Tutor 2u year 2 study guide

Business Ethics (University of Greenwich)

AQA A LEVEL BUSINESS YEAR 2 COURSE COMPANION

Edition 1

Essential Topic-by-Topic Study Notes for the AQA A Level Business Year 2 Specification Content (3.7 – 3.10)

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Topic: Corporate Objectives
3.7.1 Mission, corporate objectives and strategy

What You Need to Know
The links between mission, corporate objectives and strategy Internal and external influences on corporate objectives and decisions Influences on corporate objectives should include the pressures for short termism, business ownership, the external and internal environment. The distinction between strategy and tactics

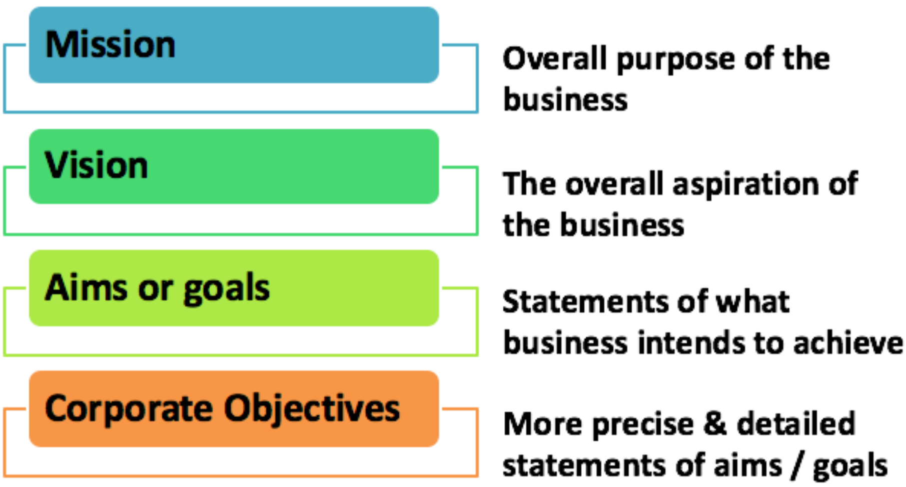
What are Objectives?
Objectives are **statements of specific outcomes that are to be achieved**

Business objectives are:

- The specific intended outcomes of business strategy
- Targets which the business adopts in order to achieve its aims

What are Corporate Objectives?
Corporate objectives are those that relate to the **business as a whole**

Corporate objective are driven and influenced by the vision, mission and aims of a business:



The main purposes of corporate objectives include to:

- Provide strategic focus
- Measure performance of the firm as a whole
- Inform decision-making (which involves strategic choice!)
- Set the scene for more detailed functional objectives

The Benefits of SMART Objectives
It is often said that objectives are more likely to be taken seriously and perhaps even achieved if they comply with the requirements of the SMART acronym. SMART stands for:

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S	**Specific**	Objective should state exactly what is to be achieved
M	**Measurable**	Objective should be capable of measurement – so that it is possible to determine whether (or how far) it has been achieved
A	**Achievable**	Objective should be realistic given the circumstances in which it is set and the resources available to the business
R	**Relevant**	Objectives should be relevant to the people responsible for achieving them
T	**Time Bound**	Objectives should be set with a realistic time-frame in mind

The Hierarchy of Objectives in Business
Corporate objectives are positioned towards the top of a hierarchy of business objectives, with the most important at the top, feeding down into more detailed tactical and operational objectives. The hierarchy can be illustrated like this:

Key Areas for Corporate Objectives and How These Are Supported by Functional Objectives

The most common aspects of a business that are impacted by corporate objectives include:

Topic: Corporate Objectives
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Area	Examples
Market	Market share, customer satisfaction, product range
Innovation	New products, better processes, using technology
Productivity	Optimum use of resources, focus on core activities
Physical & financial resources	Factories, business locations, finance, supplies
Profitability	Level of profit, rates of return on investment
Management	Management structure; promotion & development
Employees	Organisational structure; employee relations
Public responsibility	Compliance with laws; social and ethical behaviour

Lower down the objectives hierarchy, the role of functional objectives is to set targets for each key business function to help ensure that the corporate objectives are achieved.

Examples of how functional objectives might work to support corporate objectives would include:

Corporate Objective	Example Functional Objective
Increase sales	Successfully launch five new products in the next two years (**marketing**)
Reduce costs	Increase factory productivity by 10% (**operations**)
Increase cash flow	Reduce the average time taken by customers to pay invoices from 75 to 60 days (**finance**)
Improve customer satisfaction	Achieve a 95% level of high customer service (**people**)

Internal and External Influences on Corporate Objectives
Corporate objectives are influenced by a variety of factors that are within the control of management (internal) as well as factors that a business can do nothing about – except respond to them if significant (external).

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The key internal and external influences can be summarised as follows:

Internal influences:

Internal Influence	Comment
Business Ownership	Who are the business owners and what do they want to achieve?
Attitude to Profit	Is the business run to earn profits or it is not-for profit?
Ethical Stance	Do ethics play a role in a business' decision-making?
Organisational Culture	How is the business structured? How are objectives set and decisions taken?
Leadership	How strong is the influence of leadership in the business in terms of objectives and how decisions are made?
Strategic position & resources	What options & choices does the business realistically have based on its existing market position & resources?
Stakeholder influence	How influential are internal stakeholders?

External influences:

Internal Influence	Comment
Short-termism	External investor pressure to focus on and achieve short-term objectives at the expense of long-term strategy?
Economic environment	Perspective on key economic indicators such as economic growth, consumer spending & interest rates?
Political / legal environment	Impact of uncertainty about changes in the political & legal environment?
Competitors	Do competitor actions & strategies shape what a business thinks it can achieve?
Social & Technological change	How rapid is the pace of social & technological change in a business' markets? Does this make objective-setting & decision-making easier or harder?

What is Short-termism?
Short-termism is where a business **prioritises short-term rather than long-term performance.**

There are various reasons why the management of a business might be more concerned more with how the business performs in the short, rather than the long-term. These might include:

- Stock market (investor) focus on latest financial performance (e.g. shareholder pressure to see a rising share price)

- Bonuses and other financial incentives for management that are largely based on short-term performance
- Frequent changes in leadership & strategy (e.g. through takeover)

A short-termist approach is likely to involve management focusing on the following performance measures:

- Share price and market capitalisation
- Revenue growth
- Gross & operating profit
- Unit costs & productivity
- Return on capital employed

If you were looking for possible symptoms of short-termist management you might identify this from features such as:

- Low investment in R&D (particularly compared with competitors who make take a more long-term approach)
- High dividend payments rather than reinvesting profits
- Overuse of takeovers rather than internal growth

A common criticism of short-termism is that it does not focus a business on what it needs to do in order to build a sustainable competitive advantage. For example, some of the following performance measures might be considered to be more appropriate for a business taking a long-term rather than short-term perspective:

- Market share
- Quality (including reputation)
- Innovation
- Brand awareness and strength
- Employee skills & experience
- Social responsibility & sustainability

What is the Difference between Strategy and Tactics?
The key differences between strategy and tactics can be summarised as follows:

Strategy	**Tactics**
How the business intends to achieve its objectives Usually long-term Made by senior management	Support achievement of specific targets Usually routine and short-term Often delegated to junior management

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Some examples of decisions that are either strategic or tactical might include:

Strategic Decision	**Tactical Decision**
External growth via takeover	Relocate staff from takeover HQ
Enter international market	Choose locations in new market
Adopt cost minimisation strategy	Identify specific cost savings
Rebrand the business	Launch rebranding campaign
Close a major business unit	Determine detailed closure plan

Key Terms

Corporate objectives	Business objectives that relate to the performance of the business as a whole, which for the focus for business strategy decisions
Short-termism	Where the management of a business is predominantly focused on the short-term performance of the business, potentially to the detriment of long-term performance

Topic: SWOT Analysis
3.7.1 Mission, corporate objectives and strategy

What You Need to Know
The value of SWOT analysis

Introduction to SWOT Analysis
SWOT analysis is a method for **analysing a business, its resources, and its environment.**

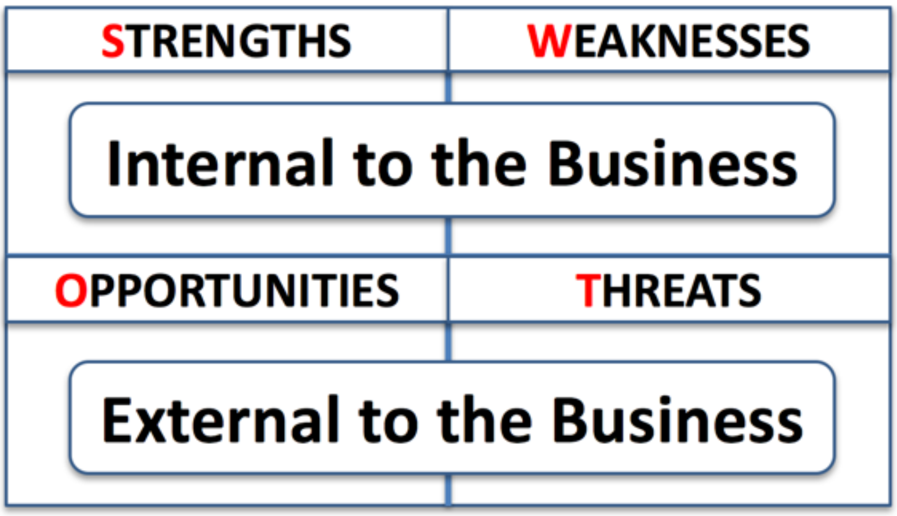
SWOT is commonly used as part of strategic planning and looks at:

- Internal strengths
- Internal weaknesses
- Opportunities in the external environment
- Threats in the external environment

SWOT analysis can help management in a business discover:

- What the business does better than the competition
- What competitors do better than the business
- Whether the business is making the most of the opportunities available
- How a business should respond to changes in its external environment

The result of the analysis is a **matrix** of positive and negative factors for management to address:



The key point to remember about SWOT is that:

Strengths and weaknesses

- Are internal to the business – they are within the control of the business
- Relate to the present situation

Opportunities and threats

- Are external to the business
- Relate to changes in the environment which will impact the business

Topic: SWOT Analysis
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Strengths

Strengths are:

- Things a business is good at
- A characteristic giving a business an important capability
- Sources of clear advantage over rivals
- Distinctive competencies and resources that will help the business achieve its objectives

Importantly, when it comes to determining strategy:

- Strengths help to build up competitive advantage and serve as a cornerstone of strategy
- Strengths should be protected and built upon

Here are some examples of possible business strengths:

Examples of Potential Business Strengths	
High market share Achieving economies of scale High quality Leadership & management skills Financial resources Research and development capabilities	Technological leadership Brand reputation Protected IP Distribution network Employee skills High productivity Flexibility of production

Weaknesses

Weaknesses are:

- A source of **competitive disadvantage**
- Things the business lacks or does poorly
- Factors that place a business at a disadvantage
- Issues that may hinder or constrain the business in achieving its objectives

Management should seek ways to reduce or eliminate weaknesses before they are exploited further by the competition. Importantly, **weakness should be seen as areas for improvement.**

Here are some examples of possible business weaknesses:

Examples of Potential Business Weaknesses	
Low market share Inefficient plant Outdated technology Poor quality Lack of innovation A weak brand name High costs	Cash flow problems Undifferentiated products Inadequate distribution Low productivity Skills shortages De-motivated staff Products at the decline stage of product life cycle

Opportunities

Topic: SWOT Analysis
3.7.1 Mission, corporate objectives and strategy

An opportunity is any feature of the external environment which **creates positive potential for the business to achieve its objectives**.

Possible sources of business opportunities in most industries and markets include:

Potential Business Opportunities	
Technological innovation	Higher economic growth
New demand	Trade liberalisation
Market growth	Diversification opportunities
Demographic change	Deregulation of the market or other legislative change
Social or lifestyle change	
Government spending programmes	

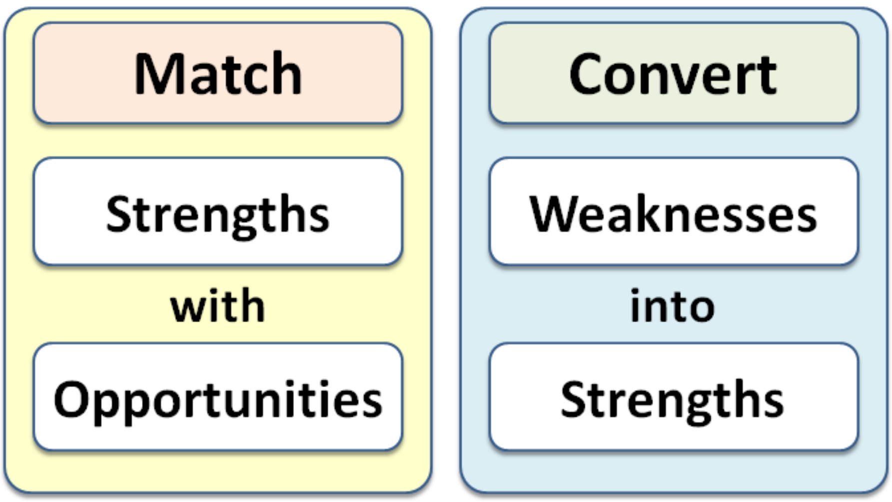
Threats
Threats are any **external development** that may hinder or prevent the business from achieving its objectives.

Possible sources of business threats include:

Potential Business Threats	
New market entrants	Economic downturn
Change in customer tastes or needs	Rise of low cost production abroad
Demographic change	Higher input prices
Consolidation among buyers	New substitute products
New regulations	Competitive price pressure

The Value of Using SWOT analysis
There is no point producing a SWOT analysis unless it is **actioned!** SWOT analysis should be more than a list - **it is an analytical technique to support strategic decisions**

Strategy should be devised around strengths and opportunities and the key words are **match and convert**:



Topic: SWOT Analysis
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Weakness	Possible Response
Outdated technology	Acquire competitor with leading technology
Skills gap	Invest in training & more effective recruitment
Overdependence on a single product	Diversify the product portfolio by entering new markets
Poor quality	Invest in quality assurance
High fixed costs	Examine potential for outsourcing or offshoring

A key challenge for any business is to convert weaknesses into strengths. Don't forget also that for every perceived threat, the same change presents an opportunity for other businesses.

Evaluating SWOT Analysis
SWOT analysis is widely and effectively used in business management. The key advantages and disadvantages of using it can be summarised as follows.

Advantages of SWOT	Disadvantages of SWOT
Easy to understand	Too often lacks focus or contains too many elements
Logical structure	Can quickly get out of date
Focuses on strategic issues	Is it an independent assessment?
Encourages analysis of external environment	

Key Terms

Strengths	Features within the control of a business that are a source of competitive advantage
Weaknesses	Features within the control of a business that are a source of competitive disadvantage
Opportunities	Features of the external environment that create opportunities for a business to leverage its strengths to benefit the business
Threats	Features of the external environment that threaten the performance and position of a business if not addressed

Topic: Mission Statements
3.7.1 Mission, corporate objectives and strategy

What You Need to Know
Influences on the mission of a business The links between mission, corporate objectives and strategy

What is a Mission Statement?
The mission of a business is the **overriding purpose of the business and the reason for its existence.** The concept of mission supports the stated "vision" for the future of the business.

Therefore, the business mission is not about:

- The goals or objectives of the business
- The core values that underpin the culture of the business
- How the business intends to compete or position itself in the market

The mission of a business is usually expressed in a "mission statement"

Where the Mission Statement Fits with Objectives and Strategy
The mission is a key part of the hierarchy of business objectives, as illustrated below:

What Makes for an Effective Mission Statement?
In order for a mission statement to be effective it needs to:

- Provide a clear sense of business purpose
- Excite, inspire, motivate & guide the intended audience
- Be easy to understand and remember
- Help differentiate the business from competitors
- Be designed for all relevant stakeholders - not just shareholders and managers

Topic: Mission Statements

3.7.1 Mission, corporate objectives and strategy

Example Mission Statements

Here are some example mission statements for well-known businesses:

Business	Mission Statement
Alibaba	To make it easy to do business everywhere
Amazon	To be Earth's most customer-centric company where people can find and discover anything they want to buy online.
Coca-Cola	To refresh the world in mind, body and spirit To inspire moments of optimism and happiness through our brands and actions To create value and make a difference.
HP	Our mission is to deliver seamless, secure, context-aware experiences for a connected world
Ikea	Our vision is to create a better everyday life for the many people
Microsoft	Our mission is to enable people and businesses throughout the world to realize their full potential
Nike	To bring inspiration and innovation to every athlete in the world
Oxfam	To create lasting solutions to poverty, hunger, and social injustice
Starbucks	To inspire and nurture the human spirit – one person, one cup and one neighborhood at a time
Uber	Transportation as reliable as running water, everywhere for everyone

Criticisms of Mission Statements

Not every mission statement is as relevant or focused as the examples above.
Common criticisms of mission statements include:

- They are not always supported by actions of the business (i.e. there is a disconnect between what the mission states and what a business actually does)
- Often too vague and general or merely statements of the blindingly obvious
- They are created largely for public relations purposes rather than acting as a focus for business strategy
- Over time they are treated quite cynically by stakeholders, particularly employees

Key Terms

Mission Statement	A statement of the defining purpose of a business or organisation

Topic: Liquidity (Current Ratio)
3.7.2 Financial Ratio Analysis

What You Need to Know
Financial ratio analysis to include: liquidity (current ratio)

What is Liquidity?
Liquidity is concerned with the ability of a business to be able to pay its way – to settle liabilities such as the monthly payroll, amounts due to suppliers and taxes collected on behalf of government and so on.

What is a Liquidity Ratio?
A liquidity ratio assesses whether a business has sufficient cash or equivalent current assets to be able to pay its debts as they fall due.

Where Does the Data to Calculate Liquidity Ratios Come From?
All the financial information you need to calculate a liquidity ratio is contained within the Statement of Financial Position (aka Balance Sheet):

Income statement	Measures business **performance** over a given period of time, usually one year. It compares the income of the business against the cost of goods or services and expenses incurred in earning that revenue
Statement of Financial Position (Balance Sheet)	A **snapshot** of the business' assets (what it owns or is owed) and its liabilities (what it owes) on a particular day
Cash flow statement	This shows how the business has generated and disposed of cash and liquid funds during the period under review

Calculating Liquidity Ratios
We calculate liquidity ratios by comparing the ratio of current assets and current liabilities. Here's a reminder of what the key parts of each of these two are:

On the top are current assets: which include cash, inventories and trade receivables (or trade debtors –i.e. amounts owed by customers)

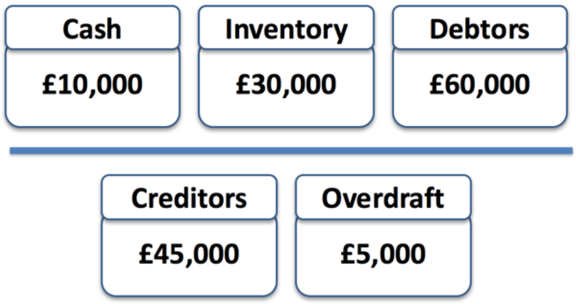
On the bottom are current liabilities, which include amounts owed to suppliers and any bank overdraft balances (money owed to the bank)

The classic liquidity ratio is known as the **current ratio.** This is calculated very simply by **dividing current assets by current liabilities.**

Topic: Liquidity (Current Ratio)

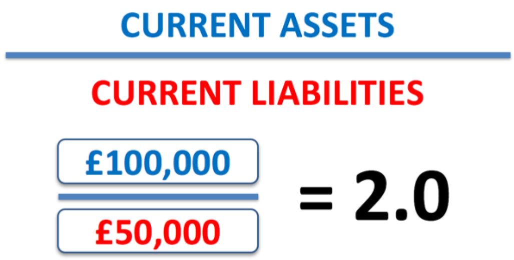
3.7.2 Financial Ratio Analysis

Let’s look at a simple example of this in action, using the following data:



Calculating the two totals we need for current assets and current liabilities gives us:

Now, simply divide current assets by current liabilities to get the current ratio:



Evaluating the Current Ratio

- A ratio of 1.5 - 2.5 would suggest acceptable liquidity & efficient management of working capital
- Low ratio (e.g. well below 1) indicates possible liquidity problems
- High ratio: suggests too much working capital tied up in inventories or debtors?

However, don’t forget that:

- The industry or market matters – they have different requirements for holding inventories, or approaches to trade debt and credit
- How does the current ratio compare with competitors?
- The trend is more important - a sudden deterioration in current ratio is a good indicator of liquidity problems

Key Terms

Liquidity	The ability of a business to settle amounts it owes

Topic: Efficiency Ratios
3.7.2 Financial Ratio Analysis

What You Need to Know
Financial ratio analysis to include: efficiency ratios: payables days, receivables days, inventory turnover

What are Efficiency Ratios?
Financial efficiency ratios analyse how effectively a business is **managing its assets**

The three most commonly used efficiency ratios are:

Inventory Turnover	Measures how often each year a business sells and replaces its inventory
Payables Days	Measures the The average length of time taken by a business to pay amounts it owes
Receivables Days	Measures the average length of time taken by customers to pay amounts owed

Inventory Turnover
Remember that inventories (or "stocks") are the raw materials, work-in-progress and finished goods held by a business to enable production and meet customer demand.

The inventory turnover ratio is calculated using this simple formula:

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Inventories}}$$

Here are two worked examples of the calculation using real data from two very different companies – Rolls Royce and Tesco:

£millions	**Rolls Royce plc**		**Tesco plc**	
	This Year	**Last Year**	**This Year**	**Last Year**
Cost of Sales	10,459	10,533	51,579	59,128
Inventory	2,637	2,768	2,430	2,957
Inventory Turnover	4.0 times	3.8 times	21.2 times	20.0 times

As you can see from the data in table above, there is a significant difference between the inventory turnover ratios for Rolls Royce (an engineering firm) and Tesco (a supermarket chain).

Some sectors like engineering, construction and industrial distribution will typically have low inventory turnover, whereas inventory turnover in retailing, fast-food & restaurants and motor vehicle production is much higher. This needs to be borne in mind when comparing the inventory turnover ratios of different businesses.

Therefore, when evaluating the results of inventory turnover calculations remember that:

Topic: Efficiency Ratios
3.7.2 Financial Ratio Analysis

- Inventory turnover varies from industry to industry
- Holding more inventory may improve customer service & allow the business to meet demand
- Seasonal fluctuations in demand during the year may not be reflected in the calculations
- Inventory turnover is not relevant to most service businesses

How can a business improve (i.e. increase) its inventory turnover? One or more of the following might be an option:

- Sell-off or dispose of slow-moving or obsolete inventory
- Introduce lean production techniques to reduce amounts of inventory held
- Rationalise the product range made or sold
- Negotiate sale or return arrangements with suppliers – so inventory can be returned if it does not sell

Payables & Receivables Days
These two ratios are concerned with how quickly payments are made (to creditors) and received (from customers) and they use very similar formulae:

$$\text{Payables Days} = \frac{\text{Trade payables}}{\text{Cost of sales}} \times 365$$

$$\text{Receivables days} = \frac{\text{Trade receivables}}{\text{Revenue (sales)}} \times 365$$

Note: both these ratios are expressed in terms of "days". A worked example of both is shown in the table below:

Trade receivables = £25,000	Trade payables = £75,000
Revenue = £150,000	Cost of sales = £500,000
Debtor days = 60.8 days	Payables days = 54.7 days

Evaluating Receivables & Payables Days

Receivables Days	**Payables Days**
Interpreting the results:	***Interpreting the results:***
Shows average time customers take to pay Each industry will have a "norm" Look out for significant changes	In general, a higher figure is better for cash flow Ideally, payable days is higher than receivable days Be careful: a high figure may suggest liquidity problems (stretching supplier goodwill)
Look out for:	***Look out for:***
Comparisons (good or bad) v competitors Balance sheet window-dressing	Evidence from the current ratio or acid test ratio that business has problems paying creditors Window-dressing: this is easiest figure to manipulate

Topic: Profitability (Return on Capital Employed)

3.7.2 Financial Ratio Analysis

What You Need to Know
Financial ratio analysis to include: Return on capital employed (ROCE)

What is Return on Capital Employed?
ROCE is a measure of relative profitability.

ROCE tells us what returns (profits) the business has made on the resources available to it. ROCE is particularly useful as a ratio as it helps:

- Evaluate the overall performance of the business
- Provide a target return for individual projects
- Benchmark performance with competitors

Calculating ROCE
To calculate ROCE, you need information about the amount of profit earned in a particular period (usually a year), which you get from the Income Statement. To calculate Capital Employed, you need information from the Statement of Financial Position (Balance Sheet). ROCE is then calculated using the following formula:

$$\textbf{ROCE (\%)} = \frac{\text{Operating Profit (or Net Profit)}}{\text{Total Equity + Non-Current Liabilities}} \times 100$$

A worked example of this formula is provided in the table below:

£'000	COMPANY X	COMPANY Y
Non-Current Liabilities	500	700
Share Capital	1,000	1,000
Reserves	250	1,500
Total Equity	1,250	2,500
Operating Profit	400	600
ROCE Calculation:	400 / (1,250 + 500)	600 / (2,500 +700)
ROCE %	22.8%	18.7%

Evaluating ROCE
Key points to remember are:
- ROCE will vary between industries; ROCE is a particularly important measure in capital-intensive industries with significant amounts of capital employed!
- ROCE is based on a snapshot of a business' balance sheet
- Comparisons over time and with key competitors are most useful

Topic: Gearing
3.7.2 Financial Ratio Analysis

What You Need to Know
Financial ratio analysis - gearing

What is "Gearing"
"Gearing" measures the proportion of a business' capital (finance) provided by **debt**

What is the Capital Structure of a Business?
The capital of a business represents the finance provided to it to enable it to operate over the long-term. There are two parts to the capital structure: equity and debt

Equity Finance	**Debt Finance**
Amounts invested by the owners of the business	Finance provided to the business by external parties:
Examples: Share capital Retained profits	Examples: Bank loans Other long-term loans

What Factors Influence the Mix of Equity and Debt in a Financial Structure?
These factors can be summarised as follows:

Reasons for Higher Equity	**Reasons for Higher Debt**
Where there is greater business risk (e.g. a startup) Where more flexibility required (e.g. don't have to pay dividends)	Where interest rates are very low = debt is cheap to finance Where profits and cash flows are strong; so debt can be repaid easily

Measuring the Level of Debt in a Business Using the Gearing Ratio
The proportion of a business' finance that is debt is measured by what is known as the **gearing ratio.**

The key benefits to calculating the gearing ratio include:

- A useful measure of the financial health of a business
- Focuses on the level of debt in the financial structure of a business
- A high gearing ratio can mean higher risk of business failure (but not always)

Worked Example of How to Calculate & Analyses the Gearing Ratio
Let's look at how to calculate & analyse the gearing ratio by considering the following information about two businesses: Company A & Company B:

£million	**Business A**	**Business B**
Non-Current Liabilities (A)	200	500
Total Equity (B)	600	300
Equity + Non-Current Liabilities (A + B)	800	800

Topic: Gearing
3.7.2 Financial Ratio Analysis

The formula for calculating the gearing ratio is as follows

$$\text{Gearing \%} = \frac{\text{Non-current liabilities}}{\text{Total equity + non-current liabilities}} \times 100$$

Applying this formula to the financial data for Business A & B, the gearing ratio can be calculated as follows:

£million	**Business A**	**Business B**
Non-Current Liabilities (A)	200	500
Total Equity (B)	600	300
Equity + Non-Current Liabilities (A + B)	800	800
Gearing (A) / (A + B)	200 / 800	500 / 800
Gearing %	**25%**	**62.5%**

As you can see, Business B has much higher gearing (62.5%) than Business A (25%). Is this a bad thing? As always, it depends!

- A gearing ratio of 50%+ is normally said to be high
- A gearing ratio of less than 20% is normally said to be low
- However, the level of acceptable gearing depends on the business & industry

The relative merits of high or low gearing can be summarised as follows:

Benefits of High Gearing	**Benefits of Low Gearing**
Less capital required to be invested by the shareholders Debt can be a relatively cheap source of finance compared with dividends Easy to pay interest if profits and cash flows are strong	Less risk of defaulting on debts Shareholders rather than debt providers "call the shots" Business has the capacity to add debt if required

Key Terms

Gearing	The proportion of a business' capital structure that is in the form of debt
Equity	The proportion and amount of the capital structure that is provided by shareholders or left as retained profits

Topic: Role, Value and Limitations of Financial Ratios

3.7.2 Financial Ratio Analysis

What You Need to Know
The value of financial ratios when assessing performance

What is Ratio Analysis?
Ratio analysis involves the **comparison** of **financial data** to gain insights into **business performance**

Ratio Analysis Helps Answer Questions Such As
Why is one business more profitable than another?
What returns are being earned in investment in a business?
Is a business able stay solvent?
How effectively is a business using its assets?

