POCKET NOTE

321 READ

CORPORATE STRATEGIC MANAGEMENT AND ETHICS



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WHILE INTEGRATED REPORTING IS NOT GUARANTEED TO FIX ISSUES LIKE THOSE SEEN AT ESKADA, THE PROCESS DOES ENCOURAGE A BUSINESS ENVIRONMENT AND THE DEVELOPMENT OF KEY RELATIONSHIPS THAT ARE IN CONTRAST TO AN ENVIRONMENT WHERE ONE INDIVIDUAL CAN MONOPOLISE DECISION MAKING.

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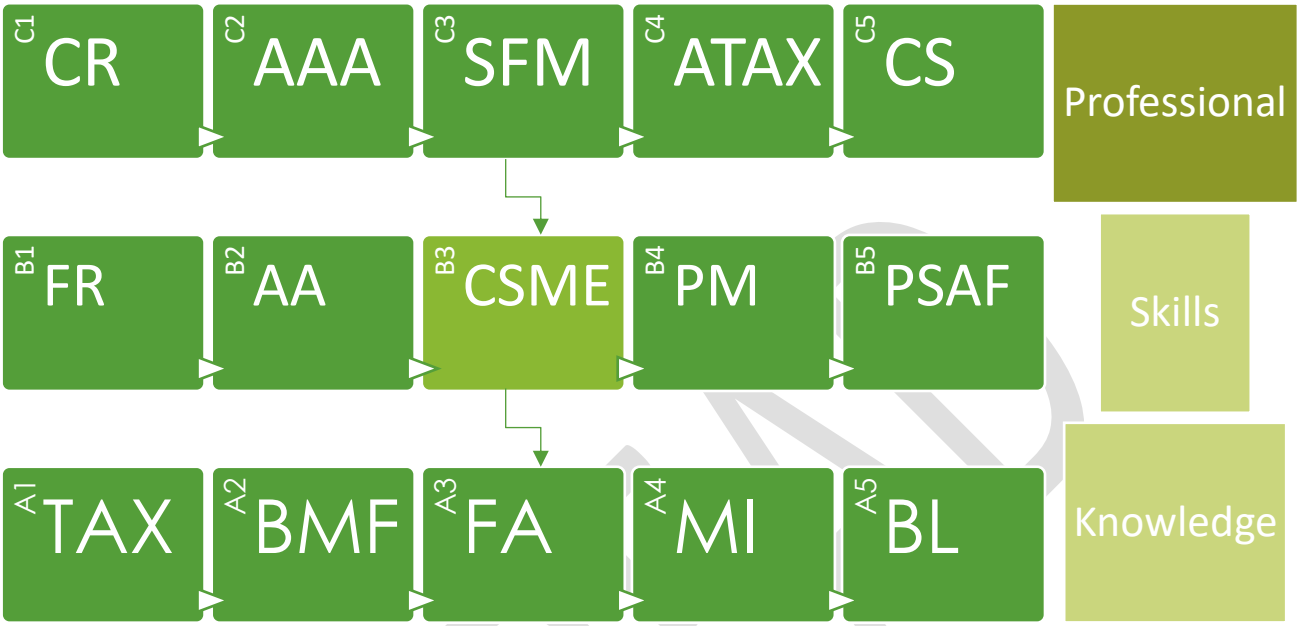

Relational Diagram with Other Papers

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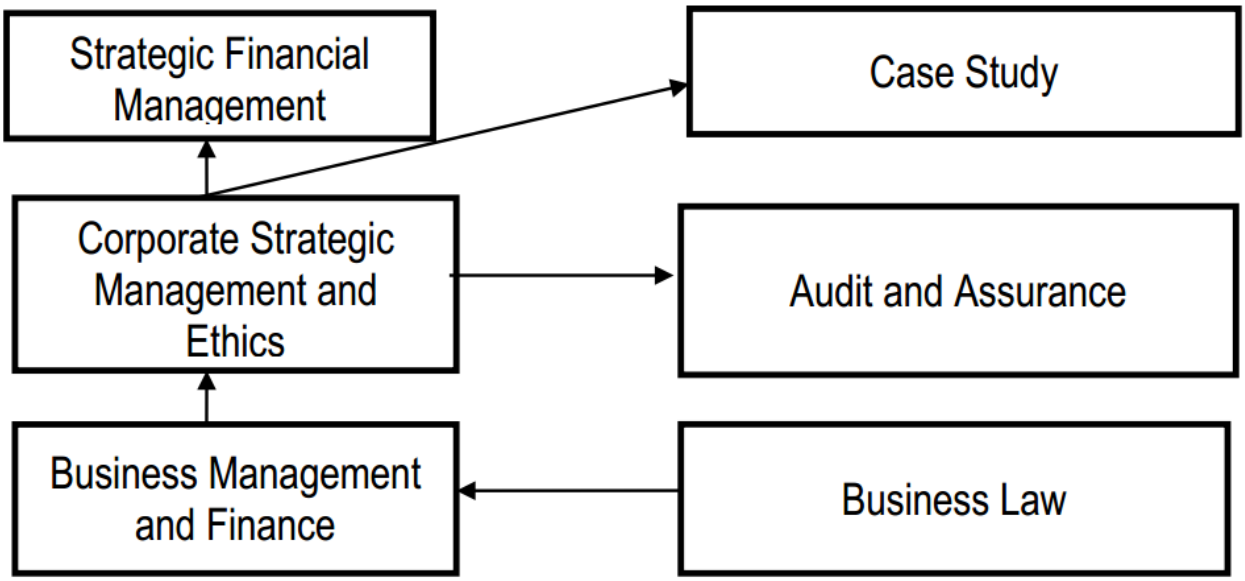

Syllabus Sections

A

- **Introduction**

B

- **Strategic Management**

C

- **Risk Management**

D

- **Governance**

E

- **Ethics**

Aim of Paper

This syllabus element takes knowledge from the first level to contemporary professional and business contexts in which excellence in corporate strategic management, effective risk management, sound corporate governance and good ethics support professional practice and business operations in private and public-sector entities.

Candidates will be equipped with knowledge and skills that will position them to effectively achieve objectives, meet expectations and remain focused on long-term sustainable success as professional accountants.

Candidates are expected to be capable of analysing simple scenarios in terms of global best practices and compliance with laws and regulations in the context of the knowledge and skills they have cumulatively acquired and developed.

Competencies

- Analyse a business position, make informed choices and implement chosen strategies;
- Appreciate the impact of risk on corporate performance and implement programmes to mitigate it;
- Differentiate between management and corporate governance and adopt best global practices to direct the affairs of an organisation; and
- Appreciate the impact of ethics on organisations and develop skills for ethical decision-making.

Exam Structure

Section A	A 40-mark compulsory scenario-based question on the core area of the subject
Section B	5 questions of 20 marks each and candidates will be required to attempt any three.
Duration	The paper will be for three hours with additional fifteen minutes reading time.
Pass Mark	The pass mark for each ICAN examination subject is 50%.

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1 Introduction to Strategic Management

What is Strategy?

A pattern of activities that seek to achieve the objectives of the organisation and adapt its scope, resources and operations to environmental changes in the long term.

—Drucker

The direction and scope of an ogranisation over the long term which achieves advantage in a changing environment through its configuration of unique resources and core competences with the aim fulfilling stakeholder expectations.

—Johnson, Scholes and Wittington

1.1 Characteristics of strategic decisions

- Determine the long-term direction of the company;
- Are concerned with entire scope of organisation;
- Aim to match resource capabilities and environment;
- Impact lower-level decisions; and
- Involve uncertainty.

1.2 Strategy Development

This asks the question: how do organisations go about setting their strategy? There a handful schools of thought.

- Rational Model
- Logical Incrementalism
- Freewheeling Opportunism

1.3 Vocabulary of strategy

Mission – an organisation's basic function in society (Mintzberg). Typically includes: purpose, basic strategy, policies and standards of behaviour, and values and culture.

Goal – a general statement or purpose.

Objective – quantification/more precise statement of the goal.

1.3.1 Rational Model

- Strategy can be developed through an intentional, thought out process.
- Business would select strategic options to achieve their goals after a review of their position.
- The selected options are implemented; feedback from implementation is used to modify the plan for the future.

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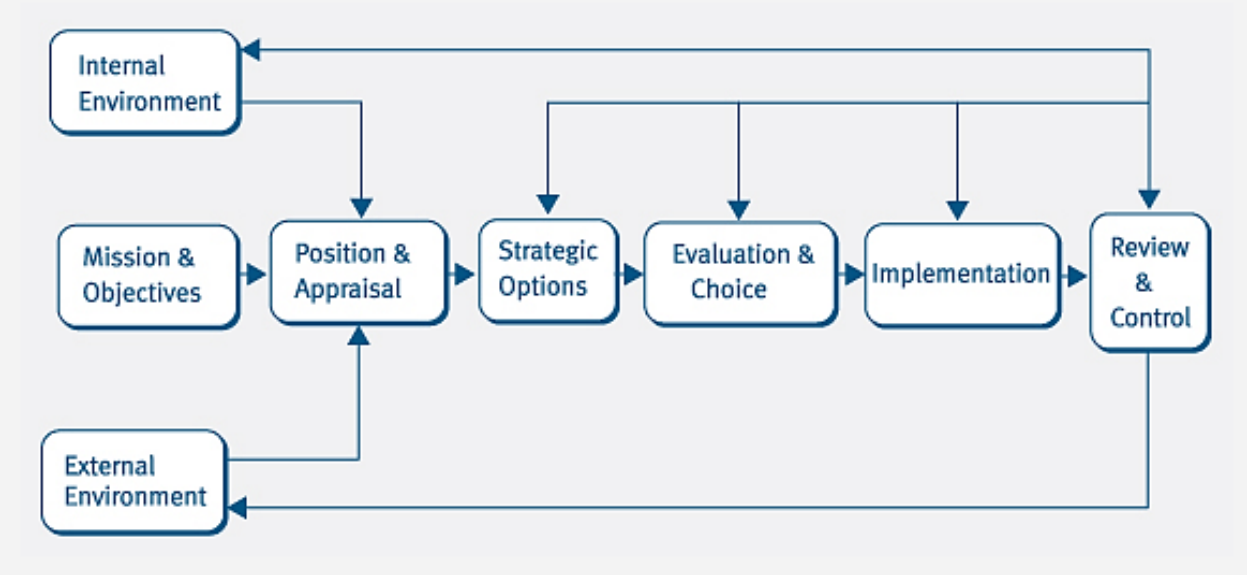


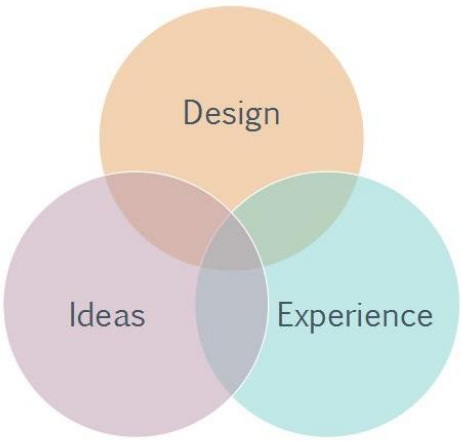
1.3.2 Strategy Development—Logical incrementalism

- A management philosophy which states that strategies do not come into existence based on a one-time decision but rather, it exists through making small decisions that is evaluated periodically.
- These small decisions are not made randomly but logically through experimentation and learning.
- businessdictionary.com

1.3.3 Freewheeling Opportunism

- The anti-planning stance. Suggests that businesses do not need formal plans but should remain flexible and be ready to take advantage of opportunities as they arise

1.4 Strategic Lenses



Johnson, Scholes and Whittington (JS&W) argue that the development and management of strategy can be viewed from different strategy lenses:

1. Design;
2. Experience;
3. Ideas.

1.4.1 Strategy as design

- Strategy is:
- formulated by top management through objective analysis and planning (e.g. the rational planning model); and
- implemented down through the organisation.

1.4.2 Strategy as experience

- Strategic decisions are made and strategies develop as the result of people's experience and the cultural processes in and around organisations.
- Based on what has worked in the past.
- Incrementalism – a step-by-step approach to strategy development by experimenting and learning from the past.

1.4.3 Strategy as ideas

- Strategy results from ideas of people within the organisation.

1.5 Other Concepts

1.5.1 Intended, realised and emergent strategies

- Intended strategies was intentionally designed, rationally designed or otherwise. Corresponds with the design lens
- Realised strategies are strategies that where actually employed once an entity began to gain experience

Mintzberg suggested that strategies do not arise from careful planning but from a number of ad hoc choices and ideas. Management must not allow emerging strategies to take over unchecked but they should be managed.

1.5.2 Strategic drift

When the organisation's strategy gradually moves away from the forces at work in the environment, strategies fail to address its strategic position and performance deteriorates.

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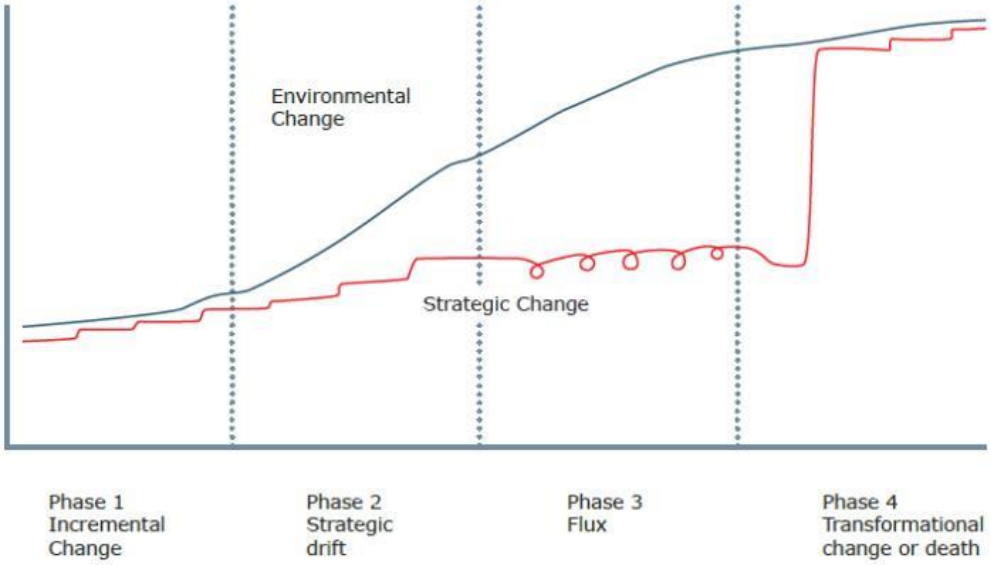

Phase 1: change in environment is small, incremental change in strategy is sufficient to match it.

Phase 2: change in the environment accelerates, strategy diverges poor performance and loss of market share.

Phase 3: management panics, new strategies have no clear direction.

Phase 4: The organisation will:

- fail; or
- be taken over; or
- need to go through transformational change.

Managers should therefore continuously monitor the external environment to ensure no strategic drift. If identified before phase 2, it is usually possible to realign the strategy with the environment.

1.6 Business Analysis

Business analysis or we may call it strategic management (although the latter is of a narrower scope) can be broken intro three sequential parts, following a rational approach.

- Strategic Position
- Strategic Choice
- Strategic Implementation

1.6.1 Position

This examines:

- Effect of external environment.
- Organisations strategic capability.
- Expectations and influence of stakeholders

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1.6.2 Strategic Choice

This examines possible strategies that would achieve the organisations goals while coping or thriving in it its environment.

Includes:

- Generic competitive strategies;
- Growth strategies;
- Portfolio managements strategies;
- Strategic screening; etc.

1.6.3 Implementation

This examines the likely success of the implementation of chosen strategies, and ways to positively affect it

Includes:

- Change management
- Organisational structure
- Culture
- Use to technology
- Business process re-engineering
- Project management; etc.

1.7 Corporate Governance

"How an organisation is directed and controlled" Cadbury report

"… who the firm is there to serve and how the purposes and priorities of the business should be decided." JS&W

- Corporate governance (CG) asks questions of how an organisation's management should be structured at the highest level. For small companies, the CG arrangements could be non-existent, comprising just the Owner/Manager, with no formal roles or procedures. For large companies, you get a full board of directors with various committees and sub-committees.
- Naturally some arrangements can be better in some cases than others, small business cannot afford and do no need a full board with Non-executive directors and various committees, large corporations do, and when the arrangements are inadequate, the organisation suffers.

External measures to improve corporate governance include:

- Accounting standards;
- Codes of professional conduct;
- Codes of best practice

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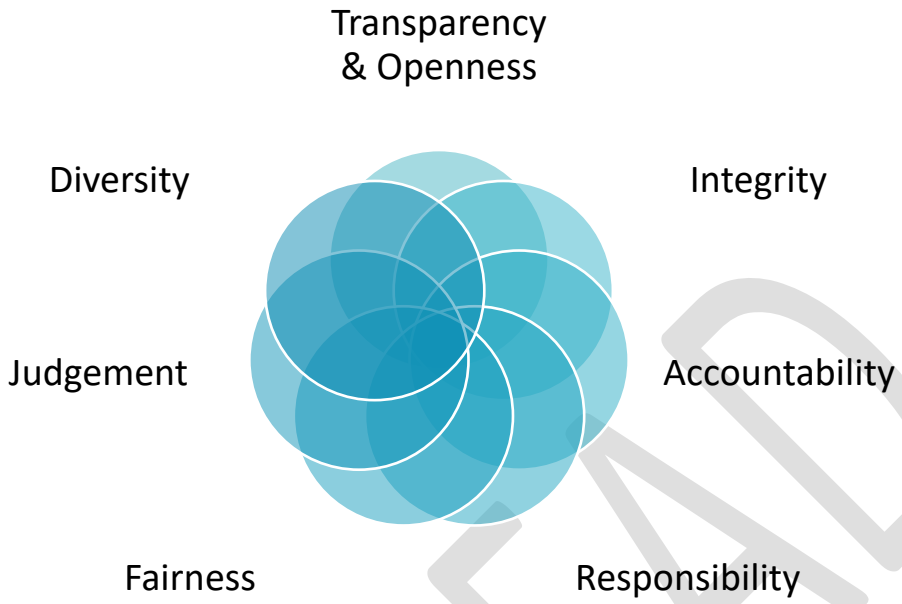
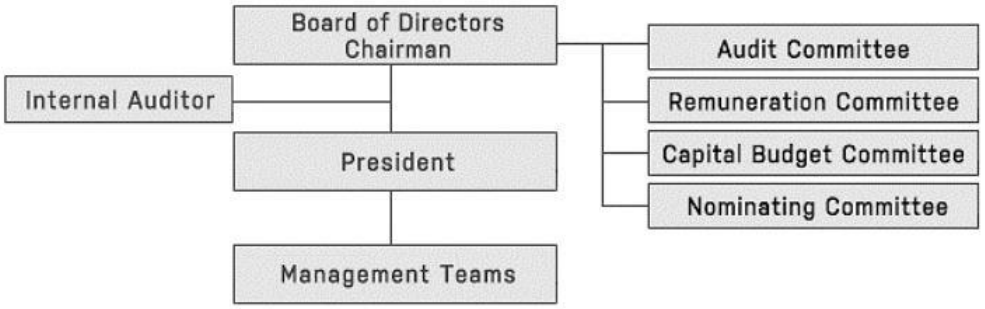
1.7.1 Principles of CG



1.7.2 A simple CG arrangement



1.7.3 Signs of poor corporate governance

- Dominance by a single senior executive who uses power to pursue own interests.
- Lack of segregation of key roles.
- Board members meet irregularly; have no proper overview of the activities and risks of the company.
- Lack of effective internal audit.
- Lack of supervision.
- Lack of independent scrutiny by external auditors.
- Poor communication with shareholders.
- Misleading figures.

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2 Strategic Position

2.1 Mission, Vision, Goals

The development of strategy should be to achieve an organisation objective for existence. This must be acknowledged when an organisation examines its position

Specifically, goals set must contain some qualities, in order for them to be of use in strategic planning. They must be SMART, i.e.

- Specific
- Measurable
- Achievable
- Realistic
- Time-bound: must have some time-frame to their achievement, or it is otherwise impossible to track achievement.

2.2 The Environment

Managers scan the environment to identify key drivers of change, which may take the form of opportunities (to achieve its objectives) or threats (threatening achievement)

Environment frameworks:

- Concern how managers (private or public sector) can make sense of the business environment.
- Provide bases for understanding the environment to help identify:
- important issues; and
- ways of coping with complexity and change.

frameworks for scanning the environment are organised into three layers:



2.2.1 Macro-environment

- The most general layer consists of a number of broad environmental factors that affect all organisations.
- PESTEL framework helps identify future trends in the *political, economic, social, technological, environmental* and *legal* aspects of organisations.
- Identification of key drivers of change (which differ from industry to industry and country to country).
- Constructing *scenarios* of possible future outcomes may be helpful.

2.2.2 Industry or sector

- Concerns organisations that produce the same products or services.
- Porter's Five Forces framework helps understand how the competitive dynamics within and around an industry or sector are changing.

2.2.3 Competitors and markets

- Knowledge of direct and indirect competitors, customer expectations (market segmentation) and critical success factors help identify:
- what customers really value; and
- how expectations can be satisfied to outperform the competition.

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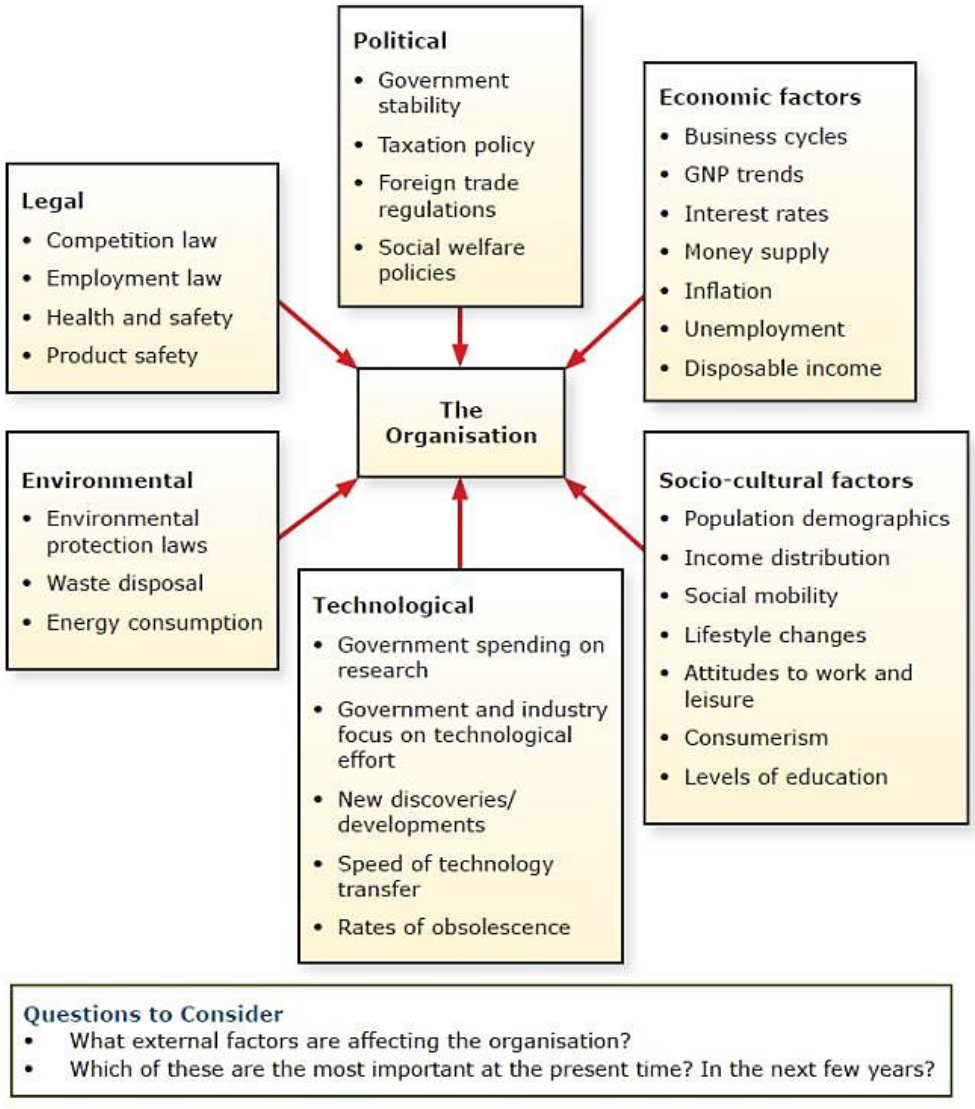
2.3 PESTEL Analysis

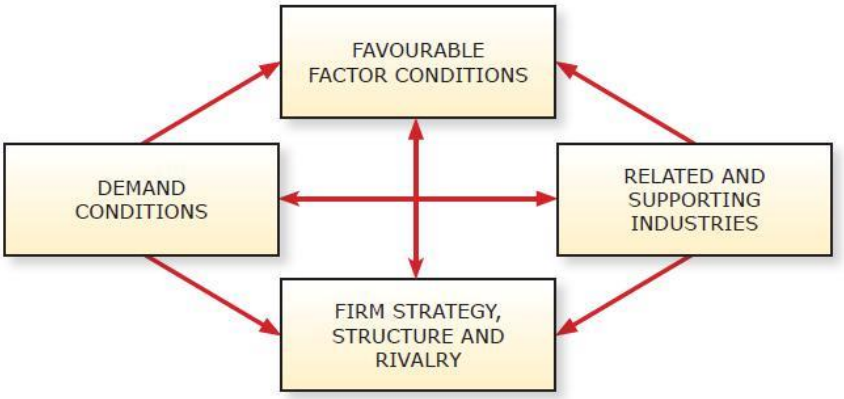


2.4 Porter's Diamond

- Considers relative competitiveness of nations and industries within nations.
- Countries are not competitive but conditions within a country may help businesses to compete.

Factors affecting competitiveness of nations and industries within the nations are given below:

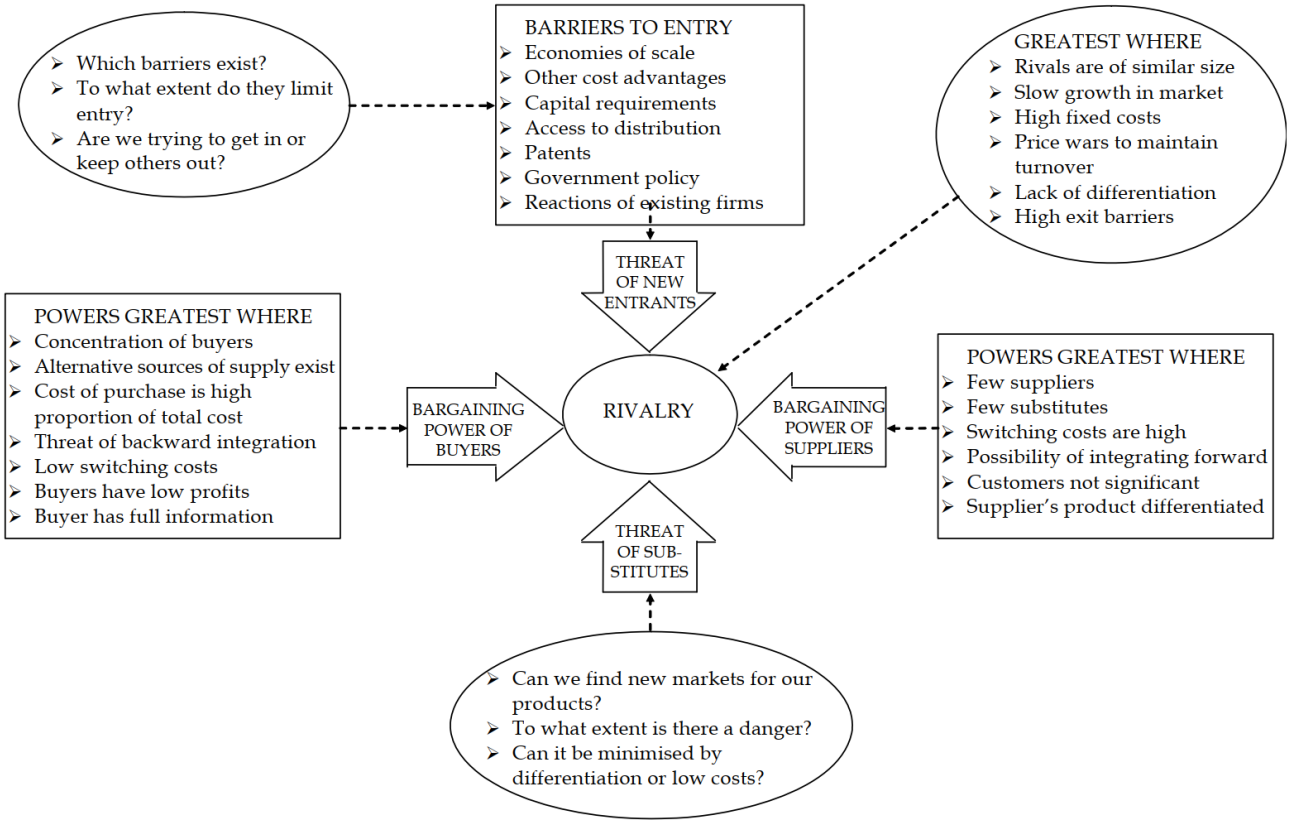
- **Favourable factor conditions**: Climate, population, mineral resources, location.
- **Demand conditions**: Sophisticated domestic business environment.
- **Market structure/rivalry**: Competitive local markets encourages innovation and favour specific structures.
- **Related industries**: Clustering of upstream and down-stream businesses around a core industry



2.5 Porter's 5 forces

"Any activity within an industry that affects the levels of margin earned."

- Porter claims that 5 "competitive forces" affect every industry:
  - threat of **new entrants** to the industry;
  - bargaining power of **suppliers**;
  - threat of **substitute** products or services;
  - bargaining power of **customers**;
  - **rivalry** amongst current competitors in the industry.
- In most industries, some force *other than* rivalry has the greatest impact on the levels of margin earned

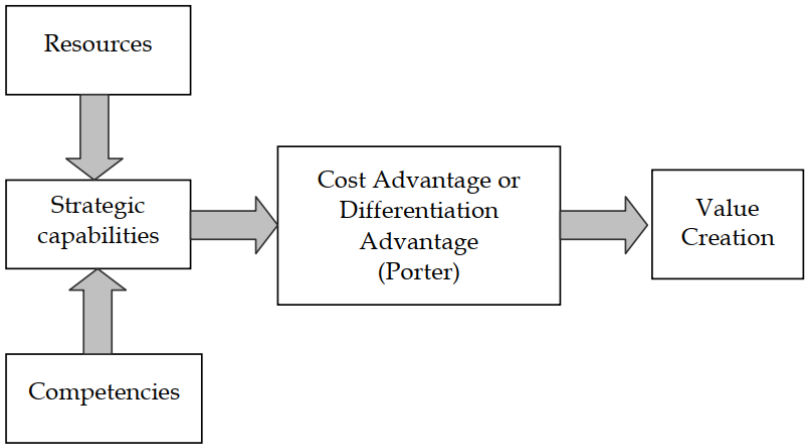


Exercise

Attempt Question 2 from the Study Question Bank

2.6 Internal Environment (Strategic Capability)

Strategic Capability is used to refer to an entity's ability to implement its chosen strategy to achieve its goals while coping with its environment. The degree of capability or lack of it can be referred to as strengths and weaknesses respectively.



An organisations capability is a combination of its;

- Resources; and
- Competences

2.6.1 Resources

Resources are items in the control of the entity with the potential to help the organisation in its chosen strategy. To make any meaningful resource-based strategy, a firm would need *unique resources* (firm-specific assets which few competitors would be able to easily acquire).

Threshold resources are the minimum necessary to survive and compete.

2.6.1.1 M's Model for resource audit

2.6.1.1.1 Men and women

- Staff – expertise, numbers, levels, turnover;
- Management – style, skills, expertise;
- Industrial relations, morale, motivation;
- Organisation – structure, internal communications.

2.6.1.1.2 Money

- Cash flow, profitability, forecasts;
- Credit rating, assets, image with stakeholders;
- Financial backing, support, available funding.

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2.6.1.1.3 Machinery

- Operational capacity and efficiency;
- Quality control;
- Technologically (up-to-date?);
- R&D;
- Outsourcing, JIT.

2.6.1.1.4 Materials

- Suppliers – reliability, flexibility, exclusivity, value.
- Inventory – levels and logistics of distribution:
    - Costs – internal and external;
    - Waste;
    - Availability.

2.6.1.1.5 Markets

- Markets, products and customers:
- Market status, potential, position, share;
- Image, reputation and brand loyalty;
- Distribution channels, control, influence

Other M's commonly included are:

- Makeup: includes brands and intangible assets
- Management
- Management information
- Method: refers to an organisation know-how.

2.6.2 competencies

a firm's ability to use its resources effectively (e.g. ability to motivate the expert staff). Competencies may be:

- Threshold: the minimum necessary to survive or compete; or
- Core: competences an organisation performs better than any competitive advantage

Related to the topic of competencies are the following;

- Benchmarking, which can be used to identify threshold competencies or spread core competencies throughout and organisation
- Critical success factors (CSFs), which are basically competencies that must be performed well for an organisation to succeed in its chosen strategy.

2.7 Benchmarking

A continuous, systematic process for evaluating products, services and processes recognised as best practice to improve an organisation. May be done by looking internally or externally for subjects to benchmark.

2.7.1 Internal Benchmarking

- Historical – relative to prior years;

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- Functional
- Divisional

2.7.2 Internal Benchmarking

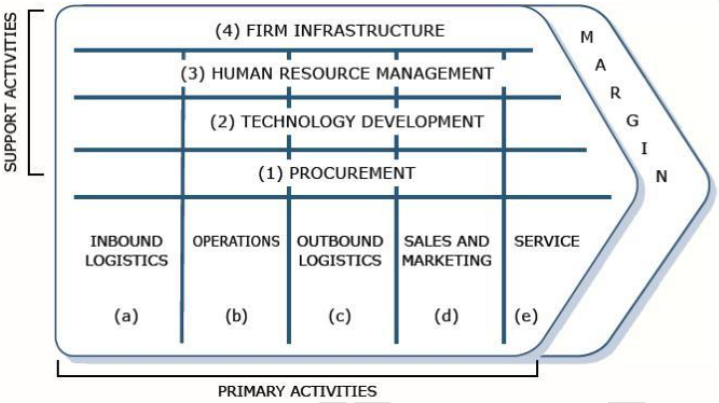
- Competitive – comparing with competitors or industry averages against a set of performance indicators
- Best-in-Class – looks at the organisation who best practises a process so as to develop a competency that

2.7.3 converting resources

2.7.3.1 The value chain.

The activities within and around an organisation that together create a product or service .

- Best value" is determined on:
  - the cost of value activities; and
  - the value that they deliver.



Primary activities *directly* concern creation or delivery of a product/service. Manufacturing example:

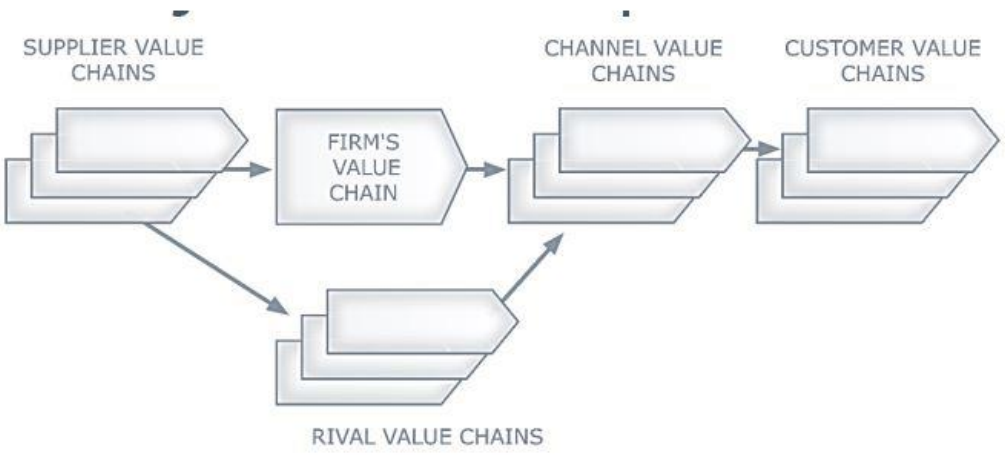
- *Inbound logistics* – receiving, storing and distributing inputs (e.g. goods inwards, inventory control),
- *Operations* – transform inputs into final product (e.g. machining, packaging, assembly, testing, etc).
- *Outbound logistics* – collect, store and distribute product to customers (e.g. warehousing, distribution).
- *Marketing and sales* – communicates availability, etc to consumers (e.g. sales admin, advertising).
- *Service (after-sales-service)* – enhances/maintains value to consumer (e.g. installation, repair, training, spares).

Support activities help improve effectiveness or efficiency of primary activities:

- *Procurement*. *Processes* for acquiring resource inputs.
- *Technology development*. Includes "know-how", R&D, product/process design, etc.
- *Human resource management (HRM)*. Recruitment, management, training & developing and rewarding.
- *Infrastructure*. Formal systems (e.g. of planning, finance, quality control, information management) and structures and routines that are part of a firm's culture.

2.7.3.2 The Value Network

The value network is the set of inter-organisational links and relationships necessary to create a product or service.



2.7.4 CSF's and KPI's

Critical success factors (CSFs) are those areas an organisation needs to perform best if it is to achieve overall success. CSFs should also be SMART

2.7.4.1 Types of CSFs

- **Internal** – relate to managers' own departmental activities (e.g. HRM). These deal with activities that are totally within the control of the manager.
- **External** – relate to issues that are less under the control of managers (e.g. the price of a critical raw material).
- **Monitoring** – used to assess short-term performance of an organisation (e.g. actual performance *v* budget or staff turnover).
- **Building** – used by managers involved in planning and implementing major change programs (e.g. successful implementation of major recruitment/training efforts
- **Industry** CSFs – specific to their particular industry.

- **Corporate** CSFs – relate to the organisation's strategy, objectives and goals.
- **Functional** CSFs – developed by each subdivision.
- **Individual** CSFs – for each manager depending on their perspective of their role and temporary factors.

2.7.4.2 Sources of CSFs

1. Structure of the industry – specific critical factors that relate to all firms in a particular industry (e.g. efficient dealer network in the car industry).
2. Competitive strategy, industry position and geographic location – companies in a specific industry will have CSFs that relate specifically to their characteristics.
3. Environmental factors (e.g. high oil prices may result in energy supply availability becoming a CSF).

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4. Temporary factors – management needs to focus on areas of performance that are temporarily below acceptable levels. For example, an insurance company recently fined for mis-selling would set a temporary CSF of ensuring that no mis-selling takes place again.
5. Functional managerial position – each managerial position has a set of associated CSFs (e.g. almost all manufacturing managers are concerned with product quality).

2.7.4.2.1 Using CSFs

The main use of the CSF concept is as a focus for implementing organisational transformation by supporting beneficial change. This is achieved by:

- Helping individual managers determine their priorities.
- Aiding an organisation in its planning process (Strategic planning, annual planning and budgeting).
- Aiding an organisation in its information systems planning process.

A key driver for strategic and tactical information systems development is the provision of better performance management information in order to match achievement against critical organisational goals.

2.7.5 Key Performance Indicators

measure the most important aspects of performance. To a large extent they measure how well CSFs are achieved. Other performance indicators measure how well other aspects of performance are measured.

Potential pitfalls in the design of performance indicators and measurement systems include:

- Not enough performance measures are set. What doesn't get measured doesn't get done.
- Too many performance indicators.
- The wrong performance measures (e.g. use of strict cost measures in an organisation adopting a differentiation strategy).
- Targets are too hard or too easy. Benchmarking helps to avoid this.
- Hit and run performance indicators – targets set, but no management follow up.

2.8 Corporate Appraisal — SWOT analysis

Summarises the key issues from the business environment and the internal strategic capabilities of an organisation that are most likely to impact strategy development.

It analyses:

- **S**trengths – what they do well or have that others don't.
- **W**eaknesses – things they do badly or lack.
- **O**pportunities – events or changes that can be exploited to the organisation's advantage.
- **T**hreats – events or changes that should be defended against.

It combines the results of environmental analysis and internal position audit into one framework to assess a company's current and future strategic fit, or lack of it.

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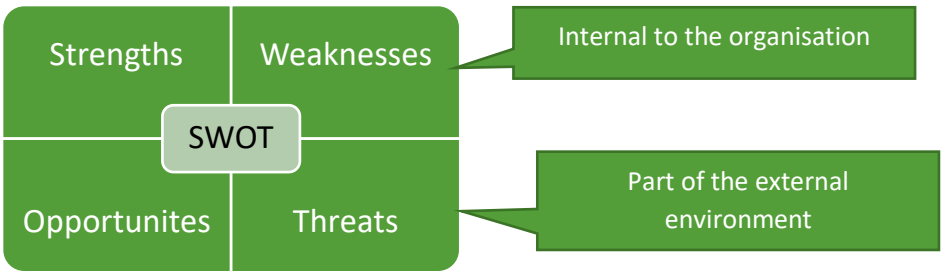


Exercise

Question 3 from the Study Question Bank

2.9 Stakeholders

- All those individuals and groups who have some interest in the future of the organisation.
- They can affect or be affected by the organisation's activities

2.9.1 Classification

- Internal – stakeholders inside the organisation
- Connected – external parties tied to the organisation by virtue of a contractual relationship
- External

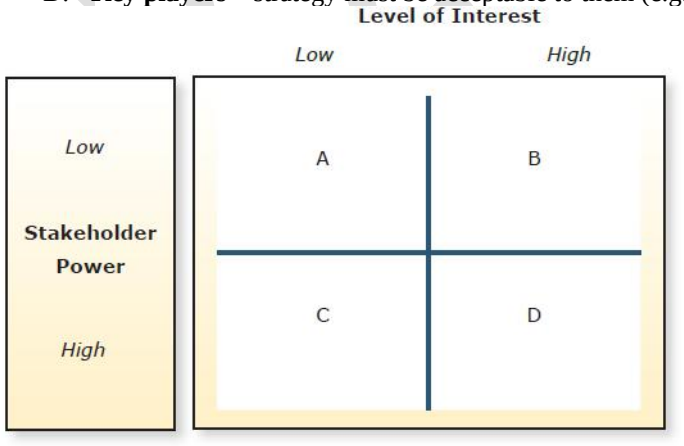
2.9.2 Management of stakeholders (Stakeholder Mapping with Mendelow's matrix)

The influence of each stakeholder on a key strategic decision can be "mapped" by looking at two aspects of their relationship with the organisation:

- **Power** held – how many bargaining tools stakeholders are able to exert, and their position in the hierarchy.
- Likelihood of showing an **interest** in the organisation.

Stakeholder mapping identifies stakeholder expectations and helps in understanding priorities.

D: **Key players** – strategy must be acceptable to them (e.g. major customer).



D: Key players – strategy must be acceptable to them (e.g. major customer).

C: Must be treated with care and **kept satisfied**. Capable of moving into segment A if they do not like what the company does (e.g. institutional shareholders).

B: No great ability to influence strategy. But views might influence more powerful stakeholders (e.g. green lobbying groups) and they need to be **kept informed**.

A: Minimal effort required.

2.10 Post-session Work

Attempt Study Question Bank Q4: Moor Farms

45 minutes

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3 Strategic Choice

An overview of the context and level of strategy development

Corporate level	Growth strategies	Organic—Collaboration Ansoff's growth matrix, et al	
	Stability	Portolio management	BCG, Ashridge PLC, etc.
	Turnaround strategies		
Business level	Generic stratgies		
	Marketing mix		
Functional level	IT strategy		
	HR strategy		
	Sales strategy		
	Finance strategy		

3.1 Corporate strategies—Growth

3.1.1 Critical mass

This is the point at which a growing company becomes self-sustaining, and no longer needs additional investment to remain economically viable. ... It is the point at which the business becomes profitable enough to continue growing by itself and no longer requires investment from outsiders

- All organisations must grow to critical mass quickly, otherwise they would haemorrhage their start-up capital, burn through loans, and finally die.

3.1.2 Forms of growth

- Organic – growth through new internal development of products and markets
- Inorganic – growth through Mergers and acquisition
- Alliances – growth through forming beneficial partnerships with other business entities. Alliances include:
    - Franchise arrangements: Giving business owners the right to use your name, brands, colours and knowhow to run their business in return for a stake in the profits
    - Licencing: Licencing intangible assets (usually patent rights) to entities in return for royalty payments. A good way to bring an idea to market if capital and business savvy are lacking
    - Joint Ventures: two entities create a third entity (a Special Purpose Vehicle (SPV)) for use in carrying out joint trading activities. Both entities do not change themselves.
    - Joint Operations: two entities carry out joint trade directly without creating the SPV

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3.1.3 Ansoffs's matrix

MARKETS	PRODUCTS: *Current*	PRODUCTS: *New*
Current	Withdrawal Market penetration Consolidation	Product development
New	Market development	Diversification

3.1.3.1 Market growth (CURRENT/CURRENT)

For example by taking over a competitor. This could achieve synergies through economies of scale and efficiency gains. There is in theory little risk.

3.1.3.2 Market development and product development

Takeovers and mergers can give rapid access to new markets and new product lines. There is greater risk present. One of the main drivers behind Kraft's bid for Cadbury was to gain access to Cadbury's markets where Kraft had poor penetration.

3.1.3.3 Diversification

Related diversification includes:

- **vertical** integration (backward and forward); and
- **horizontal** integration.

There is some connection between the different businesses.

- **Backward** integration – taking over a supplier;
- **Forward** integration – taking over a customer or distributor.

Both can offer advantages and disadvantages, such as:

- Saving costs through better coordination;
- Increased differentiation as components and delivery can be closely controlled.

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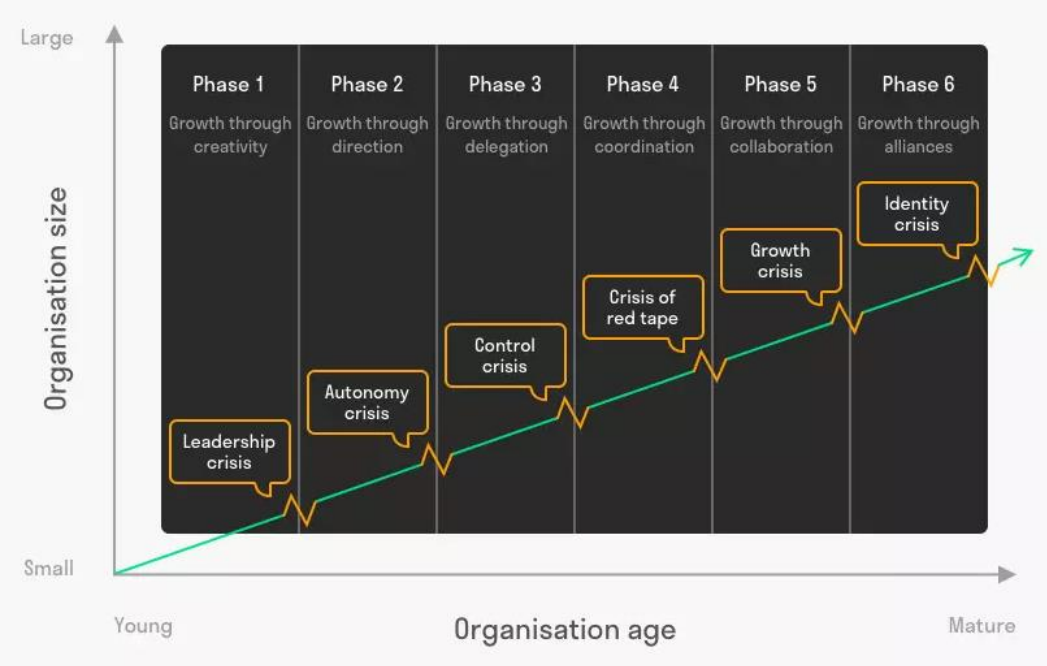
3.1.4 Greiner Growth Model

Larry Greiner originally described five phases of growth in his Greiner Growth Model to which he later added a sixth phase. Each phase ends with a short crisis/ growing pains after which the next phase begins.



3.1.4.1 1. Growth through creativity

In this pioneering phase of the Greiner Growth Model, the company is young and relatively small. The organization is informal and the employees are very loyal. There is a flat organizational structure and the entrepreneur is externally oriented; he invests in new clients.

Growing pains

Because the organization is growing (too fast) and is becoming more complex, the entrepreneur is no longer able to take stock of the situation and a leadership crisis arises. Coordination and internal control can no longer be carried out by one person. There is a need for an improved structure.

