retailing. DPP would ignore indirect costs such as head office overhead, only product specific fixed (indirect) cost would be analysed. e.g. shelf filling, warehousing and transportation
Distribution channel profitability (DCP)
DCP another ABC concept, is about relating specific distribution costs to serving customers or groups of customers, so that their relative profitability can be assessed. Typical supply chain channels today include the internet, e-mail, shops/branches, post, telephone, catalogues, other distributors etc
Activity based management (ABM)
Activity based management (ABM) is about satisfying customers whilst making fewer demands on internal resources. The aim is that once cost drivers are created, organisations can aim to reduce cost, by creating models for more effective planning and control.
Attribute costing
DPP or CPA can be taken one step further by using attribute costing, a method which applies cost-benefit analysis e.g. benefits from the value of customer utility or ósatisfactionô derived from different attributes of a product, compared to the cost of providing each attribute.

Strategies to improve customer or product profitability
1. Increase price 2. Increase volume sold 3. Reduce support activities that incur specific customer or product cost 4. Withdrawal e.g. discontinue selling

Branding

A trade name, symbol or logo synonymous or identifiable to an organisation, or its product or service e.g. Nike (and its ótickô logo).

The merits of brands

- ✓ Can support new products and services
- ✓ Can create a premium price
- ✓ Can support franchising (licensing)
- ✓ Can have longer life cycle than products
- ✓ Can differentiate a product and strengthen customer loyalty

The five brand strategies of Kotler (1997)

- **Line extensions** e.g. new sizes, flavours etc launched under same product brand
- **Brand extensions** e.g. new product category launched under same brand
- **Multibrands** e.g. new brands launched in same product category
- **New brands** e.g. new product category launched or existing product relaunched
- **Co brands** e.g. complimentary brands combined for promotional strategic benefit

Brand accounting

Brand expenditure is not capitalised under IAS 38

The valuation of intangible brands

- The historical accounting cost
- The present value of the óprice premiumô paid for the brand
- The present value of future estimated earnings from the brand
- The market price

Ethics

Morals about the right behaviour and way of conduct.

Corporate Social Responsibility (CSR)

Being aware of the impact of actions on others, and acting in the best interests of society

Ethical considerations in marketing

- Safe products and services
- Ethical products and services e.g. not tested on animals, fair trade, recycling, biodegradable etc
- Fair pricing and returns policy
- Full refund offered if customer unsatisfied
- Customers not misled e.g. information, sales staff and agents
- No text messaging or junk mail

The role of IT in supporting marketing

Marketing decision support systems (MDSS)

Databases, internet, extranet, intranet and e-commerce systems.
A coordinated collection of data, system tools, and techniques with supporting software and hardware by which an organization gathers and interprets relevant information from business and the environment and turns it into a basis for making management decisions.
(American Marketing Association)

Customer relationship management (CRM) systems

Devoting marketing and IT resources to the maintenance of existing customers, as well as strategies to attract new customers.

Examples of CRM systems

- **Face to face contact** e.g. meetings, phone calls, e-mail, online services etc.
- **Back office** e.g. booking, billing, invoicing and payment.
- **Analysis of customer trends** e.g. data warehousing and mining

Data warehousing and mining

Data warehousing
The input and storage of high volumes of data e.g. customer transactions such as time of day and type of goods purchased. Tesco collects data via its sales order processing systems using EPOS, bar-coding and magnetic stripe card (club card) technology.

Data mining
The process of extracting useful and perhaps previously unknown information from a large pool of information gathered within a data warehouse. It is also referred to as ‘shopping basket’ analysis because it is heavily applied within the retail sector.

E-marketing and E-commerce

E-marketing

Marketing over the internet. Also referred to as i-marketing, web marketing and online marketing. The presentation of the organisations brand, product and services over the internet, to help build strong customer relationships and brand loyalty.

E-commerce

The process of buying and selling goods and services electronically over the internet using website technology.

Chapter

7

Information Strategy

Key summary of chapter

Information

Data which has been processed in a meaningful way e.g. summarised, formatted, tabulated or filtered, so that it is understandable by its intended recipient.

Information system

A system of persons, data records and activities, manual or computerised, that process, collect and maintain information, to provide it to staff or other stakeholders.

The primary role of information systems is to support the business strategy and goals of the organisation. The business strategy and goals of the organisation should always be driving the information strategy of the organisation, never the other way around.

Characteristics of good information systems

A Accurate
C Complete
C Cost beneficial
U User friendly
R Relevant
A Authoritive
T Timely
E Easy to use

Quality	**Strategic planning control** **Operational**
TIME PERIOD	FORECAST <——————————>HISTORICAL
TIMELINESS	IMMEDIATE<——————————> DELAYED
OBJECTIVITY	SUBJECTIVE <——————————>OBJECTIVE
QUANTIFIABILITY	QUALITATIVE<——————————>QUANTITATIVE
ACCURACY	APPROXIMATE <——————————>ACCURATE
CERTAINTY	UNCERTAIN<——————————> CERTAIN
COMPLETENESS	PARTIAL<——————————>COMPLETE
BREADTH	BROAD<——————————> SPECIFIC
DETAIL	LITTLE DETAIL<——————> HIGHLY DETAILED

Michael Earl reasons to have an IT strategy

- IT involves high costs
- IT is critical to the success of many organisations
- IT can be used as part of a commercial strategy to gain competitive advantage
- IT impacts upon customer service
- IT impacts upon all levels of manager
- IT could mean a revolution in the way information is created and presented
- IT involves many stakeholders

Nolan's 6-stage hypothesis

- Initiation
- Contagion
- Control
- Integration
- Data administration
- Maturity

The three elements of IT strategy

- Information Systems Strategy (ISS) óWHATô
- Information Management Strategy (IMS) óWHOô
- Information Technology Strategy (ITS) óHOWô

Developing an IT strategy

1. Determine the business strategy, goals and objectives.
2. Define information needs and identify information sources.
3. Position audit and gap analysis undertaken for existing systems.
4. Heavy end user consultation and participation.
5. Change management and implementation
6. Review and control progress to ensure project objectives have been met

Earl’s Grid for assessing information systems

Business Value		Technical Quality	
		Low	**High**
	Low	**Divest** A costly and unused system.	**Reassess** Heavy user involvement to improve the value of information created and presented.
	High	**Renew** Invest in a better IT infrastructure.	**Maintain and enhance** Regular review and upgrade to maintain current position.

McFarlan's grid or the 'application portfolio'

Strategic importance of planned IT systems	Strategic importance of current IT systems: Low	Strategic importance of current IT systems: High
High	**Turnaround** Limited importance today but predicted to become more strategically important in the future e.g. high potential for future competitive advantage. New and highly innovative systems normally at early stages of development.	**Strategic** The business depends on these systems for existing competitive advantage and will continue to do so in the future. Always at the heart of the organisations success with continuous redevelopment required.
Low	**Support** Not strategically critical and does not contribute significantly to the existing or future success of the organisation. Not critical and mainly exist for economic benefit e.g. increase efficiency and reduce headcount for data processing.	**Factory** Currently viewed as strategically important and necessary for existing competitive success or advantage, but predicted that this significance in future is likely to disappear. .

Criteria for evaluating information systems

- **Q**uality of the information e.g. using óACCURATEô (see below)
- **U**ser acceptance testing e.g. surveys, interview, observation etc
- **A**ctual costs and benefits of new system compared to budget
- **T**echnical testing e.g. response time, performance and reliability
- **E**ase of recovery in the event of failure or malfunction

Tools and techniques

- User questionnaires, interviews and observation
- Testing using real and ódummyô data
- Cost-Benefit (CB) analysis
- Benchmarking
- Post implementation audit and review
- Errors, complaints and queries reported
- The VFM or 3 Es approach

Cost-Benefit (CB) analysis

An economic evaluation technique which compares the costs associated with a proposed investment with the benefits that investment will return. Both tangible and intangible factors would be considered.

Advantages	Disadvantages
✓ Considers the óintangiblesô ✓ Useful technique for screening new projects	✘ Uncertainty of estimating the future ✘ Placing a value on intangible benefits and costs

Post completion review and audit

Mistakes of management can be learned.