The Importance of Comparison and Trends
It is important to remember that calculating just one ratio is rarely enough if you are to gain useful insights into the financial performance of a business. Effective ratio analysis means you:

- Need to compare with competitors
- Need to analyse over time (trends)

Where Information for Ratio Analysis Comes From?
The financial accounts of a business are the source of the information you need for ratio analysis:

Income Statement (Profit & Loss Account)	**Statement of Financial Position (Balance Sheet)**
Revenues Cost of Sales Gross Profit Operating Profit Net Profit (Profit for the Year)	Current assets Current liabilities Inventories Trade receivables & payables Long-term liabilities Capital & reserves

Ratios perform different purposes and can be grouped into three main types:

Profitability	Liquidity	Financial Efficiency
• Gross profit margin • Operating profit margin • Return on Capital Employed	• Current ratio • Acid-test ratio	• Payables Days • Receivables Days • Inventory turnover • Gearing

Topic: Role, Value and Limitations of Financial Ratios
3.7.2 Financial Ratio Analysis

The key users of these ratio types include:

Limitations of Ratios
Whilst ratio analysis is widely used, it is important to understand some of the key limitations of ratios and also what financial ratios don't measure!

Key limitations include:

- One data set is not enough – ratio data over a period of time is much better
- How reliable is the financial data? (see below)
- Ratios are based on the past – they are not a predictor of the future
- Comparability – be careful with comparing ratios, for example, between different industries

Which might the financial data used in ratios not be wholly reliable?

- Financial information involves making subjective judgements
- Different businesses have different accounting policies
- Potential for manipulation of accounting information (e.g. window-dressing)

Remember that financial ratios are concerned with financial data. So they don't tell you directly about how well a business is performing in areas such as:

- Competitive advantages: e.g. brand strength
- Quality
- Ethical & CSR reputation
- Human resource management

Topic: Balanced Scorecard

3.7.3 Analysing the Overall Performance of a Business

What You Need to Know
Methods of assessing overall business performance to include: Kaplan and Norton's Balanced Scorecard model

What is the Balanced Scorecard?

The balanced scorecard provides a **relevant range of financial and non-financial information** that supports effective business management.

Background to the balanced scorecard

- It is important to recognise that no single measure can give a broad picture of the health or performance of a business
- So instead of a single measure, why not a use a composite scorecard involving a number of different measures. That is the basis for a "balanced scorecard" or business performance
- **Kaplan and Norton** devised a framework based on **four perspectives** – financial, customer, internal and learning and growth.
- Kaplan & Norton argued that the business should then select critical performance measures for each of these perspectives.

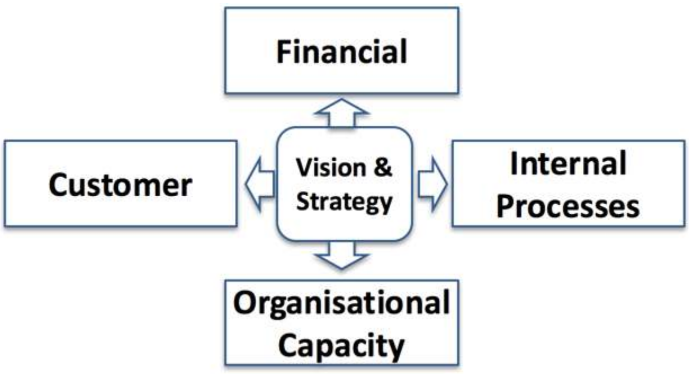
Kaplan & Norton themselves defined the purpose of the Balanced Scorecard as: "To align business activities to the vision and strategy of the business, improve internal and external communications, and monitor business performance against strategic goals."

Overview of the Balanced Scorecard

Key points to remember are:

- Scorecard is a system of corporate appraisal which looks at financial and non-financial elements from a variety of **perspectives.**
- An approach to the provision of information to management to assist strategic policy formation and achievement.
- It provides the user with a set of information which addresses all relevant areas of performance in an **objective and unbiased fashion.**
- A set of measures that gives top managers a fast but comprehensive view of the business.

The Four Perspectives of the Balanced Scorecard



Some examples of how these perspectives might be used to measure and assess **key performance indicators** might be:

Perspective	Focus	Example KPIs
Financial	Financial Performance	ROI Operating Margin
Customer	Customer Satisfaction	Level of returns Service rating
Internal Processes	Business Efficiency	New product lead time Unit costs
Organisational Capacity	Knowledge & Innovation	Employee retention Flow of NPD ideas

Benefits and Drawbacks of the Balanced Scorecard
The overall usefulness of using a balanced scorecard to measure business performance can be summarised as:

Benefits	Drawbacks
Broader view of business performance Links performance measurement to long-term (mission & vision) Involves everyone in the business (not just financial stakeholders) Highly flexible – KPIs chosen by the business	Danger of too many KPIs Need to have balance between the four perspectives – not easy Senior management may still be too concerned with financial performance Needs to be updated regularly to be useful

Key Terms

Balanced scorecard	A range of financial and non-financial performance measures that provide key insights from the perspective of customers, internal processes, organisational capacity and finance.
Key Performance Indicators (KPIs)	A performance metric that can be used to assess and evaluate the performance of a business or organisation

Topic: Non-Financial Performance Data
3.7.3 Analysing the Overall Performance of a Business

What You Need to Know
How to analyse data other than financial statements to assess the strengths and weaknesses of a business Data other than financial statements should include operations, human resource and marketing data

Why Non-Financial Data is Important – the Limitations of Financial Data in Assessing Business Performance
Though widely-used, there are limitations with relying on analysis of financial data in assessing business performance. These limitations include:

- Financial ratios tend to **look backwards** – at historical financial performance
- Financial ratios focus on measures that are possibly most important to shareholders than business management or other stakeholders
- Financial data is not solely the best way of understanding how a business is performing in terms of key **competitive performance**
- Financial data tends to be more **short-term in focus**, whereas the value of a business is often built over the longer-term

Key Areas of Non-Financial Performance Data
Some of the most important and widely-used non-financial measures of business performance are shown in the table below. You will be familiar with many of these from your studies of the main functional areas of business in addition to finance, namely, **operations, human resource management and marketing**

Operations	**HRM**	**Marketing**
Efficiency (unit costs) Labour productivity Capacity utilisation Break-even output Quality (reject rate) Quality (lead time)	Labour turnover Labour productivity Unit labour costs Absenteeism rate Revenue per employee Staff retention rate Job satisfaction	Market share Sales per employee Sales growth (volume) Customer retention rate Brand reputation & awareness

In addition to the above non-financial performance measures, a business might also useful track metrics concerned with:

- Environmental performance
- Compliance regulation
- Health & safety record
- Social media reach and engagement

How Financial and Non-Financial Measures Are Connected
A key skill for business managers (and for A Level Business students) is to understand the relationship between financial and non-financial measures.

It is often possible to explain and interpret changes in financial measures by reference to related non-financial data.

For example:

Financial Measure	**Related Non-Financial Measures**
E.g. an improving operating profit margin compared with key competitors might indicate one or more of these non-financial measures	***Potentially linked to:*** Higher market share Economies of scale (lower unit costs) Improved product quality Increasing customer retention & loyalty Lower labour turnover & higher labour productivity

Topic: Elkington Triple Bottom Line
3.7.3 Analysing the Overall Performance of a Business

What You Need to Know
The value of different measures of assessing business performance: to include Elkington's Triple Bottom Line (Profit, People, Planet)

What is the "Triple Bottom Line"?
The Triple Bottom Line is a concept that encourages the assessment of overall business performance based on three important areas: **Profit, People and Planet**

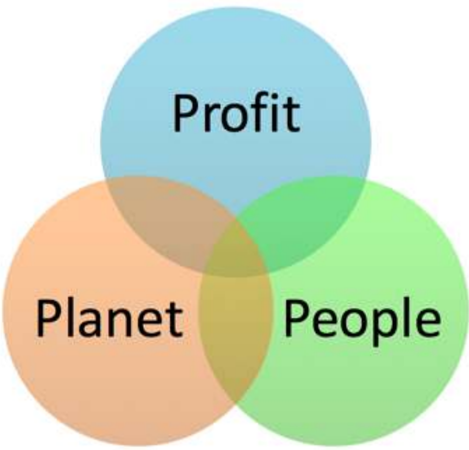
Limitations with Traditional Measures of Business Performance
The Triple Bottom Line approach (Profit, People and Planet) arose out of frustration with traditional, financially-focused measures of business performance, which have tended to emphasise profit as the key metric

- Businesses are usually assumed to be profit-maximisers
- Profit is the traditional measure of business success
- Profit is closely linked with business value (e.g. share price and market capitalisation)
- Profit is often the basis for financial incentives (e.g. senior management bonuses)

Is there More to Business Success than Profit?
In his model, John Elkington argues for a more balanced approach to measuring performance over time:

So **Profit, People and Planet** aims to measure the financial, social and environmental performance of a business over a period of time.

Profit	Familiar to managers Identified from income statement (profit and loss account) Audited = reliable figure
Planet	Measures the impact of business activity on the environment More tangible – e.g. emissions, use of sustainable inputs
People	Measures extent to which business is socially responsible Harder to calculate & report reliably & consistently



Topic: Elkington Triple Bottom Line

3.7.3 Analysing the Overall Performance of a Business

Benefits of Measuring the Triple Bottom Line

The potential benefits of measuring a broader scope of business performance based on Profit, Planet & People include:

- Encourages businesses to think beyond narrow measure of performance (profit)
- Encourages CSR reporting
- Supports measurement of environmental impact & extent of sustainability

Criticisms of The Triple Bottom Line

Amongst the criticisms that have been made of Elkington's model are:

- Not very useful as an overall measure of business performance
- Hard to reliably and consistently measure People & Planet bottom-lines
- No legal requirement to report it – so take-up has been poor

Key Terms

Corporate social responsibility	Where businesses address social and environmental considerations as part of their normal business activities.
Sustainable business	Business activity that does not degrade the long-term resources of the planet

Topic: Core Competencies
3.7.3 Analysing the Overall Performance of a Business

What You Need to Know
The importance of core competences

What is a Core Competence?
A core competence is something **unique** that a business has, or can do, **strategically well**. The concept of core competencies was first developed by Hamel & Prahalad who argued that:

"The key to competing in the future is building, deploying, protecting and defending core competencies…"

You can see, therefore, that core competencies link closely with the idea of business strengths, which you have studied as part of SWOT analysis.

Core competencies are:

- The **collective learning** within the business
- The ability of a business to **integrate skills and technologies**
- The ability of a business to **deliver superior products and services**
- Ways a business is differentiated to be competitive

Some examples of ways that well-known businesses have developed and sustained core competencies are highlighted below:

Business	**Core Competencies**
Ikea	Innovative design capabilities Unique organisational culture
Apple	Integrated ecosystem of software & devices Design built around the user
Dominos Pizza	Integration of multi-channel systems A profitable and proven franchise model
Starbucks	Localised customer experience Differentiated global brand

Topic: Core Competencies

3.7.3 Analysing the Overall Performance of a Business

What Counts as a Core Competence?

According to Hamel & Prahalad, a core competence need to satisfy three criteria:

- It provides benefits for consumers
- It is not easily copied by competitors
- It can be leveraged widely to many products & markets?

Criticisms of the Idea of Core Competencies

Whilst Hamel & Prahalad's work on core competencies is widely respected, their theory has come in for some criticism. The main criticisms are:

- By encouraging business to focus on their core competencies, many larger firms took this as a sign that they needed to outsource non-core business activities. It is argued that over-zealous outsourcing has damaged business competitiveness
- It is, of course, difficult to identify core competencies that are genuinely unique to any one particular business
- It is possible for a business to become complacent about its core competencies, believing them to be unique, only to find that a competitor has acquired the same abilities!

Key Terms

Core competencies	Things that are unique that a business has, or can do, strategically well, which provide a source of competitive advantage.

Topic: Political & Legal Change

3.7.5 Political & Legal Change

What You Need to Know
The impact of changes in the political and legal environment on strategic and functional decision making The political and legal environment should include a broad understanding of the scope and effects of UK and EU law related to competition, the labour market and environmental legislation

Important note for students:
The AQA A Level Specification was completed before the UK voted to leave the EU on 23 June 2016. Brexit will involve significant changes in the legislative and regulatory environment for businesses.

Introduction to Legislation

Government legislation is one important part of the overall external environment.

You do not need to be an expert in the areas of legislation covered in this part of the specification. What is needed is more of an overview of the key areas where legislation impacts business activity. The key points for each are set out below.

Main roles of business legislation

Legislation as it relates to business is designed to:

- Regulate the rights and duties of people carrying out business in order to ensure fairness
- Protect people dealing with business from harm caused by defective services
- Ensure the treatment of employees is fair and un-discriminatory
- Protect investors, creditors and consumers
- Regulate dealings between business and its suppliers
- Ensure a level playing field for competing business

Employee protection

The key areas impacting on business are those relating to individual employment (particularly pay and discrimination) and industrial disputes.

Equal pay

The basic rule: men and women are entitled to equal pay for work of equal value

- "Pay" includes everything in the employment contract - bonuses and pension contributions, as well as basic wages or salary
- Workers have the right to ask their employer for information to check equality – using the equal pay questionnaire
- If they believe their pay is unequal, they can take the employer to an **Employment Tribunal**

Minimum wage

- Employers are required by law to ensure they pay their workers at least the national minimum wage (NMW)
- Makes no difference when a worker is paid (monthly, weekly, daily, hourly). The NMW still applies

Topic: Political & Legal Change

3.7.5 Political & Legal Change

Discrimination

It is illegal for an employer to discriminate against an employee on the basis of:

- Sex, including pregnancy and maternity
- Marital / civil partnership status
- A person's disability
- Race
- Age
- Sexual orientation
- Religion/belief
- Trade union membership or non-membership
- Status as a fixed-term or part-time worker

Employment rights

Laws provide a variety of "rights" for employees, including:

- Reasonable notice before dismissal
- Right to redundancy
- Right to a written employment contract
- Right to request flexible working
- Right to be paid national minimum wage
- Right to take time off for parenting

Industrial relations

- Protection from unfair dismissal
- Employers must recognise union is >50% of staff are members
- Regulation of procedures for industrial action (e.g. ballots)
- Role / powers of Employment Tribunals
- EU – Works Councils requirements

Consumer Protection

Legislation provides a wide variety of protections to consumers when they transact with businesses. In particular, businesses must ensure that

- **Goods fit their description**
  - E.g. organic wine really must be organic
  - Businesses need to take care with descriptions – avoid inaccurate claims
- **Must be of satisfactory quality**
  - Test is of a "reasonable person"
  - Must work and have no major blemishes
- **Goods are fit for the purpose specified**
  - E.g. a watch should tell the time
  - Businesses should take care when explaining what a product can be used for

Other ways in which consumers are protected by legislation:

- Businesses may not use unfair commercial practices – e.g. misleading advertising
- Customers have a right of return and full refund if goods /services do not comply with law
- Services
  - Must be done at a reasonable price and by the time stated

  - Customer can request that unsatisfactory work be repaired or carried out again at no cost
- Consumers have the right to a "cooling off period"
- Distance selling regulations provide further protection for consumers against online businesses

Distance Selling Regulations	Gives consumers protection when they buy goods or services by mail order, phone or online
The Sale of Goods Act	Requires goods to be as described, fit for their purpose and of satisfactory quality. If they are not, the customer can reject them
Supply of Goods and Services Act	Customers are entitled to work that's carried out with reasonable skill, in a reasonable time, at a reasonable price
Trade Descriptions Act	Required any descriptions of goods and services given to be accurate and not misleading

Environmental Protection
Businesses must comply with a wide variety of environmental laws and regulations. These are set at local, UK and European levels. The key areas of impact are:

- Emissions into the air
- Storage, disposal & recovery of business waste
- Storing and handling hazardous substances
- Packaging
- Discharges of wastewater

Competition Laws
The main aims of laws designed to regulate market competition include:

- Wider consumer choice in markets for goods and services
- Encouraging and protecting innovation
- Effective price competition between suppliers
- Investigating allegations of anti-competitive behaviour within markets which might have a negative effect on consumers

Both UK and EC competition law prohibit agreements, arrangements and concerted business practices which appreciably prevent, restrict or distort competition (or have the intention of so doing)

Examples of prohibited agreements include:

- Agreements which **directly or indirectly fix purchase or selling prices,** or any other trading condition (e.g. discounts or rebates, etc)
- Agreements which limit or control production, markets, technical development or investment (e.g. setting quotas or levels of output)
- Agreements which share markets or sources of supply

Topic: Political & Legal Change

3.7.5 Political & Legal Change

Health & Safety Legislation

Health and safety is about **preventing people from being harmed** at work or becoming ill, by **taking the right precautions** and **providing a satisfactory working environment**.

An employer has important responsibilities for health & safety. It is not just about protecting staff – health & safety applies to many people who come into contact with the business; for example:

- Employees working at the business premises, from home, or at another site
- Visitors to the premises such as customers or subcontractors
- People at other premises where the business is working, such as a construction site
- Members of the public - even if they're outside the business premises
- Anyone affected by products and services the business designs, produces or supplies

There are stringent health & safety regulations specific to particular industries too: for example:

- Food processing (hygiene)
- Hotels (guest safety, hygiene)
- Chemical production (dangerous processes, waste disposal)
- Air travel (passenger safety)
- Tour operators (holidaymaker safety)

Topic: Inflation
3.7.5 Analysing the External Environment – Economic Change

What You Need to Know
Economic factors to include: inflation

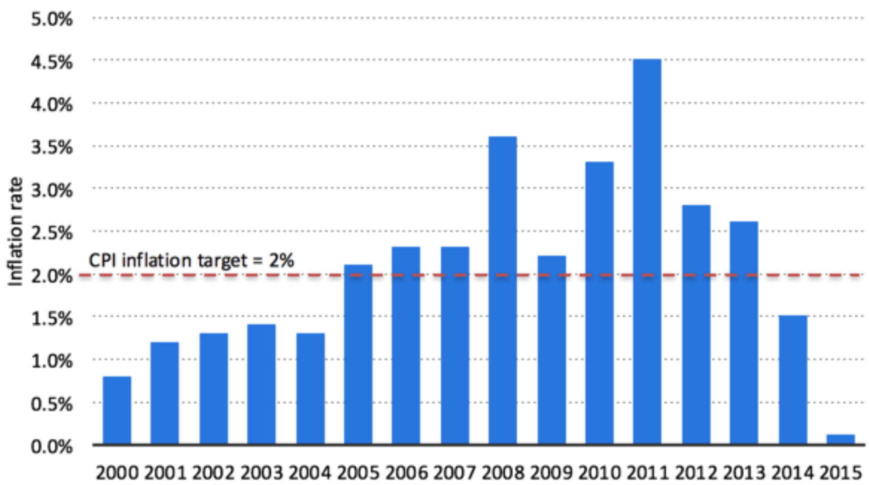
Inflation
Inflation is a **sustained increase in the average price level of an economy**.

The rate of inflation is measured by the **annual percentage change in the level of prices** as measured by the **consumer price index.** A sustained fall in the general price level is called **deflation** – in this situation, the rate of inflation becomes negative.

The consumer price index is the main measure of inflation for the UK

The government has set the **Bank of England** a target for inflation (using the CPI) of **2%**. The aim of this target is to achieve a sustained period of low and stable inflation. Low inflation is also known as **price stability**

The recent level of consumer price inflation in the UK is illustrated in the chart below:



Why is the Rate of Inflation in the UK So Low Recently?
The UK has experienced a very low level of inflation in recent years, particularly when compared with the rates of inflation in the last 10-30 years. Key reasons why UK inflation has been consistently low include:

- Falling global commodity prices including oil
- Slow wage growth in the labour market
- Falling food prices (globally + supermarket price wars)
- Sustained price deflation in technology products
- Slower real economic growth – falling towards 2%
- Still some spare capacity on the supply-side of the economy

Causes of Inflation
What causes prices to rise? There are two main causes of inflation:

Topic: Inflation
3.7.5 Analysing the External Environment – Economic Change

Too much demand	Businesses respond to high demand by raising prices to increase their profit margins Excess demand in the economy or a market is associated with the boom phase of the business cycle
Rising business costs	***Main causes:*** External shocks (e.g. commodity price fluctuations) A depreciation in the exchange rate Faster growth in wages and salaries ***What happens?*** Firms raise prices to protect their profit margins – better able to do this when market demand is price inelastic "Wages often follow prices" A rise in inflation can lead to rising inflationary expectations

The main costs and consequences of inflation:

- Money loses its value and people lose confidence in money as the value of savings is reduced
- Inflation can get out of control - price increases lead to higher wage demands as people try to maintain their living standards. This is known as a wage-price spiral.
- Consumers and businesses on fixed incomes lose out because the their real incomes falls - employees in poor bargaining positions lose out
- Inflation can favour borrowers at the expense of savers – because inflation erodes the real value of existing debts
- Inflation can disrupt business planning and lead to lower capital investment
- Inflation is a possible cause of higher unemployment in the long term – because of a lack of competitiveness
- Rising inflation is associated with higher interest rates - this reduces economic growth and can lead to a recession

Inflation and price elasticity of demand

- Remember that price elasticity of demand refers to the responsiveness of demand to changes in price
- When **demand is elastic**, a price rise leads to a more than proportionate fall off in quantity demanded
- When **demand is inelastic**, a price rise leads to a less than proportionate fall off in quantity demanded
- Businesses with products that have inelastic price elasticity of demand will be **less affected by a rise in inflation**
- Some businesses will be able to absorb price increases by becoming more efficient
- Price inflation will vary from industry to industry – be careful about making generalisations

Key Terms

Inflation	A sustained increase in the average price level of an economy

Topic: Exchange Rates
3.7.5 Analysing the External Environment – Economic Change

What You Need to Know
Economic factors to include: exchange rates

What is an Exchange Rate?
An exchange rate is the **price of one currency expressed in terms of another** currency.

The forces of demand and supply in the currency markets determine the price (exchange rate). Just like the commodity markets for oil and coffee, the price of a currency will reflect the amount of the currency that consumers and businesses want to buy (**demand**) and sell (**supply**).

The exchange rate determines how much of one currency has to be given up in order to buy a specific amount of another currency.

For example, a £/$ exchange rate might be 1.50. That means, for every £1, you can buy $1.50 US dollars

This is the price of one pound, expressed in dollars i.e. the £/$ exchange rate.

What happens when an exchange rate changes? Let's look at a simple example.

Set out below are two exchange rates for two months:

£1 buys	May	September
US Dollars ($)	$1.60	$1.45
Euros (€)	€1.15	€1.05

In the table above, you can see that in May, £1 would buy $1.60, if you wanted to convert some pounds into US dollars. Alternatively, £1 would buy €1.15 euro.

What happened to the exchange rate for the pound between May and September? The value of £1 fell against both the US dollar and the Euro. For example, by September, £1 would only buy you $1.45, a fall of $0.15 from May.

That means that the pound **weakened** against the dollar (and the euro).

Putting it another way, the value of the US dollar strengthened against the pound.

If you were holding dollars, you would need less of them to convert into £1.

Topic: Exchange Rates
3.7.5 Analysing the External Environment – Economic Change

Factors that determine effect of changing exchange rates on business

Low effect on business	**High effect on business**
No export sales – turnover all in domestic (UK) market	Significant export sales, perhaps in many currencies
All business activities located in UK	Overseas operations, earning profits in foreign currency
Raw materials and other supplies bought in UK	Significant purchases from overseas suppliers
Demand predominantly from domestic (UK) customers	Substantial demand from overseas visitors to UK
Demand is price inelastic	Demand is price elastic
Higher costs can be passed on to customers to maintain margin	Higher costs usually have to be absorbed via a lower margin

Exchange Rates and Price Elasticity of Demand
Price elasticity of demand is an important concept for any business where demand may be affected by changing exchange rates

E.g. price elastic demand
- Stronger (higher) exchange rate will increase selling price for export customers (e.g. they have to use more US$ for each £1)
- Likely to result in greater reduction in quantity demanded + overall reduction in export sales

Key Terms

Exchange Rate	The price of one currency expressed in terms of another currency

Topic: Fiscal & Monetary Policy
3.7.5 Analysing the External Environment – Economic Change

What You Need to Know
Economic factors to include: taxation, fiscal & monetary policy

Government Spending & Taxation – Fiscal Policy

Fiscal policy involves the use of government spending, taxation and borrowing to affect the level and growth of economic activity.

The government taxes in order to:

- Raise revenue – to finance government spending
- Managing aggregate demand – to help meet the government's macroeconomic objectives
- Changing the distribution of income and wealth
- Address market failure and environmental targets

There are two main kinds of taxation: direct and indirect.

Direct Taxation	**Indirect Taxation**
Levied on income, wealth and profit	Levied on spending by consumers on goods and services
Main examples: • Income Tax • National Insurance Contributions • Corporation Tax • Capital Gains Tax	Main examples: – VAT – Excise duties on fuel and alcohol, car tax, betting tax etc

Government Spending

In the UK government spending takes up around 40% of annual GDP. Three main areas of spending are:

- **Transfer Payments** - welfare payments made to benefit recipients such as the state pension and the Jobseeker's Allowance
- **Current Spending -** spending on state-provided goods & services such as education and health
- **Capital Spending** - infrastructural spending such as spending on new roads, hospitals, motorways and prisons

Why is Government spending so significant?

- Provide welfare support for low income households / the unemployed
- Government spending is also a means of redistributing income within society e.g. to reduce the scale of relative poverty
- Government spending can also be used as a tool to manage aggregate demand (GDP) as part of macroeconomic policy

Monetary Policy - Interest Rates

Topic: Fiscal & Monetary Policy

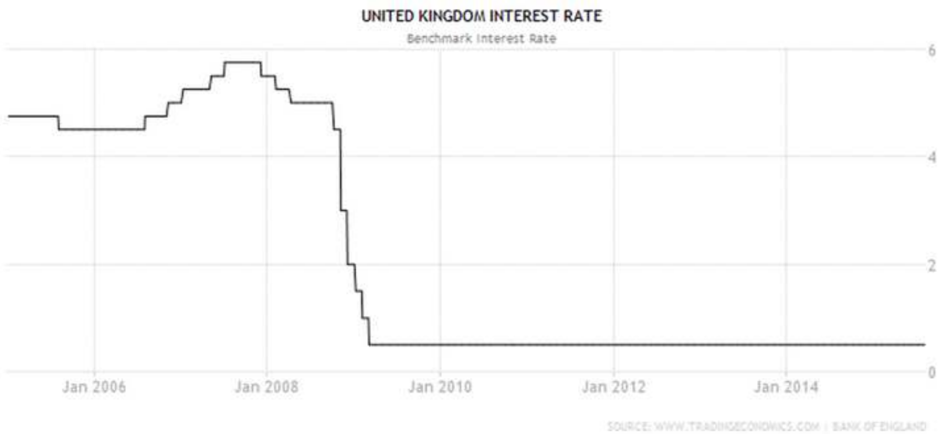
3.7.5 Analysing the External Environment – Economic Change

An interest rate is the **reward for saving** and the **cost of borrowing** expressed as a percentage of the money saved or borrowed. At any one time there are a variety of different interest rates operating within the external environment; for example:

- Interest rates on savings in bank and other accounts
- Borrowing interest rates
- Mortgage interest rates (housing loans)
- Credit card interest rates and pay day loans
- Interest rates on government and corporate bonds

The Bank of England uses policy interest rates to help regulate the economy and meet economic policy objectives.

The Bank of England Base Rate has been very low and stable for several years – at 0.5% since 2010. This has been reduced to 0.1% in 2020



What might happen if interest rates start to rise? Possible effects might be:

- Cost of servicing loans / debt is reduced – boosting spending power
- Consumer confidence should increase leading to more spending
- Effective disposable income rises – lower mortgage costs
- Business investment should be boosted e.g. prospect of rising demand
- Housing market effects – more demand and higher property prices
- Exchange rate and exports – cheaper currency will increase exports

Key Terms

Fiscal Policy	The use of government spending, taxation and borrowing to affect the level and growth of economic activity.
Monetary Policy	The management of the supply of money in an economy through interest rates and other measures to affect economic activity

Topic: Open Trade v Protectionism

3.7.5 Analysing the External Environment – Economic Change

What You Need to Know
Economic factors to include: open trade and protectionism

What is Open Trade?
Free (open) trade is an **economic policy** of not discriminating against imports from and exports to other countries.

Buyers and sellers from separate economies may trade without the domestic government applying tariffs, quotas, subsidies or prohibitions on their goods and services.

The key benefits of open trade include:

- Countries can benefit from comparative advantage
- Businesses can better achieve economies of scale
- Encourages competition and economic efficiency
- Enables businesses to grow beyond their domestic borders

The World Trade Organization (WTO) is the only international organisation dealing with the global rules of trade between nations. **Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.**

What is Protectionism?
Protectionism involves any attempt by a country to to impose restrictions on trade in goods and services.