3.1.4.2 2. Growth through direction

In this management phase of the Greiner Growth Model, functional managers are appointed as a result of which a middle management is created that controls the primary processes. Rules, procedures and business are formalised and standardised. The central coordination remains in the hands of the entrepreneur.

Growing pains

Because of further growth, the coordination problems may become too big for the entrepreneur. In addition, middle managers need more autonomy. The autonomy crisis is born.

3.1.4.3 3. Growth through delegation

In this phase of decentralization, the entrepreneur delegates important tasks to his middle management. Results are aimed for and the middle managers are responsible for achieving tactical and operational objectives. Management moves at a strategic level and rarely intervenes. A division structure is created with separate product groups and individual managers.

Growing pains
The more divisional managers, the more difficult it will become for the management board to coordinate all the divisions that operate independently. There is a risk of a management crisis. There is a good chance that the divisional managers plot their own course too much as a consequence of which the company could break up.

3.1.4.4 4. Growth through coordination and control

In the standardization phase of the Greiner Growth Model, more emphasis is put on the coordination between the various units. In large diversified organizations the various staff departments take up a strong position from the headquarters from which the divisional managers are managed.

Growing pains
When the staff departments have too much power and when there is too little scope for the divisional managers, a red tape crisis arises. The rules have made the company too inflexible and rigid.

3.1.4.5 5. Growth through cooperation

In the cooperation phase of the Greiner Growth Model, cooperation between line and staff departments is aimed at and this creates a break-up of the hierarchical coordination forms such as a matrix structure or a project organization. This phase is characterised by much mutual contact between employees via all kinds of consultation groups. There is little formalization and standardization.

Growing pains
The frequent consultations constitute a pitfall, as a result of which a consultation crisis may arise. There is every chance that supervision and control decline sharply. This could mean the end for organizations, unless they develop through external alliances.

3.1.4.6 6. Growth through alliances

In this 'growth through undertaking phase' the organization only requires good external contacts and alliances. These can be found in mergers, alliances and extensive networks.

Growing pains
Because an organization is more focused on alliances than its own core-business, there is a good chance that an identity crisis will present itself. The organization is taken over completely by other businesses and the 'old' situation will disappear completely.

3.2 Corporate Strategies—Stability

We will be examining Portfolio Management models under this section for the most part. A parent may deploy four policies (strategies) using the parental developer approach towards its SBUs:

1. **Build** in order to increase market share;
2. **Hold** to maintain the current position;
3. **Harves**t to gain short-term earning and profits at the expense of long-term-development; would involve selling the SBU
4. **Divest** to reduce negative cash flow and release resources needed somewhere else. Would involve closing down the SBU

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3.2.1 BCG Matrix

BCG matrix is a framework created by Boston Consulting Group to evaluate the strategic position of the business brand portfolio and its potential. It classifies business portfolio into four categories based on industry attractiveness (growth rate of that industry) and competitive position (relative market share).

- **Relative market share.** One of the dimensions used to evaluate business portfolio is relative market share. The absolute market share may also be used,
- **Market growth rate.** High market growth rate means higher earnings and sometimes profits but it also consumes lots of cash, which is used as investment to stimulate further growth. Therefore, business units that operate in rapid growth industries are cash users and are worth investing in only when they are expected to grow or maintain market share in the future.

3.2.1.1 Formulas

$$Absolute\ Market\ share = \frac{SBU's\ Revenue}{Total\ Market\ Revenue}$$

$$Relative\ Market\ share = \frac{SBU's\ Revenue}{Revenue\ of\ Market\ Leader\ or\ Nearest\ competitor\ *}$$

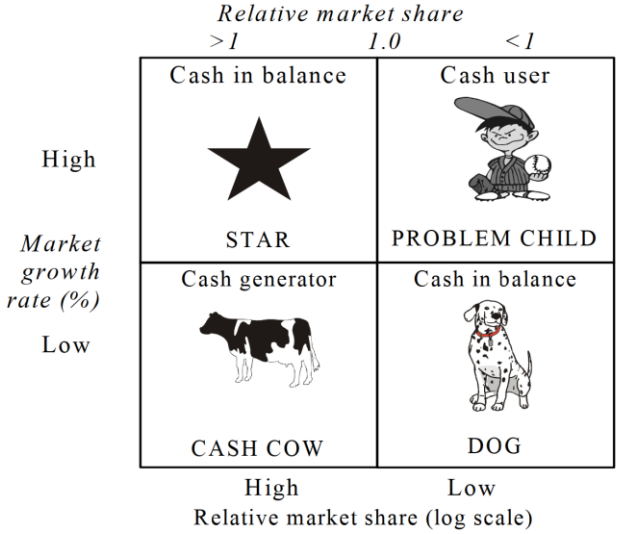
* When the SBU in question is the market leader (i.e. one with the highest revenue in the industry), use the revenue of the nearest competitor for the Relative MS computation

$$Market\ Growth\ = \left(\sqrt[n-1]{\frac{x_n}{x_0}}\right) - 1$$

Where:

- n = number of years of data
- X_n = the revenue of the latest year
- X_0 = the revenue of the earliest year

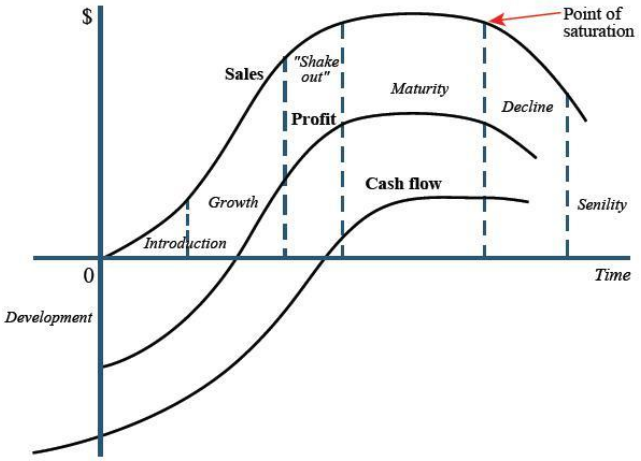
3.2.1.2 Matrix



3.2.1.3 Strategies

Dog	Harvest/Divest or Hold
Problem child	Harvest/Divest or Build
Star	Build
Cash cow	Hold

3.2.2 Product Life Cycle



Focus

- The stage in the life cycle a product has reached.
- Remaining life of a product (i.e. how much longer it will contribute to profits).
- Urgency to develop new products or improve products.

Difficulties

- Only indicates where the product/market is now – not where it will be.
- Limited application – cannot be used for forecasting, (because length of each phase is unknown).
- All different shapes – life cycle patterns vary.
- Does not allow for products which:
    - fail during development or introduction;
    - seem to be mature forever.

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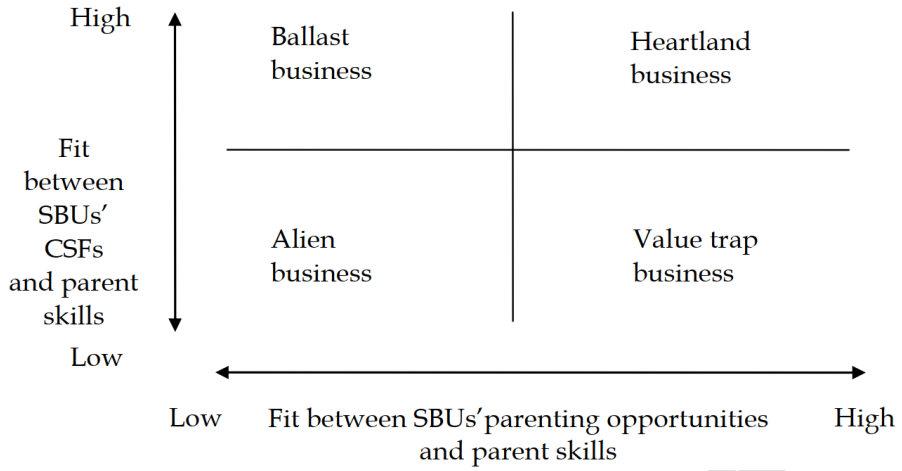
3.2.3 Ashridge Portfolio Matrix



Heartland businesses

- Have CSFs that fit the parent's resources and competences and provide opportunities to use them. They fit well into the portfolio.

Ballast businesses

- Are well understood by the parent but need little assistance. They should be divested when a good opportunity arises.

Alien businesses

- Parent does not have required competencies to support the business unit and the business unit does not need help. Should be divested.

Value trap businesses

- Need a lot of help outside the scope of the parent.
- Provide good opportunities for the parent.
- Skills and resources must be acquired to transform into heartland businesses.

3.3 Business Level— Porter's Generic Strategies

An SBU is a part of an organisation for which there is a *distinct* external market for goods/services that is different from another SBU.

Business unit strategy involves a choice between:

1. **Cost leadership** – being the lower cost producer;
2. **Differentiation** – making the product different from competitors *(product differentiation and branding)***;** or
3. **Market focus (niche)** – specialising in a particular market area.

Organisation must choose – it is not possible to adopt more than one.

3.3.1 Cost leadership

- Being lowest cost producer in the industry as a whole.
- Producer can sell at the lowest price.
- Does **not** mean *having to sell* at the lowest price (can choose to do so) – "pile them high, sell them cheap".
- Can only be achieved if aiming for a large market share.

Methods to achieve this strategy:

- Produce enough units to achieve economies of scale;
- Use the latest technology;
- Exploit the learning curve;
- Improve productivity;
- Minimise overhead cost;
- Get favourable access to sources of supply.

3.3.2 Differentiation

Assumes that competitive advantage can be gained through particular characteristics of a firm's products. I.e. because the market will perceive the firm's product as having no reasonable alternative, they will flock to the store, cash in hand, smiling all the way.

Three categories:

- Breakthrough products (e.g. iPod);
- Improved products (e.g. micro-chips);
- Competitive products (e.g. Mercedes).

3.3.3 Niche or focus

A niche is a market segment suitable for a specialised product.

- Concentration on one or more particular market (e.g. organic food).
- Does not try to serve entire market with a single product.

3.4 Business Level—Bowman's Strategic Clock

- The clock is an analysis of Porter's generic strategies in terms of price and perceived value added.
- A purchaser's perception of value created by the change in a product or techniques employed in marketing it.

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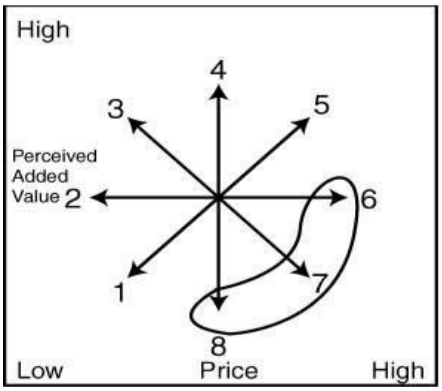
- It suggests that competitive advantage can be achieved by providing customers with what they want or need better than the competition



1 and 2 are **price-based** strategies.

- Porter's generic strategy of **cost leadership** is appropriate to a company adopting this strategy.
- They can only succeed if the segment of the market is sufficiently large.

3, 4 and 5 are all **differentiation** strategies.

- Differentiation can be created through product features, marketing (e.g. branding) and core competences.

Hybrid strategy (useful to enter a market when differentiation rests on core competences) aims at both:

- Lower price (must have low enough cost base); and
- Differentiation (must have reinvestment).

Directions 6, 7 and 8 are not viable strategies according to Porter because they are likely to result in failure.

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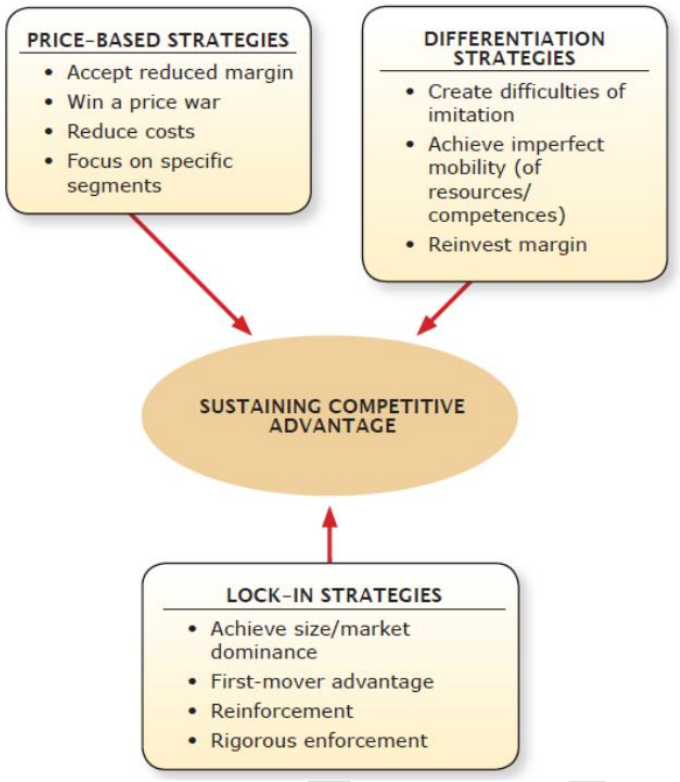
3.4.1 Sustaining Competitive advantage

Sustainable means capable of being continued over time.



3.5 Business—Marketing Mix

A set of *controllable* marketing variables used to influence a target market.

Comprises:

- Product
- Price
- Promotion
- Place.

3.5.1 Product

General factors considered to augment a product include:

- Quality (low or high);
- Packaging (plain or decorative);
- Branding (emphasis on life style or quality);
- Aesthetics (look, feel and even smell of the product);
- Product mix (being aware of the relationship between complementary products; probably introducing bundles e.g. TV and DVD player);
- Servicing, warranty, guarantee.

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3.5.1.1 Packaging

Should be considered in terms of *form* and *function:*

- Ease of handling;
- Durability;
- Freshness/safety;
- Saleable quantity;
- Aesthetic/promotional.

3.5.2 Price

- Usually the variable that is easiest to change.
- Must be consistent with other marketing mix elements (e.g. premium product should have premium price) to avoid confusion.

General factors affecting price:

Internal	***External***
• Capacity • Costs • Quality levels • Product mix	• Rivalry • Pricing • Customer perceived value • Bargaining power

3.5.3 Promotion

3.5.3.1 Main techniques

Push – supplier-driven and focused at pushing intermediaries to carry goods that customers buy on impulse or well understood benefits.

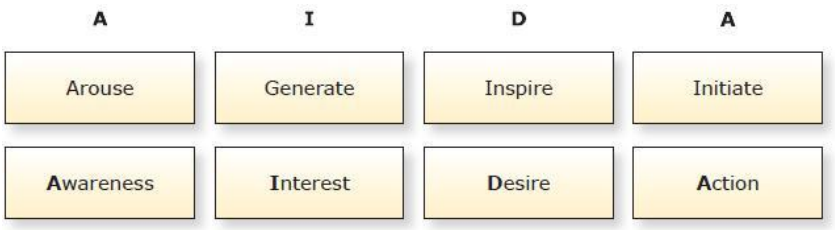
Pull – end-user focus generates demand; which intermediaries then pull from the supplier.

3.5.3.2 Main types

1. Advertising
2. Sales promotion
3. Public relations
4. Personal selling

Choice depends on cost, product type, consumer or trade customer

Ultimate goal ("AIDA")



3.5.4 Place/distribution

Place refers to the distribution channel chosen for selling the product (e.g. direct, via internet, agents, etc).

3.5.5 Extended/service marketing mix

The extended marketing mix for use in the services industries includes three additional "Ps":

- People;
- Processes;
- Physical evidence.

3.6 Functional Strategies

3.6.1 R&D Strategy

Involves driving business through research that produces product or market innovation or that finds better way of doing business.

Possible options include:

- Renew existing products. Involves major changes
- Adapt existing products. Continuous improvement on products to bring them up to date. Particularly important for the softwaremarket.
- Create new products
- Create new technology (which can the be patented and licenced out, or implementing in increasing an organisation's efficiency or effectiveness

3.6.2 IT Strategy

3.6.2.1 Information Systems

One place where IT could be immediately used is in improving an organisations information system. This could be done for two reasons:

- To improve the quality of information for planning and decision making

To enjoy efficiency savings.

Value chain impacts

- Inbound logistics (e.g. MRP, JIT, ERP).
- Operations (e.g. CAM, CIM, ERP),
- Outbound logistics (e.g. consignment tracking).
- Marketing and sales (e.g. EPOS).
- Service (e.g. after sales service using customer dbase)

3.6.2.2 E-business

When building an e-commerce strategy companies may be on one level or in-between:

Level 1: Introduction of new technology to connect electronically internally and externally.

Level 2: Re-organising how and where work is done. Affects workforce, systems and strategy to make best use of new technology.

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Level 3: Re-positioning of organisation to fit into new e-era.

A four-stage model shows how the internet is used for B2B activities:

1. **Emission:** creating informational websites for customers.
2. **Interaction:** using the Internet for interacting with customers (e.g. emails, surveys, and feedbacks).
3. **Transaction:** using the Internet to manage and support transactions with customers (e.g. online ordering).
4. **Collaboration:** using Internet to provide inter-organisational activities (e.g. setting up an extranet).

3.6.2.3 Customer Relationship Management (CRM)

- CRM captures, analyses and distributes all relevant data from customer and prospect interactions. This helps to better meet customer, product, and service needs.
- Relationship marketing focuses on building a long-term relationship with customers.
- CRM describes web-based systems that help organise marketing, sales and customer service activities.

Customer life cycle

1. **Select** – market segments.
2. **Acquire** – relationships with new customers.
3. **Retain** – get customers' repeat business
4. **Extend** – sell other products to existing customers.

E-CRM Activities include:

- Customer acquisition – via websites.
- Manage e-mail lists.
- E-mail marketing.
- Customisation of offers.
- Online customer service facilities.
- SalesForce Automation. SalesForce Automation is the most essential components of customer relationship management.
- Human Resource Management
- Lead Management.
- Customer Service.
- Marketing.
- Workflow Automation.
- Business Reporting.
- Analytics

3.6.2.4 6 I's of E-marketing

- **Interactivity**: it allows visitors to engage with the website on a higher level. A visitor has more options to find out more or move to other projects
- **Individualisation:** it refers to how to present the content of the website to suit an individual's needs. This can be used to target and personalise communications to customers to achieve relevance in all media.
- **Integration:** it refers to the merging of different media channels to provide a better marketing approach.

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- **Intelligence:** it refers to the data gained through the market research and how the company can use this information.
- **Independence of location:** it refers to consumers are having the ability to access the website at any location or via any device.
- **Industry restructuring:** The marketing industry as previously mentioned is continuously evolving. The disintermediation occurs in Internet marketing and is continuing as the middleman is constantly being removed from the marketing process.

3.6.3 Human resource Strategy

HR Planning

- Study the corporate goals
- Forecast demand
- Assess resources
- Prepare plan

3.6.4 Marketing Strategy

See: marketing mix

3.7 Evaluation Strategic Options

Success criteria are used to assess the likely success of a strategic option.

Success criteria:

- **Suitability** – is the strategy consistent with objectives of business and overall strategy? Does it match requirements identified in corporate appraisal?
- **Acceptability** – is risk and return in line with stakeholder expectations?
- **Feasibility** – does the organisation have the resources and capability to execute the strategy

Exercise

Acumen plc is a well-known corporate organization in the manufacturing industry. It owns 10 companies in manufacturing and related industries. The company was started more than 20 years ago by a dynamic CEO, Zainab, who is still with the company together with about 62% of the management team from inception. She started the company with a gift from her father who is currently the chairman of the board, her brother is the director of finance.

The company has grown by developing new business units for its only big client, KSolutions, that has also grown over the years. Although, there are three occasions where KSolutions was unable to meet up with its obligations, the credit period had to be extended by 50% and no sanctions were applied because Acumen does not want a stain on the relationship with its big and only client.

KSolutions At the moment

KSolutions who was a big time supplier to the federal government in the recently ousted regime is currently facing financial difficulties. Acumen is trying to be proactive in making necessary changes to deal with the happenings unfolding in the business environment.

Other information

AW sources all its raw materials from AP which makes up 40% of AP's sales. Two of Acumen companies information are given below:

Figure 1: Financial information. All figures in ₦'billion

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		2012	2013	2014
Acumen Water (AW)	Industry turnover	200	198.5	190
	AW turnover	24	23.5	21.5
	Gross profit	1.2	1.1	1.05
Acumen Plastics (AP)	Industry turnover	40	40.1	40.8
	AW turnover	16	16.2	16.5
	Gross profit	1.6	1.65	1.75

Required:

In the context of Acumen plc, analyse the performance of the business units using appropriate models/frameworks and recommend appropriate corporate strategies.

(6 marks)

Analyse strategic capabilities of Acumen using appropriate model and frameworks

(5 marks)

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4 Strategic Implementation

4.1 Organising for Success

Implies that the makeup of an organisation may help or hinder the implementation of certain strategies. It is therefore important to understand the effects of the different aspects of organisational configuration.

4.2 Structures

Entrepreneurial

Advantages	Disadvantages
✓ Flexibility	✘ High demands of entrepreneur
✓ Responsive	✘ Slow to respond
✓ Teamwork building	✘ De-motivation
✓ Strong unity of direction.	✘ Dysfunctional decision-making.

Divisional organisations

Advantages	Disadvantages
Product, geographical or market-based Career opportunities	✘ Sub-optimisation
Specialist companies for customers	✘ Poor implementation of policies from Headquarters
Allows diversification.	✘ Duplication of resources.

Functional

Advantages	Disadvantages
✓ Logical	✘ Not focused where value is created
✓ Economies of scale	✘ Difficult to identify profit and loss by product
✓ Offers career planning.	✘ Isolation of workers
	✘ Co-ordination problems.

Matrix structure

Advantages	Disadvantages
Optimum resource allocation	✘ Conflict between managers over allocation of resources
Flexibility	✘ Difficult to recruit equally balanced management skills
Close customer contact	✘ Role conflict due to a lack of unity of command
Encourages commercial awareness.	✘ Lots of time taken in meetings and fire-fighting.

4.3 Culture

Organisational culture was described by Handy as "The way we do things around here".

4.3.1 Handy's four cultural stereotypes

- **Power culture** – power is concentrated in the hands of one person.
  - Often seen in small companies;
  - In large organisations it is usually taken as a danger sign.
- **Role culture** – jobs are arranged by function and seniority.
  - Can be efficient in a stable environment;
  - Slows down response to change.
- **Task culture** – emphasis on getting the job done. More responsive to changes.
- **Person culture** – the organisation is seen as serving the individuals, a small galaxy of individual stars (e.g. architects' partnerships).

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4.3.2 Robert Cooke's 3 Cultures

4.3.2.1 Constructive

There are certain organizations which encourage healthy interaction amongst the employees. The individuals have the liberty to share their ideas, exchange information and discuss things to come to an innovative solution beneficial to all.

The key features of a constructive culture are:

- **Achievement:** A constructive culture helps the employees to achieve the targets within the stipulated time frame.
- **Self Actualizing:** In this kind of culture, an employee stays motivated and realises his full potential.
- **Encouragement:** A Constructive culture encourages employees to deliver their level best and strive hard for furthering the image of the organization.
- **Affiliative:** The employees avoid conflicts and unnecessary disputes and promote a positive ambience at the workplace.

4.3.2.2 Passive

In a passive culture, the employees behave in a way contrary to the way they feel is correct and should be the ideal way. In a passive culture, the main motive of the employee is to please the superiors and make his position safe and secure in the organization.

The characteristics of a passive culture are:

- **Approval:** In such a culture, employees can't take decisions on their own. They need to take their boss's approval before implementing any idea.
- **Conventional:** Employees are bound by rules and regulations of the organization and act according to the prescribed standards only.
- **Dependent:** In such a culture, the performance of the employees is dependent on the superior's decisions and they blindly follow their boss's orders.
- **Avoidance:** Employees tend to avoid their own personal interests, satisfaction and simply act according to the company's policies.

4.3.2.3 Aggressive

Organizations following an aggressive culture promote competition amongst the employees. They encourage the employees to compete against each other so that each one performs better than his fellow worker. In such a culture, employees seeking their colleague's assistance are often called as incompetent employees.

The key features of such a culture are:

- Opposition
- Power
- Perfectionist
- Competitive

In the above culture, employees are aggressive, compete against each other and try to become perfectionist by identifying their mistakes and eventually minimizing them, or getting fired in the process.

4.3.3 The cultural web

A tool for analysing cultures into 7 main components

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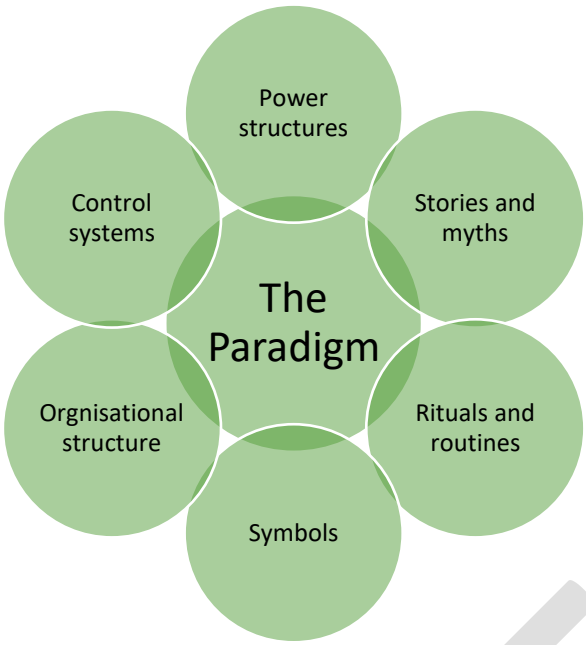
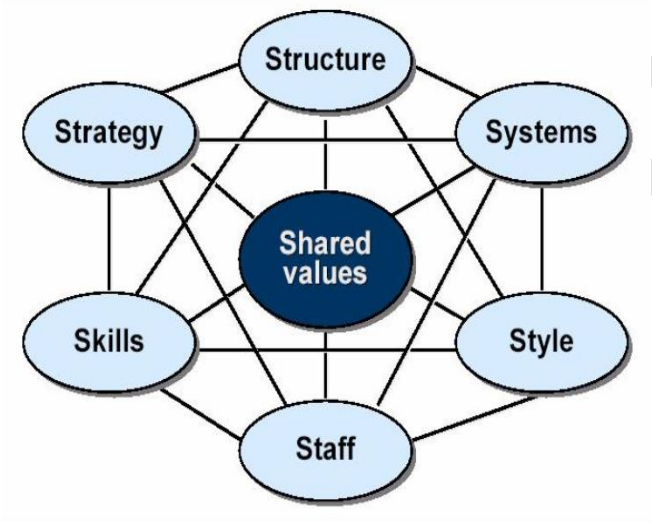


4.3.4 Mckinsey 7s



The 7S framework of McKinsey is a Value Based Management (VBM) model that describes how one can holistically and effectively organise a company. Together these factors determine the way in which a corporation operates.

Shared Value. The interconnecting centre of McKinsey's model is: Shared Values. What does the organization stand for and what does it believes in?

Strategy. Plans for the allocation of a firm's scarce resources, over time, to reach identified goals. Environment, competition, customers.

Structure. The way the organization's units relate to each other: centralised, functional divisions (top-down); decentralised (the trend in larger organizations); matrix, network, holding, etc.

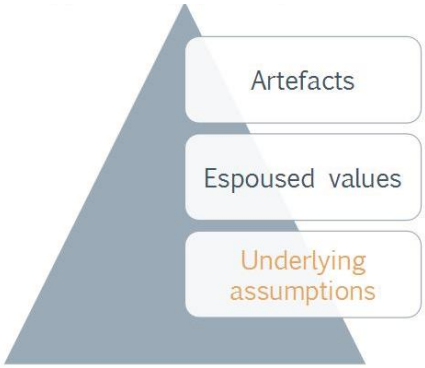
System. The procedures, processes and routines that characterise how important work is to be done: financial systems; hiring, promotion and performance appraisal systems; information systems.

Staff. Numbers and types of personnel within the organization.

Style. Cultural style of the organization and how key managers behave in achieving the organization's goals. Management Styles.

Skill. Distinctive capabilities of personnel or of the organization as a whole. Core Competences.

4.3.5 Schein

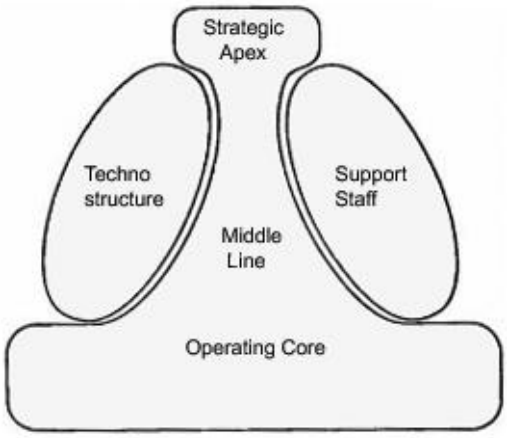


Schein's determinants of organisational culture

- **Artefacts** – the influences on culture that can be seen (e.g. how people dress).
- **Espoused values** – strategies and goals of the organisation (e.g. excellent service).
- **Basic assumptions and values** – the taken for granted beliefs (the paradigm).

4.4 Bridging Structure and culture

4.4.1 Mintzberg's building blocks



Summary of five elements:

	Based on	*Key role*	*Centralisation*
(1) Simple structure	*Direct supervision*	Strategic apex	Vertical and horizontal *centralisation*
(2) Machine bureaucracy	Standard *working processes*	Techno-structure	Limited horizontal decentralisation
(3) Professional organisation	Standard *skills*	Operating core	Vertical and horizontal *decentralisation*
(4) Division organisation	Standard *output*	Middle line	Limited vertical decentralisation
(5) Adhocracy	*Mutual adjustment*	Support structure	Selective decentralisation

The characteristics of three organisational stereotypes:

Simple structure – consists only of the strategic apex and the operating core.

Machine bureaucracy – long middle line and large technocracy. Common in mass manufacturing industries.

Professional bureaucracy – relatively short middle line and small technocracy. Typical in firms of accountants or lawyers or other organizations where work is dominated by skilled workers, and each job is unique and therefore not capable of standardization.

4.4.2 Interaction of configuration and cultures

- Cultures and configurations go hand in hand.
- Tall narrow hierarchical structure implies a role culture and machine bureaucracy.

Wide tall structure implies a task culture and professional bureaucracy

4.5 What to do with Business Processes

4.5.1 Harmon's process-strategy matrix

Harmon's matrix help answer the question of Which processes to change and how to change them during times of change.

The matrix focuses on two factor:

- The Strategic importance of the process; and
- The complexity of the process

Generally speaking, less important processes can be outsourced to outside supplies, while simple processes can be automated by a computer software.

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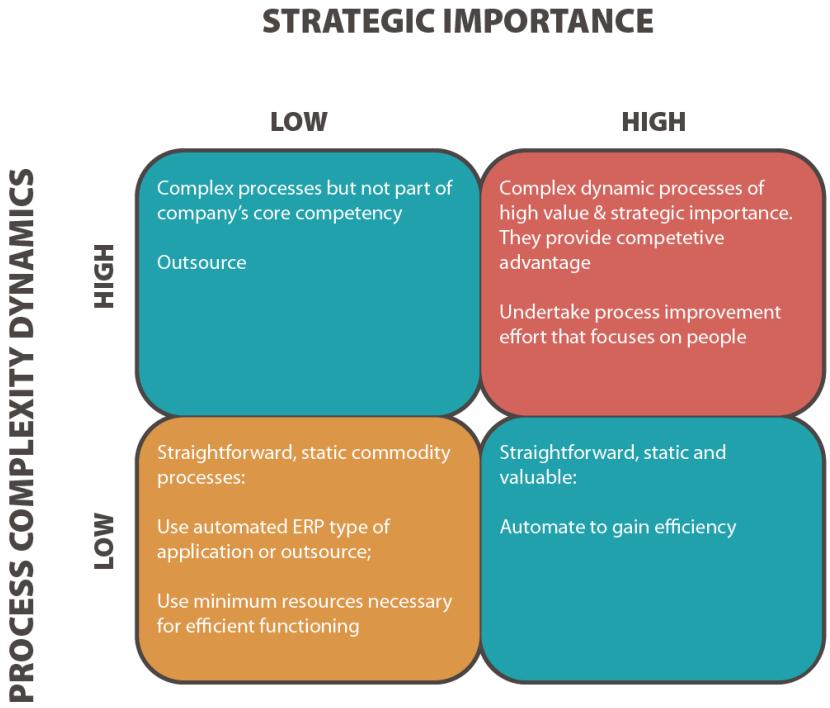


4.6 Diagnosing change

4.6.1 Balogun and Hailey: classification of change

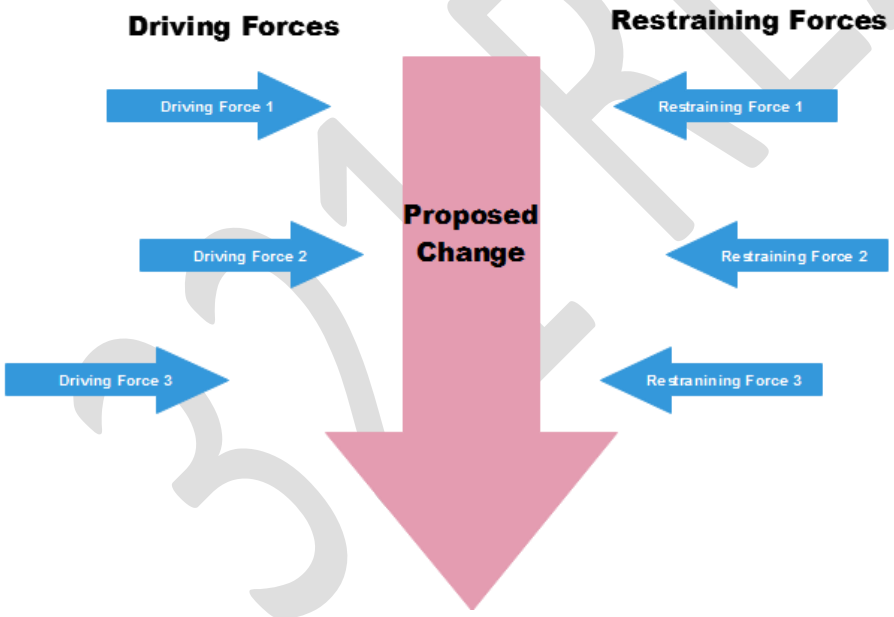
Speed of change \ Extent of change	Transformation	Realignment
Incremental	**Evolution:** Transformational change implemented gradually through inter-related initiatives; likely to be proactive change undertaken in participation of the need for future change	**Adaptation:** Change undertaken to realign the way in which the organisation operates; implemented in a series of steps
Big Bang	**Revolution:** Transformational change that occurs via simultaneous initiatives on many fronts: • more likely to be forced and reactive because of the changing competitive conditions that the organisation is facing	**Reconstruction:** Change undertaken to realign the way in which the organisation operates with many initiatives implemented simultaneously: • often forced and reactive because of a changing competitive context

- **Transformation** entails changing an organisation's culture. It is a fundamental change that cannot be handled within the existing organisational paradigm.
- **Realignment** does not involve a fundamental reappraisal of the central assumptions and beliefs.
- **Incremental change** can take a long period of time, but results in a fundamentally different organisation once completed.
- **Big Bang** change is likely to be a forced, reactive transformation using simultaneous initiatives on many fronts, and often in a relatively short space of time.

4.7 Enabling change

4.7.1 Forcefield analysis

Force Field Analysis is a method for listing and evaluating the forces for and against a situation. It helps you analyse all of the forces that have an influence on the current situation. Human behaviour is caused by forces – beliefs, expectations, cultural norms, etc. Some of these forces are positive, pushing us forward, and some of these forces are negative, preventing us from achieving a set goal. A force field analysis diagram demonstrates these driving forces and restraining forces that would influence a problem. A force field diagram can be used in all kinds of situations that occur in life from different points of view.



Exercise

Frigate Co is based in the country of Egdon. It imports electrical components from other countries and distributes them throughout the domestic market. The company was formed twenty years ago by Ron Frew, who now owns 80% of the shares. A further 10% of the company is owned by his wife and 5% each by his two daughters.

Although he has never been in the navy, Ron is obsessed by ships, sailing and naval history. He is known to everyone as “The Commander” and this is how he expects his employees to address him. He

increasingly spends time on his own boat, an expensive motor cruiser, which is moored in the local harbour twenty minutes' drive away. When he is not on holiday, Ron is always at work at 8.00 am in the morning to make sure that employees arrive on time and he is also there at 5.30 pm to ensure that they do not leave early. However, he spends large parts of the working day on his boat, although he can be contacted by mobile telephone. Employees who arrive late for work have to immediately explain the circumstances to Ron. If he feels that the explanation is unacceptable then he makes an appropriate deduction from their wages. Wages, like all costs in the company, are closely monitored by Ron.

Frigate currently has 25 employees primarily undertaking sales, warehousing, accounts and administration. Although employees are nominally allocated to one role, they are required to work anywhere in the company as required by Ron. They are also expected to help Ron in personal tasks, such as booking holidays for his family, filling in his personal tax returns and organising social events.

Egdon has laws concerning minimum wages and holidays. All employees at Frigate are only given the minimum holiday allocation. They have to use this allocation not only for holidays but also for events such as visiting the doctor, attending funerals and dealing with domestic problems and emergencies. Ron is particularly inflexible about holidays and work hours. He has even turned down requests for unpaid leave. In contrast, Ron is often away from work for long periods, sailing in various parts of the world.

Ron is increasingly critical of suppliers ("trying to sell me inferior quality goods for higher prices"), customers ("moaning about prices and paying later and later") and society in general ("a period working in the navy would do everyone good"). He has also been in dispute with the tax authority who he accused of squandering his "hard-earned" money. An investigation by the tax authority led to him being fined for not disclosing the fact that significant family expenditure (such as a holiday for his daughters overseas) had been declared as company expenditure.

It was this action by the tax authority that prompted Ron to appoint Ann Li as company accountant. Ann had previously worked as an accountant in a number of public sector organisations, culminating in a role as a compliance officer in the tax authority itself. Ron felt that "recruiting someone like Ann should help keep the tax authorities happy. After all, she is one of them".

Ann was used to working in organisations which had formal organisational hierarchies, specialised roles and formal controls and systems. She tried to install such formal arrangements within Frigate. As she said to Ron "we cannot have everyone working as if they were just your personal assistants. We need structure, standardised processes and accountability". Ron resisted her plans, at first through delaying tactics and then through explicit opposition, tearing up her proposed organisational chart and budget in front of other employees. "I regret the day I ever made that appointment", he said. After six months he terminated her contract. Ann returned to the tax authority as a tax inspector.

Required

Analyse Frigate Co using the cultural web or any other appropriate framework for understanding organisational culture.

(14 marks)

Using appropriate models, how an understanding of change management would have helped predict failure of Ann Li's proposal at Frigate

(6 marks)

(20 marks)

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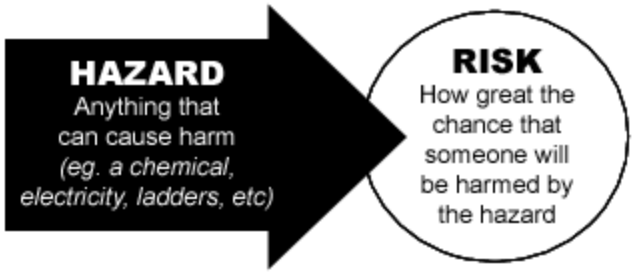
5 Risk Management

5.1 Risk, Uncertainty and Hazard

- A hazard is something that can cause harm, e.g. electricity, chemicals, working up a ladder, noise, a keyboard, a bully at work, stress, etc.
- A risk is the chance, high or low, that any hazard will actually cause somebody harm.
- For example, working alone away from your office can be a hazard. The risk of personal danger may be high. Electric cabling is a hazard. If it has snagged on a sharp object, the exposed wiring places it in a 'high-risk' category.



- Uncertainty is a lack of complete certainty. In uncertainty, the outcome of any event is entirely unknown, and it cannot be measured or guessed; you don't have any background information on the event. Whereas, there is knowledge of the possible events with risk.
- Uncertainty is not an unknown risk.
- In uncertainty, you completely lack the background information of an event, even though it has been identified. In the case of an unknown risk, although you have the background information, you missed it during the identify risks process.

5.2 Committee of Sponsoring Organisations of the Treadway Commission (COSO)

COSO is a joint initiative of five private sector organizations dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

In 1992, COSO developed a model for evaluating internal controls. This model has been adopted as the generally accepted framework for internal control and is widely recognised as the definitive standard against which organizations measure the effectiveness of their systems of internal control.

What is the COSO Framework?

The COSO model defines internal control as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance of the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations

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- Reliability of financial reporting
- Compliance with applicable laws and regulations"

In an "effective" internal control system, the following five components work to support the achievement of an entity's mission, strategies and related business objectives.

There were five original components of the risk management process as suggested by COSO. Given below with examples.



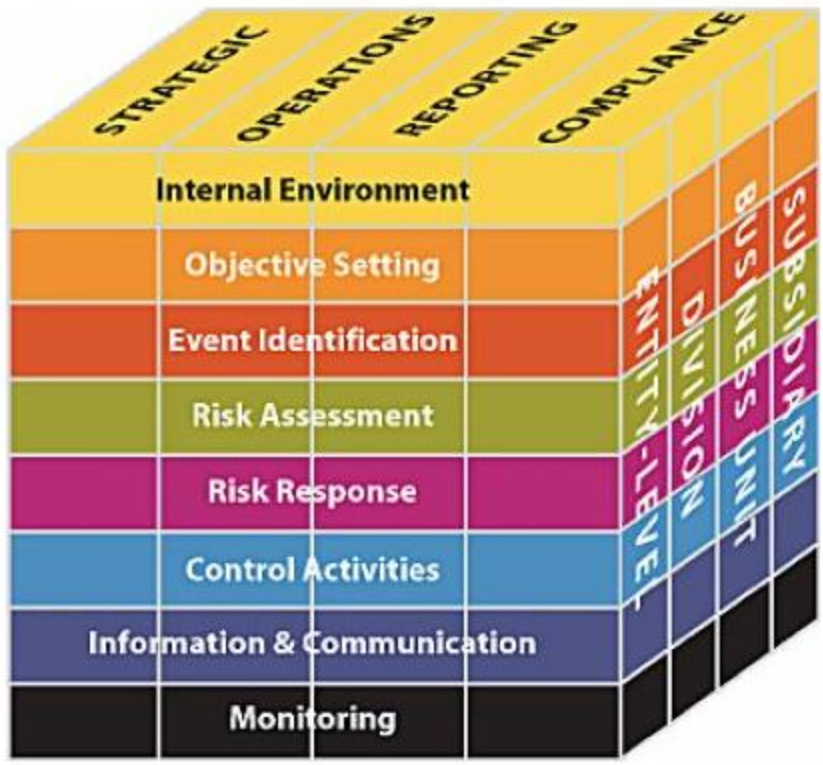
1. Control Environment
   - Integrity and Ethical Values
   - Commitment to Competence
   - Board of Directors and Audit Committee
   - Management's Philosophy and Operating Style
   - Organizational Structure
   - Assignment of Authority and Responsibility
   - Human Resource Policies and Procedures
2. Risk Assessment
   - Company-wide Objectives
   - Process-level Objectives
   - Risk Identification and Analysis
   - Managing Change
3. Control Activities
   - Policies and Procedures
   - Security (Application and Network)
   - Application Change Management
   - Business Continuity/Backups
   - Outsourcing
4. Information and Communication
   - Quality of Information
   - Effectiveness of Communication
5. Monitoring
   - Ongoing Monitoring
   - Separate Evaluations

- Reporting Deficiencies

These components work to establish the foundation for sound internal control within the company through directed leadership, shared values and a culture that emphasises accountability for control.

5.3 COSO Enterprise Risk Management

The Board commissioned and published in 2004 Enterprise Risk Management—Integrated Framework, and updated version over the previous standard, meant to cover the risk management of even large organisations. Over the past decade, that publication has gained broad acceptance by organizations in their efforts to manage risk. The rest of this section will be structured around the ERM model, introducing other topics and concepts in the context of the ERM model.



5.4 Risk Management—Environment

Management holds overall responsibility for managing risk to the entity. They must create an enabling environment for managing risk. This would involve setting.

- Risk capacity and risk appetite of organisation.
- Risk management philosophy.
- Effective board structure.
- Integrity, ethical values and corporate culture.
- Organisational structure.

- Authority and responsibility.

5.5 Objective Setting

- Developing a strategy and setting objectives is a precondition to identifying, assessing and analysing risks.
- Operational objectives must be set for each business unit and department.

5.5.1 ALARP ("as low as reasonably practicable")

ALARP is a principle that espouses reasonability in the setting of control objectives, risk reduction should only be carried out when there is still marginal benefit in doing so. Among other things it says:

- Infinite time, effort and money could be spent in trying to reduce a risk to zero.
- Describes the level to which risks would be controlled.
- A best practice of judgement to balance risk and benefit.
- Involves weighing a risk against the trouble, time and money needed to control it.

5.5.2 Six Sigma

Six Sigma is an entire performance management philosophy centred around quality.

As a control objective, Six Sigma sets an extremely low occurrence rate for the defect incidences: six standard deviations from the mean (trust me, that's quite small), or only 4 defects in 10 million products.

5.6 Risk Event Identification

Involves identifying the events that would negatively impact the organisations strategy.

- Requires understanding of which external factors will impact on achievement of strategic objectives.
- Events at operational level should also be considered

5.6.1 Risk categories

- **Market risk –** the exposure to the uncertain market value of an asset or liability (e.g. interest rate risk).
- **Credit risk –** one party to a financial instrument will cause a financial loss for the other party (e.g. they fail to settle a debt).
- **Liquidity risk –** difficulty in meeting obligations associated with financial liabilities.
- **Technological risk –** does not realise the potential of technology to maintain or gain competitive advantage.
- **Legal and regulatory risk –** breaching applicable laws and regulations ("compliance risk").
- **Health and safety risk –** unintentional harm (actual or potential) to employees or other individuals.
- **Environmental risk –** damage that an entity's activities can cause to the environment.
- **Reputation risk –** negative publicity regarding an organisation leads to loss of revenues or fines.
- **Business probity risk –** business transactions and actions may not be ethical, lawful, prudent, effective and transparent.
- **Derivative risk –** that derivatives will cause substantial financial damage to an entity
- **Strategic risk –** is the threat that failed business decisions, or lack thereof, may pose to a company. Strategic risk is often a major factor in determining a company's worth, particularly observable if the company experiences a sharp decline in a short period of time.

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- **Compliance risk –** is exposure to legal penalties, financial forfeiture and material loss an organization faces when it fails to act in accordance with industry laws and regulations, internal policies or prescribed best practices.
- **Reporting risk –** risk that information provided by the entity is materially misstated
- **Operational Risk –** is the prospect of loss resulting from inadequate or failed procedures, systems or policies. Employee errors. Systems failures. Fraud or other criminal activity. Any event that disrupts business processes.
- **Financial risk –** is any of various types of risk associated with financing, including financial transactions that include company loans. Examples are: financial gearing and default risk.

5.7 Risk Assessment and Response

The important metrics to measure are the impact of a certain risk and its likelihood of occurrence.

5.7.1 Heat map

A risk heat map is a tool used to present the results of a risk assessment process visually and in a meaningful and concise way. The number in the chart represent specific risk items or a class of risk items. Risk items in the red zone are particularly concerning.

IMPACT	LIKELIHOOD: 10 Low	20 Medium	30 High	40 Very High
10 Low	4	1	1	3
20 Medium	4	5	7	7
30 High	7	7	10	6
40 Very High	7	12	14	9

5.7.2 Risk Response—TARA

The TARA framework responds to risk after they have been mapped using their impact and likelihood. It suggests risk management strategies for different classes of risk.

