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Corporate Strategic Management and Ethics

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Developing Trusted Professionals

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Foreword

The business environment has been undergoing rapid changes caused, by globalisation and advancement in Information Technology. The impact of these changes on the finance function and the skills set needed by professional accountants to perform their various tasks have been profound. These developments have made it inevitable for the Institute's syllabus and training curriculum to be reviewed to align its contents with current trends and future needs of users of accounting services.

The Institute of Chartered Accountants of Nigeria (ICAN) reviews its syllabus and training curriculum every three years, however, the syllabus is updated annually to take cognisance of new developments in the national environment and the global accountancy profession. The Syllabus Review, Professional Examination and Students' Affairs Committees worked assiduously to produce a 3-level, 15-subject ICAN syllabus. As approved by the Council, examinations under the new syllabus will commence with the November 2021 diet.

It is instructive to note that the last four syllabus review exercises were accompanied with the publication of Study Texts. Indeed, when the first four editions of Study Texts were produced, the performances of professional examination candidates significantly improved. In an effort to consolidate on these gains and to further enhance the success rates of students in its qualifying examinations, the Council approved that a new set of learning materials (Study Texts) be developed for each of the subjects. Although, these learning materials may be regarded as the fifth edition, they have been updated to include IT and soft skills in relevant subjects, thereby improving the contents, innovation, and quality.

Ten of the new learning materials were originally contracted to Emile Woolf International (EWI), UK. However, these materials were reviewed and updated to take care of new developments and introduced IT and soft skills in relevant subjects. Also, renowned writers and reviewers which comprised eminent scholars and practitioners with tremendous experiences in their areas of specialisation, were sourced locally to develop learning materials for five of the subjects because of their local contents. The 15 subjects are as follows:

Foundation Level		
1.	Business, Management and Finance	EWI/ICAN
2.	Financial Accounting	EWI/ICAN
3.	Management Information	EWI/ICAN
4.	Business Law	ICAN

Skills Level		
5	Financial Reporting	EWI/ICAN
6	Audit and Assurance	EWI/ICAN
7.	Taxation	ICAN
8.	Corporate Strategic Management and Ethics	EWI/ICAN
9.	Performance Management	EWI/ICAN
10.	Public Sector Accounting and Finance	ICAN

Professional Level		
11.	Corporate Reporting	EWI/ICAN
12.	Advanced Audit and Assurance	EWI/ICAN
13.	Strategic Financial Management	EWI/ICAN
14.	Advanced Taxation	ICAN
15.	Case Study	ICAN

As part of the quality control measures, the output of the writers and reviewers were subjected to further comprehensive review by the Study Texts Review Committee.

Although the Study Texts were specially produced to assist candidates preparing for the Institute's Professional Examination, we are persuaded that students of other professional bodies and tertiary institutions will find them very useful in the course of their studies.

Haruna Nma Yahaya (Mallam), mni, BSc, MBA, MNIM, FCA

Chairman, Study Texts Review Committee

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A

Acknowledgement

The Institute is deeply indebted to the underlisted locally-sourced rewriters, reviewers and members of the editorial board for their scholarship and erudition which led to the successful production of these new study texts. They are:

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2.	Adepate, Olutoyin Adeagbo	Writer

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1.	Ogunniyi, Olajumoke

Management Information	
1.	Adesina, Julius Babatunde
2.	Ezeribe, Chimenka

Financial Accounting	
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Financial Reporting	
1.	Okwuosa, Innocent

Performance Management	
1.	Durukwaku, Sylvester

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Corporate Reporting	
1.	Adeadebayo, Shuaib

Advanced Audit and **Assurance**	
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The Institute also appreciates the services of the following:

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Contents

ICAN 2021

		Page
Cover		
Forward		iii
Acknowledgement		v
Content		viii
Syllabus		ix
Chapter 1	Strategy, stakeholders and mission	1
Chapter 2	Environment analysis	34
Chapter 3	Competitive forces	58
Chapter 4	Internal analysis	91
Chapter 5	Competitive advantage	136
Chapter 6	Methods of development	160
Chapter 7	Strategy implementation	205
Chapter 8	Functional strategies	264
Chapter 9	Identifying and assessing risk	287
Chapter 10	Controlling risk	323
Chapter 11	The scope of governance	344
Chapter 12	Different approaches to corporate governance	390
Chapter 13	The board of directors	405
Chapter 14	Directors' remuneration	450
Chapter 15	Governance: reporting and disclosure	469
Chapter 16	Ethical theories	493
Chapter 17	Ethics and social responsibility	519
Chapter 18	Professional practice and codes of ethics	535
Chapter 19	Conflicts of interest and ethical conflict resolution	562
Chapter 20	Social and environmental issues in ethics and business	593
Chapter 21	Soft skills for accountants	620
References		674

Syllabus

ICAN 2021

SKILLS LEVEL

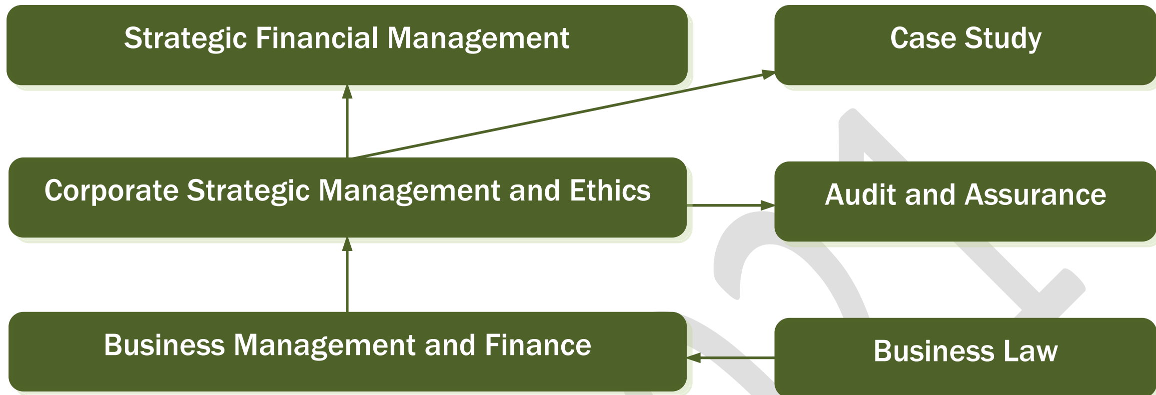
Corporate Strategic Management and Ethics

Aim
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.

Linkage with other subjects

Corporate Strategic Management and Ethics (CSME) derives from the foundation laid in Business, Management and Finance (BMF) and Business Law (BL) and feeds directly into Strategic Financial Management (SFM) and Case Study (CS) at the Professional level.

It must however be noted that the ethics component of this subject feeds into virtually all the subjects at the professional level.



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Main competencies	
On successful completion of this paper, candidates should be able to:	
•	Analyse a business position, make informed choices and implement chosen strategies;
•	Use appropriate soft skills for organisational effectiveness and efficiency;
•	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.

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Linkage of the main competencies

This diagram illustrates the linkage between the main competencies of this subject and is to assist candidates in studying for the examination.

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Syllabus overview		
Grid		**Weighting**
A	Introduction	**5**
B	Strategic management	**30**
C	Risk management	**20**
D	Governance	**20**
E	Ethics	**25**
	Total	**100**

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Detailed syllabus				Chapter
A	Introduction			
	1	Explain the concept of strategic management and its importance.		1
	2	Distinguish strategic management from strategic planning, long term planning and corporate planning.		1
	3	Distinguish the various levels of strategy: corporate, business and functional.		1
	4	Explain approaches to strategic planning using:		1
		a	Rational model;	1
		b	Logical incremental model; and	1
		c	Freewheeling opportunism model.	1
	5	Discuss the strategic management process: analysis, choice, implementation and evaluation.		1
	6	Explain the concept of corporate governance and discuss:		11
		a	Perspectives on corporate governance;	11
		b	Historical development of corporate governance: global and national; and	12
		c	Structure, principles, functions and mechanisms of corporate governance.	11 – 15
B	Strategic management			
	1	**Strategic analysis**		
		a	Analyse a business and its strategy, given its purpose, mission, vision and objectives from shareholders' and other stakeholders' perspectives.	1
		b	Analyse the external business environments and examine the opportunities and threats that could arise from events or potential events at the global, national, industry or competitive levels.	2, 3
		c	Analyse the internal environment of a business to identify the strengths and weaknesses and align them with the opportunities and threats in the external environments.	4
		d	Analyse the position of a business in terms of its competitive strategy, plans and current markets, drawing conclusions and giving simple recommendations on the chosen plans.	3, 4
		e	Analyse the position of a business with a chosen strategy in the context of its environment, based on an assessment of its resources, processes, people, information technology (IT), products, core capabilities and competences. Give simple recommendations on the best options.	4
		f	Draft an overall analysis, drawing conclusions with	4

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Detailed syllabus					Chapter
			recommendations based on given financial and non-financial data and information from a variety of sources in a given scenario.		
		g	Determine sustainable competitive advantage and the core competence of a business in a given scenario.		5
			Note: Models for analyses include PESTEL, SWOT, SOAR, Porter's diamond, Porter's Five Forces, Life Cycle, Value Chain, Benchmarking, Customer Relationship Management and BCG Matrix		2 - 4
	2	**Strategic choice**			
		a	Analyse the appropriate choices of strategy that a company may adopt based on a given scenario. This should include competitive advantage, the strategic clock, cost leadership differentiation, lock-in strategies and collaboration.		5
		b	Identify and explain, based on an analysis of choices of strategy, the impact of strategy on commercial, ethical, corporate social responsibility and sustainability objectives.		6
		c	Evaluate the appropriateness of a chosen strategy that supports business objectives, considering constraints, conflicts and other issues based on a given scenario. The following models and tools may be employed in carrying out the evaluation:		3, 5, 6
			Models		
			i	Porter's generic competitive strategies;	5
			ii	Johnson, Scholes and Whittington (JSW) model of strategic planning; and	1
			iii	Boston Consulting Group (BCG) model in strategic management.	3
			Tools		
			i	Forecasting tools;	6
			ii	Trend analysis;	6
			iii	System modelling; and	6
			iv	Delphi technique.	6
		d	Draw conclusions based on market and product analyses, that support a business strategy concerning pricing, positioning, placing and other product decisions in a strategic marketing plan.		6
		e	Determine the appropriate corporate growth strategy in a given scenario:		6
			i	Internal development;	6
			ii	Diversification;	6

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Detailed syllabus					Chapter
			iii	Forward and backward integration;	6
			iv	Mergers and acquisitions;	6
			v	Product portfolio management;	6
			vi	Griener's Growth Model; and	6
			vii	Other growth models.	6
		f	Select a strategic growth direction of a company using Ansoff's matrix.		6
	3	**Strategic implementation**			
		a	Discuss and evaluate the alternative functional strategies that are appropriate to deliver a chosen strategy in a given scenario such as production, marketing, finance, IT and human resources.		8
		b	Develop and evaluate alternative business plans and proposals and select the best option to implement a chosen strategy.		7
		c	Evaluate the tools and techniques for strategy implementation applicable to different business units in a given scenario.		7
		d	Evaluate strategic performance using: balanced scorecard, performance pyramid and Fitzgerald and Moon building blocks.		7
		e	Appraise organisational structures and related activities that may be appropriate to deliver a chosen strategy set out in a given scenario: entrepreneurial, functional, divisional, conglomerate and matrix.		7
		f	Communicate chosen strategies and performance targets to operational and tactical managers through annual budgets, monthly and weekly targets, linking critical success factors (CSFs) to key performance indicators (KPIs) and strategy.		7
		g	Evaluate and explain how information technology and information systems can support the effective implementation of a business strategy including issues of competitive advantage.		8
		h	Evaluate and explain the potential issues of change that may arise from a chosen or given business strategic implementation plan.		7
		I	Evaluate the impact of organisational change on organisation culture including cultural web and Mckinsey's 7S model.		7
		j	Evaluate the role of leadership in managing the change process, including building and managing effective teams.		7
		k	Evaluate tools, techniques and strategies for managing and leading the change process.		7
C	**Risk management**				

Detailed syllabus				Chapter
	1	Explain the meaning of risk including risks arising internally or externally and relate them to achievement of:		9
		A	Strategic objectives;	9
		B	Operational efficiency and effectiveness;	9
		C	Reliable reporting; and	9
		D	Legal, regulatory and ethical compliance.	9
	2	Identify and assess risks in a given scenario in relation to their impact(s) on objectives.		9
	3	Measure and prioritise risks.		9
	4	Discuss the role of board of directors in risk identification and assessment.		9
	5	Minimise risk using the ALARP (As Low As Reasonably Practicable) principle (objective and subjective risk principles; related and correlated risk factors).		9
	6	Evaluate appropriate responses to risks identified in a given scenario.		9, 10
	7	Explain the roles of a risk manager and risk committees in risk management.		10
	8	Discuss risk auditing and monitoring		10
	9	Identify and explain appropriate high-level procedures to mitigate risks in a given scenario using TARA (transfer, avoidance, reduction and acceptance) framework.		10
	10	Identify and explain appropriate mechanisms to monitor risk and risk management processes including information and communication systems such as enterprise risk management and ISO 31000 framework on risk management.		10
	11	Evaluate both inherent and residual risks after mitigation in relation to shareholders' and other stakeholders' risk appetites in a given scenario.		9, 10
	12	Discuss alternative risk management approaches: risk diversification, risk transfer, risk sharing and risk hedging.		9, 10
D	Governance			
	1	Identify the issues and bases of decision making, employing theories and philosophies of corporate governance in a given scenario. These include:		11
		A	Agency theory;	11
		B	Transaction cost theory;	11
		C	Stewardship theory;	11

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Detailed syllabus				Chapter
		d	Resources dependency theory;	11
		e	Managerial and class hegemony theory;	11
		f	Psychological and organisational perspective theory;	11
		g	Stakeholders' theory; and	11
		h	Systems theory.	11
	2	Explain the nature, significance and scope of enterprise governance and threats to effective governance, including:		11, 13, 14
		a	Concept of good governance;	11
		b	Roles of internal and external auditors;	13
		c	Board structure; and	13
		d	Audit committee.	13
	3	Identify and assess roles and responsibilities of an effective board in a given scenario.		13, 14
	4	Discuss 'non-compliance with laws and regulations' (NOCLAR) in relation to the responsibilities of the board.		13
	5	Discuss oversight functions of a board and institutional shareholders over management in a given scenario,		13
	6	Assess transparency of an entity through the quality of its disclosures.		15
	7	Discuss the importance and implications of probity as a principle of governance.		11
	8	Assess the extent to which a board in the public sector focuses on the value of sustainable long-term success.		11
	9	Assess the extent to which a board in the public sector focuses on: delivery of an effective and appropriate public service; and acting in the public interest.		11
	10	Discuss global developments in enterprise and corporate governance and elucidate the rules-based and principles-based approaches to corporate governance. Also, evaluate relevant national and international codes of corporate governance.		12
	11	Discuss the concept of corporate social responsibility and specify its background and scope.		15
	12	Discuss the concept of sustainability in business, sustainable asset management (SAM) and full cost analysis (FCA).		20
	13	Explain governance and management issues relating to the use of information technology in organisations.		11
E	**Ethics**			

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Detailed syllabus				Chapter
	1	Explain the nature, scope and sub-divisions of ethics (descriptive, normative and meta-ethics, professional ethics and business ethics), and the relationship between		16
		A	morality and ethics; and	16
		B	ethics and law.	16
	2	Explain and illustrate, using information in a given scenario, the importance of professional and business ethics in the public and private sectors.		16

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Detailed syllabus				Chapter
	3	Discuss and apply ethical theories to decision-making in professional practice: consequential or teleological theories (egoism and utilitarianism), non-consequential or deontological theories (ethics of duties and ethics of rights and justice), ethical relativism, ethical absolutism, ethical subjectivism and situation ethics.		16
	4	Discuss influences (individual, situational, cultural and religious), stages (Kohlberg's stages of moral development and the Heinz's dilemma) and models for ethical decision-making (Tucker's five question model, American Accounting Association (AAA) model, systems development ethics).		16
	5	Discuss the alternative models of professional-client relationship; agency, contract, paternalism and fiduciary.		17
	6	Identify and explain in the context of a given scenario, how the issues of moral duties and moral dilemma may arise in professional and business ethics.		17
	7	Discuss the nature of ethical conflicts and ethical threats confronting the accountant in a professional practice, ethical safeguards and tests for resolving the conflicts.		18, 19
	8	Examine the nature, procedure and challenges of whistle-blowing in the accountancy profession.		18
	9	Discuss the alternative ethical stances and culture of an entity (personal versus corporate ethical stance)using;		17
		A	Johnson and Scholes four ethical stances;	17
		B	Gray, Owen and Adam's seven-level classification of social responsibilities;	17
		C	Johnson and Scholes conception of the cultural web; and	17
		D	Edgar Schein's three levels of culture.	17
	10	Identify and assess issues of professional ethics and corporate governance as they may arise within the context of ICAN code of professional conduct and IFAC code of ethics for professional accountants in a given scenario.		18, 19
	11	Discuss the ethical dimension of corruption (bribery, money laundering, embezzlement, theft, fraud, extortion, and blackmail).		19

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CHAPTER 1

Strategy, stakeholders and mission

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Contents

1 Definition of strategy and levels of strategy
2 Elements of strategic management and business analysis
3 Organisational purpose and strategy
4 Stakeholders and stakeholder expectations
5 Chapter review

INTRODUCTION

Detailed syllabus

The detailed syllabus includes the following:

A1 Explain the concept of strategic management and its importance

A2 Distinguish strategic management from strategic planning, long term planning and corporate planning.

A3 Distinguish the various levels of strategy: corporate, business and functional.

A4 Explain approaches to strategic planning using:

- **(a)** Rational model
- **(b)** Logical incremental model
- **(c)** Freewheeling opportunism model

A5 Discuss the strategic management process: analysis, choice, implementation and evaluation.

B1 **(a)** Analyse a business and its strategy, given its purpose, mission, vision and objectives from shareholders' and other stakeholders' perspectives.

B2 **(b)** Models: Johnson, Scholes and Whittington (JSW) model of strategic planning

Exam context

This chapter is largely a revision and it re-introduces the basic concepts of business analysis and strategy.

By the end of this chapter students will be able to:

- Define strategy and strategic management and discuss their importance
- Explain the difference between strategic planning, long-term planning and corporate planning
- Explain the different levels of strategy including corporate, business and functional strategies
- Explain the rational, logical incremental and freewheeling opportunism approaches to strategic planning
- Give an overview of the strategic management and business analysis process including strategic position, choices and putting strategy into action
- Distinguish between vision, mission, goals, objectives and plans

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- Analyse a business and its strategy given its purpose, mission, vision and objectives from shareholder' and other stakeholder' perspectives with the aid of Mendelow's power/interest matrix

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1 DEFINITION OF STRATEGY AND LEVELS OF STRATEGY

Section overview

- Definition of strategy
- Strategic management and its importance
- Levels of strategy
- Corporate strategy
- Business strategy
- Functional strategy
- A note on levels of planning
- Different approaches to strategic planning

1.1 Definition of strategy

Definition: Business analysis

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

Definition: Strategy (Chandler)

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

Strategic management therefore involves deciding answers to questions such as:

What business or businesses should we be in?

How can this business activity contribute to the competitive advantage of our enterprise?

Drucker on strategy

Definition: Strategy (Drucker)

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

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

A strategy consists of organised activities.

The purpose of these activities (the strategy) is to achieve an objective.

Strategy is long-term. Formal strategic planning by large companies, for example, might cover five years or ten years into the future, and for some companies even longer.

The strategic choices that an enterprise makes are strongly influenced by the environment in which the enterprise exists.

The environment is continually changing, which means that strategies cannot be rigid and unchanging.

Strategies involve an enterprise in doing different things with different resources over time, as it is forced to adapt to changes in its environment.

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

Where are we now?

Where do we want to be in five years' time?

How do we get from where we are now to where we want to be?

How large will the company be?

What will it be doing?

Where will it be operating?

How many employees will it need and what skills will they need?

What technology should be used?

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Johnson, Scholes and Whittington on strategy

Definition: Strategy (Johnson, Scholes and Whittington)

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

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

An enterprise should use its resources and its skills and abilities to achieve a 'competitive advantage' in its business activities. Competitive advantage is achieved by doing something better (and more successfully) than competitors can do.

It is often assumed that the main objective of a company should be to maximise the wealth of its shareholders. Johnson, Scholes and Whittington state that the objective of an entity should be to fulfil 'stakeholder' expectations.

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

Deciding the scope of the entity's activities. What businesses should we be in?

Relating the activities of the entity to the environment in which it operates.

Ensuring that the entity has the 'resource capability' to operate in its selected areas of activity. This means making sure that the entity has enough employees with the right skills, access to sufficient raw materials and other supplies, enough equipment, suitable IT systems, and so on.

Allocating resources to the different business activities.

Providing a high-level (strategic) framework for more detailed decision-making at an operational level.

Reflecting the values and expectations of the individuals in positions of power within the entity.

Deciding the long-term direction that the entity should take.

In many cases, implementing change within the entity so that it adapts successfully to its changing environment.

Example: Business strategy

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

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

The company will continue to extract oil and natural gas, but it will also invest heavily in production of energy from renewable energy sources, such as wind and sea; and

The move into energy from renewable sources recognises the probability that public and political pressure will grow for restrictions on the use of non-renewable energy sources and for protection of the global environment.

Change is therefore essential for long-term survival.

The strategic plan should also provide for the resources required to achieve the company's goals. Important resources for the chosen plan will include exploration rights, access to pipelines and other methods of transporting energy to users, and expertise in wind and wave power technology.

A decision must be made about how many resources (including money) should

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be invested in each business activity.

This will depend partly on the strategic vision of the board of directors, and the direction they think the company should be taking. What proportion of its total energy sources in ten years' time will come from wind and wave power, and to what extent will the company still be relying on oil and natural gas?

The strategic plan also reflects the values of the board of directors. In this example, the company has not included nuclear power in its strategic plan.

1.2 Strategic management and its importance

Strategic management is concerned with the identification, selection and implementation of strategies for achieving an organisation's long-term goals and objectives. It sets the direction for an organisation and is concerned with how to get there and obtain optimal results.

Strategic management is important because it creates a framework for achieving long-term success for the organisation, and does not focus on the bottom line and short-term profitability.

Strategic management differs from strategic planning, long-term planning and corporate planning in the following ways.

Strategic planning is a process of formulating the long-term direction for an organisation, and preparing a plan of how to achieve the strategic targets that are set. It is a process of making optimal decisions for the long-term benefit of the company. Strategic management often includes strategic planning, but it is concerned with the implementation of strategies and monitoring their success. So whereas strategic planning is concerned with making optimal planning decisions for long-term success, strategic management is concerned with achieving optimal success from the implementation of strategies. Strategic management does not necessarily need a strategic planning element.

Long-term planning, like strategic planning, is concerned with making plans for the long-term success of the organisation. However long-term planning may be for an individual department or function, whereas strategic management is concerned with strategy for the organisation as a whole. Long-term planning does not necessarily have a strategic purpose: for example capital expenditure planning may be long-term planning, but is not necessarily an element of an organisation's strategy.

Corporate planning is planning for an entire company, but is at a level below strategic planning and strategic management, and can be much shorter-term in outlook. For example, a company's strategy might be to expand operations into a new geographical region and market; whereas a part of the corporate plan might be to establish a new production facility in that region.

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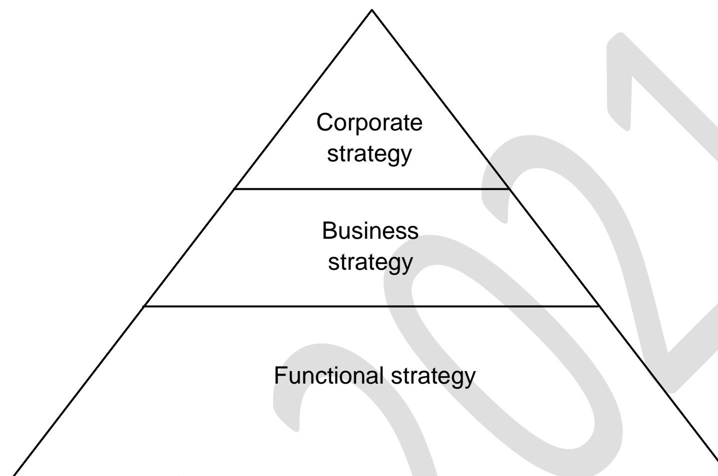
1.3 Levels of strategy

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

corporate strategy

business strategy, and

functional strategy.



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

Consistency of strategies

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

The corporate strategy should seek to achieve the overall objective or objectives of the entity.

Each business strategy should have its own objective, and achieving the objective for a business strategy should contribute towards the achievement of the corporate strategy and overall objective.

Each functional strategy should have its own objective, and achieving the objective for a functional strategy should contribute towards the achievement of the business strategy that it supports.

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1.4 Corporate strategy

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

The elements of corporate strategy are as follows:

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

Deciding the scope of the activities of the entity. Corporate strategy also involves deciding what businesses the entity should be in, including the range of businesses. For example, the purpose of a transport company is to provide transport services. Its corporate strategy must include a decision about which transport services it will provide (for example, bus travel, train services, air travel, space travel and so on) as well as the geographical areas where it will operate.

Matching the chosen **business activities to the external environment** of the entity **and** also to its **available resources**.

- The choice of business activities by an entity should be consistent with conditions in its environment. For example, a company should choose to sell products or services that customers want to buy, and for which the technology exists. Its choice of business activities might also be affected by laws or regulations.

- The choice of business activities should also be consistent with the resources that the entity expects to have available or expects that it will be able to obtain.

Matching the purpose and activities of the organisation to the expectations of its owners. The chosen corporate strategy, when put into action, should be capable of meeting the expectations of the owners of the entity. For example, a company's objectives for profits over the long term should be consistent with shareholders' long-term profit expectations.

Matching the purpose and activities of the organisation to the expectations of other stakeholders in the organisation.

Corporate strategy and the expectations of owners and other stakeholders

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

Owners' expectations. In a commercial company, the owners are the shareholders. These might expect the company to provide them over time with investment income or with growth in their wealth. Corporate strategy might therefore aim towards maximisation of the shareholders' wealth. Objectives for corporate strategy might

ICAN 2021

therefore be stated in terms of raising the share price by x% over the next five or ten years. With a state-owned organisation, the owner is the government. The expectations of a government as owner of an entity are different from those of the shareholders in a company. The 'corporate' strategy of a state-owned enterprise will therefore differ from the corporate strategy of a company.

Stakeholders' expectations. The term 'stakeholder' means any individual or group of individuals who have a strong interest (a 'stake') in the organisation and what it does. The chosen corporate strategy should also recognise the rights and expectations of other stakeholders, such as employees, customers, government, suppliers, lenders, local communities and the general public.

ICAN 2021

1.5 Business strategy

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

A large group of companies might consist of many subsidiary companies. Subsidiaries might be organised into strategic business units (SBUs) or operational divisions. Each SBU is a different business, and should have its own business strategy.

In a commercial entity, business strategy focuses on markets and business strategy is concerned with how to compete successfully in the chosen markets with the chosen products.

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

cost leadership, or

differentiation.

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

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

Example: Potato chips

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

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

1.6 Functional strategy

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

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

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Example: Functional strategy

Manufacturing strategy is a functional strategy for a manufacturing company.

The objectives of manufacturing strategy are stated in terms of:

cost

quality

delivery (speed or reliability of delivery), and

flexibility (the ability to switch between different products or production methods).

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

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

decisions about plant and equipment

production planning and control

labour and staffing

production design and engineering

the organisation and management of the manufacturing function.

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

1.7 A note on levels of planning

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

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

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

Strategic planning. This involves identifying the objectives of the entity, and plans for achieving those objectives, mostly over the longer term. Strategic plans include corporate strategy plans, business strategy plans and functional strategy plans.

Tactical planning. These are shorter-term plans for achieving medium-term objectives. An example of tactical planning is the annual budget. Budgets and

ICAN 2021

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

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

1.8 Different approaches to strategic planning

Within the strategic management process, there will be some planning. However, there are different approaches to strategic planning.

Rational planning model. The rational model of strategic planning is a 'top-down' and formal approach to strategic planning. A formal strategic plan is prepared at a senior management level, covering a period of perhaps five or ten years. It is called a rational model because it is a logical planning and management process, that goes through the stages of:

- Position analysis
- Making strategic choices from the options available
- Implementation of the chosen strategies
- Evaluation of strategic performance

The strategic plan is reviewed periodically, and a new strategic plan is prepared when the 'old' plan reaches the end of the period it covers.

Logical incremental model. This view of strategic planning is that effective strategies emerge as a series of strategies for 'sub-systems' within the organisation, one at a time and not as part of an overall coordinated plan. New strategies are therefore devised and implemented in increments. However, it is a logical or rational process, because each incremental change in strategy emerges as a result of position analysis, strategic choice, implementation and review.

Freewheeling opportunism model. A freewheeling opportunism approach to strategic decision-making is that there is no requirement at all for formal strategic planning. An organisation should be open to seeing new opportunities whenever they arise, and exploiting them. The organisation may have a general idea of the direction it is taking, but it cannot and should not plan in advance what to do.

In the rational approach to strategic planning and strategic management, the strategic management process consists of four stages, as indicated above: analysis, choice, implementation and evaluation. This rational model has been developed by Johnson and Scholes, and it is described in more detail in the next section.

ICAN 2021

2 ELEMENTS OF STRATEGIC MANAGEMENT AND BUSINESS ANALYSIS

Section overview

- Johnson, Scholes and Whittington – Defining elements of strategic management
- Strategic position
- Strategic choices
- Strategy into action
- The scope of business analysis

2.1 Johnson, Scholes and Whittington – Defining elements of strategic management

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

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

Strategic position

Strategic choices

Strategy into action.

2.2 Strategic position

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

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

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Management have to make a decision about what their company should be doing, and what the company is trying to achieve. Objectives need to be realistic, so management need to understand where the company stands now in its markets, and where it should be trying to get to in a few years.

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

The environment

Strategic capability of the entity

Expectations and purposes.

Environment (threats and opportunities)

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

Threats are developments in the environment that could threaten the ability of the entity to achieve its objectives.

Opportunities are developments that might be exploited, to improve the ability of the entity to achieve its objectives.

Environmental analysis is described more fully in a later chapter.

Strategic capability of the entity (strengths and weaknesses)

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

What is the entity good at doing? Why? What can be done to improve these strengths?

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

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

Expectations and purposes

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

Some entities make a formal statement of their purpose and reason for existence in the form of a **mission statement**. For example, a university might have a mission statement that its purpose is to provide a centre for academic and

scientific research and first-class tuition for undergraduate and postgraduate students.

We will look at mission statements in more detail later in this chapter.

A company might consider that its purpose is to provide returns to its owners, the shareholders. It might therefore state its purpose in terms of maximising shareholder wealth, or increasing shareholder wealth.

A company might consider that its purpose is to increase shareholder wealth but that it also has a significant responsibility to other stakeholder groups, such as employees and customers. A company might recognise its ethical duty as a 'corporate citizen' in society, and see a part of its purpose as the requirement to protect the environment and achieve a 'sustainable business'.

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

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

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

2.3 Strategic choices

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

Corporate level and international

Business level strategies

Development directions and methods

Corporate level and international

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

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

Business level strategies

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

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

Development directions and methods

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

If a company's management decide on a strategy of growth, and making the business bigger, decisions have to be made about how the company will grow. Will it have a strategy of internal growth, and developing the business gradually using the company's own internal resources? Or will it seek to grow by making acquisitions of other companies? Or will it seek to grow by making strategic alliances with other companies, so that all the companies in the alliance help each other to grow their businesses?

Senior management must also make strategic choices about its products and markets. One method of analysis (by Ansoff) is that companies can seek to grow in any of four ways:

- **market penetration**: this is a strategy of trying to increase market share, by selling more of the company's existing products in its existing markets
- **market development**: this is a strategy of growth by selling the company's existing products to new markets, such as markets in other countries
- **product development**: this is a growth strategy that involves developing new products or services to sell to the company's existing markets
- **diversification**: this is a higher risk strategy, which involves selling new products or services to new markets.

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

The nature of strategic choices

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

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

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What is the best way to make the entity succeed in achieving its objectives?

- Should strategic decisions be based on the significant changes that are happening in the environment? Or is success achieved by focusing on the strengths of the entity, and stick to doing what it does best?
- Should the entity choose a cost leadership strategy and sell its products at the lowest prices possible? Or should it seek to add value for the customer by differentiating its products, and charging higher prices?
- Should the entity specialise in one type of product or one market? Or should it diversify and sell a range of products and in a number of different markets?

What is the best way to manage the entity in order to get the best out of its resources? Should the organisation structure be centralised or decentralised? What management style is appropriate? (Management style is explained in a later chapter.)

2.4 Strategy into action

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

Organising

Enabling

Managing change.

Organising

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

Enabling

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

Each resource must be used to support the achievement of strategic objectives. This calls for efficient management of resources such as people (and labour skills), information, finance and technology.

Strategies should be based on making full use of the resource strengths of the entity, to achieve competitive advantage.

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Managing change

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

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

2.5 The scope of business analysis

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

Improvements in business processes are often a significant aspect of strategy implementation. Changing processes can be necessary to improve operational effectiveness.

Strategies might be implemented as new projects and investments. Project management is therefore another aspect of successful strategy implementation.

Successful strategic management also requires the support of management information systems. The information systems that management require are provided by information technology (IT) systems.

An important part of management information systems for strategic planning and implementation is financial analysis. Relevant financial analysis is an essential part of strategic management.

You need to understand the relationship between strategic management and supporting business processes. This relationship is shown simply in the following diagram (which also indicates that the management of individuals is also key to strategic success).

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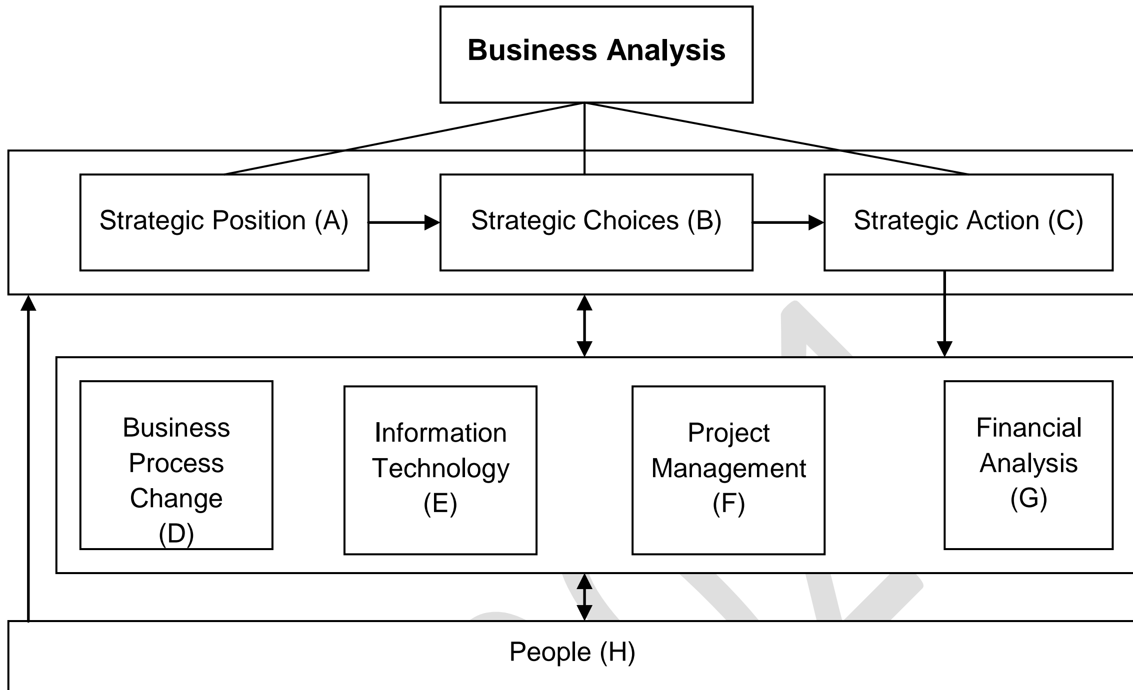


ICAN 202

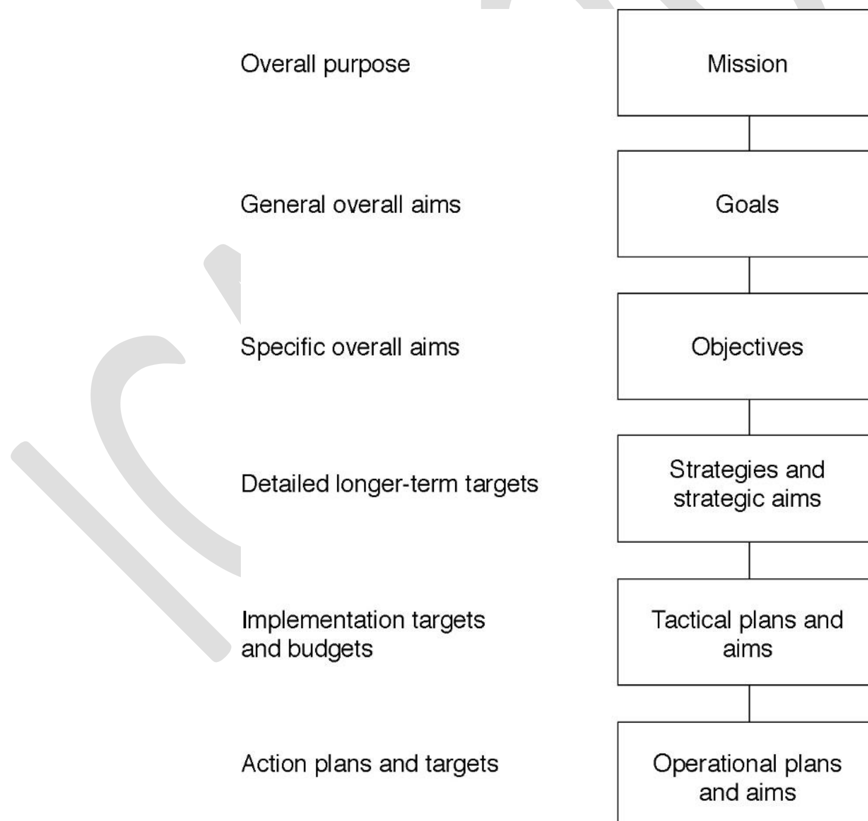
3 ORGANISATIONAL PURPOSE AND STRATEGY

Section overview

- A hierarchy of objectives and plans
- Mission and vision
- The relevance of the mission statement
- Goals and objectives
- Who decides mission, goals and objectives?