The main aim of protectionism is to cushion domestic businesses and industries from overseas competition and prevent the outcome resulting solely from the interplay of free market forces of supply and demand. The three main types of protectionism are summarised below:

Import Quotas	A tariff a tax or duty that **raises the price of imported products** and causes a reduction in domestic demand and an expansion in domestic supply. For example, until recently, Mexico imposed a 150% tariff on Brazilian chicken. The United States has an 11% import tariff on imports of bicycles from the UK!
Tariffs	Quotas are **volume limits on the level of imports allowed or a limit to the value of imports permitted** into a country in a given time period. For example, until 2014, South Korea maintained strict quotas on imported rice. It has now replaced a quota with import tariffs designed to protect South Korean rice farmers. Quotas do not normally bring in any immediate tax revenue for the government although if they cause domestic production and incomes to expand, there will be a beneficial impact on taxes paid.
Domestic & Export Subsidies	A subsidy is a **payment to encourage domestic production** by lowering their costs. Well known subsidies include Common Agricultural Policy in the EU, or cotton subsidies for US farmers and farm subsidies introduced by countries such as Russia. In 2012, the US government imposed tariffs on Chinese manufacturers of solar panel cells, judging that they benefited from unfair export subsidies after a review that split the US solar industry.

Topic: Open Trade v Protectionism
3.7.5 Analysing the External Environment – Economic Change

Whilst protectionism might seem not to be in the best interests of business and society, there are several reasons why protectionism is favoured and encouraged by some economies (to a greater or lesser extent):

Infant Industry Protection	Help infant or fledgling industries establish themselves, including achieving economies of scale
Protection of Strategic Industries	Protect jobs, skills and capabilities in key (strategic) industries to a country
Protection Against Import Dumping	Dumping is a form of predatory pricing which can seriously damage domestic industries

The key arguments against protectionism (which are in effect also arguments in support of open or free trade) include:

Higher prices for consumers	Particularly arising from import tariffs or import quotas that restrict market supply
Retaliation from other countries	Protectionist measures often result in retaliation - such as price wars
Extra costs for exporters	Protectionism that becomes widespread in global industries increases the costs facing domestic firms trying to export

Key Terms

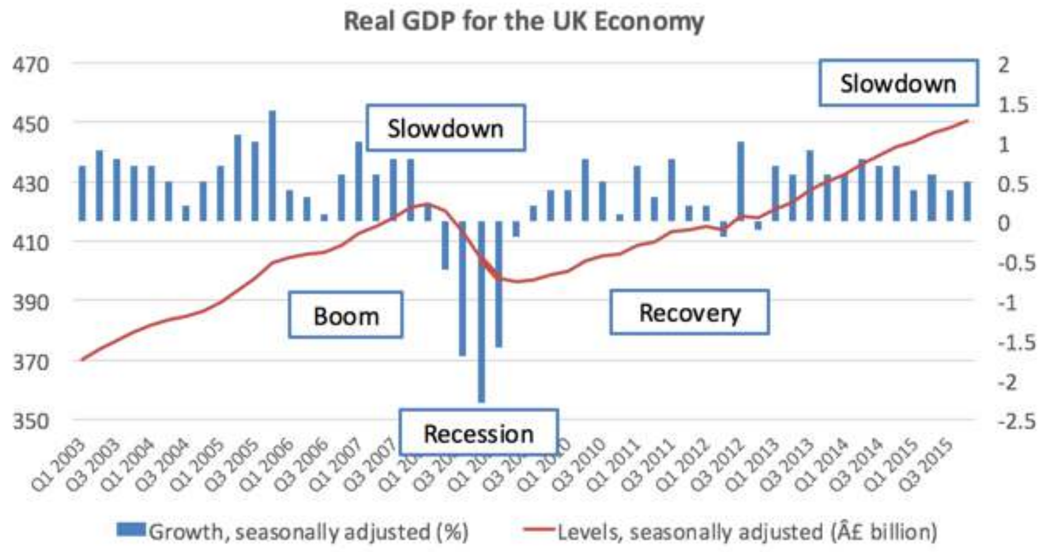
Protectionism	An economy policy that involves any attempt by a country to to impose restrictions on trade in goods and services or to favour domestic firms against international competition
Open trade	An **economic policy** of not discriminating against imports from and exports to other countries

Topic: GDP & Business Cycle
3.7.5 Analysing the External Environment – Economic Change

What You Need to Know
Economic factors to include: GDP

Business Cycle
The business cycle is all about the rate of change in the value of economic activity. The most common measure of this activity is **Gross Domestic Product (GDP).**

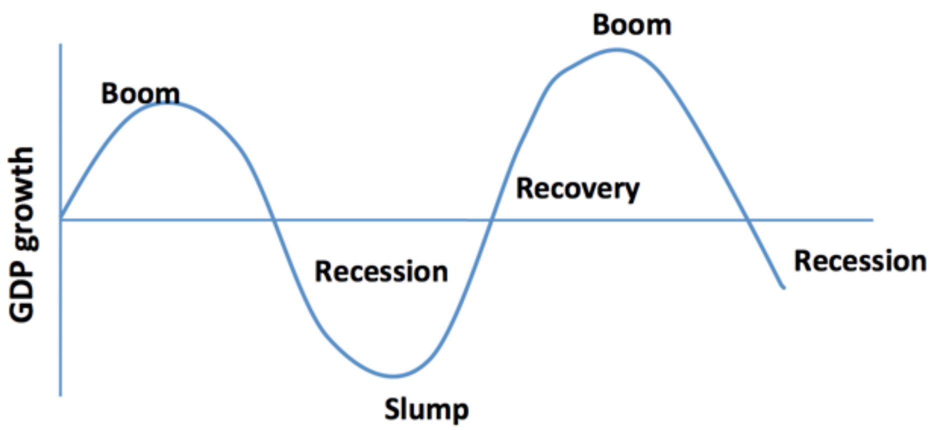
- The level of demand in most markets is influenced by the rate of economic growth
- Economies vary in terms of their "normal" long-term growth rate. A mature economy like the UK has a long-term growth rate of around 2-3%
- GDP growth will vary depending on the stage of the business cycle



The business cycle describes:

- The changes in **GDP** from one quarter to the next
- The traditional sequence of slump, recovery, boom and recession
- The regular pattern of "ups and downs" in the economy

The traditional sequence of the business cycle is usually something like this:



Topic: GDP & Business Cycle

3.7.5 Analysing the External Environment – Economic Change

The main stages in the business cycle diagram above can be summarised as follows:

Boom	• High levels of consumer spending, business confidence, profits and investment • Prices and costs also tend to rise faster • Unemployment tends to be low
Recession	• Falling levels of consumer spending and confidence mean lower profits for businesses – which start to cut back on investment • Spare capacity increases + rising unemployment
Slump / depression	• Very weak consumer spending and business investment • Many business failures • Rapidly rising unemployment • Prices may start falling
Recovery	• Things start to get better • Consumers begin to increase spending • Businesses feel a little more confident and start to invest again • But it takes time for unemployment to stop growing

What Causes the Business Cycle?

- Changes in the level of business and consumer confidence
- Alternating periods of stocking (businesses increasing their stocks) and de-stocking (reducing the value of stocks held)
- Changes in the value of consumer spending and business investment
- Changes in government policy which can induce a change in the economy

Key Terms

Gross Domestic Product (GDP)	The total measured value of economic activity in an economy, measured over a particular period.

Topic: Globalisation
3.7.5 Analysing the External Environment – Economic Change

What You Need to Know
Reasons for greater globalisation of business The importance of globalisation for business

What is Globalisation?
The OECD defines globalisation as

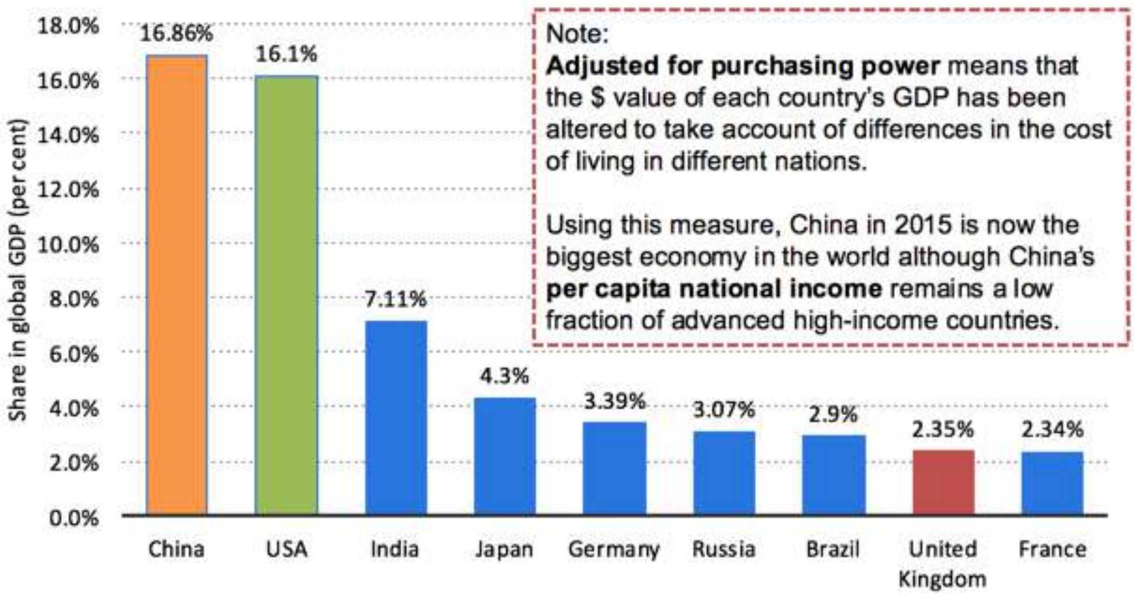
"The geographic dispersion of industrial and service activities, for example research and development, sourcing of inputs, production and distribution, and the cross-border networking of companies, for example through joint ventures and the sharing of assets."

Key points to remember about the overall process of globalisation:

- Globalisation is a **process** in which economies have become increasingly integrated and inter-dependent
- Globalisation is **dynamic** rather than an end state
- Globalisation is **not inevitable** – it can reverse, indeed the growth of world trade in goods and services slowed in recent years following the global financial crisis

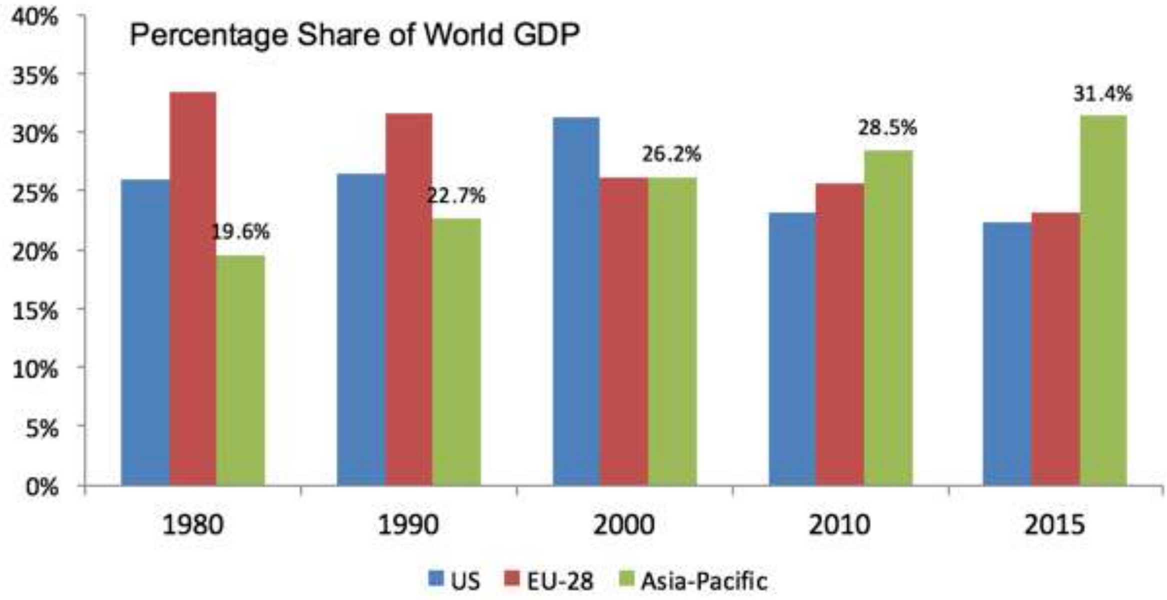
Key Features of the Changing Global Economy

The world's largest economies, as measured by their share of global GDP, are illustrated in the chart below:



It is important to understand that the world economy has changed significantly in recent decades and continues to change as emerging economies develop further. Since 1980 the share of global economic output has shifted towards Asian-Pacific countries who now dominate, as illustrated in the chart below:

Topic: Globalisation
3.7.5 Analysing the External Environment – Economic Change



The Key Features of Globalisation
The process of globalisation has had a dramatic effect on both the structure of the global economy and also how business is done in international markets. The key features of globalisation include:

- Trade to GDP ratios are increasing for most countries
- Expansion of Financial Capital Flows between countries
- Foreign Direct Investment and Cross Border M&A
- Rising number of global brands – including from emerging countries
- Deeper specialization of labour – components come from many nations
- Global supply chains & new trade and investment routes e.g. South-South trade
- Increasing levels of international labour migration and migration within countries
- Increasing connectivity of people and businesses through mobile and Wi-Fi networks

What Factors Have Contributed to Globalisation?
Whilst there are many factors that contributed to the process of globalisation, certain factors are widely considered to have played a major role over the long-term. These are summarised below:

Containerization	The costs of ocean shipping have come down, due to containerization, bulk shipping, and other efficiencies. The lower unit cost of shipping products around the global economy helps to bring prices in the country of manufacture closer to those in export markets, and it makes markets more contestable globally
Technological change	Rapid and sustained technological change has reduced the cost of transmitting and communicating information – sometimes known as **"the death of distance"** – a key factor behind trade in knowledge products using web technology.
Economies of scale	Many economists believe that there has been an increase in the minimum efficient scale (MES) associated with some industries. If the MES is

	rising, a domestic market may be regarded as too small to satisfy the selling needs of these industries. Many emerging countries have their own transnational corporations
Differences in tax systems	The desire of businesses to benefit from lower unit labour costs and other favourable production factors abroad has encouraged countries to adjust their tax systems to attract **foreign direct investment (FDI).** Many countries have become engaged in tax competition between each other in a bid to win lucrative foreign investment projects.
Shift from protectionism towards open trade	Old forms of non-tariff protection such as import licensing and foreign exchange controls have gradually been dismantled. Borders have opened and average import tariff levels have fallen. However, in the last few years, there has been a rise in non-tariff barriers such as import quotas as countries have struggled to achieve real economic growth and as a response to persistent trade and current account deficits
Growth of MNCs	In their pursuit of revenue and profit growth, increasingly global businesses and brands have invested significantly in expanding internationally. This is particularly the case for businesses owning brands that have proved they have the potential to be successfully globally, particularly in faster-growing economies fuelled by growing numbers of middle class consumers.

Who Benefits from Globalisation?
The key potential benefits for businesses and the economies in which they operate include:

- Encourages producers and consumers to benefit from deeper division of labour and economies of scale
- Competitive markets reduce monopoly profits and incentivise businesses to seek cost-reducing innovations
- Enhanced growth has led to higher per capita incomes – and helped many of poorest countries to achieve faster economic growth and reduce extreme poverty measured as incomes
- Advantages from the freer movement of labour between countries
- Gains from the sharing of ideas / skills / technologies across national borders
- Competitive pressures of globalisation may prompt improved governance and better labour protection

Drawbacks and Risks of Globalisation

Key points include:

- **Inequality**: Globalisation has been linked to rising inequalities in income and wealth. Evidence for this is the growing rural–urban divide in countries such as China, India and Brazil. This leads to political and social tensions and financial instability that will constrain growth. Many of the world's poorest people do not have access to basic technologies and public goods. They are excluded from the benefits.

Topic: Globalisation

3.7.5 Analysing the External Environment – Economic Change

- **Inflation:** Strong demand for food and energy has caused a steep rise in commodity prices. Food price inflation has placed millions of the world's poorest people at great risk.
- **Vulnerability to external economic shocks** – national economies are more connected and interdependent; this increases the risk of contagion i.e. an external event somewhere else in the world coming back to affect you has risen / making a country more vulnerable to macro-economic problems elsewhere
- **Threats to the environment:** Irreversible damage to ecosystems, land degradation, deforestation, loss of bio-diversity and the fears of a permanent shortage of water afflict millions of the world's most vulnerable
- **Race to the bottom** – nations desperate to attract inward investment may be tempted to lower corporate taxes, allow lax health and safety laws and limit basic welfare safety nets with damaging social consequences
- **Trade imbalances:** Global trade has grown but so too have trade imbalances. Some countries are running big trade surpluses and these imbalances are creating tensions and pressures to introduce protectionist policies such as new forms of import control. Many developing countries fall victim to export dumping by producers in advanced nations (dumping is selling excess output at a price below the unit cost of supply.)

Topic: Porter's Five Forces Model
3.7.7 The Competitive Environment

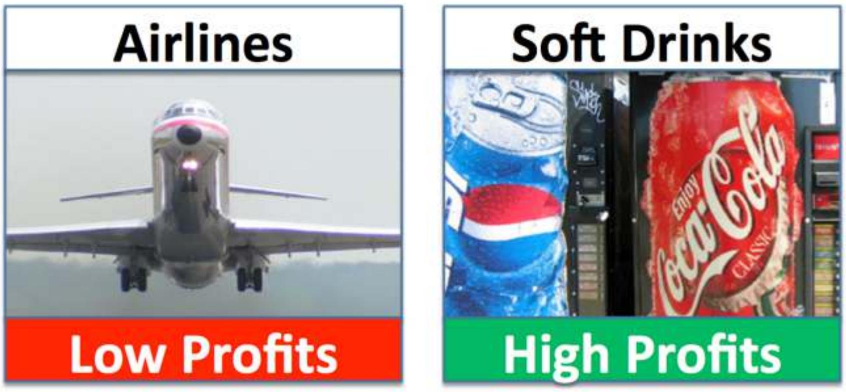
What You Need to Know
An understanding of the five forces to include: • entry threat (barriers to entry) • buyer power • supplier power • rivalry • substitute threat. Students should consider how the five forces shape competitive strategy.

Introduction to Porter's Five Forces Model
The Five Forces Model was devised by Professor Michael Porter. The model is a framework for analysing the nature of competition within an industry.

Introduction & Background - the Nature of Industry Competition
Every market or industry is different. Take any selection of industries and you should be able to find differences between them in terms of:

- Size (e.g. sales revenue, volumes, numbers of customers)
- Structure (e.g. the number of brands and competitors)
- Distribution channels (how the product gets from producer to final consumer)
- Customer needs and wants (the basis of marketing segmentation)
- Growth (the rate of growth and which businesses are growing faster or slower than the market)
- Product life cycle (the stage of the life cycle for the industry as a whole and for products and brands within it)
- Alternatives for the consumer (e.g. substitute products)

The result of the above differences is that industries vary in terms of how much profit they make. To take two classic examples:



Why do airlines make so little profit (and such big losses)? There are several factors, including:

- Very intensive competitor rivalry – mainly on price
- Low barriers to entry – lots of new airlines who want to set up
- Suppliers of aircraft & equipment are powerful – can charge high margins
- Customers have lots of substitute options – e.g. rail, car

Topic: Porter's Five Forces Model
3.7.7 The Competitive Environment

- High fixed costs – airline losses rise significantly if revenues fall only slightly since it costs roughly the same to fly half-empty planes as full ones

By contrast, why are profits so high in the soft drinks market? The answer is mainly that:

- Customers and suppliers have little power – Pepsi has many millions of individual consumers, and thousands of retail distributors none of whom has much influence over the business
- There is high brand awareness & loyalty = less consumer desire for substitutes
- High barriers to entry – how do you enter a market dominated by Coca-Cola and Pepsi?

What we have illustrated above is some analysis that you would obtain by considering Porter's **Five Forces Model.**

The Five Forces

Porter identified five factors that act together to determine the nature of competition within an industry. These are the:

- Threat of new entrants to a market
- Bargaining power of suppliers
- Bargaining power of customers ("buyers")
- Threat of substitute products
- Degree of competitive rivalry

He identified that high or low industry profits (e.g. soft drinks v airlines) are associated with the following characteristics:

Low industry profits associated with:	**High industry profits associated with:**
Strong suppliers Strong customers (buyers) Low entry barriers Many opportunities for substitutes Intense rivalry	Weak suppliers Weak customers (buyers) High entry barriers Few opportunities for substitutes Little rivalry

Topic: Porter's Five Forces Model

3.7.7 The Competitive Environment

Let's look at each one of the five forces in a little more detail to explain how they work.

Threat of New Entrants

If new entrants move into an industry they will gain market share & rivalry will intensify.

The position of existing firms is stronger if there are **barriers** to entering the market.

If **barriers to entry** are low then the threat of new entrants will be high, and vice versa

Barriers to entry are, therefore, very important in determining the threat of new entrants.

An industry can have one or more barriers. The following are common examples of successful barriers:

Barrier to Entry	Notes
Investment cost	High cost will deter entry High capital requirements might mean that only large businesses can compete
Economies of scale available to existing firms	Lower unit costs make it difficult for smaller newcomers to break into the market and compete effectively
Regulatory and legal restrictions	Each restriction can act as a barrier to entry E.g. patents provide the patent holder with protection, at least in the short run
Product differentiation (including branding)	Existing products with strong USPs and/or brand increase customer loyalty and make it difficult for newcomers to gain market share
Access to suppliers and distribution channels	A lack of access will make it difficult for newcomers to enter the market
Retaliation by established products	E.g. the threat of price war will act to discourage new entrants But note that competition law outlaws actions like predatory pricing

What makes an industry easy or difficult to enter? The following table helps summarise the issues you should consider:

Easy to Enter	Difficult to Enter
Common technology	Patented or proprietary know-how
Access to distribution channels	Well-established brands
Low capital requirements	Restricted distribution channels
No need to have high capacity and output	High capital requirements
Absence of strong brands and customer loyalty	Need to achieve economies of scale for acceptable unit costs

Topic: Porter’s Five Forces Model

3.7.7 The Competitive Environment

Bargaining Power of Suppliers

If a firm's suppliers have bargaining power they will:

- Exercise that power
- Sell their products at a higher price
- Squeeze industry profits

If the supplier forces up the price paid for inputs, profits will be reduced. It follows that the more powerful the customer (buyer), the lower the price that can be achieved by buying from them.

Suppliers find themselves in a powerful position when:

- There are only a few large suppliers
- The resource they supply is scarce
- The cost of switching to an alternative supplier is high
- The product is easy to distinguish and loyal customers are reluctant to switch
- The supplier can threaten to integrate vertically
- The customer is small and unimportant
- There are no or few substitute resources available

Just how much power the supplier has is determined by factors such as:

Factor	Note
Uniqueness of the input supplied	If the resource is essential to the buying firm and no close substitutes are available, suppliers are in a powerful position
Number and size of firms supplying the resources	A few large suppliers can exert more power over market prices that many smaller suppliers each with a small market share
Competition for the input from other industries	If there is great competition, the supplier will be in a stronger position
Cost of switching to alternative sources	A business may be “locked in” to using inputs from particular suppliers – e.g. if certain components or raw materials are designed into their production processes. To change the supplier may mean changing a significant part of production

Bargaining Power of Customers

Powerful customers are able to exert pressure to drive down prices, or increase the required quality for the same price, and therefore reduce profits in an industry.

A great example in the UK currently is the dominant grocery supermarkets which exert great power over supplier firms.

Several factors determine the bargaining power of customers, including:

Topic: Porter's Five Forces Model
3.7.7 The Competitive Environment

Factor	Note
Number of customers	The smaller the number of customers, the greater their power
Their size of their orders	The larger the volume, the greater the bargaining power of customers
Number of firms supplying the product	The smaller the number of alternative suppliers, the less opportunity customers have for shopping around
The threat of integrating backwards	If customers pose a threat of integrating backwards they will enjoy increased power
The cost of switching	Customers that are tied into using a supplier's products (e.g. key components) are less likely to switch because there would be costs involved

Customers tend to enjoy strong bargaining power when:

- There are only a few of them
- The customer purchases a significant proportion of output of an industry
- They possess a credible backward integration threat – that is they threaten to buy the producing firm or its rivals
- They can choose from a wide range of supply firms
- They find it easy and inexpensive to switch to alternative suppliers

Threat of Substitute Products
A substitute product can be regarded as something that meets the same need.

Substitute products are produced in a different industry –but crucially satisfy the same customer need. If there are many credible substitutes to a firm's product, they will limit the price that can be charged and will reduce industry profits.

The extent of the threat depends upon

- The extent to which the price and performance of the substitute can match the industry's product
- The willingness of customers to switch
- Customer loyalty and switching costs

If there is a threat from a rival product the firm will have to improve the performance of their products by reducing costs and therefore prices and by differentiation.

Overall Degree of Competitive Rivalry
If there is intense rivalry in an industry, it will encourage businesses to engage in:

- Price wars (competitive price reductions),
- Investment in innovation & new products
- Intensive promotion (sales promotion and higher spending on advertising)

All these activities are likely to increase costs and lower profits.

Several factors determine the degree of competitive rivalry; the main ones are:

Topic: Porter's Five Forces Model
3.7.7 The Competitive Environment

Factor	Note
Number of competitors in the market	Competitive rivalry will be higher in an industry with many current and potential competitors
Market size and growth prospects	Competition is always most intense in stagnating markets
Product differentiation and brand loyalty	The greater the customer loyalty the less intense the competition The lower the degree of product differentiation the greater the intensity of price competition
The power of buyers and the availability of substitutes	If buyers are strong and/or if close substitutes are available, there will be more intense competitive rivalry
Capacity utilisation	The existence of spare capacity will increase the intensity of competition
The cost structure of the industry	Where fixed costs are a high percentage of costs then profits will be very dependent on volume As a result there will be intense competition over market shares
Exit barriers	If it is difficult or expensive to exit an industry, firms will remain thus adding to the intensity of competition

Topic: Investment Appraisal – Payback Period
3.7.8 Analysing strategic options: investment appraisal

What You Need to Know
Investment appraisal should include the calculation and interpretation of payback

The Three Main Methods of Investment Appraisal
Payback period is one of three methods of investment appraisal that you need to be able to calculate and interpret:

Payback period	The time it takes for a project to repay its initial investment
Average rate of return	Looks at the total accounting return for a project to see if it meets the target return
Discounted cash flow (NPV)	Net present value ("NPV") calculates the monetary value now of the project's future cash flows

Payback period is unique in that it measures the return from investment in terms of a time period (years and days).

To calculate payback period:

- Identify the net cash flows for each period (e.g. year)
- Then keep a **running total** of the cash flows
- Initial investment = is nearly always an outflow
- Look to see when the running total move from negative (outflow) to positive (inflow)?
- When the total net cash flow becomes positive, that is the end of the payback period

An example of this approach is shown in the table below:

Year	**Cash Flow Detail**	**Cash Flow £**	**Cumulative Cash Flow**	**Payback?**
0	Investment (cash outflow)	**(500,000)**	**(500,000)**	No
1	Net Cash Inflows	100,000	**(400,000**	No
2	Net Cash Inflows	150,000	**(250,000)**	No
3	Net Cash Inflows	175,000	**(75,000)**	No
4	Net Cash Inflows	150,000	**75,000**	Yes

Payback in Year 4 can be calculated as follows:

Topic: Investment Appraisal – Payback Period
3.7.8 Analysing strategic options: investment appraisal

3 Years + the part of the 4th Year when Payback was achieved

$$3 + \left(\frac{£75{,}000}{£150{,}000} \right)$$

$$\boxed{3.5 \text{ years}}$$

Benefits and Drawbacks of Using Payback Period
These can be summarised as follows:

Benefits of Using Payback	Drawbacks of Using Payback
Simple and easy to calculate + easy to understand the results Focuses on cash flows Emphasises speed of return; good for markets which change rapidly Straightforward to compare competing projects	Ignores cash flows after payback has been reached Takes no account of the "time value of money" May encourage short-term thinking Ignores qualitative aspects of a decision Does not actually create a decision for the investment

Topic: Investment Appraisal – Net Present Value (NPV)
3.7.8 Analysing strategic options: investment appraisal

What You Need to Know
Investment appraisal should include the calculation and interpretation of net present value using discounted cash flows

The Three Main Methods of Investment Appraisal
Discounted cash flow is one of three methods of investment appraisal that you need to be able to calculate and interpret:

Payback period	The time it takes for a project to repay its initial investment
Average rate of return	Looks at the total accounting return for a project to see if it meets the target return
Discounted cash flow (NPV)	Net present value ("NPV") calculates the monetary value now of the project's future cash flows

Discounted cash flow takes account of the "time value of money" to reduce (or "discount") the importance of cash flows arising further in the future.