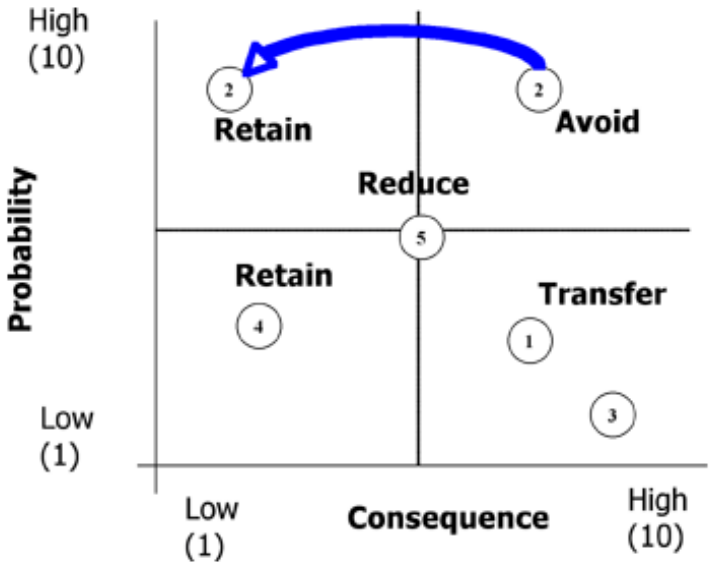
Transfer: This means to share the risk with another party. Common example will be to buy an insurance to share part of the risk of losses with insurance company. For example, this strategy is suitable when the risk has a significant impact to the company but low probability to occur. It is better to transfer rather than reduce in this case because the risk may not occur. However transfer is limited if there is no alternative arrangements for bearing the risk.

Avoid: This means to avoid the activity that causes the risk. For example, this strategy is suitable when the risk is likely to occur and has a significant impact. However if it is strategically vital to undertake the activity, then transference or reduction may have to be undertaken.

Reduce: This means to reduce the risk exposure probably by carrying out the activity in a different way. For example, this strategy is suitable when the risk does not have significant impact but likely to occur. This is to

reduce the likelihood of occurrence by using different method to carry out the activity. However, if reduction cannot be done, company might have to accept the risk if it does not have significant impact or avoid it if otherwise.

Accept: This means to accept the risk and do nothing. For example, this strategy is suitable when the risk has a low impact and low probability of occurrence. This is because the risk is not really a matter even if it is realised.



5.8 Control Activities

5.8.1 PAPAMOSS

5.8.1.1 Physical control:

This is mainly concerned with the custody and protection of assets such as cash and inventories. It involves tight security measures and procedures to ensure that only authorised personnel have access to the records and assets. For examples, the installation of fences, gates, doors as well as the use of locks and keys.

5.8.1.2 Authorisation and approval control:

No transactions should be carried out and no documents should be processed, without the approval or permission from an appropriate and responsible person. Approval like signing must be done with consent. Not only that, limits on authorisation should be clearly specified too.

5.8.1.3 Personnel control:

These are procedures put in place to ensure that staffs have capabilities commensurate with their responsibilities.

5.8.1.4 Arithmetical and accounting control:

Persons in charge should ensure that all transactions have been authorised before they are sent for recording and processing purposes. After that, the persons in charge must check whether they got left out anything and make sure that all transactions are correctly recorded and accurately processed. Such controls may include

checking the arithmetical accuracy of the records like control accounts, cross totals, reconciliations, trial balance and sequential controls over documents.

5.8.1.5 Management control:

These are the controls exercised by the management outside the daily routine of the system. For example, overall supervisory controls, review of management accounts, budgetary controls, internal audit function and other special review procedures.

5.8.1.6 Organisational control:

A well-defined organisational structure shall show clearly how responsibilities and authorities are delegated as well as identify lines of reporting for all aspects of the enterprise's operations. A tall organisational structure usually has a narrow span of control where managers can manage their subordinates easily but communication might be distorted due to higher level of hierarchy plus employing many managers is costly. Research organisations normally have these characteristics. Conversely, a flat organisational structure has a wider span of control where managers have fewer time to supervise all their subordinates but there will be lesser distortion in communication as the hierarchy level is shorter plus subordinates are cheaper to hire as compared to managers. This is common in manufacturing industries

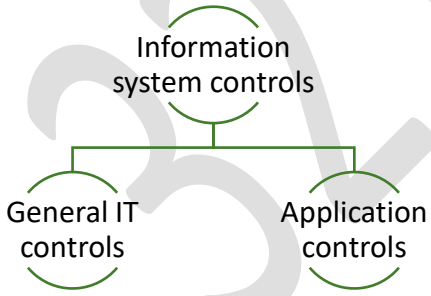
5.8.1.7 Supervision control

Supervision by responsible officials of the day-to-day transactions and the recording thereof is an integral part of any control system

5.8.1.8 Segregation of duties:

Ideally, responsibilities and duties must be separated to a number of people, so that no individual can fully record and process a transaction completely. Furthermore, it reduces the risk of intentional manipulation or mistake and increase the element of checking.

5.8.2 Control Activities—Computerised information systems



5.8.2.1 General IT controls

General controls include software controls, physical hardware controls, computer operations controls, data security controls, controls over the systems implementation process, and administrative controls.

Comprises:

- **Software controls:** Monitor the use of system software and prevent unauthorised access of software programs, system software, and computer programs. System software is an important control area because it performs overall control functions for the programs that directly process data and data file

- **Hardware controls"** Ensure that computer hardware is physically secure and check for equipment malfunction. Computer equipment should be specially protected against fires and extremes of temperature and humidity. Organizations that are dependent on their computers also must make provisions for backup or continued operation to maintain constant service.
- **Computer operations controls:** Oversee the work of the computer department to ensure that programmed procedures are consistently and correctly applied to the storage and processing of data. They include controls over the setup of computer processing jobs and computer operations and backup and recovery procedures for processing that ends abnormally.
- **Data security controls:** Ensure that valuable business data files on either disk or tape are no

5.8.2.2 Application controls

Application controls include both automated and manual procedures that ensure that only authorised data are completely and accurately processed by that application. Application controls can be classified as

1. **input controls:** Controls over input are designed to assure that the information processed by the computer is valid, complete, and accurate. E.g. form field validation;
2. **processing controls:** Controls over processing are designed to assure that data input into the system is accurately processed; E.g. logical checks.
3. **output controls:** Controls over output are designed to assure that data generated by the computer are valid, accurate, and complete; and
4. **Master data controls:** There should be procedures in place to verify that the correct version of the Master File is being used. Or that no end user should be able to quietly alter the master file.

5.8.3 Financial and Market risk control

Financial Risks can usually be hedged using derivatives or other instruments and transactions.

Market risk can usually be reduced by holding a well-diversified portfolio of market instruments, which should probably include some risk-free instruments as well.

There are three classes of financial risk that fall into consideration:

1. **Translation risk:** risk involving the fair values of reported assets and liabilities. Although this is not a cash flow, the risks can be hedged in order to reduce volatility in reported profits.
2. **Transaction risk:** risk involving the payment or receipt values of future cash transactions. This type of risk is usually hedged using derivatives
3. **Economic risk:** risks that affect the cash flows of the entity in the long run due to adverse long-term movement in economic variables like interest rates, inflation, demand, etc. This type of risk is very difficult to hedge.

5.9 Information and Communication

Management holds overall responsibility for managing risk to the entity, but it is important for management to go further: to enhance the conversation with the board and stakeholders about using enterprise risk management to gain a competitive advantage.

Chorus and Bartram: Risk management circle

Information and Communication

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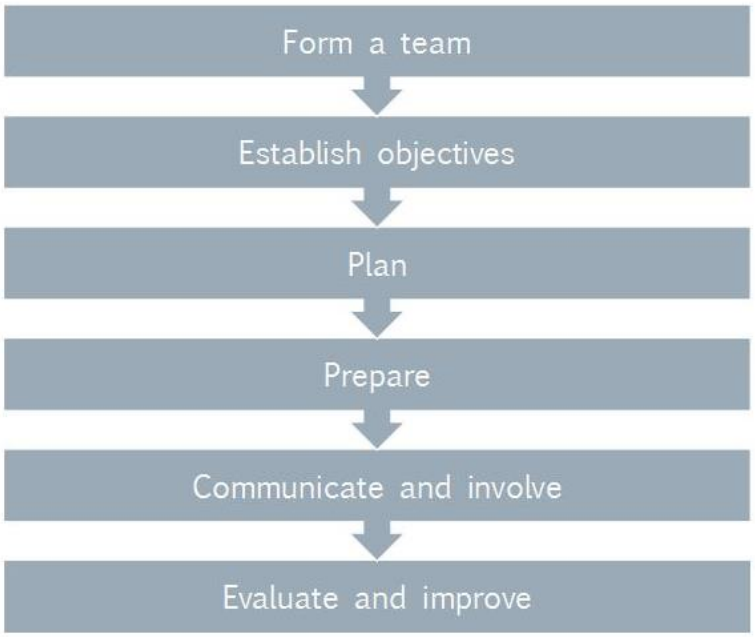

5.9.1 Financial reporting

IFRS contains multiple requirements for disclosure to give information of the key risks facing the entity. IFRS 17also requires disclosures on the risk management of financial instruments.

5.10 Monitoring

The risk management system must be monitore an--going basis to ascertain the that he controls are still as affective as they once wear

5.11 Limitations of Risk management

- **Lack of Data:** Many risk assessment analysis techniques involve gathering data. For example, developing models or simulations can help predict the impact of events, such as natural disasters caused by severe weather conditions.
- **Insufficient analysis expertise and time:** Using decision trees to analyse risks may provide comprehensive input but analysing the consequences arising from a myriad of possibilities may prove unwieldy. With the latest technology, the use of computer software programs to simulate activities that can cause a negative impact on project schedules has become much more cost effective
- **Collusion:** If employees with the resources and means decide on it, they may still be able to circumvent certain controls in order to perpetrate fraudulent acts.
- **Management Override:** Management are meant to be the champions of risk management; they however usually have the ability to override some controls. If management are not committed to controls but override them at every convenience, then the controls are doomed.
- **Residual risk:** a smidgen of risk will still be left even after the best efforts of mice and men

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5.12 Other Risk Management Models

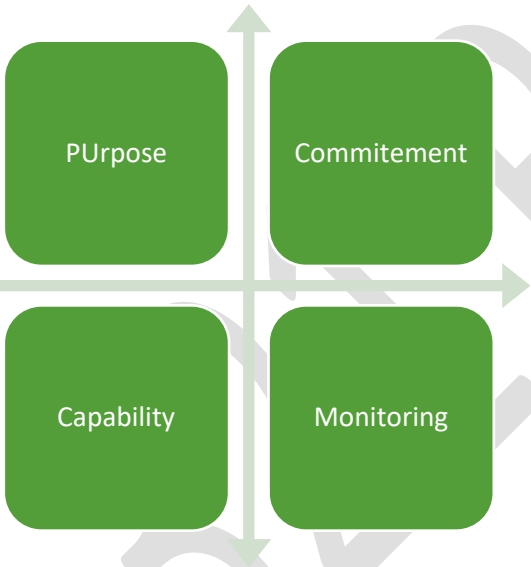
5.13 Criteria of Control (CoCO)

The **criteria of control (CoCo) framework** was developed by the Canadian Institute of Chartered The criteria of control (CoCo) framework was developed by the Canadian Institute of Chartered Accountants (now CPA Canada) and outlines 20 control criteria that management can use to manage company performance and improve its decision-making. External financial reporting is prepared for individuals and organizations outside of the company, such as shareholders and tax authorities.

The framework emphasises that control involves the entire organization but begins on an individual level, with the employee. The CoCo framework outlines criteria for effective control in the following four areas:

- Purpose
- Commitment
- Capability
- Monitoring and learning

In order to assess whether controls exist and are operating effectively, each criterion would be examined to identify the controls that are in place to address them.



6 Corporate Governance

Definitions

"Corporate governance is the system by which companies are directed and controlled"

-Cadbury report, 1999

"The system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all stakeholders and act in a socially responsible way in all areas of their business activity."

-Jill Solomon, 2004

"It is the relationship among various participants in determining the direction and performance of corporations."

-Monks and Minow, 1995

Procedures and processes according to which an organisation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making.

-OECD, 2004

6.1 Sample CG Systems—International Airlines Group (IAG)

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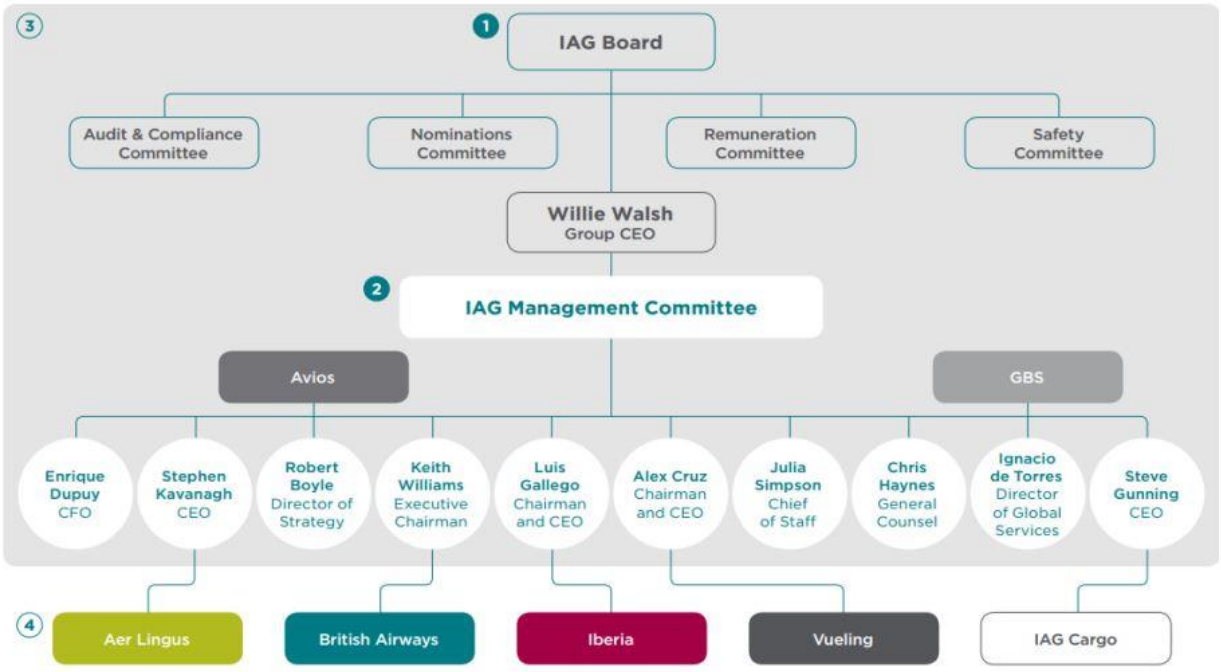
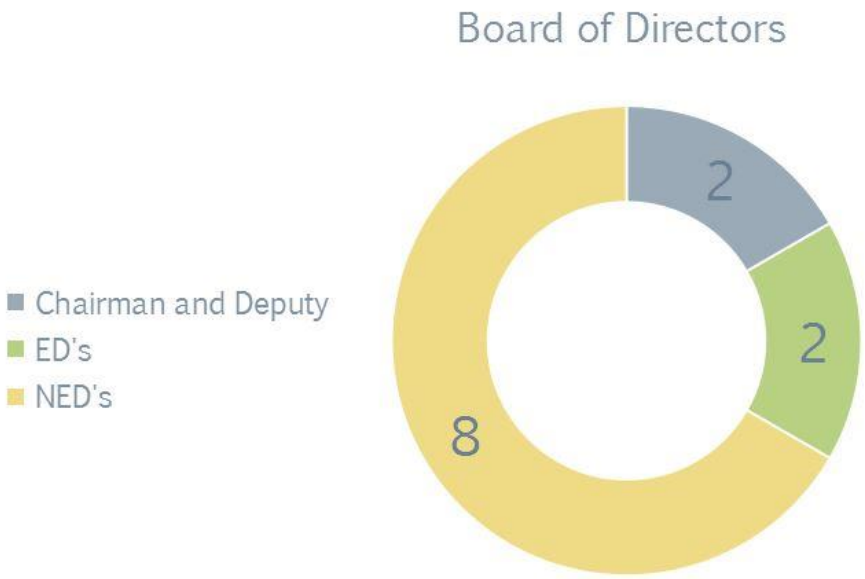


6.1.1 Board Balance of IAG



6.2 Principles of Good CG Systems

Accountability. The Code provides for accountability of the Company's Board of Directors to all shareholders in accordance with applicable law and provides guidance to the Board of Directors in making decisions and monitoring the activities of the executive bodies.

Fairness. The Company undertakes to protect shareholders' rights and ensure equal treatment of shareholders. The Board of Directors shall give all shareholders the opportunity to obtain effective redress for violations of their rights.

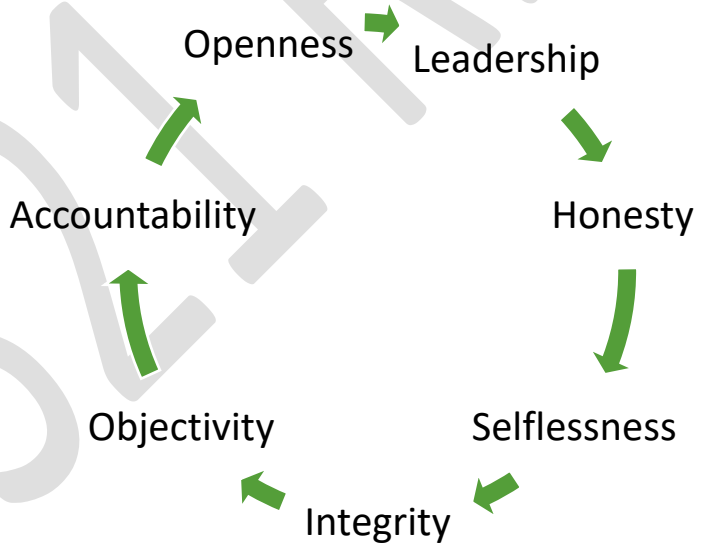
Transparency. The Company shall provide timely, accurate disclosure of information about all material facts relating to its activities, including its financial situation, social and environmental indicators, performance, ownership structure and governance of the Company, as well as free access to such information for all stakeholders.

Responsibility. The Company recognizes the rights of all interested parties permitted by applicable law, and seeks to cooperate with such persons or companies for their own development and financial stability.

Other Principles are:

- Innovation
- Skepticism
- Probity and Honesty
- Integrity
- Independence
- Reputation
- Judgement

6.3 Public sector Principles (Nolan)



The Principles of public life apply to anyone who works as a public office-holder. This includes all those who are elected or appointed to public office, nationally and locally, and all people appointed to work in the civil service, local government, the police, courts and probation services, NDPBs, and in the health, education, social and care services. All public office-holders are both servants of the public and stewards of public resources. The principles also have application to all those in other sectors delivering public services.

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6.3.1 Selflessness

Holders of public office should act solely in terms of the public interest.

6.3.2 Integrity

Holders of public office must avoid placing themselves under any obligation to people or organisations that might try inappropriately to influence them in their work. They should not act or take decisions in order to gain financial or other material benefits for themselves, their family, or their friends. They must declare and resolve any interests and relationships.

6.3.3 Objectivity

Holders of public office must act and take decisions impartially, fairly and on merit, using the best evidence and without discrimination or bias.

6.3.4 Accountability

Holders of public office are accountable to the public for their decisions and actions and must submit themselves to the scrutiny necessary to ensure this.

6.3.5 Openness

Holders of public office should act and take decisions in an open and transparent manner. Information should not be withheld from the public unless there are clear and lawful reasons for so doing.

6.3.6 Honesty

Holders of public office should be truthful.

6.3.7 Leadership

Holders of public office should exhibit these principles in their own behaviour. They should actively promote and robustly support the principles and be willing to challenge poor behaviour wherever it occurs.

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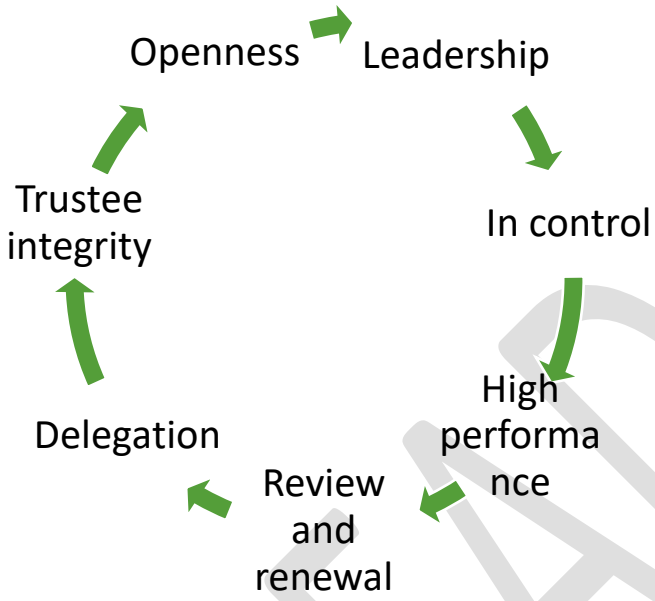
6.4 Principles for Charities (UK Voluntary code)



6.5 Agency Theory

The Agency theory hold that there exists an agency relationship between the shareholders (the principals) and the directors (the agent). This makes the shareholders the primary beneficiaries of an organisation's activities. Unfortunately, it also exposed them to all the perils of the agency problem.

6.5.1 Key concepts

- Agency – agent is hired/employed by the principal to carry out a task on behalf of principal (e.g. directors hired by shareholders).
- Agency costs – costs incurred in establishing and monitoring the agent by the principal.
- Residual loss – reduction in shareholder value resulting from excessive agency costs.
- Accountability – agent is accountable to the principal for the outcome of the work they carry out and the resources they use.

6.5.2 Fiduciary responsibilities

Fiduciary duty – duty of individuals in position of trust.

6.5.2.1 Fiduciary duties of directors:

- Act in good faith in the company's best interests.
- Act within powers conferred by the company.
- Use independent judgement on the company's behalf.
- Avoid conflicts of interest and conflicting duties.
- Not make a secret profit (includes accepting bribes).
- Exercise due skill and care in the performance of duties

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6.5.3 Agency problem

How to control agents to ensure they act in the principals' best interests not in their own interests.

- Lies at heart of corporate governance.
- Goals of company and directors may conflict (e.g. excessive remuneration).

6.5.4 Resolving the problem

The lasting way to resolve the agency problem would be to align the interest of the principal with that of the agent.

6.5.4.1 Methods

- Remuneration and incentive schemes.
- Voting at AGM.
- Determining composition of the board.
- Shareholder resolutions.
- Selling shareholding
- One-to-one meetings

6.6 Stewardship theory

- Postulates that managers are stewards (caretakers) running the business in the interests of the shareholders.
- The organisation is an asset of the shareholders under the care of the managers
- The shareholders are therefore the primary beneficiaries of the organisation's activities and the returns of the firm should accrue to them.

6.7 Stakeholder theory

Stakeholder – any group or individual who can affect, or be affected by, the achievement of an organisation's objectives.

Stakeholder theory establishes the need for the directors to consider all stakeholders in their decision making in order to maximise the wealth of the company.

6.7.1 Development of the theory

- Growth in size of firms increases their impact on all areas of society in which they operate.
- Corporate scandals have impacted a wider group of stakeholders.
- Growth of electronic media allows activist lobby groups to publicise the activities of unethical businesses.

6.7.2 Boardroom impact of the theory

- Directors cannot afford to ignore stakeholders.
- Evidence that companies that follow strong approach to stakeholders outperform.
- Two motivations to respond to stakeholder concerns:
    - Instrumental approach – managers must pay attention to needs of key shareholders to ensure maximisation of revenues, profits and shareholder value.
    - Normative approach – there is a moral duty to take account of other stakeholders.

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6.8 Transaction cost theory

This suggests that organisations are necessities. They reduce the overall transaction costs of the stakeholders when compared with if they had pursued similar activities without the presence of the organisations.

It is there in managers interest to keep the organisation running for years to come. Managers will act in the interest of their stakeholders as lion as it doesn't increase their net transaction costs.

6.9 Resource dependence theory

Resource dependence theory (RDT) is concerned with how organisational behaviour is affected by external resources the organisation utilises, such as raw materials. The theory is important because an organisation's ability to gather, alter and exploit raw materials faster than competitors can be fundamental to success.

Some commentators encourage organisations to view customers as a resource predisposed to scarcity

RDT is underpinned by the idea that resources are key to organisational success and that access and control over resources is a basis of power. Resources are often controlled by organisations not in the control of the organisation needing them, meaning that strategies must be carefully considered in order to maintain open access to resources.

6.10 Systems theory

any organised group constitutes a system, which is composed of regularly interacting or interrelating groups of activities or people performing activities. Managers therefore have a role to play in the system.

6.11 Approaches to CG

There are 2 approaches. The principles-based approach and the rules-based.

6.11.1 Principles-based

- Focuses on objectives rather than how these objectives might be achieved.
- Ensures all situations can be covered through applying the appropriate principle in the code.
- Applicable across different legal jurisdictions.
- Flexible and adaptable to different and new situations.
- Not simply a "box ticking" exercise.
- Incorporates a "comply or explain" regime.

6.11.2 Rules-based

- Focus is on definite achievements rather than the underlying factors and/or principles.
- Prescribed set of requirements. One set of rules applies to all companies.
- Emphasis placed on obeying the letter of the rule. Legally binding and enforceable by law.
- Can ensure compliance through adopting a checklist approach.
- Clear distinction between compliance and non-compliance ("yes/no").
- Easy for oversight to ensure rules have been followed.
- Black/white with no shades of grey in between.

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6.12 The Board of Directors

6.12.1 Role, responsibilities and duties

- Every company should be headed by an effective board, which is collectively responsible for its success. *UK Code*
- Board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assed and managed". *UK Code*
- To define the company's purpose and the values by which it will perform its daily existence and to identify relevant stakeholders. Board must develop a strategy combining all three factors and ensure management implements that strategy. *King Report*

6.12.1.1 Responsibilities and duties

- Setting the company's strategic aims/objectives.
- Ensuring necessary financial/human resources.
- Making decisions in the interest of the company.
- Reviewing performance of the company and the board.
- Setting the company's values/standards.
- Maintaining contact with shareholder opinion.
- Establishing various committees.
- Appointing appropriate CEO.
- Maintaining a sound system of internal control.
- Ensuring access to independent professional advice.
- Assessing what is important to broader stakeholder interests.

6.12.2 Non-Executive Directors

6.12.3 Roles

- Strategy – challenge and offer advice on strategy.
- Performance – hold exec directors to account.
- Risk – ensure adequate system of internal control and risk management.
- People – appoint and decide remuneration of executives. Deal with contractual, disciplinary and succession issues.

6.12.3.1 Skills necessary to be effective

- Integrity and high ethical standards.
- Sound judgement
- Ability, willingness to challenge and probe
- Strong interpersonal skills.
- Supporting leadership role of executives, whilst monitoring conduct.

6.12.3.2 Independence threats

- Former employee (e.g. within 5 years).
- Material business relationships (e.g. within three years).
- Remuneration paid (apart from the director's fee).
- Share options, performance-related pay, etc.
- Close ties with advisors, directors or senior employees.
- Long-standing board member (e.g. more than 9 years).
- Being, or representing, a major shareholder.

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- Holding too many NED positions and not being able to devote enough time to the tasks in hand.

6.12.4 The Board Composition

6.12.5 Single-tiered

1. Chairman

Head of the Board.

6.12.5.1.1 Responsibilities

- Run the board and set its agenda.
- Ensure that the members of the board receive accurate, timely and clear information.
- Ensure effective communication with shareholders and ensure that the members of the board develop an understanding of the views of the major investors.
- Manage the board to ensure that sufficient time is allowed for discussion of complex or contentious issues.
- Take the lead in identifying and meeting the development needs of individual directors, with (in the UK) the company secretary having a key role in facilitating provision.
- Ensure that the performance of individuals and of the board as a whole and its committees is evaluated at least once a year.
- Encourage active engagement by all the members of the board.

2. CEO

Head of the executive function (senior manager and executive directors)

6.12.5.1.2 responsibilities

- Formulating and implementing company policy.
- Developing strategic operating plans that reflect the board's longer-term objectives and priorities.
- Maintaining an ongoing dialogue with chairman.
- Implementing adequate operational planning and financial control systems.
- Maintaining operational performance.
- Monitoring the actions of the functional board directors.
- Representing the company to major customers and professional associations.
- Building and maintaining an effective executive team.

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3. NED's

Advantages	*Disadvantages*
✓ Board acts as one with equal status of NEDs and executives.	✘ No specific provision for representatives of employees, external shareholders, etc.
✓ NEDS provide different expertise, experience and perspectives.	✘ Role of the NEDs demands high expertise and time commitment.
✓ NEDs bring independent scrutiny.	✘ NEDs depend on information provided by the CEO.
✓ Greater protection against fraud and malpractice.	✘ Managers may withhold information as board scrutiny increases.
✓ All directors held equally accountable.	✘ NEDs may appear to interfere with the executives' role.
✓ Reduces likelihood of abuse by a small number of senior directors.	

6.12.6 Two-tiered board

- Management board headed by CEO focusing on operational issues and the running of the business.
- Supervisory board headed by the company chairman drawn from employees, shareholders and banks.
- Responsible for safeguarding stakeholders' interests and overseeing the management board.

Advantages	*Disadvantages*
Clear and formal separation between the monitored and the monitors.	✘ Potential for confusion over authority lack of accountability.
Stakeholders' interests will be heard. Major strategic decisions cannot be made without cooperation of supervisory board.	✘ Nomination to supervisory board may not be as independent as intended.
Direct power over management through the right to appoint and dismiss.	✘ Information may be withheld/not fully disclosed by the management board (agency problem).
Encourages transparency between management and "shop floor".	✘ Management board may influence agenda of supervisory board.
	✘ Employee represent-atives may delay or block "good" decisions.

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6.12.7 Induction, CPD and Performance

6.12.7.1 Induction

Every director should be given a formal induction on appointment into the organisation. During which they'll attempt to gain the following:

- An understanding of the nature of the company, its business and its markets.
- A link with the company's people.
- An understanding of the company's main relationships, including meeting with the auditors.
- Role, responsibilities and duties of directors.
- Need to communicate vision and culture, communicate procedural duties, reduce time for new director to become productive, make new director feel welcomed and ensure retention.

6.12.7.2 CPD (Continuing Professional Development)

- All directors should reach and maintain an effective and efficient level of operation.
- Resources should be made available for developing and refreshing the knowledge and skills of directors.
- Chairman to take pro-active role in identifying development needs.

6.12.7.3 Performance appraisal

- Board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role.
- Led by chairman – with NEDs reviewing the chairman.

6.12.8 Board Committees

6.12.8.1 Audit committee

- Comprise 3 independent NEDs. At least one should have recent and relevant financial experience.
- Monitor the financial statements integrity and significant financial reporting judgements.
- Review internal financial controls, general internal control and risk management systems,
- Monitor and review the effectiveness of internal audit.
- Make recommendations to the board on the appointment and removal of the external auditor.
- Review and monitor the external auditor's independence and objectivity.
- Review arrangements by which staff may raise concerns about possible improprieties ("whistle blowing").

6.12.8.1.1 Responsibilities relating to internal audit

- Approve the appointment or termination of the head of internal audit.
- Ensure that the internal auditor has direct access to the board chairman and to the audit committee and is accountable to the audit committee.
- Review and assess the annual internal audit work plan.
- Receive a report on the results of the internal auditors' work on a periodic basis.
- Review and monitor management's responsiveness to the internal auditor's findings and recommendations;
- Meet with the CAE at least once a year without the presence of management.
- Monitor and assess the role and effectiveness of internal audit in the context of risk management.

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6.12.8.2 Remuneration committee

- Transparent procedures for developing remuneration policy & fixing remuneration packages for directors.
- Remuneration committee of at least three NEDs (two for smaller companies).
- No executive should be involved in deciding his own remuneration.
- Terms of reference, explaining its role and the authority delegated to it by the board, should be made available.

6.12.8.2.1 Principal duties

- Establishing the remuneration policy for executives.
- Making recommendations of executive remuneration and its cost to the board.
- Deciding upon the different types of reward.
- Deciding on the time-period within which performance related packages become payable.
- Guaranteeing transparency of directors' compensation.

6.12.8.2.2 Perceived advantages

- Prevents executives from setting their own remuneration levels.
- Establishes a transparent system for setting executive remuneration levels.
- Helps to link objectives and performance-related pay and looks into a balance between short-term and long-term performance elements.
- Makes sure that directors are rewarded fairly and according to market standards.

6.12.8.3 Nomination committee

- Responsible for developing formal, rigorous and transparent procedure for the appointment of new directors to the board.
- Appointments to the board should be on merit and against objective criteria.
- Plans should be in place for orderly succession for appointments to the board and to senior management
- An appropriate balance of skills and experience within the company and on the board should be maintained.
- A majority of members of the nomination committee should be independent NEDs.
- Chairman or an independent NED should be chair.
- Committee should make available its terms of reference, explaining its role and the authority delegated to it by the board.

6.12.8.3.1 Principal duties

- Evaluating the existing balance of skills, knowledge and expertise on the board.
- Considering the ratio and number of executive and NEDs.
- Guaranteeing transparent procedures.
- Ensuring the board and individual board members are evaluated on a regular basis.
- Searching for suitable candidates in a wide range of areas to ensure that it chooses the most suitable candidates for the business.
- Developing appropriate selection criteria.
- Ensuring the new board members receive proper orientation and other necessary training.
- Preparing for succession planning.

6.12.8.3.2 Perceived advantages

- Independent selection procedure.

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- Allows senior executives to focus on business activities.
- Selection process not "captured" by an individual director (e.g. CEO).
- Forward thinking on succession matters.

6.12.8.4 Risk committee

Not a formal requirement in most jurisdictions. If no separate committee exists, then role should be taken by the Audit Committee if not by the board itself.

6.12.8.4.1 Role

- Agree and approve the risk management strategy and policies.
- Assist the board to define the risk appetite of the organisation.
- Provide general and explicit guidance to the main board on emerging risks and to report on existing risks.
- Identify actual risks and the control deficiencies in the organisation.
- Exercise oversight of management's responsibilities, and review organisation's risk profile to ensure that risk is not higher than risk appetite determined by the board.
- Receive and review risk reports from functions, divisions, subsidiaries and other business components.
- Ensure that infrastructure, resources and systems are in place for risk management and are adequate to maintain a satisfactory level of risk management discipline.
- Monitor overall exposure and specific risks.
- Monitor the effectiveness of independence risk management functions throughout the organisation.
- Review the strategies, policies, frameworks, models and procedures that lead to the identification, measurement, reporting and mitigation of material risks.
- Review issues raised by internal audit that impact the risk management framework.
- Ensure that the risk awareness culture is pervasive throughout the organisation.
- Work with the audit committee on designing and monitoring internal controls for management and mitigation of risks.

6.13 The Role of Other Stakeholders

6.13.1 Shareholders

6.13.2 Institutional Shareholders

6.13.3 External Audit

6.13.4 Internal Audit

6.14 Non-Compliance with Laws and Regulation (NOCLAR)

An IESBA framework for addressing issues of Non-compliance in corporate organisations.

Directed towards

and

Covers

Directors' and senior managers' responsibility as Senior PAIBs

Establish appropriate framework within entity to prevent NOCLAR

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Fulfil professional responsibilities

Determine if further action needed in public interest

7 Ethics

7.1 Definitions

> The basic concepts and fundamental principles of decent human conduct. It includes study of universal values such as the essential equality of all men and women, human or natural rights, obedience to the law of land, concern for health and safety and, increasingly, also for the natural environment. See also morality.

—Businessdictionary.com

1. the discipline dealing with what is good and bad and with moral duty and obligation
2. a set of moral principles **:** a theory or system of moral values

—Merriam-Webster

Obviously, there are different ways in which the word is used: we have ethics as a discipline of study, and ethics as a personal system of beliefs. We will be using both understandings during this chapter.

7.2 Ethical theories

7.2.1 Absolutism

Absolutism is making normative ethical decisions based on objective rules. It maintains that some things are always right and some things are always wrong. They are fixed for all time, places and people.

7.2.2 Relativism

Relativism says that nothing is intrinsically right or wrong. It is popular in the present day because there is a belief that everyone should be tolerant towards others' beliefs and views; this idea for freedom of speech implies that there are no ‘real’ absolute truths. Some believe that all human circumstances are different and therefore there is a need to have different moral rules for people.

7.2.2.1 Cultural (Normative) Relativism

- Says that different countries - or even areas within a country - have different values, for example, Muslims expect women to cover up (at least some of) their bodies.
- It affirms the idea 'when in Rome do as the Romans do'.
- It allows there to be variety in different cultures.
- However, as there are no overriding standard to compare cultures to, no one can say that one culture is better than another because of what they believe - this could be either an advantage or a disadvantage.

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- Moral truths are no more than subjective feelings about behaviour which can therefore never achieve the status of fact as they are the result of ways of life and opinions which vary from culture to culture or person to person depending on circumstances.

7.2.2.2 Historical Relativism

- This says that what was right one hundred years ago may not be right in the present day because times and society have moved on.
- 100 years ago, women did not have the vote but due to changing opinions in society they now do and hold principal positions in parliament, etc.
- Society also accepts the need to change sets of rules which used to be sufficient in previous times

7.2.3 Pluralism

- Middle of the ground between absolutism and relativism. Moral pluralism is the idea that there can be conflicting moral views that are each worthy of respect. hat many moral issues are extremely complicated. Thus, no single philosophical approach will always provide all the answers. Pluralists usually hold that there are three broad categories of behaviour. Two extremes, and a large middle ground between.
- Ideal behaviour: An extreme. What the pluralist would consider as objectively the best pattern of behaviour. E.g. rescuing someone from a burning building
- Forbidden behaviour: Another extreme. The objectively worst pattern of behaviour. E.g. murder.
- Tolerated behaviour: Everything in between

7.3 Ethical Approaches

Ethical approaches are the framework from which different persons approach ethical dilemmas. The approach chosen has to be combined with the persons' beliefs and norms to arrive at the decision. The approaches don't tell you what's right, but how to consider the facts of the situation when making the decisions.

7.3.1 Deontology (Duty based ethics)

This approach considers what the decision maker's duty is and ignores the consequences. E.g. It is a soldier's duty to take down an enemy personnel during combat, even though the consequences result in the death of a human being; it is the duty to the public of a professional account to blow the whistle on unethical business practices, even though he would be breaching confidentially or the company may go bankrupt and people may lose jobs

7.3.2 Teleology (Consequentialist approach)

Considers the decision in light of the consequences. The decision maker is likely to select the course of action that has the favourable outcome. The question is: favourable to who?

- **Egoism:** decisions are made to favour the decision maker
- **Utilitarianism:** decisions are made to favour the greater good
- **Altruism:** decisions are made to favour anyone but the decision maker

7.4 Kantian ethics

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7.5 Ethical Dilemmas

An ethical dilemma is a conflict between alternatives, where no matter what a person does, some ethical principle will be compromised.

7.6 Branches of Ethics

- Personal Ethics
- Business Ethics (CSR)
- Professional Ethics

7.7 Personal Ethics

7.7.1 Kohlberg's Developmental Theory

Kohlberg identified three levels of moral reasoning: pre-conventional, conventional, and post-conventional. Each level is associated with increasingly complex stages of moral development.

7.7.1.1 Level 1: Preconventional

Throughout the preconventional level, a child's sense of morality is externally controlled. Children accept and believe the rules of authority figures, such as parents and teachers. A child with pre-conventional morality has not yet adopted or internalised society's conventions regarding what is right or wrong, but instead focuses largely on external consequences that certain actions may bring.

7.7.1.1.1 Stage 1: Obedience-and-Punishment Orientation

Stage 1 focuses on the child's desire to obey rules and avoid being punished. For example, an action is perceived as morally wrong because the perpetrator is punished; the worse the punishment for the act is, the more "bad" the act is perceived to be.

7.7.1.1.2 Stage 2: Instrumental Orientation

Stage 2 expresses the "what's in it for me?" position, in which right behaviour is defined by whatever the individual believes to be in their best interest. Stage two reasoning shows a limited interest in the needs of others, only to the point where it might further the individual's own interests. As a result, concern for others is not based on loyalty or intrinsic respect, but rather a "you scratch my back, and I'll scratch yours" mentality. An example would be when a child is asked by his parents to do a chore. The child asks "what's in it for me?" and the parents offer the child an incentive by giving him an allowance.

7.7.1.2 Level 2: Conventional

Throughout the conventional level, a child's sense of morality is tied to personal and societal relationships. Children continue to accept the rules of authority figures, but this is now due to their belief that this is necessary to ensure positive relationships and societal order. Adherence to rules and conventions is somewhat rigid during these stages, and a rule's appropriateness or fairness is seldom questioned.

7.7.1.2.1 Stage 3: Good Boy, Nice Girl Orientation

In stage 3, children want the approval of others and act in ways to avoid disapproval. Emphasis is placed on good behaviour and people being "nice" to others.

7.7.1.2.2 Stage 4: Law-and-Order Orientation

In stage 4, the child blindly accepts rules and convention because of their importance in maintaining a functioning society. Rules are seen as being the same for everyone, and obeying rules by doing what one is "supposed" to do is seen as valuable and important. Moral reasoning in stage four is beyond the need for

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individual approval exhibited in stage three. If one person violates a law, perhaps everyone would—thus there is an obligation and a duty to uphold laws and rules. Most active members of society remain at stage four, where morality is still predominantly dictated by an outside force.

7.7.1.3 Level 3: Post conventional

Throughout the postconventional level, a person's sense of morality is defined in terms of more abstract principles and values. People now believe that some laws are unjust and should be changed or eliminated. This level is marked by a growing realization that individuals are separate entities from society and that individuals may disobey rules inconsistent with their own principles. Post-conventional moralists live by their own ethical principles—principles that typically include such basic human rights as life, liberty, and justice—and view rules as useful but changeable mechanisms, rather than absolute dictates that must be obeyed without question. Because post-conventional individuals elevate their own moral evaluation of a situation over social conventions, their behaviour, especially at stage six, can sometimes be confused with that of those at the pre-conventional level. Some theorists have speculated that many people may never reach this level of abstract moral reasoning.

7.7.1.3.1 Stage 5: Social-Contract Orientation

In stage 5, the world is viewed as holding different opinions, rights, and values. Such perspectives should be mutually respected as unique to each person or community. Laws are regarded as social contracts rather than rigid edicts. Those that do not promote the general welfare should be changed when necessary to meet the greatest good for the greatest number of people. This is achieved through majority decision and inevitable compromise. Democratic government is theoretically based on stage five reasoning.

7.7.1.3.2 Stage 6: Universal-Ethical-Principal Orientation

In stage 6, moral reasoning is based on abstract reasoning using universal ethical principles. Generally, the chosen principles are abstract rather than concrete and focus on ideas such as equality, dignity, or respect. Laws are valid only insofar as they are grounded in justice, and a commitment to justice carries with it an obligation to disobey unjust laws. People choose the ethical principles they want to follow, and if they violate those principles, they feel guilty. In this way, the individual acts because it is morally right to do so (and not because he or she wants to avoid punishment), it is in their best interest, it is expected, it is legal, or it is previously agreed upon. Although Kohlberg insisted that stage six exists, he found it difficult to identify individuals who consistently operated at that

7.7.2 Criticisms of Kohlberg

Is moral reasoning the same thing as moral behaviour?

For example, a person may say he will do something when given a moral dilemma. Will that person behave in a way that is consistent with what he says in a real-life dilemma?

Reliability of Kohlberg's testing.

Will a child evaluated one day by a particular researcher be assessed at the same moral level a few days later by a different researcher?

The validity of Kohlberg's model in terms of the decision the person makes based on the moral dilemmas.

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Critics question the fact that whatever solution a person picks is okay, as long as the person can base his/her solution on reasons. Basically, critics wonder if the reasoning a person uses should be enough. "Doesn't the answer have anything to do with the stage of development, instead of just the reasoning?"

7.7.2.1.1 Exercise — Acumen 2

In January 2015, NAFDAC released new regulation regarding approval of packaged juice (which is one of the business units of Acumen). After careful analysis of the implication of this to Acumen, the director of finance, Adekunle, advised the company to disregard the new legislation because the cost of compliance is much more than the fine that will be imposed in the incidence of non-compliance.

A non-executive director, Chinedu, is concerned about complying with expectation of shareholders and how information of regulatory fines might affect the company's share price and longer-term prospects.

Required:

Explain Kohlberg's three levels of moral development and identify, with reasons, the levels of development exhibited by Adekunle and Chinedu.

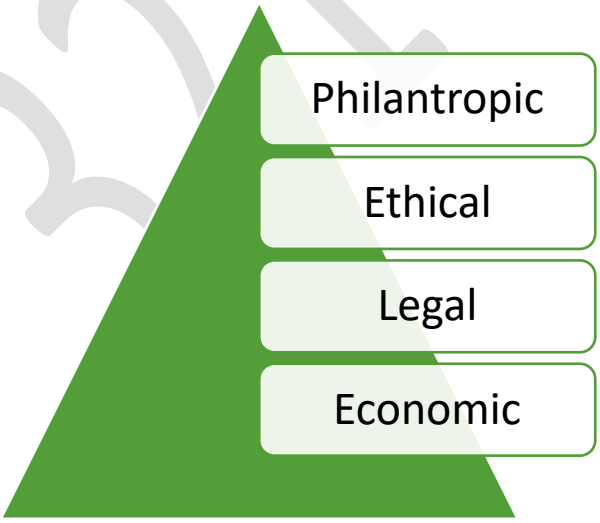
(8 marks)

7.8 Corporate Social Responsibility (CSR)

Encompasses the economic, legal, ethical and philanthropic expectations placed on organisations by society at a given point in time.

— *Carrol*

Continuing commitment to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large. It refers to all impacts a company may have on society and the need to deal with those impacts on all stakeholders in a responsible way"



Carrol's CSR Pyramid

7.8.1 Levels of corporate responsibility (Carrol)

- Economic responsibility (required – "have to") – reasonable return to shareholders, safe and fairly paid employment, quality products at a fair price.
- Legal responsibility (essential – "must do") – follow the letter and spirit of the applicable to the organisation, its dealings, environment and inter-action with stakeholders.
- Ethical responsibility (desired – "should do") – doing what is right, just and fair.
- Philanthropic (wished for – "might do") – the discretionary behaviour of organisations to improve the lives of others.

7.8.2 CSR Activities

- Should be linked to the core competencies of the firm and systematically be assessed, evaluated and communicated to emphasise benefits to:
  - stronger operational efficiency, financial performance and profitability;
  - enhanced employee commitment;
  - improved accountability to and assessments from the investment community;
  - improved access to capital;
  - competitiveness and market position;
  - enhanced attractiveness to qualified employees;
  - decreased vulnerability through stronger relationships with communities;
  - improved reputation and branding;
  - maintaining regulatory and public goodwill
  - adding to competitive advantage;
  - maintaining the social license to operate.

7.8.3 CSR Strategy v Strategic CSR

7.8.3.1 CSR strategy

- Direction and scope over the long-term which achieves advantages for the organisation through its configuration of resources (in a challenging environment) to meet the needs of markets and stakeholder expectations.
- Must be embedded within the overall corporate strategy.

7.8.3.2 Strategic CSR

- CSR activities that support core business and contributes to the entity's effectiveness in achieving its mission and objectives.
- Selective in that it builds "shared values" – creates value for society in parallel to business value.
- Can drive business innovation.

7.8.4 Ethical Stances

7.8.4.1 Johnson and Scholes 4 stances

- CSR and ethical considerations not part of the short-term shareholder interest. Governments need to regulate companies to force wider ethical stances.
- Wider stance on ethical issues maximises shareholder return over the long-term. Reduces risk of government intervention.
- Stakeholders' interests and expectations (multiple stakeholder obligations) are more incorporated in the organisation's purposes and strategies. Often leads to stakeholder conflicts thus relationships are managed proactively and carefully to sustain long-term self-interest.