3.1 A hierarchy of objectives and plans

As part of a strategic review, management should always re-consider the purpose of the entity that they manage – what it is trying to achieve. In the strategic planning process, goals, objectives and strategies should be decided with the aim of fulfilling the entity's purpose. A business entity should have a hierarchy of aims and plans. A useful way of presenting this is shown below.



3.2 Mission and vision

Mission

Definition: Mission

A mission is the purpose of an organisation and the reason for its existence. Many entities give a formal expression to their mission in a mission statement.

'A mission describes the organisation's basic function in society, in terms of the products and services it produces for its customers' (Mintzberg).

The mission defines the present state or purpose of an organisation.

A mission statement should be a clear and short statement. Drucker suggested that it should answer the following fundamental questions:

What is our business?

What is our value to the customer?

What will our business be?

What should our business be?

Some entities include a statement about the role of their employees in their mission statement, or include a statement on the ethics of the entity.

Some examples of mission statements are set out below.

Example: Mission statements

Mission statements of not-for-profit organisations often stress the ethical aspects of their mission.

The World Bank

'Our dream is a world free of poverty

To fight poverty with passion and professionalism for lasting results.

To help poor people help themselves and their environment, by providing resources, sharing knowledge, building capacity and forging partnerships in the public and private sectors.

To be an excellent institution able to attract, excite and nurture diverse and committed staff with exceptional skills who know how to listen and learn.'

Commercial entities also often emphasise the ethical aspects of their mission, perhaps as a method of motivating employees.

Pfizer Corporation (pharmaceuticals)

'Our mission. We will become the world's most valued company to patients, customers, colleagues, investors, business partners and the communities where we work and live.

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Our purpose. We dedicate ourselves to humanity's quest for longer, healthier, happier lives through innovation in pharmaceutical, consumer and animal health products.'

A mission statement might include some reference to competitive position.

Kodak (imaging products)

The Kodak mission statement starts with statements about the corporation's values, and then continues as follows:

'With the above-mentioned values in mind we plan to grow more rapidly than our competitors by providing customers with the solutions they need to capture, store, process, output and communicate images – anywhere, any time. We will derive our competitive advantage by delivering differentiated, cost-effective solutions – including consumables, hardware, software, systems and services – quickly and with flawless quality. All this is thanks to our energetic, results-oriented employees with the world-class talent and skills necessary to sustain Kodak as the world leader in imaging.'

Vision

Definition: Vision

Whilst a mission statement defines the present state or purpose of an organization a vision statement represents a desired optimal future state of what the organization wants to achieve over time. For example:

- Microsoft: *"Empower people through great software anytime, anyplace, and on any device"*
- Avon: *"To be the company that best understands and satisfies the product, service and self-fulfilment needs of women – globally"*

3.3 The relevance of the mission statement

A mission statement can have several different purposes:

- to provide a basis for consistent strategic planning decisions
- to assist with translating broad intentions and purposes into corporate objectives
- to provide a common purpose for all groups and individuals within the organisation
- to inspire employees

- to establish goals and ethics for the organisation
- to improve the understanding and support for the organisation from external stakeholder groups and the public in general.

3.4 Goals and objectives

There is some confusion about the meaning of goals and objectives, and the terms might be used to mean different things.

However, it is useful to think of goals and objectives as follows.

Goals are aims for the entity to achieve, expressed in narrative terms. They are broad intentions. For example, an entity might have the goal of maximising the wealth of its shareholders, or the goal of being the world's leading business entity in one or more markets.

Objectives are derived from the goals of an entity, and are aims expressed in a form that can be measured, and there should be a specific time by which the objectives should be achieved.

The objectives specified by the strategic planners should be SMART:

Specific/stated clearly

Measurable

Agreed

Realistic

Time-bound (a time must be set for the achievement of the objective).

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Example: Strategic objectives

A company might have a goal of maximising the wealth of its shareholders. Its objective might therefore be to double the share price within the next ten years.

Objectives might be expressed as a hierarchy of corporate and strategic objectives:

A **corporate objective** might be to double the share price within the next ten years. This is the overall objective for the entity.

In order to achieve the corporate objective, it is necessary to set **strategic objectives for key aspects of strategy**. Examples of strategic objectives might be:

- to increase the annual profit after tax by 125% in the next ten years
- to introduce an average of three new products each year for the next ten years
- to become the market leader in four market segments within the next ten years, an improvement in each case from the current position of second-largest competitor in each of these market segments.

Some strategic objectives are more important than others, and there is a hierarchy of strategic objectives. However, the main strategic objectives might be identified as **critical success factors**, for which there are **key performance indicators**.

Goals and objectives can therefore be used to convert an entity's mission into specific strategies with strategic targets for achievement within a strategic planning period.

3.5 Who decides mission, goals and objectives?

When an entity states its mission in a mission statement, the statement is issued by the leaders of the entity. For a company this is the board of directors. Similarly, the formal goals and objectives of an entity are stated by its leaders.

However, the decisions by a board of directors about the goals and objectives of an entity are influenced by the way in which the company is governed and the expectations of other stakeholders in the company.

There are differing views on how a company should be governed. The implications of corporate governance on organisational purpose and strategy are considered in the next section.

4 STAKEHOLDERS AND STAKEHOLDER EXPECTATIONS

Section overview

- Definition of stakeholders
- The expectations of stakeholders
- Stakeholder mapping
- Stakeholder position/importance matrix
- Mendelow's stakeholder power/interest matrix
- Stakeholder influence: the cultural context

4.1 Definition of stakeholders

The stakeholders in an entity are any individuals, groups of individuals or external organisations that have an interest (a 'stake') in what the entity does or is trying to achieve. Some stakeholders have much more influence than others over the strategic decision-making of an entity, and the identity of the main stakeholders varies between different entities.

The stakeholders or stakeholder groups for a business entity usually include most of the following:

the ordinary shareholders

the controlling shareholder, if there is one

other classes of shareholders

bondholders

the investment community

lenders

suppliers, especially major suppliers

customers

the directors

other senior executive managers

other managers and employees, or groups of employees

the government (local, state or federal government)

pressure groups, such as environmental protection groups and human rights groups

local communities in which the entity operates

the general public.

Although large companies have most or all these stakeholder groups, the influence and significance of each stakeholder group will vary. Many stakeholder

ICAN 2021

groups might have very little influence at all on strategic decisions by the company. The relative importance and significance of each stakeholder group will vary with the company's circumstances, and the attitudes of its shareholders and directors towards corporate governance.

4.2 The expectations of stakeholders

Each stakeholder or stakeholder group has different expectations from a company. They expect to benefit from their association with the company, and the benefits they expect are different.

According to the traditional view of corporate governance, the main stakeholders are the shareholders of the company, its board of directors and probably also its senior managers. These stakeholder groups have different rights and duties, and they also have different expectations of what the company should provide for them.

Company law varies between countries, but the rights, duties and expectations of the main stakeholder groups might be described briefly as follows.

	Rights	**Duties**	**Expectations**
Shareholders	Right to vote on certain issues	Ensure that appropriate persons are elected as Directors.	Share price growth Stable dividends
	Other rights are set out in the memorandum and articles of association of the company		Return on investment Possibly also an expectation of being consulted by the board on major issues
Directors	No rights, but extensive powers are given to the board under the company's memorandum and articles of association	The directors have certain duties in law (for example, a legal duty of due care and skill) The board of directors has a duty to give leadership to the company	Personal advancement – remuneration, status
Senior managers	Employment rights	Senior managers have a duty to carry out their delegated tasks, in accordance with their contract of employment	Personal advancement – remuneration, status Possibly a belief that they should have the power to make key strategic decisions

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Expectations of other stakeholder groups

Other stakeholder groups have different expectations from their company.

Employees expect to receive fair pay for the work that they do. They will often want job security and possibly career progress. They might also expect good working conditions. The expectations of employees might be expressed by trade union representatives.

Customers have expectations about the nature of the goods or services they receive from a company.

Suppliers might expect to develop a good business relationship with the company and collaborate on achieving improvements in the value network.

Communities might expect a company to provide employment and economic prosperity by investing in the local area

The general public and government might expect a company to show concern for the environment and to reduce pollution and develop environment-friendly ways of operating.

When these stakeholders have some power, they can influence the strategic decisions of a company.

Employees might have considerable power when they possess a high level of skills, and it would be difficult to replace them if they left the company. Employees have much less power and influence in a company with highly-automated operations and where it would be fairly easy to obtain and train replacements if the employees left the company.

The power of communities and the general public could be affected by government policy, how well organised they are and how much the company's activities impact on them and their environment. For example, the willingness of a company to invest in a particular area could be affected by government policy and whether investment incentives are available. A company's concern for the environment could be affected by the threat of government legislation against polluting companies.

The power or influence of stakeholders might come from a variety of sources.

Stakeholders within an entity(internal stakeholders) include shareholders, senior managers, middle managers and other employees and their trade union or staff association representatives. Their power or influence over decision-making within the entity might come from:

their control over formal decision-making processes (shareholders, the board of directors, senior executives)

their position in the management hierarchy (although senior managers should not rely on their formal power alone to exercise influence within the entity)

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their influence (through personal qualities)

control over strategic resources, such as the work force or key workers in the work force, or the design or research and development department

knowledge or skills (for example, accountants)

control over access to the entity's environment (for example, the marketing department often exercises influence because marketing managers can claim to know the customers best)

their ability to exercise discretion. For example, in a large organisation such as a government department, middle management often has considerable influence over the way in which senior management strategies are implemented.

External stakeholders include lenders, suppliers, customers and the government. The influence of external stakeholders might come from:

laws and regulations (the government)

the dependence of the entity on particular suppliers or customers (for example, the bargaining power of suppliers or customers)

the involvement of an external entity in the implementation of strategy (for example, the importance of distribution networks and organisations)

the knowledge or skills of an external entity (for example, an important sub-contractor).

4.3 Stakeholder mapping

A business entity should manage its stakeholders, particularly those with the greatest influence. As a part of a review of the strategic position of a company, management should identify its major stakeholder groups, their power and their expectations.

One way of presenting the results of a stakeholder assessment is to prepare a 'stakeholder map'. This is a simple diagram showing the main stakeholders or stakeholder groups, and their relative significance. The purpose of stakeholder mapping is to assist the directors of a company (or the governors of a public sector entity) to obtain an appreciation of who the main stakeholder groups are, and what their real and potential influences are over the entity and the entity's strategies.

One approach to stakeholder mapping is to show the relative significance of stakeholder groups using a 2 × 2 matrix. There are a number of different stakeholder maps. Two matrices are:

the stakeholder position/importance matrix

the stakeholder power/interest matrix.

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The power/interest matrix is associated with Mendelow, and might be referred to as a 'Mendelow matrix'.

4.4 Stakeholder position/importance matrix

This matrix compares:

the position of the stakeholders on a particular issue, on a scale ranging from 'strong opposition' (+5) to 'strong support' (–5), and

the relative importance of the stakeholders, on a scale from 'not important' (–5) to 'very important' (+5).

Importance of the stakeholder

Position on the issue	(–5)	(0)	(+5)
Oppose (–5)	Problematic		Antagonistic
(0)			
Support (+5)	Low priority		Supporter

The map can be used by the directors to assess the action they should take to try to win the support of each stakeholder group. They should give more attention to the important stakeholders.

In the matrix shown here, the main concern should be to deal with important stakeholders who are strongly opposed to proposed plans of the board of directors and are 'antagonistic'. These would be shown in the top right hand corner of the matrix. The directors should consider what measures should be taken to try to reduce the opposition of these stakeholders. Their decision will be influenced by what the consequences for the company might be if the stakeholders remain antagonistic. The solution might be to find a compromise solution, which reduces their opposition.

Management should also try to win support from the 'problematic' stakeholders, although their opposition is relatively unimportant. They should also try to maintain the goodwill of 'supporters' – important stakeholders who support their plans.

4.5 Mendelow's stakeholder power/interest matrix

This matrix compares:

the amount of interest of the stakeholders on a particular issue, on a scale ranging from 'not at all interested' (0) to 'very interested' (+10), and

the relative power of the stakeholders, on a scale from 'very weak' (0) to 'very powerful' (+10).

Interest of the stakeholder

Power of the stakeholder	*Very low (0)*	*(5)*	*Very high (10)*
Weak (0)	Minimal effort		Keep informed
(5)			
Strong (10)	Keep satisfied		Key players

The strength of the interest of a stakeholder group in the strategic decisions by the company will depend on their expectations of the benefits they expect the company to provide.

The recommended course of action for the board of directors is indicated in each quadrant of the matrix. The key stakeholders are those who have considerable power or influence, and also have strong expectations (a keen interest)about the strategic choices that the company makes.

4.6 Stakeholder influence: the cultural context

It is also important to remember that the relative importance of different stakeholder groups for an entity, and the way in which management respond to the interest of different stakeholder groups, will also vary according to culture; the culture of the country or region in which the entity operates, and the culture of the organisation itself and its senior management.

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Define strategy andstrategic management and its importance
- Explain the difference between strategic planning, long-term planning and corporate planning
- Explain the different levels of strategy including corporate, business and functional strategies
- Explain the rational, logical incremental and freewheeling opportunism approaches to strategic planning
- Give an overview of the strategic management and business analysis process including strategic position, choices and putting strategy into action
- Distinguish between vision, mission, goals, objectives and plans
- Analyse a business and its strategy given its purpose, mission, vision and objectives from shareholder' and other stakeholder' perspectives with the aid of Mendelow's power/interest matrix

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CHAPTER 2

Environment analysis

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Contents

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

INTRODUCTION

Detailed syllabus

Strategic management

B1	**Strategic analysis**
B1 (b)	Analyse the external business environments and examine the opportunities and threats that could arise from events or potential events at the global, national, industry or competitive levels. **Note:** Models for analysis include PESTEL, Porter's diamond

Exam context

This chapter focuses on analysing a business's external environment. The environmental analysis assists management in identifying opportunities and threats for their business.

The two key models used for environmental analysis are PESTEL and Porter's diamond.

By the end of this chapter students will be able to:

- Explain and apply PESTEL analysis
- Explain and apply Porter's diamond

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1 MODELS FOR ENVIRONMENTAL ANALYSIS

Section overview

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

1.1 The nature of environmental analysis

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

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

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

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

The importance of environmental factors for strategic management arises because:

organisations operate within their environment and interact with it

changes in the environment can be large and significant – and continually happening

future changes can be very difficult to predict.

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1.2 The purpose of environmental analysis

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

the factors in the environment that have a significant effect on the entity and what it does

the key drivers of change: these are the factors in the environment that will have the greatest effect on the entity, and force the entity to change its strategies in order to survive and succeed

the difference in impact that key drivers of change in the environment will have on different industries or different markets, or how changes in the environment might affect one particular entity more or less than other entities.

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

Environmental analysis is the process of:

studying the environment in which an entity operates

identifying significant factors in the environment, particularly those that will be significant in the future.

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

1.3 Two models for environmental analysis

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

The PESTEL model is used to identify significant factors in the macro-environment of an entity.

Porter's Diamond model is used to analyse reasons why entities in particular countries, or regions within a country, appear to have a significant competitive advantage over similar entities in the same industry, but operating in other countries or regions.

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2 PESTEL ANALYSIS

Section overview

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

2.1 The nature of PESTEL analysis

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

There are six categories of environmental influence:

P – Political environment

E – Economic environment

S – Social and cultural environment

T – Technological environment

E – Ecological influences

L – Legal environment

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

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

SLEPT analysis uses the same categories of environmental influence as PESTEL analysis, without ‘Ecological influences’.

PEST analysis is the same as SLEPT analysis, but includes ‘Political influences’ and ‘Legal environment’ in the same category.

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2.2 Political environment

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

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

the stability of the political system in particular countries

the threat of government action to nationalise the industry and seize ownership from private business

wars and civil unrest

the threat of terrorist activity.

Political considerations are particularly important for business entities operating in countries with unstable political regimes or dictatorships.

2.3 Economic environment

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

the rate of growth in the economy and per capita GDP;

the rate of inflation;

the level of interest rates, and whether interest rates may go up or fall;

foreign exchange rates, and whether particular currencies are likely to get weaker or stronger;

unemployment levels and the availability of skilled or unskilled workers;

government tax rates and government subsidies to industry;

the existence or non-existence of free trade between countries, and whether trade barriers may be removed; and

the existence of trading blocs of countries, such as the European Community (EC) and Economic Community of West African States (ECOWAS).

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

2.4 Social and cultural environment

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

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Factors in the social and cultural environment include the following:

The values, attitudes and beliefs of customers, employees and the general public;

Patterns of work and leisure, such as the length of the working week and popular views about what to do during leisure time;

The ethnic structure of society;

The influence of religion and religious attitudes in society; and

The relative proportions of different age groups in society.

Example: Aging population

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

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

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

Example: Healthy living

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

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

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

2.5 Technological environment

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

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

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

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

2.6 Ecological Influences

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

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

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

In other countries, companies have been forced to make such change. For example, oil companies operating in the Niger Delta area of Nigeria have been forced to deal with oil pollution due to increasing hostility from the host communities.

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

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Example: PwC

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

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

Example: Shell Petroleum in Niger Delta

In 2012 lawyers representing a Nigerian fishing community took legal action against Shell Petroleum seeking compensation for oil spills. Shell accepted responsibility for the spillage of around 4,000 barrels of oil in Ogoniland in the Niger Delta in 2008 causing environmental damage to local communities. A contributing factor was the sabotage of oil pipelines in the Niger Delta as well as leaks from old and allegedly poorly maintained pipelines.

A UN environmental assessment of Ogoniland concluded that the region may take up to 30 years to recover fully from damage caused by years of oil spills.

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2.7 Legal environment

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

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

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

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

2.8 Limitations of PESTEL analysis

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

It is easier to use PESTEL analysis to identify environmental influences in the past and present. It is not so easy to identify the environmental influences that will have the biggest influence in the future.

It is a method of identifying environmental influences, by providing a framework for analysis. It does not provide an assessment of environmental influences. It is used for qualitative analysis, but not for quantification. A manager using PESTEL analysis might need to use his (subjective) judgement to decide which environmental factors are more important than others.

2.9 PESTEL analysis examples

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

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

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Example: UK rail travel

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

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

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

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PESTEL EXAMPLE

Example: DISCO operation in Nigeria

Electricity distribution companies (DISCOs) were recently licenced for specific period of time to distribute power from the national grid through transmission lines provided by The Transmission Company of Nigeria (TCN) to electricity consumers in Nigeria.

The DISCOs do not compete amongst themselves as they are allocated specific geographical areas of the country. However, they face competition from providers of energy from other sources, such as gas turbine, solar, wind and diesel-powered generators.

PESTEL may be used by the management of these DISCOs to analyse their external environment, thus:

- Political
  - The operations of DISCOs in Nigeria are strictly regulated by Nigerian Electricity Regulatory Commission (NERC).
  - The licences of DISCOs are renewable periodically, hence, may be withdrawn after the expiration of licence period.
  - Prices are also regulated by NERC.
  - There is clamour for improved power supply to justify the need for privatisation of the sector by government.
- Economical
  - Prices for electricity supply are regulated by NERC.
  - The demand for power is steadily growing in the nation, as economic activities are increasing.
  - The challenge from other sources of energy is not yet strong, though growing.
- Social and cultural
  - Population migration from rural to urban centres is increasing demand for electricity in urban centres.
  - Demand for electricity in the rural areas is growing as social activities are increasing in these areas.
  - Most homes and industries rely primarily on public power supply, hence increasing demand.
  - There is clamour for improved power supply to justify the need for privatisation of the sector by government.
- Technological
  - As internet penetration is improving in Nigeria, there is increased demand to power devices and equipment.
  - The public demand for prepaid meters is putting pressure on the DISCOs to change from post-paid to prepaid meters.
  - There is requirement for closer monitoring of supply to the network to guide against pilfering, hence, DISCOs are now deploying more advanced technology.
  - Technical staff are mainly drawn from the legacy company of Power Holding Company of Nigeria (PHCN).

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- Ecological

  The use of overhead cables to distribute power is adversely affecting the environment, raising the demand for deployment of underground cables.

- Legal

  The National Assembly has passed a law restraining DISCOs from estimated billing of consumers and insisting on provision of pre-paid meters.

Students should note that this analysis is only indicative, they may come up with other issues as mentioned in scenarios presented in the examination.

Note also that the same point may relate to more than one factor, as in the case of demand for improved power supply occurring under "political" .

Example: Recorded music

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

- ***Political***. *None significant.*
- **Economic.** Low costs of delivering music to customers over the internet, making it easier for low-cost business operations to offer their music products to the market.
- **Social and cultural**. Growing differences in musical tastes and preferences of customers. Decline of the 'pop music' industry.
- **Technology**. The widespread practice of downloading recorded music from the internet.
- ***Ecological***. *None significant.*
- **Legal**. The inability of the music industry to enforce copyright laws and prevent illegal downloading of recorded music on the internet.

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

Example: Building construction

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

- **Political**
- There are political pressures to increase the volume of properties built as residential homes, especially 'affordable homes' for low-income families.

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

ICAN 2021

3 PORTER'S DIAMOND

Section overview

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

3.1 National competitive advantage

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

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

Clusters

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

Reasons for national competitive advantage

Traditional economic theory states that a country 'inherits' a comparative advantage over other countries in particular industries because of the natural resources that it enjoys. Natural resources include not only land and mineral deposits, but also the labour force and size of the population.

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

The strategic significance of national competitive advantage

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

3.2 The four elements in Porter's Diamond

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

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

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

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

Favourable factor conditions

Related and supporting industries

Demand conditions in the home market

Firm strategy, structure and rivalry.

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

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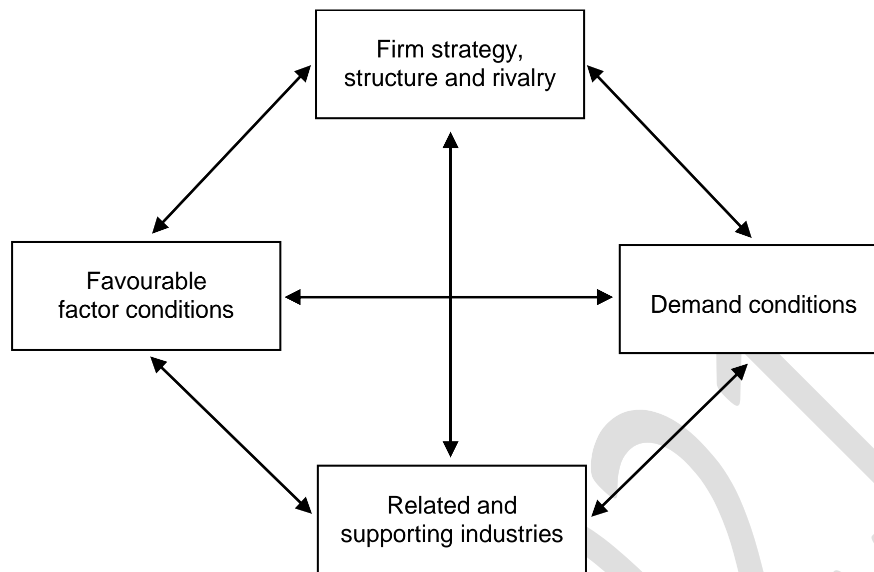

3.3 Favourable factor conditions

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

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

basic factors; and

advanced factors.

Basic factors

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

large amounts of suitable land, such as land for agriculture;

large quantities of natural materials, such as timber, fresh water, and mineral resources such as oil and metals; and

a favourable climate.

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

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Advanced factors

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

Examples of advanced factors are:

Labour skills and knowledge. These might be general skills, such as a highly educated workforce with excellent skills in language and mathematics. They might also be skills in a particular industry or type of work. For example, a country might have a working population with high levels of technical skill in computer software writing, or nuclear physics;

Technological resources. A country might benefit, for example, from the existence of scientific research centres; and

Infrastructure. A country might benefit from excellent transport networks and telecommunications networks.

Creating favourable factor conditions

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

Japan suffers from a shortage of land. Its companies therefore find it difficult to allocate space to the storage of goods and materials. Japanese companies successfully overcame the disadvantage of land shortage by developing the concept of Just-in-Time purchasing and production;

Japan has employment laws that make it difficult to dismiss employees from their job. As a result, there was extensive use of automation that gave Japan a lead over other countries in the production of high-quality manufactured goods;

Switzerland has suffered from a comparatively small population. It has a long tradition of excellence in the production of watches, and overcame the problem of labour-intensive watch production by developing innovative high-quality watch designs; and

It has been argued that the success of Switzerland in international banking is due largely to the language skills of its population and the consequent ability of Swiss bankers to establish a good relationship with customers from many different countries.

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3.4 Related and supporting industries

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

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

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

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

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

3.5 Demand conditions in the home market

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

When local demand is strong, local firms will give more attention than their foreign competitors to the needs of the local customers.

This will help to make local firms more innovative and competitive.

When local firms sell their products in global markets, the innovation and competitiveness created in local markets will help them to succeed internationally.

Innovation in local markets will help local firms to anticipate changes in global demand.

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

It has also been argued that in the Japanese market for consumer electrical and electronic goods, customers have very high expectations about the quality of products. Companies are therefore forced to produce products to very high

ICAN 2021

quality standards to satisfy demand in the Japanese market. This creates a competitive advantage for Japanese producers in foreign markets.

3.6 Firm strategy, structure and rivalry

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

Firms and their owners might have different ideas about investment strategy. For example, in the US, investors and the management of companies often have a short-term outlook, and expect returns on their investment within a relatively short time. In other countries, investors might expect to invest for longer, to obtain the benefits of long-term returns. This might help to explain, for example, why the US does well in computer industries and Switzerland excels in pharmaceuticals.

In some countries, the management structure in larger companies is formal and hierarchical. In other countries, many companies are family-run businesses. This might give companies in some countries a competitive advantage in some industries, but not others.

A country is likely to retain a competitive advantage in industries whose key employees have jobs that give the individual a high status in society. For example, the UK has some comparative strength in investment banking: jobs as investment bankers have a high status in UK society.

Rivalry between local firms is also an important factor in maintaining national or regional competitive advantage. This is because rivalry forces producers to innovate, and to keep on looking for ways of meeting customer needs better than their competitors.

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

ICAN 2021

3.7 The role of government in creating competitive advantage

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

the availability of suitable resources and skills

information that firms can use to decide how to invest the resources and skills that are available to them

goals of individuals and companies

pressure on companies to innovate and invest.

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

They can create an education and training system that develops appropriate labour skills and knowledge.

They can help companies to raise their performance levels by enforcing strict product standards.

They can create early demand for new and advanced products by purchasing the products themselves.

They can stimulate rivalry between local firms by enforcing strict anti-trust legislation.

Example: Japanese fax machines

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

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

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

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3.8 Criticisms of Porter's Diamond

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

It is more relevant to companies in advanced economies than to companies in countries with developing economies; and

The diamond model does not consider the role of the multinational company, which locates production operations in different countries across the world.

3.9 Using Porter's Diamond

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

Example: London

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

- Favourable factor conditions
  - In the UK, investment bankers have a high social status. This helps to attract highly-talented individuals into the industry from other countries as well as the UK.
  - There is a highly-skilled workforce in investment banking and also related industries.
  - London benefits from its membership of the European Union.
  - London is in a favourable time zone in Europe, between the time zones of the Far East and the US (especially New York).
  - English is the 'language' of international banking, and London benefits from being in an English-speaking country.
- Related and supporting industries
  - London's financial companies benefit from the existence of strong related and supporting industries, such as accounting firms, law firms and IT firms.
- Demand conditions in the home market
  - Investment institutions such as pension funds and insurance companies are major customers of financial services firms in the UK. They have very high expectations of the quality of service they should receive.

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- Firm strategy, structure and rivalry
  - Banks in the London market benefit from strong rivalry between firms that helps to maintain standards of service at a high level.

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

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4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain and apply PESTEL analysis
- Explain and apply Porter's diamond

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CHAPTER 3

Competitive forces

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Contents

1 Competition and markets
2 Industry competition: Five Forces model
3 Life cycle model
4 Boston Consulting Group matrix (BCG matrix)
5 Opportunities and threats
6 Chapter review

INTRODUCTION

Detailed syllabus

Strategic management

B1	**Strategic analysis**
B1 (b)	Analyse the external business environments and examine the opportunities and threats that could arise from events or potential events at the global, national, industry or competitive levels.
B1 (d)	Analyse the position of a business in terms of its competitive strategy, plans and current markets, drawing conclusions and giving simple recommendations on the chosen plans. **Note:** Models for analysis include SWOT, Porter's Five Forces, Life Cycle, BCG Matrix
B2	**Strategic choice**
B2 (c)	Evaluate the appropriateness of a chosen strategy that supports business objectives, considering constraints, conflicts and other issues based on a given scenario. The following models and tools may be employed in carrying out the evaluation: **Models** (iii) Models for strategic choice include the Boston Consulting Group (BCG) model in strategic management

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Exam context

Having considered the external environment in the previous chapter we now switch the focus to the internal environment. In this chapter you will see how business strategists think about their market and competitors using the Five Forces model. You will also see how businesses look at their own product offerings using lifecycle and BCG analyses.

The chapter closes by showing how the external and competitor analyses are brought together using SWOT analysis as a means for identifying opportunities and threats (i.e. the "OT" of SWOT).

By the end of this chapter, students will be able to:

- Explain the concepts of customers, markets, industries, sectors and convergence;
- Use the 'Five Forces' model to analyse competitive rivalry;
- State the different phases of the product life cycle considering cost implications at each phase;
- Understand the BCG matrix and how it is used to analyse product-market portfolio for strategic planning; and
- Demonstrate how SWOT analysis leverages the external and competitor analyses to identify opportunities and threats (OT).

1 COMPETITION AND MARKETS

Section overview

- Customers, consumers and markets
- Industries and sectors
- Convergence

1.1 Customers, consumers and markets

A market is a place where buying and selling takes place between vendors (sellers) and customers (buyers). A market can be defined in different ways.

It can be defined by the products or services that are sold, such as the fashion clothes market, the banking market or the market for air travel.

It can be defined by the customers or potential customers for products or services, such as the consumer market or the 'youth market'.

Customer markets might also be defined by geographical area, such as the North American market or European market.

Markets can be global or localised.

A customer is the person or entity that purchases a good or service. A consumer is the person or entity that uses (consumes) the good or service that has been purchased. Subsequently, customers and consumers need not necessarily be the same person (or entity).

For example, someone who buys an ice cream to eat themselves is both the customer and consumer. However, when a parent buys an ice cream for their child, the parent is the customer whereas the child is the consumer.

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

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

1.2 Industries and sectors

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

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

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Companies need to make strategic decisions about:

the industry and industrial segment (or segments) they intend to operate in, and

the market or markets in which they will sell their goods or services.

A distinction should be made between products and markets.

Companies in different industries might sell their goods or services to the same market. For example, small building companies compete with retailers of do-it-yourself tools and other products. Laundry services compete with manufacturers of domestic washing machines.

Companies in the same industry might not compete because they operate in different markets. For example, a ferry company operating passenger services between the UK and France is in the same industry as a ferry company operating passenger services between the Greek islands, but they operate in different markets.

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

Generic types of industry

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

- **Fragmented industries**. In a fragmented industry, firms are small and sell to a small portion of the total market. Examples are dry cleaning services, hairdressing services, and shoe repairs.

- **Emerging industries**. These are industries that have only just started to develop, and are likely to become much bigger and much more significant in the future. An example is the space travel industry.

- **Mature industries**. These are industries where products have reached the mature phase of their life cycle. (The product life cycle is described later.) Examples are automobile manufacture and soft drinks manufacture.

- **Declining industries.** These are industries that are going into decline: total sales are falling and the number of competitors in the market is also falling. An example is coal mining in Europe.

- **Global industries.** Some industries operate on a global scale, such as the microprocessor industry and the professional football industry.

1.3 Convergence

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

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Example: Communications services

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

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

A separate mobile telephone industry also developed.

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

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

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

Demand-led and supply-led convergence

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

With demand-led convergence, the pressure for industry convergence comes from customers. Customers begin to think of two or more products as interchangeable or closely complementary.

With supply-led convergence suppliers see a link between different industries and decide to bridge the gap between the industries. The convergence of the entertainment, voice communication and data communication industries, discussed in the previous example, is probably supply-led, because suppliers became aware of the technological possibilities before consumers became aware of the convenience.

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2 INDUSTRY COMPETITION: FIVE FORCES MODEL

Section overview

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

2.1 Competition analysis

Analysing competition is an important part of strategic position analysis.

It is also important to assess the strength of competition in a market, and try to understand what makes the competition weak or strong.

A company should also monitor each of its major competitors, because in order to obtain a competitive advantage, it is essential to know about what competitors are doing.

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

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

Profitability and competition

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

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

industry structure and **competition in the industry**, and also

sustainable competitive advantage: this is discussed in detail in a later chapter.

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2.2 The Five Forces

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

threats from potential entrants

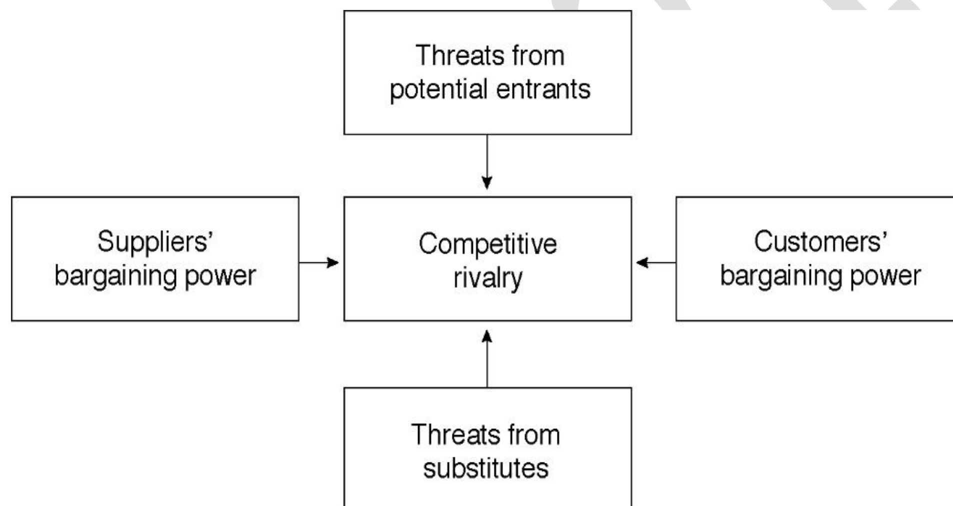
threats from substitute products or services

the bargaining power of suppliers

the bargaining power of customers

competitive rivalry within the industry or market.

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



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

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

2.3 Threat from potential entrants

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

The significance of this threat depends on how easy or how difficult it would be for new competitors to enter the market. In some markets, the cost of entering a new market can be high, with new entrants having to invest in assets and establish production facilities and distribution facilities. In other markets, the cost of entering the market can be fairly low.

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

When barriers to entry are low. If new entrants are able to come into the market without much difficulty, firms already in the market are likely to keep prices low and to meet customer needs as effectively as possible. As a result, competition in the market will be strong and there will be no opportunities for high profit margins.

When barriers to entry are high. When it is difficult for new competitors to enter a market, existing competitors are under less pressure to cut their costs and sell their products at low prices.

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

Economies of scale. Economies of scale are reductions in average costs that are achieved by producing and selling an item in larger quantities. In an industry where economies of scale are large, and the biggest firms can achieve substantially lower costs than smaller producers, it is much more difficult for a new firm to enter the market. This is because it will not be big enough at first to achieve the economies of scale, and its average costs will therefore be higher than those of the existing large-scale producers.

Capital investment requirements. If a new entrant to the market will have to make a large investment in assets, this will act as a barrier to entry, and deter firms from entering the market when they do not want the investment risk.

Access to distribution channels. In some markets, there are only a limited number of distribution outlets or distribution channels. If a new entrant will have difficulty in gaining access to any of these distribution channels, the barriers to entry will be high.

Time to become established. In industries where customers attach great importance to branding, such as the fashion industry, it can take a long time for a new entrant to become well established in the market. When it takes time to become established, the costs of entry are high.

Know-how. This can be time-consuming and expensive for a new entrant to acquire

Switching costs. Switching costs are the costs that a buyer has to incur in switching from one supplier to a new supplier. In some industries, switching costs might be high. For example, the costs for a company of switching from one audit firm to another might be quite high, and deter a company from wanting to change

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its auditors. When switching costs are high, it can be difficult for new entrants to break into a market.

Government regulation. Regulations within an industry, or the granting of rights, can make it difficult for new entrants to break into a market. For example, it might be necessary to obtain a licence to operate, or to become registered in order to operate within an industry.

2.4 Threat from substitute products

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

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

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

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

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

Plastic containers and bottles became a significant substitute for glass containers and bottles.

Synthetic fibres became a substitute for natural fibres such as wool and cotton.

Word processors and personal computers became a substitute for typewriters, and the market for typewriters was destroyed.

2.5 Bargaining power of suppliers

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

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

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Example: Bargaining power of suppliers

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

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

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

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

2.6 Bargaining power of customers

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

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

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

when the volume of their purchases is high relative to the size of the supplier;

when the products of rival suppliers are largely the same ('undifferentiated');

when the costs of switching from one supplier to another are low;

when the cost of purchased item is a significant proportion of the buyer's total costs;

when the profits of the buyer are low;

when the buyer's product is not affected significantly by the quality of the goods that it buys; and

when the buyer has full information about suppliers and prices.