So, discounting **is the method used to reduce the future value of cash flows to reflect the risk that they may not happen.**

Why might it be important to take account of the time value of money?

- It is surely better to receive cash now rather than in the future
- Future cash flows are worth less
- Using discount factors brings cash flows back to their "present value"
- The relevant discount factor is determined by the required rate of return

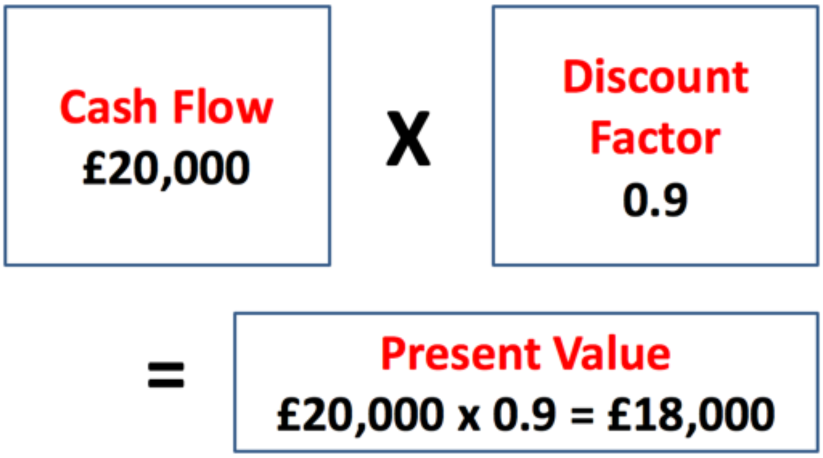
How to Calculate Present Values?
Each cash flow needs to be discounted before they can all be added up. This is done very simply by multiplying the cash flow by the relevant discount factor (which you will always be given):

Cash Flow X **Discount Factor**

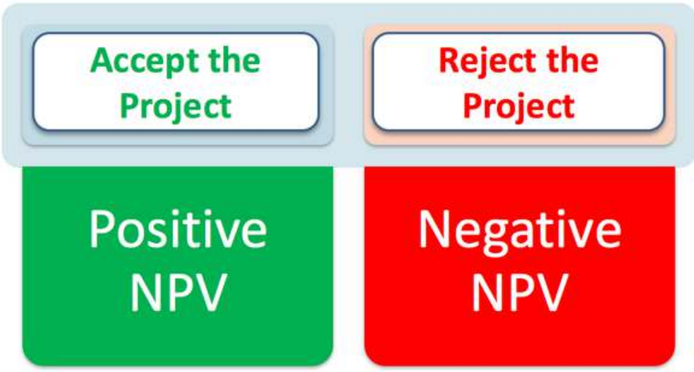
= **Present Value**

For example:

Topic: Investment Appraisal – Net Present Value (NPV)
3.7.8 Analysing strategic options: investment appraisal



To get to the Net Present Value (NPV) of an investment project, we simply add all the present values together and consider whether the total is positive or negative.



An example of these calculations is provided in the table below:

Year	Cash Flows	Net Flow	Discount Factor	Present Value
0	Investment	(100,000)	1	(100,000)
1	Project Profits	40,000	0.91	36,400
2	Project Profits	50,000	0.83	41,500
3	Project Profits	60,000	0.76	45,600
Total		50,000		23,500

In the above example, the total of the present values (the NPV) is £23,500 – i.e. it is positive. This would normally suggest that the investment project should go ahead.

Topic: Investment Appraisal – Net Present Value (NPV)
3.7.8 Analysing strategic options: investment appraisal

Benefits and Drawbacks of Using Discounted Cash Flow (NPV)
These can be summarised as follows:

Benefits of Using NPV	**Drawbacks of Using NPV**
Considers all future cash flows Reflects the risks that future cash flows will not be as expected Different levels of risk can be accounted for by adjusting the discount rate Creates a straightforward decision - positive NPV suggests project should go ahead	The most complicated method compared with Payback & ARR Choosing the discount rate is hard, particularly for long projects Result can be influenced / manipulated using the discount rate

Topic: Investment Appraisal – Average Rate of Return (ARR)
3.7.8 Analysing strategic options: investment appraisal

What You Need to Know
Investment appraisal should include the calculation and interpretation of average rate of return

The Three Main Methods of Investment Appraisal
Average rate of return ("ARR") is one of three methods of investment appraisal that you need to be able to calculate and interpret:

Payback period	The time it takes for a project to repay its initial investment
Average rate of return	Looks at the total accounting return for a project to see if it meets the target return
Discounted cash flow (NPV)	Net present value ("NPV") calculates the monetary value now of the project's future cash flows

Calculating the ARR
The key steps involved in calculating ARR are:

Step 1	Calculate the average annual profit from the investment project
Step 2	Divide the average annual profit by the initial investment ("outlay")
Step 3	Compare with the target percentage return

A Worked Example

A fashion retailer is planning to open 5 new stores next year. The initial investment will be £1,000,000. The annual profits for these stores and the initial outlay (shop fitting etc.) is shown in the table below. The target rate of return is 20% What is the ARR for the 5 new stores?

Year	Annual Profit (£)
1	100,000
2	250,000
3	400,000
4	500,000
5	500,000

Working through the three steps, here's how to calculate ARR for this example:

Topic: Investment Appraisal – Average Rate of Return (ARR)
3.7.8 Analysing strategic options: investment appraisal

Step 1: Average Annual Profit =

Total profits (150 + 250 + 400 +500 + 500)
Divided by
Number of Years (5)

£1,750,000 / 5	**£350,000 Average Annual Profit**

Step 2: Divide average annual profit by the initial outlay

£350,000 / £1,000,000

35%

Step 3: Compare the ARR with the target return

ARR: 35%	**Target 20%**

The ARR is significantly higher than the target return – suggesting the project should be accepted

Benefits and Drawbacks of Using ARR
These can be summarised as follows:

Benefits of Using ARR	**Drawbacks of Using ARR**
Simple to understand and easy to calculate Focuses on the overall profitability of an investment project Easy to compare ARR with other key target rates of return to help make a decision Uses all the returns generated by a project	Ignores the timing of returns Focuses on profits rather than cash flows Does not adjust for the time-value of money

Topic: Investment Appraisal – Factors Influencing Investment Decisions
3.7.8 Analysing strategic options: investment appraisal

What You Need to Know
Factors influencing investment decisions: to include investment criteria, non financial factors, risk and uncertainty

Key Factors Influencing Investment Decisions
The key factors can be categorised into:

Financial Factors	Non-Financial Factors
Investment criteria Total returns (cash & profit) and sensitivity Alternative investments (opportunity cost) Financial position (e.g. liquidity, gearing) of the business	Corporate objectives Organisational culture & attitude to risk Management confidence in the investment appraisal data Business image and reputation

Investment Criteria
Investment criteria are particularly important in determining whether or not to make an investment:

- Criteria = the measures by which an investment will be judged
- A target percentage rate of return is most common in business
- This target return can be compared with the ARR, or used as basis for the discount rate in NPV calculations
- Often larger businesses require investments to satisfy more than one criteria (e.g. positive NPV and above target ARR

The Role of Corporate Objectives
As you have seen from your study of corporate objectives, these are the key strategic targets that the business wants to achieve. As such, they are bound to play a very influential role in investment decisions:

- Major investments need to be consistent with corporate aims and objectives
- For example, a objective of significant profit improvement through cost reduction would be consistent with approving investments in greater automation or efficiency

Investment Decisions and Organisational Culture
Organisational (or corporate) culture is another important influence:

- All investment decisions involve an element of risk-taking
- The culture of a business is likely to significantly influence attitude to risk-taking
- The ways in which management are rewarded or accountable for investment decisions will also be important

Uncertainty
- By their nature all business investment decisions involve some uncertainty

Topic: Investment Appraisal – Factors Influencing Investment Decisions
3.7.8 Analysing strategic options: investment appraisal

- Changes in the external environment can have a particularly significant impact on investment
- Contingency planning and sensitivity analysis can help businesses address the problems created by uncertainty

Topic: Investment Appraisal – Sensitivity Analysis

3.7.8 Analysing strategic options: investment appraisal

What You Need to Know
The value of sensitivity analysis

What is Sensitivity Analysis?

Sensitivity analysis is a technique which allows the **analysis of changes in assumptions** used in **business forecasts**.

Where Can Sensitivity Analysis be Used in Business?

Sensitivity analysis is a key technique wherever a forecast is produced by management.

The table below provides some examples of the most common use of forecasts in business and ways in which the key assumptions can be tested with sensitivity analysis:

Business Forecast	**Examples of Assumptions Made**
Cash-flow forecast	Timing of cash inflows and outflows Amount of cash inflows and outflows Receivables & payables days
Budgeted profit	Sales volumes and unit selling prices Gross profit margins & overheads
Investment appraisal	Timing and amount of project cash flows Period over which project will run Amount of initial investment
Breakeven analysis	Average selling prices and variable costs Fixed costs by category and total

Sensitivity analysis of assumptions used in business forecasts helps answer questions such as:

- How reliable are the assumptions made?
- What happens if assumptions turn out to be significantly different in reality?
- Which assumptions are most significant to the forecast?

How Does Sensitivity Analysis Work?

- Allows key assumptions to be changed to analyse effect
- Helps judge the degree of risk (e.g. in an investment project)
- Recognises that there is no such thing as an accurate forecast
- Most importantly – sensitivity analysis **considers one variable or assumption at a time**

A Worked Example of Sensitivity Analysis

To illustrate the process, let's look at a simple example.

Topic: Investment Appraisal – Sensitivity Analysis
3.7.8 Analysing strategic options: investment appraisal

Managers at Business A are forecasting the profit they hope to achieve next year based on the following assumptions.

Variable	Assumption
Selling Price (SP) per Unit	£100
Variable Cost (VC) per Unit	£30
Fixed Costs for year	£500,000
Forecast Sales (Units)	10,000

Using this information above, we can work out what the forecast profit is for the business:

Variable	Assumption	Profit
Selling Price (SP) per Unit	£100	Revenue: £1,000,000
Variable Cost (VC) per Unit	£30	Variable costs: £300,000
Fixed Costs for year	£500,000	Fixed costs: £500,000
Forecast Sales (Units)	10,000	**Profit: £200,000**

So, the forecast profit is £200,000 based on these assumptions. But, what happens to forecast profit if the assumptions prove overly-optimistic? Let's take a look to see what happens to the profit forecast if each assumption is, say, 10% worse than expected:

Variable	Assumption (Expected)	Assumption (10% Worse)
Selling Price (SP) per Unit	£100	£90
Variable Cost (VC) per Unit	£30	£33
Fixed Costs for year	£500,000	£550,000
Forecast Sales (Units)	10,000	9,000

Recalculating the forecast profit assuming that only one variable is worse than expected at a time, gives the following results:

Variable	Assumption = (10% Worse)	Forecast Profit
Selling Price (SP) per Unit	£90	£100,000
Variable Cost (VC) per Unit	£33	£170,000
Fixed Costs for year	£550,000	£150,000
Forecast Sales (Units)	9,000	£130,000

How does the forecast profit compare now with the original forecast of £200,000?

Well, not surprisingly, the forecast profit is worse (lower) in each case, However, the sensitivity analysis shows that the forecast is most sensitive to the selling price assumption. Where the selling price is £90 (not £100) the forecast profit falls by 50% to £100,000.

So the key results from the sensitivity analysis are:

- Forecast profit (£200,000) is most sensitive to a fall in assumed selling price per unit
- A 10% lower selling price results in a 50% fall in forecast profit (other assumptions remaining constant)
- The next most significant assumption is sales volume, where a 10% shortfall would result in a 35% reduction in forecast profit

Evaluating the Role of Sensitivity Analysis
The main benefits and potential drawbacks of using sensitivity analysis include:

BENEFITS	**DRAWBACKS**
Identifies the most significant assumptions (which therefore require closer attention)	Only tests one assumption at a time (many assumptions may be linked)
Helps assess risk and prepare for a less-than-favourable scenario	Only as good as the data on which forecasts are based
Helps make the process of business forecasting more robust	A somewhat complicated concept – not understood by all managers

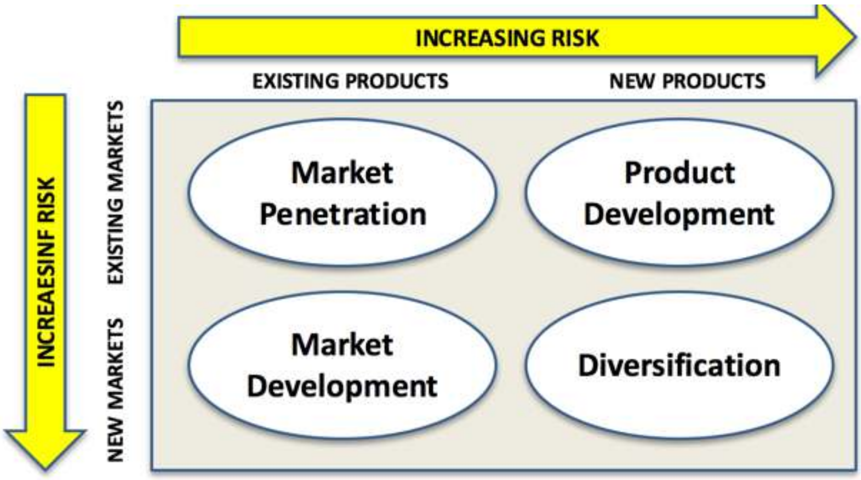
Key Terms

Sensitivity analysis	A technique which allows the analysis of changes in assumptions used in forecasts

Topic: Ansoff's Matrix
3.8.1 Strategic direction

What You Need to Know
Strategic direction to include the Ansoff matrix and value of: market penetration market development new product development diversification

What is the Ansoff Matrix?
The Ansoff is a famous marketing planning model that helps a business determine its **product and market** strategy.



The matrix identifies four different approaches to product and market strategy based around whether a business chooses to focus on existing / new products and existing / new markets.

Each of the four sections of the matrix can be summarised as follows:

Market Penetration
This is a growth strategy where a business aims to sell **existing products into existing markets**

Key points:
- Aim: to **increase market share**
- By selling more existing products to the same target customers
- Get existing customers to buy more
- Widen the range of existing products

Evaluating market penetration:
- Business focuses on markets and products it knows well
- Can exploit insights on what customers want (and competitors)
- Unlikely to need significant new market research
- But will the strategy allow the business to achieve its growth objectives?

Product Development

Topic: Ansoff's Matrix
3.8.1 Strategic direction

This is a growth strategy where a business aims to introduce **new products into existing markets**

Key points:

- This strategy is driven by investment in new product development
- Usually requires consistent, long-term investment in research & development
- Technological innovation provides significant opportunities for product development strategies
- Brand extensions are also examples of product development

Evaluating product development:

- This is a strategy that often plays to the strengths of an established business
- Strong emphasis on effective market research (insights into customer needs) and successful innovation
- A great way of exploiting the existing customer base who may respond positively to new products

Market Development
This growth strategy involves a business seeking to sell its **existing products into new markets**.

Key points:
There are various ways of approaching a strategy of market development – such as

- New geographical markets; e.g. exporting to emerging markets
- New distribution channels (e.g. using e-commerce and mail order)
- Different pricing policies to attract new customers in different segments

Evaluating market development:

- A logical strategy where existing markets are saturated or in decline
- Often riskier than product development – particularly expansion into international markets
- Existing products may not suite new markets: depends on customer needs

Diversification
A growth strategy where a business markets **new products in new markets**.

Key points:
Possible approaches to diversification:

- Innovation & R&D: develop new solutions
- Acquire an existing business in the market
- Extend an existing brand into the new market

Evaluating product development:

- Inherently risky strategy
- No direct experience of the product or market
- Few economies of scale (initially)
- However, if successful, overall risk of the business is spread

Topic: Porter's Generic Strategies
3.8.2 Strategic positioning: choosing how to compete

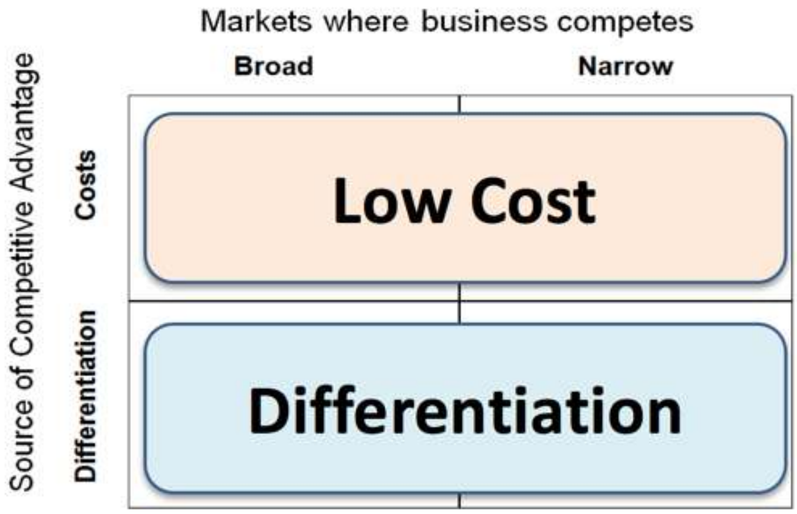
What You Need to Know
Strategic positioning to include: Porter's low cost, differentiation and focus strategies

What Porter Wrote About Strategic Positioning
Porter suggested two overall business strategies that could be followed in order to gain competitive advantage:

Porter argued that **differentiation** and **low cost** are effective strategies for firms to gain competitive advantage.

Remember that a competitive advantage is:

An advantage over competitors gained by offering consumers greater value, either by means of lower prices or by providing greater benefits and service that justifies higher prices



Strategic Positioning with a Low-Cost Strategy
With this strategy, the objective is to become the **lowest-cost operator** in a market or industry.

This typically involves production or operations on a **large scale** which enables the business to **exploit economies of scale** (which therefore reduces unit costs).

Why is cost leadership potential such a effective strategic positioning? The answer lies in the marketing advantage of being able to offer lowest prices:

- If selling prices are broadly similar, the lowest-cost operator will enjoy the highest profits
- Lowest-cost operator can also offer the lowest prices (gain market share)

What are suitable markets for a low-cost strategy? They tend to be markets with:
- A standard product

- Little product differentiation
- Where branding is relatively unimportant (though many successful low-cost operators build brands that emphasise and are associated with low-cost positioning!)

The key features of businesses that successfully position themselves using a low-cost strategy typically include:

- High levels of productivity & efficiency
- High capacity utilisation
- Large scale = economies of scale
- Use bargaining power to negotiate (or demand) lowest prices from suppliers
- Lean production methods and low-cost culture
- Access to the widest and most important distribution channels

Some examples of such businesses are shown below:

Strategic Positioning through Differentiation
With a differentiation strategy, businesses aim to offer a product that is **distinctively different from the competition**, and where the customer values (i.e. is prepared to pay for) that differentiation.

There are various ways in which a business can attempt to differentiate its product or service:

- **Superior product quality** (features, benefits, durability, reliability)
- **Branding** (strong customer recognition & desire; brand loyalty)
- **Wide distribution across all major channels** (i.e. the product or brand is an essential item to be stocked by retailers)
- **Sustained promotion** - often dominated by advertising, sponsorship etc.

Some examples of businesses who position themselves through differentiation are shown below:

Topic: Porter's Generic Strategies
3.8.2 Strategic positioning: choosing how to compete

Hybrid Strategies – Positioning as Both Low-Cost and Differentiation
Is it possible to adopt a hybrid positioning strategy and attempt to be both low-cost and differentiated? Some businesses believe this is possible. Ikea is a good example of how it might be possible:

Low Cost of Ikea	Differentiation at Ikea
Achieves its low prices via cost leadership: Furniture is flat packed to reduce storage space Large out of town retail units spread fixed costs Products are made in China and Malaysia reducing unit costs Low margins/ high volume allows economies of scale	Unique / unusual design Localisation of product range Targeting (mainly) the young, global middle class

Key Terms

Low-cost positioning	Where a business is able to operate at the lowest unit cost in the market, enabling it to charge lower prices than the competition or earn higher profit margins
Differentiation positioning	Where a business is able to distinguish its product or service in the minds of consumers as offering better value – perhaps through quality, branding or other attributes that consumers value.

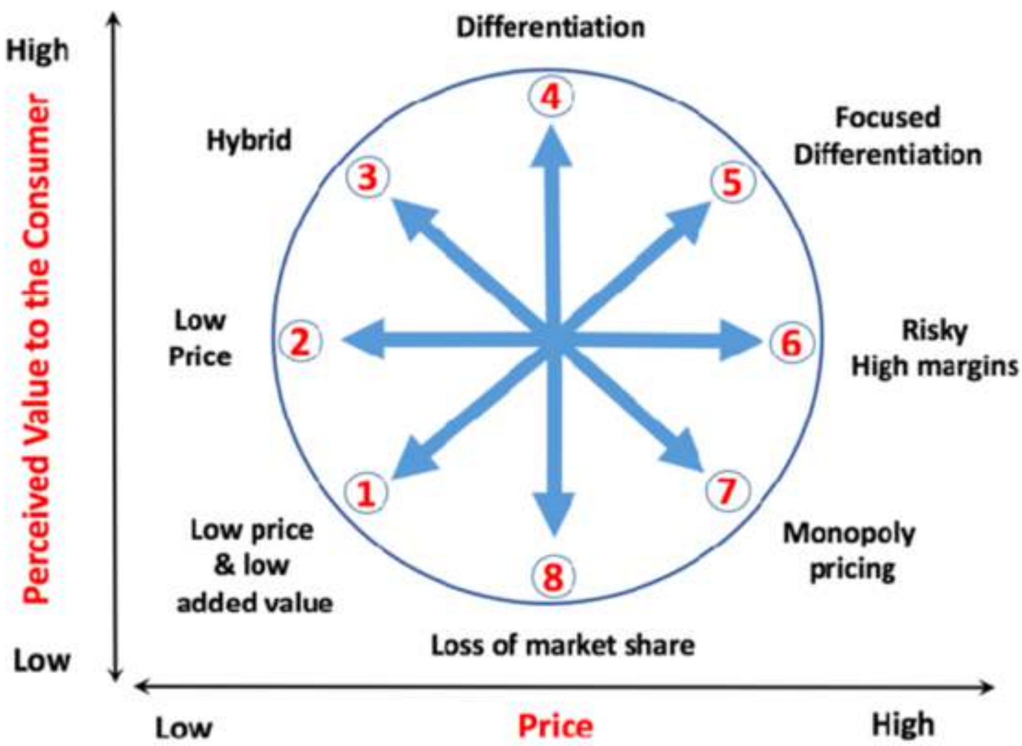
Topic: Bowman's Strategic Clock
3.8.2 Strategic positioning: choosing how to compete

What You Need to Know
How to compete in terms of benefits and price. Strategic positioning to include: • Bowman's strategic clock.

Introduction to Bowman's Strategic Clock
Bowman's Strategic Clock is a model that explores the options **for strategic positioning** – i.e. how a product should be positioned to give it the most competitive position in the market.

The purpose of the clock is to illustrate that a business will have a variety of **strategic** options of how to position a product based on two dimensions – price and perceived value.

Exploring the Strategic Positioning Options on Bowman's Clock
The Strategic Clock looks like this:



Low Price and Low Value Added (Position 1)
Not a very competitive position for a business. The product is not differentiated and the customer perceives very little value, despite a low price. This is a bargain basement strategy. The only way to remain competitive is to be as "cheap as chips" and hope that no-one else is able to undercut you.

Low Price (Position 2)
Businesses positioning themselves here look to be the low-cost leaders in a market. A strategy of cost minimisation is required for this to be successful, often associated with economies of scale. Profit margins on each product are low, but the high volume of output can still generate high overall profits. Competition amongst businesses with a low price position is usually intense – often involving price wars.

Topic: Bowman's Strategic Clock
3.8.2 Strategic positioning: choosing how to compete

Hybrid (Position 3)
As the name implies, a hybrid position involves some element of low price (relative to the competition), but also some product differentiation. The aim is to persuade consumers that there is good added value through the combination of a reasonable price and acceptable product differentiation. This can be a very effective positioning strategy, particularly if the added value involved is offered consistently.

Differentiation (Position 4)
The aim of a differentiation strategy is to offer customers the highest level of perceived added value. Branding plays a key role in this strategy, as does product quality. A high quality product with strong brand awareness and loyalty is perhaps best-placed to achieve the relatively prices and added-value that a differentiation strategy requires.

Focused Differentiation (Position 5)
This strategy aims to position a product at the highest price levels, where customers buy the product because of the high perceived value. This the positioning strategy adopted by luxury brands, who aim to achieve premium prices by highly targeted segmentation, promotion and distribution. Done successfully, this strategy can lead to very high profit margins, but only the very best products and brands can sustain the strategy in the long-term.

Risky High Margins (Position 6)
This is a high risk positioning strategy that you might argue is doomed to failure – eventually. With this strategy, the business sets high prices without offering anything extra in terms of perceived value. If customers continue to buy at these high prices, the profits can be high. But, eventually customers will find a better-positioned product that offers more perceived value for the same or lower price. Other than in the short-term, this is an uncompetitive strategy. Being able to sell for a price premium without justification is tough in any normal competitive market.

Monopoly Pricing (Position 7)
Where there is a monopoly in a market, there is only one business offering the product. The monopolist doesn't need to be too concerned about what value the customer perceives in the product – the only choice they have is to buy or not. There are no alternatives. In theory the monopolist can set whatever price they wish. Fortunately, in most countries, monopolies are tightly regulated to prevent them from setting prices as they wish.

Loss of Market Share (Position 8)
This position is a recipe for disaster in any competitive market. Setting a middle-range or standard price for a product with low perceived value is unlikely to win over many consumers who will have much better options (e.g. higher value for the same price from other competitors).

Overview
Looking at the Strategy Clock in overview, you should be able to see that three of the positions (6, 7 and 8) are uncompetitive. These are the ones where price is greater than perceived value. Provided that the market is operating competitively, there will always be competitors that offer a higher perceived value for the same price, or the same perceived value for a lower price.

Topic: Economies of Scale and Scope
3.9.1 Assessing a Change in Scale

What You Need to Know
Issues with managing growth should include: economies of scale (including technical, purchasing and managerial) economies of scope diseconomies of scale

What are Economies of Scale?
Economies of scale arise when **unit costs fall as output increases**

Remember that we can calculate unit costs (or cost per unit) using this important formula:

Average cost per unit is calculated using:

$$\frac{\text{Total production costs in period (£)}}{\text{Total output in period (units)}}$$

This calculation (and the effect of economies of scale on unit costs) can be illustrated by this simple example. Here, we assume that:

- Fixed costs are £10,000, and
- Variable costs are £100 per unit

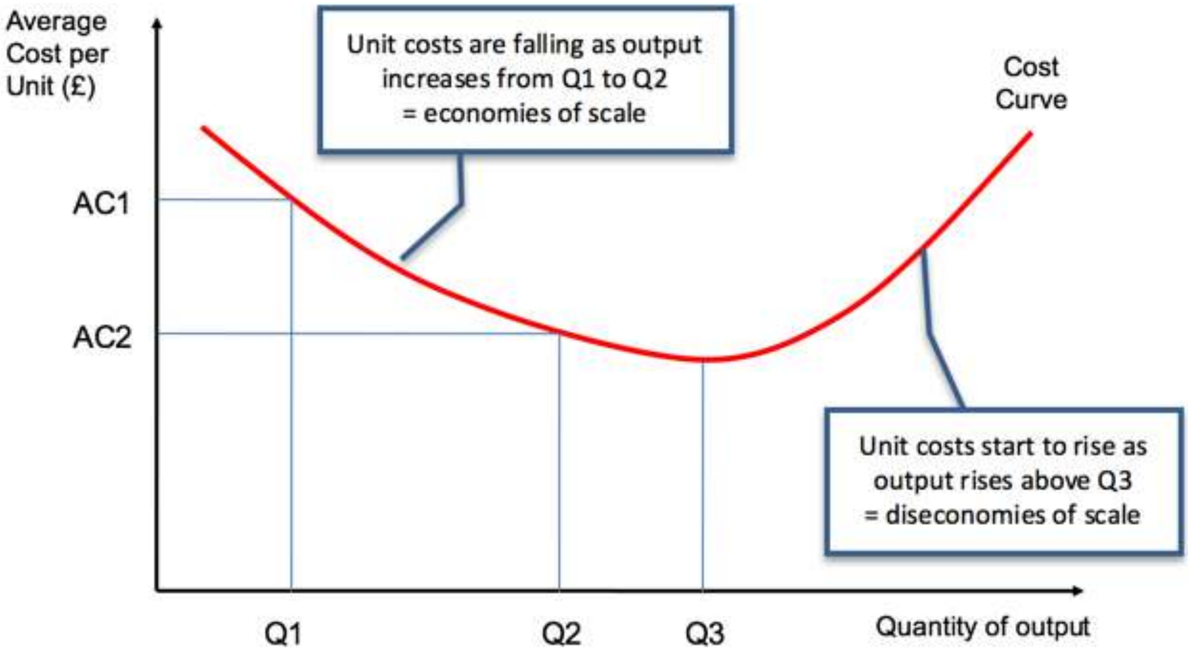
Output	**Fixed Costs**	**Total Variable Costs**	**Total Costs**	**Cost per Unit**
Units	£	£	£	£
50	10,000	5,000	15,000	**300**
100	10,000	10,000	20,000	**200**
150	10,000	15,000	25,000	**166**
200	10,000	20,000	30,000	**150**
250	10,000	25,000	35,000	**140**

As output rises from 50 units to 250 units per period, the cost per unit falls from £300 per unit to £140 per unit. This is because the fixed costs of £10,000 per period are being spread over a larger number of units produced.