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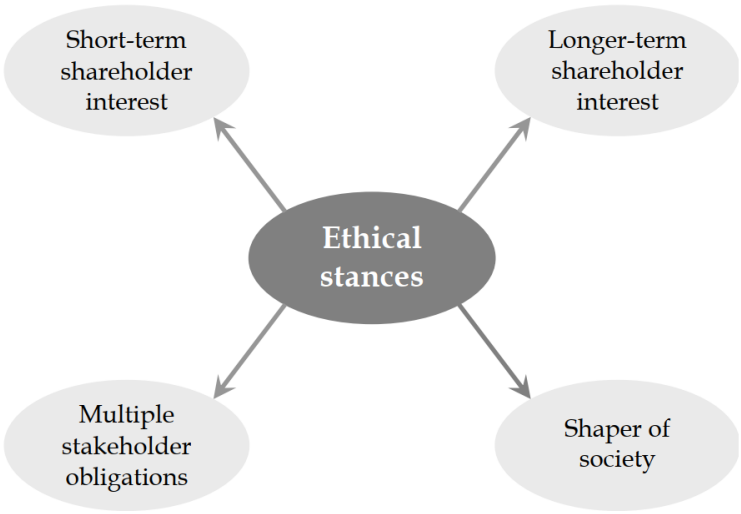
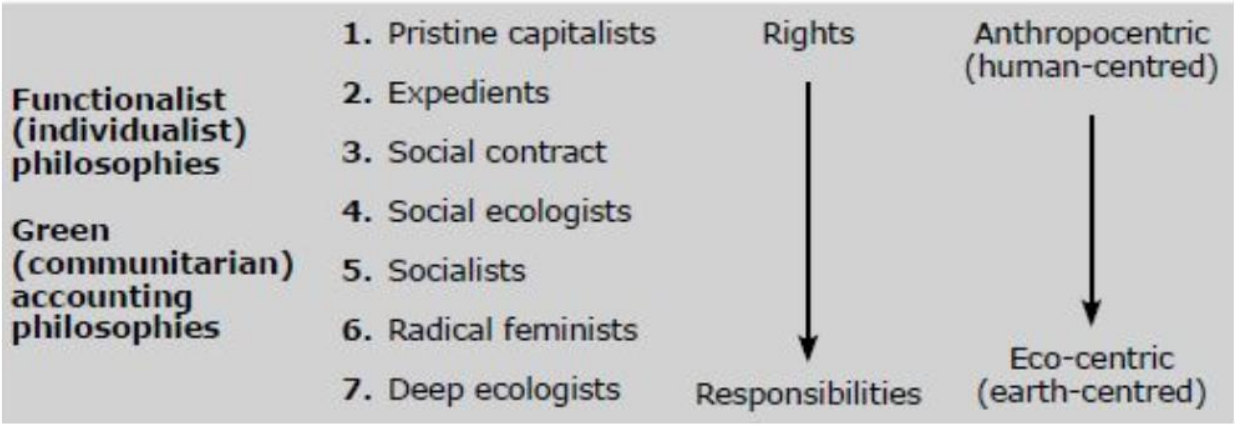
- Ability to change (shape) society for the better, trying to "make a difference" to contribute to a better world.



7.8.4.2 Gray, Owens and Adams 7 stances



- **Pristine capitalist** – profits before people; economic performance is the only legitimate goal.
- **Expedients** – must accept certain minimum CSR to maximise wealth of shareholders.
- **Social contract** – entities exist only at the will of society; actions are OK if they serve the "public interest".
- **Social ecologists** – organisations cause environment damage; moral responsibility to reverse trend; economic systems must take account of the environmental costs involved
- **Socialist** – people before profits; capital cannot dominate; current systems need to change.
- **Radical feminists** – existing social systems based on aggressive masculine contracts. Need for more feminine values.
- **Deep ecologists** – all creatures, great or small, are equal and have equal rights to the environment and resources; business cannot be trusted to protect the environment; as a minimum, economic activity must be sustainable

7.8.5 Sustainability Reporting

The following frameworks exist to report sustainability (or CSR) to stakeholders

7.8.5.1 3BL

As standard propounded by the Group Reporting Initiative (GRI). Includes guidance to report performance for a period under three headings

- Economic: Profit and the likes
- Social: Social impact, responsible employer contracts.
- Environmental: carbon footprint, material resource usage, energy consumption

7.8.5.2 GRI Standards

The GRI standards (Framework 3.1), specifically developed for CSR reporting by the GRI.

7.8.5.2.1 Principles

- Stakeholder inclusiveness
- Sustainability context
- Materiality
- Completeness

7.8.5.2.2 Qualitative Characteristics

- Balance
- Accuracy
- Timeliness
- Clarity
- Reliability

7.8.5.2.3 Disclosures

- Strategy and profile
- Management approach
- Performance indicators
    - Economic
    - Environmental
    - Social
        - Labour practices
        - Human rights
        - Society
    - Product responsibility

7.8.5.3 <IR>

A concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term

7.8.5.3.1 Goals

- To improve the quality of information available to providers of financial capital.
- To promote a more cohesive and efficient approach to corporate reporting that better reflects factors that materially affect the ability to create value over time.
- To enhance accountability and stewardship for all forms of capital.
- To promote the understanding of the interdependencies among the various capitals.
- To support integrated thinking in decision making and actions which create value over the short, medium and long term.

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7.8.5.3.2 Capitals

- IFRS has the concepts of capital and capital maintenance, which defines two forms of capital (Physical and Financial). Profit is recognised as increases in both forms of capital for a period.
- <IR> has 6 concepts of capital. The capitals include:
    - financial,
    - manufactured,
    - intellectual,
    - human,
    - social and relationship and
    - natural (natural resources).

7.8.5.3.3 Guiding principles

- Strategic focus and future orientation
- Connectivity of information
- Stakeholder relationship
- Materiality
- Conciseness
- Reliability and completeness
- Consistency and comparability

7.8.5.3.4 Content elements

- **Organisational overview and external environment**: What does it do and what are the circumstances under which it operates?
- **Governance**: How does the governance or leadership structure support its ability to create value over time?
- **Business model**: What is it?
- **Risks and opportunities**: What specific risks and opportunities affect the organisation's ability to create value over time, and how are they dealt with?
- **Strategy and resource allocation**: Where do we want to go, and how do we get there?
- **Performance**: To what extent have strategic objectives been met and what are its outcomes in terms of effects on the capitals?
- **Outlook**: What challenges and uncertainties are likely to be encountered and potential implications for business model and future performance?
- **Basis of preparation and presentation**: How are the issues to be include in the integrated report determined, and how are such issues quantified or evaluated?

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7.8.5.4 Sustainability/CSR Reporting: Banco Santander example

People

€12,047 million Personnel expenses[1]	**97%** Employees with permanent contracts	**10 years** Average length of employment

Customers

€848,914 million Loans outstanding (net)	**€473,075 million** to households; **€33,008 million** to public administrations; **€288,912 million** to companies; **€53,920 million** to others[2]	**>250,000** Microbusinesses supported in Brazil and other countries

Shareholders

€3,540 million[3] Total shareholder remuneration	**€88,410 million** Stock market value at year-end 2017, largest in the euro zone	**€0.22** Dividend per share, +7%[4]

Communities

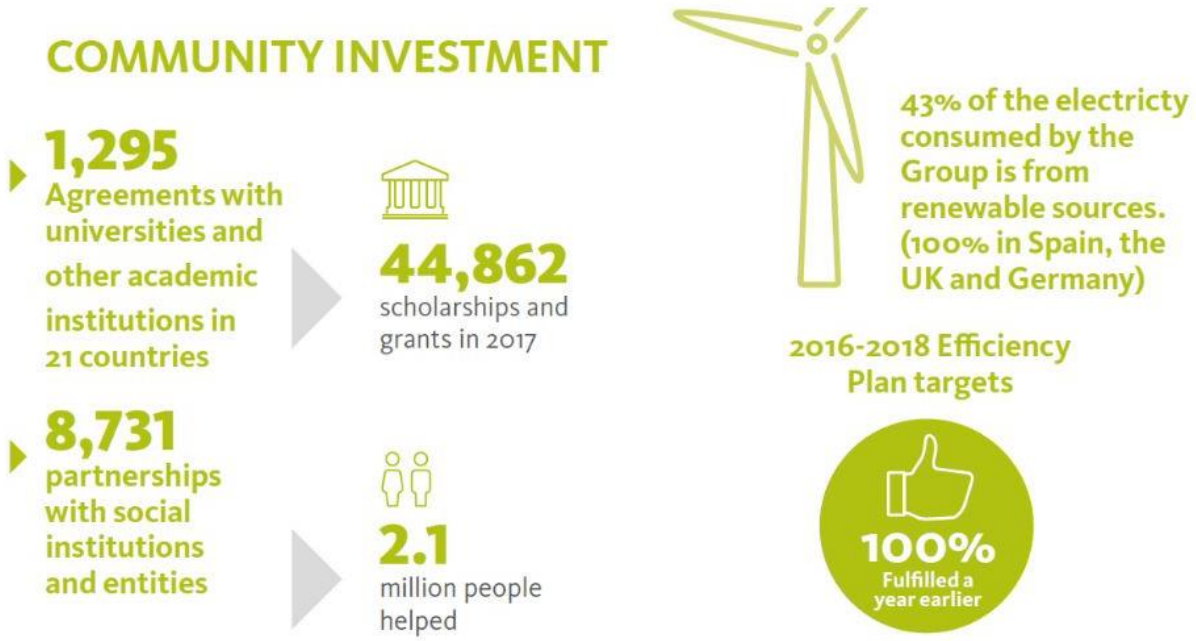
€183 million Community investment	**€129 million** Investment to universities	**€54 million** Investment to programmes and projects to support communities

Suppliers

€7,770 million Payments to suppliers	**9,104** Approved suppliers through its global procurement model	**95%** Local group's suppliers

Tax contribution

€7,972 million Taxes paid	**€ 4,137 million** Corporate income tax	**€3,835 million** Other own taxes paid, including social contributions



7.9 Professional Ethics

7.9.1 Professions and Professional Accountants

Professions are a type of occupation with a higher standard than most other occupations. 3 things distinguish professions.

- **Expertise** – including specialised knowledge and skill;
- **Responsibility** – to perform a service that is essential to society; and
- **Corporateness** – a collective sense of unity that originates from professional competence and the sharing of a social responsibility. This sets the professional member apart from laymen.

Accounting is such a profession with a duty to the public, in fact, accountant has one of the highest duties to the public interest, as the public completely relies on their work for information, which will be used to make important economic decisions.

2 **PUBLIC INTEREST**

- The collective well-being of the community of people and institutions the professional accountant serves.
- Examples of activities undertaken by accountancy bodies (e.g. IFAC) in the "public interest":
    - Auditing standards;
    - Financial reporting standards;
    - Codes of ethics and professional behaviour;
    - Audit regulations;
    - Educational standards; and
    - Oversight controls.

7.9.2 Professional codes of conduct

These are a type of ethical codes, which are: a set of standards, rules, guidelines and values that govern and guide ethical conduct in a company, profession, or organisation of its employees.

Corporate organisations can also have codes of conduct

7.9.2.1 Purposes

- Communication of organisation's ethical values in a succinct form.
- Identify key stakeholders and their rights and responsibilities.
- Convey values to stakeholders.
- Influence and control individuals' behaviour.
- Articulate the organisation's ethical reputation

7.9.2.2 ICAN Code

Based off the IFAC code of conduct, the ICAN code contains broad principles that regulate the conduct of members.

- **Integrity:** Implies a high moral standard in all dealings. The accountant with integrity will actively avoid conflicts of interest and other situations that would prejudice his ability to be independent
- **Objectivity:** Implies a duty to avoid bias and influence in forming opinions. An accountant must reach his conclusions without being influenced either by self-interest, cognitive bias or intimidation
- Professional Behaviour:
- **Professional Competence and Due care:** Implies a duty to perform all tasks to a high level of competence and to exercise due care in collecting and interpreting information and forming opinions. This principle requires the accountant to continually keep himself updated with the latest theories and practices in the profession.
- **Technical Standards:** Implies a duty
- Confidentiality:

7.9.3 Principle of Independence

To adequately discharge their duty to the public interest, the accountant must at all times maintain their independence.

7.9.4 Threats to Ethical Independence

They are,

- **Self Interest:** loans, relationships, $€£ interests, gifts, employment.
- **Self-Review:** previous work and judgement is re-evaluated by same individual.
- **Familiarity:** past colleagues, long association, close personal relations.
- **Intimidation:** dismissal, dominant personality, tight budgets.
- **Advocacy:** represents client as attorney, gives letter of credit.

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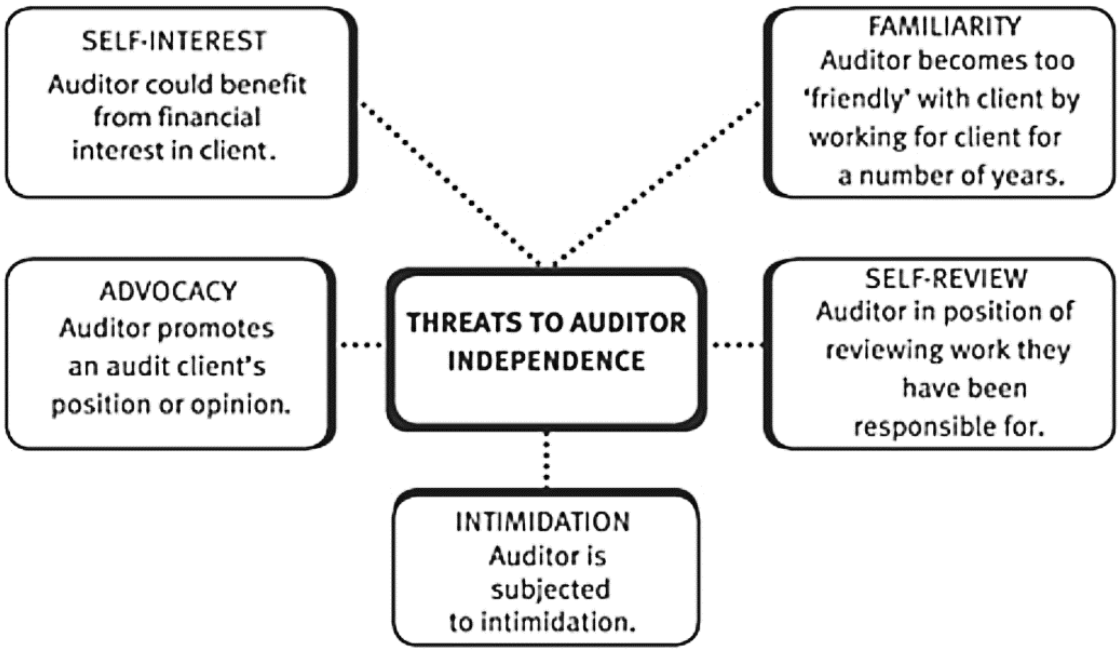

Response to Threats

7.9.5 Safeguards Against Threats

7.10 Ethical Decision Making

These models provide a framework to resolving ethical dilemmas. Note that the models may be dependent on the approach to ethics token (duty-based or consequentialist). Also, the models can't decide what is right or wrong. They merely provide a guide to considering the key points of ethical issues. The decision maker will still have to apply their norms and beliefs to the case.

7.10.1 AAA 7 Steps

The seven steps in the model are:

7.10.1.1 (1) Establishing the facts of the case.

This step means that when the decision-making process starts, there is no ambiguity about what is under consideration.

7.10.1.2 (2) Identify the ethical issues in the case.

This involves examining the facts of the case and asking what ethical issues are at stake.

7.10.1.3 (3) An identification of the norms, principles, and values related to the case.

This involves placing the decision in its social, ethical, and, in some cases, professional behaviour context. In this last context, professional codes of ethics or the social expectations of the profession are taken to be the norms, principles, and values.

For example, if stock market rules are involved in the decision, then these will be a relevant factor to consider in this step.

7.10.1.4 (4) Each alternative course of action is identified.

This involves stating each one, without consideration of the norms, principles, and values identified in Step 3, in order to ensure that each outcome is considered, however appropriate or inappropriate that outcome might be.

7.10.1.5 (5) Matching norms, principles, and values to options

The norms, principles, and values identified in Step 3 are overlaid on to the options identified in Step 4. When this is done, it should be possible to see which options accord with the norms and which do not.

7.10.1.6 (6) The consequences of the outcomes are considered.

Again, the purpose of the model is to make the implications of each outcome unambiguous so that the final decision is made in full knowledge and recognition of each one.

7.10.1.7 (7) The decision is taken.

7.10.2 Tucker's 5 Questions

- Profitable?
- Legal?
- Fair? Fair to the stakeholders involved.
- Right? Right according to the norms and belief held.
- Sustainable or environmentally sound? Can the decision be repeated or continued indefinitely.

7.11 Bribery & Corruption

Definitions of different forms of corruption

- "According to rule" – facilitation payments (bribes) paid to receive (preferential) treatment for something that the bribe receiver is required to do by law.
- "Against the rule" – the bribe is paid to obtain services the bribe receiver is prohibited from providing.
- General corruption – the dishonest or fraudulent conduct by those who hold power, typically involving bribery.
- Entity corruption – criminality and the abuse of power by the executive, managers, officials and employees of the entity, either internally or externally.
- Bureaucratic corruption – the abuse of power, office, or resources by government employees for personal gain (e.g. by extortion, soliciting or offering bribes).
- Political corruption – use of legislated powers by government officials for illegitimate private gain.
- Systemic corruption – complete subversion of a political or economic system.

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7.11.1 Impact of Bribery and Corruption

- Hinders the development of fair market structures.
- Distorts and reduces competition (i.e. lack of free and fair competition and equal opportunities).
- Reduces business opportunity for the majority of the population.
- Deters investment, especially foreign investment.
- Inflates prices of consumer goods.
- Decreases economic performance.
- Reduces government revenue.
- Results in inefficient business investment cycles.
- Reduces motivation in affected organisations.
- Diminishes economically productive activity.
- Poor quality (and often dangerous) products and services produced.
- Poor quality and reduced public services delivered (e.g. health, education, transport).
- Undermines trust in the political system, its institutions and leadership.
- Increases emigration of best-educated, most able and honest citisens (seeking better life and opportunities).
- Environmental degradation.
  Degradation of civil society to the extent that corruption, demanding and paying bribes becomes the norm – "the way business is done here".

7.11.2 Best practice against corruption

- A strong (and comprehensive) legal system plus sound and robust corporate governance.

Proportionality

- Top-down approach, risk assessment, due diligence.
- Communication, monitoring, review, evaluation.
- Gifts, hospitality, donations and facilitation payments.
- Employment procedures, contracts of employment, gross misconduct.
- Zero tolerance.
- Business risk controls.
- Transparency of all transactions and disclosure.
- Enforcement and whistle blowing (speak up).

Top-level commitment

- Effective communication of a zero-tolerance approach.
- Consequences of breaching the policy.
- Business and social benefits of rejecting bribery.
- Effective leadership and top-level endorsement of all anti-bribery procedures and actions.
- Independent oversight (e.g. by NEDs).

Risk assessment

- Exposure to external risks (e.g. country, sector, transactions, business opportunity, etc).
- Exposure to internal risks (e.g. lack of skills, culture, weak financial controls, etc).

Due diligence

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- "Know you client".

Communication

- "Tone at the top."

Monitoring and review

- "Speak up" feedback.

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PRACTICE QUESTIONS & ANSWERS

Strategy Development

Strategic Planning

X Company (X) operates a European chain of fast-food restaurants under the brand name "Take-ndEat". Designed to rival established, American-based, burger and pizza outlets, each branch provides the same standard menu with facilities for taking-out, and some tables and chairs for eating-in. A typical customer requires food quickly and to a reliable standard.

Many of the branches are franchises. That is, they are operated by individuals and companies who have paid a capital sum to buy the exclusive rights to operate in their area, and who pay a share of the turnover each year. These sums are paid in return for the management and staff training and marketing support provided by X. They are also contracted to buy all ingredients, packaging and "give-aways" (plastic toys and gadgets used as sales promotions) from X.

A condition of the franchise is that they participate in any national sales offers or price initiatives. Recently, the earnings of Take-and-Eat franchisees have fallen due to a combination of falling volumes, increased expenditures on "free-gifts", and price-cutting to match rivals. X is under pressure to improve the profits of franchises.

X's managing director has attended a conference at which one speaker extolled the virtues of long-term strategic planning to businesses, yet a second speaker said that such long-term strategic planning was obsolete. He is confused as to what to make of these comments.

Required:

Prepare a brief memo to X's managing director, discussing both the benefits of long-term strategic planning, and the case for its abolition. (15 marks)

ENVIRONMENTAL ANALYSIS

Question 2 P MCNAMEE

According to P McNamee: "Each organisation's unique environment is not static but is constantly changing due to the continuous variation in the intensity and mix of forces in it."

Required:

I. **List four factors which give rise to such turbulence. (4 marks)**

II. **Briefly explain four of the segments into which the business environment can be analysed. (6marks)**

III. **Discuss in what sense government, as a segment of the environment, may be regarded both as an aid and as an impediment to business.** (5 marks)

(15 marks)

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ENVIRONMENTAL ANALYSIS

Airtite

Airtite was set up in 20X0 as a low cost airline operating from a number of regional airports in Europe. Using these less popular airports was a much cheaper alternative to the major city airports and supported Airtite's low cost service, modelled on existing low cost competitors. These providers had effectively transformed air travel in Europe and, in so doing, contributed to an unparalleled expansion in airline travel by both business and leisure passengers. Airtite used one type of aircraft, tightly controlled staffing levels and costs, relied entirely on online bookings and achieved high levels of capacity utilisation and punctuality. Its route network had grown each year and included new routes to some of the 15 countries that had joined the EU in 20X4. Airtite's founder and Chief Executive, John Sykes, was an aggressive businessman ever willing to challenge governments and competitors wherever they impeded his airline and looking to generate positive publicity whenever possible.

John is now looking to develop a strategy which will secure Airtite's growth and development over the next 10 years. He can see a number of environmental trends emerging which could significantly affect the success or otherwise of any developed strategy. 20X6 had seen fuel costs continue to rise reflecting the continuing uncertainty over global fuel supplies. Fuel costs currently account for 25% of Airtite's operating costs. Conversely, the improving efficiency of aircraft engines and the next generation of larger aircraft are increasing the operating efficiency of newer aircraft and reducing harmful emissions.

Concern with fuel also extends to pollution effects on global warming and climate change. Coordinated global action on aircraft emissions cannot be ruled out, either in the form of higher taxes on pollution or limits on the growth in air travel. On the positive side European governments are anxious to continue to support increased competition in air travel and to encourage low cost operators competing against the over-staffed and loss-making national flag carriers.

The signals for future passenger demand are also confused. Much of the increased demand for low cost air travel to date has come from increased leisure travel by families and retired people. However families are predicted to become smaller and the population increasingly aged. In addition there are concerns over the ability of countries to support the increasing number of one-parent families with limited incomes and an ageing population dependent on state pensions. There is a distinct possibility of the retirement age being increased and governments demanding a higher level of personal contribution towards an individual's retirement pension. Such a change will have a significant impact on an individual's disposable income and with people working longer reduce the numbers able to enjoy leisure travel.

Finally, air travel will continue to reflect global economic activity and associated economic booms and slumps together with global political instability in the shape of wars, terrorism and natural disasters.

John is uncertain as to how to take account of these conflicting trends in the development of Airtite's 10-year strategy and has asked for your advice.

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Required:

Using models where appropriate, provide John with an environmental analysis of the conditions affecting the low cost air travel industry. (12 marks)

Susan Grant

Susan Grant is in something of a dilemma. She has been invited to join the board of the troubled Marlow Fashion Group as a non-executive director, but is uncertain as to the level and nature of her contribution to the strategic thinking of the Group.

The Marlow Fashion Group had been set up by a husband and wife team in 1976 in an economically depressed part of the UK. They produced a comprehensive range of women's clothing built round the theme of traditional English style and elegance. The Group had the necessary skills to design, manufacture and retail its product range. The Marlow brand was quickly established and the company built up a loyal network of suppliers, workers in the company factory and franchised retailers spread around the world. Marlow Fashion Group's products were able to command premium prices in the world of fashion. Rodney and Betty Marlow ensured that their commitment to traditional values created a strong family atmosphere in its network of partners and were reluctant to change this.

Unfortunately, changes in the market for women's wear presented a major threat to Marlow Fashion. Firstly, women had become a much more active part of the workforce and demanded smarter, more functional outfits to wear at work. Marlow Fashion's emphasis on soft, feminine styles became increasingly dated. Secondly, the tight control exercised by Betty and Rodney Marlow and their commitment to control of design, manufacturing and retailing left them vulnerable to competitors who focused on just one of these core activities. Thirdly, there was a reluctance by the Marlows and their management team to acknowledge that a significant fall in sales and profits were as a result of a fundamental shift in demand for women's clothing. Finally, the share price of the company fell dramatically. Betty and Rodney Marlow retained a significant minority ownership stake, but the company had had a new Chief Executive Officer every year for the last six years

Required:

a) **Write a short report to Susan Grant identifying and explaining the strategic strengths and weaknesses in the Marlow Fashion Group.** (12 marks)

b) Susan is aware of benchmarking as a useful input into performance measurement and strategic change.

Assess the contribution benchmarking could make to improving the position of the Marlow Fashion Group and any limitations to its usefulness. (8 marks)

(12 marks)

321READ

STRATEGIC CAPABILITY

Moor Farm

Moor Farm is a large estate in the rural district of Cornaille. The estate covers a large area of forest, upland and farmland. It also includes two villages, and although many of the properties in these villages have been sold off to private homeowners, the estate still owns properties which it rents out. The estate also has a large mansion house set inside a landscape garden designed in the 19th century by James Kent. The garden, although now overgrown and neglected, is the only surviving example of his work in the district. The estate was left as a gift to a charitable trust ten years ago. The trust is based at the estate. A condition of the gift to the trust was that the upland and forest should be freely accessible to visitors.

The estate has a manager, four full-time staff and 45 volunteers. These volunteers undertake most of the work on the estate, including the continuing excavation of Kent's original garden design. They are happy, well-motivated and fully support the current manager who is due to retire in the very near future. Three of the volunteers have become acknowledged experts on land management, through their work on the estate. Government grants for initiatives such as tree planting, protected pasture land and rural employment have been received by the estate in the past. However, a recent change in government means that this funding is unlikely to continue. This will also affect funding for the maintenance of the mansion. It was built almost 80 years ago when the climate of the area was much colder and drier. Recent warm wet winters have caused the fabric of the building to decay and increased the cost of maintaining it.

The estate has appointed a new manager who is due to take over the estate when the current manager retires. She is working alongside the current manager so that she understands her responsibilities and how the estate works. As a one-off project, she has commissioned a stakeholder survey which has requested information on the visitor experience to help with a planned re-design of the estate's website.

The website is generally thought to be well structured and presented, but it receives fewer visitors than might reasonably be expected. It provides mainly static information about the estate and forthcoming events but currently users cannot interact with the site in anyway.

Here are some extracts from the survey:

"I live in one of the villages and I am angry about visitors crowding around the village attractions – the tearooms, the craft shops, the souvenir stalls. We feel that we are prisoners in our own village and the traffic is terrible."

Homeowner, from a village on the estate

"We had a good day, but the weather was awful. If we had known it was going to rain all day, then we probably would have postponed the visit until a fine day. It spoilt a family day out."

Visitor with small family

321READ

CORPORATE LEVEL STRATEGY

McGeorge Holdings

McGeorge Holdings is a large, international consumer goods company specializing in household cleaning products and toiletries. It has many manufacturing and sales facilities throughout the world. Over several years it has offered an increasingly wide range of products appealing to differing market segments based on both socio-demographic and geographic criteria. However this product spread has not only resulted in increased sales volume but production, marketing and distribution costs have also increased disproportionately. McGeorge's costs are now about 20% higher than those of its nearest competitors. In such a competitive market it is difficult to pass on these extra costs to the customer.

In order to regain a competitive position Adrian Reed, the Managing Director of McGeorge Holdings, has been advised to reduce the range of products and the product lines. Advisors have suggested that a cut back in the product mix by about 20% could increase profits by at least 40%. Reed is keen to implement such a product divestment strategy but he fears that this cutting back could alienate customers. He needs to know which products need to be removed and which products are important to the survival of the company. He is unhappy about the overall performance of his company's activities.

Required:

Using appropriate analytical models discuss how Adrian Reed might select the products to be removed from the portfolio as part of his product divestment strategy. (10 marks)

RAMON SILVA

Ramon Silva is a Spanish property developer, who has made a considerable fortune from the increasing numbers of Europeans looking to buy new homes and apartments in the coastal regions of Mediterranean Spain. His frequent contact with property buyers has made him aware of their need for low cost hotel accommodation during the lengthy period between finding a property to buy and when they actually move into their new home. These would-be property owners are looking for inexpensive hotels in the same locations as tourists looking for cheap holiday accommodation.

Closer investigation of the market for inexpensive or budget hotel accommodation has convinced Ramon of the opportunity to offer something really different to his potential customers. He has the advantage of having no preconceived idea of what his chain of hotels might look like. The overall picture for the budget hotel industry is not encouraging with the industry suffering from low growth and consequent overcapacity. There are two distinct market segments in the budget hotel industry; firstly, no-star and one-star hotels, whose average price per room is between 30 and 45 euros. Customers are simply attracted by the low price. The second segment is the service provided by two-star hotels with an average price of 100 euros a night. These more expensive hotels attract customers by offering a better sleeping environment than the no-star and one-star hotels. Customers therefore have to choose between low prices and getting a poor night's sleep owing to noise and inferior beds or paying more for an untroubled night's sleep. Ramon quickly deduced that a hotel chain that can offer a better price/quality combination could be a winner.

The two-star hotels typically offer a full range of services including restaurants, bars and lounges, all of which are costly to operate. The low price budget hotels offer simple overnight accommodation with cheaply furnished rooms and staffed by part-time receptionists. Ramon is

convinced that considerable cost savings are available through better room design, construction and furniture and a more effective use of hotel staff. He feels that through offering hotel franchises under the "La Familia Amable" ("The Friendly Family") group name, he could recruit husband and wife teams to own and operate them. The couples, with suitable training, could offer most of the services provided in a two-star hotel, and create a friendly, family atmosphere – hence the company name. He is sure he can offer the customer two-star hotel value at budget prices. He is confident that the value-for-money option he offers would need little marketing promotion to launch it and achieve rapid growth.

Required:

(a) Provide Ramon with a brief report, using strategic models where appropriate, showing where his proposed hotel service can add value to the customer's experience. (12 marks)

(b) Discuss the advantages and disadvantages of using franchising to develop the La Familia Amable budget hotel chain. (8 marks)

(20 marks)

STRATEGY DEVELOPMENT

ANSOFF

(a) Draw Ansoff's "Product/market strategy matrix". Explain how this might be used in the formulation of corporate strategy. (5 marks)

(b) Describe the categories of diversification available to an organisation. (4 marks)

(c) Briefly describe the advantages and disadvantages of using the process of merger to effect diversification. (6 marks)

(15 marks)

ALBERT OWENS

Albert Owens was founded in 1863 as a manufacturer of confectionery. By 1978 the company commanded approximately 8% of the sugar confectionery market, in the United Kingdom, in particular "Owens Sherbets", which were marketed to the retail trade in large bottles and sold-on loose in paper bags often on a "pick and mix" basis and accounted for over half the company's sales. The remainder of the company's product range was composed of other boiled sweets sugar confectionery products such as "Blue Glacier Mints"; "Wiz Humbugs" and "Dandyfruities", marketed under one of the company's three house names "Johnsons", "Owens" and "Younger".

The company's sales force consisted of three selling units: one a small group of two senior sales managers who sold to large retail charge accounts, and the other two groups which consisted of about 50 salespersons each, and who sold the company's product according to the house-name attributed to each item either "Johnsons", "Younger", or "Owens". Because all products were sold through similar outlets, this arrangement often led to duplication of sales calls, but the chairman was of the view that it would not be effective for salespersons to sell products operating under three house names at once.

Over the years Albert Owens had achieved good profits and grown steadily by a process of vertical integration into wholesaling and by consolidating its product range. By the early 1990s the future presented

a number of threats such as the instability of sugar prices, an increasing concern about tooth decay caused by sweets, an increase in the popularity of savoury snacks and the possibility of incursions into sugar confectionery by manufacturers of chocolate products. Similarly, there was an increasing concentration of confectionery in supermarkets, at the expense of small shops which were Owens' traditional outlets.

Faced with such threats Owens' Board of Directors viewed the future stability of the company as requiring steady expansion. Of the options open to them, two were short-listed for further consideration:

(1) To adopt a programme of product development e.g., savoury snacks, chewing gums, and so on.

(2) To consolidate current positions in present markets and develop sales through supermarkets.

Required:

(a) Discuss the criteria (including financial) that would be appropriate for evaluating each option and comparing one against the other. (15 marks)

(b) Outline the competitive environment in which Albert Owens operates and to indicate which of the competitive forces in it are of greatest importance to the company. (5 marks)

(c) Suggest ways in which the number of options available to the company could be narrowed down to this short list of two during the preliminary analysis stage. (5 marks)

(25 marks)

COMPETITIVE ADVANTAGE STRATEGIES

RAMON SILVA

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Required:

(c) **Provide Ramon with a brief report, using strategic models where appropriate, showing where his proposed hotel service can add value to the customer's experience.** (12 marks)

(d) **Discuss the advantages and disadvantages of using franchising to develop the La Familia Amable budget hotel chain.** (8 marks)

(20 marks)

CORPORATE LEVEL STRATEGY

AMBION

Ambion is the third largest industrial country in the world. It is densely populated with a high standard of living. Joe Swift Transport (known as Swift) is the largest logistics company in Ambion, owning 1,500 trucks. It is a private limited company with all shares held by the Swift family. It has significant haulage and storage contracts with retail and supermarket chains in Ambion. The logistics market-place is mature and extremely competitive and Swift has become market leader through a combination of economies of scale, cost efficiencies, innovative IT solutions and clever branding. However, the profitability of the sector is under increased pressure from a recently elected government that is committed to heavily taxing fuel and reducing expenditure on roads in favour of alternative forms of transport. It has also announced a number of taxes on vehicles which have high carbon emission levels as well as reducing the maximum working hours and increasing the national minimum wage for employees. The company is perceived as a good performer in its sector. Last year's financial results reported a return on capital employed of 18%, a gross profit margin of 17% and a net profit margin of 9·15%. The accounts also showed a current liquidity ratio of 1·55 and an acid test ratio of 1·15. The gearing ratio is currently 60% with an interest cover ratio of 8.

10 years ago the northern political bloc split up and nine new independent states were formed. One of these states was Ecuria. The people of Ecuria (known as Ecurians) traditionally have a strong work ethic and a passion for precision and promptness. Since the formation of the state, their hard work has been rewarded by strong economic growth, a higher standard of living and an increased demand for goods which were once perceived as unobtainable luxuries. Since the formation of the state, the government of Ecuria has pursued a policy of privatisation. It has also invested heavily in infrastructure, particularly the road transport system, required to support the increased economic activity in the country.

The state haulage operator (EVM) was sold off to two Ecurian investors who raised the finance to buy it from a foreign bank. The capital markets in Ecuria are still immature and the government has not wished to interfere with or bolster them. EVM now has 700 modern trucks and holds all the major logistics contracts in the country. It is praised for its prompt delivery of goods. Problems in raising finance have made it difficult for significant competitors to emerge. Most are family

firms, each of which operates about 20 trucks making local deliveries within one of Ecuria's 20 regions.

These two investors now wish to realise their investment in EVM and have announced that it is for sale. In principle, Swift are keen to buy the company and are currently evaluating its possible acquisition. Swift's management perceive that their capabilities in logistics will greatly enhance the profitability of EVM. Last year's financial results for EVM are shown in Figure 1. Swift has acquired a number of smaller Ambion companies in the last decade, but has no experience of acquiring foreign companies, or indeed, working in Ecuria.

STRATEGY DEVELOPMENT

ENVIRONMENT MANAGEMENT SOCIETY

The Environment Management Society (EMS) was established in 2004 by environment practitioners who felt that environmental management and audit should have its own qualification. EMS has its own Board who report to a Council of eight members. Policy is made by the Board and ratified by Council. EMS is registered as a private limited entity.

EMS employs staff to administer its qualification and to provide services to its members. The qualification began as one certificate, developed by the original founding members of the Society. It has since been developed, by members and officers of the EMS, into a four certificate scheme leading to a Diploma. EMS employs a full-time chief examiner who is responsible for setting the certificate examinations which take place monthly in training centres throughout the country. No examinations are currently held in other countries.

If candidates pass all four papers they can undertake an oral Diploma examination. If they pass this oral they are eligible to become members. All examinations are open-book one hour examinations, preceded by 15 minutes reading time. At a recent meeting, EMS Council rejected the concept of computer-based assessment. They felt that competence in this area was best assessed by written examination answers.

Candidate numbers for the qualification have fallen dramatically in the last two years. The Board of EMS has concluded that this drop reflects the maturing marketplace in the country. Many people who were practitioners in environmental management and audit when the qualification was introduced have now gained their Diploma. The stream of new candidates and hence members is relatively small.

Consequently, the EMS Board has suggested that they should now look to attract international candidates and it has targeted countries where environmental management and audit is becoming more important. It is now formulating a strategy to launch the qualification in India, China and Russia.

However, any strategy has to recognise that both the EMS Board and the Council are very cautious and notably risk-averse. EMS is only confident about its technical capability within a restricted definition of environmental management and audit. Attempts to look at complementary qualification areas (such as soil and water conservation) have been swiftly rejected by Council as being non-core areas and therefore outside the scope of their expertise.

MMI

In 20X6 the board of MMI met to discuss the strategic direction of the company. Established in 1956, MMI specialised in mineral quarrying and opencast mining and in 20X6 it owned 15 quarries and mines throughout the country. However, three of these quarries were closed and two others were nearing exhaustion. Increased costs and falling reserves meant that there was little chance of

finding new sites in the country which were economically viable. Furthermore, there was significant security costs associated with keeping the closed quarries safe and secure.

Consequently the Chief Executive Officer (CEO) of MMI suggested that the company should pursue a corporate-level strategy of diversification, building up a portfolio of acquisitions that would "maintain returns to shareholders over the next fifty years". In October 20X6 MMI, using cash generated from their quarrying operations, acquired First Leisure, a company that owned five leisure parks throughout the country. These leisure parks provided a range of accommodation where guests could stay while they enjoyed sports and leisure activities. The parks were all in relatively isolated country areas and provided a safe, car-free environment for guests.

The acquisition was initially criticised by certain financial analysts who questioned what a quarrying company could possibly contribute to a profitable leisure group. For two years MMI left First Leisure managers alone, letting them get on with running the company. However, in 20X8 a First Leisure manager commented on the difficulty of developing new leisure parks due to increasingly restrictive government planning legislation. This gave the CEO of MMI an inspired idea and over the next three years the five quarries which were either closed or near exhaustion were transferred to First Leisure and developed as new leisure parks. Because these were developments of "brown field" sites they were exempted from the government's planning legislation. The development of these new parks has helped First Leisure to expand considerably (see table 1). The company is still run by the managers who were in place when MMI acquired the company in 20X6 and MMI plays very little role in the day-to-day running of the company.

In 20X8 MMI acquired two of its smaller mining and quarrying competitors, bringing a further five mines or quarries into the group. MMI introduced its own managers into these companies resulting in a spectacular rise in revenues and profits that caused the CEO of MMI to claim that corporate management capabilities were now an important asset of MMI.

In 20Y0 MMI acquired Boatland, a specialist boat maker constructing river and canal boats. The primary rationale behind the acquisition was the potential synergies with First Leisure. First Leisure had experienced difficulties in obtaining and maintaining boats for its leisure parks and it was expected that Boatland would take on construction and maintenance of these boats. Cost savings for First Leisure were also expected and it was felt that income from the First Leisure contract would also allow Boatland to expand its production of boats for other customers. MMI perceived that Boatland was underperforming and it replaced the current management team with its own managers. However, by 20Y2 Boatland was reporting poorer results (see table 1). The work force had been used to producing expensive, high quality boats to discerning customers who looked after their valued boats. In contrast, the boats required by First Leisure were for the casual use of holiday makers who often ill-treated them and certainly had no long-term investment in their ownership. Managers at First Leisure complained that the new boats were "too delicate" for their intended purpose and unreliability had led to high maintenance costs. This increase in maintenance also put Boatland under strain and its other customers complained about poor quality workmanship and delays in completing work. These delays were compounded by managers at

Boatland declaring First Leisure as a preferred customer, requiring that work for First Leisure should take precedence over that for established customers. Since the company was acquired almost half of the skilled boat builders employed by the company have left to take up jobs elsewhere in the industry.

Three months ago, InfoTech – an information technology solutions company approached MMI with a proposal for MMI to acquire them. The failure of certain contracts has led to falling revenues and profits and the company needs new investment. The Managing Director (MD) of InfoTech has proposed that MMI should acquire InfoTech for a nominal sum and then substantially invest in the company so that it can regain its previous profitability and revenue levels. However, after its experience with Boatland, the CEO of MMI is cautious about any further diversification of the group

Table1: Financial and market data for selected companies (all figures in $million)

	20Y2	*20Y0*	*20X8*	*20X6*
MMI Quarrying and Mining				
Revenue	1,680	1,675	1,250	1,275
Gross profit	305	295	205	220
Net profit	110	105	40	45
*Estimated market revenue	6,015	6,050	6,200	6,300
First Leisure				
Revenue	200	160	110	100
Gross profit	42	34	23	21
Net profit	21	17	10	9
*Estimated market revenue	950	850	770	750
Boatland				
Revenue	2.10	2.40	2.40	2.30
Gross profit	0.30	0.50	0.50	0.60
Net profit	0.09	0.25	0.30	0.30
*Estimated market revenue	201	201	199	198
InfoTech				
Revenue	21	24	26	25
Gross profit	0.9	3	4	4
Net profit	–0.2	2	3	3
*Estimated market revenue	560	540	475	450

*The estimated size of the market (estimated market revenue) is taken from Slott's Economic Yearbooks, 20X6–20Y2

Required:

(a) In the context of MMI's corporate-level strategy, explain the rationale for MMI acquiring First Leisure and Boatland and assess the subsequent performance of the two companies. (15 marks)

(b) Assess the extent to which the proposed acquisition of InfoTech represents an appropriate addition to the MMI portfolio. (10 marks)

(25 marks)

(25 arks)

MANAGING STRATEGIC CHANGE

CHANGE

Alan Ormerod, the senior partner at ASG, a medium-sized UK, based-accounting firm, was worried. The firm had developed an active policy towards the recruitment of graduates from various academic disciplines who were then sponsored to take professional accounting qualifications. The graduate trainees were given a week's induction course into the firm and then placed on a six month training programme organised by the personnel department.

The programme consisted of six weeks spent in each of the main areas of the firm's b
usiness – taxation, auditing, business services and financial planning, so that they could get an overview of the firm's activities and the services provided to clients. At the end of the six month training period they were assigned to one of the main areas of business as assistant accountants.

The programme had been in existence for many years and had the support of the senior partners in the firm and also the personnel department, whose budget reflected both the time taken by the graduates in training and the number of graduates on the programme. Unfortunately, there was no clear consensus amongst the partners about what, precisely, the graduate trainees should be able to do on completion of the programme. Successful completion of the programme was important to the graduates as it signalled the end of their probationary period and was linked to a significant rise in salary. The graduate trainees, however, were not happy. They felt that the lack of clarity over what precisely they should be able to do and the time taken to move them through areas of the firm which were of little interest to them was affecting their morale and commitment to the firm. Even more significant was the number who either failed to complete the training programme or who left to join one of ASG's rivals. Despite this problem, the partners insisted that to get a full appreciation of the firm the graduates needed the full six months training experience.

Alan was perplexed as to how he could reconcile the traditional view of training taken by the partners with the needs of the graduate trainees and their desire for a more focused and shorter period of training. The firm certainly needed committed, well-motivated graduate accountants to meet the increased expectations of clients and the competition from rival firms.

Required:

321 READ

Examine the change theories and models which could help Alan understand the conflict between the partners and the graduate trainees.

(10 marks)

BUSINESS AND PROCESS CHANGE

PROCESS STRATEGY AND REDESIGN

a) Discuss the process strategy matrix. (7 marks)
b) Describe how an organisation should go about planning a process redesign methodology. (8 marks)

(15 marks)

ORGANISING AND ENABLING SUCCESS

EGDON

Introduction

Frigate Co is based in the country of Egdon. It imports electrical components from other countries and distributes them throughout the domestic market. The company was formed twenty years ago by Ron Frew, who now owns 80% of the shares. A further 10% of the company is owned by his wife and 5% each by his two daughters.

Although he has never been in the navy, Ron is obsessed by ships, sailing and naval history. He is known to everyone as "The Commander" and this is how he expects his employees to address him. He increasingly spends time on his own boat, an expensive motor cruiser, which is moored in the local harbour twenty minutes' drive away. When he is not on holiday, Ron is always at work at 8.00 am in the morning to make sure that employees arrive on time and he is also there at 5.30 pm to ensure that they do not leave early. However, he spends large parts of the working day on his boat, although he can be contacted by mobile telephone. Employees who arrive late for work have to immediately explain the circumstances to Ron. If he feels that the explanation is unacceptable then he makes an appropriate deduction from their wages. Wages, like all costs in the company, are closely monitored by Ron.

Employees, customers and suppliers

Frigate currently has 25 employees primarily undertaking sales, warehousing, accounts and administration. Although employees are nominally allocated to one role, they are required to work anywhere in the company as required by Ron. They are also expected to help Ron in personal tasks, such as booking holidays for his family, filling in his personal tax returns and organising social events.

Egdon has laws concerning minimum wages and holidays. All employees at Frigate are only given the minimum holiday allocation. They have to use this allocation not only for holidays but also for events such as visiting the doctor, attending funerals and dealing with domestic problems and emergencies. Ron is particularly inflexible about holidays and work hours. He has even turned down requests for unpaid leave. In contrast, Ron is often away from work for long periods, sailing in various parts of the world.

Ron is increasingly critical of suppliers ("trying to sell me inferior quality goods for higher prices"), customers ("moaning about prices and paying later and later") and society in general ("a period working in the navy would do everyone good"). He has also been in dispute with the tax authority who he accused of squandering his "hard-earned" money. An investigation by the tax authority led to him being fined for not

disclosing the fact that significant family expenditure (such as a holiday for his daughters overseas) had been declared as company expenditure.

Company accountant

It was this action by the tax authority that prompted Ron to appoint Ann Li as company accountant. Ann had previously worked as an accountant in a number of public sector organisations, culminating in a role as a compliance officer in the tax authority itself. Ron felt that "recruiting someone like Ann should help keep the tax authorities happy. After all, she is one of them".

Ann was used to working in organisations which had formal organisational hierarchies, specialised roles and formal controls and systems. She tried to install such formal arrangements within Frigate. As she said to Ron "we cannot have everyone working as if they were just your personal assistants. We need structure, standardised processes and accountability". Ron resisted her plans, at first through delaying tactics and then through explicit opposition, tearing up her proposed organisational chart and budget in front of other employees. "I regret the day I ever made that appointment", he said. After six months he terminated her contract. Ann returned to the tax authority as a tax inspector.

Required:

The cultural web allows the business analyst to explore "the way things are done around here".

(a) Analyse Frigate Co using the cultural web or any other appropriate framework for understanding organisational culture. (15 marks)

(b) Using appropriate organisation configuration stereotypes identified by Henry Mintzberg, explain how an understanding of organisation configuration could have helped predict the failure of Ann Li's proposed formalisation of structure, controls and processes at Frigate Co. (10 marks)

(25 marks

RATIO ANALYSIS

HAIR CARE

Sam and Annabelle Burns own and manage the firm Hair Care, based in the United Kingdom. The firm was formed in 20X8 when Sam and his wife re-mortgaged their house and borrowed heavily from the bank to buy out the company from a conglomerate organisation who were disposing of non-core businesses. Sam had been a senior salesman with the hair-care subsidiary of the conglomerate. This subsidiary bought hair care products, mainly small value items and consumables – scissors, brushes, combs, hair nets, curlers and hair driers, from manufacturers and resold them to wholesalers and large retail chemist chains in the United Kingdom, mainly for use in hairdressing salons. The new business has continued in this direction. The manufacturers are almost entirely non-UK suppliers, many based in Hong Kong but with manufacturing facilities in China, Taiwan and Malaysia. However about 30% of the products are sourced in Europe – Italy and Germany predominantly. The company has met with success very quickly and the initial loans have already been repaid ahead of schedule.

The company now owns the freehold of a large warehouse/distribution centre which is five times the size of the original depot, leased when the company first started trading five years ago. Sales turnover, now in excess of $5 million, has increased by more than 50% each year and shows little signs of slowing down. Despite this apparent rapid growth Hair Care only accounts for about half of the current market, leaving some potential for growth. The company is run cost effectively, with minimum staffing. Sam, as Managing Director is solely concerned with the marketing side of the business. He spends most of his time in the selling role and in customer care which he rates as a major contributor to the company's success. The only other key manager is his wife who is responsible for managing the warehouse staff, arranging distribution, general administration and financial management. The company started with six employees, in addition to Sam and Annabelle, and now has 15. Staff rarely leave the company. The staff is almost entirely employed in the distribution and packaging function, although there are two other sales people apart from Sam, but they only deal with the smaller buyers. With the continued growth in turnover it is inevitable that the number of employees will have to increase. It is expected that there will have to be a total of about 30 staff, all non-managerial, in two years if sales continue to increase at the current rate.