2.7 Competitive rivalry

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

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

when the rival firms are of roughly the same size and economic strength;

when there are many competitors;

when there is only slow growth in sales demand in the market;

when the products of rival firms are largely the same ('undifferentiated');

when fixed costs in the industry are high, so that firms still make some contribution to profit even when they cut prices;

when supply capacity can only be increased in large incremental amounts (for example, in electricity supply industry, where increasing total supply to the market might only be possible by opening another power generation unit); and

when the costs of withdrawing from the industry are high, so that even unprofitable companies are reluctant to leave the market.

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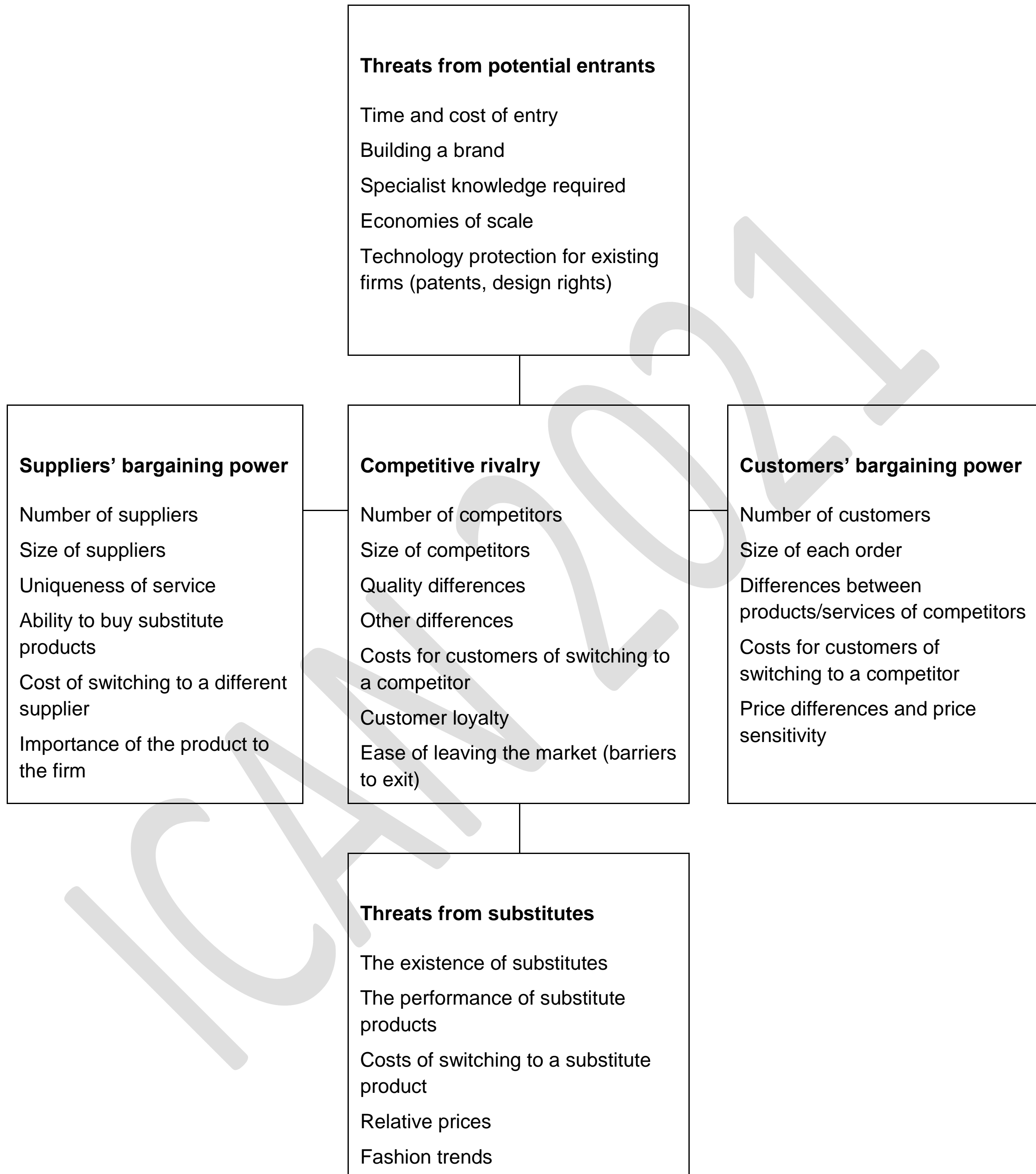
2.8 The Five Forces model summarised

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



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2.9 Using the Five Forces model

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

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

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Example: Five forces – legal services

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

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

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

Example: Five forces – CDs and DVDs

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

- **Threat from potential entrants**. This is likely to be fairly low because of the costs of establishing a selling and distribution system and the time it might take a new competitor to create 'brand awareness'.
- **Suppliers' bargaining power**. Amazon obtains its books and other products from a large number of different suppliers. The bargaining power of most suppliers is therefore likely to be weak, with suppliers needing Amazon more than Amazon needs individual suppliers.
- **Customers' bargaining power**. Amazon has a very large customer base, and the bargaining power of customers is non-existent.
- **Threat from substitutes**. Substitutes are bookshops, shops selling CDs and DVDs, internet downloads of films and music, and possibly eBay and other online auction sites as a channel for selling second-hand books. In the longer term electronic books might be another substitute.
- **Competitive rivalry**. Amazon has no direct competitor.

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

3 LIFE CYCLE MODEL

Section overview

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

3.1 The 'classical' product life cycle

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

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

Introduction;

Growth;

Maturity; and

Decline.

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

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

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

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

Decline phase - Eventually, total annual sales in the market will start to fall. As sales fall, so too do profits. Companies gradually leave the market. At some point

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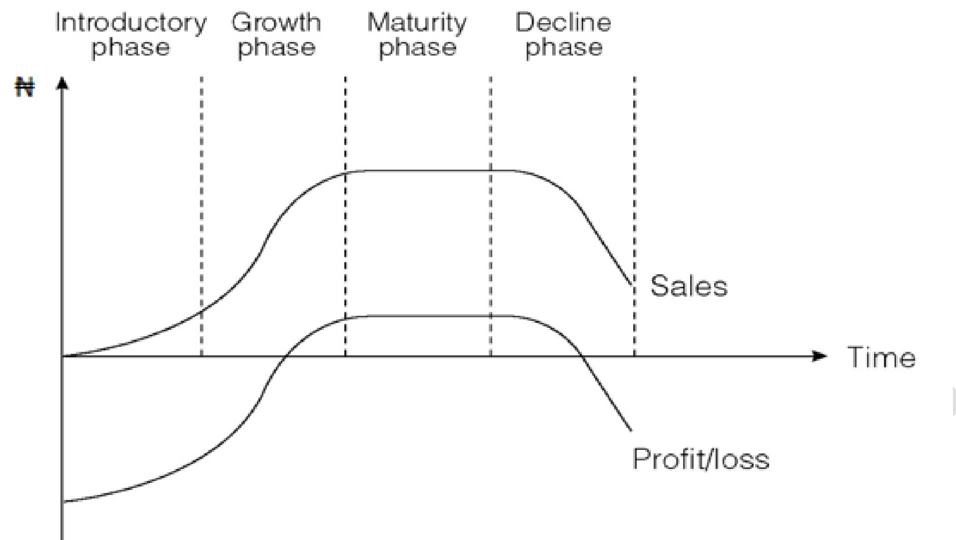
in time, it is no longer possible to produce and sell the product at a profit, and the product is therefore discontinued by the last of the companies that makes it.

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



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

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

At each phase of a product's life cycle:

selling prices will be altered;

costs may differ;

the amount invested (capital investment) may vary; and

spending on advertising and other marketing activities may change.

3.2 Cost implications of the product life cycle

Life cycle costing can be important in new product launches as a company will of course want to make a profit from the new product and the technique considers the total costs that must be recovered. These will include:

Research and development costs (decisions made at the development phase impact later costs);

Training costs;

Machinery costs;

Production costs;

Distribution and selling costs;

Marketing costs;

Working capital costs; and

Retirement and disposal costs.

Stage	Costs
Product development	R&D costs Capital expenditure decisions
Introduction to the market	Operating costs Marketing and advertising to raise product awareness (strong focus on market share) Set up and expansion of distribution channels
Growth	Costs of increasing capacity Maybe learning effect and economies of scale Increased costs of working capital
Maturity	Incur costs to maintain manufacturing capacity Marketing and product enhancement costs to extend maturity
Decline	Close attention to costs needed as withdrawal decision might be expensive
Withdrawal	Asset decommissioning costs Possible restructuring costs Remaining warranties to be supported

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Benefits of LCC

Life cycle costing compares the revenues and costs of the product over its entire life. This has many benefits:

The potential profitability of products can be assessed before major development of the product is carried out and costs incurred. Non-profit-making products can be abandoned at an early stage before costs are committed;

Techniques can be used to reduce costs over the life of the product;

Pricing strategy can be determined before the product enters production. This may lead to better control of marketing and distribution costs;

Attention can be focused on reducing the research and development phase to get the product to market as quickly as possible. The longer the company can operate without competitors entering the market the more revenue can be earned and the sooner the product will reach the breakeven point; and

By monitoring the actual performance of products against plans, lessons can be learnt to improve the performance of future products. It may also be possible to improve the estimating techniques used.

3.3 Relevance of the product life cycle to strategic management

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

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

Timing market entry and exit

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

Entrepreneurial companies might look for opportunities to enter a new market during the introductory phase, in the expectation that the product will become successful and the company will win a large share of the market by being one of the first companies to enter it.

More cautious companies, looking for growth opportunities, might delay their entry into the market until the growth phase, when the product is already making a profit for its producers.

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

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

Life cycle analysis as a technique for competition analysis

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

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3.4 Cycle of competition

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

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

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

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

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

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

Example: Life cycle

Products and raw materials related to solar energy are now in a strong growth phase of their life cycle due to growing end-user demand for solar energy. World-wide annual demand for solar electric energy has grown from 6 gigawatts in 2008 to around 36 gigawatts in 2013 with sales of global solar equipment similarly keeping pace.

Annual production of the high-purity silicon required to make solar cells was forecast to increase ten-fold between 2006 and 2015. With the growth in demand, the price of silicon rose sharply only stabilising temporarily in 2012-13.

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

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

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4 BOSTON CONSULTING GROUP MATRIX (BCG MATRIX)

Section overview

- Boston Consulting Group matrix (BCG matrix)
- Weaknesses in BCG model analysis

4.1 Boston Consulting Group matrix (BCG matrix)

The Boston Consulting Group developed a product-market portfolio for strategic planning. It allows the strategic planners to select the optimal strategy for individual products or business units, whilst also ensuring that the selected strategies for individual units are consistent with the overall corporate objectives.

The objective of the matrix is to assist with the allocation of funds to different products or business units.

The matrix is a 2 × 2 matrix.

One side of the matrix represents the rate of market growth for a particular product or business unit.

The other side of the matrix represents the market share that is held by the product or business unit.

Notes

Market growth - The mid-point of the growth side of the matrix is often set at 10% per year. If market growth is higher than this, it is 'high' and if annual growth is lower, it is 'low'. It should be said that 10% is an arbitrary figure.

Market share - This is usually measured as the annual sales for a particular product or business unit as a proportion of the total annual market sales. For example, if the product of Entity X has annual sales of ₦100,000 and total annual sales for the market as a whole are ₦1,000,000; Entity X has a 10% market share.

In the BCG matrix, however, market share is measured as annual sales for the product as a percentage or ratio of the annual sales of the **biggest competitor** in the market. The mid-point of this side of the matrix represents a situation where the sales for the firm's product or business unit are equal to the annual sales of its biggest competitor. If a product or business unit is the market leader, it has a 'high' relative market share. If a product is not the market leader, its relative market share is 'low'.

The BCG matrix is shown as follows. The individual products or business units of the firm can be plotted on the matrix as a circle. The size of the circle shows the relative money value of sales for the product. A large circle therefore represents a product with large annual sales.

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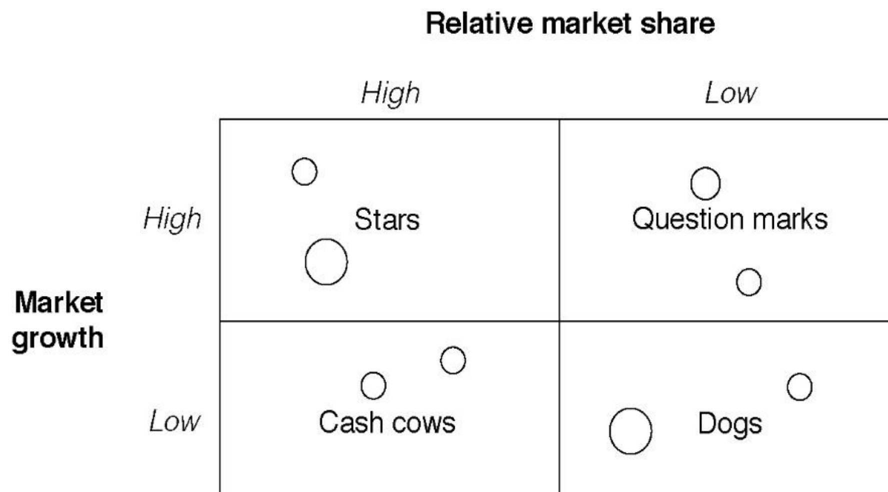
BCG matrix



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The products or business units are categorised according to which of the four quadrants it is in. The four categories of product (or business unit) are:

Question mark (also called ‘problem child’);

Star;

Cash cow; and

Dog.

Question mark

A question mark is a product with a relatively low market share in a high-growth market. Since the market is growing quickly, there is an opportunity to increase market share, but initially it will require a substantial investment of cash to increase or even maintain market share.

A strategic decision that needs to be taken is whether to invest more heavily to increase market share in a growing market, whether to seek a profitable position in the market, but not as market leader, or whether to withdraw from the market because the cash flows from the product are negative.

The BCG analysis states that a firm cannot last long with a small market share, as bigger companies will be able to apply great cost and price pressure as they enjoy economies of scale.

Star

A star has a high relative market share in a high-growth market. It is the market leader. However, a considerable investment of cash is still required to maintain its leading position. Initially, they probably use up more cash than they earn, and at best are cash-neutral. Over time, stars should gradually become self-financing. At some stage in the future, they should start to earn high returns.

Cash cow

A cash cow is a product in a market where market growth is lower, and possibly even negative. It has a high relative market share, and is the market leader. It should be earning substantial net cash inflows, because it has high economies of scale and will have become efficient through experience. Other companies will not mount an attack as they perceive that the market is old and near decline. Cash cows should be providing the business entity with the cash that it needs to invest in question marks and stars.

Dog

A dog is a product in a low-growth market that is not the market leader. It is unlikely that the product will gain a larger market share, because the market leader will defend the position of its cash cow. A dog might be losing money, and using up more cash than it earns. If so, it should be evaluated for potential closure.

However, a dog may be providing positive cash flows. Although the entity has a relatively small market share in a low-growth market (or declining market), the product may be profitable. A strategic decision for the entity may be to choose between immediate withdrawal from the market (and perhaps selling the business to a buyer, for example in a management buyout) or enjoying the cash flows for a few more years before eventually withdrawing from the market.

It would be an unwise decision, however, to invest more capital in 'dogs', in the hope of increasing market share and improving cash flows, because gaining market share in a low-growth market is very difficult to achieve.

Using the BCG matrix

Companies must invest in products and business units for the future. They need to invest in some question marks as well as in stars, and this uses up cash. Much of the cash for investing in other products will come from cash cows. The BCG matrix model can help management to decide on a portfolio of products or business units, for both short-term and longer-term returns.

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Deciding strategies using the BCG matrix

Market growth		Relative market share: High	Relative market share: Low
High	High	**STARS** Stars are the cash cows of the future. An entity should market a star product aggressively, to maintain or increase market share. A large continuing investment in new equipment and R&D will probably be needed. Stars should at some stage generate enough cash to be self-sustaining. Until then, the cash from cash cows can finance their development.	**QUESTION MARKS** The product will need a lot of new investment to increase market share. The strategic choice is between investing a lot of cash to boost market share or to disinvest/ abandon the product
Low	Low	**CASH COWS** Defend and maintain market share. Spending on innovation (R&D) should be limited. The cash generated by a cash cow can be used to develop other products in the portfolio.	**DOGS** These might generate some cash for the business, and if they do, it might be too early to abandon the product. The product has a limited future, and strategic decisions should focus on its short-term future. There is a danger that the product will use up cash if the firm chooses to spend money to preserve its market share. The firm should avoid risky investment aimed at trying to 'turn the business round'.

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Example: BCG

A company produces five different products, and sells each product in a different market. The following information is available about market size and market share for each product. It consists of actual data for each of the last three years and forecasts for the next two years.

(Note: Market share is calculated as the company's sales of a product, measured as a percentage of the total market size/sales for the product.)

	Year - 2 Actual	Last year Year -1 Actual	Current year Actual	Next year Year + 1 Forecast	Year + 2 Forecast
Product 1					
Total market size (₦ million)	50	58	65	75	84
Product 1 sales	2	2	2.5	3	3.5
Product 2					
Total market size (₦ million)	150	152	149	153	154
Product 2 sales	78	77	80	82	82
Product 3					
Total market size (₦ million)	40	50	60	70	80
Product 3 sales	3	5	8	10	12
Product 4					
Total market size (₦ million)	60	61	61	61	60
Product 4 sales	2	2	2	2	2
Product 5					
Total market size (₦ million)	100	112	125	140	150
Product 5 sales	4	5	5.5	6	6.5

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In the current year, the market share of the market leader, or the nearest competitor to the company, has been estimated as follows:

Market for:	Market share of market leader or the company's nearest competitor %
Product 1	37
Product 2	26
Product 3	12
Product 4	29
Product 5	20

Required

(a) Using the Boston Consulting Group model, how should each of these products be classified?

(b) How might this analysis help the management of the company to make strategic decisions about its future products and markets ('product-market strategy')?

Answer

A **star** is a product in a market that is growing quickly, where the company's product has a large market share or where the market share is increasing. **Product 3** appears to be a star. The total market is expected to double in size between Year – 2 and Year + 2. The expected market share in two years' time is 15%, compared with 7.5% in Year – 2. Its market share in the current year is over 13%, which makes it the current market leader.

A **cash cow** is a product in a market that has little or no growth. The market share, however, is normally quite high, and the product is therefore able to contribute substantially to operational cash flows. **Product 2** appears to be a cash cow. In the current year its market share was over 53%, and it is the market leader.

A **dog** is a product in a market with no growth, and where the product has a low share of the market. Dogs are likely to be loss-making and its cash flows are probably negative. Product 4 appears to be a dog. The total market size is not changing, and the market share for Product 4 is only about 3%. This is much less than the 29% market share of the market leader.

A **question mark** is a product with a fairly low market share in a market that is growing fairly quickly. **Product 1** appears to be a question mark. The total market is growing quite quickly, but the market share of Product 1 is about 4% and this is not expected to change. **Product 5** also appears to be a question

mark, for the same reason.

The company should decide on its strategy for the products it will sell.

It should benefit from the cash flows generated by its only cash cow, Product 2.

It should invest in its star, Product 3, with the objective that this will eventually become a cash cow.

It should give serious consideration to abandoning its dog, Product 4, and withdrawing from the market.

It has to make a decision about its two question marks, Product 1 and Product 5. The main question is whether either of these products can become a star and cash cow. Additional investment and a change of strategy for these products might be necessary, in order to increase market share.

For all the products (with the exception of Product 4, if this is abandoned) the company should also consider ways of making the products more profitable. Techniques such as **value chain analysis** might help to identify cost savings.

4.2 Weaknesses in BCG model analysis

There are several criticisms of the BCG model.

The BCG model assumes that the competitive strength of a product in its market depends on its market share, and the attractiveness of a market for new investment depends only on the rate of sales growth in the market. Unless a product can achieve a large share of the market, it is not sufficiently competitive. Unless a market is growing quickly enough, it is not worthwhile to invest more money in it. It can be argued that these assumptions are incorrect.

- A product can have a strong competitive position in its market, even with a low market share. Competitive strength can be provided by factors such as product quality, brand name or brand reputation, or low costs. Porsche earns very high profits but its market share is small compared to bigger car manufacturers such as General Motors, Ford and Toyota.
- A company might benefit from investing in an industry or market where sales growth is low.

Other factors, apart from market share and market size will influence what a company should do with a product: strength of competition, cost base and brand strength are all important considerations.

It might be difficult to define the market.

- There might be problems with defining the geographical area of the market. A market might be defined in terms of a single country, a region of a country or as an international or global market.
- It might also be difficult to identify which products are competing with each other. For example the total market for cars may be divided into different categories of car, but there may be problems in deciding which models of car belong to each category.

It might be the BCG matrix is better for analysing the performance of strategic business units (SBUs) and market segments. It is not so useful for analysing entire markets, which might consist of many different market segments.

It might be difficult to define what is meant by ‘high rate’ and ‘low rate’ of growth in the market. Similarly, it might be difficult to define what is meant by ‘high’ market share and ‘low’ market share.

Care is therefore needed interpreting a BCG analysis. For example, there are major differences in R&D and marketing spend suggested depending on whether a product is a star or a cash cow. It would be wrong to dramatically reduce marketing and R&D simply because the market growth rate fell from 10.1 to 9.9 (if 10 is taken as the low/high cut-off).

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5 OPPORTUNITIES AND THREATS

Section overview

- SWOT analysis
- Identifying opportunities and threats

5.1 SWOT analysis

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

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

S - Strengths. Strengths are internal strengths that come from the resources of the entity.

W - Weaknesses. Weaknesses are internal weaknesses in the resources of the entity.

O – Opportunities. Opportunities are factors in the external environment that might be exploited, to the entity's strategic advantage.

T – Threats. Threats are factors in the external environment that create an adverse risk for the entity's future prospects.

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

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

5.2 Identifying opportunities and threats

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

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

To identify opportunities and threats in the business environment, you should consider each aspect of the business environment. PESTEL analysis provides a

useful framework. However, whereas PESTEL analysis is used to identify significant factors in the environment, SWOT analysis is used to assess these factors and consider how they might create an opportunity or a threat for the entity.

You should then consider the competitive environment.

What is the strength of the competition? You should consider the Five Forces model. Are any of the Five Forces likely to change in the future, and if so, how might they change? What effect could this have on the nature of competition (and profitability in the market)?

Does the life cycle model offer a useful insight into the market and competition? Is the market in its introductory phase, its growth phase, its maturity phase or its decline phase? Is it likely to move from one phase to the other? If so what might be the consequences for the business?

Is the market segmented? What are the existing market segments? Are there gaps in the market, and opportunities for developing new segments? If the market is not segmented now, might it become segmented in the future, and if so what might those market segments be? Is there an opportunity to create a new market segment?

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

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

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

Example: SWOT

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

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

New technology is being developed for the production of fuel out of corn. Corn can be converted into ethanol (a ‘bio-fuel’) and cars are now being manufactured that will run on ethanol. However, the technology is in a very

early stage of development.

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

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

Required

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

Answer

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

PESTEL analysis

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

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

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

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

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

There is a problem with technology. It is not yet clear how successful the

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technology for producing ethanol will be. Improvements will be needed, and it is possible that other methods of producing bio-fuels, using other natural products, might become more successful.

Competitor analysis

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

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

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

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

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6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain the concepts of customers, markets, industries, sectors and convergence;
- Use the 'Five Forces' model to analyse competitive rivalry;
- State the different phases of the product life cycle considering cost implications at each phase;
- Understand the BCG matrix and how it is used to analyse product-market portfolio for strategic planning; and
- Demonstrate how SWOT analysis leverages the external and competitor analyses to identify opportunities and threats (OT).

ICAN 202

CHAPTER 4

Internal analysis

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Contents

1 Strategic capability
2 Customer needs
3 Critical success factors for products and services
4 Value chain
5 Customer relationship management (CRM)
6 Resources and competences
7 Capabilities and competitive advantage
8 Analysing strengths and weaknesses
9 Chapter review

INTRODUCTION

Detailed syllabus

B1	**Strategic management**
B1 (c)	Analyse the internal environment of a business to identify the business strengths and weaknesses and align them with the opportunities and threats in the external environments.
B1 (d)	Analyse the position of a business in terms of its competitive strategy, plans and current markets, drawing conclusions and giving simple recommendations on the chosen plans. ***Note:*** *Models for analysis include SWOT, SOAR, Benchmarking, Value Chain, Customer Relationship Management.*
B1 (e)	Analyse the position of a business with a chosen strategy in the context of its environment, based on an assessment of its resources, processes, people, information technology (IT), products, core capabilities and competences. Give simple recommendations on the best options.
B1 (f)	Draft an overall analysis, drawing conclusions with recommendations based on given financial and non-financial data and information from a variety of sources in a given scenario.

Exam context

The previous two chapters have focused on analysing an entity's opportunities and threats (OT) through performing environmental (PESTEL) and competitive (Porter's 5 forces and diamond) analyses.

In this chapter we move onto analysing an entity's strengths and weaknesses (SW) through the use of value chain, resource and competency analyses. You will also learn the relevance of key performance indicators, competitor benchmarking and a marketing perspective.

By the end of this chapter, students will be able to:

- Understand the concept of strategic capability and how it is achieved;
- Summarise customer needs from a marketing perspective and explain the 4Ps;
- Define and explain critical success factors, key performance indicators and competitor benchmarking;
- Explain what is meant by value chain analysis and use it to analyse an entity's primary and secondary activities;
- Explain what is meant by customer relationship management, its purpose and how it is used;
- Analyse an entity's resources and competencies (including core competencies);
- Demonstrate how SWOT analysis leverages resources and competencies to identify strengths and weaknesses in an organisation (the "SW" of SWOT); and
- Demonstrate how SOAR analysis may be used as a way of developing new strategies.

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1 STRATEGIC CAPABILITY

Section overview

- The meaning of strategic capability
- Achieving strategic capability

1.1 The meaning of strategic capability

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

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

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

Definition of strategic capability

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

1.2 Achieving strategic capability

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

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

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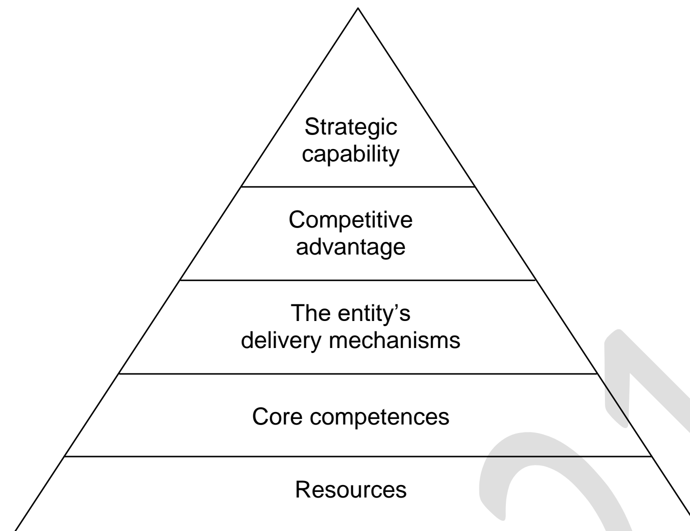
Achieving strategic capability



Understanding customer needs is fundamental to understanding and achieving competitive advantage.

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2 CUSTOMER NEEDS

Section overview

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

2.1 The marketing approach

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

Business success is achieved by providing goods or services to customers in a way that meets customer needs successfully.

Customers will buy from the business entities that meet their needs most successfully.

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

2.2 What are customer needs?

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

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

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

a better-quality product;

better design features;

availability: not having to wait to obtain the product;

convenience of purchase; and

the influence of advertising or sales promotions.

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

Customers may be grouped into three broad types:

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

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

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

2.3 The 4Ps of the marketing mix

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

Product;

Price;

Place; and

Promotion.

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

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

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

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

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

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

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3 CRITICAL SUCCESS FACTORS FOR PRODUCTS AND SERVICES

Section overview

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

3.1 Definition of a critical success factor

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

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

Example: CSF

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

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

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

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

If the partners can agree which factor or factors are critical to success, they can

concentrate on setting reasonable targets for each key factor and making every effort to ensure that those targets are achieved.

3.2 Marketing and CSFs for products and services

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

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

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

Example: Parcels

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

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

Example: Sports cars

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

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

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

3.3 CSFs and key performance indicators (KPIs)

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

CSFs should be identified during the process of assessing strategic position. Management need to understand the main reasons why particular products or services are successful.

CSFs are important in the process of making strategic choices. A business entity should select strategies that will enable it to achieve a competitive advantage over its competitors. These are strategies where the entity has the ability to excel in the critical success factors for its products or services.

CSFs are also important for strategy implementation. Performance targets should be set for each CSF. This involves deciding on a measurement of performance, that can be used to assess each CSF, and then setting a quantified target for achievement within a given period of time.

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

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

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

Step 1

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

Step 2

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

- If a critical success factor is ‘low sales price’, a critical competence might be ‘strict control over costs’;
- If a critical success factor is ‘prompt delivery after receipt of orders’, a critical competence might be either ‘fast production cycle’ or ‘maintaining adequate inventories’; and
- If a critical success factor is ‘low level of sales returns’, a critical competence might be either ‘zero defects in production’ or ‘identifying 100% of defects on inspection’.

Step 3

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

Step 4

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

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Step 5

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

Step 6

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

3.5 Competitor benchmarking

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

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

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

Methods of benchmarking

There are several methods of benchmarking:

Internal benchmarking. An entity might compare the performance of units within the organisation with the best-performing unit. For example, an organisation with 30 branch offices might compare the performance of 29 of the branches with the best-performing branch;

Operational benchmarking. An entity might compare the performance of a particular operation with the performance of a similar operation in a different business entity in a different industry. For example, a book publishing company might compare its order handling, warehousing and despatch systems with the similar systems of a company in a different industry that has a reputation for excellence – for example a company in the clothing manufacturing industry;

Operational benchmarking arrangements might be negotiated with another business entity;

Competitive benchmarking. An entity might compare its own performance and its own products with those of its most successful competitors. Unlike internal benchmarking and operational benchmarking, competitive benchmarking must be carried out without the knowledge and co-operation of the selected benchmark; and

Customer benchmarking. This is a different type of benchmark. The benchmark is a specification of what customers expect. An entity compares its performance against what its customers expect the performance to be.

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Example: Xerox

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

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

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

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

3.6 Methods of competitor benchmarking

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

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

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

Financial ratios obtained from the financial statements of the competitor should be compared with similar ratios for the company. In addition, trends in performance and in the ratios over time should also be monitored. Key performance measures might include:

- annual sales (by business segment or geographical segment);
- growth in annual sales (as a percentage increase on the previous year);
- return on capital employed;
- net profit/sales ratio; and
- gross profit/sales ratio.

Where there are significant differences in performance, the possible reasons for the differences should be considered;

The products or services of competitors should be analysed in detail. In the case of products, units of the competitor's product might be purchased and taken to a laboratory for scientific or technical analysis;

Information about competitors can be gathered by talking to customers and potential customers who have had dealings with a competitor, and who are willing to discuss what the competitor is offering as an incentive to make the customer buy its products; and

Sales prices should be compared. Some competitors might sell at higher prices and some at lower prices. Some competitors might sell a variety of similar products across a range of different prices. When there are significant price differences, management should consider whether the price differences are justified by the differences between the products or services.

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

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4 VALUE CHAIN

Section overview

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

4.1 Definition of value

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

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

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

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

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

This extra value might be real or perceived. For example a customer might be willing to pay more for a product with a well-known brand name, assuming that a similar non-branded product is lower in quality. This difference in quality might be imagined rather than real; even so, the customer will pay the extra amount to get the branded product.

The extra value might relate to the quality or design features of the product. However, other factors in the marketing mix might persuade a customer that a product offers more value. For example, a customer might pay more to buy one product than a lower-priced alternative because it is available immediately

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(convenience) or because the customer has been attracted to the product by advertising.

4.2 The concept of the value chain

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

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

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

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

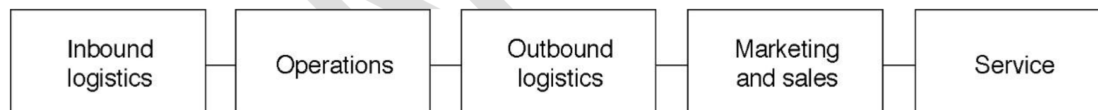
Within an entity:

there is a primary value chain; and

there are support activities (also called secondary value chain activities).

4.3 Primary value chain

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



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

Most value is usually created in the primary value chain.

Inbound logistics. These are the activities concerned with receiving and handling purchased materials and components, and storing them until needed. In a manufacturing company, inbound logistics therefore include activities such as materials handling, transport from suppliers and inventory management and inventory control.

Operations. These are the activities concerned with converting the purchased materials into an item that customers will buy. In a manufacturing company, operations might include machining, assembly, packing, testing and equipment maintenance.

Outbound logistics. These are activities concerned with the storage of finished goods before sale, and the distribution and delivery of goods (or services) to the

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customers. For services, outbound logistics relate to the delivery of a service at the customer's own premises.

Marketing and sales. These are the activities that inform customers about the product or service and persuade them to make a purchase. Marketing and sales includes activities such as advertising and promotion.

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

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

4.4 Secondary value chain activities: support activities

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

Procurement. These are activities concerned with buying the resources for the entity – materials, plant, equipment and other assets;

Technology development. These are activities related to any development in the technological systems of the entity, such as product design (research and development) and IT systems. Technology development is an important activity for innovation. 'Technology' also includes acquired knowledge: in this sense all activities have some technology content, even if this is just acquired knowledge;

Human resources management. These are the activities concerned with recruiting, training, developing and rewarding people in the organisation; and

Corporate infrastructure. This relates to the organisation structure and its management systems, including planning and finance management, quality management and information systems management.

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

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

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4.5 Adding value

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

Management should look for ways of adding more value at each stage in the primary value chain.

Similarly, management should consider ways in which support activities can add more value.

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

Who is the customer?

What features of the product or service do they value?

How do we provide value to the customer in the products or services we provide?

How can we add to the value that the customer receives?

How can we add value more successfully than our competitors? Do we have some **core competencies** that we can use to give us a **competitive advantage**?

Methods of adding value

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

One way of adding value is to alter a product design, and include features that might meet the needs of a particular type of customer better than products that are currently in the market. A product might be designed with added features. **Market segmentation** is successful when a group of customers value particular product characteristics, and are willing to pay more for a product that provides them.

Value can be added by making it easier for the customer to buy a product, for example by providing a website where customers can make purchases. Bookstores can add value to the books they sell by providing sales outlets at places where customers often want to buy books, such as airport terminals.

Value can be added by promoting a brand name. Successful branding might give customers a sense of buying products or services with a better quality.

Value can be added by delivering a service or product more quickly. For example, a private hospital might add value by offering treatment to patients more quickly than other hospitals in the region.

Value can also come from providing a reliable service, so that customers know that they will receive the service on time, at the promised time, to a good standard of performance.

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

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

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

4.6 Value creation and strategic management

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

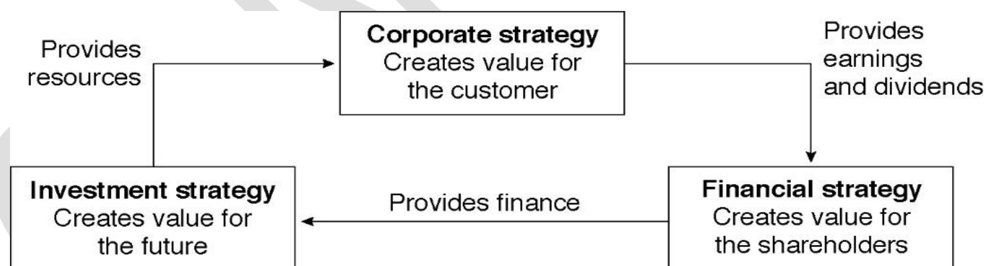
Added value does not have to be given immediately to customers (in the form of lower prices) or shareholders (in the form of higher dividends). The benefits can be re-invested to create more competitive advantage in the future.

There is a link between:

corporate strategy, which should aim to add value for the customer;

financial strategy, which should aim to add value for the shareholders; and

investment strategy, which should aim to ensure that the entity will continue to add more value in the future.



4.7 Using value chain analysis

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

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

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

How is value added by this part of the value chain?

Has the entity been successful in adding value in this part of the value chain?

Has the entity been more successful than its competitors in adding value in this part of the value chain?

Has there been a failure to add value successfully?

Does the entity have the core competencies in this part of the value chain to add value successfully? (If not, a decision might be taken to out-source the activities.)

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5 CUSTOMER RELATIONSHIP MANAGEMENT (CRM)

Section overview

- Definition and scope of customer relationship management
- CRM strategies
- CRM software

5.1 Definition and scope of customer relationship management

It can be very difficult to retain customers and build up customer loyalty over time. Retaining existing customers, as well as attracting new customers, is an important challenge for companies, especially those that use the internet for e-business.

Initially the purpose of customer relationship management (CRM) was to help companies to understand the behaviour of their customers better, and modify their marketing operations in order to provide the best service to customers. Its objectives were to:

- find out more about the purchasing habits and preferences of customers;
- profile the characteristics and needs of individual customers and groups of customers more effectively; and
- change the way the company operates, in order to improve its service to customers and the marketing of its products.

CRM has developed over time as technology and experience have developed. CRM now generally covers three areas:

- **Analytics** involves analysing customer data for a particular purpose, for example to analyse customer buying patterns;
- **Operations** involves supporting the sales and marketing and customer service processes. For example, contacts with a customer may be logged in a database, so that all personnel have an up-to-date history of client interaction when dealing with clients going forward; and
- **Collaboration** refers to direct interaction with customers such as e-mail and automated phone enquiry.

Customer relationship management is often associated with computer software. This is because companies that take CRM seriously will use CRM software. However, the scope of CRM is broader than just software.

The Business Link website states that customer relationship management 'is not just the application of technology, but is a strategy to learn more about customers' needs and behaviours in order to develop strong relationships with them. As such it is more of a business philosophy than a technical solution to

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assist in dealing with customers effectively and efficiently. Nevertheless successful CRM relies on the use of technology.'