Techniques used to conduct a post completion audit

- End user satisfaction surveys
- Staff appraisals
- Exception reports e.g. time and cost
- Results from testing

The purpose

- To support continuous improvement
- To allow for the identification and implementation of corrective action

The value for money (VFM) framework

- **Economy** (cheap)
- **Efficiency** (quick)
- **Effectiveness** (good)

Qualities of good information

- **A** Accurate
- **C** Complete
- **C** Cost beneficial
- **U** User friendly
- **R** Relevant
- **A** Authoritive
- **T** Timely
- **E** Easy to use

Organising and managing information systems

Centralisation of IT department or activities

Advantages of a centralised IT function

- ✓ Economies of scale
- ✓ Better integration and compatibility of information systems
- ✓ Higher motivation of IT staff
- ✓ Can avoid duplication of effort
- ✓ Strategic view

Benefits of in house developed information systems

- ✓ Better understanding of information needs
- ✓ Strategic control
- ✓ Less risk to the security
- ✓ More effective support to end users

Decentralisation of IT activities e.g. end user computing

End-user computing is the direct hands on approach that end users have over the development and use of IT.

Benefits of end user computing

- ✓ Creativity and innovation
- ✓ Increases productivity of information systems
- ✓ End-user satisfaction óownership and motivationô

Limitations of end user computing

- ✘ Lack of training and experience
- ✘ Lack of documentation
- ✘ Incompatibility of different systems

IT outsourcing (client-vendor relationships)	
Examples include the outsourcing of system maintenance, development or data processing agreements with third party organisations, an entire IT department could be outsourced. IT outsourcing can allow management to start with a clean sheet and eliminate what they often see as an internal irritant.	
Advantages ✓ Save overhead ✓ Reduce the complexity ✓ Management can focus on its core competencies ✓ Flexibility of using outsourcer	**Disadvantages** ✘ Loss of strategic control ✘ Over reliance ✘ Loss of competitive advantage ✘ Internal redundancy ✘ Risk to security ✘ Failure of outsourcer

Management of vendors

- Policies, procedures and effective management
- Planned selection criteria
- Tender and visiting process
- References
- Contract agreements
- Penalties and cancellation terms

Characteristics of a good service level agreement

- Terms and conditions
- Exit route for non performance
- Timescale of agreement
- Copyright and ownership
- Procedures for control
- Contact details

Criteria for evaluating suppliers

- Invitation to tender documents
- Warranty and support
- Training assistance
- Cost and composite of cost
- Reliability and solid track record

Management information systems

Management Level	OPERATIONAL	TACTICAL	STRATEGIC	ALL LEVELS
Information System	Transaction processing systems (TPS)	Decision support systems (DSS)	Executive information systems (EIS)	Expert Systems (ES)

Emerging information systems

Knowledge management systems (KWS)

KWS are information systems that facilitate the creation and integration of new knowledge into an organisation. Many organisations now attempt to formalise systems for the gathering and dissemination of knowledge across the organisation. Knowledge management is the process of trying to collect, store and use knowledge within the organisation. Knowledge can be formalised by designing processes to create, store and use it to become explicit knowledge e.g. intranets, e-mail, databases, teams and social networking.

Types of KWS

- **Knowledge distribution systems** e.g. e-mail, scanners, e-fax, voice mail and document image processing (DIP). Groupware software packages like Lotus notes can help to manage e-mail, calendars, diaries and reminders.
- **Knowledge sharing systems** e.g. expert systems, databases, intranets and extranets.
- **Knowledge creation systems** e.g. computer aided design (CAD) and virtual reality systems (VR).

Benefits of KWS

- ✓ Help knowledge workers create new knowledge and expertise.
- ✓ Facilitates the sharing of information.
- ✓ Can reduce training time for new employees.
- ✓ Retention of knowledge e.g. if an employee leaves
- ✓ Could help gain competitive advantage

Expert systems

Software that behaves similar to the way a human expert would within a certain field of knowledge e.g. legal, medical, insurance or credit risk assessment. The expert knowledge, rules and facts are pre-programmed a memory to facilitate artificial intelligence by supporting decision making.

Benefits of an expert system

- ✓ Automated óexpertiseô support for generalists.
- ✓ Speed of decision improved.
- ✓ Consistency of decision making
- ✓ Expert systems retain and acquire new knowledge

Limitations of an expert system

- ✘ Expensive to develop and maintain.
- ✘ Narrow and specific in focus.
- ✘ People can be more naturally creative than programmes.

Enterprise-wide systems

Also referred to as enterprise resource planning (ERP) or enterprise computing. Enterprise-wide systems are information systems that are used throughout a company or enterprise, to manage and coordinate resources, information and functions of a business. To be considered an ERP system, a software package must provide the function of at least two systems e.g. payroll and accounting functions if integrated.

ERP is the modern extension of MRP (material requirements planning, then later manufacturing resource planning) systems and CIM (Computer Integrated Manufacturing).

All functional departments are integrated into one holistic information system e.g. a central database. As well as integrating manufacturing, warehousing, logistics, and information technology, it would also include accounting, human resources, marketing and strategic management. óSAP Business Oneô is an example of an ERP software solution.

Benefits of ERP systems

- ✓ Speeds up óenterprise wideô exception reporting.
- ✓ Real-time data capture and reporting of financial results.
- ✓ Provides information for all levels of management.
- ✓ More effective planning and forecasting

Limitations of ERP

- ✘ Bespoke and expensive to develop and maintain.
- ✘ High switching cost.
- ✘ Industry prescriptions may not gain competitive advantage.

Customer relationship management (CRM) systems

CRM systems can automate many customer-related business activities and tasks. Customer loyalty and retention has become critical to the long-term survival of organisations, relationship management aims to build excellent relationships with customers in order to retain their loyalty.

Microsoft Dynamics CRM 4.0 is an easy to use customer management system that enables you to monitor and manage customers from their first contact all the way through to after-sales service. CRM software systems include customer contact management, sales automation, call centre applications and help desking. They allow departments to track customer information so that customers interacting with an organisation perceive the business as a single entity, despite interacting with a number of employees from different departments.

Benefits of CRM

- ✓ Increased loyalty of customers and free óword of mouthô recommendation
- ✓ Organisation builds more knowledge and understanding about customers.

Web 2.0 tools

Web 2.0 tools refers to any computer application that is web-based and will support collaboration, interaction and sharing of information over the world wide web. Web 2.0 tools represent the second generation of software for the world wide web, moving away from static web pages to dynamic and shareable content. They enable people with no specialised technical knowledge to create their own websites, publish, create and upload audio and video files, share photos and information and many other tasks.

Examples

- Social-networking sites e.g. óTwitterô
- Video sharing sites e.g. óYouTubeô
- Wikis e.g. a website that allows multiple users to create and modify web page content in a collaborative manner.
- Blogs e.g. a web site for regular entries of commentary, photos, files and descriptions, personal sites include MySpace UK and Facebook.

Benefits of Web 2.0 tools

- ✓ Facilitates creativity.
- ✓ Supports information sharing.
- ✓ Supports human collaboration e.g. virtual teams.

Electronic business (E-business)

Conducting business via electronic media e.g. telephone, fax machines, computers, video-teleconferencing etc. The internet supports óE-businessô e.g. utilises information technology to support all the activities of a business, service its employees and other external stakeholders. Web 2.0 tools enable this to be done interactively.

E-commerce

The process of buying and selling goods and services electronically using website technology.

Benefits of e-commerce

- ✓ Improves marketing e.g. óinvitation to treatô, graphics and interactivity.
- ✓ Fulfil orders satisfactorily without human intervention e.g. electronic retailing (óe-tailingô) for automated ordering and payment
- ✓ Can monitor customer trends e.g. buying habits
- ✓ Encourage feedback from customers e.g. electronic surveys

Value added networks (VANS)

A VAN is a third-party network service provider which offers access to specialised services, normally for a fee e.g. Reuters. Customers either purchase leased lines or use dial-up to access the network. VANS can add value to an organisations products or services e.g. extranets, EDI and specialised knowledge databases, can all help those that subscribe to achieve mutual competitive advantage. VANS offer direct communication links to trading partners, mailbox services for further information and 24/7 message transmission

The emergence of new forms of organisation

Virtual or network firms e.g. dotcom companies.

Network or virtual organisations rely heavily on external organisations or third parties for the delivery of their product or service.

A **virtual** organisation does not have a physical location. For example a collection of individuals that work from their home and the majority of the primary processes or activities of the organisation are outsourced to third party providers.

Characteristics of virtual or network firms

- High levels of outsourcing
- Relatively few physical assets e.g. lease rather than buy
- Relatively minimum full-time staff
- To the customer óorganisation is perceived as one organisationô

Teleworking

Teleworking (or telecommuting) is where staff employed by an organisation work from their home and communicate with the workplace via phone, fax, e-mail, intranet, extranet or any other telecommunications link.