The success of Hair Care can be accounted for by a number of factors. Sam is a very good salesman who is responsible for looking after all the major accounts. He is popular and much of the business is built on his personal relationship with the key clients. There is a considerable amount of customer loyalty which is mainly attributable to Sam, and both he and his wife are always accessible to customers and they go out of their way to provide a first class service. Even on vacation the two owners are in daily contact with the office. The company has been able to manage its purchases wisely. Most of the products, being purchased abroad, require payment in a foreign currency. Hair Care has been able to benefit from the relative weakness of the euro as against sterling for its European supplies. Although most of the products sourced in the Far East are priced in US dollars, the relative strength of that currency has enabled Hair Care to negotiate lower purchasing prices. However it is questionable as to how long this situation concerning foreign exchange can be held. The situation may change should the United Kingdom join the euro in the near future and much, of course, will depend on the level at which sterling enters the euro exchange.

Sam has also developed strong links with his suppliers and he has, until recently, attempted to trade with only a few so that his lines of communication and control are kept as simple as possible. Most of his current suppliers have been with him since the start of the company. This has provided the company with reliable and good quality products. In fact Hair Care often has exclusive access to certain products. For example it has the sole rights to distribute an Italian hair-dryer which is generally recognised to be the best on the market. This product strength has enabled the company to build on the customer loyalty. However, it is inevitable that as demand has increased, existing suppliers have not been able to keep up with the necessary volumes and Sam has had to look for, and buy from new manufacturers.

The company has benefited from a period of relatively steady growth in the economy and even in the current economic down-turn Sam has argued that demand for hair care products is usually

recession-proof. Furthermore Hair Care has currently no near competitors. Many of the small competitors in the wholesale market place have chosen to concentrate on other areas of the hair care business – salon furnishings and the supply of cheap, low-value items such as towels, razors, etc, leaving much of this basic business (sales of other relatively low-value and mainly disposable products) to Sam's company. Additionally quite a number of the small firms have even left the market. All this has helped to contribute to the overall growth rate of Hair Care. There are some major international companies who make shampoos, conditioners and other cosmetic type products who also buy-in consumer hairdressing products such as the ones sold by Hair Care. They then sell these mainly to the retail trade for domestic use by consumers and not directly to the hairdressing salons as does Hair Care. Furthermore these are large companies and Sam believes that they do not currently see his company as a major threat.

The company has registered a brand name for its main products which it re-packages, rather than using the individual brands of the original manufacturers. This has enabled Hair Care to generate even greater loyalty from its customers and often to obtain a price premium from these products.

Sam believes that part of the company's success stems from the fact that he has an organisation with minimal administrative overheads. He outsources all of his products, adding value mainly through branding and the maintenance of customer care. He believes that strategy is not mainly about beating the competition but in serving the real needs of the customer. The company has also been able to develop a strong relationship with the country's leading retail chemist chain, providing it with good quality, low-cost disposable products such as hair nets and brushes to be sold under an own -brand label. Although the margins are inevitably small, the volumes involved more than compensate for this.

The company has had to incur increased investment as a result of the large growth in turnover. The building of the warehouse, the increased stock-holding costs, capital expenditure on items such as computing systems, fork-lift trucks and automated stock control and retrieval systems could not be financed out of current earnings, but the company's bank was only too ready to lend the company the necessary money considering that the original loan had been repaid ahead of schedule.

All the success which Hair Care has achieved has not diminished Sam's appetite for growth. He now seems to be driven more by seeking power and influence than acquiring wealth. He questions the ability of the company to continue its current growth in the prevailing environment and therefore he is looking for ideas which may facilitate corporate expansion. He has asked his accountant to provide some options for him to consider.

Table 1: Details of Performance of Hair Care: 20X0–20X3

(unless otherwise stated, figures are in $000)

20X0	*20X1*	*20X2*	*20X3*
$000	$000	$000	*(forecast)*

				$000
Sales	2,300	3,500	5,010	7,500
Cost of Sales	1,450	2,380	3,507	5,250
Marketing Costs	200	250	290	350
Distribution Costs	300	400	430	500
Administration	50	55	80	120
Interest Payments	0	80	220	700
Operating Profit	300	335	483	580
Loans	0	850	2,400	5,000
Number of suppliers (actual)	15	20	30	50
Range of products (actual)	35	85	110	130
Total staff including Sam and Annabelle	12	14	15	23
Stocks	230	400	700	1,400
Fixed assets	500	1,500	2,700	6,300
Return on Sales (%)	13.0	9.6	9.6	7.7

Required:

a) Assuming the role of Sam's accountant, prepare a report for Sam, evaluating the current position of Hair Care and highlighting any financial and strategic issues concerning future developments which you feel should be brought to his attention. (20 marks)
b) As his accountant, prepare a short report for Sam, identifying and assessing the strategies which he could consider in attempting to further the company's development. (20 marks)
c) Sam currently appears to have a successful formula for growth.

Using the concept of the value chain, demonstrate how he has been able to achieve this success. (10 marks)

(50 marks)

MANAGEMENT CONTROL SYSTEMS

TREADWAY COMMISSION

The Committee of Sponsoring Organisations (COSO) of the Treadway Commission is an American voluntary, private sector organisation and is unconnected to government or any other

regulatory authority. It was established in 1985 to help companies identify the causes of fraudulent reporting and to create internal control environments able to support full and accurate reporting. It is named after its first chairman, James Treadway, and has issued several guidance reports over the years including important reports in 1987, 1992 and 2006.

In 2009, COSO issued new "Guidance on monitoring internal control systems" to help companies tighten internal controls and thereby enjoy greater internal productivity and produce higher quality reporting. The report, written principally by a leading global professional services firm but adopted by all of the COSO members, noted that "unmonitored controls tend to deteriorate over time" and encouraged organisations to adopt wide ranging internal controls. It went on to say that, the "assessment of internal controls [can] ... involve a significant amount of ... internal audit testing".

After its publication, the business journalist, Mark Rogalski, said that the latest report contained "yet more guidance from COSO on how to make your company less productive by burdening it even more with non-productive things to do" referring to the internal control guidance the 2009 report contains. He said that there was no industry sector-specific advice and that a "one-size-fits-all" approach to internal control was "ridiculous". He further argued that there was no link between internal controls and external reporting, and that internal controls are unnecessary for effective external reporting.

Another commentator, Claire Mahmood, wrote a reply to Rogalski's column pointing to the views expressed in the 2009 COSO report that, "over time effective monitoring can lead to organisational efficiencies and reduced costs associated with public reporting on internal control because problems are identified and addressed in a proactive, rather than reactive, manner". She said that these benefits were not industry sector specific and that Rogalski was incorrect in his dismissal of the report's value. She also said that although primarily concerned with governance in the USA, the best practice guidance from COSO could be applied by companies anywhere in the world. She said that although the USA, where COSO is based, is concerned with the "rigid rules" of compliance, the advice ought to be followed by companies in countries with principles-based approaches to corporate governance because it was best practice.

Required:

(a) **Distinguish between rules-based and principles-based approaches to internal control system compliance as described by Claire Mahmood and discuss the benefits to an organisation of a principles-based approach.** (7 marks)

(b) Mr Rogalski is sceptical over the value of internal control and believes that controls must be industry-specific to be effective.

Required:

Describe the advantages of internal control that apply regardless of industry sector and briefly explain the meaning of the statement "unmonitored controls tend to deteriorate over time". Your answer should refer to the case scenario as appropriate. (10 marks)

(c) The COSO report explains that "assessment of internal controls [can] ... involve a significant amount of ... internal audit testing".

Required:

Define "internal audit testing" and explain the roles of internal audit in helping ensure the effectiveness of internal control systems. (8 marks)

(25 marks)

REPORTING ON INTERNAL CONTROL

AGREX

You have been appointed Chairman of Agrex in order to assist the CEO and the board in their preparations to take Agrex to a listing. One of your first tasks will be to obtain a preliminary understanding of the company's internal control systems as the basis for drafting a report to shareholders on internal controls.

Required:

Prepare a checklist to assist you in understanding the effectiveness of the company's internal control systems. **(20 marks)**

RISK – ASSESSING, IDENTIFYING AND CONTROLLING

ULTRA-UBER

During the global economic recession that began in mid-2008, many companies found it difficult to gain enough credit in the form of short-term loans from their banks and other lenders. In some cases, this caused working capital problems as short-term cash flow deficits could not be funded.

Ultra-Uber (UU), a large manufacturer based in an economically depressed region, had traditionally operated a voluntary supplier payment policy in which it was announced that all trade payables would be paid at or before 20 days and there would be no late payment. This was operated despite the normal payment terms being 30 days. The company gave the reason for this as "a desire to publicly demonstrate our social responsibility and support our valued suppliers, most of whom, like UU, also provide employment in this region". In the 20 years the policy had been in place, the UU website proudly boasted that it had never been broken. Brian Mills, the chief executive often mentioned this as the basis of the company's social responsibility. "Rather than trying to delay our payments to suppliers", he often said, "we support them and their cash flow. It's the right thing to do". Most of the other directors, however, especially the finance director, think that the voluntary supplier payment policy is a mistake. Some say that it is a means of Brian Mills exercising his own ethical beliefs in a way that is not supported by others at UU.

When UU itself came under severe cash flow pressure in the summer of 2009 as a result of its bank's failure to extend credit, the finance director told Brian Mills that UU's liquidity problems would be greatly relieved if they took an average of 30 rather than the 20 days to pay suppliers.

In addition, the manufacturing director said that he could offer another reason why the short-term liquidity at UU was a problem. He said that the credit control department was poor, taking approximately 50 days to receive payment from each customer. He also said that his own inventory control could be improved and he said he would look into that. It was pointed out to the manufacturing director that cost of goods sold was 65% of turnover and this proportion was continuously rising, driving down gross and profit margins. Due to poor inventory controls, excessively high levels of inventory were held in store at all stages of production. The long-serving sales manager wanted to keep high levels of finished goods so that customers could buy from existing inventory and the manufacturing director wanted to keep high levels of raw materials and work-in-progress to give him minimum response times when a new order came in.

One of the non-executive directors (NEDs) of UU, Bob Ndumo, said that he could not work out why

UU was in such a situation as no other company in which he was a NED was having liquidity problems. Bob Ndumo held a number of other NED positions but these were mainly in service-based companies.

Required:

(a) Define "liquidity risk" and explain why it might be a significant risk to UU. (5 marks)

(b) Define "risk embeddedness" and explain the methods by which risk awareness and management can be embedded in organisations. (7 marks)

(c) Examine the obstacles to embedding liquidity risk management at UU. (8 marks)

(d) Criticise the voluntary supplier payment policy as a means of demonstrating UU's social responsibility. (5 marks)

(25 marks)

YGT

The board of YGT discussed its need for timely risk information. The consensus of the meeting was that risk consultants should be engaged to review the risks facing the company. One director, Raz Dutta, said that she felt that this would be a waste of money as the company needed to concentrate its resources on improving organisational efficiency rather than on gathering risk information. She said that many risks "didn't change much" and "hardly ever materialised" and so can mostly be ignored. The rest of the board, however, believed that a number of risks had recently emerged whilst others had become less important and so the board wanted a current assessment as it believed previous assessments might now be outdated.

The team of risk consultants completed the risk audit. They identified and assessed six potential risks (A, B, C, D, E and F) and the following information was discussed when the findings were presented to the YGT board:

Risk A was assessed as unlikely and low impact whilst Risk B was assessed as highly likely to occur and with a high impact. The activities giving rise to both A and B, however, are seen as marginal in that whilst the activities do have value and are capable of making good returns, neither is strategically vital.

Risk C was assessed as low probability but with a high potential impact and also arises from an activity that must not be discontinued although alternative arrangements for bearing the risks are possible. The activity giving rise to Risk C was recently introduced by YGT as a result of a new product launch.

Risk D was assessed as highly likely but with a low potential impact, and arose as a result of a recent change in legislation. It cannot be insured against nor can it be outsourced. It is strategically important that the company continues to engage in the activity that gives rise to Risk D although not necessarily at the same level as is currently the case.

In addition, Risks E and F were identified. Risk E was an environmental risk and Risk F was classed as a reputation risk. The risk consultants said that risks E and F could be related risks. In the formal feedback to the board of YGT, the consultants said that the company had to develop a culture of risk awareness and that this should permeate all levels of the company.

Required:

(a) **Criticise Raz Dutta's beliefs about the need for risk assessment. Explain why risks are dynamic and therefore need to be assessed regularly.** (8 marks)

(b) **Using the TARA framework, select and explain the appropriate strategy for managing each risk (A, B, C and D). Justify your selection in each case.** (6 marks)

(c) **Explain what "related risks" are and describe how Risks E and F might be positively correlated.** (5 marks)

(d) The risk consultants reported that YGT needed to cultivate a culture of risk awareness and that this should permeate all levels of the company.

Required:

Explain and assess this advice. (6 marks)

(25 marks)

SCOPE OF GOVERNANCE

PRIVATE, LISTED AND PUBLIC SECTOR GOVERNANCE

(a) Although the concept of corporate governance has been a feature of corporate entities ever since the first company was formed, it has only been in the last 20 to 30 years that the principles of corporate governance have been codified and recognised as being fundamental to the continued growth of the wealth generated by corporations for the benefit of corporate stakeholders.

Required:

Describe the main principles of corporate governance in the private sector. (8 marks)

(b) "The principles of corporate governance do not apply to the public sector because the objectives of state owned enterprises and public services are different from those of the private sector."

Required:

Construct an argument against this assertion. (12 marks)

(a) Agency and stakeholder relationships apply throughout the private and public sectors as well as throughout society as a whole.

Required:

Explain the principal differences between the private and public sector application of agency and stakeholder approaches. (5 marks)

(25 marks)

AGENCY RELATIONSHIPS AND THEORIES

STAKEHOLDERS, DIRECTORS AND FIDUCIARY DUTIES

Private sector companies have multiple stakeholders who are likely to have divergent interests. The directors of a company are also stakeholders of that company, but bound by their fiduciary duties.

Required:

(a) **Identify five stakeholder groups and briefly discuss their financial and other objectives.** (10 marks)

(b) **Explain the concept of fiduciary duty and describe the fiduciary responsibilities of directors.** (7 marks)

(c) **Examine the extent to which good corporate governance procedures can help manage the problems arising from the divergent interests of multiple stakeholder groups.** (8 marks)

(25 marks)

BOARD OF DIRECTORS

DING COMPANY

Sam Mesentery was appointed a director of Ding Company in October this year taking on the role of financial controller. He had moved himself and his family to a new country to take up the post and was looking forward to the new challenges. When he arrived he learned that he was on the "operating board" of Ding Company and that there was a "corporate board" above the operating board that was senior to it. This surprised him as in the companies he had worked for in his own country, all directors in the company were equal. The corporate board at Ding was small, with five directors in total, while the operating board was larger, with ten members.

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After a few days in the job he received an e-mail requiring him to report to Annette Hora, the managing director. She said that she had regretfully received two complaints from another senior colleague about Sam's behaviour. First, Sam had apparently made a highly inappropriate remark to a young female colleague and second, his office was laid out in the wrong way. Not only was his desk positioned in breach of fire regulations but also, he was told that it was normal to have the desk facing towards the door so that colleagues felt more welcomed when they went in. "It's company policy" she said abruptly. Sam remembered the conversation with the young female colleague but was unaware of anything inappropriate in what he had said to her. He said that he positioned his desk so he could get the best view out of the window when he was working.

The following day he arrived at work to find that the corporate board was in an emergency meeting. There had been a sudden and dramatic change in the circumstances of one of Ding's major suppliers and the corporate board later said that they needed to meet to agree a way forward and a strategy to cope with the change. Annette said that because of the competitive nature of its resource markets, Ding had to act fast and preferably before its competitors. Hence the necessity of a two-tier board structure. She said there was no time for lengthy discussions which was why the operating board was excluded. Sam was told that Ding operated in a "complex and turbulent" environment and when strategic factors in the environment changed, the company often had to respond quickly and decisively.

It was a month later that Sam first met with Arif Zaman, Ding's non-executive chairman. After Arif asked Sam how he was settling in, Sam asked Arif why he preferred a two-tier board structure and Arif replied that actually it was Annette's idea. He said that she prefers it that way and because he is a non-executive member doesn't feel able to challenge her opinion on it. Because "it seems to work" he had no plans to discuss it with her. He went on to say that he was an old friend of Annette's and was only in post to satisfy the corporate governance requirements to have a non-executive chairman. He said that he saw his role as mainly ceremonial and saw no need to take any direct interest in the company's activities. He said that he chaired some board meetings when he was available and he sometimes wrote the chairman's statement in the annual report.

Required:

(a) Explain the content of a director's induction programme and assess the advantages of such a programme for Sam. (8 marks)

(b) Using information from the case, critically evaluate Annette's belief that two-tier boards are preferable in complex and turbulent environments such as at Ding Company. (8 marks)

(c) Assess Arif Zaman's understanding of his role as non-executive chairman. (9 marks)

(25 marks)

BOARD COMMITTEES

SONIA TAN

Sonia Tan, a fund manager at institutional investor Sentosa House, was reviewing the annual report of one of the major companies in her portfolio. The company, Eastern Products, had recently undergone a number of board changes as a result of a lack of confidence in its management from its major institutional investors of which Sentosa House was one. The problems started two years

ago when a new chairman at Eastern Products (Thomas Hoo) started to pursue what the institutional investors regarded as very risky strategies whilst at the same time failing to comply with a stock market requirement on the number of non-executive directors on the board.

Sonia rang Eastern's investor relations department to ask why it still was not in compliance with the requirements relating to non-executive directors. She was told that because Eastern was listed in a principles-based jurisdiction, the requirement was not compulsory. It was simply that Eastern chose not to comply with that particular requirement. When Sonia asked how its board committees could be made up with an insufficient number of non-executive directors, the investor relations manager said he didn't know and that Sonia should contact the chairman directly. She was also told that there was no longer a risk committee because the chairman saw no need for one.

Sonia telephoned Thomas Hoo, the chairman of Eastern Products. She began by reminding him that Sentosa House was one of Eastern's main shareholders and currently owned 13% of the company. She went on to explain that she had concerns over the governance of Eastern Products and that she would like Thomas to explain his non-compliance with some of the stock market's requirements and also why he was pursuing strategies viewed by many investors as very risky. Thomas reminded Sonia that Eastern had outperformed its sector in terms of earnings per share in both years since he had become chairman and that rather than question him, she should trust him to run the company as he saw fit. He thanked Sentosa House for its support and hung up the phone.

Required:

(a) **Explain what an "agency cost" is and discuss the problems that might increase agency costs for Sentosa House in the case of Eastern Products.** (7 marks)

(b) **Describe, with reference to the case, the conditions under which it might be appropriate for an institutional investor to intervene in a company whose shares it holds.** (10 marks)

(c) **Evaluate the contribution that a risk committee made up of non-executive directors could make to Sonia's confidence in the management of Eastern Products.** (4 marks)

(d) **Assess the opinion given to Sonia that because Eastern Products was listed in a principles-based jurisdiction, compliance with the stock market's rules was "not compulsory".** (4 marks)

(25 marks)

APPROACHES TO CORPORATE GOVERNANCE

GEELAND

There has been a debate in the country of Geeland for some years about the most appropriate way to regulate corporate governance. Several years ago, there were a number of major corporate failures and "scandals" caused in part by a number of single powerful individuals dominating their

boards. Business leaders and policy-makers were sceptical about a rules-based approach, and this led the Geeland stock exchange to issue guidance in the "Geeland Code" as follows:

"Good corporate governance is not just a matter of prescribing particular corporate structures and complying with a number of rules. There is a need for broad principles. All stakeholders should then apply these flexibly to the varying circumstances of individual companies."

Given the causes of the Geeland corporate governance failures, there was a debate about whether the separation of the roles of chairman and chief executive should be made a legal requirement. This resulted in the stock exchange issuing guidance that whilst a rules-based or "box ticking" approach would specify that "the roles of chairman and chief executive officer should never be combined… We do not think that there are universally valid answers on such points."

One company to take advantage of the flexibility in Geeland's principles-based approach was Anson Company. In July 2015, Anson Company announced that it had combined its roles of chairman and chief executive in a single role carried out by one individual. In accordance with the Geeland listing rules, it made the following "comply or explain" statement in its 2016 annual report:

"Throughout the year the company complied with all Geeland Code provisions with the exception that from 1 July 2015 the roles of chairman and chief executive have been exercised by the same individual, William Klunker. We recognise that this has been out of line with best practice. We understand the concerns of shareholders but believe that we have maintained robust governance while at the same time benefiting from having Mr Klunker in control. On 31 July 2017 Mr Klunker will step down as executive chairman, remaining as chairman until we conclude our search for a non-executive chairman to succeed him, no later than March 2018."

Required:

(a) **Briefly distinguish between rules and principles-based approaches to corporate governance. Critically evaluate the Geeland stock exchange's guidance that "all stakeholders should then apply these flexibly to the varying circumstances of individual companies".** (12 marks)

(b) **Explain why a separation of the roles of chairman and chief executive is considered best practice in most jurisdictions.** (8 marks)

(c) **Assess the "comply or explain" statement made by Anson Company in its 2016 annual report.** (5 marks)

(25 marks)

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ETHICAL THEORIES

RAILWAY DEVELOPMENT COMPANY

Railway Development Company (RDC) was considering two options for a new railway line connecting two towns. Route A involved cutting a channel through an area designated as being of special scientific importance because it was one of a very few suitable feeding grounds for a colony of endangered birds. The birds were considered to be an important part of the local environment with some potential influences on local ecosystems.

The alternative was Route B which would involve the compulsory purchase and destruction of Eddie Krul's farm. Mr Krul was a vocal opponent of the Route B plan. He said that he had a right to stay on the land which had been owned by his family for four generations and which he had developed into a profitable farm. The farm employed a number of local people whose jobs would be lost if Route B went through the house and land. Mr Krul threatened legal action against RDC if Route B was chosen.

An independent legal authority has determined that the compulsory purchase price of Mr Krul's farm would be $1 million if Route B was chosen. RDC considered this a material cost, over and above other land costs, because the projected net present value (NPV) of cash flows over a ten-year period would be $5 million without buying the farm. This would reduce the NPV by $1 million if Route B was chosen.

The local government authority had given both routes provisional planning permission and offered no opinion of which it preferred. It supported infrastructure projects such as the new railway line, believing that either route would attract new income and prosperity to the region. It took the view that as an experienced railway builder, RDC would know best which to choose and how to evaluate the two options. Because it was very keen to attract the investment, it left the decision entirely to RDC. RDC selected Route A as the route to build the new line.

A local environmental pressure group, "Save the Birds", was outraged at the decision to choose Route

A. It criticised RDC and also the local authority for ignoring the sustainability implications of the decision. It accused the company of profiting at the expense of the environment and threatened to use "direct action" to disrupt the building of the line through the birds' feeding ground if Route A went ahead.

Required:

(a) **Use Tucker's "five question" model to assess the decision to choose Route A.** (10 marks)

(b) **Discuss the importance to RDC of recognising all of the stakeholders in a decision such as deciding between Route A and Route B.** (8 marks)

ETHICS AND SOCIAL RESPONSIBILITY

BIGGO

When Biggo Manufacturing (a public listed company) needed to build an extension to its factory, it obtained planning permission to build it on an adjacent field. The local government authority was keen to attract the new jobs that would go with the expansion and so granted the permission despite the objections of a number of residents, who were concerned that theh new factory extension would mean the loss of a children's play area.

When the board of Biggo met after the building approval had been given, the chief executive read out a letter from Albert Doo, leader of the local government authority, saying that although permission to build had been given, the company should consider making a sizeable contribution towards creating a new children's play area in a nearby location. Mr Doo said that Biggo "should recognise its social responsibility". He said that the company should consider itself a citizen of society and should, accordingly, "recognise its responsibilities as well as its legal rights".

One of Biggo's directors, Robert Tens, said he thought the request was entirely reasonable given the displacement of the play area. He also said that they could use the donation strategically to help cultivate the company's reputation locally to help in future recruitment. It might also, he said, help to reduce resistance to any future expansion the company might need to make.

Margaret Heggs, in contrast, argued that the company should not make the donation as it was likely that company profits would be low in the current year. She said that the acquisition of the land and the gaining of planning permission were done through the normal legal channels and so the company had no further contractual or ethical duties to the local government, nor to the local community. She said that Biggo provided local employment and produced excellent products and so it was unreasonable for the request for a donation to have been made. "This board is accountable to the shareholders of Biggo and not to the local community or the local government authority", she said.

Required:

(a) **Explain the meaning of "rights" and "responsibilities" in the context of Biggo and describe how these terms are interpreted at the two ends of the Gray, Owen & Adams "continuum".** (10 marks)

(b) **Justify, using evidence from the case, which of Gray, Owen & Adams's positions are best described by the comments made by Robert Tens and also Margaret Heggs.** (6 marks)

(c) **Define "social responsibility" as used by Albert Doo. Contrast how short and long-term shareholder interest perspectives may affect Biggo's attitude to the requested contribution for the children's play area.** (9 marks)

(25 marks)

ESKADA

Eskada, a bank listed on a recognised Stock Exchange, has enjoyed real annual growth in excess of 30% per annum over the last ten years under the direction of its autocratic chief executive, David Hake. This had been achieved by a strategy of takeover and aggressive selling of the bank's products and services. David is feared by his fellow board executives and senior managers. He has earned the nickname "Hacker" because of his reputation in disciplining executives and managers

who do not meet their targets and in cutting staff and costs in the bank and those banks Eskada acquired. A typical example of his attitude to those who did not agree with him was the dismissal of the bank's senior risk manager two years ago who had been warning the audit committee (all independent non-execs) that the bank was taking risks that the board did not fully understand that many of the products it was dealing with were building up systemic risk. The role of the risk manager was given to the bank's top sales manager, who was given a significant increase in remuneration, reporting directly to David.

Just before the bank's last acquisition one year ago, the BCM Banking Group, David confided (in a rare friendly chat) to the bank's Chairman that he wanted to be the "king" of the largest international banking group – he referred to it as his "empire". His rationale in making the acquisition was to prevent the bank in question from joining a rival banking group. With little regard to due diligence (David's attitude was that it was a waste of time and an outdated practice in the modern banking world) Eskada's board recommended the take over which was duly approved by the shareholders following a series of meetings between David and the major shareholders.

Nine months after BCM was taken over, it was becoming clear to David that the acquisition was a total disaster. Eskada's share price was showing signs that it was beginning to free fall and David decided that it was time to get out. In negotiations with the bank's remuneration committee (all independent non-exec directors) it was agreed that David would receive all his due bonuses (amounting to over $5 million), the bank would pay ten years of additional pension fund contribution (at least $20 million) and that he could start to immediately draw his pension ($1 million per year) as if he had retired at the normal retirement age of 60 (David was 51).

After David had left Eskada, the details of his resignation and severance deal became public knowledge. Because of the furore that followed, the Chairman and all of the non-executive directors were forced to resign without any compensation. The business press demanded to know why the bank had poor corporate governance and why a culture of poor moral and ethical behaviour had permeated throughout the bank.

Required:

(a) **Identify the corporate governance issues created at Eskada and explain how they could have been avoided.** (10 marks)

(b) **Explain the importance of personal morality and ethics, relating to the role of David within Eskada.** (8 marks)

(c) In the context of Integrated Reporting <IR>, "integrated thinking is the active consideration by an organisation of the relationships between its various operating and functional units and the capitals that the organisation uses or affects". The long-term vision of the International Integrated Reporting Council (IIRC) is that integrated thinking should be embedded within mainstream business practice, facilitated by <IR> as the corporate reporting norm.

Explain how integrated thinking could have helped to manage the issues at Eskada.

(7 marks)

(25 marks)

PROFESSIONS AND THE PUBLIC INTEREST

HAPPY AND HEALTHY

"Happy and healthy" is a traditional independent health food business that has been run as a family company for 40 years by Ken and Steffi Potter. As a couple they have always been passionate campaigners for healthy foods and are more concerned about the quality of the foods they sell than the financial detail of their business. Since the company started in 1976, it has been audited by Watson Shreeves, a local audit firm. Mr Shreeves has overseen the Potters' audit for all of the 40 year history (rotating the engagement partner) and has always taken the opportunity to meet with Ken and Steffi informally at the end of each audit to sign off the financial statements and to offer a briefing and some free financial advice in his role as what he calls, "auditor and friend". In these briefings, Mr Shreeves, who has become a close family friend of the Potters over the years, always points out that the business is profitable (which the Potters already knew without knowing the actual figures) and how they might increase their margins. But the Potters have never been too concerned about financial performance as long as they can provide a good service to their customers, make enough to keep the business going and provide continued employment for themselves and their son, Ivan. Whilst Ken and Steffi still retain a majority shareholding in "Happy and healthy" they have gradually increased Ivan's proportion over the years. They currently own 60% to Ivan's 40%. Ivan was appointed a director, alongside Ken and Steffi, in 2014.

Ivan grew up in the business and has helped his parents out since he was a young boy. As he grew up, Ken and Steffi gave him more and more responsibility in the hope that he would one day take the business over. By the end of 2015, Ken made sure that Ivan drew more salary than Ken and Steffi combined as they sought to ensure that Ivan was happy to continue in the business after they retired.

During the audit for the year ended 31 March 2016, a member of Watson Shreeves was performing the audit as usual when he noticed a dramatic drop in the profitability of the business as a whole. He noticed that whilst food sales continued to be profitable, a large amount of inventory had been sold below cost to Barong Company with no further explanation and it was this that had caused the reduction in the company's operating margin. Each transaction with Barong Company had, the invoices showed, been authorised by Ivan.

Mr Shreeves was certain Ken and Steffi would not know anything about this and he prepared to tell them about it as a part of his annual end of audit meeting. Before the meeting, however, he carried out some checks on Barong Company and found that it was a separate business owned by Ivan and his wife. Mr Shreeves's conclusion was that Ivan was effectively stealing from "Happy and healthy" to provide inventory for Barong Company at a highly discounted cost price. Although Mr Shreeves now had to recommend certain disclosures to the financial statements in this meeting, his main fear was that Ken and Steffi would be devastated if they found out that Ivan was stealing and that it would have long-term implications for their family relationships and the future of "Happy and healthy".

Required:

(a) **Explain how a family (or insider-dominated) business differs from a public listed company and, using evidence from the case, explore the governance issues of a family or insider-dominated business.** (10 marks)

(b) **Mr Shreeves is a professional accountant and auditor. Explain why he is considered a professional by society and describe the fundamental principles (or responsibilities) of professionalism that society expects from him and all other accountants.**(7 marks)

(c) **Discuss the professional and ethical dilemma facing Mr Shreeves in deciding whether or not to tell Ken and Steffi about Ivan's activity. Advise Mr Shreeves of the most appropriate course of action.** (8 marks)

(25 marks)

PROFESSIONAL PRACTICE AND CODES OF ETHICS

MRS YTTRIA & MR MORDUE

In a major policy speech, Government finance minister Mrs Wei Yttria said that the audit and assurance industry's work should always be judged by the effect it has on public confidence in business. She said that it was crucial that professional services such as audit and assurance should always be performed in the public interest and that there should be no material threats to the assurer's independence. Enron and other corporate failures happened, she said, because some accountants didn't understand what it was to act in the public interest. She stressed that it was important that firms should not provide more than one service to individual clients. If a firm audited a client then, she said, it shouldn't provide any other services to that client.

Mr Oggon Mordue, a financial journalist who had worked in audit and assurance for many years, was in the audience. He suggested that the normal advice on threats to independence was wrong. On the contrary in fact, the more services that a professional services firm can provide to a client the better, as it enables the firm to better understand the client and its commercial and accounting needs. Mrs Yttria disagreed, saying that his views were a good example of professional services firms not acting in the public interest.

Mr Mordue said that when he was a partner at a major professional services firm, he got to know his clients very well through the multiple links that his firm had with them. He said that he knew all about their finances from providing audit and assurance services, all about their tax affairs through tax consulting and was always in a good position to provide any other advice as he had acted as a consultant on other matters for many years including advising on mergers, acquisitions, compliance and legal issues. He became very good friends with the directors of client companies, he said. The clients, he explained, also found the relationship very helpful and the accounting firms did well financially out of it.

Another reporter in the audience argued with Mr Mordue. Ivor Nahum said that Mr Mordue represented the "very worst" of the accounting profession. He said that accounting was a "biased and value laden" profession that served minority interests, was complicit in environmental degradation and could not serve the public interest as long as it primarily served the interests of unfettered capitalism. He said that the public interest was badly served by accounting, as it did not address poverty, animal rights or other social injustices.

Required:

(a) **Explain, using accounting as an example, what "the public interest" means as used by Mrs Yttria in her speech.** (5 marks)

(b) This requirement concerns ethical threats. It is very important for professional accountants to be aware of ethical threats and to avoid these where possible.

Required:

(i) **With reference to the case as appropriate, describe five types of ethical threat.** (5marks)

(ii) **Assess the ethical threats implied by Mr Mordue's beliefs.** (8 marks)

(c) **Assess Ivor Nahum's remarks about the accounting profession in the light of Gray, Owen & Adams' deep green (or deep ecologist) position on social responsibility.** (7 marks)

(25 marks)

CONFLICTS OF INTEREST AND UNETHICAL BEHAVIOUR

JOJO AUDITORS

Jojo Auditors is an audit practice with five partners. The five partners have worked together for several years and, as well as being work colleagues, are personal friends with each other. At Jojo it is customary for the performance of all student accountants to be appraised after their first year of a training contract using a range of criteria including examination success, technical ability and professionalism. Three levels of outcome are possible:

(1) "Good", allowing students to continue with no issues;
(2) "Some concerns", meaning students are counselled and then allowed to continue; and
(3) "Poor", where students are dismissed from the audit practice.

The appraisal committee is comprised of three people: managing partner Jack Hu, the training manager (both of whom are professional accountants) and the person responsible for human resources. The committee receives confidential reports on each student and makes decisions based on the views of relevant engagement partners and also exam results. It is normally the training manager who makes the recommendation and in most cases his appraisal is agreed and then acted upon accordingly. Because the appraisals are confidential between the student and the firm, the list of students and their appraisal categories are not publicised within the firm.

When the 2015 intake was being appraised last year, one student was appraised by the training manager as "poor" but was not dismissed. Polly Shah was unpopular among other students because she was considered lazy and technically weak. She also failed a number of her exams. Other students who were appraised as "poor" were dismissed, but Polly received a brief counselling session from Jack Hu and then returned to her duties. Polly stayed for another year and then, having failed more exams, left Jojo to pursue other career interests outside accounting.

Polly's departure triggered some discussion amongst Jojo's partners as to why she had been retained when other poor performers had not. It later emerged that Jack Hu was a close friend of Polly's parents and had enjoyed free holidays in the Shah family's villa for several years. Because he was the managing partner, Mr Hu was able to insist on retaining Polly, despite the objections

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of the training manager and the human resources representative, although the training manager was reported to be furious at the decision to retain Polly.

Required:

(a) Define "conflict of interest" and assess the consequences of Jack Hu's behaviour after Polly Shah's appraisal. (10 marks)

(b) Describe four ethical safeguards that could be used in Jojo to prevent a recurrence of the events like those described in the case. (8 marks)

(c) The case raises issues of the importance of senior management performance measurement. In a public company, this refers to directors, and in a privately-owned partnership like Jojo, it refers to partners. The managing partner (Mr Hu's position) is equivalent to the role of chief executive.

Required:

Explain the typical criteria used in the performance measurement of individual

directors and discuss the reasons why individual performance measurement of partners may be difficult to implement at Jojo. (7 marks)

(25 marks)

STRATEGIC PLANNING

To: The Managing Director of X Company

ANSWERS

From:
Date:

This memo provides a brief summary of the benefits of strategic planning and reviews the criticisms against it.

Introduction

Long-term planning or strategic planning can be defined as "the formulation, evaluation and selection of strategies for the purpose of preparing a long-term plan of action to attain objectives".

This basic definition can be developed further and explained in two parts. It is:

(1) The formal process of developing objectives for the corporation and its component parts, evolving alternative strategies to achieve these objectives, and doing this against a background of a systematic appraisal of internal strengths and weaknesses and environmental changes; and

(2) The process of translating strategy into detailed operational plans and seeing that these plans are carried out.

Long-term planning benefits

Planning long-term strategy can be justified in the following ways:

- Certain action which is fundamental to the corporate operations is **irreversible** in the short term at least. It is difficult to imagine managers making decisions which have a degree of permanency, without first going through some form of formalised strategic planning. This is particularly so for companies involved in industries that require long-lead investments.
- The bigger an organisation grows, the bigger are the risks involved in top management decisions. Strategic planning helps to identify these risks and either prevent or mitigate their effects.
- The business environment is dynamic, and the rate of change is escalating. Integral to the strategic planning process is environmental appraisal, by the use of sophisticated forecasting techniques with expert interpretation, and the scientific evaluation of strategic options.
- Some companies have undoubtedly managed quite successfully without strategic planning. The fact is that it is probable that they could have performed much better. Even an upward sloping profit line can be criticised if it prevents the occurrence of an even steeper profit line. Strategic planning ensures that performance is targeted rather than merely assessed against loose expectations.
- Corporate planning is concerned with the long term, and the long term is an essential dimension in the overall survival pattern of a company. The planning disciplines concentrate management's attention on long-term matters, but not at the exclusion of short-term considerations.
- Strategic planning requires the clarification of corporate objectives. The process aids in the formulation of organisation goals and objectives, and the strategy formulation process can be used to evaluate whether or not the tentative objectives established are achievable.
- The systematic survey of the environment involved in strategic planning can help to improve the basis of information on which trends are identified, projections made and evaluative criteria produced.
- Strategic planning quantifies long-term resource problems and produces a basis on which resources can be planned and rationed between programmes.

Long-term planning criticisms

A criticism frequently levelled at the practice of spelling out corporate objectives is that the exercise descends into the formulation of empty platitudes which offer no positive directional indicators for decision making. Corporate strategy can be viewed from so many different angles and interests that it may be necessary to apply a whole range of evaluative standards, some of which may be in conflict, for instance a strengthening of liquid resources may be accompanied by a lower return on capital employed. An individual measure will have to be weighted according to its significance in the problem situation under review. It is not possible to carry out such evaluation with any sort of mathematical precision.

The main problems associated with trying to accurately forecast long term are as follows:

- the long-term period to be covered by the plan;
- the complexity of the environment;

- the rapidity and novelty of environmental change;
- the interrelationships between environmental variables;
- the limitations in data available; and
- the amount and complexity of the calculations involved.

The pressures on management are for short-term results and ostensibly strategy is concerned with the long term (i.e. "What should we be doing now to help us reach the position we want to be in, in five years' time?"). Often it is difficult to motivate managers by setting long-term expectations. Operational managers are frequently reluctant to specify their planning assumptions because the situations which their plans are designed to meet may change so rapidly that they can be made to look foolish. Executives are often held prisoner by the rigidity of the planning process, because plans have to be set out in detail long before the period to which they apply. The rigidity of the long-term plan, particularly in regard to the rationing and scheduling of resources, may also place the company in a position where it is unable to react to short-term unforeseen opportunities, or serious short-term crisis.

If the adherence to the strategy becomes all-important, it discounts flair and creativity. As an operational manager can generate enthusiasm or damp down potential trouble spots, quick action may be needed by him to avert trouble or improve a situation by actions outside the strategy. If he then has to defend himself against criticisms of acting "*outside the plan*", irrespective of the resultant benefits, he is likely to become apathetic and indifferent.

The strategic planning process is costly, involving the use of specialists, sometimes a specialist department, and taking up management time. The process generates its own bureaucracy and associated paper or electronic data flow. Personal authorities are, to a greater or lesser extent, replaced by written guidelines.

The process might be inhibitive in that it programmes activities and events and removes the excitement and exhilaration of spontaneity and the unexpected. A general attitude particularly shown by the managers in small growing companies is that they have managed successfully in the past without formalised strategic planning systems. So why start now?

P MCNAMEE

(a) Business environment

(i) Factors which give rise to turbulence

Turbulence is any force which can cause disruption in the environment of an organisation. The following factors in so far as they constitute disruptive forces will precipitate "turbulence":

- Increases in the size and scale of the environment.
- Increases in the complexity of the environment.
- Increases in affordability of technological advances speeding the rate of change to which the environment is subject.
- A merger between two primary competitors increasing the level of competition.
- Decreases in the life-cycles of an organisation's products.
- Significant major events like the exit of Britain from the European Exchange Rate Mechanism (ERM) or the re-unification of Germany.

(ii) Segments

The environment could be analysed into the following groupings by those involved in the strategic planning process:

- Competitors: Competitors remain a constant threat to the continued success of a firm since their actions can precipitate rapid change in the environment.
- Suppliers: Firms should be cognisant of the need to ensure that their major suppliers are not suffering under any of the influences described above to such an extent that shortages of supply become a threat to the firm itself.
- Legal and political: Legal and government influences upon the environment can place considerable constraints upon a firm which can result in a revised strategic plan.
- Technology: Technology can dramatically alter the strategic position of a firm when newer products or methods of manufacture are developed. Firms must be aware of developments in the technological areas which affect them otherwise they will find themselves trailing the competition which will impact adversely on the firm's profitability.
- Social and cultural: Social influences can cause disruption in the operating environment of the firm. The pressure groups which seek a "green environment" could target firms which create a potential hazard in their view. Changes in methods of production might well result.
- Economic: Economic influences can cause a major alteration in the strategic position of the firm. The rate of inflation, the level of unemployment and the availability or non-availability of government subsidies could well cause a significant shift in the strategic position of a firm.
- Demographic: Demographic changes in age structure and distribution of population can greatly affect the demand for some products.

(b) The effect of government

The government can aid business by providing a stable environment in which firms can operate. In particular governments can stimulate business in the following ways.

- By providing subsidies to firms in the form of cash grants as an incentive for investment and job creation. Regional selective assistance is an example of such an incentive.
- By providing grants for training or re-training purposes or to encourage business "start-up" situations.
- By providing barriers against the threat of competition from abroad via import quotas and other duties.
- In preventing the concentration market share among one or two producers. UK legislation contained in the *Monopolies and Mergers Act* is aimed at the regulation of the growth of monopolies in an industry.
- In the provision of business to many firms in different industries by virtue of its status as a major buyer. The government's decisions regarding sourcing of its required goods and services will have a significant influence upon the strength of the preferred suppliers *vis a vis* its competitors.
- By influencing those costs to which the profitability of industry is extremely sensitive (e.g. labour and raw materials).

The government may be regarded as an impediment to business in such situations where its pronouncements serve to constrain the operational activities of a firm or cause firms to incur "costs of compliance" which impact adversely upon profitability. Health and Safety legislation more often than not entails "costs of compliance" having to be borne by firms. Similarly, environmental legislation also "hurts" firms.

By the same token legislation which is aimed at protection of the consumer who buys the saleable output of firms can also impede the activities of the business.

AIRTITE

(a) Environmental analysis models

Clearly, both the macro-environment and the industry environment facing Airtite are becoming more challenging and scanning the environment and understanding the relative significance of the challenges is a key step in developing a future strategy to deal with it. Many models and tools and techniques are available to assess the size of the competitive threats facing Airtite. One of the earlier scanning models looks to measure whether the environment an organisation faces is becoming more complex and more dynamic. Evidence from the scenario suggests both are occurring and this means it is becoming increasingly difficult to predict the future nature of competition from what has happened in the past. Airtite's future is linked to an increasingly global environment and many conflicting and contradictory factors require the company to develop a process through which these factors are considered on a regular and systematic basis.

Johnson and Scholes suggest there are five steps in terms of environmental analysis:

(1) Audit of environmental influences;
(2) Assessment of the nature of the environment;
(3) Identification of the key environmental forces;
(4) Identification of competitive position;
(5) Identification of the principal opportunities and threats.

Systematic consideration of each of these steps leads to an understanding of the strategic position of the firm.

A PESTEL analysis is part of the process of environmental appraisal and it is important for John to recognise those parts of its environment it can influence. All too often firms can regard themselves as "victims" of the chosen environment, failing to recognise that through their strategic decisions they can profoundly change the competitive environment for their current or potential competitors. A good PESTEL analysis inevitably links into an informed SWOT analysis. In both instances it is necessary to isolate the key forces causing environmental change – simply creating a long list of factors may simply convince you of your inability to change the situation.

Once having decided which are the critical factors, it is then necessary to decide on the likelihood of a particular environmental change occurring and the significance of its impact on the firm. Matching the competitive capability of the firm against the attractiveness of the business sector Airtite is operating in will provide an understanding of the firm's competitive position and the options open to it. Many other models and tools and techniques are available, including Porter's five forces, product life cycle analysis and scenario building to generate alternative strategic responses.

Carrying out a systematic PESTEL analysis is a key step in developing alternative scenarios about the future. Johnson and Scholes define scenarios as "detailed and plausible views of how the business environment of an organisation might develop in the future based on groupings of key environmental influences and drivers of change about which there is a high level of uncertainty". In developing scenarios it is necessary to isolate the key drivers of change, which have the potential to have a significant impact on the company and are associated with high levels of uncertainty. Development of scenarios enables managers to share assumptions about the future

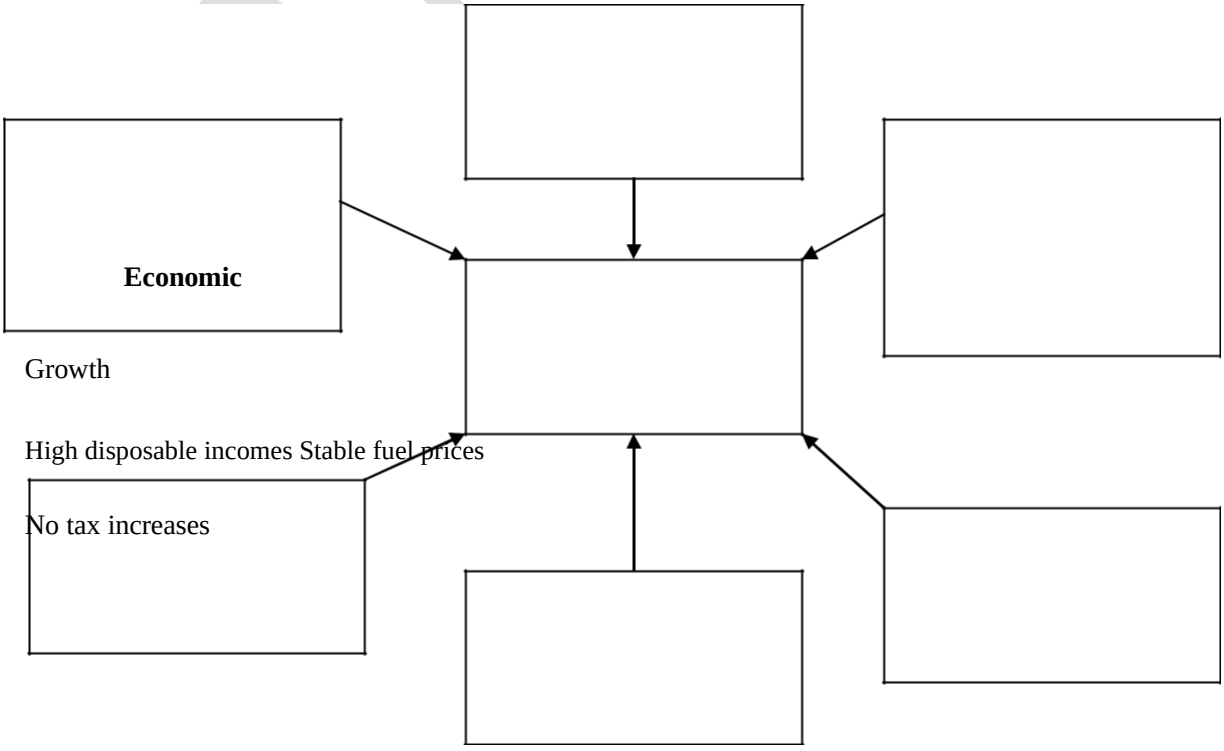
and the key variables shaping that future. This provides an opportunity for real organisational learning. They are then in a position to monitor these key variables and amend strategies accordingly. It is important to note that different stakeholder groups will have different expectations about the future and each may provide a key input to the process of developing scenarios. By their very nature scenarios should not attempt to allocate probabilities to the key factors and in so doing creating "spurious accuracy" about those factors.

(b) PESTEL analysis

A positive scenario is shown below and should provide a shared insight into the external factors most likely to have a significant impact on Airtite's future strategy. For most companies operating in global environments the ability to respond flexibly and quickly to macro-environmental change would seem to be a key capability.

The scenario as illustrated below, clearly could have a major impact on the success or otherwise of Airtite's strategy for the future. The key drivers for change would seem to be the link between technology and global emissions, fuel prices and the stability of the global political environment. Through creating a process which considers the drivers which will have most impact on Airtite and which are subject to the greatest uncertainty, Airtite will have a greater chance of its strategy adapting to changing circumstances.