5.2 CRM strategies

Acquisition : acquiring customers through electronic media

Acquisition is the process of attracting new customers to make a first purchase. e-Business acquisition techniques include:

- Profiling potential customers and market segments;
- Using customer-specific online promotion and incentives based on profiling;
- Using direct e-mail;
- Banner advertising; and
- Search engine registration and directories.

In order to target the right client base a company should analyse the target clients to decide who to target, and how to reach them.

When targeting consumers, segmentation of the consumer market on the basis of buying habits can also assist in improving the effectiveness of marketing.

Retention: retaining customers using electronic media

Customer retention is aimed at converting first-time buyers into repeat customers. The most likely form of retention is the repeat purchase of the same or similar product or service.

Business retention techniques include:

- Personalising e-mail or text message communications, such as follow-ups and reminders;
- Permission marketing (opt-in e-mail) whereby consumers provide their consent (for example by ticking a check-box) to receive marketing information;
- Offering loyalty schemes and promotions for repeat customers;
- Order tracking;
- Helpdesks; and
- Enrolling customers in a community so they develop brand loyalty through web-based discussions.

Retention ultimately requires an organisation to understand individual customer needs, maximise the service quality for each client, and once again select the appropriate channels for making contact.

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Extension: leveraging existing customers

Customer extension involves selling more to existing customers beyond just repeat purchases of their original product. This will involve cross-selling and up-selling as well as optimising service quality and using the right channels to reach customers.

Extension techniques include:

- Direct e-mails;
- Analysing customer behaviour to learn more about them, their habits and preferences; and
- On-site promotions.

Transactional vs. relationship marketing

CRM aims to focus on long-term relationship building rather than the traditional aim of maximising returns from individual transactions in the short term. This requires a collaborative approach to working with customers rather than against them.

5.3 CRM software

A number of 'off-the-shelf' CRM software applications are available. These are the cheapest software solution for companies, although off-the-shelf packages are not always ideally suited to the specific requirements of the individual company.

Some companies have developed or purchased bespoke (tailored) CRM systems.

The main functions of a CRM system are to:

- Collect information for identifying individual customers and categorising their behaviour. (Different categories of customer may be treated as different market segments, and a different marketing approach might be used for each segment of customers.);
- Store the customer information and keep it up-to-date;
- Access the information, often instantly, whenever it is needed;
- Analyse customer behaviour;
- Use the analysis of customer behaviour to develop a more effective marketing strategy;
- Provide customers with a better 'experience' when they contact the company. Customers often feel that they receive better service when they deal with a person who knows about their previous dealings with the company. Customer service staff are able to provide this type of experience because they have access to the customer's CRM record; and

- Monitor key customer management performance indicators, such as the number of customer complaints.

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Example:

CRM for handling telephone queries from a customer might operate as follows:

1 A customer phones up. The telephone system recognises the incoming number and the customer's record on the CRM is displayed on the screen of the call operator;

2 The customer's record might contain the following information:

- Customer name;
- Address and telephone number;
- Contact name;
- Contact job title;
- Contact purchasing authority;
- Personal notes about the contact, such as interests, likes, dislikes;
- Products previously purchased;
- A log summarising recent conversations and other dealings with the customer; and
- An alarm/reminder so that customers are contacted or goods despatched when promised; and

3 After the conversation ends, the log is brought up to date with details of the conversation.

CRM allows the company to offer customers a much better service. It does not matter who deals with the telephone call: full information about the customer is available for use by anyone. In particular, having details of previous conversations will save customers from having to explain, yet again, what might have happened in the past.

Areas that lend themselves particularly well to CRM automation include the following:

- Marketing
  - Campaign management
  - Prospects database
- Sales
  - Sales support
  - Order tracking
- Service
  - Help desk

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6 RESOURCES AND COMPETENCES

Section overview

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

6.1 Resources

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

Resources can be grouped into categories:

Human resources. These are the leaders, managers and other employees of an entity, and their skills;

Physical resources. These are the tangible assets of an entity, and include property, plant and equipment, and also access to sources of raw materials;

Financial resources. These are the financial assets of the entity, and the ability to acquire additional finance if this is required; and

Intellectual capital. This includes resources such as patents, trademarks, brand names and copyrights. It also includes the acquired knowledge and 'know-how' of the entity.

Threshold resources and unique resources

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

Threshold resources are the resources that an entity needs in order to participate in the industry and compete in the market. Without threshold resources, an entity cannot survive in its industry and markets.

Unique resources are resources controlled by the entity that competitors do not have and would have difficulty in acquiring. Unique resources can be a source of competitive advantage.

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

- ownership of scarce raw materials, such as ownership of exploration rights or mines;

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- location: for example a hydroelectric power generating company benefits from being located close to a large waterfall or dam, and a bank might benefit from a city centre location; and
- a special privilege, such as the ownership of patents or a unique franchise.

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

An investment bank might benefit from employing an exceptionally talented specialist; however, a rival bank might 'poach' him and persuade him to join them; and

A company might have patent rights that prevent competitors from copying a unique feature of a product that the company produces. However, competitors might find an alternative method of making a similar product, without infringing the patent rights.

6.2 Competences

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

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

Threshold competencies and core competencies

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

Threshold competences are activities, processes and abilities that provide an entity with the capability to provide a product or service with features that are sufficient to meet customer needs (the ability to provide 'threshold' product features).

Core competences are activities, processes and abilities that give the entity a capability of meeting the critical success factor requirements of the products or services, and achieving competitive advantage.

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

where the entity has the same level of competence as its competitors; or

that are easy to imitate.

To do really well, however, an entity needs to do more than merely meet thresholds; it needs capabilities for competitive advantage. Capabilities for competitive advantage consist of **core competences**. These are ways in which

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an entity uses its resources effectively, better than its competitors, and **in ways that competitors cannot imitate or obtain**.

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

6.3 Sustainable core competences

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

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

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

Durability. Durability refers to the length of time that a core competence will continue in existence, or the rate at which a competence depreciates or becomes obsolete.

Difficulty to imitate. A sustainable core competence is one that is difficult for competitors to imitate, or that it will take competitors a long time to imitate or copy.

Example of core competences

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

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

It is a **useful exercise** to think of any company that you would consider successful, and list the unique resources and core competences that you consider to be the main reasons why the company has achieved its success. (You should also think about why the company has been more successful than

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its main competitors. What makes your chosen company so much better than other companies in the same industry or the same market?).

6.4 Core competences and the selection of markets

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

Some strategists have taken the idea of core competence further. They argue that if an entity has a particular core competence, the same competence can be extended to other markets and other industries, where they will be just as effective in creating competitive advantage.

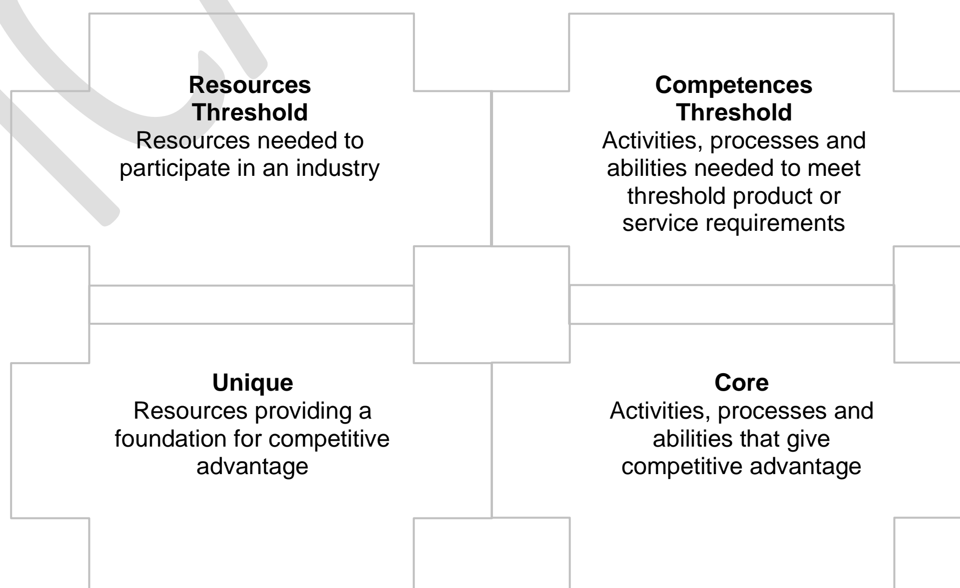
An entity should therefore look for opportunities to expand into other markets where it sees an opportunity to exploit its core competences.

Example: Marriot Group

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

6.5 Summary: resources and competences

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



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

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7 CAPABILITIES AND COMPETITIVE ADVANTAGE

Section overview

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

7.1 Competitive advantage

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

The result of competitive advantage should be anability to:

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

7.2 Capabilities

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

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

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

Dynamic capabilities

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

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

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Two definitions of dynamic capabilities are follows:

- Dynamic capabilities are abilities to create, extend and modify ways in which an entity operates and uses its resources, and its ability to develop its resource base, in response to changes in the business environment; and

- Dynamic capabilities are the abilities of an entity to adapt and innovate continually in the face of business and environmental change.

Business entities operate in a continually-changing environment. Strategic success is achieved by reacting to changes in the environment more successfully than competitors.

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

7.3 Cost efficiency and strategic capability

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

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

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

- making better use of resources or obtaining lower-cost resources; and

- improving competencies and capabilities (for example, improving the systems of inventory management).

Ways of achieving cost efficiency

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

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

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

Example: Economies of scale and scope

Economies of scale

Company A and Company B are building construction companies. Both companies construct residential homes. Company A is much smaller than Company B. Company B has been able to acquire a large share of the housing construction market because it is able to build lower-cost houses than companies such as Company A.

It achieves lower costs by exploiting **economies of scale**. It can buy raw materials (such as bricks and windows) at lower prices by purchasing in bulk. It can make better use of the time of its specialised workers. It can also reduce costs by buying its own construction equipment, instead of having to hire equipment from equipment suppliers at a higher cost (which is what Company A must do).

Economies of scope

Company C produces curtains and carpets for both commercial customers and the retail market. It competes with Company D, which produces curtains only, and Company E, which produces carpets only.

Company C might be able to achieve greater cost efficiencies than either Company D or Company E because it produces both curtains and carpets, and not just one product.

Cost efficiency and strategic capability

Cost efficiency can become a strategic capability, which will give the organisation competitive advantage, for example by achieving 'cost leadership'. A cost leadership strategy is explained in a later chapter.

7.4 Corporate knowledge and strategic capability

Corporate knowledge or organisational knowledge is the knowledge and 'know-how' that is acquired by the entity as a whole. It is created through the interaction between technologies, techniques and people. Within organisations, knowledge comes from a combination of:

- collaboration between people, who share their knowledge and create new knowledge together;
- technology, which makes it possible to store and communicate knowledge;
- information systems that make use of the technology systems; and
- information analysis techniques.

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Knowledge gives a company a competitive advantage. Another important characteristic of corporate knowledge is therefore that it cannot be easily replicated by a competitor. It is something unique to the company that owns it.

Another way of making this point is to say that the premium value of knowledge comes from the fact that it cannot be digitised, codified and easily distributed or easily acquired.

A capability in knowledge management comes from a combination of unique resources and core competences:

- experience in an industry or market, and acquiring knowledge through experience;
- the knowledge that employees have or acquire, for example through training;
- the management of people, and success in encouraging creativity and new ideas; and
- the management of IS/IT systems.

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8 ANALYSING STRENGTHS AND WEAKNESSES

Section overview

- Assessing resources and competences
- Techniques for assessing resources and competences
- Resource audit
- SWOT analysis and strengths and weaknesses
- Preparing a SWOT analysis
- Interpretation of a SWOT analysis
- SOAR analysis: strengths, opportunities, aspirations, results

8.1 Assessing resources and competences

In addition to assessing the external environment, including markets and competitors, strategic managers should also assess the internal resources of the entity, its competences and its capabilities.

The following assessment is required:

What are the resources of the entity?

Which of these resources are unique or special? What value do they provide? (What competitive advantage do they provide?)

Will requirements for resources change, as a result of changes in the business environment?

How are the resources used? Are they used effectively and efficiently? What core competences does the entity have?

8.2 Techniques for assessing resources and competences

As we have seen, there are several techniques that might be used to assess the resources and competences of an entity.

Management need to understand how value is created, and how value might be lost. An assessment of the value that is created or lost by the entity can be made using **value chain analysis**.

Management can prepare a **capability profile** of the entity. This is an assessment of the key strategic processes that are needed to provide consistently superior value to customers. This is an assessment of capabilities and competitive advantage.

A capability profile might be prepared together with a **SWOT analysis**.

In order to prepare a capability profile or a SWOT analysis, management need a thorough understanding of the resources that the entity has, the value of those resources, and the competences that the entity has acquired in using those resources.

This can be provided by a **resource audit**.

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8.3 Resource audit

A resource audit is an initial assessment of the resources of an entity. It is carried out to establish what resources there are, which are unique and how efficiently and effectively they are being used.

A resource audit should identify all the significant resources that are used by an entity. These will vary according to the nature of the entity. In general, however, a resource audit should provide data about the following resources.

Human resources (Part-time and full-time employees, consultants, sub-contractors etc.)	▪ Size and composition of the workforce ▪ Efficiency of the workforce ▪ Flexibility of the workforce ▪ Rate of labour wastage/turnover ▪ Labour relations between management and workers ▪ Skills, experience, qualifications ▪ Any particular expertise? ▪ Labour costs: salaries and wages
Management	▪ Size of the management team ▪ Historical performance ▪ Skills of the managers ▪ Nature of management structure, the division of authority and responsibility
Raw materials	▪ Costs as a percentage of total costs ▪ Sources, suppliers ▪ Availability ▪ Future provision. Scarcity? ▪ Wastage rates ▪ Alternative materials and alternative sources of supply
Non-current assets	▪ What are they? ▪ How old are they? What is their expected useful life? ▪ What is their current value? ▪ What is the amount of sales and profit per ₦1 invested in non-current assets? ▪ Are they technologically advanced or out-of-date? ▪ What condition are they in? How well are they repaired and maintained? ▪ What is the utilisation rate for each group of non-current assets?
Intangible resources	▪ Are there any intellectual rights, such as patent rights and copyrights?

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- Are there valuable brand names?
- Does the organisation have any identifiable goodwill?
- What is the reputation of the entity with its customers? How well does it know them?
- Is the work force well-motivated?

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Financial resources

- What is the capital of the entity?
- What are its sources of new capital?
- What are the cash flows of the entity?
- What are its sources of liquidity?
- How well does it control trade receivables?
- How well does it control other elements of working capital?

Internal controls and organisation

- How well does the entity control the use of its resources?
- How effective are its controls over the efficient and effective use of assets?
- How effective are its controls over accounting and financial reporting?
- How effective are its controls over compliance with laws and regulations?
- How effective are its risk management systems?
- Is the entity organised in an efficient way?

Evaluating resources

Having identified its key resources, management can evaluate them and the entity's ability to use them efficiently and effectively to create value (competences).

A simple framework for evaluating resources is the VIRO framework:

V: Value. Does the resource provide competitive advantage?

I: Imitability. Would it be costly for competitors to imitate the resource or acquire it?

R: Rarity. Do competitors own similar resources, or are the resources unique?

O: Organisation. Is the entity organised to exploit its resources to best advantage?

8.4 SWOT analysis and strengths and weaknesses

SWOT analysis was described in an earlier chapter as a technique for analysing strategic position and identifying key factors that might affect business strategy. These factors are both internal and external to the entity.

In the previous chapter, SWOT analysis was explained in the context of identifying opportunities and threats in the environment. It is also used to identify

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strengths and weaknesses in the resources, competences and capabilities of the entity.

Strengths. Strengths are resources and competences that an organisation has, and the capabilities it has developed. Strengths in resources, competences and capabilities can be exploited and developed to create sustainable competitive advantage.

Weaknesses. Weaknesses are resources, competences and capabilities that are deficient or lacking. These weaknesses are preventing the entity from developing or sustaining competitive advantage.

Identifying strengths and weaknesses

In your examination, you might be given a question that contains a case study or scenario, and asked to identify the strengths and weaknesses of the entity and the opportunities and threats that it faces.

To identify strengths and weaknesses, you should consider the following:

Resources

- Consider all the resources of the entity, and identify those that are significant and unique. Include the skills of management and other employees in your assessment. You should also consider the knowledge that the entity has acquired, and its intellectual capital; and
- Consider whether there are key resources that the entity lacks, but a competitor might have.

Competences

- Consider all the activities and processes of the entity and how it uses its resources. Identify the competences of the entity and consider whether any of these are core competences that provide competitive advantage; and
- Consider the competences that the entity lacks.

Capabilities

- Consider the capabilities of the entity, and its relative success or failure in delivering value to the customer or in creating cost efficiency.

8.5 Preparing a SWOT analysis

If you are required to use SWOT analysis in your examination, you may be required to analyse opportunities and threats as well as strengths and weaknesses in the strategic position.

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

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A SWOT analysis might be presented as four lists, in a cruciform chart, as follows. Illustrative items have been inserted, for a small company producing pharmaceuticals.

Note that strengths and weaknesses should include competences and capabilities as well as resources. In this example, the strengths relate to resources and the weaknesses relate to competences and capabilities, suggesting that the entity might not be making the best use of its resources.

Strengths	**Weaknesses**
Extensive research knowledge Highly-skilled scientists in the workforce High investment in advanced equipment Patents on six products High profit margins	Slow progress with research projects Poor record of converting research projects into new product development Recent increase in labour turnover
Opportunities	**Threats**
Strong growth in total market demand New scientific discoveries have not yet been fully exploited	Recent merger of two major competitors Risk of stricter regulation of new products

In order to prepare a SWOT analysis, it is necessary to:

- analyse the internal resources of the entity and try to identify strong points and weak points; and
- analyse the external environment, and try to identify opportunities and threats.

An analysis might be prepared by a team of managers, a think tank, a risk management committee or another group of individuals within the entity.

Using the technique

If you are required to use SWOT analysis in your examination, you may be expected to do so to answer a case study question. The technique is fairly simple to use. You can prepare four lists as 'workings' for your answer, one for each of the SWOT categories (strengths, weaknesses, opportunities and threats). Read through the question carefully, and add to each of the lists as ideas come to your mind. You will need to think 'strategically'. You will also be required to interpret the results of your analysis and consider their strategic implications.

8.6 Interpretation of a SWOT analysis

An initial SWOT analysis is simply a list of strengths, weaknesses, opportunities and threats. The **significance** or **potential value/cost of each item** is not considered in the initial analysis, and the items are not ranked in any order of importance.

A problem with SWOT analysis is that it can encourage very long lists of strengths, weaknesses, opportunities and threats, without any differentiation between those that are significant and those that are fairly immaterial.

Having prepared an initial SWOT analysis, the next step is to interpret it. Interpretation involves identifying those strengths, weaknesses, opportunities and threats (SWOTs) that might be significant, and what their implications might be for the future. The process of interpretation therefore involves ranking the SWOTs in some order of priority or importance.

Another problem with SWOT analysis is that it can be used to identify significant issues, but it cannot be used for evaluation. It cannot be a substitute for a more rigorous strategic analysis.

Having identified the most significant issues facing the organisation, strategic management should then consider:

- how major strengths (for example, core competencies) and opportunities might be exploited, to obtain competitive advantage; and
- how major weaknesses and threats should be dealt with, in order to reduce the strategic risks for the entity.

8.7 SOAR analysis: strengths, opportunities, aspirations, results

SOAR analysis is an alternative approach to strategic analysis that might be used instead of SWOT analysis. Whilst SWOT analysis focuses on four things (strengths, weaknesses, opportunities, threats) SOAR analysis focuses on just two of them (strengths and opportunities). SWOT is a method of strategic analysis: SOAR can be used for both strategic analysis but also to develop new strategies with measurable goals.

The reason for this is that there might be limited benefits in tackling weaknesses, especially if management find it difficult to agree on the seriousness of weaknesses and how to put them right. Threats exist, but may not become a reality.

A more constructive and rewarding approach to strategic analysis is to focus on the positive aspects: strengths and opportunities.

Together, strengths and opportunities can be combined to develop strategies that create aspirations (targets) for the future.

Aspirations must be measurable in terms of the results that the strategy will bring.

SOAR analysis focuses on the outcomes from a strategy and the benefits that they will represent.

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Example: SOAR analysis – car manufacturer

A car manufacturer has considerable engineering expertise in the design and construction of electric cars (astrength). It has identified an opportunity for sales of electric cars, especially in Africa (an opportunity).

The company therefore decides to launch a strategy for the design of a small range of electric cars with certain countries in Africa as a specific target market. The aim is to develop and grow sales of electric cars in Africa (an aspiration).

The strategy should have a measurable outcome. The company therefore sets targets for the number of electric car sales each year over a period of ten years, and the target market share in Africa in each of those years (a result).

Strategic analysis techniques

Elicitation

Elicitation comprises a number of data collection techniques used in anthropology, cognitive science,counseling, education, engineering, linguistics, management, philosophy, psycholog y, or others to gather knowledge or information from people. Recent research in behavioural sciences has claimed that elicitation techniques can be used to control subject misconceptions and mitigate errors from generally accepted experimental design practices.

Elicitation, in which knowledge is sought directly from human beings, is usually distinguished from indirect methods such as gathering information from written sources.

A person who interacts with human subjects in order to elicit information from them may be called an elicitor, analyst, experimenter, or knowledge engineer, depending on the field of study.

Elicitation techniques include:

- Interviews;
- Project scope;
- Brain storming;
- Focus groups;
- Exploratory prototypes;
- User task analysis;
- Observation;
- Surveys;
- Questionnaire; and
- Story board

Techniques for strategic analysis

Business case development

Business case development is a process that companies often use for project selection. It analyses how adoption of the **business case** for the project will implement the corporate strategy and sustain the competitive advantage of the **company**. The **business case** can be further **developed** with the addition of more details.

The **Five Case Model** is the approach for developing **business cases** recommended by HM Treasury, the Welsh Government and the UK Office of Government Commerce. It has been widely used across central government departments and public sector organisations.

Business case development framework

- Financial analysis

Conduct a financial analysis of the situation or project.

- Identify opportunity
  Clearly identify the opportunity presented by the situation.
- Analyse opportunity
  Analyse the requirements go fully harness the opportunity presented by the situation.
- Outline the benefits
  Quantify the benefits derivable by adopting the strategy.
- Finalise business case
  Articulate and prepare the business case for the project.

Mind mapping

This is a way of linking key concepts using images, lines and links.

A central concept is linked via lines to other concepts which in turn are linked with other associated ideas.

Mind mapping uses the concept of "radiant thinking" which states that thoughts radiate out from a single idea, often expressed as an image.

Steps in mind mapping

- Create a Central Idea.
  This is the starting point of a mind map and represents the subject of the investigation.
- Add branches to your map for new ideas.
- Add keywords to guide understanding.
- Color code your branches.
- Include images as visual signifiers.

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Brain storming

Brainstorming is a design method used to generate ideas to solve clearly defined problems. In regulated environment designed to encourage flow of ideas on the issue at hand, teams approach the issue with open ended questions. They generate a vast array of ideas and draw links between them to find potential solutions. This process enables ideas to go in many directions. It encourages thinking-out-of-the-box, rather than limiting ideas to conventional positions and thinking.

The rules for brainstorming sessions are lax, however, no judgements are allowed to be passed on any ideas, no matter how weird it seems.

For good results, brainstorming sessions must have a good mix of team members and some house rules. Everyone in the team should have a clear definition of the target problem. The facilitator enforces house rules and encourages free flow of ideas.

Some usual house rules for brainstorming sessions

- Set a time limit – This depends on the complexity of the issue.
- Start with a target problem – The goal should be well defined and clear to every member of the team.
- No judgment/criticism – No idea should be discountenanced.
- Give ear toodd ideas – No restriction on ideas.
- The more the ideas generated, the better – Screening of ideas will be done later.
- Build on other people's ideas – This ensures everyone's contribution and buy-in.
- Visualize all ideas – This gives life to ideas.
- Stay focused on a conversation at a time – This ensures that ideas are treated conclusively.

Questionnaire

A questionnaire is an instrument consisting of a set of questions or other types of prompts that aims to collect information from a respondent. The data collected through a questionnaire may be qualitative as well as quantitative in nature.

There are two main types of questionnaire; structured and unstructured. Quasi-structured questionnaire, which is a blend of structured and unstructured types is used mostly in social science research. Structured questionnaires include pre-coded questions with well-defined patterns to follow the sequence of questions, while unstructured questionnaire consists of questions soliciting open-ended responses .

Interview

An **interview** is essentially a structured conversation where one participant asks questions, and the other provides answers.

There are **three types of interviews**: unstructured, semi-structured, and structured.

Process Design

This is the act of transforming an organization's vision, goals, and available resources into a discernible, measurable means of achieving the organization's vision.

We can differentiate three **types of process design, thus**:

- Analytical;
- Experimental; and
- Procedural.

7 steps of project design

- Analysis of the assignment brief
- Research the issue
- Brainstorm session
- Sketching options generated
- Development of project concept
- Revision of project concept
- Completion of project design.

ICAN 20

CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Demonstrate an understanding of the concept of strategic capability and how it is achieved
- Summarise customer needs from a marketing perspective and explain the 4Ps
- Define and explain critical success factors, key performance indicators and competitor benchmarking
- Explain what is meant by value chain analysis and use it to analyse an entity's primary and secondary activities
- Explain what is meant by customer relationship management, its purpose and how it is used
- Analyse an entity's resources and competencies (including core competencies)
- Demonstrate how SWOT analysis leverages resources and competencies to identify strengths and weaknesses in an organisation (the "SW" of SWOT)
- Demonstrate how SOAR analysis may be used as a way of developing new strategies

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Skills Level

Corporate Strategic Management and Ethics

CHAPTER 5

Competitive advantage

Contents

1 Competitive advantage
2 The strategic clock
3 Cost leadership, differentiation and lock-in strategies
4 Collaboration
5 Chapter review

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INTRODUCTION

Detailed syllabus

B	**Strategic management**
B1	**Strategic analysis**
B1 (g)	Determine sustainable competitive advantage and the core competence of a business in a given scenario.
B2	**Strategic choice**
B2 (a)	Analyse the appropriate choices of strategy that a company may adopt based on a given scenario. This should include competitive advantage, the strategic clock, cost leadership differentiation, lock-in strategies and collaboration.
	Models
B2 (c) (i)	Porter's generic competitive strategies

Exam context

Businesses need to establish a strategy for achieving and subsequently sustaining competitive advantage. This chapter looks at the different options of how to achieve and sustain competitive advantage and hence make adequate returns over the long term.

By the end of this chapter students will be able to:

- Describe the two key factors that affect profitability when aiming to achieve competitive advantage;
- Explain how Bowman's strategic clock can be applied to help establish an appropriate price vs. perceived benefit mix;
- Summarise Porter's generic strategies and differentiate between cost leadership, differentiation and focus strategies; and
- Describe how different types of collaborations are used in business to help generate competitive advantage.

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1 COMPETITIVE ADVANTAGE

Section overview

- Two factors affecting profitability
- Value and competitive advantage
- Selecting business strategies for competitive advantage

1.1 Two factors affecting profitability

Porter argued that two factors affect the profitability of companies:

- industry structure and competition within the industry: he used the Five Forces model to explain the factors affecting competition; and
- at the level of the individual company, achieving a sustainable competitive advantage.

Sustainable competitive advantage is achieved by creating value for customers.

1.2 Value and competitive advantage

Companies and other business entities in a competitive market should seek to gain an advantage over their competitors. As explained in earlier chapters, competitive advantage means doing something better than competitors, and offering customers better value.

Having some competitive advantage over rival firms is essential. Without it, there is no reason why customers should buy the company's products instead of the products of a competitor.

Essentially, competitive advantage arises from the customers' perception of value for money. Value was explained in the chapter on the value chain and value networks. The key point to understand is that value comes from:

- a low price; or
- features of the product (or the way it is made available to customers) – both real and imagined – that make the customer willing to pay a higher price; or
- a combination of price and product features that gives 'best value' to a group of customers in the market.

Note that value is determined by the perception or opinion of customers. A combination of price and product features that gives 'best value' to one customer might not give 'best value' to another, because the customers have different perceptions of value.

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1.3 Selecting business strategies for competitive advantage

Since there are different perceptions of value, companies have to make a strategic decision about how they will try to offer value and gain competitive advantage.

Companies decide their corporate strategy, and the combination or portfolio of businesses ('product-markets') they want to be in.

They must then select one or more business strategies that will enable them to succeed in their chosen product-markets.

There are several approaches to identifying and choosing business strategies. Some of these are explained in the remainder of this chapter.

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2 THE STRATEGIC CLOCK

Section overview

- Purpose of the strategic clock
- Drawing a strategic clock
- Using a strategic clock

2.1 Purpose of the strategic clock

The two key factors in providing value to customers are the price of the product or service and the benefits that customers believe the product or service provides. Competitive advantage comes from offering an attractive combination of price and perceived benefits.

The strategic clock was suggested by Bowman (1996) as a way of looking at combinations of price and perceived benefits. Companies should consider which combination of the two they should try to offer, although to do this they must also understand the perception of customers about the benefits that the product or service provides.

Companies can also use the strategic clock to assess the business strategies of competitors, and the combination of price and benefits that they are offering.

2.2 Drawing a strategic clock

The strategic clock has two dimensions: price and perceived benefits. Price can be shown on a scale ranging from 'low' to 'high'. Similarly, perceived benefits can be shown on a scale from 'low' to 'high'.

The 'clock' consists of a series of business strategies. Each business strategy is shown as the hand of a clock, pointing in the direction of a combination of price and perceived benefits. Each business strategy has a different combination of price and perceived benefits, where customers have different requirements in terms of value for money.

The different positions on the clock also represent a set of generic business strategies for achieving competitive advantage.

There can be any number of different business strategies, each with its own combination of price and perceived benefits. However, the different business strategies can be grouped into:

five business strategies that might enable a firm to gain a competitive advantage; and

strategies that will fail because they cannot provide competitive advantage.

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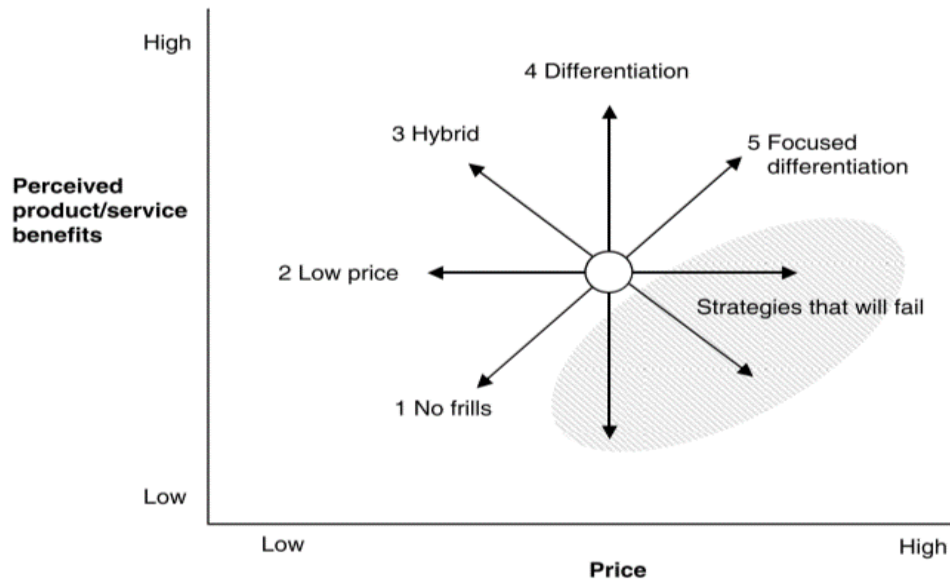

2.3 Using a strategic clock

A strategic clock can be used to consider different business strategies for gaining competitive advantage, based on providing a combination of price and perceived benefits.

In your examination, you might be given a case study or scenario and asked to suggest a suitable business strategy for a company. The strategic clock might be a useful basis for making an analysis – looking at the business strategies of competitors, and what a company must do to find an appropriate combination of price and perceived benefits that it should offer to customers.

The five broad groups of business strategy that might succeed are:

a ‘no frills’ strategy (position 1 on the clock);

a low-price strategy (position 2);

a differentiation strategy (position 4);

a hybrid strategy (position 3); and

a focused differentiation strategy (position 5).

No frills strategy: Position 1

A ‘no frills strategy’ is to offer a product or service at a low price and with low perceived benefits. It should attract customers who are price-conscious, and are happy to buy a basic product at the lowest possible price.

This strategy has been used by low-cost airlines, which offer a basic service for a low price.

With a 'no frills' strategy, customers understand that they are buying a product or service that gives them fewer benefits than rival products or services in the market.

Low price strategy: Position 2

With a 'low price' strategy, customers perceive that the product or service gives average or normal benefits. It is not regarded as a low-quality product. The price, however, is low compared with similar products in the market.

Only the lowest-cost producer in the market can implement this business strategy successfully. If a company that is not the **least-cost producer** tries to implement a 'low price strategy' there will be a continual threat that the least-cost producer will copy the same strategy, and offer prices that are even lower. Only the least-cost producer could win such a price war.

However, a 'low price' strategy can be applied in segments or sections of the market. For example, supermarkets offer their 'own brand' products at prices that are lower than similar branded goods. Customers shopping in a supermarket might buy the low-price own-brand goods rather than higher-priced branded goods (which might be perceived as offering more benefits to customers).

Differentiation strategy: Position 4

A differentiation strategy is based on making a product or service appear to offer more benefits than rival products or services. Companies try to differentiate their own particular products – make them seem different. There are various ways in which differentiation can be achieved: products or services might have **different features**, so that rival products do not offer exactly the same benefits. Companies might also promote the perception that their products or services are much better in **quality**.

In the strategic clock a strategy of differentiation involves charging average prices for the product or service, or prices that are perhaps only slightly higher than average. The strategy does not involve charging prices that are very much higher than average. Customers therefore believe that they are getting more benefits for every ₦1 they spend.

Hybrid strategy: Position 3

A hybrid strategy involves selling a product or service that combines:

higher-than average benefits to customers; and

a below-average selling price.

To be successful, this business strategy requires low-cost production and also the ability to provide larger benefits. It tries to achieve a mix between a low-price strategy and a differentiation strategy.

Focused differentiation strategy: Position 5

A focused differentiation strategy is to sell a product that offers above-average benefits for a higher-than-average price. Products in this category are often

strongly branded as premium products so that their high price can be justified. In Europe, gourmet restaurants and Ferrari sports cars are examples of products sold using this business strategy. In Nigeria, a focused differentiation strategy exists in parts of the high fashion industry, where some ranges of high-quality fashion wear sell at very high prices.

Business strategies on the clock that will fail

The diagram of the strategic clock shown above indicates some business strategies that will not succeed, because they do not enable the company to gain a competitive advantage. There are other strategies that competitors might adopt that will be more successful.

Strategies in the area that could be described as ‘three o’clock’ to ‘six o’clock’ on the strategic clock are clearly inferior to strategies on other parts of the clock.

Products with perceived benefits that are below-average cannot be sold successfully when there are lower-priced products offering the same perceived benefits. Customers will not pay more for products that, in their opinion, give them nothing extra.

Similarly products cannot be sold successfully at an above-average price when they have below-average perceived benefits. Customers can pay similar prices for products offering more benefits (which will be sold by companies pursuing a focused differentiation strategy).

Conclusion: strategic clock

Each business strategy is ‘market facing’, which means that it aims to meet the needs of customers, or a large proportion of potential customers in the market. It is therefore very important to understand the critical success factors (CSFs) for each position on the clock. In particular, what exactly does ‘above average’ benefits mean?

A useful exercise is to think about any product or service with which you are familiar, and a company that provides the product or service. The market should be competitive. Then try to describe the business strategy that the company has for its product or service, using the strategic clock as a basis for analysing business strategies.

Remember that the benefits of a product or service do not have to be different product design or different product quality. Other features of a product or service could give them better value in the opinion of customers, such as fast speed of delivery, availability in stock, convenience of purchase, a better after-sales service or a product guarantee. Benefits do not have to be real: what matters is whether customers believe that a product offers more benefits. Branding and advertising can create extra benefit in the perception of customers.

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3 COST LEADERSHIP, DIFFERENTIATION AND LOCK-IN STRATEGIES

Section overview

- Porter's generic strategies for competitive advantage
- Cost leadership strategy
- Differentiation strategy
- Focus strategy
- Porter: six principles of strategic positioning
- Target markets
- Leaders, followers, challengers and nichers
- Product positioning
- Lock-in strategy
- Strategies in conditions of hyper-competition

3.1 Porter's generic strategies for competitive advantage

Porter has suggested three strategies for sustaining competitive advantage over rival firms and their products or services. These strategies, which are similar to some shown on a strategic clock, are:

a cost leadership strategy;

a differentiation strategy; and

a focus strategy.

Porter argues that sustainable competitive advantage is achieved by offering customers a '**value proposition**'. This is a set of benefits that the product or service will provide, that are different from those that any competitors offer. A value proposition can be created in two ways:

Operational effectiveness -This means doing the same things better than competitors, and so providing the same goods or services at a lower cost. Through lower costs, sustainable competitive advantage can be gained through lower selling prices.

Strategic positioning - Strategic positioning means doing things differently from competitors, so that the company offers something unique to customers, so that customers will be prepared to pay a higher price to acquire the unique value combination that the product or service offers.

Operational effectiveness provides the basis for a cost leadership strategy and strategic positioning provides the basis for a differentiation strategy.

3.2 Cost leadership strategy

Cost leadership means being the lowest-cost producer in the market. The least-cost producer is able to compete effectively on price, by offering its products at a lower price than rival products. It can sell its products more cheaply than competitors and still make a profit.

Companies with a cost leadership strategy must have excellent systems of cost control and should continually plan for further cost reductions (in order to remain the cost leader in the market). The source of their competitive advantage is low cost and they must never lose sight of this fact.

In general, the cost leader in a market is a large company, because large companies can benefit from economies of scale that smaller companies are unable to achieve.