The effect of economies of scale on unit costs can also be illustrated diagrammatically as follows:

Topic: Economies of Scale and Scope

3.9.1 Assessing a Change in Scale



How Economies of Scale Can Provide a Competitive Advantage

In your studies of strategic positioning you look at the two key methods of strategic positioning for competitive advantage – low cost and differentiation.

Achieving economies of scale is a key aim for businesses that wish to position themselves as low-cost operators. One useful exercise is to compare the unit costs of different businesses in a market to see which is able to operate most efficiently.

A simple example of this kind of comparison is provided in the table below:

Business	Output Units	Total Costs £	Unit Costs £
A	10,000	50,000	**5**
B	20,000	80,000	**4**
C	5,000	30,000	**6**
D	25,000	75,000	**3**
E	15,000	75,000	**5**

Categories of Economies of Scale

Economies of scale can be distinguished between:

Internal Economies of Scale: arise from the increased output of the business itself

External Economies of Scale: occur within an industry: i.e. all competitors benefit

The main types of internal economies of scale are summarised in the following table:

Topic: Economies of Scale and Scope
3.9.1 Assessing a Change in Scale

Economy	How It Works	Example
Purchasing	Buying in greater quantities usually results in a lower price (bulk-buying).	The major grocery supermarket chains are able to obtain much lower prices from key suppliers than smaller independent retailers – due to the volume of demand they provide to those suppliers. This gives the largest supermarkets a significant cost advantage
Technical	Use of specialist equipment or processes to boost productivity.	As firms grow, they are often able to invest heavily in automation in order to further improve their efficiency and productivity. Capital-intensive and automated production can provide firms with a significant unit cost advantage over smaller firms as well as creating a tough barrier to market entry. The car industry is, perhaps, the best example of this.
Managerial	Specialist managers can be employed to help reduce unit costs and boost efficiency	Smaller firms are often unable to afford managers with specialist expertise (e.g. in finance, HR, marketing). As a firm grows it is better able to bring in specialist managerial expertise which should enable it to be more efficiently run.

External Economies of Scale
These arise from the way an industry operates as a whole – i.e. all competitors benefit They are often associated with particular geographic areas – for example the concentration of creative & media businesses in London. Examples of why this works include:

- Having many specialist suppliers close by
- Access to research and development facilities
- Pool of skilled labour to choose from

Economies of Scope
Economies of scope occur where it is cheaper to produce a range of products rather than specialize in a very limited number.

Diseconomies of Scale
There is no guarantee that unit costs will fall as the scale of a business' operation rises. There may be reasons why inefficiencies arise as a business gets larger. For example:

- **Control** – problems in monitoring productivity and work quality, increasing wastage of resources
- **Co-operation** - workers in large firms may develop a sense of alienation and loss of morale
- Negative effects of internal politics, information over-load, unrealistic expectations among managers and cultural clashes between senior people with inflated ego

Topic: Experience Curve

3.9.1 Assessing a Change in Scale

What You Need to Know
Goes here

What is the Experience Curve?

The concept behind the Experience Curve is that **the more experience a business has in producing a particular product, the lower its costs.**

The Experience Curve concept was devised by the Boston Consulting Group.

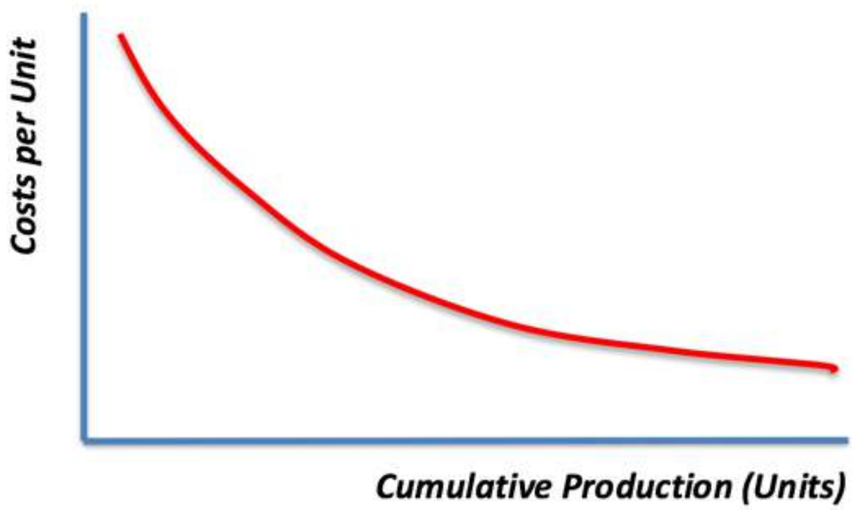
From BCG's research into a major manufacturer of semiconductors, they found that **the unit cost of manufacturing fell by about 25% for each doubling of the volume that it produced**.

BCG concluded: the more experience a firm has in producing a particular product, the lower are its costs

The logic behind the Experience Curve is this:

- As businesses grow, they gain experience...
- That experience may provide an advantage over the competition...
- The "experience effect" of lower unit costs is likely to be particularly strong for large, successful businesses (market leaders)

The Experience Curve can be illustrated diagrammatically as follows:



Implications of the Experience Curve for Strategy

If the Experience Curve concept is valid, then it has some significant implications for growth strategy:

- Business with the most experience should have a significant cost advantage
- Business with the highest market share likely to have the most / best experience
- Therefore:

Topic: Experience Curve
3.9.1 Assessing a Change in Scale

- Experience is a key barrier to entry
- Firms should try to maximise market share
- External growth (e.g. takeovers) might be the best way to do this if a business can acquire firms with strong experience

Criticisms of the Experience Curve Model

- Market leaders often become complacent – perhaps because of their "experience"
- Experience may cause resistance to change and innovation
- Might this cancel out cost benefits of experience?
- The Experience Curve concept is a relatively old theory that is less relevant in a competitive environment that changes so rapidly

Key Terms

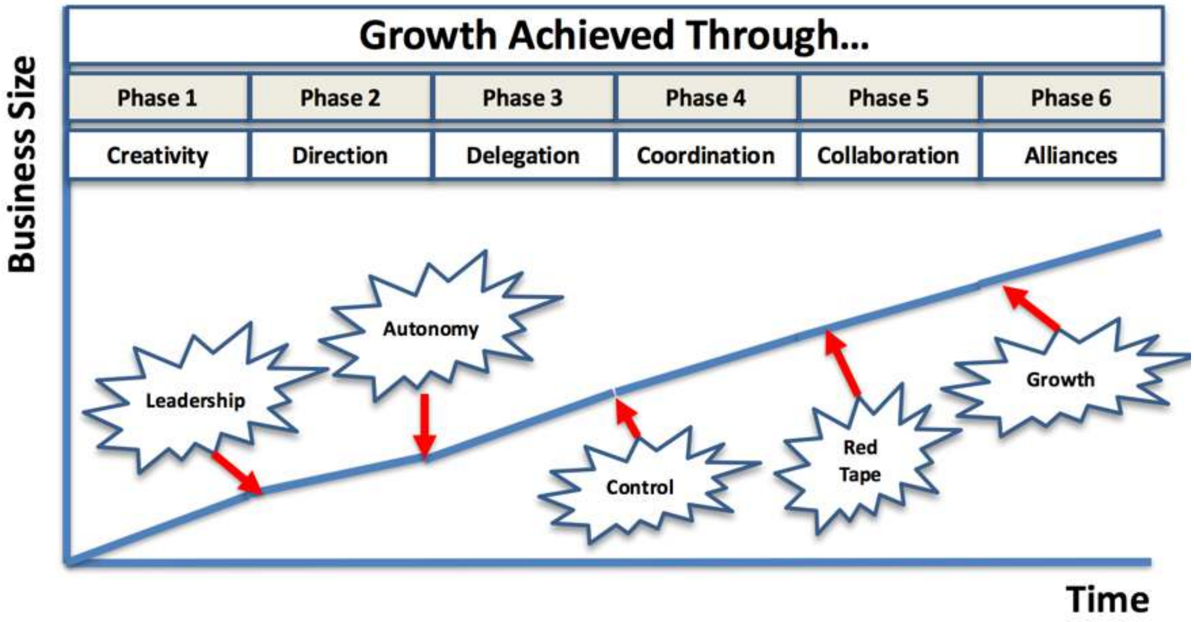
Experience Curve	A mode that predicts that the more experience a business has in producing a particular product, the lower are its costs

Topic: Greiner's Model of Growth
3.9.1 Assessing a Change in Scale

What You Need to Know
Issues with managing growth should include Greiner's model of growth.

Introduction to Greiner's Growth Model
Greiner's Growth Model attempts to predict the **six phases** and **five crises** that businesses may experience as they grow.

The phases of the Greiner Growth Model are illustrated below:



What are the Five Crises of Growth Predicted by Greiner's Model?
The five predicted crises of growth according to the model are:

Growth Phase: Direction - Crisis of Leadership
- Informal communication starts to fail
- Business now too big for leader to get involved in everything

Growth Phase: Delegation - Crisis of Autonomy
- Business now has functional management
- But founder / leader still struggling to let go (e.g. not delegating)

Growth Phase: Coordination - Crisis of Control
- More formal management structures are now in place
- But new layers of hierarchy needed to keep control

Growth Phase: Collaboration - Crisis of Red Tape
- A dangerous growth in organisational bureaucracy
- Slowing decision-making & and increased risk of missing important changes in the external environment

Topic: Greiner's Model of Growth

3.9.1 Assessing a Change in Scale

Growth Phase: Alliances - Crisis of Growth

- Growth slows as business runs out of ideas
- Alliances are sought (including new business owners)
- But are these the right alliances for the business?

Key Messages from Greiner's Growth Model

What can we learn about the challenges of growing a business if, for a moment, we assume that Greiner's Growth Model is valid?

- Growth is hard and uncertain
- Growth poses many management and leadership challenges (crises)
- Leadership and organisational structure have to evolve to reflect the growth of a business
- Businesses that don't adjust as they grow will experience lower growth than those that do

Evaluating Greiner's Growth Model

Key criticisms that can be made of this model include:

- Like most models – it is simplistic
- Not every business will suffer crises as it grows – many adapt easily without suffering any obvious panics or crises
- The model doesn't really take account of the pace of growth, particularly in an increasingly dynamic external environment

Topic: Methods of Growth
3.9.1 Assessing a Change in Scale

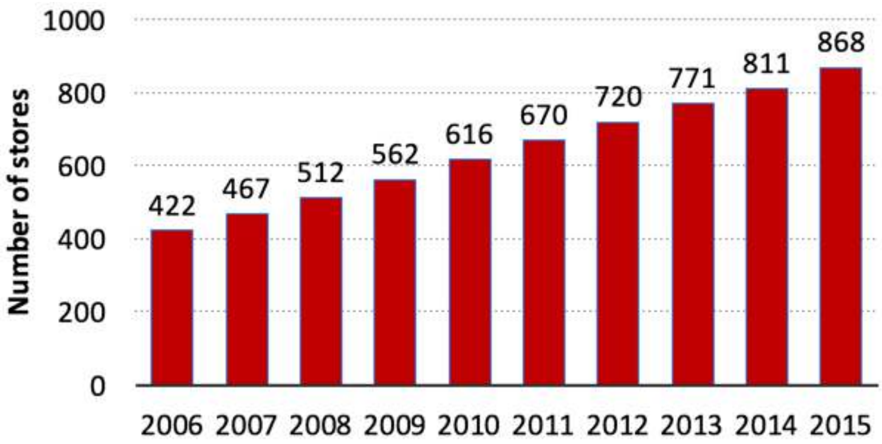
What You Need to Know
Types of growth to include organic and external. Methods of growth to include mergers, takeovers, ventures, franchising. Types of growth to include vertical (backward and forward), horizontal and conglomerate integration

Methods of Business Growth
Most business want to grow and there are a variety of methods this can be achieved. Let's look at the key features of each approach.

Organic (Internal) Growth
Organic growth involves expansion **from within a business**, for example by expanding the product range, or number of business units and locations.

Note: organic growth is also often called **"internal growth".**

A good example of organic growth is the increase in number of Dominos UK pizza outlets in the UK, as illustrated by the chart below:



The main benefits and drawbacks of organic growth can be summarised as follows:

Advantages	Disadvantages
Less risk than external growth (e.g. takeovers)	Growth achieved may be dependent on the growth of the overall market
Can be financed through internal funds (e.g. retained profits)	Hard to build market share if business is already a leader
Builds on a business' strengths (e.g. brands, customers)	Slow growth – shareholders may prefer more rapid growth
Allows the business to grow at a more sensible rate	Franchises (if used) can be hard to manage effectively

Topic: Methods of Growth

3.9.1 Assessing a Change in Scale

Franchising

Franchising arises when a **franchisor grants a license (franchise) to another business (franchisee) to allow it trade using the brand / business format.**

Where appropriate, franchising is a classic growth strategy for a business (franchisor) that wants to allow others to license the right to trade using its **business format**:

- A classic growth strategy for a proven business format
- Enables much quicker geographical growth for a relatively low investment
- Still have the option to open locations that are operated by the Franchisor
- Capital investment by franchisees is an important source of growth finance

For a business that wants to operate a franchise (the franchisee) the key benefits and drawbacks are:

Benefits for the Franchisee	**Drawbacks for the Franchisee**
Running your own business Tried & tested brand Advice, support, training Easier to raise finance Buying power of franchisor Lower risk method of market entry + lower failure rate	Not cheap! Initial fees + royalties & commission Restrictions on actions, including selling Franchisor owns the brand What happens if franchisor fails?

External Growth - Joint Ventures

A joint venture (JV) is a **separate business entity created by two or more parties, involving shared ownership, returns and risks.**

Joint ventures are different from takeovers and mergers in that the risks and returns of the business formed as the joint venture are shared by the parties involved. Usually this is a 50:50 share, although that doesn't have to be the case.

The parties involved in a joint venture are usually looking to benefit from complementary strengths and resources brought to the venture, as well as sharing the risks and rewards involved.

Joint ventures are often used as a method of one business entering international markets. Indeed, in some cases, this is a requirement of firms entering certain industries in some countries

The potential benefits and drawbacks of using joint ventures as a method of growth include:

Topic: Methods of Growth
3.9.1 Assessing a Change in Scale

Benefits of a Joint Venture	Drawbacks of a Joint Venture
JV partners benefit from each other's expertise and resources (e.g. market knowledge, customer base, distribution channels, R&D expertise) Each JV partner might have the option to acquire in the future the JV business based on agreed terms if it proves successful Reduces the risk of a growth strategy - particularly if it involves entering a new market or diversification	Risk of a clash of organisational cultures - particularly in terms of management style The objectives of each JV partner may change, leading to a conflict of objectives with the other In practice, there turns out to be an imbalance in levels of expertise, investment or assets brought into the venture by the different partners What happens if the JV business fails? Can the JV be closed or sold amicably?

External Growth – Takeovers
A takeover (or acquisition) involves **one business acquiring control of another business.**

Takeovers are the most common method of external growth and are undertaken for a wide variety of reasons: for example:

Reasons for Growing through Takeovers	
Increase market share Acquire new skills (e.g. research) Access economies of scale Secure better distribution Acquire intangible assets (brands, patents, trade marks)	Overcome barriers to entry to target markets Defend itself against a takeover threat Enter new segments of an existing market To eliminate competition Spread risks by diversifying

Takeovers might be the most appropriate method of growth for some businesses, for example when:

- Existing products are in the later stages of their life cycles
- Business lacks knowledge or resources to develop organically
- Speed of growth is a high priority
- Competitors enjoy significant advantages that are hard to overcome

However, takeovers are a high risk strategy and many end in failure. The many drawbacks of using takeovers include:

- High cost involved
- Problems of valuation
- Upset customers and suppliers
- Problems of integration (change management)
- Resistance from employees

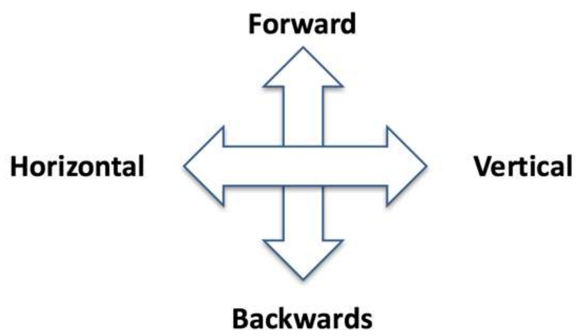
Topic: Methods of Growth
3.9.1 Assessing a Change in Scale

- Non-existent cost savings
- Incompatibility of management styles, structures and culture
- Questionable motives

Why Do Some Many Takeovers Fail?
Takeovers are a very popular method of growth – but so many fail to achieve their objectives. Why is this? Here are the key reasons:

- Price paid for takeover was too high (over-estimate of synergies)
- Lack of decisive change management in the early stages
- The takeover was mishandled
- Cultural incompatibility between the two businesses
- Poor communication, particularly with management, employees and other stakeholders of the acquired business
- Loss of key personnel & customers post acquisition
- Competitors take the opportunity to gain market share whilst the takeover target is being integrated

Types and Direction of Integration
Growth strategies can also be categorised in terms of whether they involve a business moving forwards or backwards in the supply chain, or whether the strategy simply consolidates its position at the same stage of the supply chain.



Each of these directions of integration can be summarised as follows:

Direction	Explanation
Forward + vertical	Acquiring a business further up in the supply chain – e.g. manufacturer buys a distributor
Backward + vertical	Acquiring a business operating earlier in the supply chain – e.g. a retailer buys a wholesaler
Horizontal	Acquiring a business at the same stage of the supply chain – e.g. a manufacturer buys a competitor
Conglomerate	Where the acquisition has no clear connection to the business buying it

Topic: Methods of Growth

3.9.1 Assessing a Change in Scale

Horizontal Integration

The potential benefits of growing through horizontal integration include:

- More likely to achieve economies of scale
- Cost synergies (savings) from the rationalisation of the business
- Potential to secure revenue synergies
- Wider range of products - (i.e. diversification)
- Reduces competition by removing key rivals – this increases market share and long-run pricing power
- Buying a existing and well-known brand can be cheaper than organically growing a brand – this can then make the entry barriers higher for potential rivals

Vertical Integration

The potential benefits of growing through vertical integration include:

- Enables a business to capture a greater share of the profit on each sale
- Secures important sources of supply or distribution
- Create a barrier to entry to potential new competitors
- Gain greater insights into customer needs and wants at each stage of the supply chain

Key Terms

Organic growth	Growth that comes from within the business, e.g. through the launch of a new product or opening new locations
External growth	Growth that comes from outside the business, e.g. through a takeover or joint venture
Horizontal integration	Acquiring a business at the same stage of the supply chain
Vertical integration	Acquiring a business at either an earlier or later stage of the supply chain
Joint venture	A separate business entity created by two or more parties, involving shared ownership, returns and risks

Topic: Synergy
3.9.1 Assessing a Change in Scale

What You Need to Know
Issues with growth should include: synergy

What is Meant by "Synergy"?
Synergy happens when the value of two businesses brought together is higher than the sum of the value of the two individual businesses. in other words, when synergy happens.

The concept of synergy is, therefore, particularly important when a business pursues an **external growth strategy** through takeovers or mergers.

Cost and Revenue Synergies
These two types of synergies can be summarised as follows:

Cost Synergies	**Revenue Synergies**
Reductions in costs as a direct result of the combination of businesses	Increased revenues that are generated as a direct result of the combination of businesses
Examples:	***Examples:***
Eliminate duplicated functions & services Better deals from suppliers Higher productivity & efficiency from shared assets	Cross-selling to customers of both businesses Access to new distribution Brand extensions New geographic markets opened up

Topic: Retrenchment
3.9.1 Assessing a Change in Scale

What You Need to Know
The impact of retrenchment on the functional areas of the business

What is Retrenchment?
Retrenchment is a term used to describe when a business decides to significantly cut or scale-back its activities.

Retrenchment might occur when one or more of the following happen to a business:

- Reduce output & capacity
- Job losses / redundancy programmes
- Product / market withdrawal
- Disposal of business unit
- Scaling back planned capital investment

What Are the Causes of Retrenchment?
Retrenchment arises from strategic change, which in turn happens because of:

- New leadership (usually a new CEO)
- Excessively-high costs and low profitability
- Low ROCE
- High gearing
- Loss of market share
- A failed takeover or merger
- Economic downturn
- Change of ownership

Implications of Retrenchment for Change Management

A decision to adopt a strategy of retrenchment by definition involves change for a business. Can this change be implemented successfully? Much depends on the circumstances, scale and scope of the retrenchment.

- Small-scale, incremental retrenchment has only limited impact
- Significant retrenchment is often associated with a fundamental reappraisal of the business – and therefore with complex and costly change management

Some of the key implications of retrenchment for change management are summarised in the table below:

Topic: Retrenchment

3.9.1 Assessing a Change in Scale

Retrenchment Action	Possible Implications for Change
Changed organisation structures	Changed management responsibilities Greater workloads / higher stress (possibly) New teams and colleagues Different reporting structures
New leadership and/or ownership	Different leadership style Uncertainty (particularly amongst management) New priorities, aims and objectives A threat to the prevailing corporate culture Previous projects often abandoned (e.g. investment) A new / renewed sense of urgency
Fewer people	Loss of morale and increased de-motivation Bad news for some external stakeholders (e.g. local community, local suppliers)

Key Terms

Retrenchment	When a business decides to significantly cut or scale-back its activities.

Topic: Overtrading

3.9.1 Assessing a Change in Scale

What You Need to Know
Issues with growth should include: overtrading

What is Overtrading?

Overtrading happens **when a business expands too quickly without having the financial resources to support such a quick expansion.**

If suitable sources of finance are not obtained, overtrading can lead to business failure.

Importantly, overtrading can occur even a business is profitable. It is an issue of working capital and cash flow.

Overtrading is, therefore, essentially a problem of growth. It is particularly associated with **retail businesses who attempt to grow too fast**

When is Overtrading Most Likely to Happen?

Overtrading is most likely to occur if:

- Growth is achieved by making significant capital investment in production or operations capacity before revenues are generated
- Sales are made on credit and customers take too long to settle amounts owed
- Significant growth in inventories is required in order to trade from the expanding capacity
- A long-term contract requires a business to incur substantial costs before payments are made by customers under the contract

Classic Symptoms that a Business Might Be Overtrading

Whilst the following symptoms do not guarantee that a business is overtrading, one or more of them might prove to be good indicators:

- High revenue growth but very low gross and operating profit margins (compared with key competitors
- Persistent use of a bank overdraft facility
- Significant increases in the payables days and receivables days ratios
- Significant increase in the current ratio
- Very low inventory turnover ratio
- Low levels of capacity utilisation (alongside high levels of investment in capacity)

How Can Businesses Manage the Risk of Overtrading?

The most effective steps to avoid overtrading are essentially those that would be taken as part of a sensible cash flow and working capital management. For example:

- Reducing inventory levels
- Scaling back the pace of revenue growth until profit margins and cash reserves have improved
- Leasing rather than buying capital equipment

- Obtaining better payment terms from suppliers
- Enforcing better payment terms with customers (e.g. through prompt-payment discounts)

Key Terms

Overtrading	When a business expands too quickly without having the financial resources to support such a quick expansion.

Topic: Benchmarking
3.9.2 Assessing Innovation

What You Need to Know
The ways of becoming an innovative organisation: Benchmarking

What is Benchmarking?
The objective of benchmarking is to **understand and evaluate the current position of a business or organisation in relation to best practice** and to identify areas and means of performance improvement.

What is Involved in Benchmarking?
There are four key steps in benchmarking:

1. Understand in detail existing business processes
2. Analyse the business processes of others
3. Compare own business performance with others
4. Implement steps necessary to close performance gaps

What Are the Main Types of Benchmarking?
These can be summarised as follows:

Type	What is it?
Strategic benchmarking	Examines the long-term strategies and general approaches that have enabled high-performers to succeed
Performance or Competitive Benchmarking	Businesses consider their position in relation to performance characteristics of key products and services
Process Benchmarking	Comparing against best practice organisations that perform similar work or deliver similar services
Functional Benchmarking	Comparing with partners drawn from different business sectors to find ways of improving work processes
Internal Benchmarking	Benchmarking businesses or operations from within the same organisation, for example business units in different countries
External Benchmarking	Analysing outside organisations that are simply known to be "best in class"

Topic: Innovation
3.9.2 Assessing Innovation

What You Need to Know
Types of innovation should include product and process innovation Ways of protecting intellectual property include patents and copyrights

What is Innovation?
Innovation is about **putting a new idea or approach into action**.

Innovation is commonly described as 'the commercially successful exploitation of ideas'.

Successful innovation is mainly about creating or adding value. It does so either by:
- Improving existing goods, processes or services (process innovation), or by
- Developing goods, processes or services of value that have not existed previously (product innovation)

However, both kinds of innovation require a business to:
- Challenge the status quo in a market
- Have a deep understanding of customer needs
- Develop imaginative and novel solutions to how those needs might be met

Innovation can come in many forms:
- Improving or replacing business processes to increase efficiency and productivity, or to enable the business to extend the range or quality of existing products and/or services
- Developing entirely new and improved products and services - often to meet rapidly changing customer or consumer demands or needs
- Adding value to existing products, services or markets to differentiate the business from its competitors and increase the perceived value to the customers and markets

Whatever form it takes, innovation is a creative process. The ideas may come from:

- **Inside the business** – e.g. from employees, in-house designers, sales staff
- **Outside the business,** e.g. suppliers, customers, media reports, market research insights or from contacts at local universities or other research organisations

Product and Process Innovation
A distinction can be made between:

Product innovation	Launching new or improved products (or services) on to the market ***Key advantages:*** Higher prices and profitability Added value Opportunity to build early customer loyalty Enhanced reputation as an innovative company PR coverage Increased market share
Process innovation	Finding better or more efficient ways of producing existing products, or delivering existing services

	Key advantages: Reduced costs Improved quality More responsive customer service Greater flexibility Higher profits

Benefits of Successful Innovation

The benefits of innovation can be significant. They include:

Benefit	Examples
Improved productivity & reduced costs	A lot of process innovation is about reducing unit costs. This might be achieved by improving the production capacity and/or flexibility of the business – to enable it to exploit economies of scale
Better quality	By definition, better quality products and services are more likely to meet customer needs. Assuming that they are effectively marketed, that should result in higher sales and profits
Building a product range	A business with a single product or limited product range would almost certainly benefit from innovation. A broader product range provides an opportunity for higher sales and profits and also reduces the risk for shareholders
To handle legal and environmental issues	Innovation might enable the business to reduce it carbon emissions, produce less waste or perhaps comply with changing product legislation. Changes in laws often force business to innovate when they might not otherwise do so
More added value	Effective innovation is a great way to establish a unique selling proposition ("USP") for a product – something which the customer is prepared to pay more for and which helps a business differentiate itself from competitors
Improved staff retention, motivation and easier recruitment	Not an obvious benefit, but often significant. Potential good quality recruits are often drawn to a business with a reputation for innovation. Innovative businesses have a reputation for being inspiring places in which to work.

Successful innovation comes from filtering those ideas, identifying those that the business will focus on and applying resources to exploit them.

Using Kaizen Groups to Drive Innovation

- Linked with developing an innovative culture in business
- Another kind of quality assurance
- Based on concept / culture of continuous improvement
- Encourages employees to engage fully with finding ways to improve quality processes

Topic: Innovation
3.9.2 Assessing Innovation

Potential problems with and risks of innovation
A strategy of investing in R&D and innovation can bring significant rewards, but it is not without risk. Amongst the potential pitfalls are:

Competition	An innovation only confers a competitive advantage if competitors are not able to replicate it in their own businesses. Whilst patents provide some legal protection, the reality is that many innovative products and processes are hard to protect. One danger is that one research-driven, innovative company makes the initial investment and takes all the risk – only to find it is competing with many me-too competitors riding on the coat-tails of the innovation.
Uncertain commercial returns	Much research is speculative and there is no guarantee of future revenues and profits. The longer the development timescale the greater the risk that research is overtaken by competitors too.
Availability of finance	Like other business activities, R&D has to compete for scarce cash. Given the risks involved, R&D demands a high required rate of return. That means that for businesses that have limited cash resources, the opportunity cost of investing in R&D can be very high.