Advantages to employee

- ✓ No commuting
- ✓ Flexible working hours

Advantages to employer

- ✓ Saves office overhead
- ✓ Larger pool of labour

Disadvantages to employee

- ✘ Room in your house for workspace
- ✘ Family interruptions

Disadvantages to employer

- ✘ Less loyalty from employees
- ✘ Staff training can be difficult

Virtual (or geographically dispersed) teams (GDT)

Virtual teams are groups or teams who are geographically dispersed but working and collaborating together. Virtual teams are not normally present in the same office, they are often working in different parts of the world and over different time zones.

Benefits of virtual teams

- ✓ Employer saves on staff office overhead
- ✓ Employer can recruit the best staff anywhere geographically
- ✓ Lower social cost to society from commuting

Limitations of virtual teams

- ✘ Cross-cultural management problems
- ✘ Time zones can cause delay in communication
- ✘ New methods of working maybe unfamiliar to those participating
- ✘ Isolation and lack of project team integration
- ✘ Group cultural norms can make teams very insular

IT to support virtual teams

Computer-supported Co-operative Working

Computer systems that support collaborative and the coordination of tasks and activities.

- Groupware
- Workflow management
- Internet, extranets and intranets
- E-mail, Video conferencing and Web 2.0 tools
- Knowledge work systems (KWS)

Groupware (collaborative software) supports multiple users on a network. Examples of groupware include Lotus Notes (or Lotus Domino) a client-server, collaborative application developed by IBM, or Microsoft Exchange. Features include quick notes, ideas and reminders, sharing of calendars, public folders, address books and schedulers to arrange meetings.

Workflow systems ensure less delay and greater efficiency of managing workflow. Image based workflow systems automate the flow of paper throughout the organisation by digitising paper based images. Form based workflow systems route text based documents around the organisation.

Chapter

8 Corporate Social Responsibility and Ethics

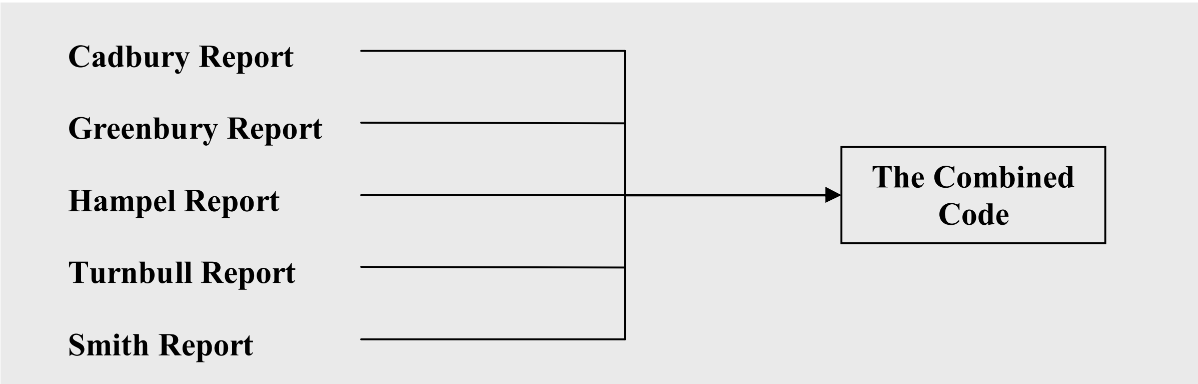
Key summary of chapter

Corporate Governance

ñThe corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals corporations and society"

(Sir Adrian Cadbury in 'Global Corporate Governance Forum' World Bank 2000)

UK corporate governance reporting and recommendations



Cadbury and Greenbury report recommendations

- Split chairman and chief executive role
- Regular and more formal meetings.
- Directors remuneration clearly shown within the published accounts
- Pay awards to be decided by a remuneration committee using non-executive directors only
- Establish an audit committee using non-executive directors only
- Every company should have at least 3 non-executives directors

The Hampel report incorporated the recommendations from both the Cadbury and Greenbury Committees as well as amendments from the London Stock Exchange, it was published as the Combined Code in June 1998.

Benefits of good corporate governance

- ✓ Greater fairness and openness of directors
- ✓ Greater public confidence in companies
- ✓ Reduced risk for investors and other stakeholders
- ✓ Lower risk of strong CEO domination
- ✓ Transparency, timely and clearer communication of information
- ✓ Improves performance and leadership by the board

Summary of the principles for good governance

Directors responsibilities

- The Board should be effective to lead and control the company.
- Clear division of responsibilities between Chairman and CEO to ensure balance of power and authority.
- Board balance e.g. executive and non-executive roles.
- Supply of 'transparent' information.
- Timely and of appropriate quality of information.

Appointment of directors

- Formal and transparent procedures.
- Re-election e.g. all directors at regular intervals and at least every three years.

Directors Remuneration

- Level and make-up of remuneration should be sufficient to attract and retain but not more than necessary.
- A proportion linked to performance.
- Formal and transparent procedure fixing remuneration of each director.
- Disclosure e.g. details of the remuneration of each director.

Relations with Shareholders

- Dialogue with institutional shareholders.
- Constructive use of the Annual General Meeting (AGM).
- To communicate with private investors and encourage their participation.

Accountability and Audit

- Financial reporting e.g. balanced and understandable assessment of the company's position, performance and prospects.
- Maintain effective internal controls.
- Audit committee for maintaining an appropriate relationship with the auditors.

International perspective on corporate governance

This is of paramount practical concern for policymakers, managers, accountants and others since they are affected by the regulatory regimes and changes of regulations on a daily basis in their working environment.

Organisation for economic co-operation and development (OECD)

- Rights of shareholders e.g. one share equals one vote for all shareholders.
- Equitable treatment of shareholders e.g. protection of t minority interests..
- Equitable treatment of all stakeholders.
- Accurate and timely information for users of published information.

US, the Sarbanes-Oxley Act (2002)

- Legal requirement for all companies with a US listing.
- Attempts to address auditor independence and corporate governance issues.
- Places restrictions on the nature of non-audit services that can be performed by auditors. Audit committees must approve any allowed additional services.
- Audit committee members should be independent, and are responsible for the appointment, remuneration and overseeing of external auditors.
- Audit committee must establish rules for the protection of whistleblowers.

South Africa, the King Report (2002)

- Broader stakeholder approach to governance.
- Considers social, environmental, economic aspects of company activities (HIV/AIDS impact, black economic empowerment, equal opportunities and human capital development)
- Accountability and independence of the board emphasised more.
- Delegation did not diminish ultimate responsibility of the board.
- Board is responsible for risk management processes including internal audit.
- Openness to all stakeholders

Ethics and social responsibility

Corporate social responsibility (CSR) is concerned with being aware of the impact of actions on others, and to act in the best interests of society.

Ethics is concerned with rules or morals about the right behaviour and conduct, it is one part of CSR

Advice on how to be more ethical and socially responsible

- Good public relations.
- Protection of the ecological environment
- Control energy consumption, waste and emissions
- Recycle all packaging material
- Support charities and the local community
- Good conditions of work provided for employees
- Embody ethical culture through a mission statement and training.
- Set and publish aims and objectives to achieve greater CSR.

Ethics for members of CIMA

The CIMA Code of Ethics for Professional Accountants sets out the fundamental principles of professional behaviour that members and students are required to follow. Other accountancy bodies and professions such as the ACCA, ICAEW and AAT, have similar standards of behaviour and conduct.

Code of conduct for CIMA management accountants

- Integrity
- Objectivity
- Professional competence and due care
- Professional behaviour
- Quality to the client
- Confidentiality
- Serve the public interest

Code of conduct ensures

- A positive global image to CIMA
- Protection for public interest.
- Prevention and limitation of malpractice.
- Repeat business in the long-term for CIMA and CIMA members

Chapter

9 Organisations

Key summary of chapter

Private sector organisations

Sub-sectors of the economy not directly controlled by the government or state e.g. private business and households.

Examples

- Private businesses
- Companies (corporations)
- Private banks and building societies
- Non-governmental organisations e.g. trade unions, charities, clubs etc

Public organisations

Sub-sectors of an economy, or organisations, owned and directly controlled by the state or government.

Examples

- Local authorities.
- State owned industries e.g. the UK post office.
- Public corporations e.g. the British Broadcasting Company (BBC).

Characteristics of public organisations

- Ultimately accountable to government.
- Goals and guidelines determined by government.
- Not-for-profit motive (NPO).
- Funded by the general public e.g. through taxation.