The success of a cost leadership strategy is based on offering products at the lowest price, which means that in order to make a reasonable profit the company must sell large quantities of the product. Total profits usually come from selling large volumes at a low profit margin per unit.

A cost leadership strategy is similar to a 'low price' strategy or a 'no frills' strategy on the strategic clock.

3.3 Differentiation strategy

A differentiation strategy has been explained in relation to the strategic clock. For Porter (and for writers on marketing management) differentiation means making a product different from rival products in a way that customers can recognise. Customers might be willing to pay a higher price for the product, because they value its different features. Companies pursuing a differentiation strategy need to offer products and services that are perceived as better or more suitable than those of their competitors. To deliver better products and services usually requires **investment** and **innovation**.

Companies with a differentiation strategy cannot ignore cost. They should keep costs under control and try to reduce costs, so that they can offer more value to customers and retain their competitive advantage. However, they are not trying to be the least-cost producers. It is more important for a successful differentiation strategy that products should give more benefits to the customer, even if this means having to spend more to deliver the product.

3.4 Focus strategy

A cost leadership strategy and a differentiation strategy can be pursued in a market that is not segmented.

However, many consumer markets are segmented, and companies might select one or more particular segments as target markets for their product. This is a focus strategy - concentrating on selling the product to a particular segment of the market and to a particular type of customer.

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Within a market segment, a business entity might seek competitive advantage through:

cost leadership within the market segment; or

product differentiation within the market segment.

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Example: Soap

In the market for manufacturing and selling soap, one or two companies might pursue a strategy of being the cost leader in the market, and offer their standard products to customers at the lowest prices.

Other producers of soap might pursue a differentiation strategy, and promote the superior quality of their products, for example by including ingredients that are better for the skin or provide a more attractive aroma.

Some producers of soap might focus on a particular market segment, such as the market for liquid soap. Within this market segment, firms might either seek to be the least-cost producers or to offer a differentiated liquid soap product.

Example: Porter and airlines

Porter's generic strategies can be used to suggest how airline companies seek competitive advantage.

These are suggestions.

Cost leadership	Low-cost airline. Reduce operating costs, such as: cheaper ticket production (on-line), no free in-flight meals or drinks, use low-cost 'out-of-city' airports, eliminate seat reservations, and reduce baggage allowances for passengers. Go for high capacity usage (high % of seats sold on each flight).
Differentiation	Offer extra facilities for customers at airports. Offer extra facilities on flights. Promote the airline through branding/advertising. Fly to major airports. Maintain a modern fleet of aircraft.
Focus	Pursue a cost leadership strategy or a differentiation strategy in a particular geographical region of the world (for example South West United States), or focus on particular high-profit routes (such as London-New York). Possibly focus on a particular type of customer. In the UK an airline might focus on services for business customers in the City of London, offering convenient flights to and from City of London Airport on small planes.

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Example: Holiday companies

The market in the UK for holiday companies is another example of a segmented market, in which different companies pursue a cost leadership, differentiation or focus strategy.

The main market for holiday companies is probably the package holidays market, where a small number of competitors attempt to be the cost leader, although differences in some features of holiday packages mean that a competitive advantage can be gained from low prices, even if these are not the lowest prices in the market.

Some companies offer a package holiday at a higher price, but with better quality accommodation or additional benefits such as onsite pastimes and entertainment (for example Center Parcs and Club Mediteranée).

There are a number of market segments, such as fly-drive holidays, city breaks and adventure holidays. Within each market segment competitors seek to be the cost leader or differentiate their products.

3.5 Porter: six principles of strategic positioning

It is useful to summarise the views of Porter on how individual firms can achieve sustainable competitive advantage.

Principle 1. The **strategic goal for a company should be to achieve a superior long-term return on investment**. A company should not select as its strategic goal any other objective, such as maximising sales volume or maximising market share, on the assumption that high profits will result from this. Maximising sales or market share does not necessarily provide a superior return on investment.

Principle 2. The strategy must offer a **unique value proposition** for the customer. This is a combination of price and benefits that competitors do not (and cannot) offer. The value proposition might be for customers in the entire market, or for customers in a segment or niche of the market.

Principle 3. There should also be a **distinctive value chain**. A company should perform similar activities to competitors, but in a different way that offers customers more value.

Principle 4. The selected strategy will involve some **trade-offs**. This means that by selecting one set of strategic options, a company inevitably chooses not to select alternative options. For example, there has to be a trade-off between the selling price of the product and the benefits that it offers. By offering one set of benefits, the firm is choosing not to offer others. (If a company could alter its product or value chain without having to make trade-offs, it cannot be achieving any sustainable competitive advantage, and competitors will be able to copy what the company is doing.)

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Principle 5. All the different elements in the strategy and in the value chain should link together and reinforce each other.

Principle 6. There should be **continuity of strategic direction**. Having chosen its strategies and the direction it wants to take its businesses, a company should apply the strategy consistently. It should avoid the temptation of changing strategy every time a new threat emerges.

3.6 Target markets

An entity must decide which markets or market segments it should target. It must:

identify the total market for the products or services that it sells;

recognise the ways in which the market is or might be segmented;

decide whether to sell its products to all customers in the market;

decide whether to try to be the market leader or to pursue a differentiation strategy;

if it chooses a segmentation strategy (focus strategy), select the segments that it will target with its product; and

within the targeted market segment (or segments), decide whether to try to be the market leader or whether to pursue a differentiation strategy.

Market niche

A market niche is a small segment of a market. An entity might target a market niche, and expect to achieve its corporate objectives by selling its products or services to the fairly small number of potential customers in that niche.

3.7 Leaders, followers, challengers and nichers

A business entity can be classified as a leader, follower, challenger or nicher in its markets.

The **leader** is the entity that sells most products in the market. Examples are Microsoft for PC operating software and Coca-Cola for cola drinks.

A **challenger** is an entity that is not the market leader, but wants to take over as the market leader.

A **follower** is an entity that does not have any ambition to be the market leader, and so follows the strategic lead provided by the market leader (or challenger). A follower will try to differentiate its product.

A **nicher** is an entity that targets a particular market segment or market niche for its product, and does not have any strategic ambition to gain a position in the larger market.

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3.8 Product positioning

The concept of product positioning is now widely used in marketing. The idea originated with Ries and Trout in the late 1960s.

They defined product positioning as the concept of the product in the mind of the customer. Advertising is an important factor in creating product position.

Ries and Trout argued that consumers receive vast amounts of advertising information, but they will only accept the messages that are consistent with their existing knowledge and experience.

They also argued that the best product position to achieve in the mind of consumers is the position of number 1. The market leader dominates the market for many products and services, and customers will often buy a product because it is the number 1.

Being the number 1

When an entity is the market leader, it should want to maintain its market leadership. To do this, it needs to maintain its position as number 1 in the mind of consumers.

The most effective way of becoming number 1 in the mind of consumers is to be first into the market at the beginning of the product's life cycle.

If this is not possible an entity needs to create a new image for its product that will enable it to take over as the perceived number 1.

Being the number 2

When an entity is only the number 2 in its market, customers will know this. Unless the entity wants to challenge for the position of number 1, it must do what it can to win customers from its position as number 2. Advertising can help.

In the US, Avis has been the number 2 car-hire company, and Hertz the number 1. Avis achieved a position as an attractive number 2 by recognising its number 2 position, but offering something better than the number 1. Its successful advertising message was: 'Avis is only the number 2 in rent-a-car, so why go with us? **We try harder**.' (It is not clear what trying harder means, but this did not matter!)

Pepsi promoted its 7-Up soft drink against market leader Coca-Cola by advertising it as the 'Uncola'. This recognised that it was not the number one soft drink, but offered customers the attraction of not being cola.

Product positioning for followers and nichers

Ries and Trout argued that entities that are not the number 1 in their market should try to find a way of being number 1 in a particular way. It is much better to be seen as the number 1 in a market segment (or in a special way) than the number 5 in the market as a whole.

To create a product position of number 1 in the mind of customers, entities might devise various marketing strategies.

The approach recommended by Ries and Trout is to be the number 1 for a particular type of customer, such as the number 1 product for women or the number 1 product for professional businessmen. For example:

- a newspaper or magazine might claim to be the number 1 choice for investment bankers or investors);
- a local radio station might claim to be the number 1 commercial station in its geographical area, or the number 1 station for a particular type of music; and
- Apple Mac PCs were not the number 1 make of personal computer, but it was marketed as the number 1 PC for graphic designers.

3.9 Lock-in strategy

A lock-in strategy is another approach to gaining and keeping competitive advantage. The idea of 'lock-in' is that when a customer has made an initial decision to purchase a company's product, it is committed to making more purchases from the same company in the future. The customer is 'locked in' to the supplier and the supplier's products.

Lock-in strategies are fairly common in the IT industry.

Microsoft has successfully locked in many customers to its software products. Customers would find it difficult to switch to personal computers that do not have a Microsoft operating system or do not include some of the widely-used application packages such as Word and Excel.

Apple Computers adopted a lock-in strategy for digital downloading of music from the internet. Its iTunes service cannot (currently) be used on non-Apple MP3 players or on most mobile telephones. Customers buying an Apple iPod are currently locked in to buying digital downloads from Apple.

A successful lock-in strategy often depends on becoming the industry 'leader' or provider of the standard product to the industry (such as the Microsoft operating systems for PCs). Once an organisation has become the industry standard, it is very difficult for other suppliers to break into the market. Indeed, market standard positions tend to be reinforced as time goes on as more and more people turn to that supplier.

Lock-in tends to be achieved early in a product's life cycle when the new supplier achieves an unassailable lead.

However, another type of lock-in strategy is used by companies that make and sell expensive equipment with a long useful life, such as military aircraft. Once a customer has made a decision to buy such products from one supplier, it is

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committed to buying spare parts and maintenance services from the manufacturer, for many years into the future.

3.10 Strategies in conditions of hyper-competition

Cost advantage is much more difficult to sustain when there is hyper-competition in the market. **Hyper-competition** occurs when 'the frequency, boldness and aggressiveness of dynamic moves by competitors create conditions of consistent disequilibrium and change.'

Organisations are in a hypercompetitive environment when they face fast-changing uncertain and dynamic business environments in which there are aggressive competitors constantly challenging current assumptions and methods. For example, internet sites such as Expedia.com, Lastminute.com and a host of no-frills airlines have radically changed the travel business.

In a market where competitive conditions are more stable, business strategy is concerned with building and **sustaining** competitive advantage.

In a hypercompetitive environment it is much more difficult to establish sustained competitive advantage through either cost leadership or differentiation, because any competitive advantage that is gained will be temporary. Competitors in a hypercompetitive environment continually look for ways of competing in different ways, so that no company can sustain competitive advantage for long using the same basis for achieving its advantage. Product and services that were once successful might not be relevant for long. Long-term competitive advantage is achieved only through making a continual sequence of short-term competitive initiatives.

Strategies that might be pursued in a hypercompetitive market include:

Shorter product life cycles. Seek to introduce new improved products quickly, to compete against established products of competitors. Introducing a 'better' product might allow a company to gain market share, although this advantage will only last until another competitor introduces a new, improved product that is even better;

Imitate competitors. Imitating competitors might remove the competitive advantage that the competitors currently enjoy;

Prevent a competitor gaining a strong initial position by responding quickly;

Concentrate on small market segments that might be overlooked by competitors. Eventually, the market might be divided into many small market segments;

Unpredictability. Companies should continually strive for radical solutions. Be prepared to abandon current approaches; and

In some situations, it might be possible to compete by building alliances with some smaller competitors to compete with larger companies that are financially stronger and currently are the market leaders.

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4 COLLABORATION

Section overview

- The nature of collaboration
- Collaboration and strategic alliances
- Collaboration and joint ventures
- Franchising
- Licensing
- Possible problems with collaboration: restricting competition

4.1 The nature of collaboration

In a competitive market, companies need to achieve a competitive advantage over competitors in order to succeed (and survive).

In some situations, companies might be able to achieve competitive advantage through collaboration with:

suppliers or customers in the value network/value system;

other business entities in the value network; and

some other competitors.

Collaboration with suppliers and customers can create additional value, in areas such as:

- product design: suppliers and customers might collaborate to improve the product design, by improving the design of product components or providing better raw materials; and
- delivery times: suppliers and customers might collaborate to improve the reliability and speed of delivery, for example through a just-in-time purchasing arrangement.

For example, if a supplier and purchaser collaborate on the supply of goods by allowing their IT systems to communicate, then the costs of ordering and supply will be reduced. Both parties can share in those savings and, additionally, switching costs are created which safeguard the supplier against competition.

The development of high definition (HD) television would not have been possible without co-operation between the manufacturers of televisions and media companies who will supply the programme content.

Finding ways of increasing value in the value network, through collaboration with other entities, has been discussed in an earlier chapter.

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4.2 Collaboration and strategic alliances

Another way of trying to increase competitive advantage is to collaborate with other companies in the same industry, who might possibly be regarded as competitors. One form of collaboration is to create a strategic alliance.

A **strategic alliance** is an arrangement in which a number of separate companies share their resources and activities to pursue a joint strategy. By collaborating, all the companies in the alliance are able to offer a better product or service to their customers.

Examples of strategic alliances are in the airline industry where groups of airlines might form alliances in order to offer travellers a better selection of routes and facilities than any single airline could offer on its own. Strategic alliances have included One world (British Airways, American Airlines and others) and Star Alliance (Lufthansa, BMI and others).

The success of a strategic alliance depends on the members of the alliance not being in direct competition with each other. They are in the same industry, but serve different markets or market segments.

Example: Airlines (2)

A strategic alliance of airlines enables the combined alliance to offer customers the ability to arrange journeys by air to and from most parts of the world with a single booking; however, the airlines do not compete on most routes.

A UK-based international airline might want to offer its customers linked flights from anywhere in the UK to anywhere in the US. Since it does not have a US flight network, it might enter into a strategic alliance with a domestic US airline. As a result of the alliance, it expects to be in a better position to compete against larger US airlines for transatlantic air traffic.

A US domestic airline might want to offer its customers an all-in-one flight service from anywhere in the US to the UK. It can achieve this aim by forming a strategic alliance with the UK airline.

For example, a customer in the UK wanting to arrange a flight to a city in the US not serviced by British Airways might be able to book the journey through British Airways: the customer would then fly to the US on British Airways to New York and then switch to American Airlines for onward travel to the US city destination.

4.3 Collaboration and joint ventures

A joint venture is a formal venture by two or more separate entities to develop a business or an activity jointly. Many joint ventures are established in the form of a separate company which is jointly owned by the joint venture partners. No single partner being able to dominate and dictate the way that the company is run.

Joint ventures are frequently used for investing in a new business venture where:

- there is considerable risk;
- large amounts of capital are needed; and
- a mix of skills is essential.

The joint venture allows the business risk and financing to be shared by the joint venture partners. The partners might be companies that compete in some markets of the world, but have agreed to collaborate in a particular venture. Alternatively the joint venture partners might be companies in different markets, and do not compete with each other directly; however each partner brings special skills to the venture that will help to give the joint venture a competitive advantage.

When multinational companies are seeking to expand by investing in a different country, they might seek to do so by establishing a joint venture with a local company. There are several advantages in entering a foreign market in an alliance with a 'local' company.

It might be a legal requirement for foreign companies setting up business in the country to operate as a joint venture with a local company.

The local company management should have a better knowledge of business conditions and practices in the country.

It is probably easier to succeed by forming an alliance with a local company than in competition with local companies. For example, the government might be a major customer, and it might have a policy of favouring domestic companies when it makes its purchase decisions.

The local company might already have customers to which the new joint venture can sell its products.

Difficulties can arise with joint ventures, and lead to the eventual break-up of the partnership. This can happen when:

one joint venture partner is perceived (by the other partners) not to be contributing adequately;

one joint venture partner wants to withdraw from the venture; or

the joint-venture companies start to compete with each other instead of collaborating.

4.4 Franchising

Some business entities have been able to grow through franchising. This is another form of collaboration. The basic idea of a franchise is that a company develops a product with the following features:

- It is a standard product (or range of products), delivered to customers in a standard way;
- It has brand recognition, achieved through advertising and other sales promotion;
- Systems for delivering the product to customers are standardised (using standard equipment, and standard work practices; and
- Customers want to buy it.

The most well-known examples of franchise operations are some of the fast-food restaurant chains, such as McDonalds. The company that originates the product, the franchisor, protects its patent rights or intellectual property rights over the product. It then sells the concept to franchisees that pay for the right to open their own store and sell the branded product.

The franchisor supplies the product 'design' and the right to sell the product. It also provides a centralised marketing service, which includes extensive advertising and brand promotion. It also supplies other support services, such as business advice to franchisees.

The franchisee pays for the franchise, and in addition pays a royalty based on the value of its sales or the size of its profits.

By buying into a successful franchise, a franchisee suffers much less risk than would be experienced setting up a business from scratch and can benefit from extensive marketing by the franchisor.

The franchisor receives a constant inflow of cash from new franchisees, as the operation expands, and is therefore able to grow by selling its business concept to a large number of other businesses, sometimes worldwide. Additionally, their head office is kept small because there is considerable delegation of day-to-day management to the franchisee.

However, the franchisor will always want to protect its brand name and to present a consistent appearance to its customers. This means that franchise agreements have very extensive rules governing franchisees' behaviour and they will also supply the products. Many franchisees find these rules and the monopoly supply of products very restrictive and frustrating.

4.5 Licensing

In a typical licensing agreement, a licensee is given permission by the licenser to make goods, normally making use of a patented process, and to use the appropriate trademark on those goods. In return the licenser receives a royalty. The licensee is exposed to relatively little risk and goods can be made wherever the licensee is located.

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4.6 Possible problems with collaboration: restricting competition

The purpose of collaboration should be to gain competitive advantage in a market. However, it should not seek to create unfair restrictions on competition.

Governments in countries with advanced economies are generally in favour of 'free' competition in their national markets (and in international trade), although there are many exceptions to this general rule. When it has a policy of encouraging competition in markets, a government will seek to discourage actions by companies that will distort or reduce competition in their industry and markets. They might do this by making some forms of anti-competitive behaviour illegal.

In the UK, for example, the government seeks to ensure that there is sufficient competition in domestic markets so that consumers get a 'fair deal'. Some industries have special regulatory bodies, whose responsibilities include ensuring that the consumer is protected. For industries generally, the Office of Fair Trading is responsible for identifying cases where fair competition might be at risk, and referring cases to a Competition Commission for investigation.

The UK's Competition Commission might be asked to investigate:

- a market, where the Office of Fair Trading suspects that competition is being prevented or restricted by anti-competitive behaviour;
- a proposed merger or takeover (or merger that has already occurred), where it is suspected that a consequence of the merger will be a significant reduction in competition; and
- competition in a regulated industry, such as electricity, gas, water, telecommunications, postal services, broadcasting, airports and air traffic.

Firms within an industry might seek to reduce the strength of the competition, in order to increase their profitability. There are several ways of reducing competition; some of them illegal.

Cartels

A cartel is an arrangement between the rival firms in an industry to operate the same policies on pricing. By operating a price cartel, the firms are able to charge higher prices than if they competed with each other, and as a result make higher profits. Provided that the cartel includes all the firms in the industry (or at least all the major firms), they are able to exercise supplier power.

Price cartels are often illegal within a country, although an example of a successful major price cartel is the powerful Organisation of Oil Producing Countries (OPEC).

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5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Describe the two key factors that affect profitability when aiming to achieve competitive advantage
- Explain how Bowman's strategic clock can be applied to help establish an appropriate price vs. perceived benefit mix
- Summarise Porter's generic strategies and differentiate between cost leadership, differentiation and focus strategies
- Describe how different types of collaborations are used in business to help generate competitive advantage

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Skills Level

Corporate Strategic Management and Ethics

CHAPTER 6

Methods of development

ICAN 2021

Contents

1 Strategic direction: introduction
2 Strategic direction: Ansoff's growth matrix
3 Methods of strategic development
4 Forecasting tools for strategic planning
5 Assessment of business strategies
6 Ethical influences and corporate social responsibility
7 Strategy selection
8 Chapter review

INTRODUCTION

Detailed syllabus

Strategic management

B2 (b) Identify and explain, based on an analysis of choices of strategy, the impact of strategy on commercial, ethical, corporate social responsibility and sustainability objectives.

B2 (c) Evaluate the appropriateness of a chosen strategy that supports business objectives, considering constraints, conflicts and other issues based on a given scenario. The following models and tools may be employed in carrying out the evaluation:

Tools

B2 (c) (i) Forecasting tools

B2 (c) (ii) Trend analysis

B2 (c) (iii) System modelling

B2 (c) (iv) Delphi technique

B2 (d) Draw conclusions based on market and product analyses that support a business strategy concerning pricing, positioning, placing and other product decisions in a strategic marketing plan.

B2 (e) Determine the appropriate corporate growth strategy in a given scenario:

B2 (e) (i) Internal development

B2 (e) (ii) Diversification

B2 (e) (iii) Forward and backward integration

B2 (e) (iv) Mergers and acquisitions

B2 (e) (v) Product portfolio management

B2 (e) (vi) Greiner's Growth Model

B2 (e) (vii) Other growth models

B2 (f) Select a strategic growth direction of a company using Ansoff's matrix.

Exam context

This chapter explains the various strategies that can be used to grow a business either organically or externally.

The chapter then demonstrates how a strategy can be selected with reference to the SFA (suitability, feasibility and acceptability) model and also considering ethics and corporate social responsibility.

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By the end of this chapter students will be able to:

- Explain and apply the different strategies of Ansoff's product/market growth vector;
- Advise on methods of growth including both internal (organic) and external (e.g. mergers and acquisition) growth strategies;
- Summarise how diversification and vertical and horizontal integration operate;
- Explain the strategic nature of product portfolio management;
- Explain the use of trend analysis, system modelling and the Delphi method as strategic forecasting tools;
- Assess business strategies using the SFA (suitability/feasibility/acceptability) model;
- Consider ethical and corporate social responsibility influences on strategy selection; and
- Explain the final strategy choice considering formal evaluation, enforced choice, learning and experience.

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1. STRATEGIC DIRECTION: INTRODUCTION

Section overview

- PIMS analysis
- Product-based and resource-based strategies
- Four key areas for successful strategy development
- Product-based strategies and strategic direction

1.1 PIMS analysis

PIMS analysis stands for **P**rofit **I**mpact of **M**arketing **S**trategy analysis.

It originated in the 1960s at General Electric in the US, but the PIMS database is now maintained by the Strategic Planning Institute.

The PIMS database contains data provided by several thousand strategic business units (SBUs) of major corporations. The data consists of details about the activities and performance of the SBUs, and the database can be used to analyse the factors that appear to make some strategies more successful than others.

The database can be used, for example, to relate the success of a SBU to factors such as market share, diversification strategy, investment intensity, product or service quality or labour productivity.

The PIMS database appears to show a link between profitability and relative market share. The higher the market share, the higher the return on investment will be.

This connection between market share and investment return or profitability is probably due to economies of scale for a large firm in its markets, arising perhaps from the following factors.

The purchasing benefits of being a large buyer (the ability to obtain better terms from suppliers; for example bulk purchase discounts).

The advantage of selling in large volumes. (In an industry where profit margins are low, it is vital to have the ability to sell in large quantities in order to make a reasonable-sized profit).

Scale of advertising. Large firms can obtain greater benefits from advertising; for example by advertising nationally.

More efficient use of equipment and other non-current assets.

For retailing firms, the advantages of a large market share also include:

- easier access to new products from suppliers; and

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- easier access to retail property: for example, large retail firms are more likely than smaller firms to obtain valuable out-of-town retail space in a new shopping centre.

PIMS analysis would therefore suggest that an appropriate product-market strategy should be to seek a large share of a chosen market (or market segment)

Other findings of PIMS analysis

PIMS analysis has also produced several other conclusions, which appear to have remained consistent over time.

Relative quality of a product or service is an important factor in obtaining high investment returns. 'Relative quality' means 'value for money' for the customer.

Although high market share reduces costs and so should improve profitability and return, the benefits of high market share can be lost due to poor relative quality.

High investment in capital equipment seems to reduce profitability. This is often a characteristic of an industry as a whole, but can also apply to individual companies within an industry. The most successful companies get better asset utilisation (more sales per ₦1 invested).

Acquisition strategies are not successful at increasing return on investment for shareholders. The main beneficiaries of acquisitions are usually the shareholders in the acquired company.

Diversification is not a particularly successful strategy in terms of return on investment.

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1.2 Product-based and resource-based strategies

Here are two different approaches to the selection of product-market strategies:

a product-based strategy; and

a resource-based strategy.

With a product-based strategy, a firm should identify the products that it wants to sell and the markets or market segments in which it should sell them. The focus of attention is on which products are likely to be the most successful in their market, and so the most profitable.

Hamel and Prahalad suggested that instead of a product-based strategy approach, entities should use a resource-based approach. Instead of looking for the most profitable products, an entity looks instead at the strengths and competencies in its internal resources. The entity should then look for product-market opportunities that will enable it to exploit its core competencies. By choosing products and markets in this way, the entity should have a competitive advantage over its competitors.

Hamel and Prahalad argued that a resource-based approach to strategy selection:

- provides a basis for deciding which new product-market areas to enter; and
- is a more flexible approach to strategic planning than the selection of target products and markets as part of a formal, long-term business plan.

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Example: Amazon.com

Amazon.com was originally a specialist online seller of books via the internet. Over time, it developed several core competencies

a user-friendly website for online purchasing

an efficient delivery service for small packages to customer addresses

a recognised name and reputation.

The company has been able to use these core competencies to develop its business outside the sale of books. The same competencies that sell books successfully can be applied to similar products that are easily warehoused and can be despatched in small parcels, such as CDs and DVDs.

1.3 Four key areas for successful strategy development

An entity should give clear signals, to outsiders and to its own management, about:

Product-market scope (strategic scope). The entity should make clear the product-market areas in which it expects to operate. This aspect of strategic choice (corporate strategy selection) was discussed in a previous chapter;

Competitive advantage. The entity should identify those properties of the product-market areas in which it intends to operate that will give the entity a strong competitive advantage over its rivals. Making strategic choices about competitive advantage was discussed in the previous chapter;

Growth vector. A growth vector is the direction in which the entity is moving from its current product-market position. It indicates where the entity sees its future growth. The growth vector might be a new product area, a new market, or both; and

Synergy. An entity should also indicate how it might expect to benefit from synergy by moving into new product-market areas. Synergy is perhaps best described as the '2 + 2 = 5 effect'.

Examples of synergy include:

Instead of making just one product, making two different products with the same equipment and getting better utilisation of the equipment as a result; and

Selling two products with the same sales force, instead of selling just one product.

Synergy can therefore provide extra benefits from making and selling two products instead of one, or making and selling a product in two different markets instead of one.

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1.4 Product-based strategies and strategic direction

Strategic choices must be made about the direction that the entity should take. For companies, **strategic direction** is often expressed in terms of:

- the products or services that the company wants to sell;
- the markets or market segments it wants to sell them in; and
- how to move into these product areas and market areas, if the entity is not there already.

To achieve growth in the business, an entity must:

- sell more in its existing markets (try to make its existing markets bigger);
- sell new products in its existing markets;
- sell existing products in new markets or new market segments (for example in other countries); and
- sell new products in new markets.

These are strategic directions that Ansoff described in a growth vector matrix.

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2 STRATEGIC DIRECTION: ANSOFF'S GROWTH MATRIX

Section overview

- Growth vector analysis: Ansoff
- Market penetration strategy
- Market development strategy
- Product development strategy
- Diversification strategy
- Gap analysis
- Withdrawal strategy
- Consolidation and corrective strategies

2.1 Growth vector analysis: Ansoff

Ansoff (1957) argued that when a firm is planning its growth strategies, there should be a link between its current products and markets and its future products and markets. This link is necessary so that outsiders (for example, investors) can see in which direction the entity is moving. It also provides guidance to the entity's own management.

As indicated earlier, the strategic direction a company can take is to move into new markets for its products or to develop new products.

Ansoff summarised the potential strategies for product-market development with a 2 × 2 matrix. It sometimes referred to as Ansoff's growth vector matrix or product mission matrix.

		Product: Existing products	New products
Market	Existing market	**Market penetration strategy**	**Product development strategy (or innovation strategy)**
	New market	**Market development strategy**	**Diversification strategy**

A market penetration strategy is sometimes called a 'protect and build' strategy.

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2.2 Market penetration strategy

With a market penetration strategy, an entity seeks to sell more of its current products in its existing markets. This strategy is a sensible choice in a market that is growing fast. With fast growth, all the companies competing in the same market can expect to benefit from the rising sales demand.

A market penetration strategy is more difficult to implement when the market has reached maturity, or is growing only slowly.

Kotler suggested that market penetration calls for aggressive marketing, and that there are three ways in which this strategy might be successful:

- Persuade existing customers to use more of the product or service, and so buy more. This is a strategy based on trying to increase total market sales demand;
- Persuade individuals who have not bought the product in the past to start buying and using the product. Marketing tactics for attracting new users might include advertising or special promotional offers. This is another strategy based on trying to increase total market sales demand; and
- Persuade individuals to switch from buying the products of competitors. This is a competitive strategy based on winning a bigger market share. This strategy has the obvious risk, however, that competitors will retaliate with their own marketing initiatives to win customers.

Example: Shower gel

A manufacturer of shower gel might decide on a market penetration strategy, by trying to persuade existing customers to take showers more often. One way of encouraging a change in the rate of usage would be to have a special promotional offer for a short period of time, such as ‘Buy one, get one free’.

However, offers such as ‘buy one, get one free’ can only be short-term marketing initiatives. If this tactic were turned into a longer-term strategy, the effect would be to reduce the selling price by 50% and the company would be pursuing a low price strategy. To succeed with this strategy it would need to become the least-cost producer in the market.

A market penetration strategy is a low-risk product-market strategy for growth, because unless the market is growing fast, it should require the least amount of new investment. However, there are some risks with this strategy.

- If the company fails to increase sales, its business will have no strategic direction, and will suffer from ‘strategic drift’.

A strategic choice of ‘doing nothing new’ is a high-risk choice, because competitors are likely to be much more innovative and competitive.

The strategies selected by major competitors might be a threat, particularly if there is a ‘war’ to win customers from each other.

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2.3 Market development strategy

Market development involves opening up new markets for existing products. Kotler suggested that there are two ways of pursuing this strategy:

- The entity can start to sell its products in new geographical markets (through regional, national or international expansion); and
- The entity can try to attract customers in new market segments, by offering slightly differentiated versions of its existing products, or by making them available through different distribution channels.

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Example: Chocolate bars

A business entity specialising in making and selling a branded type of chocolate bar might develop its markets by offering the same product in new sizes:

- a small size, to attract purchases by diet-conscious customers; and
- a large size, to attract customers who might buy a chocolate bar as their lunch.

In this example, the target new market segments are segments differentiated by the 'life style' of the customer.

Example: Corn farmers

Many farmers in the US who grow corn are starting to sell their produce to energy companies, which are making bio-fuels out of the corn to fuel motor engines.

The energy market is a new market segment for these farmers, who also continue to sell corn to food product manufacturers.

2.4 Product development strategy

Product development is a strategy of producing new products for an existing market. There are several reasons for choosing this strategy.

- The business entity might have a strong brand name for its products, and it can extend the goodwill of the brand name to new products.
- The entity might have a strong research and development department or a strong product design team.
- The entity has to react to new technological developments by producing a new range of products or product designs.
- The market has growth potential provided that new products are developed.
- The entity wants to respond to a strategic initiative by a major competitor, when the competitor has developed a new product.
- Customer needs might be changing, so that new product development is essential for the survival of the business.

Disadvantages of a product development strategy are that:

- developing new products can be expensive; and
- a large proportion of new products are unsuccessful.

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Example: Health and diet drinks

Many food and drinks companies have adopted a strategy in recent years of developing 'healthy foods' and 'diet' drinks or 'health drinks'.

They have often been able to use the strength of their existing brand name to persuade customers to buy their new products.

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Example: Tesco

In the UK, Tesco is the leading supermarket company. Its successful growth in the UK has been based partly on a product penetration strategy. The company has extended the range of goods it sells in its stores to include items such as clothing and domestic electrical equipment.

2.5 Diversification strategy

Diversification is a strategy of selling new products in new markets. A distinction can be made between:

concentric diversification (also called **related or horizontal diversification**), which means that the new product-market area is related in some way to the entity's existing products and markets; and

conglomerate diversification, which means that the new product-market area is not related in any way to the entity's existing products and markets.

Both forms of diversification are normally achieved in practice by means of an acquisition strategy (in other words, buying companies that already operate in the new product-market areas).

Concentric diversification

The aim of concentric diversification might be to use the entity's existing technological know-how and experience in a related but different product-market area. Here are some examples:

- A manufacturer of vacuum cleaners (e.g. Dyson in the UK) might diversify into the manufacture of washing machines;
- An airline company might acquire an international chain of hotels. There could be obvious benefits from co-operation in providing good services to passengers and from cross marketing. Both are in the people/travel business so many corporate values could be shared and the brand strengthened;
- A company selling men's clothes by mail order might diversify into selling women's clothes; and
- A company that provides driving lessons for learner drivers might expand into the market for providing driving lessons for advanced drivers.

Some concentric diversification strategies have a lower amount of business risk than others.

Conglomerate diversification

The aim of conglomerate diversification is to build a portfolio of different businesses. The reasoning behind this strategy might be as follows:

- Diversification reduces risk. Some businesses might perform badly, but others will perform well. Taking the businesses as a diversified portfolio, the overall risk should be less than if the entity focused on just one business. However, this view is rejected by some business analysts, who argue that shareholders can themselves reduce risk if they want to, by spreading their investments in shares over different companies in different industry sectors. For a company in car manufacturing, diversifying into supermarkets is unlikely to be popular with shareholders who have carefully constructed a portfolio that suits their needs;

- Diversification will save costs and generate 'synergy'. (Synergy is the idea that 2+2 = 5.) But synergy can only occur if costs can be saved (for example by economies of scale) or there is some other beneficial linkage between the companies. However, if the companies are truly unrelated then it is not easy to see how synergy can be created. Purchases, manufacturing, customers and management will all be radically different; and

- An entrepreneurial management team should be able to succeed in any markets, and the entity therefore seizes different business opportunities whenever and wherever they arise. This is the only potentially valid argument for unrelated diversification, but it is only valid if the company taken over is not being managed well, or it holds undervalued assets that could be sold at a profit. If it is already well-managed, holds no under-valued assets and is taken over at a fair price, it is not clear where shareholder value can be added. All too often, new owners destroy value by meddling with an already successful business.

Example: PepsiCo vs. Coca-Cola

Management must select a strategy that they believe is best suited to the needs of the entity. The strategy they choose might differ from the strategy of close competitors. When two rival companies select different strategies, it will not necessarily be clear whose strategy is the most successful, particularly over the longer term.

An interesting example is the product-market strategy of PepsiCo compared with Coca-Cola. In 1996, Pepsico was struggling in its competition with Coca-Cola. Since then, PepsiCo has turned round its business and is currently larger than Coca-Cola.

Coca-Cola remains predominantly a drinks business. Its strategy in recent years has been to expand its range of products for existing markets, and to develop more geographical markets. Coca-Cola has stronger markets outside the US than Pepsi for its carbonated drinks products.

In contrast, PepsiCo pursued a strategy of concentric diversification, in addition to product and market development within its existing drinks business. It successfully developed its existing snack foods business (Frito-Lay) and also purchased two businesses with strong nutritional food ranges – Quaker Oats and Tropicana juices.

2.6 Gap analysis

Gap analysis is a technique that might be used in strategic planning.

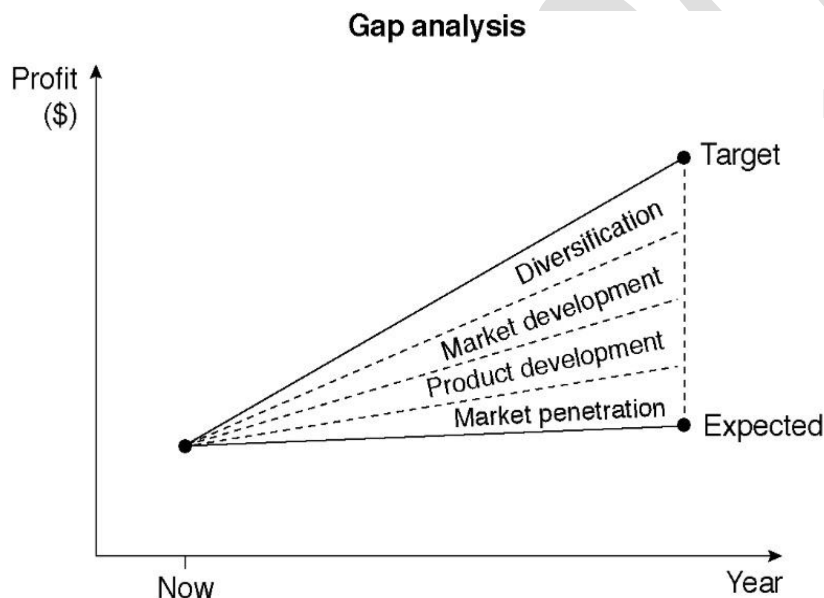
A gap is the difference between:

- the position a business entity wants to be in by the end of the planning period, in order to meet its overall objectives; and
- the position the entity is likely to be in if it does not have any new strategy or change in strategy.

The strategies selected for the planning period should be sufficient to close this strategic gap.

In the following diagram, the forecast of where the entity will be without any new strategies might be estimated by statistical forecasting methods, such as regression analysis. For simplicity, the forecast is a forecast of annual profit.

The corporate objectives are expressed in the same terms (in this example, profit). The strategic gap might be closed by a combination of product-market strategies.



Example: Fine China

Fine China is a manufacturer of high-quality dinner services (plates, saucers, bowls, cups, saucers etc.) and has a dominant position at the high-quality end of its national market. The market is in a slow decline.

Management is considering its strategies for the future. The aim is to achieve a 5% average annual growth in the entity's share price over the next five years.

Required:

Suggest briefly a strategy that the entity might adopt if its strategic direction is:

- market penetration;
- product development;
- market development; and
- diversification.

Answer

Here is a suggested answer.