Example of scenarios using the PESTEL framework – positive scenario



Technological

Engines more efficient Larger aircraft

Less pollution

321 READ

Political

Global stability

Free trade

No wars

AIRTITE

Environmental

No global emission policy

No global warming threat

321 READ

Social

More travel

Pensioners living longer

– traveling more More working abroad More second homes

Legal

Free trade

No emission controls No war

SUSAN GRANT

(a) SWOT analysis

To: Susan Grant

From:

Strategic strengths and weaknesses in Marlow Fashion Group

In carrying out a strategic strengths and weaknesses analysis one becomes aware that what were formerly strengths often become weaknesses as the competitive environment changes over time. Strengths and weaknesses analysis is focused on the internal sZide of the business and is usually linked to an external appraisal of the external opportunities and threats facing the company. Marlow Fashion Group is clearly at a crisis point in its company life and needs a strategic turnaround in order to survive. The business model that has served them so well is no longer appropriate to the fashion world in which they are now competing. Rodney and Betty Marlow have built a highly vertically integrated model, which gave them considerable control over the growth and development of the company. In terms of the value chain the relationship they built up with suppliers was mutually supportive and clearly facilitated the global expansion of the

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group. Control was even tighter over the design, manufacturing and retailing of the company's products. Marlow Fashions had successfully developed a niche market for its products based around traditional English values. This enabled it to expand successfully and develop a worldwide reputation for design excellence and quality.

Unfortunately, its competitive environment has changed considerably, becoming increasingly competitive and hostile. The economics of clothing manufacturing has changed, with most clothing retailers choosing to outsource the manufacture of their clothes. Women's tastes in clothing have also changed and there is no longer the market for the clothes Marlow Fashion sells. The tight control exercised by the founders has prevented recognition of these changes. Marlow Fashion has continued to pursue outdated designs and expensive manufacturing processes that had served it well in the past.

There has been some recognition of the strategic nature of the problems as indicated by the succession of CEOs over the last six years given the task of preventing the fall in sales and cutting costs. Unfortunately, the changes in its environment have led to some uncertainty as to whether Marlow Fashion is a brand, a manufacturer, a retailer or an integrated fashion company.

Overall, Marlow Fashion, from being in a strategically sound position, now requires a swift strategic turnaround. Its products and markets have changed; the relationships it has with key stakeholders are no longer strengths and its value chain and system no longer deliver distinctive value to its customers.

Yours,

(b) Benchmarking approaches

Benchmarking at Marlow Fashion will not be an easy exercise. Marlow Fashion has developed a distinctive way of reaching its markets that means direct comparisons will be hard to make. Certainly, it can carry out historical benchmarking in comparing how its own processes and activities have improved, or otherwise, over a relevant period of time. Unfortunately, this is likely to simply confirm worsening performance. It can compare its own key operations against the "best in class"; regardless of which industry the excellent performer comes from. It could and should have been carrying out competitive benchmarking on the retail side of the business where information should be more easily available. There may be an opportunity to benchmark itself against firms that have gone through a similar crisis and achieved a successful turnaround.

In terms of the advantages and disadvantages, the willingness of managers responsible for a key area of performance to compare themselves against relevant external performance measures should make them take responsibility for any changes necessary. In Marlow Fashion, the acceptance that things have to be done differently will be the first stage in the turnaround. Getting managers face-to-face with the problems, accepting responsibility for change and recognising that the necessary changes are "doable" is an important stage in creating a willingness to change. The disadvantages are that every organisation and situation is different and there is no one best way. Marlow Fashion thought it had discovered the best way and this created an unwillingness to change. There is also the danger that you are solving today's problems with yesterday's solutions. A good competitor will be trying to maintain its competitive advantage through constantly improving its processes. It also has a vested interest in trying to prevent its improvements from being revealed to its competitors. Also, many of the "softer" processes – typically involving people – are difficult if not impossible to replicate in another organisation. These advantages are to do with culture and leadership and not easily transferable to another organisation and the context in which it is operating.

MOOR FARM

(a) Evaluation of the strategic position of the estate

Many issues will need to be considered in the formulation of a strategy for the estate. However, in the context of the scenario, special attention will have to be paid to the expectations of stakeholders, to external environmental factors beyond the control of the estate and to the strategic capabilities of the estate itself. These are now considered in turn.

Expectations of stakeholders

Any proposed strategy will have to take into account the expectations of many stakeholders, some of which have conflicting objectives. From an internal perspective, the strategy has to take into account the objectives of volunteers who make up 90% of the workforce. Any strategy that alienates volunteers may leave the charity unable to maintain the estate or meet its basic operational obligations. Volunteers have different objectives to a paid workforce and these needs have to be understood. Replacing volunteers is not as straightforward as replacing a paid workforce, where scarce labour can be attracted through improved pay and conditions.

Most organisations have relatively straightforward relationships with their customers. Providing a service or product to one customer rarely conflicts with offering a service or product to another. Where it does conflict, for example in providing audit and consultancy services, a supplier can usually elect not to supply the customer, who then looks elsewhere for a similar service. In the case of Moor Farm, potential customers do conflict. There are documented examples of cyclists clashing with walkers and dog walkers with farmers. Access to the land is free (a stipulation of the charitable bequest) and so it is difficult to exclude potential customers. Consequently, a strategy has to be developed that is sensitive to the conflicting needs of customers, within the constraints of the charitable bequest.

Finally, the Moor Farm estate also surrounds two villages where private homeowners are angry about the increasing number of visitors to certain parts of the estate. Attractions have been created, causing traffic problems. As well as having a moral responsibility to these homeowners, the estate also depends, to some extent, on rental income from some of the houses in these villages. Again, residents need to be considered in the definition of the estate's strategy.

External environmental issues

The estate needs to continually scan the external environment to identify issues that might affect its situation. Strategy may have to be developed to either exploit or reflect these external changes, most of which are outside the control of the estate. At best, it can only lobby those responsible for creating these influences.

In the scenario, mention is made of a changed political landscape where government funding is to be reduced on initiatives such as tree planting, protected pasture land and rural employment. This will affect the income of the estate. Changes in weather patterns are also causing problems for the mansion that is situated in the estate. Built originally to resist cold dry weather typical of the time, it has proved susceptible to the warmer, wetter winters now experienced in this part of the country. This is causing long-term maintenance issues as the fabric of the mansion deteriorates.

Finally, the population of the country is increasingly vocal about the "rights" of individuals. The survey suggests that individuals believe that they have a "right to roam" on private land, even when this violates the "rights" of others (e.g. farmers and other land users). The estate has to take into account this social trend and potential stakeholder conflicts in its planned strategy.

Strategic capability

Finally, the strategy has to take into account the internal resources and competencies of the estate. The estate has significant tangible resources (e.g. land and property). It also has a unique resource, the only landscape garden developed by James Kent in the district. This is a unique resource which the strategy should aim to exploit. There are also other internal capabilities that should be recognised. A happy, motivated volunteer workforce must be properly utilised by any strategic change, not alienated. Amongst these are volunteers with exceptional skills in land management which could be used to exploit other opportunities on similar estates in the country. Leadership style also needs to be considered. The previous manager was well-liked and successful. Any sudden change in style may cause disruption and a fall in morale. The new leader has to be sensitive to her predecessor's leadership style, whilst building on the success of the previous leader by improving the visitor experience.

The estate has valuable and, in some cases, unique resources, which it needs to exploit with a varied set of stakeholders who sometimes come into conflict with each other. A stakeholder analysis, leading to appropriate stakeholder management policies, seems key here, and may provide some insights into how the website might be improved (see part (b)). One of these stakeholders, the government, needs to be particularly monitored, as their policies threaten the funding of the trust.

(b) **Development of the website**

There is little point in having a well-designed website if it is difficult to find. The role of search engines is significant here. Moor Farm needs to be near the top of the search engine listings for search terms that are directly relevant. The estate needs to discuss what these terms might be. "Moor Farm" is an obvious one, but searches such as "walking in rural Cornaille" may bring in visitors who are not aware of the estate's existence. There is conflicting advice on how to structure a website to achieve a high position in a search engine listing. One fool-proof way is to buy sponsored links which are shown as such at the top of the displayed page. Some commercial organisations are dubious about the value of such links, but they seem completely appropriate in the context of a charitable estate.

Although the website is well regarded and well presented, it does not appear to have weather feeds that would avoid people coming on days when the weather was so poor that it might be dangerous, or, as in the quote, when it might spoil a family's enjoyment. The website may have a weather forecast, a feed on current conditions, and perhaps webcams showing the actual weather at a number of agreed locations. Of course, these feeds and webcams will also show good weather conditions as well, perhaps enticing people to the estate who were prevaricating about their visit.

The website currently shows information about events, but it does not allow customers to book these events. The interactivity of the site has to be improved, allowing customers to book and pay in advance, so that they can be sure that they will be able to attend the event and avoid the disappointment of the family who travelled 100 km only to find the event fully booked. Such a facility also has advantages for the estate. For example, it has some feel about the popularity of the event before it is run, so that the scale of the event can be altered to reflect the likely demand. Furthermore, payment is received in advance, thus improving cash flow.

Feedback from satisfied customers can be an important factor in attracting new customers. At present the site does not appear to allow visitors to post comments, photographs and recommendations. This means that an effective marketing tool, unsolicited recommendations, do not appear on the site. Comment has also been made about the enthusiasm and knowledge of the volunteers. This could be harnessed on the site by asking volunteers to write blogs, explaining what they are doing and what is going on. This could be linked through to Twitter and other social networking sites.

Finally, there is obviously a group of regular visitors to Moor Farm who wish to become more involved. As the quotation suggests "we really want to know what is going on!". The website can be used to develop a community that supports and promotes the estate. This could be achieved by asking users to register with their email address. They will then receive newsletters, special offers and information about forthcoming events. Special events can be offered to this community and part of the website can be set aside for members of this community. Not only will this provide the estate with valuable resource, it will also allow them to build up a marketing profile of likely visitors and, through surveys and questionnaires, continue to understand what different types of visitor want from the estate.

MCGEORGE HOLDINGS

(a) Product divestment analysis tools

Tutorial note: *There are several academic models that could be applied to analyse this situation including those such as Shell, Little, Abel and Hammond and PIMS. Two of the most widely used models refer to the product life cycle and the Boston Consulting Group's (BCG) growth-share matrix. It is on these two that this suggested answer will concentrate.*

It is obvious that McGeorge Holdings has allowed its range of products to grow without too much regard to the overall efficiency and effectiveness of the product spread. It is required that a more rational approach should be taken so as to rationalize the product portfolio.

The product life cycle can be used to assess where each of the products are located. Some products, in their introductory stage, may not be contributing well to overall profits because of initial research and market development costs but may, in future, provide a regular stream of income to the company. Those in the growth stage should already be profit providers. It is in the later stages of the life cycle that attention needs to be paid. In the maturity/saturation stages it may be prudent to assess whether there is any long-term future in the products. Would investment in alternative products be more sensible? This question is more critical when one investigates products in the decline stage. One has to ask the question whether withdrawing these products may be wise. Products can still be profitable in the decline stage particularly if competitors are exiting the market faster than market demand is falling. It is also important to assess how these products contribute to the overall performance of the company. Maybe withdrawing from a given line might alienate key customers.

The products may also provide a complementary range and withdrawal from one area may adversely affect other product sales. If one withdraws certain products are there others which consumers can turn to or must they seek products from key competitors? It is also important to assess how costs such as marketing, distribution and even manufacturing have been allocated. The withdrawal of certain products could result in others having to share and carry higher costs, so making them price uncompetitive. One must not rush into product rationalisation programmes without considering the consequences of such an action.

The BCG growth -share matrix examines the inter-relationships between market share and market growth of given products. It assesses resource generation alongside resource needs. The "cash-cow", described as such because products in this criteria (low growth and high market share) are usually very profitable and generate surplus funds and so are often used to finance other developments. Such products are not recommended for deletion. The "stars" generate high revenues because the products have high market shares, but because the market is growing fast such products need to invest heavily to maintain their position. These are unlikely to be highly profitable as yet, but decisions to withdraw such products should be rejected. It is likely that such products will become more profitable as market growth stabilizes. The "problem child" or

"question mark" product is probably currently losing money. A prognosis needs to be made of future movements. Can the product achieve a significant share of the market? If the assumption is positive then the product may proceed to become a "star" and later a "cash cow". However if there are considerable doubts then the product may have to be withdrawn. It is often assumed that "dogs" – those products with low market share and low growth potential should be withdrawn from the market place. However some "dogs" are known as "cash dogs". They occupy a niche position and are still capable of returning a profit. If this is the case then they can be persevered with until such a time that they have little to offer the company. However true "dogs" need to be eradicated. They consume too much management time and money. These need to be focused on present and future winners.

Adrian Reed needs to be careful which products to remove from the portfolio. Some rationalisation will be needed but this should be carried out carefully and not rushed into.

(b) Benchmarking

"Benchmarking" the McGeorge organisation will enable Adrian Reed to assess in which areas the performance of his company falls short of that of his competitors and can help determine what action needs to be taken to correct any adverse findings.

There are several ways in which benchmarking can be carried out. Internal benchmarking can compare different units in McGeorge Holdings. Some centres may be more proficient than others and a transfer of knowledge and skills could be beneficial to the group as a whole. Competitive benchmarking attempts to compare products, processes and results and show where the company is failing with reference to those of competitors. The difficulty here is accessing confidential data of competitors. They are not going to make it easy for McGeorge by providing them with this information. Customer benchmarking attempts to compare corporate performance with the performance expected by customers. How far is there a gap between expected performance and actual? Generic benchmarking compares similar business functions between companies operating in different industries. For example how do financial results – gearing, liquidity, etc compare in differing industrial sectors? Process or activity benchmarking attempts to identify the current best practice in an organisation (regardless of sector) for activities such as manufacturing, engineering or human resource management. Then this best practice can be imported into the McGeorge organisation, assuming compatibility.

There are a number of limitations associated with benchmarking. Can relevant data be obtained to make any comparison meaningful? Some of the comparisons may be meaningless. Circumstances between firms, environments and products all differ so making a comparison appear like comparing "apples with oranges". The process can appear to be an historical exercise. The world moves on and what was acceptable yesterday may be out of date tomorrow. Furthermore there is an implicit assumption that there is an optimum solution. A process can be efficient but does it add value – is it effective? It is possible that distribution costs can be reduced to almost zero by distributing nothing. Is this solution useful? If benchmarking concentrates on efficiency, ignoring effectiveness, then it is missing its purpose.

Reed could utilize benchmarking to assess the corporate performance of the company but this needs to be implemented carefully and results must be analysed critically without snap judgements being made.

ANSOFF

(a) Product/market strategy matrix

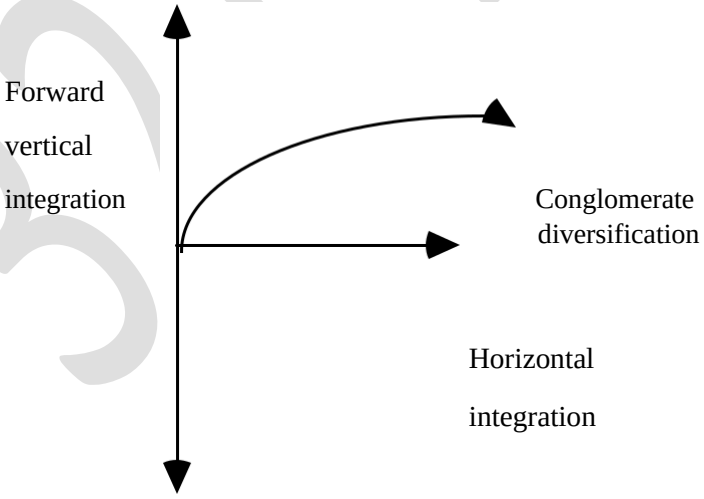


ProductsExistingNew

New	Market	Diversification
Existing	Market penetration	Product development

The "Ansoff matrix" is a tool for categorising the available growth strategies of any organisation. It divides strategies into four groups, depending on their product/market characteristics. It is used at the strategic choice stage of the planning process to help the organisation consider all the available strategies. It is not, however, detailed enough for the strategic choice exercise, as the quadrants are categories of strategy and not strategies.

(b) Diversification strategies



integration

There are four categories of diversification to an organisation, shown by the "vectoring" diagram above.

Forward vertical integration is when a firm moves into product/market areas previously occupied by its customers (e.g. when a farmer sells vegetables from a stall outside the farm gate).

Backward vertical integration is when a firm moves into product/market areas previously occupied by its suppliers (e.g. when a petrol retailer moves into oil exploration).

Horizontal integration is a merger with or takeover of a direct rival.

Conglomerate diversification is a move into unrelated product/market areas.

(c) Diversification through merger

Advantages

(i) It is much faster than organic growth as the firm acquires an existing market share.
(ii) The risk of failure is significantly reduced.
(iii) Experience of the new product/market area is acquired, eliminating the cost of learning.

Disadvatages

(i) The price paid may capitalise all the future earnings potential.
(ii) The merger partner may not be using the most up-to-date technology and may therefore be less profitable.
(iii) The complexity of integration may hinder the realisation of anticipated merger benefits.

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ALBERT OWENS

(a) Option evaluation

One of the most difficult tasks undertaken in planning strategy is that of evaluating various options. This must be carried out logically and analytically. Numerous writers have attempted to produce lists of criteria for testing strategy, probably the best known being those of Argenti and Tilles. For example, Argenti lists six criteria by which to test any proposed strategy:

(1) Can it be shown that this strategy gives the company a performance risk curve similar to the one selected by its shareholders (and managers; employees, etc)?
(2) Has the company the necessary competence to carry it out?
(3) Does it eliminate or reduce the company's outstanding weaknesses?
(4) Does it allow the company to exploit any opportunities that may occur in future?

(5) Does it sufficiently reduce any of the severe threats that may face the company?
(6) Does it call for any action that is or may become objectionable on moral or social grounds?

What *Argenti* and the other writers really say is that any strategy must:

- be consistent internally and with the environment;
- be appropriate in the light of available resources as well as being workable; and
- have a satisfactory degree of risk and an appropriate time horizon.

Another way of looking at this evaluation is to see whether the strategy meets the criteria of:

- **suitability** – consistent with the objectives of the organisation both internally and externally;
- **feasibility** – in the resources and capability of the organisation; and
- **acceptability** – in the degree of risk and uncertainty, the time scale, as well as politically, ethically and morally.

This approach could be adopted to analyse the case of Albert Owens.

Suitability

Owens must review each option to establish whether it is in line with its objectives. Such criteria might include:

- cost of entry, initial and continuing investment;
- profitability and cash flow objectives;
- fitting into strategic structure and general compatibility, synergy aspects;
- other financial objectives (e.g. gearing ratios, etc).

Both options should be examined and then listed according to some agreed rating scale. For example Option 1 (a programme of product development) will not receive as high a rating with regard to cost of entry, etc as will Option 2; however it may well be rated higher in respect of profitability. Both options must be measured against the twin criteria of internal consistency (Option 2 seems high in this respect), and consistency with the environment (Option 1 might score high points for this). If the strategy meets these criteria it might be considered suitable. The strategy must match up to the overall image of the organisation and its social goals. In addition, it must be suitable for the organisational and employee objectives.

One important fact that cannot be avoided when analysing the position of Owens is that it has become mismatched with its environment. It is facing threats and its current product/market situation indicates considerable weaknesses. Customer preferences are obviously changing as is the distribution environment. The company needs to consider these factors when assessing the suitability of a particular option.

Feasibility

This is probably the most important criterion which asks the question "What is the company able to do?" A capability profile is a most useful tool – it is simply a declaration of the resources available (actual or potential) to the organisation. This would be in a form of SWOT ("strengths, weaknesses, opportunities and threats") analysis. Factors to be considered include competence of management, availability of finance, company image, manpower, skills and products. Secondly it asks the question "Is the strategy workable?" For example a good discounted cash flow return might be achieved from Option 1 but can it be supported by the cash flow throughout the period?

Acceptability

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After studying the suitability and feasibility of an option, the organisation must consider whether it is acceptable. For example, does the degree of risk and the time span involved in adopting a programme of product development (Option l) make its worth doubtful? Over the time period, is it acceptable politically, internally and externally? For example is it acceptable for Owens to enter further into an environment where the power of the buyer is as strong as would be the case with Option 2? Finally the strategy might be satisfactory internally, but what about questions such as social responsibilities and the company's overall image? Albert Owens has built its goodwill as a manufacturer of confectionery. Will entering into markets of savoury snacks and chewing gum, etc water down the company's image?

(b) Five forces model

The extent of competitive rivalry in the market

It would seem that Albert Owens is protected by its brand differentiation, although all the other factors listed suggest that its market is highly competitive. The decline in the market added to the high exit barriers (in terms of committed investment costs) cause particular problems.

The threat of substitutes

The board of Owens has already recognised the very real threat from the substitute offerings threatening its confectionery products. One of the strategic options under consideration is to move into these markets.

The threat of entry

Although there is a threat in the form of large chocolate manufacturing firms looking to maximise their under capacity there seems little threat to Albert Owens which appears to hold a firm position in a well-defined and differentiated niche.

The power of buyers and the power of suppliers

The power of suppliers and buyers has an important effect on market conditions. There are numerous aspects involved in these two forces but of particular concern to Owens is the strength of the buyer power. The buyers may restrict the future freedom of Owens in terms of product packaging, product development, advertising and promotion generally, pricing and merchandising policies. In this respect Owens is in a market which is becoming increasingly concentrated and competitive:

RAMON SILVA

(a) Competitive advantage through differentiation

To: Ramon Silva

From:

Value innovation in La Familia Amable hotel chain

In strategic terms you are looking to create a competitive advantage over existing hotels based on a cost focus strategy. Although, the success of this niche marketing strategy will depend on your ability to attract customers from the existing providers, there does seem a gap to exploit. In many ways you have an advantage in that you are not constrained by previous experience in the hotel industry and this has enabled you to look to deliver a significantly different value proposition to your customers and not simply look to marginally improve on what currently is on offer. One particular study on innovation drew attention to five dimensions of strategy where innovators can

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significantly outperform existing companies. This is important, as the industry does not look particularly attractive with low growth and overcapacity – a recipe for low profitability.

Industry assumptions – here existing companies take the competitive conditions as given whereas innovators are looking to influence and change those conditions.

Strategic focus – simply benchmarking against the current hotel providers may not create any real advantage, innovators are seeking to provide a step change in the experience given to the customer.

Customers – the route to success may not be through ever increasing segmentation and customisation but by actually looking to focus on the shared attributes of the service that customers value – a good night's sleep for a low price being a prime example.

Assets and capabilities – rather than looking to leverage existing assets and capabilities the innovator looks to ask what would we do if we were starting a new business.

Product and service offering – existing competitors may again be constrained in their thinking by the existing boundaries of the industry and the innovator by identifying new customers and services that take them outside this boundary may offer a "total solution" that transforms the industry. The "no frills", low cost budget airlines are a good example of such thinking.

In the hotel business "location, location, location" is argued to be at the heart of a successful strategy. Clearly this will be your choice and is affected by the customer groups you are looking to attract. Establishing a brand name and reputation is an important marketing strategy and this will be facilitated by growing the chain rapidly and giving customers easy access to your hotels. In value chain terms the company infrastructure looks to be lean with a reliance on trained husband and wife teams to deliver the service. Franchising would also seem to be a route to grow the business that will place reduced strain on company headquarters. The creation of a chain should lend itself to significant buying and procurement advantages, right from the design of the hotels which will focus on the core value you are providing – namely quiet and cost. One French hotel chain was able to cut in half the average cost of building a room, its "no frills" service cut staff costs from between 25% and 35% of sales – the industry average – to between 20% and 23%.

Good design will therefore affect the quality of service that the operations side of the value chain delivers to the customer. This may be a simpler service to that provided by its competitors – simpler, more basic rooms, no expensive restaurants or lounge areas all impact on the cost of operations and consequently the price charged. Marketing, as previously referred to above, is much more effectively done through satisfied customers' recommendations than by expensive advertising. Many hotel chains have used technology to create customer loyalty schemes of questionable benefit to the customer. You will certainly have to seriously consider the value of such an after sales service. The established competitors often make assumptions as to what a customer wants and typically this is offering more and more services that are expensive to provide. Your entry into a "mature" industry such as this, allows you to really challenge these assumptions and deliver a price/value combination that is hard to beat.

Yours,

(b) Franchising

Franchising is typically seen as a quick and cost effective way of growing the business but Ramon should be aware of both the advantages and disadvantages of using it as the preferred method of growth. Franchised chains are argued to benefit from the sort of brand recognition and economies of scale not enjoyed by independent owner/managers. When combined with the high levels of

motivation normally associated with owner/managed businesses, franchises can be argued to get the best of both worlds.

Franchising is defined as "a contractual agreement between two legally independent companies whereby the franchisor grants the right to the franchisee to sell the franchisor's product or do business under its trademarks in a given location for a specified period of time. In return, the franchisee agrees to pay the franchisor a combination of fees, usually including an up-front franchise fee, royalties calculated as a percentage of unit revenues, and an advertising contribution that is also usually a percentage of unit sales."

Ramon is considering a type of franchising called "business-format franchising", where the franchisor sells a way of doing business to its franchisees. Business-format franchising is a model frequently found in the fast food and restaurant industry, hotels and motels, construction and maintenance and non-food retailing. Often these franchises are labour intensive and relatively small-scale operations.

Franchising is seen as a safer alternative to growing the business organically, so while this may be true of well-established global franchises, failure rates among franchised small businesses were greater than those of independent businesses (in one US study a 34.7% failure rate for franchises as opposed to 28.0% for independents over a six or seven-year period). Often it is the failure of the franchisor that brings down its franchisees. Failure stems from the franchisee not only having to rely on their own skills and enthusiasm but also the capacity of the franchisor and other franchisees to make the overall operation work.

The advantages to the franchisee are through gaining access to a well-regarded brand name that will generate a higher level of demand and use of a tried and tested business model that should reduce the franchisee's operating costs. Both of these benefits stem from being a member of a well-established franchised system. Yet La Familia Amable along with many other franchises will be new and small. These smaller franchises tend to be regional in scope and fairly unknown outside their regional market. This has a significant effect on what the franchisees can expect to gain from their franchisors and their prospects of success. Both parties need to carefully assess the strengths and weaknesses of the system. Companies growing via franchises need to take the time to understand their business model thoroughly and determine how franchising fits with their long-term strategy. Care must be taken with the franchise agreement that creates a genuine partnership with the right balance between freedom and control over the franchisees.

AMBION

(a) Attractiveness to Swift of EVM as an acquisition target

Tutorial note: *The acquisition of EVM can be analysed using the success criteria of suitability, acceptability and feasibility.*

Suitability is concerned with whether a strategy addresses the issues identified when considering the strategic position of the company. In general terms the acquisition appears to make sense. The market is mature and competitive in Ambion, pushing down margins. These margins are further eroded by a government that is hostile to road transport resulting in high taxation on fuel, road taxes linked to carbon emission and restricted working practices. The acquisition of EVM provides an opportunity for Swift to exploit their core competencies in a different geographical market where demand is rising, the national government is investing in road infrastructure and competition is immature. The increased size of the group will further allow Swift to exploit economies of scale when purchasing trucks and other equipment.

Concerns around suitability surround the potential clash of cultures between Swift and EVM. Swift has no experience of acquiring or running foreign companies. It has no experience of trading in Ecuria. Furthermore, although EVM is now in private hands, it may be possible that the work practices and expectations of employees may still reflect the time when they were working for the central government. Although altering these practices may give scope for even greater profitability, it may lead to labour disputes that harm the service and reputation of the company. Swift wishes to acquire this company and adopt the practices, principles and technology of the Ambion operation. This may lead to conflict that they may find hard to resolve.

Acceptability is concerned with the expected performance of a strategy in terms of return, risk and stakeholder reactions.

Return: EVM delivers a very similar (18%) Return on Capital Employed (ROCE) to Swift Transport. This appears to be a strong performance for the sector, and should certainly be acceptable to the Swift shareholders. The gross profit margin (20%) is higher than Swift, but the net profit margin (7.5%) is lower. This may support some of the concerns discussed under suitability. The company may still be carrying high costs from its days as a nationalised company. Swift presumably believes that it can improve the net profit margin by implementing competences gained in the Ambion market.

Risk: Both the current liquidity ratio (1.14%) and the acid test ratio (1.05%) are lower than the Swift equivalents and Swift will need to look at this. The introduction of Swift's practices may help reduce trade payables. The gearing ratio (30%) for EVM is much lower than Swift and perhaps reflects a more conservative approach to long-term lending and a reflection of the fledgling capital markets in the country. However, the interest cover ratio (5) is half that of Swift, perhaps reflecting lower profitability and higher business taxation.

Stakeholders: Joe Swift and his family are the major stakeholders in what is still a family-run private limited company. It is unlikely that there will be any opposition to the acquisition from shareholders. However, stakeholders such as drivers might be wary of this strategy and also the government, outspokenly criticised by Joe, may also respond in some way (e.g. by imposing taxation on foreign investment).

Feasibility is about whether an organisation has the resources and competencies to deliver the strategy. It appears that Swift does, as funds are in place and the competences are what are partly driving the acquisition.

(b) Factors which could influence Swift's decision

In his book *The Competitive Advantage of Nations*, Michael Porter suggests that there are inherent reasons why some nations are more competitive than others, and also why some industries within nations are more competitive than others. He suggests that the national home base of the organisation plays an important role in creating international advantage, something that will be very important to Joe Swift. He identifies four main determinants of national advantage and arranges these as a diamond, with each of these determinants interacting with and reinforcing each other. Two further determinants, chance and government, are discussed outside of the diamond in terms of how they influence and interact with the determinants inside the diamond.

Tutorial note: *This answer uses Porter's diamond as its basis. However, credit would also be given for alternative appropriate frameworks or models.*

The four main determinants are:

(1) The nation's position in *factor conditions*, such as skilled labour or infrastructure, necessary for firms to compete in a given industry. The acknowledged work ethic of the people and the investment in transport infrastructure by the government are significant factor conditions in Ecuria.

(2) The nature of the home *demand conditions* for the industry's product or service. Home demand influences economies of scale, but it also shapes the rate and character of improvement and innovation. In Ecuria, the move to a market economy has stimulated a rapid growth in the transport of goods. The Ecurian people are traditionally demanding in their standards. They have a passion for precision and promptness and this has shaped the operations of EVM.

(3) The presence or absence of *related and supporting industries* that are internationally competitive. Competitive advantage in certain industries confers potential advantages on firms in other industries. Porter suggests that the "Swiss success in pharmaceuticals was closely connected to previous international success in the dye industry". There is no evidence in the case study that Ecuria has internationally competitive industries related to logistics. Hence, it is the absence of these that is significant when considering this determinant.

(4) *Firm strategy, structure and rivalry* concerns the conditions in the nation governing how companies are created, organised and managed. It also considers the nature of domestic rivalry. EVM was created by nationalising the state-run haulage system. For the first few years of operation it had few competitors. The nature of the capital markets makes it very difficult to raise finance in Ecuria. Consequently, most of EVM's competitors are small, family-run companies who offer a local service. Porter suggests that there is a strong relationship between vigorous domestic rivalry and the creation and persistence of competitive advantage in an industry. There is little evidence of this emerging in Ecuria.

Porter also recognises the influence of chance and government. Chance events are developments outside the control of firms and the nation's government. Wars, external political developments and a reduction in foreign demand are all examples of chance factors. Government, in effect, helps shape the diamond by enacting policies that influence each of the determinants. In Ecuria, the government's approach to infrastructure investment and policies towards capital markets has affected factor conditions and impacted on firm structure and rivalry.

ENVIRONMENT MANAGEMENT SOCIETY

Context

The decline in the number of people taking the qualification appears to be a reflection of the maturity of the marketplace. The large pool of unqualified environmental managers and auditors that existed when the qualification was launched has now been exploited. There are now fewer candidates taking the examinations and fewer members joining the EMS. The organisation's response to this has been to look for international markets where it can promote the qualifications it currently offers. It hopes to find large pools of unqualified environmental managers and auditors in these markets.

The scenario suggests that EMS currently has relatively limited strategic ambitions. There is no evidence that EMS plans to develop new qualifications outside its current portfolio. Indeed, attempts to look at complementary qualifications (such as soil and water conservation) have been rejected by Council. Hence, expansion into new strategic business markets does not appear to be an option.

Strategy development

(a) Internal development

Internal development takes place when strategies are developed by building on or developing the organisation's own capabilities. It is often termed organic growth. This is how EMS has operated up to now. The original certificates were developed by the founders of the Society. Since then, additional certificates have been added and the Diploma programme developed at the instigation of members and officers of the Society.

In many ways this type of organic growth is particularly suited to the configuration of the organisation, one where there is a risk-averse and cautious culture. The organic approach spreads cost and risk over time and growth is much easier to control and manage. However, growth can be slow and indeed, as in the case of EMS, may have ceased altogether. Growth is also restricted by the breadth of the organisation's capabilities. For example, EMS has not been able to develop (or indeed even consider developing) any products outside of its fairly restricted product range. Furthermore, although internal development may be a reasonable strategy for developing a home market it maybe an inappropriate strategy for breaking into new market places and territories. This is particularly true when, as it appears in the case of the EMS, internal resources have no previous experience of developing products in overseas markets.

In summary, internal growth has been the method of strategy development at EMS up to now, based on a strategic direction of consolidation and market penetration. There is no evidence that EMS is considering developing new products to arrest the fall in qualification numbers. However, the Board has suggested developing new markets for the current qualification range and India, China and Russia have been identified as potential targets. It seems unlikely that internal development will be an appropriate method of pursuing this strategic direction.

(b) *Mergers and acquisitions*

A strategy of acquisition is one where one organisation (such as EMS) takes ownership of other existing organisations in the target countries. One of the most compelling reasons for acquisition is the speed it allows an organisation to enter a new product or market area. EMS might look to acquire organisations already offering certification in its target markets. These organisations would then become the mechanism for launching EMS qualifications into these markets. In addition, it is likely that these organisations will have qualifications that the EMS does not currently offer. These qualifications could then be offered, if appropriate, in EMS's home market. This arrangement would provide EMS with the opportunity to quickly offer its core competences into its target markets, as well as gaining new competencies which it could exploit at home.

However, acquisitions usually require considerable expenditure at some point in time and evidence suggests that there is a high risk that they will not deliver the returns that they promised. It is unlikely that the EMS will have enough money to fund such acquisitions and its status as a private limited entity means that it cannot currently access the markets to fund such growth. Any acquisitions will have to be funded from its cash reserves or from private equity investment groups. Furthermore, acquisitions also bring political and cultural issues which evidence suggests the organisation would have difficulty with. Under achievement in mergers and acquisitions often results from problems of cultural fit. This can be particularly problematic with international acquisitions, which is exactly the type of acquisition under consideration here. So, although acquisitions are a popular way of fuelling growth it is unlikely that EMS will have either the cash or the cultural will to pursue this method of strategy development. There is no evidence that EMS has any expertise in acquiring organisations in its home market and so such acquisitions overseas would be extremely risky.

(c) *Strategic alliances*

A strategic alliance takes place when two or more organisations share resources and activities to pursue a particular strategy. This approach has become increasingly popular for a number of reasons. In the context of EMS it would allow the organisation to enter into a marketplace without the large financial outlay of acquiring a local organisation. Furthermore, it would avoid the

cultural dislocation of either acquiring or merging with another organisation. The motive for the alliance would be co-specialisation with each partner concentrating on the activities that best match their capabilities. Johnson, Scholes and Whittington suggest that co-specialisation alliances "are used to enter new geographic markets where an organisation needs local knowledge and expertise". This fits the EMS requirement exactly.

The exact nature of the alliance would require much thought and indeed different types of alliance might be forged in the three markets targeted by EMS.

- A joint venture is where a new organisation is set up jointly owned by the parents. This is a formal alliance and will obviously take some time to establish. EMS will have to contribute cost and resources to the newly established company, but such costs and resources should be much less than those incurred in an acquisition.

However, joint ventures take time to establish and it may be not be an option if EMS wants to quickly move into a target marketplace to speedily arrest its falling numbers.

- A licence agreement could be an alternative where EMS licenses the use of its qualification in the target market. This could be organised in a number of ways. For example, a local organisation could market the EMS qualification as its own and pay EMS a fee for each issued certificate and diploma. Alternatively, the qualification may be marketed by the local organisation as an EMS qualification and EMS pays this organisation a licence fee for every certificate and diploma it issues in that country. This requires less commitment from EMS but it is likely to bring in less financial returns, with less control over how the qualification is marketed. Furthermore, if the qualification is successful, there is the risk that the local organisation will develop its own alternative so that it gains all the income from the transaction, not just a percentage of the transaction fee.

At first sight, the strategic alliance appears very appropriate to EMS's current situation. The licensing approach is particularly attractive because it seems to offer very quick access to new markets without any great financial commitment and without any cultural upheaval within EMS itself. However, the uptake of the qualification is unpredictable and the marketing and promotion of the qualification is outside the control of EMS. EMS may find this difficult to accept. Furthermore, the EMS will only be receiving a fraction of the income and so it must ensure that this fraction is sufficient to fuel growth expectations and service the newly qualified members in other countries. Finally, there is often a paradox in organisations where internal development has been the strategic method adopted so far. An organisation used to internal development and control often finds it difficult to trust partners in an alliance. Yet trust and cooperation is probably the most important ingredient of making such strategic alliances work.

MMI

(a) Analysis of acquisition rationale and integration

First Leisure (FL)

The initial motivation for the acquisition of FL was the need to diversify out of a declining market place (falling 5% over the recorded period) into an expanding one (increasing over 25% in the recorded period). The cash generated by the quarrying company was used to purchase a profitable, well-run company in an expanding market. Diversification was a direct response to environmental changes. Increased costs and falling reserves meant that there was little chance of finding new sites in its core market. MMI initially played no managerial role in FL, allowing the managers who had made it successful to continue running the company. However, buying a company concerned with leisure appeared to be an example of unrelated diversification and there were some negative comments about the financial wisdom of this acquisition.

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After a period of consolidation, certain unexpected synergies emerged that had not been clear at the time of acquisition. These came from the conversion of disused or unprofitable quarry sites into leisure parks. This conversion was doubly advantageous.

(1) It reduced the operating costs of MMI, allowing it to shed costs associated with running unprofitable mines and maintaining security and safety at disused sites.

(2) It allowed FL to acquire sites relatively easily and cheaply in an environment where it was becoming more expensive and harder, because of planning restrictions, to purchase new sites.

Johnson, Scholes and Whittington discuss the principles of economies of scope where an organisation has underutilised resources that it cannot effectively use or dispose of. It makes sense to switch these if possible to a new activity, in this instance leisure parks.

The turnover of FL has doubled in six years. The figures summarised in Table 1 suggest an expanding company in an expanding market and its market share continues to grow (up from 13% to 21% in the recorded period). Furthermore, gross profit margins have remained fairly constant but recent increases in the net profit margin suggests that costs appear to be under control, despite the recent issues concerning the supply of boats from Boatland. In corporate management terms MMI probably perceived that it would initially be playing a "portfolio management" role at FL. However, the discovery of unexpected synergies has led to it adopting (and perhaps claiming in hindsight) a synergy manager role. In terms of the BCG matrix, FL exhibits all the characteristics of a star business unit and so it should be retained in the portfolio. It has a high market share in a growing market and increasing margins means that even if it has spent heavily to gain this share (and there is no direct evidence of this in the scenario), costs are now beginning to fall.

Boatland

The synergies that emerged from acquiring FL appear to have been unexpected. However, the acquisition of Boatland in 20Y0 was largely justified on the grounds of synergy. Synergies were expected with FL and with MMI itself. By this time the directors felt that they had built up significant managerial competencies that could be successfully applied to acquired companies. These managerial competencies could be used to drive extra value from underperforming companies and so deliver benefits to shareholders. In the case of Boatland the expected synergies with FL were as follows:

- FL had experienced difficulties in the supply and maintenance of boats for their leisure parks. Boatland seemed to offer a way out of this problem. FL would become a preferred customer of Boatland, taking priority over other customers. MMI also perceived that cost savings could be found by bringing boat manufacture and maintenance into the Group. In this instance, MMI was pursuing a policy of *backward integration*, producing one of the inputs into FL's current business activities.
- Boatland itself appeared to be undervalued. The management team appeared to lack ambition, focusing on producing a limited number of craft to high specification. It was felt that the production of boats for FL would help the company expand, allowing it to increase market share partly based on guaranteed orders from FL.

In this instance MMI probably thought of itself as a synergy manager, helping Boatland develop strategic capabilities and exploiting synergies with both MMI and FL. However, the acquisition has not brought the expected benefits. The boats provided for FL have not been appropriately constructed for their purpose and, paradoxically, because of the way they are misused by holiday makers, maintenance costs and "downtime" has increased. Furthermore, the status of FL as a preferred customer has led to delays in boat manufacture and maintenance for established customers. Orders have fallen and so has the reputation of the company. This is reflected in the data provided in Table 1. Revenue and market share has fallen in a static market place. More worrying is the significant fall in gross and net profit margins. The net profit margin has fallen

from 13·04% in 20X6 to just 4·29% in 20Y2. Furthermore, difficulties also have been created for FL, which are also disturbing its relationship with MMI. The problem at Boatland appears to be cultural and this is reflected not only on the results but in the loss of experienced boat building employees. When the company was bought it concentrated on building a small number of high quality boats to discerning customers who valued and cherished their boats. In contrast, FL required a large number of simple, robust boats that could be used and abused by holiday makers. The products and markets are different and the perceived synergy was an illusion.

In BCG terms Boatland has a very small share of a static market. Although there is no evidence of it being a cash drain on MMI the conflict between the culture of Boatland and the cultures of MMI and FL probably used up a disproportionate amount of company time and resources. In terms of the Ashridge Portfolio Display, Boatland appeared as a *heartland* business but it soon turned into a *value trap* business. It seems sensible to divest Boatland from the portfolio. However, the supply implications of this to FL will have to be investigated and so divestment may have to wait until FL has built up a relationship with an alternative supplier.

(b) Analysis of proposed acquisition

Introduction

Since 20X6 MMI have built up a small portfolio of businesses that reflect different strategic directions. It has consolidated in its own market by shedding unprofitable or closed quarries and purchasing smaller competitors. This is reflected in the data given in Table 1. During a period when the marketplace has declined by 5%, MMI has increased its market share from 20% to 28%. Gross profitability has remained fairly steady during the period, but the net profit margin has increased significantly since 20X8. The increase in market share is probably due to the acquisition, in 20X8, of two smaller competitors. The increase in the net profit margin can largely be traced to the disposal of redundant and unprofitable quarries to FL. MMI's attempts at diversification have had mixed success. FL, acquired in 20X6, turned out to be an inspired acquisition as unexpected synergies emerged which assisted MMI's profitability. However, the expected synergies from the Boatland purchase have not materialised and MMI appear to have destroyed rather than created value in this acquisition.

In 20X8 MMI acquired two of its smaller competitors, bringing five further mines or quarries into the group. MMI introduced its own managers into these companies resulting in a spectacular rise in revenues and profits that caused the CEO of MMI to claim that *corporate management capabilities* were now an important asset of MMI. So there appears to be evidence that MMI management can successfully improve the performance of an acquisition. However, Boatland is in a significantly different industry to these earlier acquisitions. MMI managers are familiar with the management of mines and quarries and probably found that the employees of these companies shared the culture of an industry they were familiar with. In contrast, at Boatland the sought after synergy was with FL, not MMI, and so the MMI managers entered an industry and an environment they were unfamiliar with. Evidence from the FL and Boatland acquisitions suggests that MMI is more successful when it employs a "hands-off" approach to managing acquisitions which are not directly related to its core mining and quarrying operations. The incumbent management team are left to get on with the job with minimal interference from MMI.

InfoTech

The current financial position of InfoTech suggests that its management team may not be able to deliver the turnaround required. Market share and gross and net profit margins have fallen over the recorded period. Revenues have decreased by 16% at InfoTech in a period where the size of

the market has increased by almost 25%. If MMI acquires InfoTech then the preferred "hands-off" approach will be very risky, particularly considering the financial investment the company requires. MMI appears to have two alternatives if it goes ahead with the acquisition.

(1) To learn from its experience at Boatland and install managers who are more sensitive to the culture of the organisation and the industry as a whole. To do this, it will have to recognise that its perceived value adding managerial capabilities actually turned out to be value destroying at Boatland.

(2) MMI could recruit managers with established track records in the IT industry. However, there is no evidence that MMI has successfully adopted this approach before.

The financial position alluded to above also needs to be considered. Boatland and FL were both successful, profitable companies when they were acquired. In contrast, Infotech is making a loss and appears to require investment which it has failed to secure in its own right. This is a controversial reason for acquisition and in this context MMI is playing the role of a portfolio manager, one it has never played for a failing company. In terms of the BCG matrix, InfoTech is a business unit in a growing market but with a low market share. It would be defined as a *question mark* or *problem child*.

Tutorial note: *Suitability is one of the three success criteria JS&W use to judge strategic options. An approach which evaluates whether the acquisition addresses the situation in which MMI and InfoTech are operating would be a perfectly valid approach to answering this question.*

CHANGE

Alan has a difficult, if not altogether unusual, job at ASG in trying to reconcile the attitudes and ambitions of two, or rather three groups, if including the personnel department, with very different views of the training and development process the graduates should undergo. These three groups are important stakeholders in ASG, which they see as the means for achieving significant personal and career goals.

In this scenario, we are looking at a complex situation with individuals and groups motivated by a number of goals and objectives which are likely to change over time and requiring the partners concerned to change their attitudes and relationship to the graduates. The partners may feel their job security and professional status are threatened by a shorter training programme. These concerns are magnified by the dangers to partner cohesion threatened by the speedier movement of graduate trainees through the programme and more rapid progression towards their ultimate aim of becoming partners in the firm.

ASG, as an accounting firm, is what Mintzberg would term a professional bureaucracy where the qualified accountants have considerable discretion in their work and co-ordination is achieved by the standardisation of skills and the graduate training programme is clearly seen by the partners as a key method to achieve such skills. The graduates will also be undertaking professional examinations to complement the practical experience they gain in the firm and to ensure that they have the professional skill base to work as accountants in the partnership.

In ASG the three groups are in danger of pursuing conflicting goals with detrimental effects on the company's performance. Each group will perceive the issue differently and reconciling these perceptions lies at the heart of Alan's problems. These goal differences may stem from the uncertainty of what the training programme is trying to achieve. The partners are convinced that the graduates should have to go through exactly the same training process as they themselves did, and in so doing will acquire the necessary skills and experience to make them effective accountants. There is a danger that in so doing they will merely succeed in cloning themselves and destroying the energy, enthusiasm and different ways of thinking brought in by the graduates and now much needed in a changing competitive environment. The personnel department may reinforce the partners' position through their professional convictions of the benefits of the training programme but also from the fact that their own position and power in ASG partly stems from the resources they are seen to control including the training budget.

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Many authors have written about the change process and how to manage it effectively. Alan needs to establish whether the changes to the training programme represent incremental or transformational change at ASG. The "trigger' for the change seems largely internal in the shape of the graduate trainees but their recruitment reflects a need to respond to an external challenge in the shape of increased client demands and competitors' actions. Johnson and Scholes' model of change would help Alan understand the nature of the change proposed and the partners' response to it. Certainly the partners response to date has been purely reactive and the nature of change incremental affecting only part of the firm's activities. This implies a process of adaptation needs to occur.

PROCESS STRATEGY AND REDESIGN

(a) Process strategy matrix

In order to discuss the process strategy mix, we must start by defining process re-engineering. This is used at strategic level when major environmental opportunities or threats make it necessary for fundamental, large scale changes to core processes, which are critical success factors in the value chain.

The process strategy matrix is a strategic tool used to analyse this approach by categorising the organisation's processes into four groups.

On the vertical axis of the matrix, processes are plotted in terms of complexity and dynamics, and on the horizontal axis processes are plotted based on their degree of strategic importance.

Harmon's Process Strategy Matrix

Process complexity and dynamics		**Strategic importance**	
Complex decision, design or negotiation processes / Many complex rules; expertise required	High	Complex and dynamic processes but not part of company's core competences. Hard to automate, so outsource. Examples: advertising, staff counselling.	Complex, dynamic; high value processes. Careful process improvement. Focus on people, their skills and their interactions. Example: product development.
Some rules present / Simple procedure or algorithm	Low	Simple, commodity-like processes. Automate with off-the-shelf systems or outsource. Example: payroll accounting.	Simple but important: automate to improve efficiency using e.g. workflow, CRM, Six Sigma. Example: sales order processing.
		Low	High
		Essential, but low added value	Vital for success, high added value

(b) Process redesign methodology

Harmon suggests that methodology should be used in any process redesign, particularly if it is applied to project management techniques. The main benefit is that a methodology provides discipline and improves focus; however, successful implementation will only be achieved if it is accepted by all management and staff.
There are five phases to this methodology.