Protecting the Intellectual Property (IP) of a Business
Many businesses invest heavily in developing intellectual property (IP) and it is important to take whatever steps are appropriate to:

- Keep control of intellectual property
- Maintain "unique selling point"
- Maximise return on investment
- Reduce threat of competition

Two key ways of protecting IP are:

Patents	**Copyright**
To be protected by a patent, the invention must be: New An innovative step (i.e. not obvious to other people with knowledge of the subject) Capable of industrial application (i.e. it can be made and used!) Not be excluded (certain inventions don't count - e.g. scientific theories, artistic creations)	Important protection for many industries – e.g. media, design, publishing Protection is automatic for any original work Lasts for 70 years after authors death Can control how copyrighted work is exploited (e.g. license, royalties) Widely used as a way of protecting creative work of all kinds

Topic: Intrapreneurship
3.9.2 Assessing Innovation

What You Need to Know
The ways of becoming an innovative organisation: to include intrapreneurship

Introduction to Intrapreneurship
Established businesses often wish their employees and management were more "entrepreneurial". In other words, they want people within an existing, established business to display the characteristics and traits associated with entrepreneurs.

What is Intrapreneurship?
Intrapreneurship involves people within a business creating or discovering new business opportunities, which leads to the creation of new parts of the business or even new businesses.

An intrapreneur is someone within a business that takes risks in an effort to solve a given problem. Two famous examples of products that were the result of intrapreneurial activity are:

Gmail (Google)	Employees at Google are allowed time for personal projects. Some of Google's best projects come out of their 20 percent time policy. One of these was Gmail, launched on 1 April 2004.
PlayStation (Sony)	Ken Kutaragi, a relatively junior Sony Employee, spent hours tinkering with his daughters Nintendo to make it more powerful and user friendly. What came from his work turned into one of the world's most recognisable brands - the Sony PlayStation

What is the Difference between Intrapreneurship and Entrepreneurship?
The key difference between these two similar concept relates to who owns the risks and rewards of entrepreneurial activity, as summarised in this diagram:

Entrepreneurship	**Intrapreneurship**
Entrepreneurial activity by Entrepreneur	*Entrepreneurial activity by employees and managers*
Rewards go to Entrepreneur	*Rewards (most) go to company*
Risk taken by Entrepreneur	*Risk taken by company*

Potential Business Benefits of Intrapreneurship
In addition to identifying and executing new business opportunities, intrapreneurs can help drive innovation within businesses. In a similar role to that of entrepreneurs, intrapreneurs seek to provide solutions to problems – for example low productivity, excess waste, poor quality.

Topic: Intrapreneurship

3.9.2 Assessing Innovation

What Can a Business Do to Encourage and Facilitate Intrapreneurship?
There are a series of actions a business can do to support and encourage intrapreneurship, including the following:

- Actively look out for – and encourage - entrepreneurial activity
- Give employees ownership of projects
- Make risk-taking and failure acceptable
- Train employees in innovation
- Give employees time outside the confines of their job description
- Encourage networking & collaboration
- Reward entrepreneurial thinking and activity

So Why Are Big Businesses Often Accused of Lacking Entrepreneurial Spirit?
The reality is that we associated entrepreneurial activity with start-ups and other smaller businesses where there is a compelling reason to be entrepreneurial – the need to ensure business survival.

Larger businesses can sometimes struggle to engender an entrepreneurial for a variety of reasons including:

- Complacency / arrogance
- Bureaucracy (stifling initiative)
- Reward systems do not provide an incentive to innovate
- Short-termism (discouraging long-term thinking or risk-taking)

Key Terms

Intrapreneurship	Involves people within a business creating or discovering new business opportunities, which leads to the creation of new parts of the business or even new businesses

Topic: Bartlett Ghoshal Model

3.9.3 Assessing Internationalisation

What You Need to Know
Managing international business includes Bartlett and Ghoshal's international, multidomestic, transnational and global strategies.

Introduction to the Bartlett & Ghoshal Model
The Bartlett & Ghoshal Model indicates the strategic options for businesses wanting to manage their international operations based on two pressures:

- Local responsiveness, and
- Global integration

	LOW PRESSURE FOR LOCAL RESPONSIVENESS	HIGH PRESSURE FOR LOCAL RESPONSIVENESS
HIGH PRESSURE FOR GLOBAL INTEGRATION	Global	Transnational
LOW PRESSURE FOR GLOBAL INTEGRATION	International	Multi-domestic

The two "pressures" or forces on firms wanting to compete in international markets, which determine the four grids in the box above are:

Force for local responsiveness
This considers questions such as:

- Do customers in each country expect the product to be adapted to meet local requirements?
- Do local (domestic competitors) have an advantage based on their ability to be more responsive?

Force for global integration
This considers questions such as:

- How important is standardisation of the product in order to operate efficiently (e.g. economies of scale)?
- Is consistent global branding required in order to achieve international success?

The key features of each box in the Bartlett & Ghoshal model are summarised in the table below:

Topic: Bartlett Ghoshal Model
3.9.3 Assessing Internationalisation

Strategy	Pressure for Responsiveness	Pressure for Global Integration	Key Features
Global	Low	High	Highly centralised Focus on efficiency (economies of scale) Little sharing of expertise locally Standardised products
Transnational	High	High	Complex to achieve Aim is to maximise local responsiveness but also gain benefits from global integration Wide sharing of expertise (technology, staff etc.)
International	Low	Low	Aims to achieve efficiency by focusing on domestic activities International operations are largely managed centrally Relatively little adaption of product to local needs
Multi-domestic	High	Low	Aims to maximise benefits of meeting local market needs through extensive customisation Decision-making decentralised Local businesses treated as separate businesses Strategies for each country

Topic: Internationalisation
3.9.3 Assessing Internationalisation

What You Need to Know
Reasons for targeting, operating in and trading with international markets Methods of entering international markets include: Export, licensing, alliances, direct investment Targeting overseas markets may include being a multinational. Factors influencing the attractiveness of international markets

Why Do Businesses Increasingly Want to Target International Markets?
Whilst many businesses are content to target their domestic customers, the opportunity to trade internationally is increasingly seen as attractive by businesses.

The key reasons why international markets are targeted include:

- Reducing dependence on domestic market
- Accessing faster-growing markets & demand
- Achieving economies of scale
- Better serving customers located overseas
- Building brand value, particularly global brands

Factors Influencing the Attractiveness of International Markets
Analysing and evaluating the attractiveness of an international market to a large extent should involve similar considerations to those a business will consider before it enters any market.

The key factors that influence the relative attractiveness of an international market will include:

- Size and growth of target customer base
- Ease of entry to an international market
- Extent to which product will need to be adapted
- Existing competitive structure in the target market
- Economic conditions in the target economy
- Need for local expertise or partners
- Consistency with corporate objectives
- Other external environment factors (e.g. legal)

Methods of Entering International Markets
The four key methods of entering international markets, which are further summarised below, are:

- Exporting direct to international customers
- Selling via international agents & distributors
- Opening an operation overseas
- Joint venture or takeover

Direct Exporting
This is the simplest method of trading with international markets. Customers located overseas order directly from your business and you send the goods to them, or deliver

the service, directly. Most businesses enter international markets this way and, for most, it is the only method they continue to use (particularly small businesses). The main benefits and drawbacks are:

Benefits of Exporting Directly	Drawbacks of Exporting Directly
Uses existing systems – e.g. e-commerce Online promotion makes this cost-effective Can choose which orders to accept Direct customer relationship established Entire profit margin remains with the business Can choose basis of payment – e.g. terms, currency, delivery options etc.	Potentially bureaucratic No direct physical contact with customer Risk of non-payment **Payment providers ensure seller protection** Customer service processes may need to be extended (e.g. after-sales care in foreign languages)

Selling Via International Agents / Distributors
For some international markets the challenge is to gain access to the best distribution channels in order to reach target customers. This is often achieved by contracting with agents and distributors based in key international markets or areas. The main benefits and drawbacks are:

Benefits of Agents / Distributors	Drawbacks of Agents / Distributors
Agent or distributor should have specialist market knowledge and existing customers Fewer transactions to handle Can be cost effective – commission or distributor margin is a variable cost, not fixed	Loss of profit margin Unlikely to be an exclusive arrangement – question mark over agent and distributor commitment & effort Harder to manage quality of customer service Agent / distributor keeps the customer relationship

Opening an Overseas Operation
This involves a much higher degree of risk and a longer-term investment commitment. A typical approach is to initially open a "sales office" in the target international market. Much more complex is building and opening product capacity or wholly-owned sales outlets. The main benefits and drawbacks are:

Benefits of Overseas Operations	Drawbacks of Overseas Operations
Local contact with customers & suppliers Quickly gain detailed insights into market needs Direct control over quality and customer service Avoids tariff barriers	Significant cost & investment of management time Need to understand and comply with local legal and tax issues Higher risk

Topic: Internationalisation
3.9.3 Assessing Internationalisation

Joint Ventures & Overseas Takeovers
These are by some distance the highest risk approach to international expansion. They tend to be undertaken only by the largest businesses, who have the resources to take such risks. In some countries (e.g. China) it is a requirement to joint-venture partner with a local (domestic)business in order to trade. The main benefits and drawbacks are:

Benefits of JV's & Overseas Takeovers	Drawbacks of JV's & Overseas Takeovers
Speed & potentially transformational Popular way of entering emerging markets Reduced risk – shared with joint venture partner Buying into existing expertise and market presence JVs may be a requirement in some markets	Higher risk, particularly if the wrong JV partner or takeover target is selected Significant cost & investment of management time Need to understand and comply with local legal and tax issues Costly to withdraw if the strategy goes wrong

Multinational Companies (MNCs)
A multinational company (MNC) is a business that has **operations in more than one country**.

Note that a business does not become an MNC simply because it sells its goods and services overseas. The key to being an MNC is that the business has **business operations** in two or more countries.

The number of MNCs has grown rapidly in recent decades, alongside the rise of globalisation. The key reasons for the emergence of MNCs include:

- Global brands seeking to drive revenue and profit growth in emerging economies (in particularly seeking rising demand from increasingly affluent consumers)
- The search for economies of scale, to reduce unit costs by concentrating production in a few key international locations
- The perceived need to supplement relatively weak demand in existing, developed economies
- The need to operate in many countries to avoid protectionism
- Increased takeover activity that has built businesses with widespread international operations

Do MNC's benefit the countries in which they operate? Supporters of MNCs point to the following advantages:

- MNCs provide significant employment and training to the labour force in the host country
- Transfer of skills and expertise, helping to develop the quality of the host labour force
- MNCs add to the host country GDP through their spending, for example with local suppliers and through capital investment

Topic: Internationalisation
3.9.3 Assessing Internationalisation

- Competition from MNCs acts as an incentive to domestic firms in the host country to improve their competitiveness, perhaps by raising quality and/or efficiency
- MNCs extend consumer and business choice in the host country
- Profitable MNCs are a source of significant tax revenues for the host economy (for example on profits earned as well as payroll and sales-related taxes)

From the perspective of the economies in which MNCs operate, critics of MNCs point to the following drawbacks:

- Domestic businesses may not be able to compete with MNCs and some will fail
- MNCs may not feel that they need to meet the host country expectations for acting ethically and/or in a socially-responsible way
- MNCs may be accused of imposing their culture on the host country, perhaps at the expense of the richness of local culture.
- Profits earned by MNCs may be remitted back to the MNC's base country rather than reinvested in the host economy.
- MNCs may make use of transfer pricing and other tax avoidance measures to significant reduce the profits on which they pay tax to the government in the host country

Key Terms

Multinational	A business that has operations in more than one country

Topic: Offshoring & Reshoring
3.9.3 Assessing Internationalisation

What You Need to Know
Reasons for producing more and sourcing more resources abroad: Decisions regarding producing overseas include off-shoring and re-shoring

Introduction to Offshoring
Offshoring involves the **relocation** of business activities from the home country to a different international location.

It is the **changed international location** of where the business activity is performed that is key to understanding offshoring.

Offshoring has traditionally been associated with the relocation of manufacturing activities from a domestic economy overseas (e.g. from the US to China, or UK to Poland). However, offshoring is also increasingly common with business services (e.g. UK financial services using call centres based in India).

The Difference between Offshoring and Outsourcing
Take care with the difference between two similar-sounding terms! They are not (quite) the same thing!

- Offshoring is about **WHERE** the work is done
- Outsourcing is about **WHO** does the work

So, offshoring involves changing the international location of WHERE work is done for or by a business.

Outsourcing involves changing WHO does work for a business - away from the business itself to an external supplier. The table below illustrates some examples of the distinction between offshoring and outsourcing:

Operations Decision	**Offshoring**	**Outsourcing**
A UK business sets up its own call-centre in India to serve UK customers	Yes	No
A toy manufacturer uses overseas suppliers to produce components which it imports to the UK	Yes	Yes
A UK bank hands over its payroll and recruitment services to a specialist supplier in the UK	No	Yes
A UK chocolate manufacture moves production from York to a factory it has built in Poland	Yes	No

Key Reasons for Offshoring
Why might a business decide to change the international location of where its business activities are undertaken? Key reasons include:

- To access lower manufacturing costs (particularly in emerging markets which enjoy the advantage of lower labour costs)

- To access potentially better skilled & higher quality supply
- To makes use of existing capacity overseas
- To take advantage of free trade areas and avoid protectionism
- To make it easier to supply target international markets (where it is important to be located in, or near to, those markets)

Potential Drawbacks to Offshoring
Like all decisions about where to locate business operations, there are potential drawbacks to offshoring, including:

- Longer lead times for supply & risks of poorer quality
- Implications for CSR (harder to control aspects of operating long distances away from the home country)
- Additional management costs (time, travel)
- Impact of exchange rates (potentially significant)
- Communication: language & time zones

Reshoring
Reshoring is the **reverse of offshoring.** it involves a business returning production or operations to the host country that had previously been moved to a different international location.

Reasons for Reshoring
Whilst the extent of reshoring is nowhere near as significant as offshoring in recent decades, there have been an increasing number of businesses who have decided to move production or operations back to the home country.

Key reasons for reshoring include:

- Greater certainty around delivery times (including shorter delivery times)
- Minimising risk of supply chain disruptions
- Reducing the complexity of the supply chain
- Making it easier to collaborate with home-based suppliers
- Getting greater certainty about the quality of inputs and components
- Recognising that the cost advantage of producing or sourcing overseas is not as significant as it used to be (particularly in China where unit labour costs have risen significantly in recent years).

Key Terms

Offshoring	The **relocation** of business activities from the home country to a different international location
Outsourcing	The transfer of business functions from being done within the business to be provided by a supplier
Reshoring	Involves a business returning production or operations to the host country that had previously been moved to a different international location.

Topic: Assessing Digital Technology
3.9.4 Assessing Greater Use of Digital Technology

What You Need to Know
The pressures to adopt digital technology The value of digital technology (should include e-commerce) The impact of digital technology on the functional areas of the business

What are the Key Pressures to Adopt Digital Technology?
Almost every business of any size or complexity is now under pressure to adopt and invest in digital technology. Indeed, some businesses are built entirely on digital technology and would not exist without it.

The key pressures, which clearly vary by industry, include:

- Serve existing customers better (and meeting their higher expectations)
- Reach new customers in new segments & locations
- Offer new ways of delivering products and services using digital technology
- Reduce costs by integrating digital technology into operations
- The need to respond to digital innovation by competitors
- Access, analyse and action data that provides key insights into customer needs and business performance

What is E-Commerce?
E-commerce can be defined quite widely as:

Digitally enabled commercial transactions between and among organisations and individuals

The Disruptive Impact of E-Commerce
Much has been written about the highly disruptive impact of e-commerce on the nature of competition in many markets and industries.

E-commerce has challenged almost every aspect of how business is done, impacting areas such as:

- Market size (revenues, quantity)
- Market structure
- Distribution channels
- Customer needs and wants
- Profitability
- Length of product life cycles
- Alternatives for the consumer

Linking the developments in e-commerce to a key theory – Porter's Five Forces Model – it is possible to highlight some ways in which e-commerce has significantly changed the barriers to entry to markets and the nature of competitive rivalry. For example:

- Widespread availability of smartphones and the associated app "eco-system" has created new ways of delivering existing products & services
- Global e-commerce platforms such as Amazon, ebay, Google, Alibaba etc. have made it much easier for small businesses to access their target customer base

Topic: Assessing Digital Technology

3.9.4 Assessing Greater Use of Digital Technology

- E-commerce has made it much easier to expand into international markets
- Technological change has shortened product life cycles and enabled new market entrants to challenge established market leaders

The Impact of Digital Technology on the Functional Areas of Business

The table below summarizes some examples of how digital technology has impacted the four key functional areas of business:

Marketing

Impact on Marketing	Examples
Marketing strategy of differentiation increasingly effective	E-commerce enables mass customisation Easier to target niche market segments online
Product life cycles are shortened	Rapid pace of technological change More competition (lower barriers to entry)
Greater use of digital promotion	Digital promotion now mainstream Social media increasingly important
Brands and retailers increasingly using multiple distribution channels	Omnichannel retailing – where online and offline channels are closely integrated
Greater use of dynamic pricing	Based on customer preferences & responding to market conditions; use of big data
Increased need for localisation	Essential in order to expand into international markets using ecommerce
Ability to sell a much wider product range (the "long tail")	No physical constraints on selling space Niche & specialist products promoted more easily

Human Resource Management

Impact on HRM	Examples
Need for employees to have a broader range of digital skills	Digital literacy now a key employability skill New types of workforce roles and jobs essential for any firm using e-commerce Coders, data analysts, digital marketers etc.
Workforce planning – to support highly seasonal demand	Peak demand for e-commerce is Nov-Dec Like physical retailers, major e-commerce employ substantial numbers of temp staff
Concerns over the working conditions of staff working in e-commerce warehouses	Exposes of conditions in Amazon in US and UK highlighted concerns about how staff are treated and managed

Topic: Assessing Digital Technology
3.9.4 Assessing Greater Use of Digital Technology

Operations

Impact on Operations	**Examples**
Logistics behind large-scale e-commerce platforms are complex	The leading e-commerce operations are hugely complex and are highly integrated with other business systems Businesses operating multi-channel platforms have particularly demanding challenges Supply chains are becoming much more complex due to e-commerce, meaning that firms and their suppliers have to work much closer together
Economies of scale are becoming increasingly important	The largest e-commerce firms and platforms benefit from significant "network economies of scale" where the extra customers, products, suppliers etc. added to the platform add very little to operating costs
It is now relatively easy for smaller firms to sell online	Platforms like Amazon and eBay are designed to encourage as many people businesses as possible to sell online.

Finance

Impact on Finance	**Examples**
Significant investment required to set-up e-commerce platforms and to integrate them with other systems	Many retail firms have stuck with legacy IT and logistics systems that were developed long before the explosion of e-commerce Upgrading these systems requires substantial investment
E-commerce likely to involve greater use of multi-currency transactions	As firms expand their e-commerce activities, greater demand from international customers can usually be expected. This increases the risks of foreign currency fluctuations which will thereby affect the returns made from international sales

Key Terms

E-commerce	Digitally enabled commercial transactions between and among organisations and individuals

Topic: Big Data and Data Mining

3.9.4 Assessing Greater Use of Digital Technology

What You Need to Know
Digital technology should include big data and data mining

What is Big Data?

Big data is the process of collecting and analysing large data sets from traditional and digital sources to identify trends and patterns that can be used in decision-making.

These large data sets are both **structured** (e.g. sales transactions from an online store) and **unstructured** (e.g. posts) on social media.

The quantity of data generated is growing exponentially, including data generated by:

- Retail e-commerce databases
- User-interactions with websites and mobile apps
- Usage of logistics, transportation systems, financial and health care
- Social media data
- Location data (e.g. GPS-generated)
- Internet of Things (IoT) data generated
- New forms of scientific data (e.g. human genome analysis)

How Businesses are Using Big Data

Some important uses of big data include:

- Tracking and monitoring the performance, safety and reliability of operational equipment (e.g. data generated by sensors)
- Generating marketing insights into the needs and wants of customers, based on the transactions, feedback, comments (e.g. from e-commerce analytics, social media posts). Big data is revolutionising traditional market research.
- Improved decision-making - for example analysing the real-time impact of pricing changes or other elements of the marketing mix (the use of big data to drive dynamic pricing is a great example of this).
- Better security of business systems: big data can be analysed to identify unusual activity, for example on secure-access systems
- More efficient management of capacity: the increasing use of big data to inform decision-making about capacity management (e.g, in transportation and logistics systems) is a great example of how big data can help a business operate more efficiently

What is Data Mining?

Data mining is the process of analysing data from different perspectives and summarising it into useful information, including discovery of previously unknown interesting patterns, unusual records or dependencies.

There are many potential business benefits from effective data mining, including:

- Identifying previously unseen relationships between business data sets
- Better predicting future trends & behaviours
- Extract commercial (e.g. performance insights) from big data sets

Topic: Big Data and Data Mining
3.9.4 Assessing Greater Use of Digital Technology

- Generating actionable strategies built on data insights (e.g. positioning and targeting for market segments)

Data Mining and Marketing
Data mining is a particularly powerful series of techniques to support marketing competitiveness.

Examples of the use of data mining in marketing include:

- **Sales forecasting:** analysing when customers bought to predict when they will buy again
- **Database marketing:** examining customer purchasing patterns and looking at the demographics and psychographics of customers to build predictive profiles
- **Market segmentation**: a classic use of data mining, using data to break down a market into meaningful segments like age, income, occupation or gender
- **E-commerce basket analysis:** using mined data to predict future customer behavior by past performance, including purchases and preferences

Key Terms

Big Data	The process of collecting and analysing large data sets from traditional and digital sources to identify trends and patterns that can be used in decision-making.
Data Mining	The process of analysing data from different perspectives and summarising it into useful information, including discovery of previously unknown interesting patterns, unusual records or dependencies

Topic: Enterprise Resource Planning (ERP)
3.9.4 Assessing Greater Use of Digital Technology

What You Need to Know
Digital technology should include enterprise resource planning (ERP)

What is Enterprise Resource Planning?
ERP is a software system that a system that helps businesses integrate and manage their often complex financial, supply chain, manufacturing, operations, reporting, and human resource systems.

Although the introduction and management of ERP systems is both complex and costly, there are some significant business benefits if ERP is implemented successfully.

These benefits include:

- **Financial management:** better control over assets, cash flow, and accounting
- **Supply chain and operations management:** streamlined purchasing, manufacturing, inventory, and sales order processing
- **Customer relationship management:** improved customer service, and opportunities to cross-sell
- **Project management:** complex projects better managed and to lower cost
- **Human resources management:** may help attract and retain good employees
- **Business intelligence:** improved management reporting, analysis, and business analytics
- **International business:** helps coordinate multi-location business management

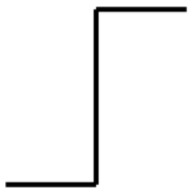
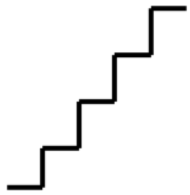
Topic: Causes and Types of Change
3.10.1 Managing Change

What You Need to Know
Types of change include: internal change, external change, incremental change, disruptive change.

What is Change Management?
Change management involves the **process** that ensures a business responds to the **environment** in which it operates

Key Types of Change: Incremental, Step and Disruptive
Classifying change into different categories based on the degree and nature of change is a good way of understanding the context for change management.

A classic way to distinguish change is to compare Step change with Incremental Change. These two are summarised below.

Step Change Significant & occurs rapidly	**Incremental Change** Many small and frequent changes
	
Key features:	***Key features:***
Dramatic or radical change in one fell swoop Often required when a business has suffered from strategic drift Often involves significant alteration in the business Gets it over with quickly / decisively May require some coercion to overcome resistance	Many small changes which take place as a business develops and responds to subtle changes in the external environment Usually involves little resistance Arises as strategy develops Often not noticed A culture of accepting and embracing incremental change may develop

Disruptive Change
This is a form of step change that arises from changes in the external environment which impact the market as a whole.

Disruptive change impacts the market as a whole, challenging the established "business model" (i.e. how products and services are sold).

Rapid improvements in technology are the main driver of disruptive change since technological innovation provides new ways of delivering goods and services as well as reducing barriers to market entry.

Topic: Causes and Types of Change

3.10.1 Managing Change

Internal and External Causes of Change

A distinction can be made in terms of the causes of change between those that are **"internal" (i.e. within the control of the business)** and those that are **"external" (i.e. outside of the control of the business** but which still need to be addressed).

Internal Causes of Change	External Causes of Change
*Arise from factors **within the control** of the business – i.e. the decisions taken by business management*	*Arise from factors **outside the control** of the business – i.e. as a result of changes in the external environment*
Examples: New leadership Change in strategic direction & corporate objectives Significant investment decisions Changes to scope of business activities (e.g. business unit closures) Adjusting the organisational structure (e.g. delayering)	***Examples:*** Significant competitor actions (e.g. new products, takeovers) Political & legal changes (e.g. deregulation or new taxes) Significant changes in economic environment (e.g. post Brexit for UK firms) Longer-term changes in society (e.g. lifestyles, demographics) Technological change (e.g. rapid growth or mobile device usage and related market disruption)

Key Terms

Change management	The process that ensures a business responds to the environment in which it operates
Step change	Significant and often transformational change that is significant to the business
Incremental change	Small, frequent and relatively insignificant changes to the business
Disruptive change	Change that arises from changes in the external environment which impact the market as a whole.

Topic: Change and Organisational Structures
3.10.1 Managing Change

What You Need to Know
Organisational structures to include: functional, product based, regional and matrix structure

Introduction to Organisational Structure
The organisational structure shows how employees and management are organised in a business.

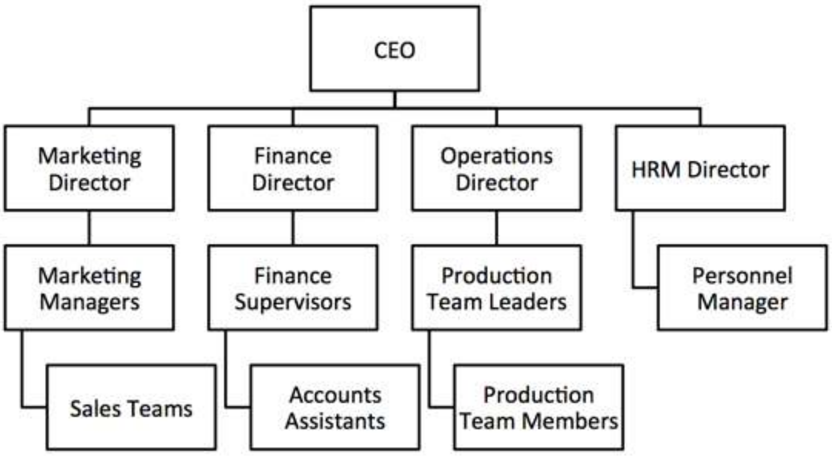
The organisational structure is vitally important because it determines:

- **Authority** and **responsibility** – who is responsible for whom and who is in charge?
- Individual job roles and titles
- The people to whom others are **accountable**
- The formal routes through which **communication flows** in the business

The simplest way to show how a business is organised is to look at an organisation chart. This shows the management hierarchy in a business. It works from the top to bottom and also illustrates:

- Span of Control
- Line management
- Chain of command

An example organisation chart is shown below:

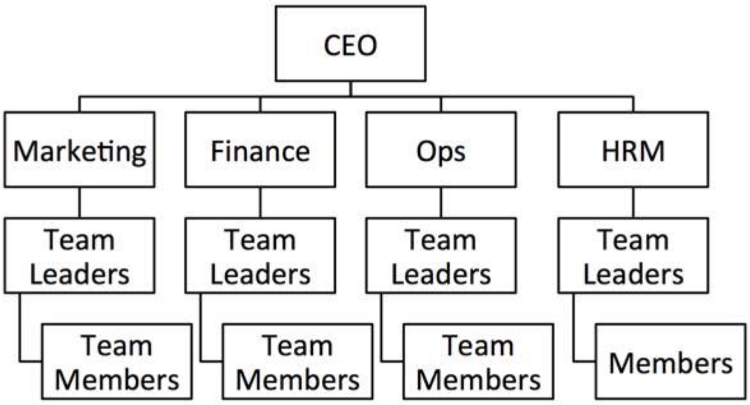


Hierarchy
The levels of hierarchy refer to the number of layers within an organisation.