Market penetration	Aim to win more share of the existing market, possibly by means of a takeover (acquisition of a competitor's business).
Product development	Aim to develop new products for the same market. This might be achieved by developing lower-quality and lower-priced products, under a new brand name, for sale through the same outlets as the existing products.
Market development	Try to sell the company's existing products in new geographical markets – in selected other countries.
Diversification	The company might be able to diversify into related products and markets (concentric diversification) by developing household ornaments made from china.

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2.7 Withdrawal strategy

As the name suggests, a withdrawal strategy is a strategy for withdrawing from a particular product-market area. This might be appropriate, for example, when:

- the entity can no longer compete effectively; or
- the entity wishes to use its limited funds and other resources in a different product-market area.

A withdrawal strategy might be adopted as a deliberate policy by deciding to:

- reduce the range of products offered to the market;
- reduce the number of markets or market segments (for example, pulling out of a market in one or more regions of the world); and
- withdrawing entirely from the market, and no longer operating in the market.

The reasons leading to a withdrawal from a product-market area might be any of the following:

- A decline in the size of the market or market segment, for example because the product is becoming obsolete. (For example, due to technological change, videotape and music cassettes are becoming obsolete);
- More effective and successful competition from rival firms;
- Poor financial results; for example, the product might be loss-making; and
- A decision by the entity that the product is no longer a 'core product' and the entity therefore does not intend to continue making and selling it.

2.8 Consolidation and corrective strategies

A business entity might decide that it does not need to grow. A **consolidation strategy** is a strategy for maintaining market share, but not increasing it.

There are several reasons why an entity might choose a non-growth strategy.

The entity might be managed by their owner, who does not want the business to get any larger.

Management might take the view that if the entity gets any bigger, there will be serious problems in managing the enlarged entity. They might prefer to avoid the problems by remaining the same size.

However, a strategy of non-growth does not mean a strategy of doing nothing. Business entities must continue to innovate even to 'stand still'. If a business entity does not have clear strategies for its products and markets, it will lose its market share to competitors.

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A **corrective strategy** is a strategy for making corrections and adjustments to current strategy, to counter threats from competitors or to respond to changes in customer needs.

Corrective strategies might be necessary as a part of a consolidation strategy.

Example: BBC

In the UK, the British Broadcasting Corporation (BBC) does not have a growth strategy, and is not particularly looking for more viewers or listeners for its television and radio programmes. However, it recognises the significance of digital broadcasting. A corrective strategy in recent years has therefore been to develop digital television and radio broadcasting. The BBC launched several digital television and radio channels, designed to attract existing customers to the new technology.

Business entities in a competitive market should seek to obtain an advantage over their competitors. Competitive advantage means doing something better than competitors, and offering customers better value. Competitive advantage is essential; otherwise there is no reason why customers should buy the entity's products instead of the products of a competitor.

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3 METHODS OF STRATEGIC DEVELOPMENT

Section overview

- Growth through internal development
- Greiner's growth model
- Mergers and acquisitions
- Diversification and integration
- Forward and backward integration
- Product portfolio management

Whatever product-market strategies are selected, an entity must also decide how to develop the chosen strategies.

There are three main approaches to developing a product-market strategy for growth:

- internal growth;
- growth through acquisitions or mergers; and
- joint ventures and strategic alliances.

3.1 Growth through internal development

An entity might grow its business with its own resources, seeking to increase sales and profits each year.

There are several **advantages** of internal development over other forms of strategy for growth:

- Management can control the rate of growth more easily, and ensure that the entity has sufficient resources to grow successfully. The entity might not have sufficient resources to meet the growing sales demand. However, it will only make and sell as much as it can, efficiently and effectively, with the resources at its disposal;
- The entity should be able to focus on its core competencies, and develop these in order to grow successfully; and
- If the entity finds that it is short of a key labour skill, it can buy the labour skills it needs by recruiting new staff.

There are some **disadvantages** with growth through internal development:

- The biggest disadvantage is probably that there is a limit to the rate of growth a business entity can achieve with its internal resources. Rival firms might be able to grow much more quickly by means of mergers, acquisitions and joint ventures;

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- In order to expand a business beyond the limits of its current capacity, it is necessary to invest in new capacity. For a production company, this means investing in new production facilities. The lead time between taking a decision to invest and the opening date for the new production facilities (possibly in another country) can be long. Until the new production facilities are opened, the entity may be unable to meet customer demand, and it might therefore lose business to competitors. After the new production facilities are opened, production capacity will probably exceed demand, and for a time (until demand grows further) there will be some unused capacity and idle resources;

- If there is an element of diversification, then internal growth presents some risks because the organisation will have to learn new skills. Mistakes are almost inevitable; and

- Another disadvantage is that even with internal growth, the entity will eventually need to change its organisation and management structures, in order to handle the growth in its business. Unless an organisation does change, it will become inefficient. Unfortunately, introducing change to the organisation structure and management style is by no means simple and easy to accomplish.

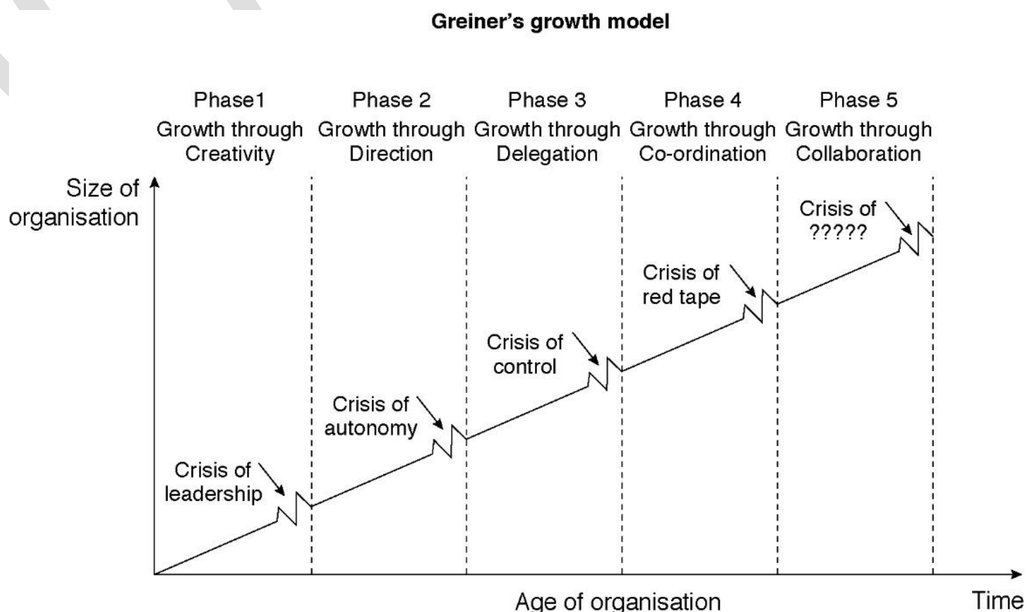
Greiner's growth model provides an analysis of how organisation and management structures might need to change as a business grows.

3.2 Greiner's growth model

In the 1970s, Greiner suggested that an entity that grows in size goes through a series of changes as it gets bigger. Each change occurs in response to a 'crisis', when the existing organisation and management structure is no longer capable of handling a business as large as it has now become.

According to Greiner, there are five phases in the life of an entity. These phases, and the crisis that starts each new phase, are set out in the diagram below.

Greiner's growth model



Phase 1: Period of growth through creativity

The early years of a successful business entity are a period of creativity and innovation. The entity is probably managed in an entrepreneurial way, and it is producing new products that appeal to customers and is developing new markets.

Over time, production becomes more organised. As the entity grows, the entrepreneurial method of management and the existing organisation structure both become inefficient. The organisation needs organisation and planning and control systems.

There is a **crisis of leadership**. Management must become more 'professional'. The entity therefore introduces professional management, and it enters its next phase of growth.

Phase 2: Period of growth through direction

The entity is now more structured, with a 'traditional' management hierarchy. Formal systems are introduced, such as planning and control systems (budgeting and budgetary control), accounting systems, inventory control, production scheduling, communication and IT systems, etcetera.

However, as the entity grows, the hierarchical management structure becomes inefficient. The control systems and reporting systems are designed for close control from the top by senior management. However, management control from the top is not as effective as it used to be. Top management are far away from actual operations, and 'local' managers know much more about how the business functions in their area of operations.

There is a **crisis of autonomy**. The 'tensions' between senior management and local management grow. Until local managers are given more authority to take decisions for themselves, the entity will be managed inefficiently from the top.

Phase 3: Period of growth through delegation

In order to survive, the entity is reorganised, with much more authority delegated to 'local' managers. The entity is organised in divisions, which might be profit centres. Central management receive reports from the divisions, but divisional managers take most of the decisions about how the division should be run. Central management concentrate much more on strategy and business expansion.

However, as the business continues to grow, central management realise that they are losing most of their own authority, and that the local managers are becoming perhaps too powerful and unaccountable.

This leads to a **crisis of control**. Central/senior management must change the organisation and management structure, to avoid losing control.

This leads the entity into its next phase of development, a period of growth through co-ordination.

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Phase 4: Period of growth through co-ordination

In this phase of growth, central management monitor their local managers carefully, using sophisticated reporting systems. Local managers are more accountable, although they have delegated authority to make decisions.

The focus is now on:

- co-ordinating the activities of all the different local operating divisions within the entity; and
- consolidating the business.

However, as the entity continues to grow, the reporting systems start to create a bureaucratic culture at head office. Local managers become angry at having to provide so many reports, and explain so much to head office, when they feel that their time would be better spent in managing operations. This leads to a **crisis of red tape** – with too much form-filling, report-writing and bureaucracy.

Phase 5: Period of growth through collaboration

Greiner suggested that the crisis of red tape leads to a further change. To overcome the problems of red tape, head office management and local managers find ways to collaborate more constructively. There is a greater emphasis on teamwork and problem-solving, and less emphasis on formal reporting systems and accountability. Participation in decision-making by more individuals is encouraged.

Since no entity has gone beyond Phase 5 of its development Greiner suggested that it was too early to tell whether there is a crisis at the end of Phase 5, leading perhaps to even more change.

If entities continue to grow, they will have to go through the phases of transformation. If they do not, they will become inefficient and will fail to survive. (For example, they might become a takeover target).

3.3 Mergers and acquisitions

An entity can grow quickly by means of mergers or acquisitions. Both mergers and acquisitions involve the creation of a single entity from two separate entities.

- With a merger, the two entities that come together are approximately the same size.
- With an acquisition, one entity is usually larger than the other and acquires ownership (control) by purchasing a majority of the equity shares.

Acquisitions are more common than mergers, but large mergers are possibly more significant, because they can create market leaders in their industry. Examples of large mergers have been:

- pharmaceuticals firms SmithKline Beecham and Glaxo to form Glaxo SmithKline;

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- the merger of media giant Time Warner with AOL; and
- the merger of consumer products manufacturers Proctor & Gamble with Gillette.

Advantages of acquisitions and mergers

Acquisitions and mergers have several advantages as a strategy for growth, compared with a strategy of internal development.

Growth by acquisition or merger is much faster than growth through internal development.

An acquisition can give the buyer immediate ownership of new products, new markets and new customers, that would be difficult to obtain through internal development.

An acquisition enables an entity to enter new market where the barriers to entry are high, so that it would be very difficult to set up a new business in competition.

An acquisition prevents a competitor from making the acquisition instead.

It might result in cost savings and higher profits ('synergy'). This point is discussed in more detail later.

Disadvantages of acquisitions and mergers

An acquisition might be expensive. The bid price has to be high enough to make the shareholders of the target company willing to sell their shares. The return on investment for the entity making the acquisition might therefore be very low.

A merger or acquisition can result in a loss of proportional ownership of the entity. For example, if two entities with an equal total value are merged together, a shareholder who held say 10% of one of the companies before the merger might only own 5% of the merged company. (The actual change in proportional ownership will depend on the structure of the merger or acquisition, and how it is financed.)

The two entities will have different organisation structures, different management styles, different cultures, different systems of salaries and wages. Bringing them together into a single entity will be extremely difficult. Naturally, many employees will feel threatened, as often takeovers are followed by the company seeking cost efficiencies (including redundancies). Many good employees could leave. Generally, the period of disruption following a takeover or merger will last around a year.

When individuals from different 'cultures' are brought together into a single organisation, there will probably be a 'clash of cultures', and it may be difficult for individuals from the different cultures to work together easily. They will have a different outlook on business, and will have different ideas about the way that work should get done. The problems of a clash of cultures are particularly severe when companies merge, or when one company takes over another. There have been several well-publicised examples of a clash of cultures in the banking

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industry, when a commercial bank (a traditional 'lending bank') merges with an investment bank.

Mergers and acquisitions: will there be synergy?

Synergy is often a key reason for a merger or acquisition. Synergy will occur when, as a result of a merger or acquisition, there are operational or financial benefits.

There might be over-capacity of equipment and property, so that the surplus assets can be sold off.

It might be possible to make operational changes to save resources In particular, an acquisition often results in redundancies for large numbers of employees. Running costs are reduced.

Two Research and Development departments can be combined into just one, and savings in running costs should be possible.

However, it has been found in practice that a very large proportion of acquisitions and mergers fail to achieve the expected synergy.

The difficulties with bringing together two different organisations, management styles, management structures and cultures mean that there is often a high risk of a loss in efficiency and higher operating costs.

Acquisitions: the need for financial strength

A successful strategy of growth through acquisition requires financial strength. A company needs one or more of the following;

- A large amount of cash that is available for long-term investment. Some acquisitive companies have a 'war chest' of cash that they use to buy target companies;
- Access to additional funding, in the form of new equity (from new share issues) or borrowing (bond issues or loans); and
- Highly-regarded shares. Many acquisitions are negotiated as a share-for-share exchange, with shareholders in the target company agreeing to accept shares in the acquiring company as payment for their shares. To succeed with acquisitions financed by a share-for-share exchange, a company's shares must be well-regarded by investors, so that shareholders in a target company are willing to accept shares as payment.

3.4 Diversification and integration

Diversification and risk

Diversification has already been described as a strategy for growth. Entities that grow by diversification usually do so by means of merger or acquisitions.

It has also been stated that diversification is a high-risk growth strategy, because the entity is moving into both new product areas and new markets at the same time, and it does not have experience in either.

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Conglomerate diversification is a greater risk than concentric diversification, because with concentric diversification, the entity is moving into related product-market areas, where it might be able to use its experience and core competencies more effectively.

Integration

Integration is a term that means extending a business. There are two main types of integration:

- horizontal integration; and
- vertical integration.

Horizontal integration - With horizontal integration, an entity extends its business by obtaining a larger share of its existing product markets. Typically, an entity might acquire one or more of its competitors.

Vertical integration - With vertical integration, an entity extends its business by acquiring (or merging with) another entity at a different stage in the supply chain. A strategy of vertical integration is usually a form of concentric diversification.

3.5 Forward and backward integration

Vertical integration might be:

- forward; or
- backward.

With **forward vertical integration**, also called 'downstream' integration, an entity enters the product markets of its customers. For example:

- a manufacturer of tyres might go into the production of motor cars or motor cycles;
- a wholesaler (selling goods for resale to retailers) might go into the business of retailing itself; and
- an entity specialising in oil and gas exploration might move into the market for oil and gas extraction.

With **backward vertical integration**, also called 'upstream' integration an entity enters the product markets of its suppliers. For example:

- an entity specialising in oil and gas extraction might move into the market for oil and gas exploration;
- an entity operating a chain of cinemas might go into the market for film production; and
- a shoe manufacturer might enter the market for leather production.

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Arguments for vertical integration

Integration can give an entity a position of strength in the supply chain, particularly if it is a major competitor in its market.

The reasons given for forward or backward vertical integration might be as follows:

- Backward integration gives an entity control over its source of supply;
- Forward integration can give an entity control over its channels of distribution;
- Vertical integration allows an entity to extend its expertise and skills into related product markets;
- Vertical integration makes it easier to find ways of reducing costs in the supply chain, and adding value; and
- Vertical integration can help to differentiate the product. Backwards integration could aid designing and making unique components; forwards integration could help to sell products in a unique environment.

However, it might not be certain how customers or suppliers might react. For example, if a wholesaler goes into the business of retailing, will its other retailer customers stop buying its goods and switch to buying from a different wholesaler who is not also a competitor?

There is also a risk that integration might reduce the competitiveness of the entity.

Arguments against vertical integration

Avoiding the discipline of the market. A cosy, relaxed relationship is likely to grow between, say, an in-house component manufacturer and producer of the finished product. The component manufacturer knows that the group company will almost certainly buy its components, and so there is little pressure for cost efficiency and innovation.

Other companies might turn out to be more successful than the one bought in by the group. For example, a rival component manufacturer makes a technical breakthrough so that their components are better and cheaper. It might be better on each purchasing occasion to have the pick of all manufacturers so that the best and most suitable cost effective components can be bought.

Different management skills. If a manufacturer takes over a distribution chain, the skills needed to manage that will be quite different, and the company could easily mess things up.

Core business. The company should examine its value chain and distinctive competences. These must be protected, and buying another company can mean that management pays less attention to the areas of its business that really matter.

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Use of capital. Is buying, or setting up, a supplier or distributor really the best way for a company to use its capital?

Example: Integration

Several companies that manufacture high-quality goods have adopted a strategy of acquiring their own retail outlets to sell their products and to project a sophisticated brand image. These companies include Louis Vuitton (luggage) and Apple (computers).

Another example is Nespresso, a subsidiary of Nestlé. This company originally (1986) sold coffee capsules for espresso machines, and then expanded its business into selling coffee machines that were manufactured by other companies but sold under the Nespresso brand name.

More recently, the company has opened a small number of 'coffee boutiques' in prestigious locations such as Madison Avenue in New York and Beauchamp Place in London, selling high-priced coffee in luxurious surroundings. The aim of this strategic development, however, is not to sell more Nespresso coffee or become an upmarket chain of coffee shops. The concept is to make customers more aware of Nespresso coffee machines and to persuade more customers to buy the machines.

3.6 Product portfolio management

Product portfolio management is another approach to developing a corporate growth strategy. Most companies sell a variety of products or services, which together make up their product portfolio. Resources are always limited, so companies should try to allocate available resources between the different products in the best way possible.

- By managing products as a portfolio, companies are able to:
- Allocate resources (finance etc) in the optimal way between the different products: priority can be given to the best-value products in the portfolio;
- Identify areas for potential improvement; and
- Balance the mix of products in the portfolio to ensure that the company optimises profits.

Strategic management of a product portfolio should mean that a company maintains a range of products at different stages in their life cycle. Well-established and profitable products (the 'cash cows') can provide finance to support products that are in the early stages of their development or which are still in their growth stage. And decisions can be taken about when to stop making some products when they move into their decline phase.

A well-balanced portfolio will contain both established products and products that will be tomorrow's winners. A balanced portfolio can be aligned with the company's strategic objectives and acceptable risk.

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Developing strategies for the product portfolio as a whole also enables a company to review and revise the portfolio continually, according to changes in market conditions, competitors' actions and resource availability.

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4 FORECASTING TOOLS FOR STRATEGIC PLANNING

Section overview

- Introduction
- Trend analysis
- System modelling
- Delphi technique

4.1 Introduction

Strategic planning should be based on reasonable expectations of what is likely to happen in the future. Organisations should therefore make long-term forecasts. Because they are long-term, strategic forecasts cannot usually be exact or specific; however, they should be sensible forecasts making use of the best available information.

A number of different forecasting tools are available to help with long-term forecasting. These may be either quantitative or qualitative:

Quantitative forecasts are forecasts that predict future outcomes in numerical terms (for example, sales revenue), using mathematical or statistical techniques. They may use historical data, such as previous sales or production figures, as a basis for making forecasts for the future.

Qualitative long-range forecasting methods are based on the experience or judgement of forecasters.

4.2 Trend analysis

Trend forecasting is a quantitative forecasting method. It is a technique that uses historical data to identify a trend or pattern, and predict how the trend will continue into the future in order to make the long-term forecast. Different mathematical techniques can used to identify the trend and project the trend into the future.

Constant pattern

A trend may be one of no change, with no increase or decrease over time. In this situation, there is a constant pattern, and long-term forecasts will be the same as current figures, with perhaps some adjustments for any specific changes that are expected to occur.

Linear pattern

A linear pattern is a steady ('straight line') increase or fall in numbers over time. On a time series graph, this would be shown as a straight line sloping up or down from left to right. Typically, a linear pattern may be used to predict future growth on sales. A mathematical technique known as linear regression analysis can be used to prepare forecasts of future growth (or decline) based on the historical trend.

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Exponential growth

Rather than a slow, steady increase over time, an exponential pattern or trend indicates that something is increasing at an ever-faster rate over time. Instead of a straight line trend, an exponential trend is curved, rising more steeply over time. An example of exponential growth might be forecasts of a company's requirements for data storage over time, as its operations become increasingly digitised.

4.3 System modelling

Trend forecasting can be used to estimate future values for one variable (such as sales revenue) or a small number of variables.

However, sometimes simple trend analysis is insufficient and unreliable, because there may be a number of different factors that will influence future outcomes. In other cases, an organisation may want to make forecasts for a large number of different items ('factors'). In such cases, the organisation may construct a model for the system that it is forecasting.

A system model will have a number of 'input variables' or factors that will affect the future outcome. It may also have a number of different items or 'output variables' that it is trying to forecast. By experimenting with the model, and varying the values of the input variables, an organisation can look at a range of possible future outcomes, and prepare a strategic plan on the basis of the potential variations in outcomes that might occur.

For example, a strategic planning model may include, as input variables:

Historical growth in markets;

Current prices;

Current costs;

Current employee numbers;

Strength of customer attitudes to the organisation's product or service (as a quantitative measure); and

Use of robots (as a quantitative measure, such as costs of investments).

Outputs from the model might include:

Total market size for the product or service;

The organisation's sales;

The organisation's profits; and

Employee numbers.

By changing values for any or all of the input variables, different forecasts can be produced for the output variables. The various outputs for different scenarios can then be used to make a 'most likely' strategic forecast.

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Using system modelling to make forecasts is a complex form of quantitative forecasting.

4.4 Delphi technique

The Delphi technique is a method of qualitative forecasting, in which a consensus forecast is developed from the opinions of a number of different experts.

A questionnaire is sent out to each of the experts, and their anonymous responses are aggregated and shared with all the experts in the group. The experts are able to compare their own forecasts with those of the other (anonymous) experts. Another round of questionnaires follows, and the experts submit their views again, this time in the knowledge of what the other experts think.

This process continues a number of times, with round after round of questionnaires. Each time the experts are told what their anonymous colleagues now think, and they are allowed to adjust their answers in each subsequent round. The responses of the experts should change in each subsequent round, based on the information they receive each time about the current views of the other experts. Since the responses of the participant experts are anonymous, individuals do not have to worry about what others think about their opinions or forecasts. Consensus is reached over time as opinions change in each round.

The questionnaire rounds can be repeated as many times as necessary to achieve a general sense of consensus.

The aim of the Delphi method is that eventually, the experts will reach agreement or consensus in their forecasts, and this becomes the forecast for the purpose of strategic planning.

The main disadvantage of the Delphi method for long-range forecasting is that it might take the experts a long time and many rounds of questionnaires to reach a consensus.

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5 ASSESSMENT OF BUSINESS STRATEGIES

Section overview

- The basis for assessing business strategy
- Suitability of a strategy
- Suitability: life cycle analysis and the life cycle portfolio matrix
- Suitability: assess resources and competencies
- Suitability: business profile analysis
- Feasibility of a strategy
- Acceptability of a strategy
- Selecting individual investments: strategic fit

5.1 The basis for assessing business strategy

Before deciding whether or not to choose a particular business strategy, an assessment should be carried out to judge whether the strategy is acceptable. Johnson and Scholes suggested that when judging the strengths or weaknesses of a proposed strategy, the strategy should be evaluated for its:

suitability: does it address the strategic requirements, given the circumstances and the situation?

acceptability: does it address the strategic requirements in a way that will be acceptable to significant stakeholders?

feasibility: is it practical?

Included within an assessment of acceptability or feasibility should be a financial analysis of the proposed strategy. Strategies might be suitable, and they might succeed in achieving their business objectives, however, if the expected financial return is too low, or if the strategy could only be implemented at a loss, it should not be undertaken.

An assessment of strategy **must always consider the financial aspects**. In your examination, you should bear this in mind. If you are given a case study and asked to recommend a business strategy, you should not recommend anything that is financially unacceptable!

5.2 Suitability of a strategy

A strategy is suitable if it would achieve the strategic objective for which it is intended.

If the purpose of the strategy is to gain competitive advantage, it is necessary to assess how the strategy might do this, and how effective the strategy might be. Will the strategy succeed in reducing costs, if this is its purpose? Will the strategy succeed in adding value, if adding value is the purpose?

If the purpose of the strategy is market development, how successful might the strategy be?

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Similarly, how suitable are the chosen strategies for market development, product development or diversification?

Is the business risk in the strategy acceptable, or might the risk be too high?

Several techniques might be used to assess the suitability of a strategy. These include:

life cycle analysis and the life cycle portfolio matrix;

an assessment of resources and competencies; and

business profile analysis.

5.3 Suitability: life cycle analysis and the life cycle portfolio matrix

The life cycle portfolio matrix can be used to assess the suitability of a particular strategy in relation to the stage of its life cycle that the entity's product has reached.

A choice from several different strategies might be appropriate for a product in a particular stage of its life cycle, but some strategies are more appropriate than others. For example, a strategy that might be appropriate for the growth stage of the life cycle might not be appropriate during its decline stage.

The life cycle portfolio matrix suggests what the appropriate strategies might be, in view of both:

the stage of the life cycle; and

the entity's competitive position in the market.

A version of a life cycle portfolio matrix is shown on the next page. This suggests which business strategies might be appropriate at each stage of the life cycle, depending on the company's position in the market. Some of the terms used in the table are explained below:

- 'Fast grow' means 'grow the company's business at a faster rate than the rate of growth in the market as a whole';
- 'Grow with the industry' means 'grow the company's business at the same rate as the average rate of growth in the market as a whole';
- 'Find niche' means try to develop a market niche for the product;
- 'Retrench' means cut expenditure and reduce investment: usually this means accepting a reduction in market share;
- 'Renew' means give the product new 'life' by introducing new and improved features; and
- 'Harvest profits' means treat the product as a 'cash cow': take the money from profits but do not invest further.

One version of a life cycle portfolio matrix is set out below.

		Stage of product life cycle			
		Introduction	**Growth**	**Maturity**	**Decline**
Competitive position	**Dominant**	Fast grow Start-up	Fast grow Achieve cost leadership Renew product Defend position	Defend position Achieve cost leadership Fast grow	Defend position Focus Renew Grow with the industry
	Strong	Start-up Differentiate Fast grow	Fast grow Catch up Achieve cost leadership Differentiate	Achieve cost leadership Renew Focus Differentiate Grow with the industry	Find niche market Hold niche Hang in Grow with the industry Harvest profits
	Favourable	Start up Differentiate Focus Fast grow	Differentiate Focus Catch up Grow with the industry	Harvest Hang in Find niche Hold niche Renew Turnaround Differentiate Focus	Retrench Turnaround
	Weak	Find niche Catch up Grow with the industry	Turnaround Retrench	Withdraw Divest	Withdraw

5.4 Suitability: assess resources and competencies

Another approach to strategy evaluation is to consider the strategy in relation to:

- the resources that the strategy will need, to carry it out; and
- the competencies of the entity, and in particular its core competencies.

Unless the strategy will enable the entity to take advantage of its core competencies, it will be difficult – or impossible – for the entity to gain a competitive advantage by pursuing the strategy.

A strategy should not be considered suitable **unless** it is expected to make use of the entity's core competencies.

5.5 Suitability: business profile analysis

A strategy can also be evaluated by comparing:

- the features of the marketing strategy that appear to make it successful and profitable; with
- whether the strategy under consideration will have these features, and if so, to what extent.

For example, a product could be positioned in the market as being up-market and exclusive and could have a brand name associated with luxury. A strategy to sell the product in supermarkets might not therefore be suitable.

5.6 Feasibility of a strategy

The feasibility of a strategy is concerned with whether it will work. A strategy is feasible if it can be implemented successfully. Assessing whether or not a strategy is feasible will require some judgement by management.

Some of the questions to consider are as follows:

Is there sufficient finance for the strategy? Can we afford it?

Can we achieve the necessary level of quality that the strategy will require?

Do we have the marketing skills to reach the market position that the strategy will expect us to achieve?

Do we have enough employees with the necessary skills to implement this strategy successfully?

Can we obtain the raw materials that will be needed to implement this strategy?

Will our technology be sufficient to implement the strategy successfully? For example, will our IT systems be good enough?

If there are serious doubts about the feasibility of a strategy, it should not be selected.

An important aspect of strategy evaluation is the financial assessment.

Will the strategy provide a satisfactory return on investment?

Is the risk acceptable for the level of expected return?

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What will be the expected costs and benefits of the strategy? How will it affect profitability?

What effect is the strategy likely to have on the share price?

5.7 Acceptability of a strategy

The acceptability of a strategy is concerned with whether it will be acceptable to key stakeholders. If it is not acceptable to a key stakeholder, the stakeholder will oppose the strategy. Management should then consider whether a strategy that is not acceptable to a key stakeholder should be undertaken or not.

In most cases, management are likely to reject a strategy that will not be acceptable to a key stakeholder.

There are several aspects of 'acceptability'.

Management will not regard a strategy as acceptable if the expected returns on investment are too low, or if the risk is too high in relation to the expected return.

Investors might regard a strategy as unacceptable if they will be expected to provide a large amount of additional investment finance.

Employees and investors might consider a strategy unacceptable if they regard it as unethical.

Example: Deutsche Borse

In 2005, the company that owns the German stock exchange, the Deutsche Borse, made a takeover bid for the London Stock Exchange. Under German law, the company's management did not have to consult its shareholders about the bid.

However, a large number of shareholders formally expressed their hostility to the bid, and opposed management's strategy. They stated their preference for the company to use its large amounts of cash to increase dividends.

In spite of the stated objection of the shareholders to the management strategy, however, the management team continued with the takeover bid.

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5.8 Selecting individual investments: strategic fit

When an entity has decided its business strategies, it might make new investments or undertake new business initiatives in order to put the strategy into practice. In principle, all new investment decisions:

- should be expected to provide a minimum acceptable financial return (in other words, should have a positive net present value when its cash flows are discounted at an appropriate cost of capital); and also
- should be consistent with the chosen strategies, and there should be a 'strategic fit' between strategy and investments.

However, an investment opportunity might be identified that will provide high financial returns, but is not a good strategic fit. Even though the investment is not consistent with agreed strategy, it would probably be undertaken – provided that the expected financial returns were high in relation to the investment risk. This would possibly be an example of emergent strategy, which was described in an earlier chapter. (Alternatively, it would be a one-off investment with the sole aim of making money!)

In other situations, an entity may decide to undertake an investment with low financial returns, because it is an excellent 'strategic fit'.

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6 ETHICAL INFLUENCES AND CORPORATE SOCIAL RESPONSIBILITY

Section overview

- Business ethics
- Consequences of unethical behaviour
- Ethical codes
- Corporate social responsibility
- Implications of ethics and CSR for strategy

Companies that acknowledge their ethical responsibilities and corporate social responsibility need to demonstrate their genuine commitment to these ideals. To do this, they need to consider the implications of ethics and CSR for their strategic planning and objectives.

6.1 Business ethics

Companies should comply with the law. Many companies go further and state that they will act in an ethical way. Ethical behaviour (for most people) involves compliance with the law. However, it is possible to act within the law but behave in an unethical way.

The ethics of doing business are different from the ethics of normal social behaviour. Businesses compete with each other, and many decisions are taken for commercial reasons, regardless of their effect. For example, companies will close down loss-making operations, regardless of the impact on the employees who are made redundant.

The ethics of business conduct by individual companies depends largely on the ethical stance of the company and its leaders.

Ethical issues

Ethics in business is generally associated with the following aspects of behaviour:

- Acting within the law. In international business, ethical behaviour often means compliance with accepted international codes of behaviour, such as a code against bribery by companies seeking to win a major contract from a customer;
- Fair and honest dealing with suppliers and customers;
- Acting fairly towards employees and showing due concern for the welfare of employees;
- Showing respect and concern for the communities in which the business entity operates;

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- Showing respect for human rights, and refusing to deal with entities that do not show concern for human rights. A significant issue for some companies in recent years has been public pressure to avoid dealing with suppliers in developing countries who use child or slave labour; and
- Showing concern for the environment and the need for sustainable businesses.

Ethical stance

The business ethics of a company can also be described as an ethical stance. An ethical stance is the extent to which an entity will exceed its minimum legal and ethical obligations to stakeholders and society in general.

There is a range of different ethical stances that a company might take, but it is useful to group them into four broad positions on a scale from position 1 to position 4.

Position 1. The company takes the view that its only interests should be the short-term interests of its shareholders. Business decisions should be taken with satisfying shareholder interests as the only objective.

Position 2. The company takes the view that the interests of its shareholders are the most important concern, but that in the long term the company will benefit by showing some concerns for the interests of employees, communities, the general public and the environment. The company therefore acts in its 'enlightened self-interest'.

Position 3. The company recognises an obligation not only to its shareholders, but to other stakeholder groups.

Position 4. The company has an ethical obligation towards society as a whole, and should be a 'shaper of society', creating a fair and just society for everyone. Financial objectives should be of secondary importance.

'Ethical behaviour' by companies is generally associated with an ethical stance around position 2 or position 3.

6.2 Consequences of unethical behaviour

Acting ethically reduces risk. There are several possible consequences of unethical behaviour.

When business conduct is illegal or in breach of regulations, there is a risk of being 'found out'. The consequences could be the payment of fines to the authorities or compensation to individuals who have suffered as a consequence of the illegal behaviour. In some cases, individual directors might be liable to imprisonment for illegal behaviour.

When businesses act legally but in a way that the general public considers 'immoral', there is a risk of action by the government to makes such action illegal.

Businesses that act in an unethical way are also exposed to reputation risk.

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Reputation risk

Many large companies take the view that in a competitive business environment, customer loyalty depends on the general public's perception of the company's behaviour, which establishes a reputation. Reputation comes from business practice, such as providing high quality products at a fair price. It also comes from ethical behaviour.

Companies with a good reputation find it easier to win and keep loyal customers, and also loyal employees. When a business reputation is damaged, there is a risk of losing customers to rival companies.

Although the evidence for the importance of reputation risk is inconclusive, there is no doubt that many large companies are very aware of their reputation and reputation risk, and they invest heavily in trying to maintain their business reputation, through public relations and pursuing 'ethical' business strategies.

Companies that have been exposed to reputation risk include:

- companies accused of buying from suppliers in developing countries that use child labour or slave labour;
- companies accused of polluting the environment; and
- companies in the food and drugs industries accused of selling dangerous food products or dangerous drugs.

6.3 Ethical codes

Many public companies have a published code of business ethics.

The New York Stock Exchange rules require companies whose shares it trades to have a publicly displayed code of business conduct and ethics.

In the UK, 90% of the top UK companies have a code of ethics.

If ethical codes are to be effective then:

They must be strongly endorsed from the top of the company. (Enron, the collapsed US corporation, had an ethical code but the board of directors chose to over-rule it.);

Training must be given. If not, many employees might not even be aware that it exists, let alone know how to apply it;

The code must be kept up-to-date;

The code must be available to all, for example, through the corporate intranet; and

Adherence to the code should be part of employees' contracts and departure from the code should be a disciplinary offence.

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Example: Ethics

Citigroup, the international banking group, attracted adverse publicity in 2004 following two reported incidents – breaches of regulations in Japan and trading activity in the European bond market that was investigated by the authorities for possible breaches of financial regulations and was also criticised by other bond trading firms as unethical.

Citigroup announced that it was introducing an education programme to make employees aware of their ethical responsibilities.

In 2005, two executives of advertising agency Ogilvy & Mather were found guilty of overcharging the US government. The company announced that its response to the incident included the appointment of an ethics officer and the introduction of a 'hot line' that employees could use to 'blow the whistle' on colleagues, in confidence.

6.4 Corporate social responsibility

Corporate social responsibility (CSR) is the responsibility that companies recognise for acting in a socially responsible way. 'While there is no single commonly-accepted definition of corporate social responsibility or CSR, it generally refers to business decision-making linked to ethical values, compliance with legal requirements, and respect for people, communities and the environment' (*Business for Social Responsibility*).

CSR usually means that a company goes further than required by law in order to:

- treat employees fairly and with respect;
- operate in an ethical way and with integrity, in all its business dealings with customer, suppliers, lenders and others;
- respect human rights;
- sustain the environment for future generations; and
- be a responsible neighbour in the community and a good 'corporate citizen'.

CSR is therefore closely linked to ethical behaviour. Many large stock market companies issue reports on corporate social responsibility and their CSR activities.

These reports might be included in the annual report and accounts. For example, quoted companies in the European Union are now required to provide information on social and environmental issues in a business review within the annual report and accounts.

Some companies publish a separate corporate social responsibility report. This may be called a 'social and environmental report' or a 'sustainability report'. These describe the company's social and environmental strategies and their progress towards achieving their CSR strategic objectives.

6.5 Implications of ethics and CSR for strategy

Companies that acknowledge their ethical responsibilities and corporate social responsibility need to demonstrate their genuine commitment to these ideals. To do this, they need to consider the implications of ethics and CSR for their strategic planning and objectives.

The growing importance of environmental (ecological) issues was discussed in an earlier chapter on environmental analysis. Many large public companies have adopted formal environmental policies, with objectives for creating a sustainable business and being environment-friendly. For example:

- A company that uses large quantities of timber as a raw material might adopt a policy of re-forestation, to replace trees that they have cut down; and
- A company that sells sea fish might adopt a policy of maintaining fish stocks in the seas.

Ethics might also affect a company's policy to its employees. If a company has a formal policy of providing secure employment, fair wages and salaries, and good working conditions to its employees, this policy might affect strategic decisions about re-locating business and making staff redundant.

A policy of ethical business dealing might involve a business decision that all suppliers will be paid promptly.