Multinational Companies (MNC)

A multinational corporation (MNC) can also be referred to as a transnational corporation (TNC) and a multinational enterprise (MNE). A global or international organisation which has production or service facilities in more than one country.

Emerging markets

An emerging market (or emerging economy) is a country in the early stages of development and often receptive to foreign investment. Emerging markets have very high growth rates in national product and yield enormous market potential. Examples of emerging markets include China and India considered to be two of the largest, also Mexico and Brazil, these nation's social or business activities are in the process of rapid economic growth and industrialisation. There are approximately 30 emerging markets in the world today.

Emerging market multinationals e.g. Korea's Samsung

Emerging market multinationals are changing the rules of the game, firms from developing countries are able to develop global competitive advantage, surviving local competition from their own unprotected economies and beating western multinationals.

The rise of emerging markets signals the greatest shift in global economic power since the industrial revolution. Emerging market economies are set not only to emerge, but also dominate the economic future of the world. Domestic companies from such countries as Brazil, Russia, India, Egypt and South Africa are successfully making progress in international trade and in every imaginable industry sector.

Characteristics of emerging multinationals

- Recognised as a global leader
- Has global presence
- Competitive in price, quality, technology design and management
- Can be benchmarked against the biggest and best in the world.

Comparing and contrasting organisational structures

The small or entrepreneurial structure	The functional structure	The divisional structure	The matrix structure
Informal, small organisation	Formal, bureaucratic, large organisation	Formal, bureaucratic, complex group	Formal or informal teamwork
Founder driven with less bureaucracy.	Bureaucratic. ÓA place for everything and everything in its placeÔ	Bureaucratic. ÓA place for everything and everything in its placeÔ	Teamwork and project focused
Communication in all directions	Vertical communication	Vertical communication	Communication in all directions
Power culture	Role culture	Role culture	Task culture
Customer focused	Process or activity focused	Customer focused	Project focused
Suits a dynamic and uncertain environment.	Suites a stable and certain environment.	Suits a dynamic and uncertain environment.	Suits a dynamic and uncertain environment.
Flatter and flexible structure	Tall and inflexible structure	Flatter and flexible structure	Flatter and flexible structure
Integrated	Specialised	Specialised	Integrated
Unity of command	Unity of command	Unity of command	Dual authority
Centralised decisions	Centralised decisions	Decentralised decisions	Decentralised decisions

Virtual or network firms e.g. dotcom companies.

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- Relatively minimum full-time staff
- To the customer Óorganisation is perceived as one organisationÔ

Types of workforce flexibility

- **Functional flexibility** (task flexibility/multi-skilled employees) concerns breaking down traditional occupational boundaries and avoidance of ‗over' specialisation.
- **Financial flexibility** aims to convert staff cost from fixed to variable cost.
- **Numerical flexibility** enables a firm to adjust rapidly to changing levels of demand by increasing or decreasing the number of employees.
- **Temporal flexibility** can be achieved by varying the hours worked by employees in response to changes in demand.

Lean production or the Toyota production system (TPS)

Lean production (also known as the Toyota Production System) is a manufacturing methodology originally developed by Toyota
"good thinking means good product".

Toyota Production System (TPS) was built on two main principles: Just In Time (JIT) and Jidoka e.g. continuous improvement of quality within the production system.

Lean production focuses on delivering resources when and where they are needed.

Lean production tools and techniques

- Getting things right first time
- Minimising inventory e.g. JIT stock control
- Minimising waste
- Flexible workforce practices
- High commitment to human resource policies
- Culture of commitment to continuous improvement

Concepts that support lean production

Total productive maintenance (TPM) aims to shorten lead times by ensuring production and machine maintenance staff work closer together. Machine operators are empowered and trained in order to speed up routine servicing, fault diagnosis and maintenance of operating machinery.

Just in time (JIT) requires that products should only be produced if there is an internal or external customer waiting for them. It aims ideally for zero stock e.g. raw materials delivered immediately at the time they are needed, no build up of work-in-progress in production and finished goods only produced if there is a customer waiting for them.

Total quality management (TQM) is the process of embracing a quality conscious philosophy or culture within an organisation, it aims towards standards of near perfection and continuous improvement.

Quality circles is an American idea, whereby a group of 5 to 8 employees, normally working in the same area, volunteer to meet on a regular basis to identify areas for improvement or analyse work related problems in order to find solutions.

Information technology to support capacity planning

Flexible manufacturing systems (FMS) consist of several machines along with part and tool handling devices such as robots, arranged so that it can handle any family of products or parts for which the system has been designed and developed. These systems are highly computerised, automated and integrated.

Computer aided design (CAD) automates the design, drafting and display of graphically oriented information early in the design process aids good production planning.

Computer aided manufacturing (CAM) automates production e.g. robotic and programmable production cycles.

Optimised production technology (OPT) helps to avoid the build up of unnecessary work in progress and supports a JIT environment e.g. resource planning centred around ‘bottleneck resources’ (limiting factors) or the binding constraints that limit capacity.

Materials <u>requirement</u> planning (MRP I) is an inventory control system which provides an automated list of components and materials required for the type and number of products entered. This allows better production planning and accuracy of inventory management.

Manufacturing <u>resource</u> planning (MRP II) Evolved from MRP I. A system that incorporates not only material requirements, but all manufacturing resources such as different labour types, machine types and other manufacturing resources required for the type and number of products entered.

Computer-integrated manufacturing (CIM) is manufacturing supported by computers. The total integration of computer aided design, manufacturing,. quality control and purchasing in one centralised system.

Enterprise-wide systems (ERP systems) also referred to as enterprise resource planning (ERP) or enterprise computing. Enterprise-wide systems are information systems that are used throughout a company or enterprise. A company-wide computer software system used to manage and coordinate all the resources, information and functions of a business.

Chapter

10 Change Management

Key summary of chapter

Change

óA gradual evolution or sudden transformation, not normally within the control of the organisation, change often due to influences from the organisations environment.ô

Change management

A structured approach to transition individuals, groups, departments, divisions etc from a ócurrent stateô to a desired ófuture stateô. Other terms for change management include configuration management, change control or change leadership.

Internal 'change triggers'

Internal factors within the organisation which cause change to be necessary e.g. new CEO, dissatisfaction of management or staff, reorganisation, rationalisation programmes, new information system etc.

External 'change triggers'

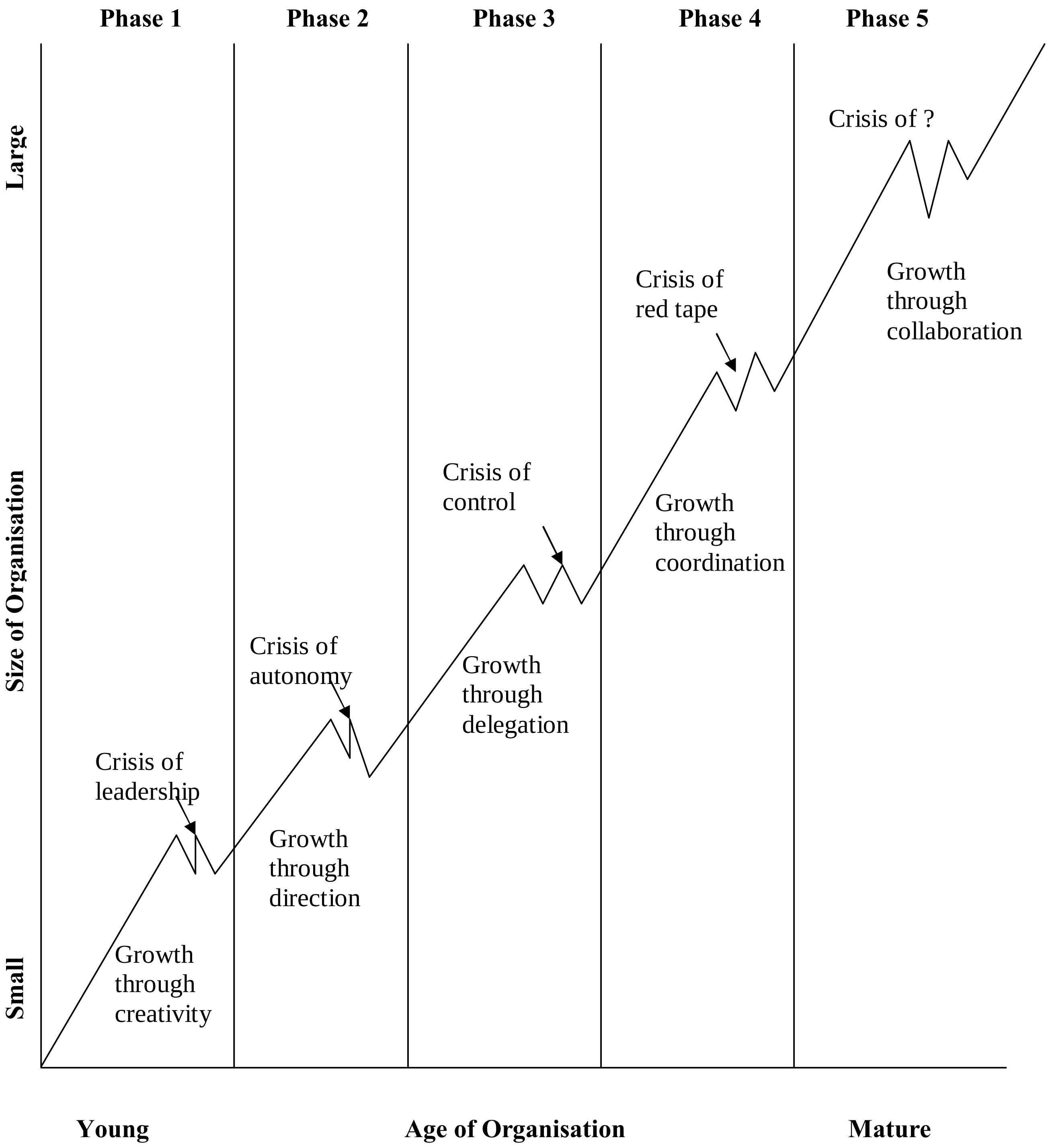
External (environmental) influences which cause change to be necessary e.g. new competition, changes in strategy by the competition, new legislation, economic, technological, social changes in customer needs etc.