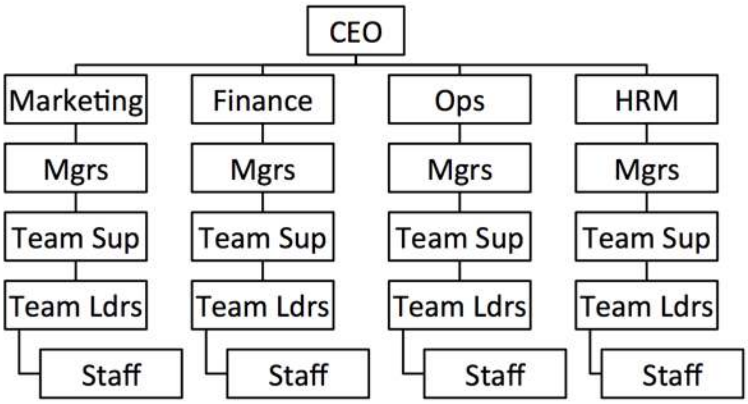
Traditional organisations were tall with many layers of hierarchy and were often authoritarian in nature.

The organisation chart above shows a business with four levels of hierarchy – from the Managing Director at the top, to assistants and team members at the bottom.

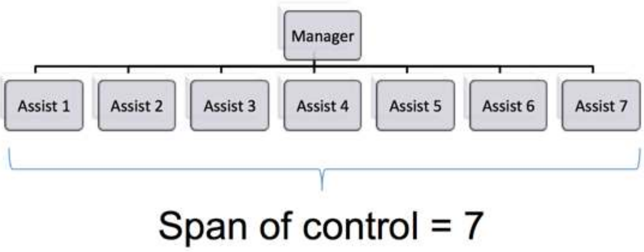
Topic: Change and Organisational Structures
3.10.1 Managing Change



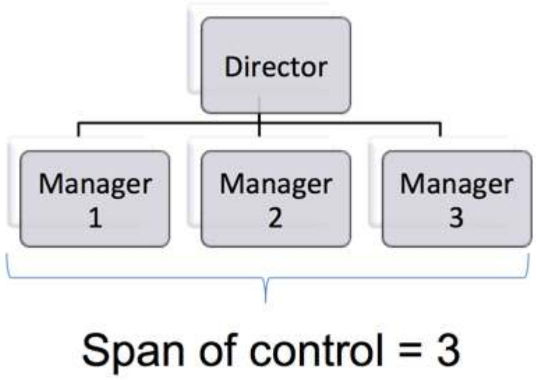
Below is another organisation chart, which shows a taller hierarchy.



Span of Control
The span of control is the number of subordinates for whom a manager is directly responsible. The two diagrams below illustrate two different spans of control:



A span of control of 7 would be considered to be quite wide. Contrast this with a span of 3 below, which would be considered "narrow"



Is there an ideal span of control? The answer is generally no – a suitable span of control will depend on factors such as the:

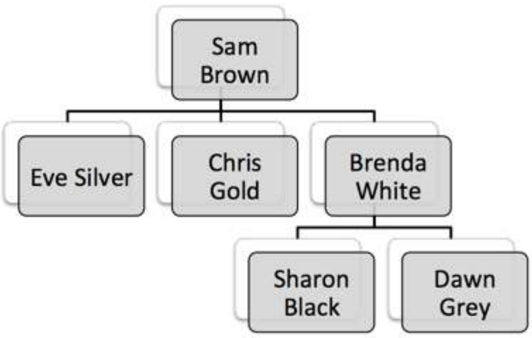
- Experience and personality of the manager
- Nature of the business. If being a line manager requires a great deal of close supervision, then a narrower span might be appropriate
- Skills and attitudes of the employees. Highly skilled, professional employees might flourish in a business adopting wide spans of control
- Tradition and culture of the organisation. A business with a tradition of democratic management and empowered workers may operate wider spans of control

Should spans of control be wide or narrow?

Narrow Span of Control	Wide Span of Control
Allows for closer supervision of employees	Gives subordinates the chance for more independence
More layers in the hierarchy may be required	More appropriate if labour costs are significant – reduce number of managers
Helps more effective communication	

Chain of Command

The chain of command describes the lines of authority within a business. In the simple organisation chart below Sam is responsible for Eve, Chris and Brenda. Further down the chain, Brenda is responsible for Sharon and Dawn.

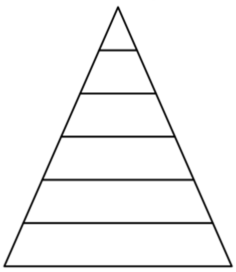


What is the Most Effective Hierarchy?

Topic: Change and Organisational Structures
3.10.1 Managing Change

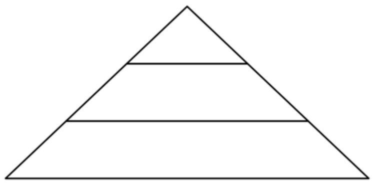
Although it is a generalization, there are traditionally two categories of organisational structure based around the number of layers in the hierarchy and span of control: tall and flat

Tall structure



- Key features – many layers of hierarchy + narrow spans of control
- Allows tighter control (less delegation)
- More opportunities for promotion
- Takes longer for communication to pass through the layers
- More layers = more staff = higher costs

Flat structure



- Key features – few layers of hierarchy + wide spans of control
- Less direct control + more delegation
- Fewer opportunities for promotion, but staff given greater responsibility
- Vertical communication is improved
- Fewer layers = less staff = lower costs

Changing the Organisational Structure
Organisational structures are dynamic – they change! Indeed, a business that doesn't regularly assess how effective its organisational structure may find itself becoming uncompetitive.

- **Why change the structure?**
  - Growth of the business means a more formal structure is appropriate
  - Reduce costs and complexity (key)
  - Employee motivation needs boosting
  - Customer service and/or quality improvements

- **Challenges of changing the structure**
  - Manager and employee resistance
  - Disruption and de-motivation = potential problems with staff retention
  - Costs (e.g. redundancies)
  - Negative impact on customer service or quality

Delayering (from Tall to Flat)
Delayering involves removing layers of management from the hierarchy of the organisation. The potential benefits and drawbacks of delayering an organisational structure include:

Benefits of Delayering	Drawbacks of Delayering
Lower management costs Faster decision making Shorter communication paths Stimulating employee innovation	Wider spans of control – too wide? Potential loss of management expertise

Topic: Change and Organisational Structures

3.10.1 Managing Change

Matrix Structures

In a matrix structure, individuals work across teams and projects as well as within their own department or function.

For example, a team established to develop a new product might include engineers and design specialists as well as those with marketing, financial, personnel and production skills.

These teams can be temporary or permanent depending on the tasks they are asked to complete. Each team member can find himself/herself with two managers - their normal functional manager as well as the team leader of the project.

An example of a matrix structure might look like this:

	Marketing	Operations	Finance	HRM
	Marketing Manager	*Operations Manager*	*Finance Manager*	*HR Manager*
Project A (Team Leader)	Marketing Team (A)	Operations Team (A)	Finance Team (A)	HR Team (A)
Project B (Team Leader)	Marketing Team (B)	Operations Team (B)	Finance Team (B)	HR Team (B)
Project C (Team Leader)	Marketing Team (C)	Operations Team (C)	Finance Team (C)	HR Team (C)
Project D (Team Leader)	Marketing Team (D)	Operations Team (D)	Finance Team (D)	HR Team (D)

The benefits and drawbacks of a matrix structure are summarised below:

Advantages of a Matrix Structure	Disadvantages of a Matrix Structure
Help to breaks down traditional department barriers, improving communication	Members of project teams may have divided loyalties as they report to two line managers
Individuals get to use their skills within a variety of contexts	May not be a clear line of accountability for project teams
Likely to result in greater motivation amongst the team members	Difficult to co-ordinate
Encourages sharing of good practice and ideas across departments	Team members may neglect their functional responsibilities
A good way of sharing resources across departments	It takes time for matrix team members to get used to working in this kind of structure

Topic: Change and Organisational Structures

3.10.1 Managing Change

Authority and Organisational Design: Who Makes the Decisions?

Decision-making in an organisation is about a**uthority.**

A key question is whether authority should rest with senior management at the centre of a business (**centralised**), or whether it should be delegated further down the hierarchy, away from the centre (**decentralised**).

Centralised Decision-Making

Businesses with a centralised structure keep decision-making firmly at the top of the hierarchy (amongst the most senior management). The main benefits and drawbacks of a centralised approach include:

Advantages of Centralisation	**Disadvantages of Centralisation**
Easier to implement common policies and practices for the whole business	More bureaucratic – often extra layers in the hierarchy
Prevents other parts of the business from becoming too independent	Local or junior managers are likely to much closer to customer needs
Easier to co-ordinate and control from the centre – e.g. with budgets	Lack of authority down the hierarchy may reduce manager motivation
Economies of scale and overhead savings easier to achieve	Customer service does misses flexibility and speed of local decision-making
Quicker decision-making (usually) – easier to show strong leadership	

Decentralised Decision-Making

In a decentralised organisational structure, decision-making is spread out to include more junior managers in the hierarchy, as well as individual business units or trading locations. The main benefits and drawbacks of a decentralised approach include:

Advantages of Decentralisation	**Disadvantages of Decentralisation**
Decisions are made closer to the customer	Decision-making is not necessarily "strategic"
Better able to respond to local circumstances	Harder to ensure consistent practices and policies at each location
Improved level of customer service	May be some diseconomies of scale – e.g. duplication of roles
Consistent with aiming for a flatter hierarchy	Who provides strong leadership when needed (e.g. in a crisis)?
Good way of training and developing junior management	Harder to achieve tight financial control – risk of cost-overruns
Should improve staff motivation	

Topic: Change and Organisational Structures
3.10.1 Managing Change

Using Organisational Design to Improve Motivation: Delegation & Empowerment
Two ways in which the way work is organised better to improve employee motivation are delegation and job empowerment:

Delegation
Be careful not to confuse delayering with a similar-sounding term: delegation.
Delegation is the assignment to others of the authority for particular functions, tasks, and decisions. The advantages and disadvantages of encouraging greater delegation include:

Advantages of Delegation	Disadvantages of Delegation
Reduces management stress and workload Allows senior management to focus on key tasks Subordinates are empowered and motivated Better decisions or use of resources (potentially) Good method of on-the-job training	Cannot / should not delegate responsibility Depends on quality / experience of subordinates Harder in a smaller firm May increase workload and stress of subordinates

Job Empowerment
Job (or employee) empowerment is about giving employees the power to do their job. The concept is closely linked to motivation and customer service. Put simply, employees need to feel that their actions count. Empowerment is a catch-all term that covers:

- Giving authority to make decisions to front-line staff (e.g. hotel receptionist, call centre assistant)
- Encouraging employee feedback
- Showing more trust in employees

Key Terms

Hierarchy	The structure and number of layers of management and supervision in an organisation
Span of control	The number of employees who are directly supervised by a manager
Delegation	Where responsibility for carrying out a task or role is passed onto someone else in the business.
Empowerment	Delegating power to employees so that they can make their own decisions
Delayering	The process of removing one or more layers from the organisational structure
Centralisation	An organisational structure where authority rests with senior management at the centre of the business
Decentralisation	An organisational structure where authority is delegated further down the hierarchy, away from the centre

Topic: Flexible Organisations
3.10.1 Managing Change

What You Need to Know
Flexible organisations include: • restructuring • delayering • flexible employment contracts • organic structures v mechanistic

What is a Flexible Organisation?

A flexible organisation is one that is able to **adapt and respond** relatively quickly to changes in its **external environment** in order to **gain advantage and sustain its competitive** position.

Whilst it is not easy to achieve or sustain, there are some significant potential benefits to a business having a flexible organisation. These include:

- More likely to be efficient & productive (impact on unit costs)
- More likely to respond to and meet changing customer needs and wants
- Improved decision-making (better informed and quicker)
- The organisation can concentrate on its core competencies rather than trying to undertake every business activity
- A more attractive place to work for the best people
- Essentially – more likely to identify and respond to the need for change – before it is too late to change

Restructuring

Businesses of any size or complexity often find it necessary to restructure the way they operate.

Restructuring usually involves changing the organisational structure, both in terms of the type of structure and layers. This might also mean how business units (e.g. divisions) are organised. Restructuring also involves decisions about:

- Activities are undertaken directly by a business
- Where activities are undertaken (e.g. a decision to **offshore)**
- Activities that are **outsourced** to external suppliers

Restructuring through Delayering

The traditional way to achieve a flatter organisational structure is through **delayering.**

Delayering **involves removing one or more levels of hierarchy from the organisational structure.**

Frequently, the layers removed are those containing middle managers. For example, many high-street banks no longer have a manager in each of their branches, preferring to appoint a manager to oversee a number of branches. Some schools adopt this policy too – with a director of studies looking after several schools in a local area.

Delayering **does not necessarily involve cutting jobs and overheads.** But it does usually mean increasing the average span of control of senior managers within the business. This can, in effect, chop the number of layers without removing a single name from the payroll, as the people affected are moved elsewhere in the business. However, it is fair to say that, increasingly delayering ***is*** seen as a way of reducing operating costs, particularly as a response to the economic downturn.

Delayering can offer a number of advantages to business:

- It offers opportunities for better delegation, empowerment and motivation as the number of managers is reduced and more authority passed down the hierarchy
- It can improve communication within the business as messages have to pass through fewer levels of hierarchy
- It can remove departmental rivalry if department heads are removed and the workforce is organised more in teams
- It can reduce costs as fewer (expensive) managers are required
- It can encourage innovation
- It brings managers into closer contact with the business' customers – which should (in theory) result in better customer service

But disadvantages exist too, making a decision to delayer less clear cut:

- Not all organisations are suited to flatter organisational structures - mass production industries with low-skilled employees may not adapt easily
- Delayering can have a negative impact on motivation due to job losses, especially if it is really just an excuse for redundancies
- A period of disruption may occur as people take on new responsibilities and fulfil new roles
- Those managers remaining will have a wider span of control which, if it is too wide, can damage communication within the business. There is also a danger of

increasing the workload of the remaining managers beyond that which is reasonable.

- Delayering may create skills shortages within the business – a danger is that delayering means that the business loses managers and staff with valuable experience

Any programme of delayering needs to be carefully thought-through. Get it wrong, and the damage to a business can be significant.

Flexible Employment Contracts ("Flexible Working)

Flexible working involves arrangements where there are a variety of options offered to employees in terms of working time, working location and the pattern of working.

Amongst the most popular flexible working practices included in employment contracts are:

Part-time working	Term-time working	Working from home
Flexitime	Career breaks	Job sharing
Annual hours contracts	Mobile working	Shift swapping

Of the options listed above, by far the most popular in the UK currently is part-time working.

There are good business reasons why businesses are increasingly likely to offer employees one or more flexible working options. For example:

- Most importantly, savings on costs. A business can make substantial savings on overheads if it does not have to provide office and other accommodation for so many employees or if staff can work from home rather than commute into work every day
- As a way of helping with recruitment and staff retention. There is lots of evidence that flexible working results in better job satisfaction and higher staff morale
- To reflect the changing profile of the UK workforce. There are more women in the labour market and an ageing population – as a result, it is increasingly common for staff to have caring responsibilities outside work
- To take advantage of developments in technology – it is now simple and cost-effective for employees to be able to access their employers online and other networked systems, and to communicate digitally with colleagues
- An increasing need for businesses to be able to deliver services to customers on a 24/7 basis. Flexible working makes it easier for businesses to offer extended opening hours, for example
- To meet employment legislation – increasingly the law allows certain groups of employees the legal right to request flexible working

Whilst there any many advantages to flexible working, it is not always simple or appropriate to introduce it.

Amongst the concerns that employers often raise about flexible working are:

- Additional administrative work and "red-tape" involved in setting up and running flexible working
- The potential loss of customers if key employees reduce their working hours
- Lower employee productivity
- Inability to substitute for certain skills if certain employees are absent (a common concern of smaller businesses_
- Managers finding it difficult to manage or administer the flexibility

A study by the Joseph Rowntree Foundation found that flexible working practices were most likely to be found in the following situations:

- In large organisations and businesses
- In public sector organisations
- Where the business does not operate in a highly competitive industry
- Where there are recognised unions
- Where there is a well established HR function
- Where there is high employee involvement in decision-making
- In workforces with larger proportions of women
- Where there is a highly educated workforce who has a large amount of discretion in organising work (e.g. professions, creative industries)

Organic vs Mechanistic Organisational Structures

A flexible organisation is more likely to have adopted what is often referred to as an "organic" structure, as compared with a "mechanistic" structure.

The differences between these two can be summarised as follows:

Organic Structures	Mechanistic Structures
Characterised by: Informality Flexible and fluid (easy to change) Favours informal (e.g.) verbal communication Associated with decentralised decision-making & employee empowerment Find change easier to handle	***Characterised by:*** More formality & bureaucratic Associated with centralised decision-making & supervision Reliance on formal communication methods Favours standardised policies and procedures Little perceived need to change Greater resistance to change when implemented

Key Terms

Delayering	Involves removing one or more levels of hierarchy from the organisational structure.
Flexible working	Arrangements where there are a variety of options offered to employees in terms of working time, working location and the pattern of working.

Topic: Kotter & Schlesinger Change Model
3.10.1 Managing Change

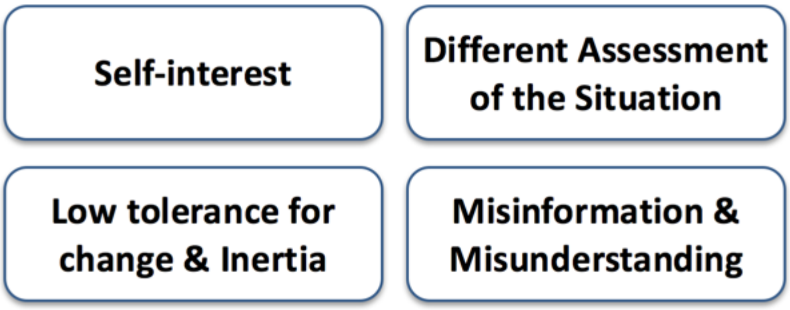
What You Need to Know
Barriers to change: Kotter and Schlesinger's four reasons for resistance to change. How to overcome barriers to change: Kotter and Schlesinger's six ways of overcoming resistance to change

Introduction
Kotter and Schlesinger developed theories to explain two key areas of change:

(1) Why is change resisted
(2) What can be done to overcome resistance to change

Let's look at each area.

Kotter and Schlesinger's Four Reasons for Resistance to Change
Kotter & Schlesinger suggest that there are four main reasons why change is resisted:



The key points to remember for each of the four reasons above are:

Self-interest

- Self-interest is a powerful motivator
- Arises from a perceived threat to job security, status and financial position
- Understandable - why would you want to lose something you believe to be valuable?
- Individuals often place their own interests ahead of those of their organisation, particularly if they don't feel a strong loyalty to it

Misinformation & Misunderstanding

- People don't understand why change is needed, perhaps because they are misinformed about the real strategic position of the business
- Perception may be widespread that there is no compelling reason for change
- Perhaps even an element of people fooling themselves that things are better than they really are

Different Assessment of the Situation

- Here there is disagreement about the need for change or what that change needs to be

Topic: Kotter & Schlesinger Change Model
3.10.1 Managing Change

- Some people may simply disagree with the change proposed, or they may feel they have a better solution
- This is different from "self-interest" – the resistance here is based on disagreement about what is best for the business

Low Tolerance and Inertia

- Many people suffer from inertia or reluctance to change, preferring things to stay "the way they are"
- Many people need security, predictability & stability in their work
- If there is low tolerance of change (perhaps arising from past experience) then resistance to change may grow

Kotter and Schlesinger's Six Ways of Overcoming Resistance to Change
How can senior management overcome the inevitable resistance to change when change is required? In their work, six approaches suggested by Kotter & Schlesinger.

Here are the key points for each of the six approaches:

Education & Communication

- The starting point for successful change is to communicate effectively the reasons why change is needed!
- Honest communication about the issues and the proposed action helps people see the logic of change
- Effective education helps address misconceptions about the change, including misinformation or inaccuracies
- Education and communication are unlikely to achieve very short-term effects. They need to be delivered consistently and over a long-period for maximum impact

Participation & Involvement

- Involvement in a change programme can be an effective way of bringing "on-board" people who would otherwise resist
- Participation often leads to commitment, not just compliance

Topic: Kotter & Schlesinger Change Model

3.10.1 Managing Change

- A common issue in any change programme is just how much involvement should be permitted. Delays and obstacles need to be avoided.

Facilitation & Support

- Kotter & Schlesinger identified what they called “adjustment problems” during change programmes
- Most people (though not all) will need support to help them cope with change
- Key elements of facilitation and support might include additional training, counselling and mentoring as well as simply listening to the concerns of people affected
- If fear and anxiety is at the heart of resistance to change, then facilitation and support become particularly important

Co-option & Manipulation

- Co-option involves bringing specific individuals into roles that are part of change management (perhaps managers who are likely to be otherwise resistant to change)
- Manipulation involves the selective use of information to encourage people to behave in a particular way
- Whilst the use of manipulation might be seen as unethical, it might be the only option if other methods of overcoming resistance to change prove ineffective

Negotiation & Bargaining

- The idea here is to give people who resist an incentive to change – or leave
- The negotiation and bargaining might involve offering better financial rewards for those who accept the requirements of the change programme
- Alternatively, enhanced rewards for leaving might also be offered
- This approach is commonly used when a business needs to restructure the organisation (e.g. by delayering)

Explicit & Implicit Coercion

- This approach is very much the “last resort” if other methods of overcoming resistance to change fail
- Explicit coercion involves people been told exactly what the implications of resisting change will be
- Implicit coercion involves suggesting the likely negative consequences for the business of failing to change, without making explicit threats
- The big issue with using coercion is that it almost inevitably damages trust between people in a business and can lead to damaged morale (in the short-term)

Topic: Lewin's Force Field Analysis
3.10.1 Managing Change

What You Need to Know
Managing change should include: Lewin's force field analysis.

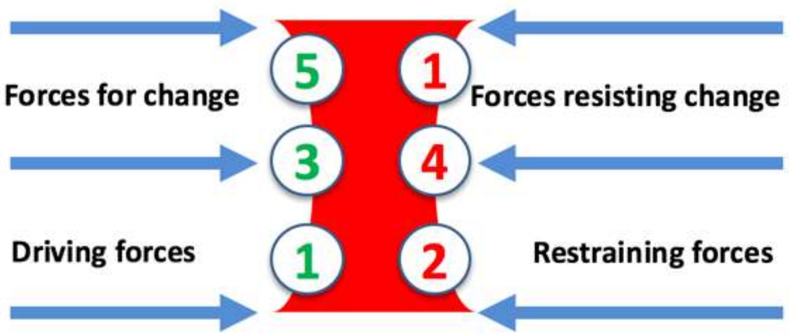
Introduction to Lewin's Force Field Analysis
Lewin's **Force Field Analysis** model provides an overview of the balance between **forces driving change** in a business and the **forces resisting change**.

Lewin argued that successful businesses tend to be constantly adapting to their environment and changing, rather than being inflexible. However, he recognised that businesses found it difficult to change, in particular as a result of the forces resisting change being strong than those driving change.

Key Features of the Force Field Analysis Model
The key points to remember are:

- There are forces driving change and forces restraining it
- Where there is an equilibrium between the two sets of forces there will be no change
- In order for change to occur the driving force must exceed the restraining force

This is represented diagrammatically below:



The idea with the model is to assign values to the key driving forces and restraining forces.

If the total value of driving forces is greater than the total value of the restraining forces, then change can be achieved. Conversely if the restraining forces are stronger (higher in value) than the driving forces, change is hard to implement.

The key action for management trying to implement change, therefore, is to take action to reduce the power of the restraining forces – i.e. try to overcome resistance.

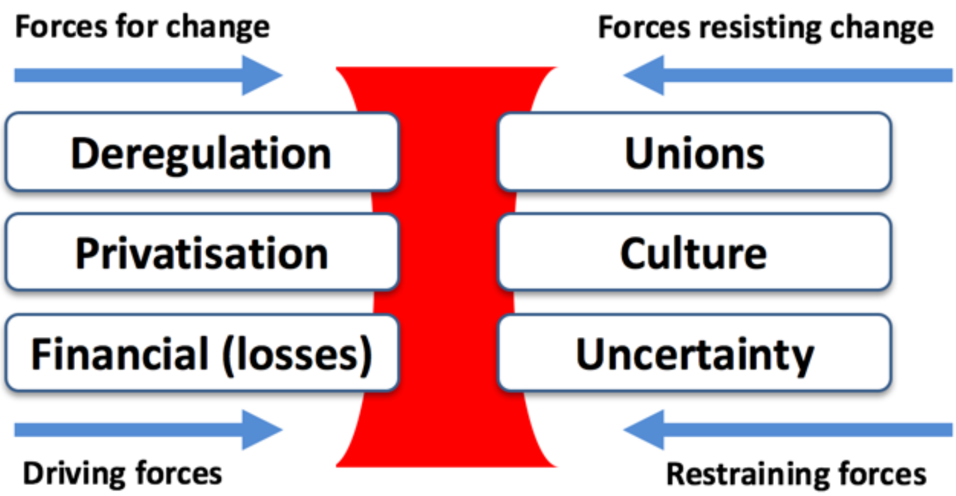
The models of Kotter & Schlesinger suggest different ways in which this can be done:

Topic: Lewin's Force Field Analysis
3.10.1 Managing Change

Examples of forces driving change include:

Internal Forces Driving Change	External Forces Driving Change
Need for higher profits Poor efficiency Lack of innovation Need to change culture Change of leadership	Customer demand Competition Legislation & taxes Political environment Ethics & social values Technological change

An example of the Force Field Analysis approach – as applied to the Royal Mail – is illustrated below:



Topic: Changing Organisational Culture
3.10.2 Managing Organisational Culture

What You Need to Know
The influences on organisational culture The reasons for and problems of changing organisational culture

What is Organisational Culture?
Although most of us understand in our own minds what is meant by organisational culture, it is hard to define precisely. We know (and can often sense) a "culture" exists when we visit a business as a customer or work there, but how can this be explained?

Charles Handy described organisational (or corporate) culture as:

"The way we do things around here"

Culture consists of factors such as:

- The shared values of a business
- The beliefs and norms that affect every aspect of work life
- The behaviours typical of day-to-day behaviour
- The strength of a culture determines how difficult or easy it is to know how to behave in the business

The culture of a business is reflected in many ways – including:

- How employees are recruited – the cultural factors that make one applicant more suitable than another
- The way that visitors and guests are looked after
- How the working space is organised
- The degree of delegation & individual responsibility
- How long new employees stay in a business
- How contracts are negotiated and agreed
- The personality and style of the sales force
- The responsiveness of communication
- The methods used for communication
- How staff call each other (e.g. first name)
- The nature and style of marketing materials
- The speed with which decisions are taken
- The number of layers in the management hierarchy

Strong v Weak Culture
When you visit a range of businesses you soon get a sense of the strength of the business culture. If a culture can be measured as then how might this show itself?

Signs of a strong organisational culture include:

- Staff understand and respond to culture
- Little need for policies and procedures
- Consistent behaviour
- Culture is embedded

Evidence that points to a weak organisational culture include:

- Little alignment with business values

- Inconsistent behaviour
- A need for extensive bureaucracy & procedures

Note: strong culture is particularly hard to change!

Key Influences on Organisational Culture
Organisational culture is complex and is built on a variety of influences, some of which will be much more important than others in certain organisations. Key influences include:

- Influence of the founder **("shadow of the leader")**
- Size & development stage of the business (e.g. start-up, multisite, multinational)
- Leadership & management style
- Organisational structure, policies & practices
- Employee & management reward structures (e.g. pay, bonuses, individual v team rewards)
- Market /industries in which it operates
- Working environment & nature of tasks (e.g. physical, office, remote working, flexible working)
- External environment (e.g. legal, economic)
- Attitude of organisation to risk-taking & innovation

What Are the Signs that Organisational Culture Might Need Changing?
Attempts to change organisational culture are often associated with other transformational ("step") change projects in organisations.

Accordingly, the signs that culture may need to change are often the same symptoms of the need for broader organisational change, including:

- Declining profits and sales
- Inadequate returns on investment
- Low quality or standards of customer service
- Loss of market share
- Failure to innovate

The above list are largely strategic business issues. Other culture-related symptoms might point to a more deep-seated problem with culture that needs to be addressed, such as:

- Internal fighting; management criticism ("us & them mentality")
- High levels of voluntary staff turnover & hard to retain top talent
- Greater absenteeism
- Processes become more bureaucratic
- Innovation is no longer valued
- Evidence of declining customer service
- Leadership show double standards or decision-making becomes inconsistent
- Communication becomes more closed and restricted

Topic: Changing Organisational Culture
3.10.2 Managing Organisational Culture

Changing Organisational Culture is Hard
Almost by definition, if an existing organisational culture is strong (i.e. deeply embedded) then it is going to be hard to change, particularly in the short-term.