When companies adopt ethical or CSR policies, they should do so out of a genuine wish to act in an ethical and socially responsible way. There is often a suspicion that many companies claim to have CSR policies, when in reality they fail to implement them. For example, many environmental disasters and many serious fires and explosions at work have been caused by poor safety procedures in companies that have publicised their CSR policies on protection of the environment and employee safety.

CSR and competitive advantage

The significance of CSR probably varies between different countries, but in some countries, particularly in Europe and North America, companies are waking up to the strategic possibilities and strategic advantages of being an environmental-friendly company.

Customers might be willing to pay more for environment-friendly products and for 'healthy food'. There is growing interest in smaller motor cars and cars driven by bio-fuel or electricity. CSR activities can therefore create value.

Michael Porter (Harvard Business Review, 2006) suggested that companies should not merely be taking corporate social responsibility seriously as an idea. They should also be 'embedding' CSR into their corporate and business strategy, in order to build a competitive advantage.

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7 STRATEGY SELECTION

Section overview

- Formal evaluation
- Enforced choice
- Learning and experience

The process of strategy evaluation provides an assessment of the suitability, feasibility and acceptability of different strategies. Strategy proposals that are not suitable, not feasible or not acceptable can be rejected. This might still leave several different alternative strategies to consider. If so, the preferred strategies must be selected from the strategy options that are available.

7.1 Formal evaluation

Where there is a free choice from several available strategies, the selection might be based on a formal financial evaluation and strategic evaluation of the expected returns and the risks, over the long term as well as the short term.

7.2 Enforced choice

In some cases, management might take the view that they have no real choice, and that they are 'forced' to adopt a particular strategy. The reasons for having to select an enforced strategy might be that:

- a key stakeholder, such as a major shareholder, is insisting on a particular strategy; or
- every competitor is doing the same thing.

However, it is probably a sign of weak management that a strategy is considered necessary or unavoidable. Strategy selection should be positive. Management should be looking for the strategies that are most likely to achieve the corporate objectives.

7.3 Learning and experience

A distinction can be made in strategy selection between experience and learning.

Experience is acquired over time. With experience, an entity should develop skills and competencies. Strategic opportunities should arise that enable the entity to use its skills and experience to develop its businesses. Using acquired skills to develop and grow is consistent with the logical incremental model of strategic management.

Learning is the acquisition of new ideas. An entity might select a strategy that forces it to learn something new. This might require a significant change in behaviour as well as skills. Although the learning process can be rapid, strategies based on new learning are likely to introduce change more suddenly. This type of strategy might therefore be fairly risky.

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8 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain and apply the different strategies of Ansoff's product/market growth vector
- Advise on methods of growth including both internal (organic) and external (e.g. mergers and acquisition) growth strategies
- Summarise how diversification and vertical and horizontal integration operate
- Explain the strategic nature of product portfolio management
- Explain the use of trend analysis, system modelling and the Delphi method as strategic forecasting tools
- Assess business strategies using the SFA (suitability/feasibility/acceptability) model
- Consider ethical and corporate social responsibility influences on strategy selection
- Explain the final strategy choice considering formal evaluation, enforced choice, learning and experience

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CHAPTER 7

Strategy implementation

Contents

1 Organising for success
2 Internal and external relationships
3 The most appropriate organisation structure
4 Business plans
5 Models for evaluating strategic performance
6 Communicating chosen strategies
7 Strategic change
8 Managing strategic change
9 Organisational change and organisational culture
10 Chapter review

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INTRODUCTION

Detailed syllabus

Strategic management

B3	**Strategic implementation**
B3 (b)	Develop and evaluate alternative business plans and proposals and select the best option to implement a chosen strategy.
B3 (c)	Evaluate the tools and techniques for strategy implementation applicable to different business units in a given scenario.
B3 (d)	Evaluate strategic performance using: balanced scorecard, performance pyramid and Fitzgerald, and Moon building blocks.
B3 (e)	Appraise organisational structures and related activities that may be appropriate to deliver a chosen strategy set out in a given scenario: entrepreneurial, functional, divisional, conglomerate and matrix.
B3 (f)	Communicate chosen strategies and performance targets to operational and tactical managers through annual budgets, monthly and weekly targets, linking critical success factors (CSFs) to key performance indicators (KPIs) and strategy.
B3 (h)	Evaluate and explain the potential issues of change that may arise from a chosen or given business strategic implementation plan.
B3 (i)	Evaluate the impact of organisational change on organisation culture including cultural web and McKinsey's 7S model.
B3 (j)	Evaluate the role of leadership in managing the change process, including building and managing effective teams.
B3 (k)	Evaluate tools, techniques and strategies for managing and leading the change process.

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Exam context

Having learnt about internal and external analysis as a basis for performing a SWOT analysis, then considering mission, gap and strategic choice, the next two chapters focus on implementing the chosen strategy.

In this chapter you will learn about generic strategy implementation topics such as organisation structure, business plans and managing the change process. The following chapter then addresses specific functional strategies.

By the end of this chapter students will be able to:

- Advise on appropriate organisation structures for effective strategy implementation;
- Analyse internal and external relationships for implementing strategy including outsourcing;
- Draft and analyse a business plan;
- Apply three models for evaluating strategic performance: the balanced scorecard; the performance pyramid; and Fitzgerald and Moon's building block model;
- Explain how chosen strategies and performance targets should be communicated to operational and tactical management;
- Evaluate and advise on managing change in an organisation including applying Lewin and Gemini theories; and
- Advise on the cultural aspects of organisational change, and the need to address the possibility of cultural resistance to change.

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1 ORGANISING FOR SUCCESS

Section overview

- Strategy implementation
- Organisation structure
- Entrepreneurial organisation
- Functional organisation structure
- Divisional organisation structure
- Conglomerate organisation structure
- Matrix organisation structure
- Project-based and team-based structures
- Span of control
- Organisational processes

1.1 Strategy implementation

After a strategic position analysis has been undertaken, available strategies have been evaluated and the preferred strategies have been selected, the selected strategies must be implemented. Achieving strategic objectives requires successful strategy implementation.

Strategy implementation takes the form of day-to-day actions and relationships. Three key aspects of strategy implementation are:

- organisation structure, including the organisation of processes and relationships;
- managing strategic change; and
- implementing strategy through a combination of intended strategy and emergent strategy.

1.2 Organisation structure

Organisation structure is an aspect of strategy implementation. Strategy is implemented through actions, and actions are planned and controlled through the management and decision-making structure within the entity.

Organisation structures differ between entities. The organisation structure of an entity should be appropriate for the size of the entity, the nature of its operations, and what it is trying to achieve. Most important, the organisation structure must enable the entity to develop plans and implement them effectively.

There are several different types of organisation structure. Within a single entity, particularly a large entity, there might be a mixture of different organisation structures, with different structures in different parts of the entity.

From a strategic perspective, however, the key question is: 'What is the most appropriate structure for a particular entity that will help it to achieve its strategic objectives in the most efficient way?'

You should also be familiar with the following basic structures that might exist within any entity or part of an entity:

- an entrepreneurial organisation structure;
- a functional structure;
- a divisional structure; and
- a matrix organisation.

1.3 Entrepreneurial organisation

An entrepreneurial organisation is an entity that is managed by its entrepreneurial owner. The main features of an entrepreneurial organisation are usually that:

- the entrepreneur takes all the main decisions, and does not delegate decision-making to anyone else;
- the entity is therefore organised around the entrepreneur and there is no formal management structure; and
- operations and processes are likely to be simple, and the entity will probably sell just a small number of products or services.

An entrepreneurial structure is appropriate when an entity is in the early phase of its life. As it grows larger, however, an entrepreneurial structure will become inefficient, and a formal management structure is needed.

1.4 Functional organisation structure

A functional structure is usually the next stage in the development of the organisation structure of a growing entity. In a functional organisation structure, decision-making authority is delegated in a formal arrangement, and responsibilities are divided between the managers of different activities or functions. Typically, functions in a manufacturing entity include production (or operations), marketing and sales, and finance and accounting. There might also be a human resources function, an IT function, a research and development function, and so on.

Each function has its own management structure and its own staff.

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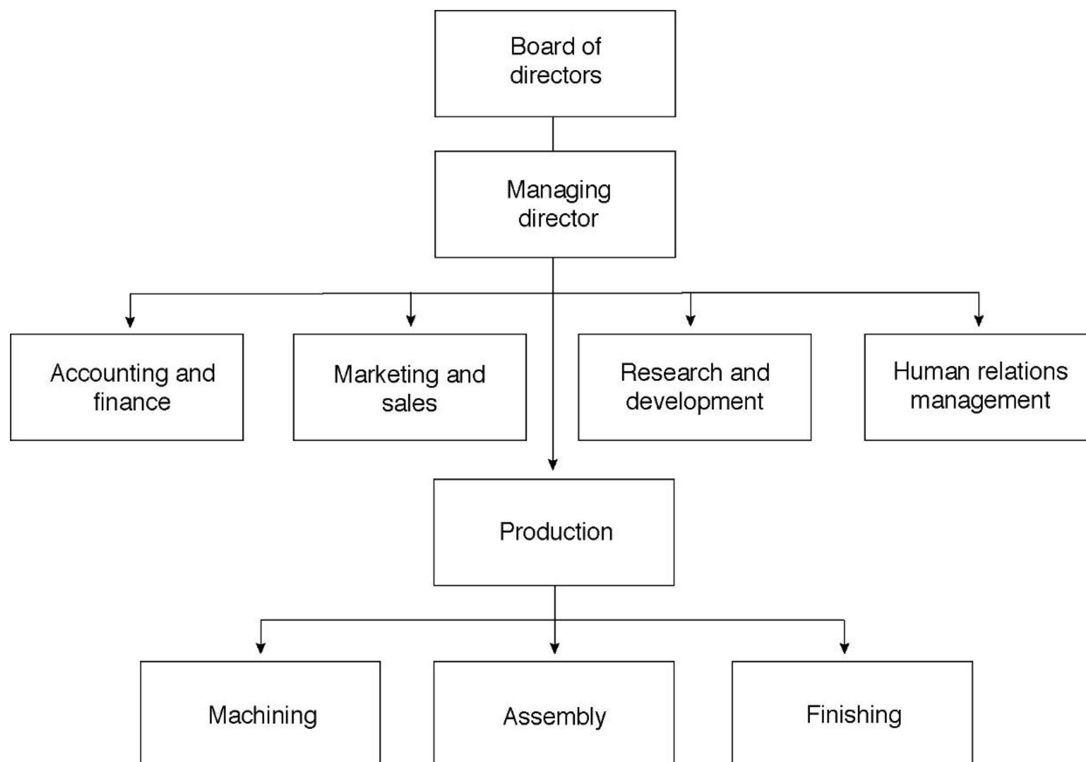
An organisation chart showing a simple functional structure is shown below.



1.5 Divisional organisation structure

As entities grow still further, and develop their business operations into different product-markets, a divisional structure might become appropriate. A division is an area of operations, defined by:

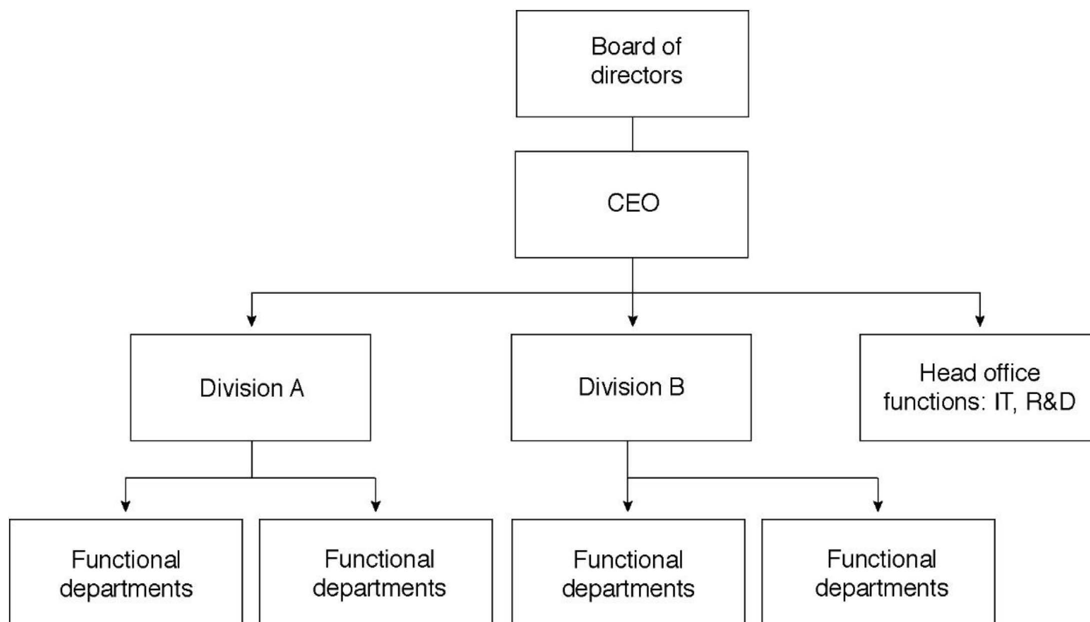
- markets in different geographical areas (for example, the European and the North American divisions);
- different products (for example the bus division and the rail division of a transport company); and
- different customers (for example, industrial products and consumer products).

A division might be a strategic business unit of the entity (group). Each division has its own functional departments, such as marketing and sales, operations (production), accounting and finance, and so on.

Authority is delegated from head office to the divisional management (led perhaps by a divisional managing director), and responsibility for the implementation of product-market strategy is mainly at divisional level.

Head office retains overall control, and there may be some head office functions providing support services to all the divisions, such as corporate strategy, IT and research and development.

The simple organisation chart below shows the organisation structure for a divisionalised organisation with two divisions, where IT and research and development are head office support functions.



1.6 Conglomerate organisation structure

A conglomerate is an organisation structure consisting of two or more companies operating in entirely different industries, but which are part of the same group and under the same control. Typically a conglomerate consists of a parent company and a number of subsidiary companies (and sub-subsidiaries etc).

This type of structure is appropriate when a group of companies operates in several different industries or industry sectors.

Example: Conglomerate

- A conglomerate in the travel and leisure sector may consist of a parent company and three subsidiary companies: an airline company, a hotel company and a restaurants company.
- An oil conglomerate may consist of a parent company with subsidiary companies for oil drilling, oil refining and oil distribution.

The advantages of a conglomerate structure are that:

- Each subsidiary within the group can focus on its own special area of operations; and
- Adding new subsidiaries to the group in an acquisition, or selling off businesses in a disposal is relatively straightforward.

Most, if not all, major global companies have a conglomerate structure.

1.7 Matrix organisation structure

Some entities have developed a matrix organisation structure for some of their activities. The matrix organisation originated in the 1950s and 1960s, in entities where it was recognised that different functions within the entity needed to work closely together. Horizontal relationships across different functions were as important as the 'traditional' reporting relationship within functions.

Matrix organisations and project organisation structures were both first used in the defence and aerospace industries, where companies were required to carry out major projects for customers, such as building a quantity of aircraft for a government customer.

The challenge was to complete projects on time and on budget. However, the traditional functional structure within the construction companies meant that no one was responsible for the project as a whole. A matrix organisation or project management organisation was introduced to overcome the problem.

- Project managers were appointed with overall responsibility for individual projects. Project managers had to organise the efforts of individuals in all the different functions.
- At the same time, functional managers such as management of engineering, production and sales and marketing, retained their decision-making authority.

In this way, a dual command structure was created. In a matrix organisation, the traditional vertical command structure has an overlay of horizontal authority or influence.

A matrix organisation has been defined as: 'any organisation that employs a multiple command system that includes not only a multiple command structure but also related support mechanisms and an associated organisational culture and behaviour pattern' (Davis and Lawrence 1977).

The difference between a matrix organisation structure and a project organisation is that with a project organisation, the project management comes to an end when the project ends. With matrix organisation, the matrix structure of authority and command is permanent.

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Functional managers	→	**Production**	**Quality control**	**Design**
Project managers ↓			↑ Responsible to quality control manager	
Project A				
Project B	Responsible to Project Manager B ←		Quality control expert	
Project C				

In the diagram above, the person shown is a quality control expert and is responsible to the quality control manager for technical aspects of the job, maintaining quality systems and so on.

The person is also responsible to the manager of Project B. That manager will be concerned with completing the project on time, within the cost budget and to the proper standard.

Obviously conflicts can arise: the project manager might want to skip some tests to make up time, but the quality control department won't want to do that. Both can put the employee under some pressure. However the matrix structure should allow the employee to ask the two managers to discuss the problem, as it is plain that they are both involved.

Overall, matrix structures should:

- encourage communication; and
- place emphasis on 'getting the job done' rather than each manager defending his or her own position.

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Example: Matrix

Examples of matrix organisations are as follows.

- A large company in which there are:
  - divisional managers responsible for a geographical market or a particular product, and for the profitability of the market or the product, and in addition
  - functional managers at head office responsible for the major functions across the entire entity – for production, marketing and sales, human resources management and so on.
- A university in which there is a traditional command structure based on heads of faculty and heads of department, but in addition a course-based management structure in which individual lecturers are responsible for all aspects of particular courses or degree programmes (for example, obtaining and managing the teachers from different faculties or departments, finding the lecture rooms, marking the examinations, and so on).

1.8 Project-based and team-based structures

In addition to having a formal management structure, entities might also use project teams and other management teams to implement some activities.

Project teams are usually assembled to accomplish a specific task, such as introducing a new system or a new process. The project team should consist of members from different disciplines or functions, so that a wide range of skills is assembled to implement the project.

Project teams might be used for implementing planned strategic changes.

1.9 Span of control

The span of control refers to the number of people who directly report to a manager in a hierarchical management 'command' structure. There are two extreme shapes:

- **Tall-narrow** - In this type of structure, each manager has a small number of subordinates reporting directly to him. As a result, in a large organisation, there are many layers of management from the top down to supervisor level. The span of control is narrow, and the shape of the organisation structure is tall, because of the many layers of management.
- **Wide-flat** - In this type of structure each manager has a large number of subordinates reporting directly to him. As a result, even in a large organisation, there are only a few layers of management from the top down to supervisor level. The span of control is wide, and the shape of the organisation structure is flat, because of the small number of management levels.

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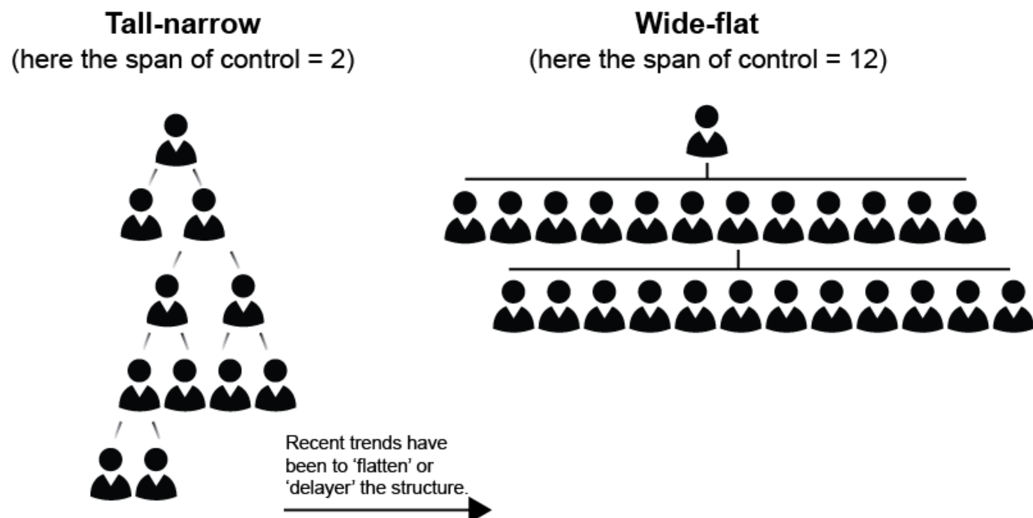

The tall-narrow structure often has the following characteristics:

- Formality in relationships between managers and subordinates;
- Close supervision, with managers spending much of their time monitoring the work of subordinates and giving them directions;
- Task specialisation, with a small group of manager and subordinates specialising in a very narrow aspect of the entity's operations;
- A strong cultural and procedural emphasis on formal roles, job titles and job descriptions; and
- Slow vertical communication. Because of the many levels of management, it can take a long time for information to get from top to bottom of the management hierarchy, and from bottom to top. As a result, tall-narrow organisations can be slow to react to change.

The wide-flat organisation structure often shows the following characteristics, where the work is **fairly complex** and **non-routine**:

- Greater egalitarianism. 'Bosses' and 'subordinates' will often respect each other for their skills and experience, and will treat each other as equals;
- Team-work and co-operation;
- Greater delegation of responsibility to subordinates. Managers have too many subordinates to apply close control. Managers must therefore trust subordinates to get on with their work, with relatively little supervision;
- Flexibility. There is less emphasis on roles and job descriptions, and individuals are more willing to switch from doing one type of task to another, as the demands of the work change; and

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- There is rapid vertical communication and decision-making. Information travels quickly from top to bottom of the organisation structure and from bottom to top.

Wider and flatter organisation structures have replaced tall bureaucratic structures in many organisations. The reasons why wide-flat organisations are often preferred are as follows;

- Wide-flat structures are more suitable to rapidly-changing business environments, where entities must respond to changes quickly and with flexibility. An organisation in which information travels quickly and decisions can be made quickly is more appropriate in these circumstances than a structure that is more formal and hierarchical; and

- Cost savings. It has been argued that in a tall-narrow organisation, managers spend too much time managing each other, instead of adding value. If middle managers do not add value, they should be eliminated from the organisation structure.

1.10 Organisational processes

Actions are implemented within an entity through established processes. The processes that are used within an entity vary. As explained above, they differ between tall-narrow organisation structures and wide-flat organisations.

Processes affect the way that plans are made and implemented, and activities are controlled. The nature of planning and control can differ widely between different entities.

- At one extreme, actions are controlled through direct and close supervision of the work of individuals by their supervisor or superior manager.

- At the other extreme, there is minimal supervision, and control is exercised mainly by the individual himself.

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Example: Supervision

Some investment banks have developed very complex financial products which they sell to customers or trade for profit.

Due to their complexity, senior management do not understand the products in any great detail. They rely on small investment management teams to use and develop new products that are consistent with the bank's strategic intent.

Supervision is therefore minimal, and control is often exercised through self-control by the individual product experts.

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2 INTERNAL AND EXTERNAL RELATIONSHIPS

Section overview

- Organisational relationships and implementing strategy
- Internal relationships: centralisation versus decentralisation
- External relationships
- Outsourcing
- The virtual organisation

2.1 Organisational relationships and implementing strategy

Plans are put into action by the co-ordinated efforts of many individuals and groups within the entity. The way in which plans are implemented depends on:

- the nature of internal relationships: these are relationships between different parts of the organisation; and
- the nature of external relationships: in many entities a significant amount of work is done by other entities and individuals who are external to the entity and not a part of it.

2.2 Internal relationships: centralisation versus decentralisation

An important aspect of internal relationships is the extent to which decision-making is centralised, so that major planning decisions are made (and implemented) by 'head office', or decentralised.

- In a centralised organisation, senior management retain most (or all) of the authority to make the important decisions.
- In a decentralised organisation, the authority to take major decisions is delegated to the management of units at lower levels in the organisation structure, such as SBU managers, and divisional managers.

The choice between a centralised and a decentralised organisation depends to some extent on the preference of senior management. However, the size and complexity of the entity also influence the extent to which decision-making, planning and control are centralised or decentralise ('devolved'). It is difficult to control a large and complex entity from head office, without delegating substantial amounts of authority to divisional managers.

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Advantages of centralisation

Advantages of centralisation are as follows:

- Decisions by management are more likely to be taken with regard for the corporate objectives of the entity as a whole. There is a very strong argument in favour of making strategic decisions centrally;
- Decisions by management should be co-ordinated more effectively if all the key decisions are taken centrally; and
- In a crisis, it is easier to make important decisions centrally.

Advantages of decentralisation/devolution of authority

Advantages of decentralisation are as follows:

- In many situations, junior ('local') managers have better knowledge than senior management about operational conditions. Tactical and operational decisions are probably better when taken by local management, particularly in a large organisation;
- Giving authority to managers at divisional level and below helps to motivate the management team;
- Decisions can be taken more quickly at a local level, because they do not have to be referred to head office; and
- In a large and complex organisation, many decisions have to be made – probably too many for senior management at head office.

The appropriate amount of centralisation or decentralisation for an entity will depend on the circumstances.

It has already been suggested (**Greiner's growth model**) that as it gets larger, an entity might go through periods of centralisation, decentralisation and co-ordination between local management and head office.

2.3 External relationships

An entity might use external relationships to deliver a particular strategy. These are relationships with other entities, or with individuals who are not a part of the entity but are external to it. External relationships may take the form of:

- strategic alliances;
- value networks;
- outsourcing of functions; and
- virtual organisation.

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2.4 Outsourcing

An entity does not need to carry out operations itself. Instead, it can outsource work to a sub-contractor.

Outsourcing is common in certain industries, such as the construction industry. It is also common to outsource 'non-core' activities, such as the management of the entity's fleet of motor vehicles, security services, some IT work and some accountancy work (for example, payroll operations).

The size of an entity, and its organisation structure, will depend to some extent on how much of its operational activities it chooses to outsource.

The reasons for outsourcing

Outsourcing is consistent with the view that an entity achieves competitive advantage by concentrating on its core competencies. It does not achieve competitive advantage doing work that can be done just as well – if not much better – by another entity.

- The entity should therefore focus activities within the entity on core competencies, with the aim of gaining more competitive advantage in these core areas.
- The entity should outsource work to entities that have core competencies in these areas of work. They should be able to add value more effectively than the entity would if it were to carry out the work internally instead of outsourcing it.
- The outsourced work might require specialist skills that the entity cannot employ internally, because it cannot offer enough work or a career structure to full-time specialists. It therefore outsources its specialist work to specialist firms.

Problems with outsourcing

The nature of the relationship with suppliers of outsourced work is critical to the successful implementation of strategy.

A potential problem with outsourcing is the loss of control over the outsourced activities. This can be significant when something goes wrong, and action performance does not meet expectations.

For example a company might outsource its IT work and might commission a software company to write some new software. The software, when written, might not function properly. The problem is then to manage the external relationship with the software company, to find a satisfactory solution to the problem.

2.5 The virtual organisation

The virtual company or virtual organisation does not have an identifiable physical existence, in the sense that it does not have a head office or operational premises. It might not have any employees.

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A virtual organisation is operated by means of:

- IT systems and communications networks – normally telephone and e-mail; and
- business contacts for outsourcing all operations.

Many small businesses operate as virtual organisations. For example, a house builder might operate his business from his home. When asked to build a new house, he can hire all the labour – skilled and unskilled – that he needs to do the work, supervise it and check it. He can employ a firm of accountants to deal with the invoicing and payments. The builder does not need an office, or full-time employees. His core competence is his personal skill and experience, which he should use to give his firm its competitive advantage over rival house builders.

In the same way, there is no reason why a larger business should not be operated as a virtual company. For example, a company that sells branded footwear could operate as a virtual company, using its brand name as its major core competence. It could outsource all its value chain and support activities. Manufacture could be outsourced to producers in developing countries; warehousing companies could be used to hold inventories. A network of self-employed sales representatives might be used to sell the footwear into retail organisations, and marketing activities might be outsourced to an external agency.

One person, or a small number of individuals, can operate a virtual organisation and indirectly control the actions of many 'external' entities and individuals.

A key to a successful virtual organisation is the successful management of all the different external relationships, and successful co-ordination of their activities.

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3 THE MOST APPROPRIATE ORGANISATION STRUCTURE

Section overview

- Contingency theory of organisation structure
- Burns and Stalker: mechanistic and organic structures
- Mintzberg's five building blocks for organisational configurations
- Mintzberg's six organisational configurations
- Conclusion: the most appropriate organisation structure

3.1 Contingency theory of organisation structure

Contingency theory of organisation structure is that the most effective organisation structure for an entity depends on the circumstances. An entity should use the organisation structure that is best suited to its size, complexity and strategies. Organisation structure will vary according to differences in organisational processes and internal and external relationships.

3.2 Burns and Stalker: mechanistic and organic structures

An example of contingency theory is the management study of Burns and Stalker. They identified two categories of organisation structure, a mechanistic structure and an organic structure.

The differences between the two types of structure are set out in the table below.

Mechanistic organisation	Organic organisation
Authority is delegated through a hierarchical management structure. Power over decision-making is obtained from a person's position in the management hierarchy.	There is a network structure of control. Individuals influence decisions on the basis of their knowledge and skills, regardless of their position in the organisation.
A bureaucracy.	Control is cultural, not bureaucratic.
Communication is vertical, up and down the chain of command.	There is much more horizontal communication and free-flow of information.
Jobs are specialised, and individuals concentrate on their specialist area. Doing the job is the main priority.	Specialist knowledge and expertise are shared, and contribute to the 'common task' of the entity. Contributing to the common task is the main priority.
Job descriptions are precise.	Job descriptions are less precise.

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Mechanistic organisation	Organic organisation
Tasks and operations are governed by instructions from a superior manager.	Communications consist of information and advice, rather than decisions and instructions from a manager.

Burns and Stalker found from their research that one type of organisation is not necessarily better than the other. However, they did find that:

- an organic structure is better-suited to an entity that needs to be responsive to change in its products and markets, and in its environment; and
- a mechanistic structure is better suited to an entity in a stable environment, where change is gradual.

Burns and Stalker also found that entities with an organisation structure better suited to their environment perform better than entities whose structure is not well suited to their environment. For example an entity with a mechanistic structure performs better in a stable market than an entity with an organic structure.

Example: Nestlé

It is important to recognise that the most suitable organisation structure depends partly on circumstances and partly on management preference. Organisation structures can also be changed.

An example is Nestlé. In an article in the Financial Times newspaper (22 February 2005), the CEO of Nestlé explained that in the past he had been frustrated by the minor role played by the marketing function in the company. He had also disliked the matrix organisation structure used by the company, where ‘local’ managers were responsible for the profitability of their local markets, and functions such as marketing had responsibility for their functions, but not for markets. The marketing management were responsible for some innovation, but not for country performance. Marketing managers had targets for returns on investment in advertising, rather than responsibility for returns on business investment.

This organisation structure was changed. The head of marketing was made responsible for the company’s seven strategic business units – dairy, confectionery, beverages, ice cream, food, pet care and food services. These units established the global business strategy for the company’s product markets. They were responsible for research and development, production expertise and systems control.

Regional business strategy was developed from the business strategies for each of the SBUs. Local market strategy was developed from the regional

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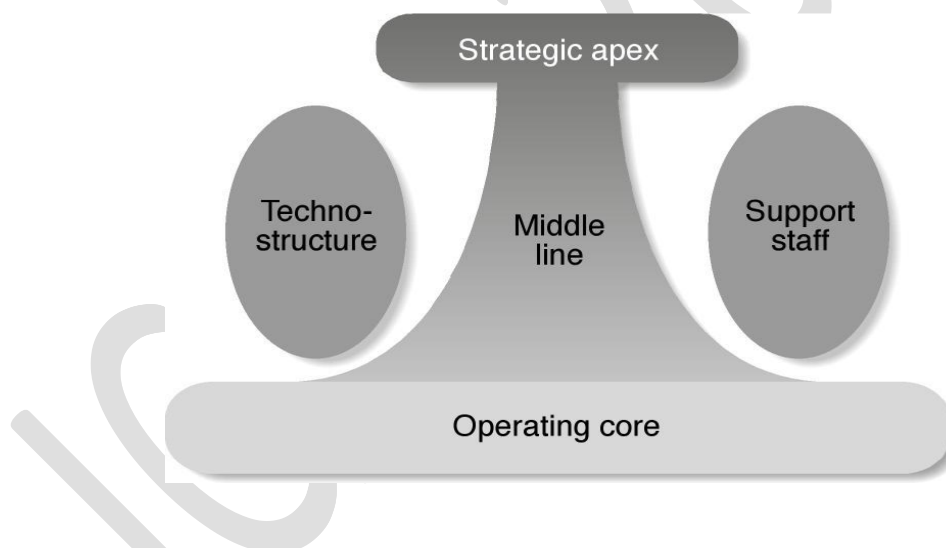
business strategies. In this way, the head of marketing became a key figure in strategic management. He had to authorise every new factory opening by guaranteeing the capacity utilisation of the factory and the return on investment.

The change in organisation structure, giving much more responsibility to the marketing function, was the result of management preference rather than strategic necessity. Clearly, however, the CEO believed that the new structure would be more effective.

3.3 Mintzberg's five building blocks for organisational configurations

Mintzberg argues that an organisation structure exists to co-ordinate the activities of different individuals and work processes, and to implement plans into action. The nature of the organisation structure varies with differences in processes and internal and external relationships. He suggested that there are five elements or 'building blocks' in an organisation. The way in which an entity is organised most effectively depends on which of these elements is dominant.

These five elements are shown in the diagram below.



- **Strategic apex.** This is the top management in the organisation.
- **Operating core**. This represents the basic work of the organisation, and the individuals who carry out this work.
- **Middle line**. These are the managers and the management structure between the strategic apex and the operating core.
- **Support staff**. These are the staff who provide support for the operating core, such as secretarial staff, cleaning staff, repair and maintenance staff, IT staff and so on.

- **Technostructure**. These are staff without direct line management responsibilities, but who seek to standardise the way the organisation works. They produce procedures and systems manuals that others are expected to follow.

Mintzberg argued that the group that has the greatest influence determines the way in which the entity is organised, and the way that its processes and its relationships operate.

- When the strategic apex is powerful, the organisation is entrepreneurial. The leaders give the organisation its sense of direction and take most of the decisions.
- When the technostructure is dominant, the organisation often has the characteristics of a bureaucracy, with organising, planning and controlling being prominent activities. The organisation continually seeks greater efficiency.
- When the organisation is divisionalised and local managers are given extensive authority to run their own division in the way that they consider best, the middle line is dominant.
- Some organisations are dominated by their operating core, where the basic 'workers' are highly-skilled and seek to achieve proficiency in the work that they do. Examples might be schools, universities, and hospitals, where the teachers and doctors can have an exceptionally strong influence.
- In a professional bureaucracy, such as a firm of accountants or lawyers, the middle line tends to be short (close contact between the partners and staff). Unexpectedly, in view of the amount of standardised audit documentation, the technostructure is small. This is because, although the documentation is extensive, the use of the documentation is unique for each client. No two audits or law cases are the same, so standardisation must be limited.

3.4 Mintzberg's six organisational configurations

Mintzberg identified six different organisational configurations, each having a different mix of the five building blocks. He suggested that the most suitable organisational configuration would depend on the type and complexity of the work done by the entity. The six configurations are:

- simple structure;
- machine bureaucracy;
- professional bureaucracy
- divisionalised form;
- adhocracy; and
- missionary organisation.

Simple structure

This is found in an entrepreneurial company. The strategic apex exercises direct control over the operating core, and there is no middle line. There is also little or no support staff or technostructure. The strategic apex might be an owner-director of the company. This type of structure is very flexible, and can react quickly to changes in the environment, because the strategic apex controls the operating core directly.

Machine bureaucracy

In a machine bureaucracy, the technostructure is the dominant element in the organisation. The entity is controlled and regulated by a bureaucracy and the emphasis is on control through regulation. It is difficult for an entity with this type of organisation to react quickly to environmental change. This structure is therefore more suitable for entities that operate in a stable business environment.

Professional bureaucracy

In this type of structure, the operating core is the dominant element. Mintzberg gave the name 'professional bureaucracy' to this type of structure because it is often found in entities where the operating core consists of highly-skilled professional individuals (such as investment bankers in a bank, programmers in a software firm, doctors in a hospital, accountants and lawyers in a professional practice, and so on).

Divisionalised form

In this type of structure, the middle line is the dominant element. There is a large group of powerful executive managers, and the organisation structure is a divisionalised structure, each led by a divisional manager. In some divisionalised structures, divisional managers are very powerful, and are able to restrict the influence of the strategic apex on decision-making.

Adhocracy

Mintzberg identified a type of organisation that he called an 'adhocracy'. This is an organisation with a complex and disordered structure, making extensive use of teamwork and project-based work. This type of organisation will be found in a complex and dynamic business environment, where innovation is essential for success. These organisations might establish working relationships with external consultancies and experts. The 'support staff' element can therefore be very important.

Missionary organisations

In this type of organisation, all the members share a common set of beliefs and values. There is usually an unwillingness to compromise or accept change. This type of organisation is only appropriate for small entities that operate in simple and fairly static business environments.

Differences between the six organisational configurations

The differences between the six organisational configurations are summarised below. Note in particular how each configuration is likely to be suitable for

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different types of business environment and different types of organisational relationships. The main controlling and co-ordinating factor within each type of configuration also differs.

	Business environment	Internal features	Key organisational element	Main co-ordinating factor
Simple structure	Simple and dynamic	Small entity Simple tasks	Strategic apex	Direct control by strategic apex
Machine bureaucracy	Simple and static	Large and well-established. Regulated processes and systems	Technostructure	Standardised procedures
Professional bureaucracy	Complex but static	Simple processes. Control by the professionals	Operating core	Standardisation of skills
Divisionalised form	Fairly static Diverse activities	Large and well-established. Divided activities	Middle line	Standardisation of outputs
Adhocracy	Complex and dynamic	Complex tasks. Young entity	Support staff or operating core	Flexibility and adaptation
Missionary organisation	Simple and static	Simple systems. Fairly well established (not young)	-	Standard beliefs and values

3.5 Conclusion: the most appropriate organisation structure

The organisational configurations suggested by Mintzberg, or the idea of Burns and Stalker, can be used to consider whether the organisation structure of an entity is well-suited to its circumstances and situation. The key point to note is that the organisation structure should be designed to enable the entity to implement its strategies successfully.

Johnson, Scholes and Whittington have commented: ‘Poor performance might be the result of an inappropriate configuration for the situation or inconsistency between structure, processes and relationships.’