Models for analysing external change triggers

- PEST or SLEPT (general environment) e.g. social, legal, economic, political and technological.
- Porterôs 5-forces (task or competitive environment) e.g. threat of new entrants, competitive rivalry, substitutes, bargaining power of suppliers and bargaining power of customers.

Greiner' organisational growth model

Greiner's Growth Model describes the different stages an organisation passes through over time as they grow in size. Larry E. Greiner originally proposed his model in 1972 with five phases of growth. A sixth phase was added further in 1998. Greiner explained the management problems that would be experienced over the different phases, each phase reaching a crisis or turning point. Organisations often have to change or reorganise at each of these phases, so if effectively planning for it, they can ensure smoother transition from one phase to another to avoid the chaos this may cause.



Stages in the change process 'planned change theory'

1. Diagnose current problems
2. Create dissatisfaction with the existing state
3. Participation by those affected
4. Demonstrate support by senior management
5. Implementation of change.
6. Reward systems modified
7. Review and feedback obtained

Different reactions to change

- Acceptance
- Indifference
- Passive resistance
- Active resistance

Parameters for successful change

Wilson suggests the following parameters for how to consider change

- **Scale** e.g. scope and size of the program.
- **Investment** e.g. investment in resources defined in monetary terms.
- **Timescale** e.g. how long the process will take.
- **Change** e.g. the nature of the change required.
- **Impetus for change** e.g. the reasons for the programme of change required.
- **Strategy** e.g. the plan or strategy driving the change process.

Kotter and Schlesinger gave six methods of dealing with resistance to change

- Education and communication
- Participation and involvement
- Facilitation and support
- Negotiation and agreement
- Manipulation and co-optation
- Explicit and implicit coercion

Kurt Lewin - 3 stage (process) approach to managing change

- **Unfreeze**

  This process spells out the reasons why change needs to occur.

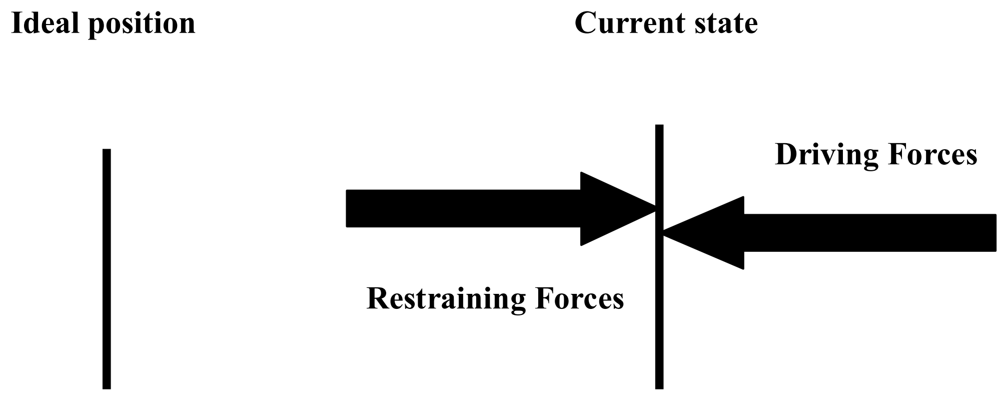
- **Behaviour change**

  This process identifies and crafts new norms, attitudes and beliefs.

- **Refreeze**

  This process reinforces new ways through reward and encouragement.

Lewinŝ **force field analysis** illustrates the forces that drive change and the restraining forces which push change back and prevent or hinder it from occurring. Lewin recommended weakening restraining forces as the popular strategy for managing change.



Practical techniques to reduce resistance

- ✓ Bringing conflict into the open
- ✓ Top down commitment with clear vision of change
- ✓ Supporting positive behaviour
- ✓ Reward systems
- ✓ Communication and education

Johnson and Scholes

		Nature of change	
		Incremental	**Transformational**
Management Role	**Pro-active**	**Tuning** e.g. ófine tuningô or incremental change.	**Planned** e.g. centralised, top-down, rigid and systematic approaches.
	Reactive	**Adaptation** e.g. emergent.	**Forced** e.g. when in crisis.

Types of change

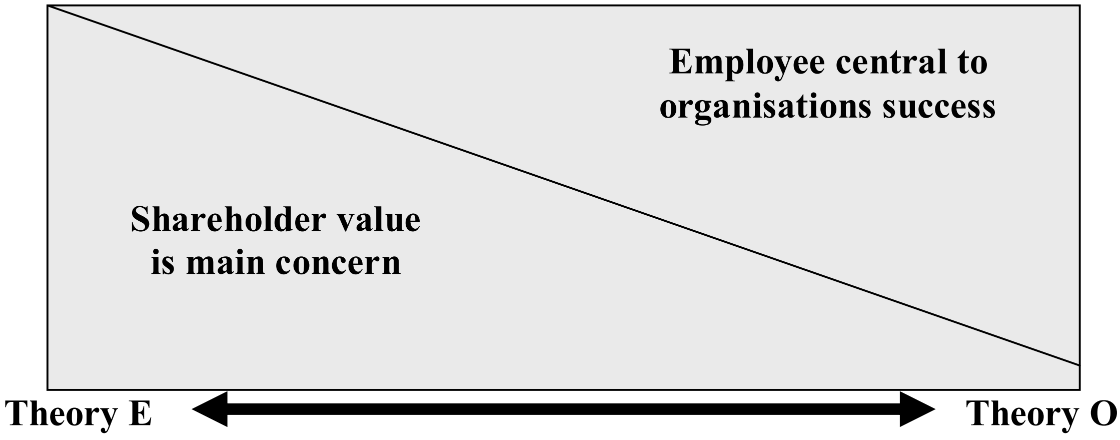
Planned contrasted to emergent approaches to change

	Emergent Approaches	**Planned Approaches**
Management Style	Bottom-up and decentralised	Top-down and centralised
Control of change	Informal, decentralised and emergent	Tight control, rules and procedures
Environment	Dynamic, chaotic and uncertain environment.	Stable and certain environment.
Change	Flexible and adaptive	Slow and inflexible

Step change
Change that happens over a very short period of time and which makes a significant and radical difference to the organisation. Step change is when the trend line of performance makes a significant jump in direction, up or down, and stops being smooth. Step change is different from incremental change, which occurs gradually over an extended period of time.
Transformational change
Change that is radical, large scale changes to the strategy or operations of the organisation. Often transformational change involves major restructuring, reorganisation and/or cultural change necessary.
Incremental change
Change enforced gradually by management using a planned and consultative approach. This approach to change management would be used when no major restructuring or change of culture is necessary within the organisation.

Beer and Nohria

- **Theory E** (change based on economic value) e.g. hard and coercive approach to change, shareholder value as the only legitimate concern.
- **Theory O** (change based on organisational capability) e.g. soft and consultative approach to change, long-term need for the organisation to recognise the needs of all stakeholders, not just shareholders.