Professor Ed Schein, an expert on organisational culture, argues that senior management should never start with the intention of changing a culture. Instead they should start with the issues that the organisation faces and assess whether the existing culture gets in the way of resolving those issues.

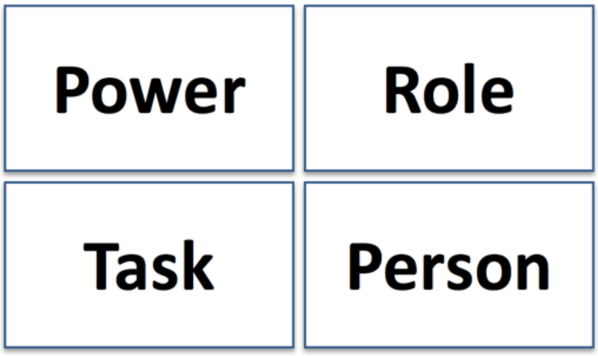
Schein argues that management should always think first of the organisational culture as a source of strength even if some elements are dis-functional. If major changes are needed, try to build on existing cultural strengths.

Topic: Handy's Model of Culture
3.10.2 Managing Organisational Culture

What You Need to Know
Organisational culture models should include: Handy's task culture, role culture, power culture and person culture

Introduction to Handy's Model of Organisational Culture
Charles Handy, a leading authority on organisational culture, defined four different kinds of culture:

- **Power culture**
- **Role culture**
- **Task culture**
- **Person culture**



Let's summarise what each of those kinds of organisational culture mean, according to Handy:

Power Culture
In an organisation with a power culture, power is held by just a few individuals whose influence spreads throughout the organisation.

There are few rules and regulations in a power culture. What those with power decide is what happens. Employees are generally judged by what they achieve rather than how they do things or how they act. A consequence of this can be quick decision-making, even if those decisions aren't in the best long-term interests of the organisation.

A power culture is usually a strong culture, though it can swiftly turn toxic. The collapse of Enron, Lehman Brothers and RBS is often attributed to a strong power culture.

Role Culture
Organisations with a role culture are based on **rules**. They are highly controlled, with everyone in the organisation knowing what their roles and responsibilities are. Power in a role culture is determined by a person's position (role) in the organisational structure.

Role cultures are built on detailed organisational structures which are typically tall (not flat) with a long chain of command. A consequence is that decision-making in role cultures can often be painfully-slow and the organisation is less likely to take risks. In short, organisations with role cultures tend to be very bureaucratic.

Task Culture
Task culture forms when teams in an organisation are formed to address specific problems or progress projects. The task is the important thing, so power within the team will often shift depending on the mix of the team members and the status of the problem or project.

Whether the task culture proves effective will largely be determined by the team dynamic. With the right mix of skills, personalities and leadership, working in teams can be incredibly productive and creative.

Person Culture
In organisations with person cultures, individuals very much see themselves as unique and superior to the organisation.

The organisation simply exists in order for people to work. An organisation with a person culture is really just a collection of individuals who happen to be working for the same organisation. Perhaps some Premier League football teams have a person culture!

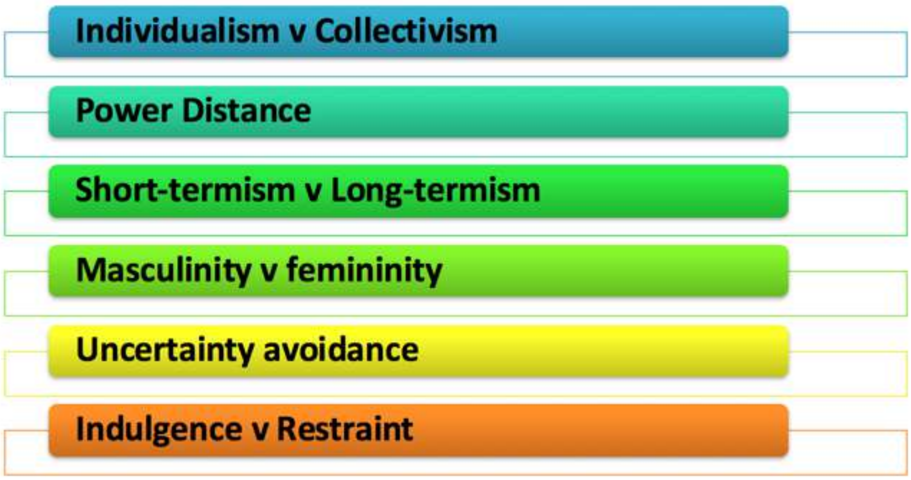
Topic: Hofstede National Cultures
3.10.2 Managing Organisational Culture

What You Need to Know
Cultural models should include: Hofstede's national cultures

Introduction to Hofstede's National Cultures
Social psychologist Geert Hofstede has conducted extensive research into the different categories of **culture** that help distinguish the ways business is conducted **between different nations**.

Hofstede carried out research amongst over 100,000 employees working around the world for IBM. He attempted to categorise cultures of different nationalities working at IBM.

Hofstede has extended the categories to six based on his latest research, which are summarised below:



Let's briefly outline the main points about these categories of cultural difference:

Individualism v Collectivism
- Some societies value the performance of individuals
- For others, it is more important to value the performance of the team
- Has important implications for financial rewards at work (e.g. individual bonuses v profit-sharing for bigger groups)

Power Distance
- This considers the extent to which inequality is tolerated and whether there is a strong sense of position and status
- A high PD score would indicate a national culture that accepts and encourages bureaucracy and a high respect for authority and rank
- A lower PD score would suggest a national culture that encourages flatter organisational structures & a greater emphasis on personal responsibility and autonomy

Long-term orientation
- This category is concerned with the different emphases national cultures have on the time horizons for business planning, objectives & performance

Topic: Hofstede National Cultures

3.10.2 Managing Organisational Culture

- Some countries place greater emphasis on short-term performance (so-called short-termism), with financial and other rewards biased towards a period of just a few months or years.
- Other countries take a much longer-term perspective, which is likely to encourage more long-term thinking.
- The key implication of this category is the impact on investment decisions and risk-taking

Masculinity v Femininity

- This somewhat unfortunately-named category considers the differences in decision-making style
- Hofstede linked what he called a "masculine" approach to a hard-edged, fact-based and aggressive style decision-making
- By contrast, "feminine" decision-making involved a much greater degree of consultation and intuitive analysis

Uncertainty Avoidance

- This category essentially considers the different attitudes to risk-taking between countries
- Hofstede looked at the level of anxiety people feel when in uncertain or unknown situations
- Low levels of uncertainty avoidance indicate a willingness to accept more risk, work outside the rules and embrace change. This might indicate a more entrepreneurial national culture
- Higher levels of uncertainty avoidance would suggest more support for rules, data, clarity of roles and responsibilities etc. These cultures might be less entrepreneurial as a consequence

Indulgence v Restraint

- Indulgence stands for a society that allows relatively free gratification of basic and natural human drives related to enjoying life and having fun
- Restraint stands for a society that suppresses gratification of needs and regulates it by means of strict social norms

Some Selected Hofstede National Culture Indicators

	Power Distance	Individualism v Collectivism	Masculinity v Femininity	Uncertainty Avoidance	Long-term Orientation	Indulgence v Restraint
Australia	38	90	61	51	21	71
China	80	20	66	30	87	24
UK	35	89	66	35	51	69
India	77	48	56	40	51	26
South Korea	60	18	39	85	100	29
Singapore	74	20	48	8	72	46
U.S.A.	40	91	62	46	26	68

Topic: Network Analysis
3.10.3 Managing Strategic Implementation

What You Need to Know
The value of network analysis in strategic implementation Network analysis to include: • understanding and interpreting network diagrams • amendment of network diagrams • identifying the critical path and total float

Introduction
Network, or as it is otherwise known - critical path analysis ("CPA") - is a widely-used **project management tool** that uses network analysis to **help project managers handle complex and time-sensitive operations.**

Many larger businesses get involved in projects that are complex and involve significant investment and risk. As the complexity and risk increases it becomes even more necessary to identify the relationships between the activities involved and to work out the most efficient way of completing the project.

Building the Network Analysis Model
The essential technique for using CPA is to construct a model of the project that includes the following:

- A list of all activities required to complete the project
- The time (duration) that each activity will take to completion
- The dependencies between the activities

Using this information, CPA calculates:
- The longest path of planned activities to the end of the project
- The earliest and latest that each activity can start and finish without making the project longer

This process determines which activities are **"critical" (i.e., on the longest path)** and which have **"total float"** (i.e. can be delayed without making the project longer).

In project management, a critical path is:
The sequence of project activities which add up to the longest overall duration

The critical path determines the shortest time possible to complete the project.

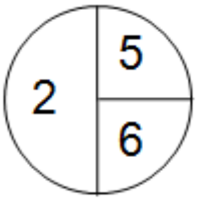
Any delay of an activity on the critical path directly impacts the planned project completion date (i.e. there is no float on the critical path).

Illustrating CPA

Here is worked example to illustrate how the critical path for a project is determined. Conventions in drawing the network

The main components of a network analysis are summarised below:

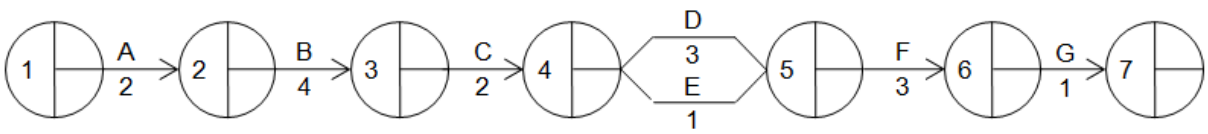
Topic: Network Analysis
3.10.3 Managing Strategic Implementation

Component	Description
Node	A circle that represents a point in time where an activity is started or finished. The node (circle) is split into three sections:  The left half of the circle is the unique node (activity) number – the network diagram draws these in order The top right section shows the earliest start time (EST) that an activity can commence based on the completion of the previous activity The bottom right section shows the latest finish time (LFT) by which the previous activity must be completed
Activities	An activity is something that takes time. An activity is shown on the network as a line, linking the nodes (circles). A description of the activity, or a letter representing the activity, is usually shown above the relevant line
Duration	The length of time it takes to complete an activity – shown as a number of the relevant units (e.g. hours, days) under the activity line

Example Network Diagram
Consider the following series of activities in a business planning to launch a new product:

Task	Activity	Order	Duration (months)
A	Conduct customer research	Starting activity	2
B	Design product concept	Begin when A complete	4
C	Design and test product prototype	Begin when B complete	2
D	Develop and test production tooling	Begin when C complete	3
E	Notify suppliers of requirements	Begin when C complete	1
F	Commence production	Begin when D complete	3
G	Conduct launch promotion	Begin when F complete	1

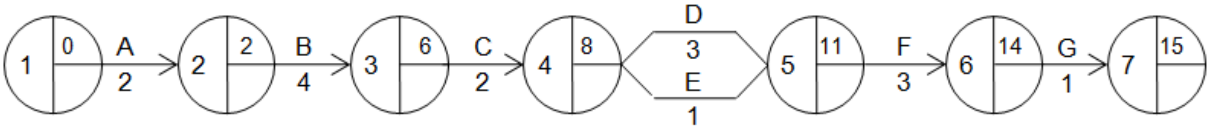
Laid out in the correct sequence of activities, the network diagram would look like this before we calculate the EST and LFT for each activity:



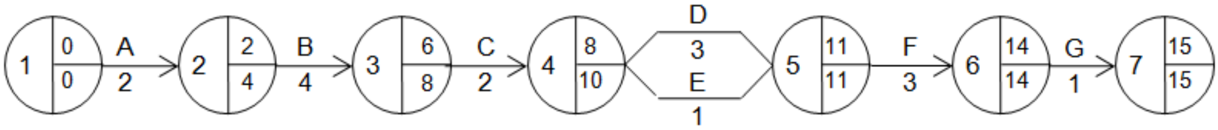
The next step is to calculate the EST for each activity.

For example:
The EST for task B is 2 months – the time taken to conduct market research (task A)
To calculate the EST for task C, we add the 2 months for task A to the 4 months for designing the product concept (task B) = 6 months
The remaining ESTs can then be added to the network diagram:

Topic: Network Analysis
3.10.3 Managing Strategic Implementation



The LFTs show the latest time an activity must be completed by to avoid a delay to the project. LFTs are calculated by looking right to left on the network diagram. So:



Evaluating Network Analysis / CPA
The main advantages and disadvantages of a business using CPA can be summarised as follows:

Advantages	**Disadvantages**
Most importantly – helps reduce the risk and costs of complex projects	Reliability of CPA largely based on accurate estimates and assumptions made
Encourages careful assessment of the requirements of each activity in a project	CPA does not guarantee the success of a project – that still needs to be managed properly
Help spot which activities have some slack ("float") and could therefore transfer some resources = better allocation of resources	Resources may not actually be as flexible as management hope when they come to address the network float
A decision-making tool and a planning tool – all in one!	Too many activities may the network diagram too complicated. Activities might themselves have to be broken down into mini-projects
Provides managers with a useful overview of a complex project	
Links well with other aspects of business planning, including cash flow forecasting and budgeting	

Key Terms

Network analysis	A management planning tool to help manage complex and time-critical projects

Topic: Contingency Planning

3.10.4 Problems with Strategy and Why Strategies Fail

What You Need to Know
The value of contingency planning

Introduction to Contingency Planning

Contingency planning involves:

- Preparing for predictable and quantifiable problems
- Preparing for unexpected and unwelcome events

The aim of contingency planning is to **minimise the impact** of a **significant foreseeable event** and to plan for how the business will resume normal operations after the event.

Contingency Planning and Risk Management

Contingency planning is one of the three approaches a business can take to manage risk. These are:

Risk management	Identifying and dealing with the risks threatening a business
Contingency planning	Planning for unforeseen events
Crisis management	Handling potentially dangerous events for a business

What do we mean by "risk" in business? Risk can be:

- The possibility of loss or business damage
- A threat that may prevent or hinder the ability to achieve business objectives
- The chance that a hoped-for outcome will not occur (e.g. customers do not respond well to a new product launch)

Risk is ever-present in business and there are a variety of possible responses to it:

- Ignore it (wait and see)
- Share/deflect the risk (e.g. take-out insurance)
- Make **contingency plans** - prepare for it
- Embrace risk as an opportunity- particularly if it also affects other competitors

Some examples of how action can be taken to reduce risk include:

Area	**Risk Management Action**
Marketing	Avoid over-reliance on customers or products Develop multiple distribution channels Test marketing for new products
Operations	Hold spare capacity Rigorous quality assurance & control procedures & culture
Finance	Insurance against bad debts Investment appraisal techniques
People	Key man insurance – protect against loss of key staff Rigorous recruitment & selection procedures

Topic: Contingency Planning

3.10.4 Problems with Strategy and Why Strategies Fail

What is Involved in Contingency Planning

The **process** of contingency planning involves:

- Identifying what and how things can and might go wrong
- Understanding the potential effects if things go wrong
- Devising plans to cope with the threats
- Putting in place strategies to deal with the risks before they happen

Almost by definition, contingency planning should focus on the most important risks; those that have the potential for significant business disruption or damage. Risks vary in terms of their significance to the business

Contingency planning is not required for every eventuality. However, risks of strategic significance cannot be ignored

Key Terms

Contingency planning	The process of preparing for predictable and quantifiable problems and preparing for unexpected and unwelcome events

Topic: Corporate Governance

3.10.4 Problems with Strategy and Why Strategies Fail

What You Need to Know
The effect of the divorce between ownership and control to include corporate governance.

What is Corporate Governance?
Corporate governance is the system by which companies are directed and controlled.

The Role of the Board of Directors
It is the **Board of directors** of each company that is **legally responsible** for the governance of the company.

The shareholders' role in corporate governance is to:
- **appoint the directors** (and the auditors where required) and
- to satisfy themselves that an appropriate governance structure is in place.

The responsibilities of the Board of directors include:

- Setting the company's objectives and aims
- Determining the strategy to achieve those aims and objectives
- Providing the leadership to put them into effect
- Supervising the management of the business
- Reporting to shareholders on their stewardship of the business

Divorce between Ownership and Control
The so-called "divorce between ownership and control" happens when **the owners of a business do not control the day-to-day decisions made in the business.** For example, the majority of shareholders in public companies are not involved in any way with operational decision-making by the companies in which they have invested.

The owners of a company normally elect a Board of Directors to control the business's resources for them. Often in smaller firms, there is no difference between the Directors and the Shareholders - they are the same person or people.

However, when the share ownership of the business becomes more widespread (for example when shares are sold to external investors) the original owners of the business sacrifice some of their control.

Other shareholders can exercise their voting rights, and providers of loans often have some control (security) over the assets of the business.

This may lead to conflict between them as different shareholders can have varying objectives. This is known as the principal agent problem.

The Principal Agent Problem
How do the shareholders of a business know that managers charged with running the business are acting in their best interests by building shareholder value?

The principal agent problem revolves around how best to get your employees to act in your interests rather than their own?

Topic: Corporate Governance

3.10.4 Problems with Strategy and Why Strategies Fail

Shareholders tend to want strong returns in the form of dividend payments and a rising share price. However, managers may have objectives such as power, bonuses, prestige and status.

The problem is the many shareholders have no day-to-day control over managers.

For example, pension fund managers cannot dictate what CEOs and CFOs of businesses decide to do and senior executives may have little knowledge of what their managers are doing. Many investors are 'passive'. The biggest investors in UK-listed companies tend to be large institutional shareholders such as pension funds and insurance companies.

What is in the best interest of the management is not necessarily the same as what is in the best interests of the shareholders.

Dealing with the Divorce between Ownership & Control

Strategies to deal with the potential conflict between shareholders and managers include:

- Ensuring that financial rewards and incentives offered to managers are aligned with shareholder holder interests - e.g. based on the share price, dividends, profits achieved
- Implementing suitable corporate governance procedures to ensure shareholders are protected as far as possible (e.g. through non-executive directors, management remuneration committees)
- Company legislation ensuring that Directors are accountable for their actions to shareholders.

The Growth of Activist Shareholders

Activist shareholders look to put pressure on existing management or force through changes to management boards.

Some insist on businesses using profits to buy-back shares to increase returns to existing shareholders.

An activist shareholder uses an equity stake to put pressure on existing management.

The goals of activist shareholders can range from financial (e.g. increase of shareholder value through changes in dividend decisions, plans for cost cutting or investment projects etc.) to non-financial (e.g. dis-investment from particular countries with a poor human rights record, or pressuring a business to speed up the adoption of environmentally friendly policies and build a better reputation for ethical behaviour, etc.)

Rules for Corporate Governance in Public Companies

The need for effective corporate governance is particularly important in quoted (or public) companies. This is because of the **"divorce between ownership and control",** described above whereby most shareholders have no involvement in the day-to-day management of the company.

Topic: Corporate Governance
3.10.4 Problems with Strategy and Why Strategies Fail

The essential elements of "best practice" corporate governance for such companies are:

- The CEO and Chairman of companies should be separated
- Boards should have at least three **non-executive directors**, two of whom should have no financial or personal ties to executives
- Each board should have an audit committee composed of non-executive directors

Key Terms

Corporate governance	The system by which companies are directed and controlled
Activist shareholders	An activist shareholder uses an equity stake to put pressure on existing management
Board of Directors	The people who are appointed by shareholders and who are legally responsible for the governance of a company.

Topic: Planned and Emergent Strategy

3.10.4 Problems with Strategy and Why Strategies Fail

What You Need to Know
Planned v emergent strategy

What is Planned Strategy?

Much of your studies of business management and strategy focus on the models, tools and theories of classic planned business strategy.

Planned strategy is based around a formal process of setting corporate objectives and developing a coherent business strategy designed to achieve those objectives with the resources available.

Planned strategy is, therefore, the formal business planning process that is outlined in all the business textbooks.

What is Emergent Strategy?

If only business strategy was as easy as writing a business plan and then implementing it in order to achieve the strategic objectives. If all strategy could be carefully planned, then surely all businesses would succeed.

Of course, strategic success is not easy. It is messy. Often the most successful strategies emerge from a series of management decisions in response to a changing environment rather than by slavishly following the original planned strategy.

That is the concept behind **"emergent strategy",** a term initially used by **Professor Henry Mintzberg** to describe:

"a pattern of action that develops over time in an organization in the absence of a specific mission and goals, or despite a mission and goals."

Mintzberg argued that "strategy emerges over time as intentions collide with and accommodate a changing reality."

Planned v Emergent Strategy - Compared

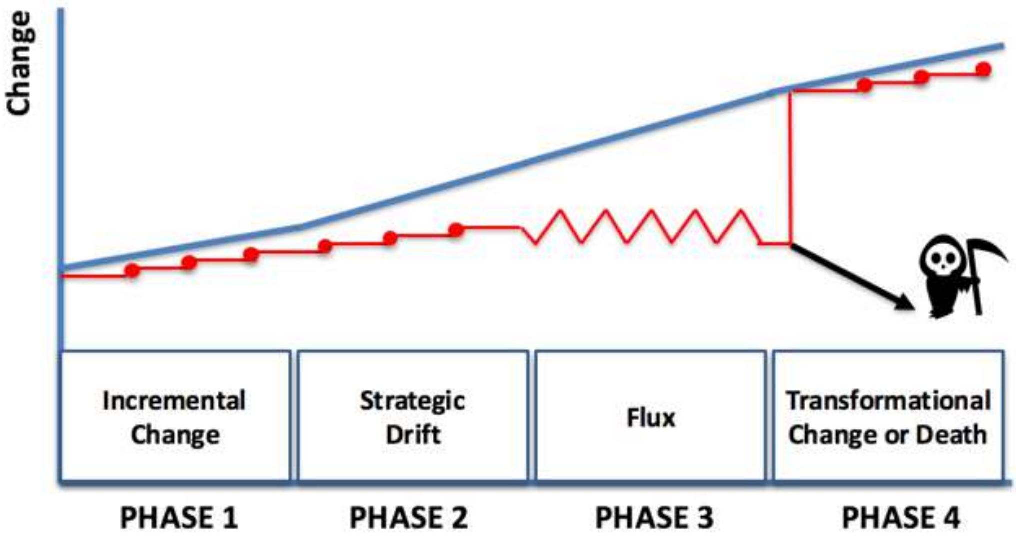
Planned Strategy	Emergent Strategy
The **intended strategy** Influenced by specific corporate objectives Based around a formal strategy planning process Supported by traditional planning tools and methods (e.g. SWOT Analysis, PESTLE framework, Porter's Five Forces) Described in formal business plan	The strategy that actually happens Strategy responds to events as they arise (e.g. changes in external environment) Often involves strategic and tactical changes Not restricted by formal planning tools and methods

Topic: Strategic Drift
3.10.4 Problems with Strategy and Why Strategies Fail

What You Need to Know
Reasons for strategic drift

What is Strategic Drift?
Strategic drift happens when the **strategy** of a business is no longer relevant to the **external environment** facing it.

Illustrating Strategic Drift
The process of strategic drift is illustrated (and explained further below) in this diagram:



Why Does Strategic Drift Happen?
Strategic drift usually arises from a **combination of factors,** including one or more of the following:

- Business **failing to adapt to a changing external environment** (for example social or technological change)
- A discovery that what worked before (in terms of competitiveness) doesn't work anymore
- **Complacency** sets in – often built on previous success which management assume will continue
- Senior management **deny** there is a problem, even when faced with the evidence

The Four Phases of Strategic Drift
Referring to the diagram above, the four phases of strategic drift can be described as follows:

Phase 1 - Incremental Change
In this phase there is little significant change in the external environment. A series of small, incremental changes to strategy enable the business to remain in touch with the external environment.

Topic: Strategic Drift

3.10.4 Problems with Strategy and Why Strategies Fail

Phase 2 - Strategic Drift
Now things are starting to drift apart. The rate of change in the external environment is accelerating and small, incremental changes in strategy are not enough on their own to remain in touch. The business will be losing its **competitive advantage**.

Phase 3 - Flux
This phase is characterised by **management indecision**. There is now a significant gap between what the market expects and what a business is delivering. Management may have recognised this gap and begun to alter strategy, however there is no decisive improvement. There may be disagreement between the senior management team about how to address what is now significant strategic drift.

Phase 4 - Transformational Change or Death
The moment of truth. Either management recognise the need for a transformational change in strategic direction, or the business fails. It often takes new, external leadership for this recognition to be made and the relevant strategic change programme implemented. For some businesses, this phase comes too late.

Examples of Businesses that Suffered from Strategic Drift

Kodak	Failed to respond to rapid development & take-up of digital photography – despite having created such technology!
Nokia	Lost dominant global market leadership in mobile phones by failing to respond to smartphone technology
MySpace	At one stage, the world's leading social media platform; failed to respond to changing social trends & lost leadership to Facebook
Blackberry	Arrogance and complacency were features of their lack of response to the launch of the iPhone which sound started to destroy a previously dominant market share
Tesco	Complacent leadership failed to respond to the rapid emergence of low-cost discount retailers such as Aldi and Lidl.

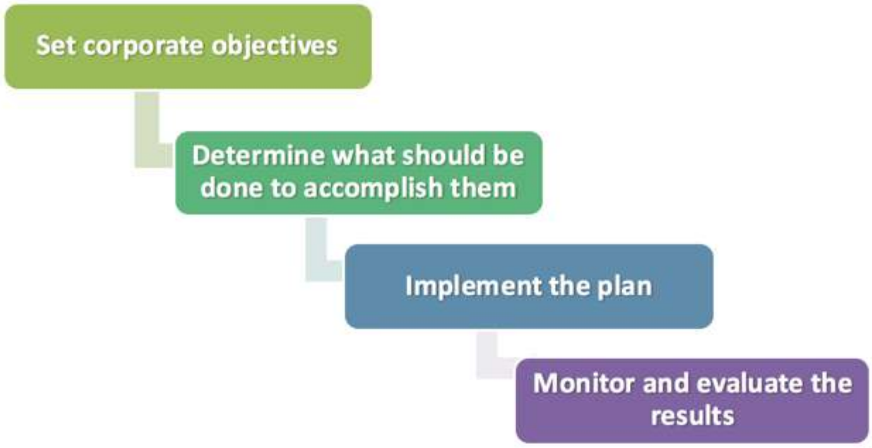
Key Terms

Strategic drift	When the **strategy** of a business is no longer relevant to the **external environment** facing it.
External environment	The political, economic, social, technological, ethical and legal environmental factors which impact a business but which are outside of its control

Topic: Strategic Planning
3.10.4 Problems with Strategy and Why Strategies Fail

What You Need to Know
The value of strategic planning

The Strategic Planning Process
In simple terms, the classic strategic planning process can be illustrated as follows:



Strategic direction is set through the following elements of strategic planning:

Vision	Non-specific directional and motivational guidance for the entire business What will the business be like in five years time
Mission statement	A business's reason for being It is concerned with the scope of the business and what distinguishes it from similar businesses
Objectives	Ideally SMART objectives
Goals	Specific statements of anticipated results

The Different Plans in Business
The strategic plan is just one of the traditional series of plans in business management:

Strategic plan	Sets out the overall direction for the business in broad scope
Business plan	The actions that a business will take to to achieve corporate objectives
Operational plans	Details how each objective is to be achieved Specifies what senior management expects from specific departments or functions

The role and scope of these plans can be further summarised as follows:

Topic: Strategic Planning
3.10.4 Problems with Strategy and Why Strategies Fail

	Strategic	Business	Operational
Level	Business wide	Business unit	Functional area
Focus	Direction and strategy for whole business	Direction and strategy for the business unit	Resources and action for functional area
Nature	Broad and general	More detail on goals and tasks	Specific to the function
Time horizon	Long term 3+ years	1-2 years	Up to one year

Benefits of Strategic Planning
If the strategic planning process is managed properly, then a variety of business benefits can arise, including:

- Clarify direction of the business
- Ensure efficient use of business resources (allocated to strategic priorities)
- Provide a way of measuring progress (corporate objectives)
- Support effective decision-making (a focus for senior management)
- Co-ordinate activities
- Allocate responsibility
- Motivate & guide people

How Does a Business Evaluate Its Strategic Performance?
In order for a business to be able to evaluate its strategic performance, it needs:

- A **strategic plan** with measurable objectives
- **Data** to measure performance against those objectives

The regular performance-measurement and monitoring processes that are commonly used to evaluate performance then include:

- Business Planning
- Budgeting & Variance Analysis
- Regular Performance Reviews
- Monitoring of External Environment
- Financial & Other Ratio Analysis
- Benchmarking

The use of a Balanced Scorecard, monitoring Key Performance Indicators, is another crucial part of evaluation, particularly for more complex and larger businesses.

Key Terms

Strategic plan	A document used to communicate with the business the goals and objectives, the actions needed to achieve those goals and all of the other critical elements developed during the planning exercise