(1) The **planning phase** is where goals are set, the scope of the project is defined, project team members and other roles are identified and the overall schedule is developed. The planning phase ends with the agreement of a detailed project plan which would include time and cost budgets.

(2) The **analysis phase** is concerned with current workflow, identifying problems and establishing a redesign plan. This phase may not be relevant in all projects but when it is full, documentation is required.

(3) The **design phase** is just one of the areas covered in phase three. Other areas include supporting management roles and responsibilities, reporting responsibilities and running simulations and preparing cost estimates for two or more possible new designs.

(4) The **development phase** follows the design into all of its functional and resource implications. This is one of the most important areas for the project sponsor. This phase comes to a completion when all the new arrangements have been tested and deemed satisfactory.

(5) The **transition phase** is where the redesigned process is implemented. Its success will depend on the overall change management process.

Harmon suggests three conditions for successful implementation:

- Each individual project improvement should be tied to specific corporate goals.
- In order to get management and staff to support the change, some kind of incentive should be made.
- IT specialists must be able to take strategic view of the organisation so they are seen to be supporting line managers.

EGDON

(a) Organisational culture frameworks

Tutorial note: *The question specifically references the cultural web, but any framework that is appropriate for understanding the culture of an organisation can be used.*

The cultural web is a representation of the taken-for-granted assumptions, or paradigm, of an organisation. These include:

Symbols

Symbols such as logos, offices, cars, titles, language and terminology are a shorthand representation of the nature of the organisation. At Frigate, the adoption of the term "Commander" by its managing director, Ron Frew, and his use of naval terminology is indicative of how he wishes to be perceived and the way he wants the company to run. Indeed the name of the company itself reflects his naval obsession. The main symbol of his success is the motor cruiser that Frew owns and moors at the local port. The irony is that Frew actually has no naval experience. He is acting out a stereotype of how he perceives naval life to be.

Power structures

Power structures are also likely to influence the key assumptions of an organisation. The most powerful groupings within the organisation are likely to be closely associated with core assumptions and beliefs. At Frigate, power is centred on one person. Leadership comes from a person who holds strongly held views, opinions and beliefs.

The organisational structure is likely to reflect power and show important roles and relationships. At Frigate, there is little formal structure and Ann Li's attempt to put one in place was opposed.

Controls

Control systems, measurements and reward systems emphasise what is important to monitor in the organisation. Frew is primarily concerned with cost control. Emphasis is on punishment (making deductions from wages for late arrival), rather than reward, which fits his naval stereotype. There appear to be few formal process controls and relationships with both customers and suppliers are confrontational. Ann Li's attempt to install formal controls throughout the organisation was resisted by Frew.

Routines and rituals

Routines and rituals define the "way we do things around here". For Frew there is a distinction between the routines of staff (must arrive on time, minimum holidays with no flexibility) and the rules that apply to himself – flexible working, long holidays, the expectation that employees will help him with his personal life.

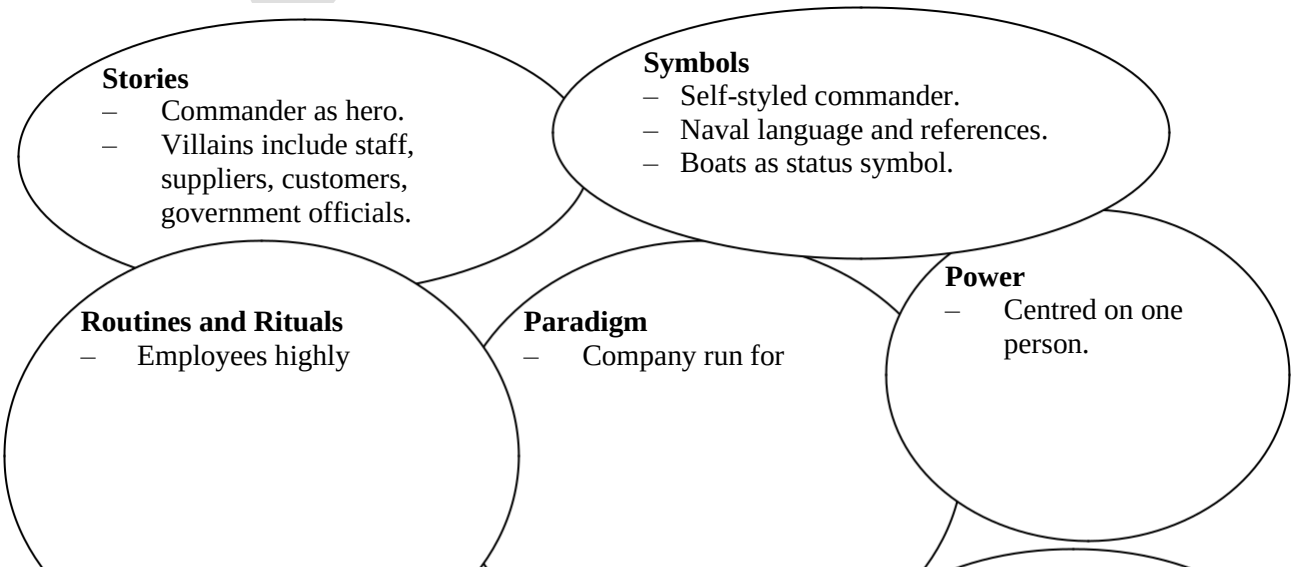
Stories

The stories told by members of an organisation are usually concerned with success, disasters, heroes, villains and mavericks. It appears that Frew is the hero, seeing off lazy staff, unscrupulous suppliers (trying to sell me inferior quality goods for higher prices), problematic customers (moaning about prices and paying later and later) and bureaucratic officials (squandering my hard-earned money). These are identified as the villains. He even extends his stories to society as a whole, believing that a period working in the navy would do everyone good.

Paradigm

The company paradigm summarises and reinforces the other elements of the cultural web. Underpinning all of this is Frew's belief that the company is run for his own gratification and that of his immediate family. The benefits he receives and the lifestyle he enjoys is his reward for being a risk taker in a hostile environment which is always trying to limit him. He appears to see expenditure on his family (such as share gifts and holidays) as perfectly acceptable.

Figure 1 summarises the cultural web for Frigate.



structured hours and holidays.
- In contrast commander has long holidays and flexible hours.
- Employees support commander's social life.

gratification of primary risk taker.
- Legitimate for his family to be beneficiaries.
- Hostile environment where he is the possible victim.

- Leadership from him.
- Strong beliefs.

Organisational Structure
- Largely informal structure.
- Attempts to impose one resisted.

Controls
- Costs closely controlled.
- Emphasis on punishment, not reward.
- Few formal controls.
- Controls resisted.

Figure 1: The cultural web at Frigate

(b) Mintzberg's configurations

An organisation's configuration considers how the structure, processes and relationships of an organisation work together. Henry Mintzberg has identified six configuration stereotypes. Each configuration is idealised, a simplification. Mintzberg is at pains to point out that no real organisation is exactly like any one of them. Some come close to a specific stereotype, others reflect combinations and yet others are in transition from one form to another.

In the context of Frigate, two configurations are of interest; entrepreneurial organisation and machine bureaucracy.

Entrepreneurial organisation

This configuration has the following attributes relevant to Frigate:

Structure

- Simple, informal and flexible with few staff and no significant middle-line hierarchy.
- Activities revolve around the chief executive, who controls personally through direct supervision.

Context

- Simple and dynamic environment
- Strong leadership, autocratic
- Small organisation.

Power is focused on the chief executive, who personally exercises it. Formal controls are discouraged and seen as a threat to that person's authority. The typical owner (such as Ron Frew) exercises control through informal, direct (face-to-face) supervision. Employees may find such organisations highly restrictive. In Mintzberg's words they may not feel "like the participants in

an exciting journey, but like cattle being led to market for someone else's benefit". Frigate has many of the characteristics of an entrepreneurial organisation.

Machine bureaucracy

In contrast, Ann Li has joined from an organisation which is likely to have the attributes of a machine bureaucracy – another stereotype identified by Mintzberg. In structural terms these organisations are characterised by:

Structure

- Formal procedures
- Sharp division of labour
- Strict hierarchy.

Context

- Usually larger, mature organisation
- Rationalised, standardised processes.
- Simple and stable environment

In such organisations some operations are routine, many are rather simple and repetitive and as a result work processes are highly standardised. This is Ann Li's experience that she is trying to bring to Frigate.

An understanding of organisational configurations would have helped identify the likely failure of Ann Li's proposal. She is trying to introduce a functional organisational structure into a CEO-controlled environment and a formal set of processes into an environment where flexible processes are directed by the CEO. The key factor here is the mismatch between structure, processes and context. The failure of her proposals could have been predicted by someone who understood the need to correctly match organisational structure, controls and processes.

HAIR CARE

(a) Analysis of current position

To: Sam Burns
Managing Director, Hair Care

From: The Accountant
Date: June 20X3

Assessment of Current Corporate Position of Hair Care

Introduction

I have assessed the current financial position of your company and I have also taken the liberty of drawing your attention to some difficulties which may arise in the future. Whilst your financial position is currently sound there are some worrying trends which need to be addressed. Furthermore you need to be careful not to be over -optimistic and assume that current favourable conditions will continue. You need to put in place some contingency plans.

Conclusions drawn from the quantitative data obtained from Table 1

You have prided yourself in running a lean organisation. However the data suggests that this is becoming less so. The cost of sales has risen from just over 63% in the year 20X0 to 70% in the forecasts for the coming year. This could be the result of higher costs by buying from less efficient suppliers or a squeezing of margins in a more competitive environment. It is unlikely to be the result of currency exchange deterioration as there has been little noticeable change over the past few years. You have been fortunate because this worsening in the cost of sales figure has been compensated for by favourable cost movements elsewhere. Costs of distribution and marketing, whilst increasing, are doing so at a slower rate than the increase in sales. This is to be expected to a certain extent as economies of scale are now being achieved. Administrative costs are rising more swiftly, possibly as a result of the increased number of employees in the firm.

The one key statistic is the level of loans taken out. In the next forecasted year this is expected to be about 67% of turnover. It is recognised that you need to have access to increased storage capacity, especially with the forecasted increase in turnover. However other methods of achieving this might have been explored (e.g. rental, leasing). I appreciate that owning the freehold might give you more flexibility and that you will benefit from any appreciation in the land values. However, in the short term it is a burden on the company despite the relative low rates of interest (although your rates have risen as your level of debt has soared). This is a prime factor in the worsening of your return on sales position, forecasted to be about 7·7%, almost half the level achieved three years ago.

Another worrying trend is the increase in the number of products which your company deals in. The range has almost quadrupled in the past three years. Whilst recognizing that customers are looking for greater choice, this accelerated increase must have an adverse effect on the efficiency of your company's operations. It also probably accounts for a significant part of the increase in the level of stocks being held, the cost of which is affecting your profits. Maybe some rationalisation of this position needs to be considered.

Although this is not a financial issue I feel that I should draw to your attention the fact that the proposed increase in employee levels may put a strain on your management systems. Goal congruence may be eroded. Currently the running of the company is centred on you and your wife. I appreciate that you founded the company and incurred all the financial risk and that you wish to maintain your control over the company. Notwithstanding this, the company is vulnerable if anything should happen to either of you even for a short period of time. You need to ensure that operations can continue in your absence. Maybe you should consider implementing a staff development programme. Too many of your staff are currently concerned with low level operations. You need to appoint one or two (maybe newcomers) who could, in an emergency, take over the management of the company. So far you have been able to maintain direct control over all your staff. However as the number of employees grows, the span of control is likely to be too large to be effective. You will tend to become over-burdened by operational issues when you should be spending more time on strategic concerns.

Issues for your future consideration

It is apparent that you have taken advantage of some favourable foreign exchange rates in your product purchases. The likelihood of the United Kingdom joining the euro-system will have a mixed effect on your position. It is possible that sterling will have to depreciate against the euro-currency to prevent problems from entry at too high a level as occurred with the previous ill-fated exchange rate mechanism (ERM). This will mean that your imports from Europe will be more expensive. However there are also signs that the dollar, currently claiming to be over-valued as a result of high levels of foreign investment into the USA, may seek a lower level to make its current adverse balance of trade more acceptable. If this is the case then your purchases from the Far East, denominated in dollars, could be cheaper in sterling terms. It is important that you continue to watch the movements in foreign exchange rates and do not get dangerously caught out by any adverse movements.

You have implied that you are too small to attract attention from the major UK hair care companies who deal directly with the retail market. This is a myopic perspective. If you continue to grow at about 50% per annum you will soon impinge on their markets, or make the competitors aware of the potential in your arena. They will surely react in an aggressive manner at some point. Furthermore your assertion that the market is recession-proof is optimistic. You have been fortunate in that your company has only existed in a period of relative prosperity. Whilst it may be true that the demand for hair care products may be relatively constant there is a danger that

your consumers may move down market. You are currently selling premium-priced products to hairdressing salons. It is a possibility that they may seek out cheaper products if the market becomes more competitive.

You have argued that a significant contribution to your success is the relationship developed with your suppliers. Will you be able to continue to develop this relationship with the increased number of suppliers you are now dealing with? Will these suppliers also be able to maintain the quality you have come to expect and will the reliability of delivery be continued?

Conclusion

Although your company is still profitable and showing strong signs of growth, the level of profitability is falling. Your level of debt needs to be addressed and you need to consider your organisational structure as well as your range of products and your relationship with suppliers. There are also a number of environmental factors which can impinge on Hair Care

– exchange rate movements, competitive reactions and economic conditions. These all need to be monitored to assess their likely impact on your company. It is better to anticipate change rather than react to it.

If you need any further advice or information please contact me whenever you wish.

Accountant to Hair Care

(b) Strategies for future development

To: Sam Burns **From:** The Accountant

Managing Director, Hair Care **Date:** June 20X3

Strategies for Achieving Growth

Introduction

There are a number of options which will enable Hair Care to achieve continued growth in the future. These can be usefully summarised, using Ansoff's product-market matrix. Apart from considering different directions of growth it is useful to assess whether a strategy involving an acquisition or a strategic alliance might prove to be beneficial.

Strategic options

Market penetration

You have stated that you think that in the current environment there is little opportunity for continued growth in the present direction. Any further penetration in the current market is likely to bring you up against larger and more powerful competitors. This could be disastrous for your business and should be avoided. There are other areas for expansion where the opportunities may be greater and the risks smaller.

Product development

You may consider focusing on selling a range of different products into the same market. However, as noted in my earlier report, your decision to already widen your range of products

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appears to be adversely affecting the efficiency of your organisation. The products would inevitably have to be focused on hairdressing businesses. Products such as hairdressing hardware and furniture – wash basins, and chairs are high-value items and not the type of products in which you have experience. Furthermore these products may require an installation service which you are currently unable to provide. You may consider selling fast-moving consumables such as shampoos and conditioners. However these items are usually well-known brands and such a move will bring you into direct competition with some of the powerful toiletries and chemical producers. I do not believe that you can effectively compete at this level.

Market development

This can be examined from two perspectives:

(1) You can attempt to sell to similar sectors internationally, maybe in continental Europe. There will need to be considerable marketing research carried out to assess the similarities and differences in market conditions. However, given favourable findings, this could be a realistic strategy. However you would need to develop stronger links with the key buyers (that being one of your key strengths) and assess the strength of the existing competition.

(2) You may wish to focus on a different segment in the UK. An obvious one is the retail market – selling to the general household market. This has large potential but it is doubtful whether you have sufficient resources to effectively operate in this segment. Additionally this will bring you into competition with the major players in this market – an unattractive proposition.

Diversification

The concept of you moving into new markets with new products is unappealing. It is a high risk strategy (despite the potential of high rewards) and will use none of your strengths. However there are also options of related diversification by means of vertical integration. Moving downstream into buying some of the outlets will be very expensive, and given your current levels of debt, it is not an attractive proposition. Furthermore the concept of moving upstream into manufacturing is not really an option. Your success is built on your ability to outsource many of your activities, buying from the best and most competitive suppliers. You have no expertise in the manufacturing field and such a move risks more than it promises to deliver.

Focus

You could decide to shrink the organisation slightly and focus more on profitability and not simply on turnover. You will need to concentrate both on your most profitable lines and your key customers. A reduction in the products offered could minimize problems with dealing with increasing numbers of suppliers and by focusing on key clients, this could reduce your workload and enable you to direct more of your energies towards planning for the future and any critical strategic issues not currently being attended to.

Acquisition

You could achieve growth by means of an acquisition, maybe accessing an international market in this way. However, again, this may prove to be expensive and the new acquisition may not fit smoothly into your way of doing business. I suspect that any domestic acquisition will be irrelevant. The acquired company is either going to operate in an area which is of no direct interest to you or if it is in your area of influence then you could possibly grow organically at its expense without incurring the costs of acquisition.

Strategic alliance

Although this strategic approach may enable you to grow much faster, using another company's technical or marketing knowledge, I am not sure that you would be sympathetic to such an approach. You are an entrepreneur by nature and you personally like to have the levers of control in your possession. Sharing power does not come easily to you. I do not think that you would be happy in such a situation.

Conclusion

You appear intent on growing faster as a company. You may wish to consider consolidating your current position and reducing your debt but if you are seeking a growth strategy the one which may provide expansion in your areas of expertise may be market development internationally. However this is not without risk and any venture into this area should not be contemplated without carrying out the necessary marketing research.

Signed

Accountant to Hair Care

(e) Value chain analysis

Sam's company has been successful because he has concentrated on those things he does well and has integrated the separate elements effectively. He has built up a profitable and, until relatively recently, a cost-effective organisation. By using *Michael Porter's* model of the value chain it is possible to demonstrate how this success has been achieved. If one examines the five primary value activities the inbound and outbound logistics can be assessed together. Sam has taken a personal interest in these two areas, dealing directly with both suppliers and key customers. He believes that his success depends on buying wisely and in keeping his customers satisfied. He has invested in up-to-date warehousing and stock control facilities and order processing and distribution is given high priority. This is complemented by efficient and, until recently, relatively cost-effective operations. As noted in the case scenario these operations have been kept to a minimum by most of the business being outsourced.

The other two primary activities appear to have been given considerable attention. Sam sees service as one of his critical success factors to the extent that he almost seems obsessive about it – he feels unable to delegate here. Additionally the branding decision demonstrates that Hair Care is aware of the benefits that can accrue from such an approach. The company has been able to generate a premium pricing strategy by doing this. This not only generates more revenue, it removes the company from the danger of predatory commodity pricing.

The support or secondary value activities have been used to support and develop the primary activities. The firm's infrastructure is simple to operate and understand. Overheads have generally been kept under control. This area may show signs of deteriorating as the number of employees grow and as the debt levels rise, almost an inevitability given the current growth rates but Sam needs to be aware of the dangers that can arise from such a rapid expansion.

Human resource management needs addressing. Negligible staff turnover is often a sound indicator of reasonable morale and sound management. However there is a marked absence of managerial training and succession planning in the organisation. Everything depends on Sam and Annabelle, understandable in a small and entrepreneurial company. However as the company grows there should be more rigorous structures and systems set in place.

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Technology development appears to be satisfactory. There has been a large investment in warehousing, computing and in stock control and retrieval systems. Sam realizes that an efficient distribution facility is critical to the company's success and he is prepared to invest to ensure that this area does not fail him. Similarly procurement is central to the company's operations. The interface between suppliers and the company is seen as being of critical importance and, as such, is given high priority.

There are no obvious, critical weaknesses. Overall the operations are geared towards accessing good value products as competitively as possible. The company operates with minimal overheads and aims to distribute products as efficiently as possible. Customer and supplier care are considered to be important, as is the image of the own-brand products. It appears that Hair Care is using the value chain effectively.

TREADWAY COMMISSION

(a) Distinction between rules-based and principles-based approaches

This case refers to compliance relating to internal control systems in particular but rules and principles are the two generic approaches to corporate governance and depend on the nature of regulation. Rules-based control is when behaviour is underpinned and prescribed by statute of the country's legislature. Compliance is therefore enforceable in law such that companies can face legal action if they fail to comply.

In a principles-based jurisdiction, compliance is required under stock market listing rules but non-compliance is allowed based on the premise of full disclosure of all areas of non-compliance. It is believed that the market mechanism is then capable of valuing the extent of non-compliance and signalling to the company when an unacceptable level of compliance is reached.

Benefits to an organisation of a principles-based

approach There are four main benefits:

(1) It avoids the need for strict compliance with inflexible legislation which, typically, fails to account for differences in size and the risk profiles of specific companies or sectors.

(2) This means that compliance is less burdensome in time and expenditure for the organisation as the minutiae of general legislation can be interpreted in context rather than obeyed in detail.

(3) It allows companies to develop their own sector and situation-specific approaches to internal control challenges. These will typically depend on each company's interpretation of its own internal control challenges. For example, physical controls over cash will be vital to some businesses and less relevant or not applicable to others.

(4) This, in turn, allows for flexibility and temporary periods of non-compliance with relevant external standards on the basis of "comply or explain", a flexibility that would not be possible in a rules-based jurisdiction.

(b) Non-industry specific (i.e. general) advantages of internal controls

The advantages and benefits of internal controls are partly as described in COSO's reasons. The case describes these benefits in terms of enjoying "greater internal productivity and producing higher quality reporting". In addition, internal control underpins investor confidence, ensures compliance with internal and external control measures and facilitates the provision of management reports as needed.

Mr Rogalski is incorrect in his view that controls need to be industry sector specific to be effective. The effective and efficient performance of businesses of all kinds rest on the observance of well-designed and tightly-monitored internal controls. Waste in the form of lost time, wasted resources, faults and other costs are avoided. Efficiency is increased by conformance to standards designed to support productivity. However, the types of controls in place and the systems supporting them will differ from sector to sector.

The information gained from compliance with internal control measures is used in the preparation of content for internal and external reporting. This is especially applicable to the external reporting on internal controls such as under Sarbanes Oxley s.404 which is mandatory in the US. Other national codes have similar provisions.

Where compliance with agreed standards is an important part of the business, internal control data allows for this. This can be industry sector-specific but the general principles of effective control apply to all types of organisations: internal control data is needed to demonstrate compliance. Examples of sector specific internal controls (for managing sector-specific risks) include measures in financial services or those complying with certain ISO standards in their products or processes (e.g. ISO 14000).

Internal controls underpin and cultivate shareholder confidence which is relevant in any industry setting. Acceptable returns on shares rest on conformity with systems to ensure adequate levels of efficiency, effectiveness, security, etc and the avoidance of waste and fraud.

Internal control systems enable the provision of reports and other information as needed by either external agencies or internal management. Although some industries are likely to have a need for external reporting (e.g. nuclear, oil and gas), internal report provision is necessary in any industry.

Tutorial note: *Credit would be given for other relevant points (e.g. from F8 Audit and Assurance).*

"Unmonitored controls tend to deteriorate over time"

This statement refers to the need to establish which controls need to be monitored to support a sound system of internal controls and how to monitor those controls. Once a control system is designed and responsibilities for its management allocated, only those targets and controls that are made a part of someone's job or performance measurement will be monitored and thereby maintained. Any metrics that are not a part of this control regime will go unchecked and may not remain within compliance limits as circumstances change over time. The main roles of internal audit are to provide information to management on the relevance and effectiveness of internal control systems and to provide the evidence to demonstrate why those controls are effective or not. This requires the identification of which controls to monitor and developing effective ways of monitoring those controls.

The complexity of the control regime is also relevant. There is a balance between having a sufficient number of controls in place and having too many. In this context, "too many" means that control systems must be actually useable. Over-complex controls are likely to deteriorate over time if their monitoring is not possible within reasonable cost limits and this could also cause operational inefficiencies.

Furthermore, an organisation is not static and so different controls will be needed over time. As activities change as a result of changes in organisational strategy, the controls that need to be monitored change and the tolerances of those controls may also change (they may become tighter or looser). Constant updating of controls is therefore necessary, especially in frequently changing business environments.

(c) Internal audit testing

This is the internal assessment of internal controls using an internal auditor or internal audit function applying audit techniques to controls based on predetermined measures and outcomes. It is a management control over the other internal controls in an organisation and ensures the levels of compliance and conformity of the internal controls in an organisation.

Roles of internal audit in ensuring effective internal controls

Internal audit underpins the effectiveness of internal controls by performing several key tasks.

Internal audit reviews and reports on the controls put in place for the key risks that the company faces in its operations. This will involve ensuring that the control (i.e. mitigation measure) is capable of controlling the risk should it materialise. This is the traditional view of internal audit. A key part of this role is to review the design and effectiveness of internal controls. Many organisations also require internal audit staff to conduct follow-up visits to ensure that any weaknesses or failures have been addressed since their report was first submitted. This ensures that staff take the visit seriously and must implement the findings.

Internal audit may also involve an examination of financial and operating information to ensure its accuracy, timeliness and adequacy. In the production of internal management reports, for example, internal audit may be involved in ensuring that the information in the report is correctly measured and accurate. Internal audit needs to be aware of the implications of providing incomplete or partial information for decision-making.

It will typically undertake reviews of operations for compliance against standards. Standard performance measures will have an allowed variance or tolerance and internal audit will measure actual performance against this standard. Internal compliance is essential in all internal control systems. Examples might include safety performance, cost performance or the measurement of a key environmental emission against a target amount (which would then be used as part of a key internal environmental control).

Internal audit is used to review internal systems and controls for compliance with relevant regulations and externally-imposed targets. Often assumed to be of more importance in rules-based jurisdictions (e.g. the US) many industries have upper and lower limits on key indicators and it is the role of internal audit to measure against these and report as necessary. In financial services, banking, oil and gas, etc, legal compliance targets are often placed on companies and compliance data is required periodically by governments.

Tutorial note: *Again credit would be given for relevant content from earlier papers, particularly F8.*

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AGREX

The following checklist is based on the Turnbull Guidance for the board to consider (as a minimum) as part of its review process when preparing the annual statement on internal controls.

Risk assessment

- Does the company have clear strategic and operational objectives?
- Have the objectives been fully communicated to provide effective direction to employees on risk assessment and control issues?
- Are the significant internal and external operational, financial, compliance and other risks identified and assessed on a continuous basis?
- Is there a clear understanding by management and others within the company of what risks are acceptable to the board?

Control environment and control activities

- Does the board have clear strategies and policies for dealing with and managing the significant risks that have been identified?
- Do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives, risk management and internal control system?
- Does senior management demonstrate, through its actions as well as its policies, the necessary commitment to competence, integrity and foster a climate of trust within the company?

- Are authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people?
- Are the decisions and actions of different parts of the company appropriately co-ordinated?
- Does the company communicate to its employees what is expected of them and the scope of their freedom to act?

Customer relations.

Service levels for both internal and outsourced activities. Health, safety and environmental protection.

Security of tangible and intangible assets. Business continuity issues.

Expenditure matters.

Accounting, financial and other reporting.

- Do people in the company (and in its providers of outsourced services) have the knowledge, skills and tools to support the achievement of the company's objectives and to manage effectively risks to their achievement?
- How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?

Information and communication

- Do management and the board receive timely, relevant and reliable reports on progress against business objectives (quantitative and qualitative) and the related risks

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Key performance reports and benchmarking key performance indicators. Variance analysis and indicators of chang

Regulatory reports, customer satisfaction and employee attitudes.

- Do they use such reports for decision-making and management review purposes?
- Are information needs (thus related information systems) reassessed as objectives and related risks evolve and as reporting deficiencies are identified?
- Are periodic reporting procedures, including half-yearly and annual reporting, effective in communicating a balanced and understandable account of the company's position and prospects?
- Are there established channels of communication for individuals to report suspected breaches of law or regulations or other improprieties (whistle-blowing)?

Monitoring

- Are there on-going processes embedded in the company's overall business operations which monitor the effective application of the policies, processes and activities related to internal control and risk management?

Control self-assessment and confirmation by personnel of compliance with policies and codes of conduct

Internal audit reviews and specific management reviews

- Do these processes monitor the company's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, its business, and its external environment?
- Are there effective follow-up procedures to ensure that appropriate change or action occurs in response to changes in risk and control assessments?
- Is there appropriate and timely communication to the board (or board committees) on the effectiveness of the monitoring processes on risk and control matters?
- Are there specific arrangements for management monitoring and reporting to the board on risk and control matters of particular importance?

Actual or suspected fraud.
Illegal or irregular acts.

Matters that could adversely affect the company's reputation. Matters negatively impacting financial position.

ULTRA-UBER

(a) "Liquidity risk"

Liquidity risk refers to the difficulties that can arise from an inability of the company to meet its short-term financing needs (i.e. its ratio of short-term assets to short-term liabilities). Specifically, this refers to the organisation's working capital and meeting short-term cash flow needs. The essential elements of managing liquidity risk are, therefore, the controls over receivables, payables, cash and inventories.

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Manufacturing has historically had a greater challenge with the management of liquidity risk compared to some other sectors (especially low inventory businesses such as those in service industries like those that Bob Ndumo is NED for). In the case of UU, this is for three reasons:

(1) Manufacturing usually requires higher working capital levels because it buys in and sells physical inventory, both on credit. This means that both payables and receivables are relatively high. It also, by definition, requires inventory in the form of raw materials, work-in-progress and finished goods, and therefore the management of inventory turnover is one of the most important management tasks in manufacturing management. In addition, wages are paid throughout the manufacturing process, although it will take some time before finished goods are ready for sale.

(2) Manufacturing has complex management systems resulting from a more complex business model. Although other business models create their own liquidity problems, the variability and availability of inventory at different stages and the need to manage inventories at different levels of completion raises liquidity issues not present in many other types of business (e.g. service-based business).

(3) UU has a number of weaknesses that amplify its structural liquidity position as a manufacturer. Its ineffective credit control department and its voluntary 20 day supplier payment policy both increase the short-term cash pressure and thereby increase the likelihood of liquidity risks becoming realised.

(b) Risk embeddedness

Risk embeddedness refers to the way in which risk awareness and management are interwoven into the normality of systems and culture in an organisation. These two twin aspects (systems and culture) are both important because systems describe the way in which work is organised and undertaken, and culture describes the "taken-for-grantedness" of risk awareness and risk management within the organisation.

The methods by which risk awareness and management can be embedded in organisations are as follows:

Aligning individual goals with those of the organisation and building these in as part of the culture. The need for alignment is important because risk awareness needs to be a part of the norms and unquestioned assumptions of the organisation. Training of staff at all levels is essential to ensure risk is embedded throughout the organisation.

Including risk responsibilities with job descriptions. This means that employees at all levels have their risk responsibilities clearly and unambiguously defined.

Establishing reward systems that recognise that risks have to be taken (thus avoiding a "blame culture"). Those employees that are expected to take risks (e.g. those planning investments) should have the success of the projects included in their rewards.Establishing metrics and performance indicators that monitor and feedback information on risks to management. This would ensure that accurate information is always available to the risk committee and/or board, and that there is no incentive to hide relevant information or fail to disclose risky behaviour or poor practice. A "suggestion box" is one way of providing feedback to management.

Communicating risk awareness and risk management messages to staff and publishing success stories. Part of the dissemination of, and creating an incentive for, good practice,

internal communications is important in developing culture and continually reminding staff of risk messages.

(c) Obstacles to embedding liquidity risk management at UU

The case draws attention to three aspects of working capital management at UU: payables, receivables and inventory. All of these are necessary issues in the management of liquidity and hence the reduction of liquidity risk. Specifically, however, it identifies four potential obstacles to embedding the management of liquidity risk. Primarily, however, the individual managers of the company are all acting in isolation and not working together for the good of the company.

The *sales manager's desire to have high levels of finished goods* for maximum customer choice. It is quite reasonable for a sales manager to support high levels of finished goods inventory but there is an inventory-holding cost associated with that which increases the amount of money tied up in working capital. A wider recognition of the overall liquidity pressures on the business would be a very helpful quality in the sales manager and this is a potential obstacle.

The same points apply to the *manufacturing director's desire to have high raw material levels*. Clearly, his effectiveness as head of manufacturing is partly measured by the extent to which the factory fulfils orders and avoids the disruptions to production that arise through inventory "stock-outs". He prefers having raw materials in stock rather than having to order them with a supplier's lead time but this, of course, leads to a greater exposure to liquidity risk.

The *ineffective credit control department*. According to the manufacturing director, the credit control department, responsible for the timely payment of receivables, was poor. The vulnerability to liquidity risk is clearly influenced by days receivable and so an ineffective credit control department is a major obstacle.

Finally, the *CEO's desire to pay payables early* as part of the company's social responsibility efforts. Brian Mills is clearly of the view that offering a voluntary prompt payment of payables is an important component of the company's social responsibility and that is costing the company an average of 10 days payables on most accounts. Over the course of a year that will place a great deal of arguably unnecessary pressure on working capital. The fact that it is the CEO himself that holds this view might make it difficult to change.

(d) Voluntary supplier payment policy

Supplier payment disclosures have become increasingly popular in recent years in some countries as a signal of intent to suppliers that larger buyers will not exploit the economic advantage that they sometimes have over smaller suppliers. It is usual for these statements to announce that all payments will be made in line with the supplier's terms and so UU's intention to voluntarily pay within 20 days is more generous that would usually be expected.

In terms of criticism as a means of demonstrating social responsibility, the case says that the purpose of the policy is to "publicly demonstrate our social responsibility". A key limitation of the policy is, however, that the policy *only focuses on one stakeholder* (suppliers) and apparently ignores other groups. Given the information in the case, the

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social responsibility policy is apparently aimed at one single stakeholder which is an ineffective overall strategy.

Further, it is unlikely that this policy is the best use of resources *if the desire is to "publicly demonstrate" social responsibility*. Measures aimed more at customers or more charitable causes would be likely to attract more publicity if that is the intention.

The policy is *very costly to UU in terms of cash flow*. So much so that the finance director has questioned whether it can actually be afforded, especially at times of a lack of short-term credit, particularly during the global economic recession. It is, of course, a matter of ethical debate as to how committed UU should be to its social responsibility in terms of resources.

Finally, the policy *does not enjoy the support of the other directors* and is thus hard to maintain as an on-going commitment. This means it is vulnerable and susceptible to change if the CEO is the only person who really believes in it. As a part of the company's overall strategic positioning, the components of social responsibility must enjoy widespread support, especially among the senior officers in the company, and arguably most importantly, it must enjoy the support of the finance director.

YGT

(a) Risk assessment

Raz Dutta's beliefs

Raz is wrong in both of her assertions. The belief that risks do not change very much is only true in static environments. In reality, the changeability of risks depends upon the organisation's place on a continuum between highly dynamic and completely static. The case mentions changes in some of YGT's risks and this suggests that there is some dynamism in its environment. Clearly then, her belief is very difficult to defend.

Her belief that risks "hardly ever" materialise may be historically true (but this is also unlikely) but the risk assessment highlighted at least two "likely" risks which could well materialise. Risk D was assessed as "highly likely" and Risk B was also likely with a high potential impact. Neither of these variables would be known were it not for intelligence gained as part of the risk assessment. Importantly, Risk B was a "high/high" risk meaning that it is a likely risk with a high impact once it materialised. Being unaware of this could have caused great damage to the organisation.

Why risks are dynamic and need to be assessed regularly

Risk assessment is a dynamic management activity because of changes in the organisational environment and because of changes in the activities and operations of the organisation which interact with that environment. At YGT, the case describes Risk C as arising from a change in the activity of the company: a new product launch. The new product has obviously introduced a new risk that was not present prior to the new product. It may be a potential liability from the use of the product or a potential loss from the materials used in its production, for example.

Changes in the environment might include changes in any of the PEST (political, economic, social, technological) or any industry level change such as a change in the competitive behaviour of suppliers, buyers or competitors. In either case, new risks can be introduced, existing ones can become more likely or have a higher impact, or the opposite (they may disappear or become less important). The case describes Risk D as arising from a change in legislation which is a change in the external environment.

(b) TARA – Strategies for managing each risk assessment

Risk A is **accept**. This means that the likelihood is low and the impact is low such that even if the risk materialised, it would not have a high severity. The case says that the activity giving rise to Risk A is capable of making good returns so given that both likelihood and severity are low, there is no obvious reason to pursue any of the other strategies with regard to this risk.

Risk B is **avoid**. When the likelihood and impact are high, it would be irrational to accept the risk and so the risk should be avoided. This may involve changing behaviour or discontinuing a certain activity. The case says that the activity giving rise to Risk B is capable of making good returns, but importantly, it is not strategically vital. Given this, and because the case information does not mention the possibility of viably transferring the risk, there is no reason to bear the risk unless the potential return is very large and the company has a high risk appetite.

Risk C is **transfer**. YGT says that the activity giving rise to the risk must not be discontinued (so avoidance is not an option) and specifies that it can be transferred ("alternative arrangements for bearing the risks are possible"). To transfer risk is to share it with another party. The most common way to do this is to insure against losses or to outsource or licence the activity to a third party thereby transferring that risk to that third party.

Risk D is **reduce**. The case emphasises that the risk cannot be transferred (by insurance or outsourcing) but that the activity that gives rise to the risk can be reduced. Reduction involves reducing the risk exposure by carrying out the activity in a different way, doing less of the activity that gives rise to the risk or adopting behaviour that, whilst still exposing the company to the risk, results in a lower impact if the risk is realised.

(c) Related risks and positive correlation

Related risks are risks that vary because of the presence of another risk. This means they do not exist independently and they are likely to rise and fall in importance along with the related one. Risk correlation is a particular example of related risk.

Risks are positively correlated if the two risks are positively related in that one will fall with the reduction of the other and increase with the rise of the other. They would be negatively correlated if one rose as the other fell. In the case of environmental risks and reputation risk, they may be positively correlated for the following reasons.

Environmental risks involve exposure to losses arising from an organisation's consumption of resources or impacts through its emissions. Where an environmental risk

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affects a sensitive situation, (be it human, flora, fauna or other), this can cause negative publicity which can result in reputation damage. These two risks can have a shared cause (i.e. they can arise together and fall together because they depend upon the same activity). They are considered separate risks because losses can be incurred by either of both of the impacts (environmental or reputational).

Activities designed to reduce environmental risk, such as acquiring resources from less environmentally-sensitive sources or through the fitting of emission controls, will reduce the likelihood of the environmental risk being realised. This, in turn, will reduce the likelihood of the reputation risk being incurred. The opposite will also hold true: a reduction of attention to environmental risk will increase the likelihood of reputation loss.

(d) Culture of risk awareness

advice *Explanation*

Risk awareness is a *capability of an organisation* to be able to recognise risks when they arise, from whatever source they may come. A culture of risk awareness suggests that this capability (or competence) is present throughout the organisation and is woven into the *normal routines, rituals, ways of thinking and is taken-for-granted* in all parts of the company and in all employees.

Assessment

Risks can arise in any part of the organisation and at any level. Not all risks are at the strategic level and can be captured by a risk assessment. A culture of risk awareness will help ensure that all employees are capable of identifying risks as and when they arise.

Risks are dynamic and rise and fall with changes in the business environment and with changes in the company's activities. With changes to the company's risk profile occurring all the time, it cannot be assumed that the risks present at the most recent risk assessment will remain the same. Being prepared to adapt to changes is a key advantage of a culture of risk awareness.

A lack of risk awareness is often *evidence of a lack of risk management strategy* in the organisation. This, in turn, can be dangerous as the company could be more exposed to risk than it need be because of the lack of attentiveness by staff. A lack of effectiveness of risk management strategy leaves the company vulnerable to unrecognised or wrongly assessed risks.

PRIVATE, LISTED AND PUBLIC GOVERNANCE

(b) Main principles

Corporate governance is a key element in improving economic efficiency and growth as well as enhancing investor confidence. It involves a set of relationships between a company's management, its board, its shareholders and other stakeholders and also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its

shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, in an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.

Governance is achieved through a variety of ways (e.g. legal requirements placed on all firms, listing requirements and separate "best practice" codes) usually to be applied by listed companies. Where legal procedures are relatively weak, the respective corporate governance code would normally be more detailed.

The OECD principles, for example, detail a number of elements:

The protection and facilitation of the exercise of shareholders' rights.
Ensuring the equitable treatment of all shareholders, including minority and foreign shareholders with the opportunity to obtain effective redress for violation of their rights.
Recognising the rights of stakeholders established by law or through mutual agreements and encouraging active co-operation between corporations and stake-holders in creating wealth, jobs, and the sustainability of financially sound entities.
Ensuring that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
Ensuring the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

In a number of jurisdictions, some of the above principles (e.g. protection of shareholder rights and disclosure of information) are already enshrined in corporate law.

Tutorial note: *Using another basis (e.g. the UK Code) would obtain the marks just as well.*

(c) State owned enterprises and the public sector

The Commonwealth Association for Corporate Governance (CACG) issued a set of Guidelines in 1999 wherein it was stated that most of the largest and economically significant industries in many jurisdictions are state-owned and that many of their directors are not independent as their appointments are often politically motivated. The guidelines also noted that there was a severe shortage of skilled individuals to act as company directors.

State-owned entities differ from public companies in that the directors of these concerns have a duty to the taxpayers and to the community as a whole, compared to the fiduciary relationship between shareholders and the board of directors in private companies.

The guidelines also suggested that sound corporate governance in state-owned enterprises is of particular importance in developing economies because they provide a role model for companies in the growing private sector to encourage more ethical corporate governance.

However, with the growth of "best practice" in the private sector, many governments are taking a lead in applying similar governance requirements on state owned enterprises. Even if such enterprises are not in direct competition with private companies, their

stakeholders (e.g. the taxpayers) are demanding stronger leadership, transparency and accountability from such enterprises.

Many governments are also introducing corporate best practice into the general areas of public services (e.g. local authorities, health service and transport). The UK's Seven Principles of Public Life (Nolan Report) are a good example of implementing corporate governance in the public service. The principles cover:

(d) **Selflessness** – holders of public office should act solely in terms of the public interest. They should not do so in order to gain financial or other material benefits for themselves, their family, or their friends.

(e) **Integrity** – holders of public office should not place themselves under any financial or other obligation to outside individuals or organisations that might seek to influence them in the performance of their official duties.

(f) **Objectivity** – in carrying out public business, including making public appointments, awarding contracts, or recommending individuals for rewards and benefits, holders of public office should make choices on merit.

(g) **Accountability** – holders of public office are accountable for their decisions and actions to the public and must submit themselves to whatever scrutiny is appropriate to their office.

(h) **Openness** – holders of public office should be as open as possible about all the decisions and actions that they take. They should give reasons for their decisions and restrict information only when the wider public interest clearly demands.

(i) **Honesty** – holders of public office have a duty to declare any private interests relating to their public duties and to take steps to resolve any conflicts arising in a way that protects the public interest.

(j) **Leadership** – holders of public office should promote and support these principles by leadership and example.

A further example is the report by the Independent Commission for Good Governance in

Public Services where six principles of good governance were identified:

(b) Focusing on the organisation's purpose and outcomes for citizens and service users.

(c) Performing effectively in clearly defined functions and roles.

(d) Taking informed, transparent decisions and managing risk.

(e) Developing the capacity and capability of the governing body to be effective.

(f) Engaging stakeholders and making accountability real.

(g) Promoting values for the whole organisation and demonstrating the values of good governance through behaviour.

In conclusion, the above examples show that the principles of good corporate governance can just as easily be applied to public services as to private and listed companies.

- **Agency and stakeholders in the public sector**

In a private sector company, agents are usually the company's directors with the company's shareholders being the principals. The directors have a fiduciary duty to maximise the long-term value of the business to the benefit of the shareholders. The shareholders set the directors the objective of maximising their return.

Within the public sector there are no shareholders, but there are individuals and other participants that provide the equivalent financing (i.e. corporate and individual taxpayers through direct or indirect taxation). In the majority of cases, the taxpayers are also the users of the services provided by the public sector. Just as in the private sector, shareholders are stakeholders, so taxpayers and service users are stakeholders within the public sector.

Private sector directors have a fiduciary duty based around generating profits and investing wisely. For the public sector, profits are not the key objective but the delivery of appropriate services efficiently, effectively and economically (the "3Es") are.

Efficiency is about delivering an agreed (acceptable to stakeholders) level of service for less cost, time or effort. It is about the action taken.

Effectiveness concerns delivering a better (continually improving) service or getting a better "return" for the same amount of expense, time or effort of the resources used. It is about achieving results.

Economy is the careful use of resources to save expense, time or effort. This will be about the delivery of a service within the appropriate constraints.

Public sector value for money can often lead to conflicting views, very often based upon political stances. First of all the social purpose and social contract has to be agreed. Some stakeholders, through their stakeholder claims, will agree a particular service is needed, others will not. Some will consider the service to be value for money (e.g. the public funding of a high speed railway link) others will consider such extravagance to be a total waste of money and that the money could have been more effectively used in other areas (e.g. education or health).

Although the concepts of agency and stakeholders are easily understood for public services at a basic level they are far more complex in practice.

STAKEHOLDERS, DIRECTORS AND FIDUCIARY DUTIES

(a) Stakeholder groups

The range of stakeholders includes many diverse groupings (e.g. shareholders, directors/managers, lenders, employees, suppliers (materials and services), customers, governments, communities and the environment).

Tutorial note: *Only FIVE were asked for. If more than five were listed, ensure you only discuss, as below, five. Marks will only be awarded based on five.*

These groups are likely to share in the wealth and risk generated by a company in different ways and thus conflicts of interest are likely to exist. Conflicts also exist not just between groups but within stakeholder groups. This might be because sub groups exist (e.g. preference shareholders and equity shareholders). Alternatively it might be that individuals within a group have different preferences (e.g. to risk and return, short term

and long term returns). Good corporate governance is partly about the resolution of such conflicts.

Stakeholders' financial and other objectives may be identified as

follows: *Shareholders*

Shareholders are normally assumed to be interested in wealth maximisation. This, however, involves consideration of potential return and risk. Where a company is listed this can be viewed in terms of the share price returns and other market-based ratios using share price (e.g. price earnings ratio, dividend yield, earnings yield).

Where a company is not listed, financial objectives need to be set in terms of accounting and other related financial measures (e.g. ROCE, EPS, gearing, growth, profit margin, asset utilisation, market share). Other measures may collectively capture the objectives of return and risk.

Shareholders may have other objectives for the company and these can be identified in terms of the interests of other stakeholder groups. Thus, shareholders, as a group, might not only be interested in wealth maximisation but also profit maximisation (to be reinvested in the business rather than distributed) the welfare of their employees or the environmental effects of the company's operations.

Directors and managers

While directors and managers are in essence attempting to promote and balance the interests of shareholders and other stakeholders it has been argued that they also promote their own interests as a separate (internal) stakeholder group regardless of their fiduciary duties.

This arises from the divorce between ownership and control where the behaviour of managers cannot be fully observed giving them the capacity to take decisions which are consistent with their own reward structures and risk preferences. Directors may thus be interested in their own compensation package including payment for losing their job in the event of a takeover or early retirement.

In a non-financial sense, they may be interested in building empires, exercising greater control, or positioning themselves for their next promotion. Non-financial objectives are sometimes difficult to separate from their financial effects.

Lenders

As connected stakeholders, lenders are concerned to receive payment of interest and ultimate re-payment of capital.

They do not share in the upside of very successful organisational strategies as the shareholders do. They are thus likely to be more risk averse than shareholders, with an emphasis on financial objectives that promote liquidity and solvency with low risk (e.g. gearing, interest cover, security, cash flow).

Non-financial interests are few, but a typical semi-financial interest is the kudos attached to the sponsorship of a major event (e.g. Wimbledon tennis tournament, test cricket matches, Formula One).

Employees

The primary interest of employees (as internal stakeholders) is their salary/wage and security of employment. To an extent there is a direct conflict between employees and shareholders as wages are a cost to the company and a revenue to employees.

Performance-related pay based on financial or other quantitative objectives may, however, go some way toward drawing the divergent interests together.

Non-financial interests of employees would cover the workplace environment and perhaps the status of working for a particular organisation.

Suppliers and customers

Suppliers and customers are external stakeholders with their own set of objectives (profit for the supplier and, possibly, customer satisfaction from the goods or services received) that, within a portfolio of businesses, are only partly dependent on the company in question.

Nevertheless it is important to consider and measure the relationship in terms of financial objectives relating to quality, lead times, volume of business, price and a range of other variables in considering any organisational strategy.

(c) Fiduciary duties

A fiduciary duty is one that is imposed on certain persons because of the position of trust and confidence in which they stand in relation to another. The duty is more onerous than generally arises under a contractual or tort relationship. It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflicts of interest.

Under English law, for example, the fiduciary duties of directors (as derived under common law) to the company include:

To act in good faith in the best interests of the company and promote the success of the company;
To act within the powers conferred by the company's constitution and exercise powers for proper purposes;
Not to restrain discretion (must use independent judgement on the company's behalf);
To avoid conflicts of interest and conflicting duties;

Not to make a secret profit (includes accepting benefit or bribes from third parties);

To exercise due skill and care in the performance of their duties.