Contrasting Theory E and Theory O

	Theory O	Theory E
Management Style	Bottom-up Participative/Democratic	Top-down Autocratic
Objective	Develop organisational capabilities	Maximise shareholder value
Control of change	Informal, decentralised and emergent	Tight control, rules and procedures
Change	Flexible and adaptive	Slow and inflexible
Reward	Commitment and challenge	Financial incentive

The learning organisation

According to Peter Senge, learning organisations are organisations that facilitate the learning by all its members and continuously transforms itself in order to cope with change. Rosabeth Moss Kanter, argued that segmentalist companies e.g. those which are organised by functions, lack creativity and entrepreneurial spirit. She argued that more integrative approaches would release more ideas from unconnected sources within the organisation.

Organisational Development

Bennis defined OD as ña response to change, a complex educational strategy intended to change the beliefs, attitudes, values and structure of organisations so that they can better adapt to new technologies, markets and challenges, and to the dizzying rate of change itself.ò

OD specialists are third party consultants and used for when chronic change or major transformation is needed or where severe problems in performance exist within the organisation.

Often described as "change agents," OD consultants come from varied backgrounds with experience and training in organisational development, organisation behaviour, psychology, education, management or human resources. Many have advanced degrees and most have experience in a variety of organisational settings.

Managing job reduction (or redundancy)

Redundancy occurs when the role that an employee performs no longer exists or is not required. This is a sensitive issue, the loss of motivation and morale of the entire workforce can be devastated when such news does occur not just those individuals affected by it.

A process to manage job reduction

1. Identify what changes will be necessary
2. Clear vision of change communicated
3. Educate and communicate the reasons
4. Participation encouraged by staff to aid change
5. Plan and determine how change needs to occur
6. Review and feedback obtained

Ethical advice offered

- Compulsory redundancy should be last resort
- A sensitive matter so plan for it
- Management must act as honestly and fairly as possible
- Selection methods used on a fair basis e.g. last in first out

A team is a group of individuals with complimentary skills and a commitment to a common purpose. They normally share a common sense of purpose; identity and social belonging and work interdependently toward a common goal often collectively sharing reward.

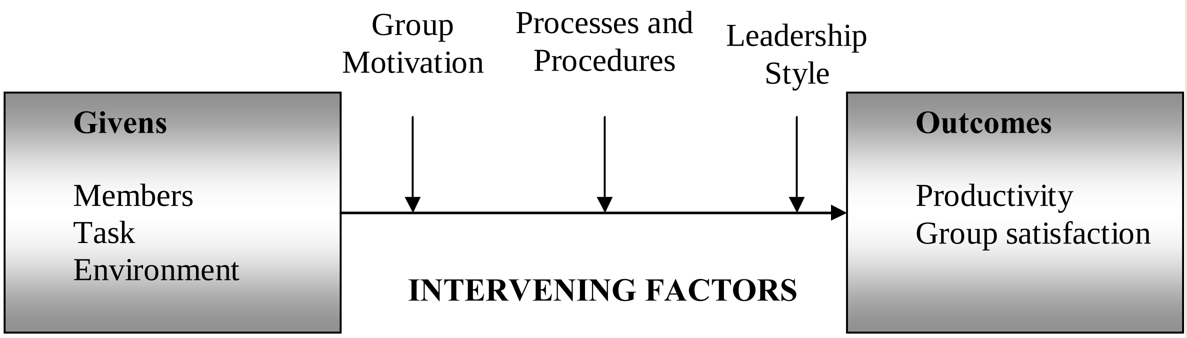
‘A collection or group of individuals who share a sense of common identity and contribute to the same common aim or purpose’.

Advantages	Disadvantages
✓ Dynamic and creative ✓ Flexible to change ✓ Improves staff morale ✓ Improves communication ✓ Group norms óunifyô members	✘ Inadequate leadership ✘ Unclear goals or objectives ✘ Personality clashes ✘ Group norms create óinsular barriersô ✘ Too many meetings to get things done ✘ Dual authority e.g. if a matrix structure exists

Bruce Tuckman’s stages of team development	**Forming**	**Storming**	**Norming**	**Performing**
	óAn inefficient collection of individualsô	óOpen conflict, a highly defensive and emotional stage.ô	óTeam conforming to norms with greater efficiency.ô	óFully integrated team, development ceases.ô

Charles Handy's contingency approach to team effectiveness

A manager cannot in the short-term vary the **'givens'** e.g. team size, members, aims and the challenges faced. Managers must use instead **'intervening factors'** to maximise the output of a team to achieve greater group productivity and satisfaction.



Examples of 'intervening factors'

- A good leader
- Clear and structured óreward systemsô
- Clear establish aims and objectives
- Common processes and procedures
- Promotion of openness and trust
- Time for a group to óintegrateô

Chapter

11 Strategic Performance Measurement

Key summary of chapter

Control theory

Feedback control 'appraisal'

- Feedback is any process where part of the output of a system is measured and returned as input to regulate the systems further output.

Feed-forward control 'prevention rather than cure'

- Feed-forward control would be a system that in a pre-emptive way, reacts to changes in its environment, normally to maintain some kind of desired state.

Hopwood's three forms of control

1. Social controls e.g. group norms, staff culture and social interaction.
2. Administration control e.g. management ‚exception reportingô systems.
3. Self control.e.g. staff exerting self-control by modifying their own behavior.

Bureaucracy

An organisation bound by an elaborate set of rules and procedures to tightly control it.

Reward

Monetary reward is an example of extrinsic reward and considered as the most important of all ‚hygiene factorsô according to Frederick Hertzberg.

Types of financial incentive schemes

- Performance related pay (PRP) systems
- Bonuses
- Profit sharing schemes

Staff appraisal

The review and assessment of an employeeÆs performance with the potential for improving effectiveness of performance through training and development.

The aims of an appraisal system

- Reward
- Performance
- Potential for development

Examples of control in the workplace

- Job descriptions, grades and authority levels
- Span of control and scalar chain
- Organisational structure
- Standardisation of work procedures
- Rules and procedures
- Disciplinary procedures
- Reward
- Dress code
- Handbook
- Induction
- Training and development
- Recruitment and selection
- Contracts
- Staff appraisal

Classical school of management contrasted to human relations approach

	'Classical School' approach	**'Human Relations' approach**
Theorists	Henry Fayol Frederick Taylor Max Weber	Elton Mayo Abraham Maslow Frederick Herzberg
History	Late 19th century	Early 20th century.
Management Style	Autocratic, lack of consultation.	Participative, democratic.
Motivation	Extrinsic Reward e.g. money.	Intrinsic Reward e.g. job enrichment.
Management Control	Carrot and stick approach.	Contented cows produce more milk.
Management Focus	Task planning and design	Human welfare and psychology.

Burns and Stalker

Characteristics of ‘organic’ verses ‘mechanistic’ organisations

	Organic	**Mechanistic**
Management Style	Participative and democratic	Autocratic and lack of consultation
Control	Informal and decentralised	Formal and centralised
Communication	Lateral (all direction)	Vertical (up and down)
Change	Flexible and adaptive	Inflexible and slow to change
Structure	Flat chain of command e.g. Matrix/Team/ entrepreneurial	Tall chain of command and clearly defined roles
Environment	Dynamic/Uncertain	Stable/Certain
Outcome	Creative	Efficient

The concept of clan/cultural control

Hofstede’s dimensions of national culture

- **Power distance.** Extent to which people accept inequality of power.
- **Uncertainty avoidance.** Tolerance towards uncertainty or ambiguity.
- **Individualism /collectivism.** óCollectivismô strong affiliation towards one another e.g. strong and cohesive groups. óIndividualismô, individuals are expected to take care of themselves e.g. a strong need for individual success.
- **Masculinity/femininity.** Men's ómasculineô values e.g. very assertive and competitive, are relatively different from women's ófeminineô values e.g. modest and caring. Masculinity is a culture with a strong need for achievement, assertiveness and materiality. Femininity is a culture where relationships, modesty and quality of life are considered more important.
- **Long-Term Orientation.** Long Term Orientation e.g. perseverance, verses Short Term Orientation e.g. protection of reputation and traditions.

The 5 dimensions of culture can help management determine

- Leadership style
- Motivation incentives
- Organisational structure
- The degree of rules and procedures

Controlling subsidiaries

- Mission statement, goals and objectives.
- Performance measurement systems
- Systems for strategic planning and control
- Management appraisal process.
- Reward
- Culture

Goold and Campbell

Goold and Campbell identified three ‘styles of strategic management’

- **Strategic planning** Senior management work closely with individual business unit managers to develop strategies for their business units.
- **Strategic control** Senior management decentralise the development of strategic plans to business unit managers.
- **Financial control** Control of strategy through a budget (financial) process e.g. financial controls and profit targets which business units are required to adhere to.

The divisional structure

A division is a distinct business set up within a larger company to ensure a certain product or market is handled and promoted as though it were a separate business.

Advantages

- ✓ Quicker decision making
- ✓ Focus on product and market performance
- ✓ Ring fencing of financial results
- ✓ More empowerment
- ✓ Good training ground for managers.
- ✓ Frees up senior management time

Disadvantages

- ✘ High cost of head office
- ✘ Duplication of functions (or departments)
- ✘ Reluctance to delegate by senior management
- ✘ Lack of goal congruence

The functions of a performance measurement system

- Publicise and communicate direction
- Control the organisation.
- Plan and allocate resources

Neely's 4Cs in performance measurement (1998)

1. Check position
2. Communicate position
3. Confirm priorities
4. Compel progress

Recommended process to develop a performance measurement system

1. Senior management ‘a clear vision of change’
2. Benchmark with other organisations
3. Participation by staff throughout the process
4. Targets/criteria should be set after consultation
5. Reward systems should be modified
6. Introduction of new appraisal procedures.
7. Training for managers and staff
8. Review and monitor the new system

Evaluating the performance of divisions

The controllability principle

The controllability principle is concerned with assessing performance based upon measures that can be controlled only by a manager and omitting any items which are uncontrollable.

Profit based methods for evaluating the performance of divisions

Operating profit (net profit) margin

$$= \frac{\text{Profit before interest and tax (PBIT)}}{\text{Turnover}} \times 100\%$$

Gross profit (sales) margin

$$= \frac{\text{Turnover less cost of sales (gross profit)}}{\text{Turnover}} \times 100\%$$

Generally the gross profit or sales margin can also be referred to as the contribution to sales (C/S) ratio e.g. gross profit (sales less variable cost) ÷ sales.

Mark up

$$= \frac{\text{Turnover less cost of sales (gross profit)}}{\text{Cost of sales}} \times 100\%$$

Return on capital employed (ROCE)

$$= \frac{\textbf{Profit before interest and tax (PBIT)}}{\textbf{Capital employed}} \times \mathbf{100\%}$$

ROCE is also referred to as return on investment (ROI) and return on net assets (RONA). ROCE measures profitability and shows how well the business is utilising its capital to generate profits.

.

Residual income (RI)

Residual income is the profit earned by a division less a ónotional interest chargeô for the investment of finance within it.

	£
Profit before interest and tax (PBIT)	X
Capital employed x head office % interest charge	(X)
Residual income	X

Residual income uses the same profit before interest and tax and capital employed value as the ROCE measure. Residual income is an absolute measure that deducts from profit before interest and tax, an imputed ónotionalô interest charge using a cost of capital or return required.

Economic value added (EVA)

Economic value added was developed by Stern Stewart & Co and is a registered trademark. EVA is an estimate of economic profit, measured as Net Operating Profit after Taxes (or NOPAT) less the money cost of capital. MVA and EVA are strongly correlated.

óThe economic value created by a division in a given period of timeô

EVA =

Net cash operating profit after tax
(óadjustedô for accounting distortions e.g. add back depreciation)
less
Economic depreciation (based on market value or replacement cost of assets)
less
Amortised R&D, advertising, marketing, goodwill, brand or new product development cost
less
(‘adjusted’ capital employed x cost of capital)

Contrasting ROI, RI and EVA

<table>
<tr><th>ROI</th><th>RI</th><th>EVA</th></tr>
<tr><td colspan="3">All measures support goal congruence for profit maximisation</td></tr>
<tr><td colspan="2">Accounting based measures</td><td>Cash based measure</td></tr>
<tr><td colspan="2">Historical accounting for non-current assets</td><td>Use of replacement cost</td></tr>
<tr><td colspan="2">Long-term expenditure
written off in the same financial period</td><td>Capitalises long-term
expenditure and amortises</td></tr>
<tr><td>Relative measure</td><td colspan="2">Absolute measures</td></tr>
<tr><td>No finance charge</td><td colspan="2">Finance charge recognised</td></tr>
</table>

Alfred Rappaport’s definition of shareholder wealth (value)

Shareholder value = corporate (business) value ï Debt

Total shareholder return (TSR)

$$TSR = \frac{\text{Dividend per share + Growth in share price}}{\text{Market share price at the start of the period}} \times 100\%$$

The increase in the share price plus the value of any dividends paid or proposed.

Market value added (MVA)

MVA is an external measure of shareholder wealth, measured by taking the rise in the market capitalisation during a period less the increase in capital invested during a period by investors. If MVA is positive, then the firm has added shareholder value. MVA and EVA are strongly correlated.

Value based management

Value based management may often be referred to as shareholder value analysis (SVA). Value based management (VBM) is an approach which focuses on strategies and actions to create more value for shareholders. Value being measured by share price (market capitalisation), dividends and other principles such as RI or EVA.

Alfred Rappaport developed seven óvalue driversô

1. Sales growth
2. Operating profit margin
3. Cash income tax rate
4. Incremental fixed capital investment rate
5. Investment in working capital rate
6. Planning period
7. Cost of capital

Managing VBM

- Strategic selection of projects which create high shareholder wealth.
- Resource allocation and funding should have a recognised opportunity cost.
- Performance targets clearly communicated.
- Reward linked and correlated to performance targets.
- Change management to facilitate implementation.
- Review of VBM system for continuous improvement.

Multidimensional performance measurement

The balanced scorecard developed by Kaplan and Norton

The four perspectives of the balanced scorecard

- **Customer perspective** e.g. what must we do right for our customers?
- **Internal perspective** e.g. what must we excel at internally?
- **Innovation and learning perspective** e.g. how can we innovate?
- **Financial perspective** e.g. how do we satisfy shareholders?

Advantages

- ✓ Long-term view of performance
- ✓ Non-financial as well as financial measures considered
- ✓ Performance measures can be ťailor madeô
- ✓ Monitor and control operations
- ✓ Communicate and publicise goals to all stakeholders
- ✓ Link to remuneration of management and staff

Disadvantages

- ✘ Historical performance no guide to the future
- ✘ Manipulation performance measures
- ✘ Costly ďbespokeô information systems support BSC
- ✘ Conflict or ťrade offô between BSC perspectives
- ✘ Too many performance measures can distort the benefits

A process to implement balanced scorecard (BSC)

1. A clear vision BSC communicated
2. Demonstration that senior management are committed to the idea
3. Education given to all managers and staff
4. Consultative meetings and presentations
5. Participation encouraged by all staff and management
6. Plan and determine how change needs to occur
7. Implement change
8. Reward and staff appraisal systems modified
9. Review and feedback obtained

The value for money (VFM) framework (the 3Es)

- Economy (Cheap)
- Efficiency (Quick)
- Effectiveness (Good)

The 6-dimensional performance matrix

Developed by Fitzgerald (1991)

Results

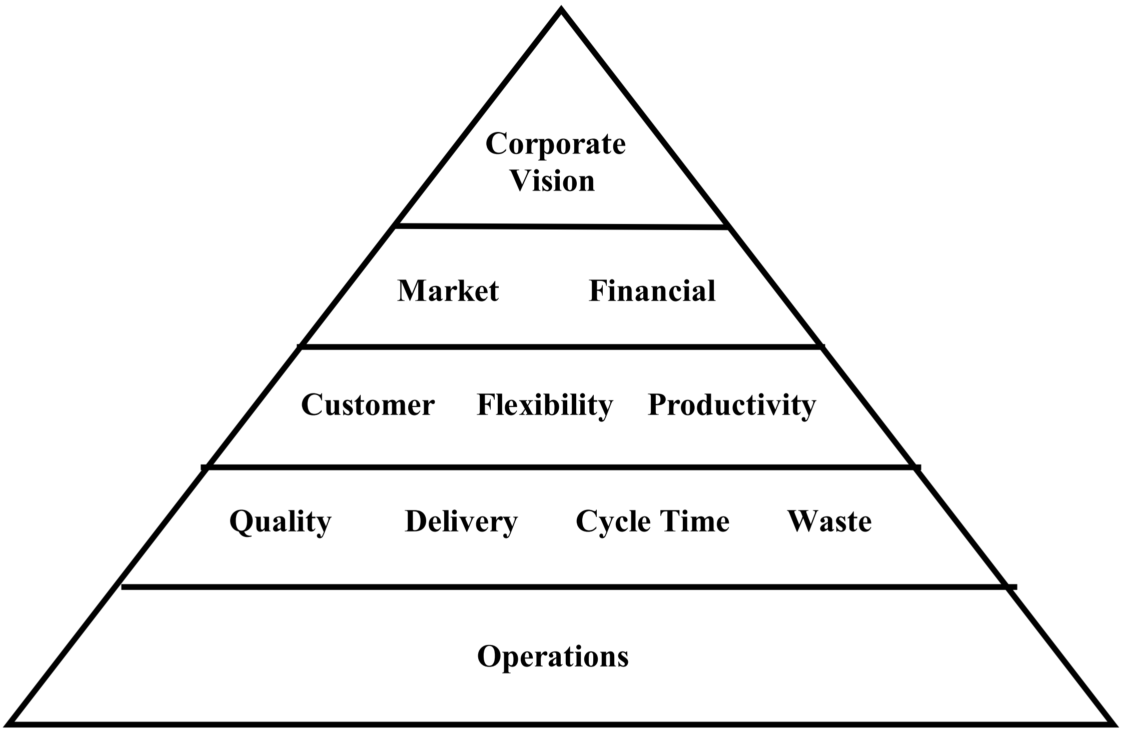
- Competitiveness
- Financial performance