A director must act in a way that they consider, in good faith, would be most likely to promote the success (i.e. long-term increase in value) of the company for the benefit of its members as a whole. This duty adds a focus of "enlightened shareholder value" which must take (at least) into account:

- the likely consequence of any decision in the long term;
- the interests of the company's employees;

- the need to foster the company's business relationships with suppliers, customers and others;
- the effect of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between the members of the company.

This appears to be moving agency fiduciary duties into the realm of stakeholder theory.

- **How good corporate governance procedures can help manage the problems**

Corporate governance is the system by which organisations are directed and controlled.

Where the power to direct and control an organisation is given, then a duty of accountability exists to those who have devolved that power. Part of that duty of accountability is discharged by disclosure both of performance in the normal financial statements but also of the governance procedures themselves.

The UK Corporate Governance Code is an example of a principles based code. Although it has mandatory application for companies listed on the London Stock Exchange, there is an overall "comply or explain" provision. Thus any divergence from the requirements of the code must be explained.

In deciding on which of the divergent interests should be promoted, the directors have a key role. Much of the corporate governance regulation in the UK (including the Corporate Governance Code) has therefore focused on the control of this group and disclosure of its activities. This is to assist in controlling their ability to promote their own interests and make more visible the incentives to promote the interest of other stakeholder groups.

A particular feature of the UK is that Boards of Directors are unitary (i.e. executive and non-executive directors sit on a single board). This contrasts to Germany for instance where there is more independence between the groups in the form of two-tier boards (where directors on a management board report to the non-executive directors of a supervisory board).

Particular corporate governance features in the UK'S Corporate Governance Code include:

- independence of the board with no covert financial reward;
- adequate quality and quantity of independent non-executive directors to act as a counterbalance to the power of executive directors (at least 50% of the board);
- remuneration committee (to decide on the remuneration of executives) that is 100% independent non-executives;
- appointments committee (to recommend appointments to the board) comprising a mix of executive and independent non-executives with no one group being able to dominate;
- audit committee, comprising 100% non-executive directors, responsible for overseeing the financial integrity of the company and financial statements (including external auditors, their work and fees and internal auditors);
- separation of the roles of chairman and chief executive to prevent concentration of power;

- full disclosure of all forms of director remuneration including shares and share options;
- dialogue with institutional shareholders and encouraging private investors to participate in the annual general meeting (AGM); and
- maintaining a sound system of internal control (based on risk assessment) to safeguard shareholders' investment and the company's assets.

Overall, the visibility given by corporate governance procedures goes some way toward discharging the directors' duty of accountability to stakeholders and makes more transparent the underlying incentive systems of directors.

DING COMPANY

(a) Director's induction programme

The overall purpose of induction is to minimise the amount of time taken for the new director to become effective in his new job. There are four major aspects of a director's induction.

To convey to the new starter, the organisation's norms, values and culture. This is especially important when the new employee is from a different type of culture. Because Sam moved from a different country to join Ding Company, he had to adjust to a new national culture as well as a new corporate culture. There is evidence from the case that he misunderstood some of the cultural norms in that it was alleged that he made what he considered normal but what was perceived as an inappropriate remark to a young female employee. An induction programme including content on culture and norms may have prevented this situation from occurring.

To communicate practical procedural duties to the new director including company policies relevant to a new employee. In Sam's case this would involve his orientation with his place in the structure, his reporting lines (up and down), the way in which work is organised in the department and practical matters. In the case scenario, Sam made a simple error in the positioning of his office furniture. Again, this is an entirely avoidable situation had the induction programme provided him with appropriate content on company policy in this area.

To convey an understanding of the nature of the company, its operations, strategy, key stakeholders and external relationships. For a new director, an early understanding of strategy is essential and a sound knowledge of how the company "works" will also ensure that he adapts more quickly to the new role. In the case of a financial controller such as Sam, key external relationships will be with the company's auditors and banks. If Sam is involved in reporting, the auditor relationship will be important and if he is involved in financing, the banks and other capital providers will be more important.

To establish and develop the new director's relationships with colleagues, especially those with whom he will interact on a regular basis. The importance of building good relationships early on in a director's job is very important as early misunderstandings can be costly in terms of the time needed to repair the relationship. It is likely that Sam and Annette will need to work together to repair an unfortunate start to their working relationship as it seems that one of her first dealings with him was to point out his early misunderstandings (which were arguably due to her failure to provide him with an appropriate induction programme).

(b) Critically evaluate Annette's belief

Countries differ in their employment of various types of board structure. Companies in the UK and US have tended towards unitary structures while Japanese companies and some European countries have preferred two–tier or even multi-tier boards. The distinction refers to the ways in which decision-making and responsibility is divided between directors.

In a unitary structure, all the directors have a nominally equal role in board discussions but they also jointly share responsibility (including legal responsibility) for the outcome of those discussions.

On a two tier board, the senior board acts as a "kitchen cabinet" in which decisions are concentrated while other directors, typically departmental managers, will be on the "operating board" and brought into board discussions where the senior (upper tier) board deem it appropriate.

There are some arguments in favour of the adoption of a two-tier structure in turbulent environments. As the case implies, turbulent and dynamic environments change often and strategic leadership is partly about continually adjusting strategy to optimise the company's fit with its environment. A smaller board can act quick and decisively in a way that larger and more cumbersome boards cannot. This is because meetings of larger numbers of people require excessive consultation, discussion and debate before a decision can be reached.

When a decision needs to be taken quickly, this can be inconvenient. The meeting of a small number of people is therefore easier, cheaper and quicker to arrange because there are fewer diaries to match. As these arguments focus on both the efficiency and effectiveness of strategic decision-making, Annette has a strong case for supporting two-tier boards.

Arguments against two-tier boards

- In any complex situation where finely balanced judgments are made, such as making strategic decisions in turbulent environmental conditions, input from more people is likely to provide more views on which to make the decision. Where, say, technical, detailed financial or operational details would be of benefit to the decision then a larger board would be likely to provide more feedback into the decision making process.
- Decisions taken by a corporate board with little or no consultation with the operating board may not enjoy the full support of those key departmental directors who will be required to implement the decision. This, in turn, may cause friction, discord and resentment that will hinder good relations and thus impede the implementation of the strategy.
- Additionally, without a full understanding of operations, an inappropriate decision may be taken by the corporate board and unworkable procedures implemented.
- Finally, Annette is quite an autocratic personality and the two-tier board may be little more than a device to grant her excessive powers over company strategies and activities.

(c) Arif Zaman's understanding of his role

The first observation to make is that, overall, Arif Zaman has a poor understanding of his role as chairman and poorly represents the interests of Ding's shareholders. He does not seem to understand his role as intended by Cadbury, Sarbanes Oxley and other influential codes on corporate governance.

It appears from the case that he cedes too much power to Annette. One of the purposes of having a separate chairman is to avoid allowing the chief executive to operate without recourse to the chairman. The chairman, along with the non-executive directors, should hold the chief executive to account.

Arif allowed Annette's views to take effect on matters such as board structure. Arif is legally head of the board and not Annette. Ding's shareholders have a reasonable expectation that Arif will personally ensure that the strategic oversight of the board will be a matter for the chairman who is, notionally at least, an independent non-executive director.

Being old friends with Annette threatens Arif's independence as chairman. Is he acting as a representative of the shareholders or as Annette's friend? He seems to be doing the job as a favour to Annette and seems to see no intrinsic value in his role in terms of acting to provide checks and balances on the activities of the executive board and the chief executive in particular.

Arif seems to view the chairing of board meetings as optional. He said that he saw his role as "mainly ceremonial" and that he "chaired some board meetings when he was available". Both of these attitudes are inappropriate and demonstrate an underestimation of the importance of the chairman in leading the company and its strategy.

SONIA TAN

(a) Agency costs

An agency cost is a cost incurred by the shareholder in monitoring the activities of company agents (i.e. directors). Agency costs are normally considered as "over and above" existing analysis costs and are the costs that arise because of compromised trust in agents (directors). In this case, the increased agency costs that arise are the increased monitoring and "policing" costs that Sentosa House (Sonia) will incur because of the irregular behaviour described in the case.

The first problem identified is Eastern's non-compliance with relevant codes/requirements in respect of non-executive directors and committee structure. There are an insufficient number of NEDs to form the normal committee structure for a public company which means that Sentosa may consider itself to have to monitor some of the risks to Eastern that otherwise the risk committee would undertake.

The investor relations department shows evidence of being unhelpful and uninformed – an unfortunate combination of failings. The chairman appears to be arrogant and potentially untrustworthy (he saw no need for risk committee and dealt very abruptly with Sonia when she called). Finally, the company is pursuing risky strategies with no obvious explanation as to why such strategies are necessary.

In this situation, then, Sentosa House has the choice of selling its holding in Eastern or incurring increased monitoring costs to ensure that its own investors' interests, in turn, are adequately represented.

(b) Institutional investor intervention

Intervention by an institutional investor in a company whose stock it holds is usually considered to be radical step and normally represents a step change in agency costs for the investor. This caveat notwithstanding, it is an important "last resort" for institutional

investors to have available to them as they seek to adequately represent the interests of their own investors.

There are a number of conditions under which it would be appropriate for institutional investors to intervene in a company whose shares it is holding:

- Concerns about strategy in terms of products sold, markets serviced, expansions pursued or any other aspect of the company's overall strategic positioning.
- Its operational performance may give rise, especially if there are one or more segments that have consistently underperformed without adequate explanation.
- When non-executive directors do not hold executive management to account. There may, for example, be evidence of unaccountable "kitchen cabinets" or curious executive decisions that are not adequately challenged by nonexecutive directors.

- Consistent or serious failure in internal controls would justify intervention, although this, in turn, may become evident through operational underperformance. On-going or unaddressed failures in, for example, quality assurance, health and safety, environmental emissions, budgetary control or information systems might justify intervention.
- Failing to comply with the relevant code, laws or stock market rules is the next situation. If the company is listed in a rules-based jurisdiction, it is a matter of law but in a principles-based country, compliance is only "optional" under the stock market's "comply or explain" rules. Consistent or unexplained non-compliance is like to be penalised by the market.
- Inappropriate remuneration policies, if extreme or obviously self-serving, might attract intervention. Such a situation would normally also signify a failure of the remunerations committee which would make it a double cause for concern.
- A poor approach to social responsibility is a condition for possible intervention, especially if there is publicly-available evidence that might adversely affect the reputation of the company.

With reference to the case, Eastern Products fail on three counts that might encourage institutional shareholder intervention:

(1) its failure to comply with relevant code (particularly on number of non-executive directors and lack of risk committee);
(2) the NEDs are not holding executives to account because there is an insufficient number of them;
(3) there are concerns about strategy (which is considered to be very risky).

(c) Risk committee

Risk committees are considered best practice by most corporate governance regimes around the world for a number of reasons. Sonia has, for good reason, doubts over the competence and good faith of the management of Eastern Products and a risk committee made up of non-executive directors could help her confidence in a number of ways.

In the first instance, the information systems put in place to provide information for the risk committee. This would generate awareness of and facilitate review of all relevant risks for discussion by the risk committee, including those arising from the "very risky" strategy.

It would review and assess the effectiveness of internal controls on risk. A committee made up of independent, non-executive directors would bring scrutiny to Thomas on two fronts. There is evidence that Thomas may be relatively inexperienced, having been in post for only two years, and the way that he dealt with Sonia's entirely legitimate enquiry

shows some evidence of immaturity and/or impatience. Non-executive presence would be able to challenge and act as a counterweight to this failing. Non-executive directors would also bring scrutiny of Thomas's leadership over strategy, especially (in the context of the risk committee) the wisdom of his "very risky" strategies.

(d) Principles-based jurisdiction

The opinion shows confusion over the meaning of the term "compulsory". Although, in a principles-based jurisdiction, compliance is not legally compulsory, it is required for the stock market listing. Therefore, compliance is effectively compulsory if the company wishes to enjoy the benefits of its listing. Companies in principles-based jurisdictions are subject to "comply or explain" in that non-compliance needs to be explained in terms of specific areas of non-compliance and the reason for noncompliance.

Compliance is also necessary for market confidence in the Eastern Products stock in that the market would be likely to devalue a stock that was a consistent non-complier. Finally, shareholders and stock markets are entitled to challenge the explanation for non-compliance if they are not satisfied with the explanation given in the annual report.

GEELAND

(a) Rules and principles-based approaches to corporate governance *Distinction*

There are two broad approaches to the regulation of corporate governance provisions: rules-based and principles-based. In a rules-based country (jurisdiction), all provisions are legal rules, underpinned by law, transgression against which is punishable in law. Often characterised as a "box ticking" approach, full compliance is required by all companies at all times (excepting where dispensations are granted, again, under the provisions of the law).

In a principles-based jurisdiction, legal force applies to the provisions of company laws but additional listing rules are enforced on a "comply or explain" basis. It is important to note that compliance is not voluntary in that the provisions can be ignored, but that provisions may not be complied with in full, usually for a limited period if the full reason for non-compliance is explained to the shareholders. This allows for the market to judge the seriousness of the non-compliance and to potentially re-appraise or revalue the company as a result.

Critical evaluation of stock exchange guidance

The remark in the Geeland Code strongly argues in favour of a principles-based approach to corporate governance. In particular, it is critical of rules-based codes that would, for example, place a blanket ban on combining the roles of chairman and chief executive. In order to allow for differences between circumstances, it is arguing for flexibility and "common sense".

Arguments for

In most cases, compliance with general principles is cheaper than compliance with a detailed "box ticking" regime. A common criticism of rules-based approaches is the

expense of compliance including the establishment of information systems to meet reporting requirements (for example on internal controls), consultancy costs, increased management costs and reporting costs. Where some flexibility is possible, the principles-based approach allows some "common sense" to be employed in the extent of detailed compliance.

A principles-based approach is flexible and allows companies to develop their own approach, perhaps with regard to the demands of their own industry or shareholder preferences. This places the emphasis on investor needs rather than legal demands. There may be no reason, for example, why companies in lower risk industries should be constrained by the same internal control reporting requirements as companies in higher risk industries. As long as shareholders recognise and are satisfied with this, the cost advantages can be enjoyed.

An example of the flexibility afforded by a principles-based approach is that it allows for transitional arrangements and unusual circumstances. Details such as the contract terms of directors may need to be varied to meet individual needs or the notice periods might similarly be varied. In the event of a sudden, unexpected change such as a death in service, a company can enter a phase of technical non-compliance but, with suitable explanation of the reason for non-compliance, most shareholders will nevertheless be satisfied.

It avoids the need for expensive and inconvenient monitoring and support structures, the costs of which are ultimately borne by the companies themselves (through stock market or regulatory bodies) or by the taxpayer. The costs and inconvenience of policing compliance with rules has been shown to be material in some situations, especially in smaller companies. Similarly, the costs of a large national "watchdog" to monitor and enforce detailed compliance are considerable.

Arguments against

There may be confusion over what is compulsory under law and what is principles-driven under listing rules. A lack of clarity might be present, especially where compliance expertise is not available to management (such as in some smaller companies) between legally-required compliance and listing rules which are subject to comply or explain. This may confuse some management teams and cause non-compliance borne of lack of advice and information.

A principles-based approach assumes that markets are capable of understanding the seriousness of any temporary or lengthier periods of non-compliance and of revaluing the shares as a result. Non-specialist shareholders may not understand why a given provision is not complied with nor appreciate the potential consequences of the non-compliance. Cleverly-worded comply or explain statements might mislead shareholders.

A "box ticking" approach offers the advantage of gaining full compliance at all times (i.e. all boxes are actually ticked) whereas a principles-based approach allows some bad practice to continue. A full compliance regime is likely to provide a greater overall confidence in regulation and this, in turn, will further support long-term shareholder value.

A rules-based approach provides standardisation and prevents any individual companies gaining competitive or cost advantages with lower levels of compliance. This creates a "level playing field" in which all competitors in an industry understand what is required.

(b) Separation of roles of chairman and chief executive

The strongest and most common reason for the separation of these roles is to avoid the dangers of unfettered power that may arise when power is concentrated in a single, powerful individual. The original proposition for the separation of roles was in the UK's Cadbury Report in 1992 which was itself a response to a number of corporate "scandals", similar to those in Geeland, involving unfettered power and the abuse of shareholder wealth as a result.

Accountability is better served by the separation of roles because the chief executive has a named person, in addition to the non-executive directors (NEDs), to whom he must account for the company's performance and his own behaviour. This serves to protect against conflicts of interest where chief executives may be tempted to act in their own self-interest rather than to serve the best interests of the shareholders.

Further, both roles are complex and demanding. In large companies, it is likely that the two roles cannot be carried out effectively by one person. By gaining the advantages of a separation of duties (and hence a division of labour), the performance of the company's management in total will be enhanced. The two roles are materially different in terms of their skills, and it enhances organisational effectiveness for one to chair the board (chairman) and another, with different skills, to manage the strategy of the company. It is usual for the chairman role to be undertaken by a NED, whilst the chief executive is an executive director. Having this distinction at the top of the company allows the chief executive to be hands on and directly involved in the management of the company, whilst the chairman can adopt a more supervisory position.

Finally, it is considered best practice because it provides a reassurance to investors and ensures compliance with relevant codes. Investor confidence in company management is very important and this is enhanced by having a transparent and clear separation of roles. Where codes specify separation and this can be demonstrated, unlike at Anson Company, unqualified comply or explain statements can be issued thereby promoting investor confidence.

(c) Assessment of "comply or explain" statement

The statement clearly identifies the one area of non-compliance and represents a full discharge of the company's reporting obligation to comply or explain. In a principles-based jurisdiction, this statement is required under listing rules and involves informing shareholders of the level of compliance and also specifying any areas of non-compliance, which the company has done in this case.

It is clear and free of ambiguity in what it says. Clearly though, one area of non-compliance is explained. The area of non-compliance is identified and the individual is named. The naming of William Klunker may be material because if he is known and trusted by shareholders, the breach may be less important than if he were less known and less trusted.

It does not provide a good reason for the non-compliance other than saying that it was "benefiting from having Mr Klunker in control" which might be seen as weak by some investors. The reasons for combining the roles in July 2009 are not given and so it could probably be argued that this is not a full explanation.

It does, however, provide a date for returning to full compliance against which management can be held accountable for failure. This will reassure investors that its period of non-compliance is temporary and the default position of the company is to remain in full compliance with the relevant code.

RAILWAY DEVELOPMENT COMPANY

(a) Tucker and Route A

Is the decision to choose Route A profitable?

Yes. This will be cheaper for the company (RDC) because it avoids the need to make the compulsory purchase of Mr Krul's farm. This will save the company $1 million and enable a profit to be made, over 10 years, of $5 million. The equivalent 10-year profit figure for Route B would, accordingly, be $4 million.

Is it legal?

The case says that both routes (A and B) had been given planning permission, so there is no difference between them on matters of legality. Route A is a legally allowable option as it has planning permission from the local government authority.

Is it right?

This depends upon the ethical perspective adopted. Route A would deliver a higher profitability for RDC and also preserve important local social and economic benefits by keeping Mr Krul's farm. The farm supports local jobs, perhaps has an important role in the local community and, being a farm, provides a source of local food. If these benefits are seen as more important than the future of the birds, then it is right to choose Route A. If the claim of the birds and their impact on the local ecosystem is more important than the profitability of the project and the benefits provided by the farm, then it was wrong to choose Route A.

Is it fair?

This depends upon how the legitimate and reasonable claim of Mr Krul to remain on his land is weighed against the claim of the colony of birds to survive. The choice of Route A ignores the claim of the birds' right to gain access to their feeding site and because the birds are endangered, it may threaten their future. It is fair to Mr Krul, but unfair to the colony of birds. Mr Krul, however, employs people who would otherwise lose their jobs, potentially having a negative impact on them and their families. In addition, the farm has been in Mr Krul's family for four generations and that may also be a relevant factor when considering the fairness of the decision.

Is it sustainable and/or environmentally acceptable?

Route A was probably the less environmentally-sustainable of the two options. Because Route A was chosen, it will mean destroying the important feeding site for the colony of threatened birds. This will threaten the population of these birds and the case suggests

that this may represent a threat to the environmental sustainability of local ecosystems. The loss of the feeding ground and the birds may therefore have other unforeseen environmental consequences. Whichever route is chosen, an environmental benefit may accrue because of the replacement of car journeys with increased rail travel.

Summary

The company chose to prioritise cost-savings and the impact of the farm on the local community over the negative environmental impact that Route A entailed. This may have something to do with Eddie Krul having a louder "voice" than the birds and so more able to express his claim than the voiceless birds (the pressure group did not speak up until after the decision was made). RDC essentially had two choices which would both have had negative effects on some of the stakeholders. It chose to take the decision that was less sustainable but more favourable to shareholders and the stakeholders in the farm.

(b) Stakeholder recognition

A decision such as the selection of a new route for a major construction project is bound to create "winners" and "losers". In most projects it is important to identify and recognise the claims of all of the stakeholders for several reasons:

- It is necessary to gain an understanding of the sources of potential risk and disruption. "Save the Birds", for example, has threatened to disrupt the construction of Route A as it seeks to protect the birds' feeding ground. Mr Krul, similarly, threatened to bring legal action in the event that Route B was chosen.
- It is important in terms of assessing the sources of influence over the objectives and outcomes for the project (such as identified in the Mendelow model). Stakeholder influence is assessed in terms of each stakeholder's power and interest, with higher power and higher interest combining to generate the highest influence.

BIGGO

(a) Rights and responsibilities

The comment by Albert Doo identifies rights and responsibilities as being two essential characteristics of citizenship, be it human or organisational in nature. In the same way that individuals have rights and responsibilities in society, so do business organisations such as Biggo. The question asks about rights and responsibilities in the context of Biggo.

A right is an expectation of the benefits that Biggo can receive, by virtue of citizenship, from society. Biggo can expect the right to have the freedom to conduct business by engaging in resource and product markets, to enjoy the protection of the law and the goodwill of other members of society in supporting the right of the organisation to exist, to innovate and grow. Biggo had the right, for example, to expect fair treatment under law in respect of its planning application (and in fact received this permission).

A responsibility is a duty owed, by the citizen (in this case, Biggo), back to society as a quid pro quo for the extension of rights. These are owed by virtue of the citizen's membership of society. In most societies, responsibilities extend to compliance with all relevant laws and regulations, including the payment of taxes, and compliance with the behavioural norms of that society. Biggo, along with all other businesses, has a number

of legal and ethical responsibilities but it is the extent to which the ethical responsibilities are recognised that is the subject of dispute along the Gray, Owen & Adams continuum.

Interpretation at the two ends of Gray, Owen & Adams "continuum"

Gray, Owen & Adams described seven possible positions that can be adopted on a company's relations with its stakeholders. These concern the ethical assumptions of the roles of a business in society and are as follows: the pristine capitalist, the expedient, the social contractarian, the socialist, the social ecologist, the radical feminist and the deep green. The range of views along this continuum are primarily characterised by the ways in which they interpret the rights and responsibilities of business.

Broadly speaking, the nearer to the pristine capitalist end of the continuum, the greater the rights of shareholders and the fewer their responsibilities to a wider constituency. Conversely, the nearer the "deep green" end of the continuum, the fewer the perceived rights and the greater the responsibilities of the company and its agents to a more widely defined group of stakeholders.

At the "pristine capitalist" end of the continuum, rights and responsibilities are understood principally in terms of economic measures. The company has the right to pursue its legal business activity and to develop that business with the support of society and the governing authorities. In return, its responsibilities are limited to the profitable production of goods and services and, accordingly, the generation of profits that are entirely attributable to shareholders. It is not the responsibility of businesses to pursue any other social, environmental or benevolent end. In this context, it is clearly not the company's responsibility to use shareholders' money to contribute to the new children's play area.

At the socialist-to-green end of the continuum, it is argued that businesses like Biggo have fewer (and contestable) rights and much greater responsibilities. According to positions at the deep green end, Biggo, does not, for example, have the right to consume non-sustainable resources "simply" for the purposes of wealth creation. They may not have the moral right, even if they have a legal right, to build on the community's play area. At the same time, Biggo has a wide responsibility to society and to the environment that might seriously constrain their behaviour and activities.

(b) Which positions are best described? *Robert Tens*

Robert is closest to the expedient position. The expedient position is one in which social responsibility is seen in terms of what return can be gained from social responsibility policies and actions. In other words, it may be expedient to adopt social responsibility actions but only if by doing so, it furthers its strategic interests. The expedient position does not recognise any implicit social responsibility as such and social policies are therefore only pursued if a clear strategic rationale can be identified for them.

His comment considers the actions towards the community in terms of cultivating current and future employees: it is an exercise of specific stakeholder management with the key stakeholder being the local community. By engaging in activities that give the appearance of being socially responsible (i.e. making the requested donation) other economically

advantageous ends can be achieved. He highlighted three strategic benefits that might arise:

(1) it might "cultivate the company's reputation";
(2) specifically in order to "help in future recruitment";

(3) it might "help to reduce resistance to any future expansion the company might need to make".

He clearly sees the donation in instrumental terms.

Margaret Heggs

Margaret's comment is closest to the pristine capitalist position. Her comment suggests that she believes that the social responsibilities of Biggo do not extend beyond the social benefits it already provides through employment and the provision of "excellent products". The purpose of Biggo is not to engage in costly social responsibility measures such as community donations, even if they can be shown to have a positive strategic benefit. That is not the purpose of a business. In accepting that the company had "no further contractual or ethical duties to the local government nor to the local community", she was demonstrating a pristine capitalist perspective.

(c) Social responsibility and short and long-term shareholder interest perspectives *Definition*

"Social responsibility" refers to the belief that companies such as Biggo must act in the general public interest as well as in the specific interest of their shareholders. This can apply to the company's strategy and the way in which the company is governed, but Albert is referring to the specific social footprint that the company has locally. It can also apply to the environmental footprint that a company has (i.e. the effect of company activities on resource consumption or the effect that emissions from operations have). It is possible to interpret this phrase narrowly, as Margaret has done, or more widely, as Albert has.

Short and long-term perspectives

Tutorial note: *This question recognises that the attitude that a company may take towards a particular stakeholder claim can vary when a time perspective is introduced.*

A short-term perspective is likely to consider a time period of days, months or perhaps up to a given financial year in terms of an action affecting short-term performance. A longer-term perspective, typically looking to years rather than months ahead, is likely to consider the legitimacy of a claim in terms of its effect on long-term shareholder value.

In the short term, Biggo may see the claim from Albert, on behalf of the community, as a cost because a "sizeable" contribution would have an effect on the profit for the year and hence the return to the shareholders. The case mentions that profits are likely to be low in the current year and so all costs should be carefully scrutinized for value for money and reduced or eliminated if possible. As Biggo is a public listed company, a short-term reduced profit can erode shareholder value because of reduced dividends and a potential reduction in share price.

In the longer term, Biggo can be seen to be cultivating two potentially key stakeholders (Albert and the local community) and hence may create longer term value in terms of the advantages identified by Robert (e.g. local employees and lower resistance to future factory enlargements). The case mentions the resistance from the local community and, given that the company will have to "live with" the community for many years to come, it may be in Biggo's long-term strategic interest to do what it reasonably can to reduce any friction with this key stakeholder. There may, therefore, be a strategic case for making the contribution as requested.

ESKADA

(a) Corporate governance issues

As with Enron, Eskada appears to be applying all the necessary requirements of good corporate governance (as required at the time). The scenario shows that the role of the CEO and Chairman are separated, there is an audit committee and remunerations committee duly composed of independent non-exec directors, the risk manager reported to the audit committee (although this was later changed with the new risk manager reporting directly to the CEO) and there appears to be communication with the institutional shareholders. It thus appears that Eskada is applying the letter, but not the spirit, of corporate governance.

The UK Corporate Governance Code states that every company should be headed by an effective board, which is collectively responsible for the success of the company. The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assed and managed. Decisions should be taken objectively in the interest of the board.

It is clear from the scenario that the board failed to effectively control the CEO and the company. David had built up an atmosphere of fear to ensure his policies were carried through with very little opposition or challenge. His style seemed to be that if anyone upset him, they would be moved sideways, disciplined or sacked. Thus fellow executives were probably in fear for their jobs (which would have been well paid and with good bonuses for achieving targets) and would thus not wish to challenge David.

As part of their role as members of a unitary board, NEDs should constructively challenge and help develop proposals on strategy. They should challenge any aspect of strategy they see fit and offer advice or input to help to develop successful strategy; they are required to represent the shareholders' interests against the possibility that agency issues arise to reduce shareholder value and they need to ensure that the company has an adequate system of internal control and risk management.

The Tyson report identified four personal attributes required by NEDs in order to carry out the responsibilities of their role:

- Integrity and high ethical standards;
- Sound judgement;
- Ability and willingness to challenge and probe;
- Strong interpersonal skills

Although they follow the requirements of good corporate practice, the NEDs singularly failed in their responsibilities as detailed above. They showed little willingness, integrity or ethical standards to challenge the actions of David and his methods to increase profits.

No action appears to have been taken by the audit committee (or the non-exec directors as a group) when bringing to the attention of the board the concerns of the risk manager only to have them ignored by David. The lack of challenging David over the sacking of the risk manager and changing the reporting line of the new risk manager shows a similar lack of sound judgement.

Lastly, the non-executive directors on the remuneration committee completely failed to hold David accountable for the disastrous acquisition of BCM. By negotiating the terms of his leaving the bank, they seemed to have shown weak interpersonal skills (e.g. negotiating, being assertive) in accepting his terms and thus rewarding him for failure. It would be well within the rights of the remuneration committee to have recommended to the board for David to have been dismissed for gross misconduct.

(b) Problems of personal ethics

Although corporate governance codes may be considered as being best practice, that practice can easily be negated by directors (either singularly or as a group) who do not uphold good moral and ethical standards. Laws and regulations, including Codes of Corporate Governance, can never be enough on their own. Good corporate governance practice requires high personal ethics on the part of directors including the non-executive directors and executive managers.

Individuals must adhere to strict ethical conduct in their personal decision making in business as well as in private life for corporate governance to be truly effective. True ethical conduct would be a behaviour that is in accordance with an unwritten code of ethics and set of moral values. If directors carried out their duties in accordance with acceptable ethical and moral norms, there is an argument that written corporate governance codes, corporate social responsibility and similar practice would not be necessary.

There are several ways of considering the moral and ethical development of David. As he has progressed through his career, David's moral development does not appear to have risen beyond Kohlberg's Level 1, pre-conventional morality. He may have seen that as he gained greater power he was able to judge right or wrong in terms of the expected rewards. Greater power within the boardroom would allow him to only be concerned with greater rewards, with minimal fear of failure and punishment. His approach has become instrumentalist – what's in it for me? Aspects of fairness, reciprocity and equality are interpreted in physical or practical terms rather than in terms of loyalty, gratitude or justice.

David has a very high internal locus of control. He has developed a strong belief in his ability to determine his own life and destination. He does not however appear to consider the moral consequences on others of the actions he takes and therefore his personal integrity may be considered as low. This also reflects his moral imagination – it seems not to stretch beyond ways of making profits.

As a career banker, he will have been exposed to a culture of high rewards, bonuses and compensation – often earning more than his fixed salary in bonuses. Basing rewards on set criteria and benchmarks (e.g. sales made, share price, contracts won, strength of the statement of financial position) will always run the risk that managers and employees will engage in unethical (and often illegal) practices in order to meet or exceed

expectations. This will be compounded where the unethical practice is accepted (and not punished) by senior management so that it becomes accepted practice within the organisation. David's treatment of his executive managers implies that he encourages such behaviour so long as it is making profits.

Finally, his approach reflects teleological egoism. He is very self-centred and his actions reflect this self-interest. He uses the bank to pursue his own aims and interests rather than to please others. Even when he decides to move on he fails to recognise his faults and aims to derive the greatest benefit from events.

(c) Integrated thinking

Integrated thinking is the active consideration by an organisation of the relationships between its various operating and functional units and the capitals that the organisation uses or affects.

Integrated thinking leads to integrated decision-making and actions that consider the creation of value. David clearly did not engage in the practice of integrated thinking with other people in governance of Eskada. This is especially evidenced by his dismissal of those who did not agree with him.

Integrated reporting is based on a business environment in which integrated thinking is embedded in mainstream business practice and places value on the organisation's relationship with its stakeholders. Integrated thinking in the business environment and the adoption of integrated reporting cannot force a change in behaviour but does not facilitate the type of aggressive and controlling behaviour exhibited by David.

The phrase "tone at the top" is often used to describe the environment and culture internal to a business which is set by those in governance of an organisation. Integrated thinking and reporting encourages the "tone at the top" to be one which is inclusive of others and considers the opinions of others. Integrated reporting encourages those in governance to reflect and consider how decisions and actions will impact the business, its stakeholders, and the external environment.

Integrated reporting often uses key performance indicators of financial and non-financial information to communicate the creation of value for an organisation. In the case of Eskada, these key performance indicators could have included a measurement of employee morale and dissatisfaction with management. The measurement of these attitudes could have been an early indication that the organisation was not creating value through human capital. David's sole reliance on financial targets, aggressive selling of the bank's products and dismissal of staff who disagreed with him were strong indicators of the "negative" culture at the bank.

Integrated reporting shifts the focus of decision making to consider how the decisions create value over the short, medium, and long term and not just in the short term.

While integrated reporting is not guaranteed to fix issues like those seen at Eskada, the process does encourage a business environment and the development of key relationships that are in contrast to an environment where one individual can monopolise decision making.HAPPY AND HEALTHY

(a) How an insider-dominated business differs from a public listed company

A family or insider-dominated business is one in which the controlling shareholding is held by a small number of dominant individuals. In many cases, these individuals will also work for the business making them owner-managers. When the insiders belong to a nuclear or extended family it is common to refer to the business as a family firm. In a listed company, the shares are dispersed between many shareholders, the shares are publicly traded and managers are unlikely to be substantial shareholders themselves (although they may own shares as a part of their reward packages).

Governance issues

The agency issues are quite different in the two types of business. There are usually lower agency costs associated with insider-dominated businesses owing to there being fewer agency trust issues. Less monitoring is usually necessary because the owners are often also the managers. Principals (majority shareholders) are able to directly impose own values and principles (business or ethical) directly on the business without the mediating effect of a board. Ken and Steffi have been the majority owners of "Healthy and happy" for its entire 40 years and as long as they trust each other, director monitoring costs should be very low. This is complicated by the new knowledge that there are trustworthiness questions over Ivan.

Short and long-term decision-making issues and the pursuit of motives other than short-term profits. A smaller base of shareholders is more likely to be flexible over when profits are realised and so the expectations of the rates and timings of returns are likely to be longer. This gives management more strategic flexibility especially if, as is the case at "Happy and healthy", the purpose of the business is simply to leave it in a good state to pass on to Ivan when Ken and Steffi retire. Ken and Steffi are motivated by factors other than the pursuit of short-term profit (e.g. promotion of healthy food, good service to customers, etc).

"Gene pool" and succession issues are common issues in family businesses. It is common for a business to be started off by a committed and talented entrepreneur but then to hand it on to progeny who are less equipped or less willing to develop the business as the founder did. When the insiders are unwilling or unable to buy in outside management talent then this issue is highlighted. There are clearly doubts over Ivan's commitment to the business if he has started up a competing business with his wife and this may mean an unfortunate outcome for "Happy and healthy".

"Feuds" and conflict resolution can be major governance issues in an insider-dominated business. Whereas a larger bureaucratic business is capable of "professionalising" conflict (including staff departures and disciplinary actions) this is less likely to be the case in insider-dominated businesses. Family relationships can suffer and this can intensify stress and ultimately lead to the deterioration of family relationships as well as business performance. Ivan's actions are likely to be relevant here as his transfer of inventory to Barong Company is likely to place a severe strain on the Potter family relationships.

Tutorial note: *The requirement to "explore" allows for a range of relevant responses.*

(b) Accountants as professionals

Society accords professional status to those that both possess a high level of technical knowledge in a given area of expertise (accounting, engineering, law, dentistry, medicine) on the understanding that the expertise is used in the public interest. The body of knowledge is gained through passing examinations and gaining practical expertise over time. Acting in the public interest means that the professional always seeks to uphold the interests of society and the best interests of clients (subject to legal and ethical compliance).

Fundamental principles (responsibilities) of professionalism

Society has reasonable expectations of all professionals. The major professional responsibilities of any professional are as follows:

Integrity: The highest levels of probity in all personal and professional dealings. Professionals should be straightforward and honest in all relationships. This has clear implications for Mr Shreeves in his dealings with Ken and Steffi.

Objectivity: Professionals should not allow bias, conflicts of interest or undue influence to cloud their judgements or professional decisions. In this case, Mr Shreeves should not allow his friendship with the Potters to affect his judgement as an auditor.

Professional competence and due care: Professionals have a duty to ensure that their skills and competences are continually being updated and developed to enable them to serve clients and the public interest. This includes continuing to study and scrutinise ethical guidance from Mr Shreeves's own professional accounting body and also IFAC.

Confidentiality: Professionals should, within normal legal constraints, respect the confidentiality of any information gained as a result of professional activity or entrusted to them by a client.

Professional behaviour: Professionals should comply fully with all relevant laws and regulations and, at the same time, avoid anything that might discredit the profession or bring it into disrepute.

(c) Professional and ethical dilemma facing Mr Shreeves

The normal behaviour for the auditor, regardless of the options available in this situation, would be to initially seek representations from Ivan to establish whether there is an explanation that has so far been overlooked or not known about. Following that, there are two options in Mr Shreeves's dilemma: to tell or not tell Ken and Steffi about Ivan's behaviour. In discussing these options, a number of issues are relevant.

Issues

Mr Shreeves is clearly in a difficult situation but he must be aware of his duty as a professional accountant which includes, in his role as auditor, a duty to the public interest. He has a duty of due care and diligence to society and government as well as the shareholders of a company being audited. Being complicit in Ivan's activity is clearly not an option as this would be incompatible with his duties to the shareholders and to society

in his role as auditor. Furthermore, he has realised a disclosure of such transactions is required and it would be unprofessional not to discuss this with his clients.

He feels he owes a debt to the Potter family as a long-standing family friend and this has the potential to cloud his judgement as the company's auditor. The effect of Ken and Steffi finding out about Ivan's theft could be "devastating" and this is bound to weigh heavily on Mr Shreeves's mind. In getting too close to the family, Mr Shreeves has compromised his duty as auditor as he is probably less objective than he should be. He should probably have chosen between being a family friend or being the auditor some years ago and that would have made his resolution of the dilemma somewhat easier.

Ivan has been unprofessional and has acted fraudulently in his dealings with "Happy and healthy". In such a situation, the auditor does not have latitude in how he deals with such a discovery. It is a very serious breach of trust by Ivan, regardless of whether he is the Potters' son or not, and it would be inexcusable to withhold this information from the owner-managers of the business.

Advice

Given that the auditor has a duty to the public interest and the company shareholders, he should inform the majority shareholders (Ken and Steffi) what he has found during the audit. To do anything other than this would be to act unprofessionally and irresponsibly towards the majority shareholders of the company. Family relationships or friendships must never be allowed to interfere with an auditor's professional duty and independence. This approach need not be in the form of a blunt confrontation, however, and it would not be unprofessional to speak with Ivan before he spoke to his parents in order to convey to him the potential seriousness of his actions.

MRS YTTRIA & MR MORDUE

(a) Explain "the public interest"

Public interest concerns the overall welfare of society as well as the sectional interest of the shareholders in a particular company. It is generally assumed, for example, that all professional actions, whether by medical, legal or accounting professionals, should be for the greater good rather than for sectional interest.

Accounting has a large potential impact and so the public interest "test" is important. Mrs Yttria made specific reference to audit and assurance. In auditing and assurance, for example, the working of capital markets – and hence the value of tax revenues, pensions and investment – rests on accountants' behaviour. In management accounting and financial management, the stability of business organisations – and hence the security of jobs and the supply of important products – also depends on the professional behaviour of accountants.

(b) Ethical threats

In its code of professional ethics, the International Federation of Accountants (IFAC) identified five types of ethical threat. These are (quoted verbatim):

(1) Self-interest threats, which may occur as a result of the financial or other interests of a professional accountant or of an immediate family member;
(2) Self-review threats, which may occur when a previous judgement needs to be re-evaluated by the professional accountant responsible for that judgement;

(3) Advocacy threats, which may occur when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised;
(4) Familiarity threats, which may occur when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others; and
(5) Intimidation threats, which may occur when a professional accountant may be deterred from acting objectively by threats, actual or perceived.

There are obvious familiarity threats in supplying multiple services to the same client in that the firm will possibly be less likely to be rigorous in the audit and may tend to give the client the benefit of the doubt in marginal cases to avoid upsetting them and risk losing the other services.

The potential lack of impartiality may give rise to advocacy threats in that while acting as a "referee" in audit and assurance work, the firm may be lobbying for the client on other areas of work. The high degree of dependence that the firm has on the client opens it up to the threat of intimidation.

The more dependent the firm becomes on the client for its revenues and profits, the more tempting it may become for the client to seek favourable audit judgements from the firm with the implied threat that the firm could lose other business if it was too harsh.

A self-interest threat therefore arises as senior members of the accounting firm give precedence to the protection of their own financial position over the wider public interest of having an auditor partially captured by a client.

(c) Accounting profession and deep green (or deep ecologist) position

Mr Nahum's remarks are similar to some of the positions espoused by deep green theorists, tending as they are, towards the anti-capitalist and the anti-corporatist political left.

Biased and value laden – the belief that accounting (and other professions) work within an unstated set of contestable values. The deep green position argues that accounting is captured by the minority interests of capitalism and acts as the "servant" of capital.

Environmental degradation is a key charge made by deep greens against business in general and, by implication, against accountants. Accountants serve the interests of business (rather than the environment) and hence accountants are complicit in the creation of environmental damage by their unquestioning adherence (in the opinion of the deep greens) to a set of rules that supports capital.

Poverty and "animal rights" are themes raised by deep greens as items that should be on accounting's agenda. One view among some deep greens is that humans have no more moral rights than animals and that activities perpetuating animal unfairness or human poverty should be challenged by accounting as a profession.

Inter and intra-generational "social injustices" are often cited as problems with the "unfettered" capitalist business model which, the deep greens argue, accounting supports and is therefore complicit in. Some business activities result in wealth disparities in this generation (intra-generational) and deprive future generations of resources (inter-generational injustice).

Tutorial note: *Other approaches to this answer would gain marks, if valid.*

JOJO AUDITORS

(a) Conflict of interest

A conflict of interest occurs when a person's freedom of choice or action is constrained by a countervailing interest, which means that the most objectively correct course of action cannot be taken. The discretion to act correctly is fettered by the need to protect a related but contradictory interest.

In the case of Jojo Auditors, Jack Hu experienced a conflict of interest between carrying out the agreed policy of dismissing all students assessed as "poor" (such as Polly Shah) and his familiarity with the Shah family and his making a personal gain from the family in the form of free holidays.

Jack acted against the best interests of the firm including his fellow partners. In his role as managing partner, he owes it to the other partners, and to the employees and clients of the firm, to act responsibly and always in the best interests of the firm. His conflict of interest prevented this from happening.

In acting as he did, Jack compromised the other committee members and made them compromise their own professional values. Both the training manager and the representative from human resources are engaged in order to maximise their benefit to Jojo and as managing partner, Jack "bullied" them into accepting his view. This decision undermined the training manager and thus circumvented the normal chain of command in matters of student assessment.

He knowingly allowed a technically weak student to be retained thereby potentially compromising the quality and integrity of the audits she would work on. He owes a professional duty to the shareholders of the companies that Jojo audits. Audits should be conducted diligently, and technical accuracy should underpin the application of auditing standards and in following procedures and protocols. A technical weakness (such as Polly's) would potentially weaken the effectiveness of the audit and hence be a failure of a duty of care to the client's shareholders.

In acting as he did, Jack gave the appearance of unfairness and a lack of objectivity. The appearance of integrity and probity is important in leading organisations and even were it not true, he allowed his integrity and objectivity to be seen as questionable. Once discovered, confidence in the assessment process at Jojo would have been lost and this could have the effect of damaging its reputation as a provider of training contracts, and therefore in the services provided by the firm.

(b) Ethical safeguards

- Jack could undergo some instruction or continuous professional development (CPD) on the fundamental principles of professionalism and the need to avoid conflicts of interest. As a professional accountant, he is bound in any case by the codes of ethics and/or rulebook of his professional body and the IFAC code. Most of these specifically warn against such conflicts, including the acceptance of gifts unless the value is trivial and inconsequential, and his professional body may provide such a course of instruction.
- Enforce a requirement to declare any conflicts of interest at the beginning of each meeting to consider student assessments. This could be made a "standing item" on the agenda so that it had to be considered before each time that assessments were considered. The

declaration of conflicts of interests could also be made a part of the recruitment process for new partners where appropriate.

- Rotate the partner who chairs the assessment committee. This would mean that the chance of Mr Hu being the partner considering Polly Shah's case would be reduced (in the case of Jojo) to one in five. Other partners without the conflict of interest would, in any given meeting, be more likely to be chairing.
- Involve an additional partner in the review of student assessments, more able to confront Mr Hu than the training manager or HR manager, neither of whom are at partner level. Another partner would have the organisational "weight" to confront Mr Hu in a way that the training manager or HR manager evidently did not.
- The outcomes of the assessments could be validated by an external party (akin to the role that a non-executive director might play if Jojo were a public company). A retired partner could discharge such a role, for example, or a human resources consultant. The final decision on each student would not be made known until each had been "signed off" by the external party.
- Keep an internal HR file formally recording the list of students by assessment category. This would make the decision to retain Polly, in spite of her "poor" assessment, much more visible to relevant business managers. This would apply greater consistency because it would be more transparent that Polly was retained even though her assessment was rated as "poor".

Tutorial note: *Credit would be given for any reasonable safeguard that addresses the problem.*

(c) Performance measurement criteria

The criteria used to measure the performance of directors and/or partners (in a partnership) vary according to the situation. Some criteria will be much more important than others, and highly context-specific criteria may apply in some organisations. In general terms, however, there are four typical criteria that are helpful:

(1) The level of independence of the person (i.e. being free from external vested interests) and commitment to the public interest. This is especially important in accounting practices where serving the public interest is an important component of professional service.

(2) Preparedness and fitness to practise including maintaining the relevance of skills and undertaking relevant continuing professional development. For the partners and Jojo, this would involve maintaining knowledge of current audit and reporting standards, for example.

(3) Practice, including levels of participation in their allocated roles and their competence in those roles. Linked to this is the contribution made to the formulation and implementation of the organisational strategy.

(4) Contribution to committee work and administrative duties as appropriate. Jack's effectiveness in his role as member of the committee that evaluates student progress would fall within this area.

Difficulties of individual performance measurement at Jojo

As a privately-owned business, there is no external pressure for such a procedure. This is because, as an unincorporated business, there are no listing rules enforced by a stock exchange and no external shareholder pressures to be applied. There is no agency gap created by a separation of ownership and management.

There is unlikely to be an independent non-executive director (NED) structure in place to support and carry out the performance measurement. Because of the difficulties raised by

full-time senior management appraising each other, NEDs take a role in this in listed companies. Without this element of external independent scrutiny, it would be very difficult to maintain independence and fairness in a performance measurement system.

The informality of relationships in a smaller partnership may make objective assessment impossible, especially if, as in a smaller practice, longstanding personal friendships may be a strong component of the culture. As the five partners are personal friends with each other, it would be very difficult for them to conduct objective performance appraisals on each other.

There is likely to be resistance from some partners, at least from Jack Hu, who, if appraised, would be likely to receive a poor assessment on some criteria. As the managing partner (the equivalent of a chief executive in a partnership), it would be difficult to arrive at a fair measurement process for Mr Hu without the involvement of external parties such as NEDs.

The local government authority, for example, had no view on which was chosen but as a high power stakeholder (capable of granting or withholding legal permission), it could have been very influential had it expressed a view either way.

- It is necessary to identify potential areas of conflict and tension between stakeholders, especially relevant when it is likely that stakeholders of influence will be in disagreement over the outcomes.

A survey of the stakeholders in a rail-building project such as this, once mapped in terms of influence, would signal which stakeholders are likely to cause delays and paralysis by disagreement and whose claims can then be studied for ways to reduce disagreement.

- There is an ethical and reputational case for knowledge of how decisions affect stakeholders, both inside the organisation or external to it. Society can withdraw its support from organisations that it perceives as unethical or arrogant. This can affect organisational performance by reducing their reputations as employers and suppliers of future services.

RDC may acquire a reputation for environmental damage and this could mean they lose public trust on future projects of this type. A “deep green” perspective would take an unfavourable view of companies that failed to recognise some stakeholder claims.