Determinants

- Quality of service
- Flexibility
- Resource utilisation
- Innovation

The performance pyramid

Developed by McNair et al (1990).



Financial (ratio) analysis

The objective of financial statements is to provide information to all users of accounts to help them for decision-making. Note that most users will only have access to published financial statements.

The use of ratios

- To compare results over a period of time
- To measure performance against other organisations
- To compare results with a target
- To compare against industry averages

Limitations of ratio analysis

A ratio on its own is meaningless, accounting ratios must always be interpreted in relation to other information. Ratios based on historic cost accounts do not give a true picture of trends, because of the effects of inflation and different accounting policies. Investorsôratios particularly have a disadvantage, because investment means looking into the future and the past may not always be indicative of the future. Comparing the financial statements of similar businesses can also be misleading.

Ratios can be grouped into 3 main areas

1 Performance (profitability) – how well has the business done	
Return on capital employed (ROCE)	$\frac{\text{Profit before interest \& tax (PBIT)}}{\text{Capital employed (CE)}}$ x 100%
Operating profit margin	$\frac{\text{PBIT}}{\text{Turnover}}$ x 100%
Asset turnover	$\frac{\text{Turnover}}{\text{Total assets}}$ (number of times)
Return on equity (ROE)	$\frac{\text{Profit after tax, interest \& pref share divis}}{\text{Shareholder funds (equity)}}$ x 100%

2 Position (liquidity)– short term standing of the business	
Current ratio	Current assets (number of times) Current liabilities
Quick ratio	Current assets ï inventory (number of times) Current liabilities
Gearing - equity	Debt capital x 100% Equity (shareholders funds)
Gearing – total	Debt capital x 100% Debt + equity (total capital)
Interest cover	Profit before interest & tax (PBIT) (no of times) Interest paid
Trade payable days	Trade payables x 365 days Cost of sales (or purchases)
Inventory days	Inventory x 365 days Cost of sales
Trade receivable days	Trade receivable x 365 days Sales
Working capital cycle	Trade receivable days + inventory days ï trade payable days = working capital cycle (days)

3 Potential (investor) – what investors are looking at	
Earnings per share (EPS)	$\frac{\text{Profit after tax}}{\text{Number of shares}}$
P/E ratio	$\frac{\text{Share price}}{\text{Earnings per share}}$
Dividend yield	$\frac{\text{Dividend per share}}{\text{Share price}} \times 100\%$
Dividend cover	$\frac{\text{Earnings per share}}{\text{Dividend per share}}$

Transfer Pricing

A transfer price is a price charged for goods or services provided internally between divisions or departments in the same group or company.

The common aims of transfer pricing systems

- Motivate mangers
- Fair performance evaluation
- Promote autonomy
- Goal congruence
- To ensure optimal allocation of resources

Change transfer price	Selling Division	Buying Division	The Group
Increase transfer price	Profit increases	Profit Decreases	No change
Decrease transfer price	Profit decreases	Profit Increases	No change

International aspects to transfer pricing

- Exchange rates
- Import tariffs or quotas
- Taxation
- Worldwide prices and quality
- Other international legislation

Methods of transfer pricing

Cost based approaches

The pricing of products or services are based on their full or variable (marginal) production cost per unit.

Two-part tariff (two part charging) system

With a two-part tariff system the buyer is charged:

- A transfer price equal to the sellerǿs variable (marginal) cost
- A fixed charge per period by the seller irrespective of the amount of units sold

Market based approaches

When the external market price is used as a transfer price, a seller will always be encouraged to sell because they would be indifferent between their charging policy for internal or external customers.

Dual pricing (or two prices)

Dual transfer pricing means setting one transfer price for the internal seller and another transfer price for the internal buyer.

- **Internal seller** The transfer price received set at the external market price.
- **Internal buyer** The transfer price paid set at the sellers variable (marginal) cost.

Opportunity cost pricing

Opportunity cost pricing is considered the most mathematically correct way of viewing transfer pricing. The reason is that it looks at transfer pricing issues from a group not divisional perspective and therefore promotes goal congruence.

Minimum price for a seller

Full capacity → **Market Price**

Spare capacity → **Marginal Cost**

Maximum price for a buyer

Maximum Price

The lower of?

The external market price for the internal product or service.

The net realisable value of the buyers final product.

So long as a maximum and minimum price range can be established it indicates that internal trade should take place, any transfer price set between the range will motivate both the internal seller and buyer to do so.

Chapter

12

Numerical Skills for Strategic Evaluation

Key summary of chapter

Investment appraisal techniques

- Payback
- Accounting rate of return (ARR)
- Net present value (NPV)
- Internal rate of return (IRR)

Sensitivity analysis

Sensitivity measures the percentage change in a key input e.g. cash inflow or outflow needed, to make a project break even, in other words to have a project with a zero NPV.

Sensitivity = NPV of project ÷ PV of cash inflow or outflow

Expected values

Expected values calculate an 'average' return or an average financial calculation of some kind by the assignment of probabilities to the different returns possible. By doing so it recognises risk, something that may or may not occur.

Limitations of expected values

- ✘ Expected values are no use for one off decisions
- ✘ Expected values calculate an average return not an outcome
- ✘ Expected values rely heavily on probability estimates

Comparing projects of different time periods

The profitability index

A relative measure for a project of the NPV per £ invested.

$$\text{Profitability index} = \frac{\text{Present value of cash inflows}}{\text{Present value of cash outflows}} = \text{decimal}$$

Equivalent annual value (EAV)

The EAV is a yearly equivalent undiscounted cash-flow (assumed as an annual constant) calculated using an annuity factor for the life of the project.

$$\text{EAV (using the annuity approach)} = \frac{\text{NPV of project}}{\text{Annuity for the life of the project}}$$

Real Options as a tool for strategic analysis

Note: Complex numerical questions will not be set.

The technique of real options can be used when projects face a high degree of uncertainty. Real options analysis (ROA) applies put and call option valuation techniques to capital budgeting decisions, it is an extension of theory derived from the Black-Scholes model for valuing options, which won the 1997 Nobel prize for economics.

When applied to investment appraisal, ROA calculates mathematically óreal optionsô for such decisions as to contract, abandon, continue, expand or extend the project, it could also include the decision to switch and divert resources away to other alternative projects e.g. opportunity cost. ROA is useful for NPV projects because it forces decision makers to be explicit about the assumptions underlying their projections, it is also increasingly being applied as a tool for business strategy formulation.

Process by McKinsey & Company

1. Calculate NPV of the project without flexibility.
2. Use scenario planning to identify different óparallelô universes that may occur.
3. Identify different óoptionsô that could be exercised over the life of the project.
4. Apply approaches similar to the Black-Scholes model for valuing each option,

Capital rationing

- **Soft capital rationing** ï internal or political reasons why funds capped.
- **Hard capital rationing** ï external or real reasons why funds are capped.
- **Divisible projects** ï can invest in ópartsô of projects.
- **Non-divisible projects** ï can only invest in all or none of the projects.

The process of investment decision making

The basic stages are:

- Spend forecast
- Projects identified
- Financially evaluate projects
- Consider qualitative factors
- Best options are chosen and approved
- Monitor and control project
- Deal with risk
- Post completion audit