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4 BUSINESS PLANS

Section overview

- Basic structure of a business plan
- In detail - components of a business plan

4.1 Basic structure of a business plan

Illustration: Basic structure of a typical business plan

A typical business plan will adopt the following layout:

- Title page;
- Table of contents;
- Introduction;
- Executive summary;
- Body of the report;
  - Business description
  - Business environment analysis
    - Industry background
    - Competitor analysis
    - Market analysis
  - Operating plans
  - Management summary
  - Financial plan
- Conclusions and recommendations; and
- Appendices
  - Detailed financial information
  - CVs of key management.

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4.2 In detail – components of a business plan

Title page

The title page is there to attract the reader to the report and assist them in finding the report at a later date. You would typically include:

- Title (and any sub-titles) – this should distinguish the report and ensure it is easily identifiable from others;
- Author (internal reports only);
- Your organisation's name (external reports only);
- Any reference numbers;
- Degree of confidentiality; and
- Date.

You might also include some kind of unobtrusive artwork such as logos (your organisation and the client) plus a simple graphic that relates to the report subject.

Table of contents

A table of contents is a list of all the sections that are included in the report (in the same order in which they appear) plus relevant page numbers.

Introduction

The introduction prepares the reader for the report itself by reminding them of what they already know i.e. why the report has been written and the question that the report answers.

The introduction should address the following:

- Make the subject of the report clear;
- State the purpose of the report; and
- Briefly explain the methods used to get the information.

Executive summary

The benefit of including an executive summary is that for senior people with little time it is the one section they will read. Therefore, a succinct, clear and well written executive summary should always reach the reader.

The executive summary should include:

- What the report is about;
- What the problems are;
- The conclusions you arrived at; and
- What you recommend.

The skill in writing an executive summary is to give the overall picture without including too much detail. One useful by-product of writing the executive summary is that by going through the writing process you will be able to check that the report itself is logical.

Body of the report

The body of the report should be split into sections with logical headings and sub-headings. These will likely reflect the groupings and sub-groupings you created during the planning and structuring phase.

The headings are essentially 'signposts' that allow the reader to navigate to the relevant detail in a logical fashion to further investigate something they have read in the executive summary. Typical components would include:

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- Business description, which briefly explains:
  - Overall mission and objectives;
  - History and ownership; and
  - Products and services

- Business environment analysis
  - Industry background
    - PESTEL analysis: A PESTEL analysis describes the political (P), economic (E), social (S), technological (T), Ecological (E) and Legal (L) factors that impact the business. For example:
      - **Political**: A change in government policy may lead to a reduction in grants available;
      - **Economic**: High interest rates make it expensive to borrow money from a bank to fund expansion
      - **Social/cultural**: An ageing population increases the demand for pharmaceuticals and old-age-related healthcare;
      - **Technological**: The evolution from traditional hand-held mobile phones with buttons to smart-phones with touch-sensitive screens;
      - **Ecological**: An industry may face the risk that their sources of raw materials will be used up e.g. in the fishing industry or timber production; and
      - **Legal**: In many countries, companies are faced with environmental legislation and/or health and safety legislation, affecting the ways in which they operate, as well as the design of the products they make and sell.
    - SWOT analysis: A SWOT analysis describes a business's strengths (S), weaknesses (W), opportunities (O) and threats (T). For example:
      - **Strength**: the business employs a highly skilled and dedicated workforce;
      - **Weakness**: the factory is full of old machinery that frequently breaks down;
      - **Opportunity**: there is huge demand for the businesses products overseas so they could start exporting their products; and
      - **Threat**: A large new competitor could open an outlet in the same town where the business is currently the only supplier.

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  - Competitor analysis
    - Who are the main competitors?
  - Market analysis
    - Size, segmentation, growth/decline
- Operating plans
  - Marketing plan
  - Operations plan
- Management summary
  - Who the key management personnel are and their backgrounds
  - Organisation chart (summary only – can include more detail as an appendix)
- Financial plan
  - Summary financial information – income statement, statement of financial position and cash flow statement

Conclusions and recommendations

The conclusions and recommendations must follow logically from the rest of the report. When writing the conclusions and recommendations section, consider the following:

- Do the conclusions and recommendations follow logically from the rest of the report?
  - Draw out the main point(s) of the report and present a considered judgement of them
  - Only draw conclusions that are justified by the evidence and facts contained in the body of the report
  - Make recommendations based only on your discussion and conclusions
  - Never introduce a new line of argument or material in the conclusions and recommendations section;
- Check the conclusions and recommendations against the original objective of the report;
- Make sure you have answered the reader's key question; and
- Finish with the final impression you want to make.

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Appendices

The appendices should include detailed information that the reader can essentially do without in order to make sense of the main body of the report. For example: calculations, examples, questionnaires and CVs. They are effectively the bottom level of the logical pyramids you constructed during the structuring phase.

In summary, appendices should be:

- Included only if absolutely necessary;
- Non-essential for understanding the main arguments;
- Referred to somewhere in the body of the text i.e. there must be a link; and
- Mentioned as the final item in the table of contents.

An alternative approach is to exclude appendices but invite the reader to contact the author should they wish to see a copy of the detail. However, as a minimum most business plans would include the following two appendices:

- Detailed financial information – more detail than in the financial plan in the main body; and
- CVs of key management – certainly board members but also include for other key management personnel.

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5 MODELS FOR EVALUATING STRATEGIC PERFORMANCE

Section overview

- The balanced scorecard
- The balanced scorecard: four perspectives of performance
- The performance pyramid
- Interpreting the performance pyramid
- Fitzgerald and Moon building block model
- Applying the Fitzgerald and Moon framework

This section looks at three models that can be used to evaluate strategic performance.

5.1 The balanced scorecard

The balanced scorecard can be used to measure performance in relation to long-term objectives. For a commercial business, the most important objective is a financial objective. However, in order to achieve financial objectives over the long term, it is also necessary to achieve goals or targets that are non-financial in nature, as well as financial.

The concept of the balanced scorecard is that there are several key aspects of performance ('perspectives on performance') and targets should be set for each of them. These different 'perspectives' may sometimes appear to be in conflict with each other, because achieving an objective for one aspect of performance could mean having to make a compromise with other aspects of performance. The aim should be to achieve a satisfactory balance between the targets for each of the different perspectives on performance. These targets, taken together, provide a balanced scorecard, and actual performance should be measured against all the targets in the scorecard.

A balanced scorecard approach should remove the emphasis on financial targets and short-term results.

However, although a balanced scorecard approach takes a longer-term view of performance, it is possible to set shorter-term targets for each item on the scorecard. In this way it is possible to combine a balanced scorecard approach to measuring performance with the annual budget cycle, and any annual incentive scheme that the entity may operate.

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5.2 The balanced scorecard: four perspectives of performance

In a balanced scorecard, critical success factors are identified for four aspects of performance, or four 'perspectives':

- customer perspective;
- internal perspective;
- innovation and learning perspective; and
- financial perspective.

Of these four perspectives, three are non-financial in nature.

For each perspective, Kaplan and Norton argued that an entity should identify key performance measures and key performance targets. The four perspectives provide a framework for identifying what those measures should be, although the specific measures used by each entity will vary according to the nature of the entity's business.

Perspective	The key question
Customer perspective	**What do customers value?** By recognising what customers value most, a company can focus its performance targets on satisfying customers more effectively. Targets might be developed for several aspects of performance such as cost (value for money), quality or place of delivery.
Internal perspective	**To achieve its financial and customer objectives, what processes must the organisation perform with excellence?** Management should identify the key aspects of operational performance and seek to achieve or maintain excellence in these areas. For example, a company may consider that customers value the quality of its service, and that a key aspect of providing a quality service is the effectiveness of its operational controls in preventing errors from happening.
Innovation and learning perspective	**How can the organisation continue to improve and create value?** The focus here is on the ability of the organisation to maintain its competitive position, through the skills and knowledge of its work force and through developing new products and services, or making use of new technology as it develops.
Financial perspective	**How does the organisation create value for its owners?** Financial measures of performance in a balanced scorecard system might include share price growth, profitability and return on investment.

Kaplan and Norton argued that although the main objectives of a business are financial, it is essential for long-term success that the organisation should be able to meet the needs of its customers (the customer perspective). In order to satisfy customers, it must have internal processes that are efficient and effective in

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delivering the goods or services that customers need (the internal perspective). Also to have effective and efficient internal processes, an organisation needs people with knowledge and skills, as well as a capacity to continue innovating (the innovation and learning perspective).

Several measures of performance may be selected for each perspective, or just one. Using a large number of different measures for each perspective adds to the complexity of the performance measurement system.

Examples of measures of performance for each of the four perspectives are as follows. The list is illustrative only, and organisations will use balanced scorecard measures that are appropriate for their business.

Perspective	Outcome measures
Critical financial measures	Return on investment Profitability and profitability growth Revenue growth Productivity and cost control Cash flow and adequate liquidity Avoiding financial risk: limits to borrowing
Critical customer measures	Market share and market share growth Customer profitability: profit targets for each category of customer Attracting new customers: number of new customers or percentage of total annual revenue obtained from new customers during the year Retaining existing customers Customer satisfaction, although measurements of customer satisfaction may be difficult to obtain On-time delivery for customer orders
Critical internal measures	Success rate in winning contract orders Effectiveness of operational controls, measured by the number of control failures identified during the period Production cycle time/throughput time Amount of re-working of defective units
Critical innovation and learning measures	Revenue per employee Employee productivity Employee satisfaction Employee retention or turnover rates Percentage of total revenue earned from sales of new products Time to develop new products from design to completion of development and introduction to the market

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5.3 The performance pyramid

Another performance evaluation model is the performance pyramid. The concept of a performance pyramid is based on the idea that an organisation operates at different levels. Each level has different concerns, but these should support each other in achieving the overall business objectives.

Performance can therefore be seen as a pyramid structure, with a large number of operational performance targets supporting higher-level targets, leading to targets for the achievement of overall corporate objectives at the top.

The performance pyramid was developed by Lynch and Cross (1991). They argued that traditional performance measurement systems were not as effective as they should be, because they had a narrow financial focus – concentrating on measures such as return on capital employed, profitability, cash flow and so on. They argued that in a dynamic business environment, achieving strategic business objectives depends on good performance with regard to:

- **Customer satisfaction** (a 'marketing' objective: here, the focus is on external/market effectiveness);
- **Flexibility** (the flexibility objective relates to both external effectiveness and internal efficiency within the organisation); and
- **Productivity** (resource utilisation: here, the focus is on internal efficiency, much of which can be measured by financial performance).

These key 'driving forces' can be monitored at the operational level with performance measures relating to quality, delivery, cycle time and waste.

Lynch and Cross argued that within an organisation, there are different levels of management and each has its own focus. However, there must be consistency between performance measurements at each management level, so that performance measures at the operational level support the corporate strategy.

They presented these ideas in the form of a pyramid of targets and performance that links operations to corporate strategy.

A performance pyramid can be presented as follows:

Performance pyramid

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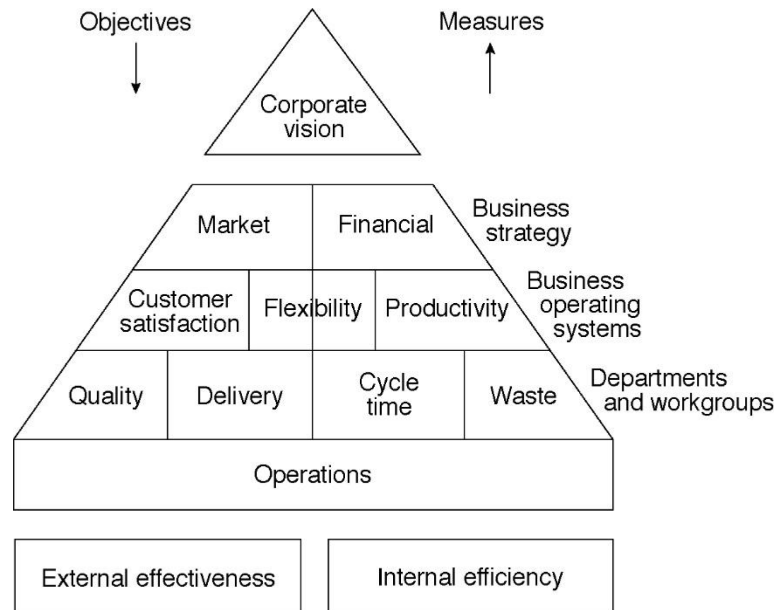

5.4 Interpreting the performance pyramid

The performance pyramid links strategic objectives with operational targets, and internally-focused with externally-focused objectives.

- Objectives and targets are set from the top level (corporate vision) down to the operational level. Performance is measured from an operational level upwards. If performance targets are achieved at the operational level, targets should be achieved at the operating systems level. Achieving targets for operating systems should help to ensure the achievement of marketing and financial strategy objectives, which in turn should enable the organisation to achieve its corporate objectives.

- A key level of performance measurement is at the operating systems level – achieving targets for customer satisfaction, flexibility and productivity. To achieve performance targets at this level, operational targets must be achieved - for quality, delivery, cycle time and waste.

- With the exception of flexibility, which has both an internal and an external aspect, performance measures within the pyramid (and below the corporate vision level) can be divided between:

  – market measures, or measures of external effectiveness; and

  – financial measures, or measures of internal efficiency.

- The measures of performance are inter-related, both at the same level within the pyramid and vertically, between different levels in the pyramid. For example:

  – New product development in a business operating system. When a new product is introduced to the market, success depends on meeting

customer needs (customer satisfaction), adapting customers' attitudes and production systems in order to make the changes (flexibility) and delivering the product to the customer at the lowest cost for the required quality (productivity).

- Achieving improvements in productivity depends on reducing the cycle time (from order to delivery) or reducing waste.

Lynch and Cross argued that the performance measures that are chosen should link operations to strategic goals.

- All operational departments need to be aware of how they are contributing to the achievement of strategic goals.
- Performance measures should be a combination of financial and non-financial measures that are of practical value to managers. Reliable information about performance should be readily available to managers whenever it is needed.

5.5 Fitzgerald and Moon building block model

Many organisations provide services rather than products. There are many examples of service industries: hotels, entertainment, the holiday and travel industries, professional services, banking, recruitment services, cleaning services, and so on.

A starting point for analysing performance measurement in service industries is that companies in a service industry should be able to link their competitive strategy to their operations, to make sure that the services that they are providing will enable the company to achieve its strategic objectives. Performance management systems have an important role, because they can:

- show how well or how badly the organisation has performed in achieving its strategic objectives; and
- identify where improvements are needed.

Fitzgerald and Moon (1996) provided a framework for analysing performance management systems in service industries. They suggested that a performance management system in a service organisation can be analysed as a combination of three building blocks:

- Dimensions;
- Standards; and
- Rewards.

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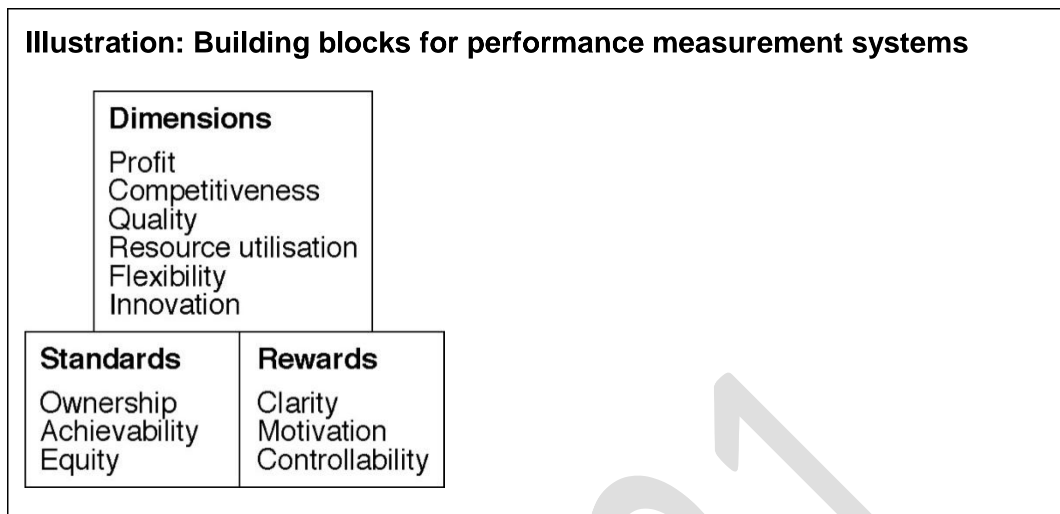
These are shown in the following diagram.

Illustration: Building blocks for performance measurement systems



Dimensions of performance

Dimensions of performance are the aspects of performance that are measured. A critical question is: What are the dimensions of performance that should be measured in order to assess performance?

Fitzgerald and Moon concluded that there are six dimensions of performance measurement that link performance to corporate strategy. These are:

- profit (financial performance);
- competitiveness;
- quality
- resource utilisation;
- flexibility; and
- innovation.

Some performance measures that might be used for each dimension are set out in the following table:

Dimension of performance	Possible measure of performance
Financial performance	Profitability Growth in profits Profit/sales margins Note: Return on capital employed is possibly not so relevant in a service industry, where the company employs fairly small amounts of capital.
Competitiveness	Growth in sales Retention rate for customers (or percentage of customers who buy regularly: 'repeat sales')

	Success rate in converting enquiries into sales Possibly market share, although this may be difficult to measure
Service quality	Number of complaints Whether the rate of complaints is increasing or decreasing Customer satisfaction, as revealed by customer opinion surveys Number of errors discovered
Flexibility	Possibly the mix of different types of work done by employees Possibly the speed in responding to customers' requests
Resource utilisation	Efficiency/productivity measures Utilisation rates: percentage of available time utilised in 'productive' activities
Innovation	Number of new services offered Percentage of sales income that comes from services introduced in the last one or two years

The dimensions of performance should also distinguish between:

- 'results' of actions taken in the past; and
- 'determinants' of future performance.

Performance: results of past actions

Some dimensions of performance measure the results of decisions that were taken in the past, that have now had an effect. Fitzgerald and Moon suggested that results of past actions are measured by:

- financial performance; and
- competitiveness.

Determinants of future performance

Other dimensions of performance will not have an immediate effect, and do not measure the effects of decisions taken in the past. Instead they measure progress towards achieving strategic objectives in the future. The 'drivers' or 'determinants' of future performance are:

- quality;
- resource utilisation;
- flexibility; and
- innovation.

These are dimensions of competitive success now and in the future, and so are appropriate for measuring the performance of current management. Measuring performance in these dimensions 'is an attempt to address the short-termism criticism frequently levelled at financially-focused reports' (Fitzgerald).

Standards

The second part of the Fitzgerald and Moon framework relates to setting expected standards of performance, once the dimensions of performance have been selected.

There are three aspects to setting standards of performance:

- To what extent do individuals feel that they **own** the standards that will be used to assess their performance? Do they accept the standards as their own, or do they feel that the standards have been imposed on them by senior management?
- Do the individuals held responsible for achieving the standards of performance consider that these standards are **achievable**, or not?
- Are the standards **fair ('equitable')** for all managers in all business units of the entity?

It is recognised that individuals should 'own' the standards that will be used to assess their performance, and managers are more likely to own the standards when they have been involved in the process of setting the standards.

It has also been argued that if an individual accepts or 'owns' the standards of performance, better performance will be achieved when the standard is more demanding and difficult to achieve than when the standard is easy to achieve. This means that the standards of performance that are likely to motivate individuals the most are standards that will not be achieved successfully all the time. Budget targets should therefore be challenging, but not impossible to achieve.

Rewards

The third aspect of the Fitzgerald and Moon performance measurement framework is rewards. This refers to the structure of the rewards system, and how individuals will be rewarded for the successful achievement of performance targets.

One of the main roles of a performance measurement system should be to ensure that strategic objectives are achieved successfully, by linking operational performance with strategic objectives.

According to Fitzgerald and Moon, there are three aspects to consider in the reward system.

- The system of setting performance targets and rewarding individuals for achieving those targets must be clear to everyone involved. Provided that managers accept their performance targets, **motivation** to achieve the targets will be greater when the targets are **clear**.
- Employees may be motivated to work harder to achieve performance targets when they are **rewarded for successful achievements**, for example with the payment of a bonus.
- Individuals should only be held **responsible for aspects of financial performance that they can control**. This is a basic principle of responsibility accounting.

5.6 Applying the Fitzgerald and Moon framework

The actual measures of performance used by companies in service industries will vary according to the nature of the service. Fitzgerald and Moon used case studies, however, to show how their framework can be used to assess performance management systems.

One successful (and large) organisation reported as a case study was a food retailing business with a large number of stores. Applying the Fitzgerald and Moon framework, the performance management system was analysed as follows:

Dimensions of performance

The company used four of the six dimensions of performance to assess the performance of individual stores and the performance of each region.

Dimension of performance	Measures used	Comments
Financial performance	Profit by store and by region.	Profit is seen as a very important measure of performance. The performance of each store and region is publicised within the company, by means of 'league tables', so that each store manager knows how his store has performed in comparison with others.

Dimension of performance	Measures used	Comments
Competitiveness	Market share (at company level). Prices of competitors for each local store.	The company places great importance on monitoring the prices charged by competitors. Prices are monitored for each store, at the 'local' level.
	Observation.	Market share is assessed from published market share statistics. Managers of local stores may visit the stores of competitors to see how full their car park is, and compare this with the number of cars in the car park of their own store.
Quality of service on specific transactions	Letters and other messages from customers. Observation	The quality of service is monitored by 'mystery shoppers' – individuals hired by the company to visit stores disguised as customers, to observe the quality of service provided.
Quality of service overall	A range of measures for each store and warehouse/depot	A number of different aspects of service quality are monitored and measured, and a performance league table for stores and warehouses is published internally.
Flexibility	No formal performance measurement	However, managers are aware of the need for flexibility. For example, when there are staff shortages due to absenteeism, store managers will telephone part-time staff and ask them to fill the vacancies at short notice.
Resource utilisation	Sales per square metre. Wastage rates	
Innovation	No formal performance measurement	The need to innovate continually is recognised, however, and innovation is discussed regularly at business planning meetings.

Standards of performance

The research found a significant difference between the level of ownership for:

- profit; and
- quality of service.

Managers participated in the process of setting profit targets for their store or region, through the formal business planning process. However, standards for quality of service were imposed by central management (head office). The view of senior management was that quality standards must be the same at every store in the country; therefore standards must be decided at head office for the company as a whole.

'Standards' of performance were assessed for both profitability and quality of service.

Standard	Comment
Profit	
Ownership	Managers were involved in setting profit targets, as part of the discussions with head office about annual targets and business planning.
Achievability	The standards/targets were considered achievable by the managers responsible for achieving them.
Equity	In setting profit targets for each store, allowance was made for the effect of competition from local competitors to each individual store.
Quality of service	
Ownership	Standards were imposed by head office.
Achievability	However, they were seen as achievable. An aspect of standard-setting was the use of internal benchmarks, and comparisons of quality standards at different stores within the company.
Equity	No allowances were made for different local conditions. All stores throughout the country were expected to achieve the same standards.

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6 COMMUNICATING CHOSEN STRATEGIES

Section overview

- CSFs and KPIs
- Linking performance targets and measures

6.1 CSFs and KPIs

Within an overall strategic plan there should be a number of critical success factors (CSFs). A CSF is something that is an essential requirement for an organisation to achieve strategic success and its overall objectives. For commercial organisations, CSFs include financial factors such as profit and return on investment. However, as the previous section has shown (for example, with the balanced scorecard and the performance pyramid) CSFs should include non-financial factors too.

For each strategic CSF, there should be a target for achievement or performance over a given period of time: key performance indicators (KPIs). Ideally, these targets of performance should be quantitative measures, but they may also be qualitative in nature. Actual performance can be compared with the target, and success can be judged according to how well actual performance compares with the target.

CSFs and KPIs are established at a strategic level and should be built into the strategic plan. They should also be linked to performance targets for managers at all levels throughout the organisation, i.e. at operational and tactical levels as well as at the strategic management level.

6.2 Linking performance targets and measures

In a well-structured strategic planning and performance management system, performance targets should be consistent with each other and linked to each other throughout the organisation.

- Senior management should communicate the organisation's long-term objectives to management throughout the organisation hierarchy. This enables all managers to see what the organisation is trying to achieve, and how their particular area of responsibility will contribute to these overall goals.
- At a strategic level, KPIs should be established for each CSF, and a target for achievement should be included in the strategic plan.
- The strategic KPIs should be linked to performance targets and performance measurements at the operational level of management, through budgets and budget targets (or through non-financial performance targets). Each budget target for operational managers should support a KPI and CSF at the strategic level. Actual performance at an operational level is monitored through regular budgetary monthly control reports.

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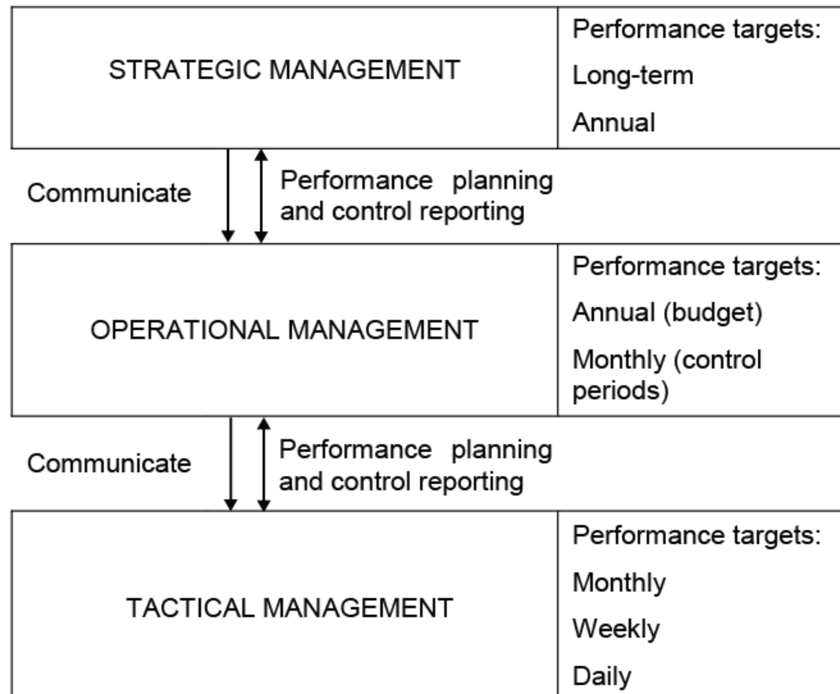
- Performance targets and performance measurements at the operational level of management should be linked to monthly, weekly or even daily performance targets at the tactical management level (first line management).

The coordination of performance targets throughout an organisation is illustrated in the diagram below. However, for this overall system of performance management to be effective, communication of targets by senior management is an essential requirement.



7 STRATEGIC CHANGE

Section overview

- The nature of change
- Triggers for change
- Consequences of change
- Attitudes to change

7.1 The nature of change

Change happens continually within organisations and their markets. Strategic development inevitably results in some change, which needs careful management. Change is either planned or unplanned.

- **Planned change** (or **proactive change**) is deliberate and intended. The entity makes the change to move from an existing situation (or way of doing things) to a new situation.
- **Unplanned change** (or **reactive change**) happens in response to developments, events and new circumstances that have arisen. The change is not intended in advance.

With planned change, the entity might see an opportunity to develop. Unplanned change is often seen as a reaction to a threat or an adverse event.

Change is either incremental or transformational.

- **Incremental change**is a fairly small change. This type of change happens without the need for a major reorganisation or restructuring of the organisation and its systems and procedures. The entity should be able to adapt easily to the change.
- **Transformational change** is a big change. A transformational change requires a major reorganisation or a restructuring of the organisation and its systems and procedures. The change has a big impact on the entity, and also on the people working in it.

Transformational change requires change management skills from the managers who are responsible for introducing the change (the 'change managers').

Change is also either:

- a 'one-off' event, so that the entity moves quickly from the old state of affairs to a new state of affairs; or
- a continuing process of development and change over a long period of time.

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7.2 Triggers for change

Triggers for change are the reasons for making a change, or the reasons for the motivation to change. A trigger for change might come from either outside or inside the entity.

External triggers for change

External triggers for change are caused by changes in the environment. The PESTEL analysis of the external environment provides a useful framework for analysing external reasons for change.

Political reasons for change

- Changes in strategy might be caused by an unexpected political crisis – such as a civil war or major civil unrest – in a country that is either a major source of supply or a major export market.

Economic reasons for change

- Unexpected developments in the economies of various countries might result in a change of strategy on foreign sales or expansion into foreign markets.

Social and cultural reasons for change

- Changing public attitudes and opinions might persuade an entity to alter its strategy. For example, changing public attitudes to food safety following a 'health scare' about a food product might persuade a food manufacturer to change its strategy to the design and production of its products.

- Changing public attitudes to retirement age might persuade an entity to change its retirement policy for employees, and its human resource plan.

Technological reasons for change

- The significance of technological development has been mentioned earlier.

Ecological/environmental reasons for change

- Change might be driven by ecological change, such as diminishing supplies of fresh water, diminishing supplies of energy or factors related to climate change. These changes might force a company to consider how its businesses will continue to survive in the future, and what changes will be needed to make the business sustainable.

Legal reasons for change

- New laws on health and safety at work, laws against pollution and laws to protect the environment might have an impact on strategy and procedures.

Internal triggers for change

Change might be motivated or caused by developments within the organisation.

- **Change of senior management.** When there is a new senior manager, such as a new chief executive officer or managing director, the new person

in charge might want to introduce change because he has his own ideas about how things should be done.

- **Acquisitions and mergers.** When there is a large acquisition or a merger, major changes will probably be required to integrate the two separate firms into a single entity.
- **Demergers and divestments**. Similarly, when an entity is split up into two separate entities (a demerger) or when a large part of the entity is sold off (a divestment), changes in organisation, management and systems will be necessary.
- **Reorganisation, downsizing and rationalisation**. Change might be necessary because the current organisation and systems are no longer appropriate and change is needed. This might happen when a loss-making entity needs to close down an operating division, or needs to reduce the size of its total workforce. Current operational systems might need to change because they are no longer appropriate and have become inefficient or ineffective.

7.3 Consequences of change

Transformational change must be managed carefully. It is extremely difficult to introduce major changes without causing disruption. Many changes fail to achieve the planned benefits because of the difficulties experienced with implementing the change.

Change management requires:

- identification of the strategic changes that should be made;
- recognising the need to change systems and organisation structures to make the changes work successfully;
- recognising the effect of change on employees: this aspect of change management is often overlooked, but is probably the most common reason why attempts to make major changes are unsuccessful;
- careful planning and implementation of the change; and
- making sure that the changes 'stick' and remain in place, after they have been made.

There are several strategic models for the management of change. All models for change management recognise the importance of people and attitudes to change.

7.4 Attitudes to change

Some employees might welcome change and support the changes. More often, however, employees fear change and resist change. Attitudes and culture may therefore act as **blockages to change**. Here are several reasons for opposing change:

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Reasons related to the job

- Employees might believe that the change will put their job at risk, and make them redundant.
- Employees might believe that their existing skills will no longer be required. This is why employees often resist major technological changes.
- Employees might fear that their working conditions will change for the worse.

Personal reasons and fears

- Employees might fear that the change will make them less important to their employer.
- They might believe that the call for a change is a criticism of the way they have been working.
- They might think that after the change, their work will be less interesting. They might be reluctant to learn new ways of working.
- They might fear the unknown.

Social reasons

- Employees might resist change because they believe it will break up their work group, and separate them from the people they enjoy working with.
- They might think that after the change, they will be forced to work on their own more, and there will be less interaction with colleagues.
- They might dislike the manager who is driving the change.
- They might dislike the way that the change is being introduced, without consultation with the employees affected.

Change and organisation culture

Some entities are more capable of adapting to change than others. The reasons listed above, and the earlier description of the cultural web, might suggest reasons why resistance to major changes could be strong. Some entities, however, are better at adapting to change than others, and in some entities, change might be seen as a 'good thing'.

The management writer Rosabeth Moss Kanter suggested that there are cultural reasons why an organisation might be more change-adept than others. According to Kanter, change-adept organisations have three key attributes:

- The **imagination to innovate** - This comes from a leadership that seeks new ideas for positive change.
- The **professionalism to perform** - The management of the entity are competent at introducing change. In addition, the workforce has been

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suitably trained and developed, and has the ability to support its management in introducing change.

- The **openness to collaborate** - Change-adept entities share ideas with other entities, such as suppliers and joint venture partners, and are able to work well with other entities in making changes.

Kanter argued that change should be accepted by entities as something that is natural, desirable and welcome. When change occurs as a defensive reaction, in response to a threat, it is not welcomed. However, it is more appropriate to see change as an opportunity for the successful implementation of business strategies.

Entities that welcome change are most likely to be the first to innovate and adapt to new technology, or entities with an ability to create sustainable competitive advantage by creating extra value for its customers. Kanter argued that entities that are change-adept are ‘fast, agile, intuitive and innovative’.

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8 MANAGING STRATEGIC CHANGE

Section overview

- Guidelines for change management: change levers and management skills
- Lewin: force field analysis
- Lewin: unfreeze, change, re-freeze
- The change agent
- The Gemini 4Rs

8.1 Guidelines for change management: change levers and management skills

A general guideline for managing strategic change is as follows:

- When change is planned, managing the change involves deciding how to get from where we are to where we want to be, and recognising the changes that are necessary to get there;
- The change process consists of planning the changes, implementing them and then maintaining the change, so that there is no 'going back' to former ways and methods of operating; and
- There are several requirements for successful change. These are often referred to as **levers of change**.

Levers of change

The following requirements are needed for successful implementation of change:

- A clear understanding of the need for change, and what will be the desired result of the change;
- The commitment of the entity's leaders to the change;
- Effective communication with everyone affected by the change. This should be two-way communication. Management should listen as well as explain;
- Management should have the required qualities to implement change successfully;
- The organisation structure and relationships within the organisation should be adapted to meet the requirements of change;
- Reward systems should be amended, so that rewards to managers and other employees are based on performance targets that are consistent with the requirements of the change;
- Critical success factors and key performance indicators should be revised, so that they are consistent with the requirements of the change; and

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- Employees should be given education in the purpose of change and training to meet the operational requirements of the change.

Role of leadership in managing change

Transformational change within an organisation can be difficult to achieve successfully, and the role of the manager or team leader is critically important. Managers lead the change process, and it is their responsibility to bring their team along with them in accepting and welcoming the change. In particular, managers as team leaders should:

- communicate the reasons for the change (‘sell’ the change) to the team;
- have the trust of the team members, so that they are willing to believe and accept what the team leader says, and follow where the team leader takes them; and
- where possible, allow team members to participate in planning and implementing the change, so that they identify with the change more readily.

Skills for managing change

Rosabeth Moss Kanter suggested that a manager in a change-adept entity should have the following skills.

- **Tuning in to the environment**. Managers need to be aware of changes in the environment that will make change by the entity necessary or desirable. Kanter suggested that managers should create a network of ‘listening posts’ that they should use to monitor environmental change. She commented: ‘Pay special attention to customer complaints, which are often your best source of information about an operational weakness or unmet need. Also search out broader signs of change – a competitor doing something differently or a customer using your product or service in unexpected ways.’
- **Challenging the prevailing organisational wisdom**. Change managers should be prepared to challenge the ’conventional wisdom’ and question accepted views about what is necessary or the way that things should be done.
- **Communicating a compelling aspiration**. A change manager should have a clear idea of what he wants to achieve and should communicate this ‘vision’ to everyone he deals with. The manager must have personal conviction that the change is necessary. Without this sense of purpose, he will not be able to ‘sell’ the need for change to others.
- **Building coalitions**. Managers cannot make change happen through personal effort alone. They need to win the support and co-operation of all the individuals with the knowledge, influence or resources to make change happen. Making change happen is therefore a process of building alliances and support.

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- **Learning to persevere**. Managers should continue with the process of change even though there are likely to be setbacks and 'defeats' on the way.

- **Making everyone a hero**. The manager should give full credit to everyone who helps to introduce change successfully, and should make them feel that their efforts are fully appreciated. If possible, individuals who help to introduce changes successfully should be rewarded.

Models for managing change

There have been several different suggestions about how transformational change might be managed. Several of these 'models' for change are described in the remainder of this section.

8.2 Lewin: force field analysis

Kurt Lewin was a social psychologist. He developed a theory, which he called force field analysis, to describe the forces that come into conflict over planned changes. He suggested that there are two opposing forces:

- the **driving forces** that support the need for change; and

- the **restraining forces** that oppose and resist the change.

Any of the following factors might be a driving force or a restraining force:

- the people involved in the change, and what they want for themselves;
- the habits and customs of the individuals;
- their attitudes;
- the relationships between the people involved;
- organisation structures within the entity;
- vested interests;
- the entity's policies;
- the resources available to make the change;
- regulations; and
- events (happenings).

Lewin argued that each driving force or restraining force has a strength, which might be measured on a scale of 1 to 5. The strength of the total driving forces and the strength of the total restraining forces can therefore be measured.

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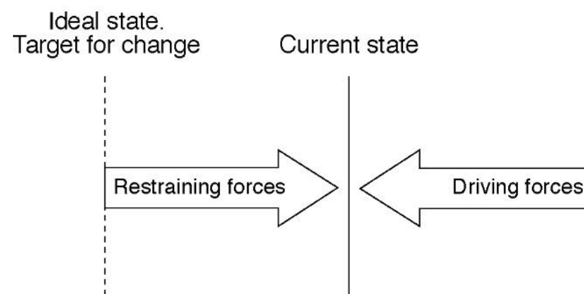
Force field analysis



Lewin also argued that:

- Change will not occur if the forces resisting the change are stronger than the driving forces for change; and
- Change is only possible when the driving forces for change are stronger than the restraining forces against change.

A key task of the change manager is therefore to ensure that the strength of the driving forces is stronger than the strength of the restraining forces. There are two ways that this might be done:

- **Strengthen the driving forces for change**
    - It might seem that the best answer is to strengthen the driving forces for change. However, Lewin argued that by increasing the driving forces, management run the risk that the restraining forces against the change will also grow stronger.
- The best approach is therefore to try to **reduce the restraining forces against change**. Management should therefore:
    - identify the main restraining forces against change; and
    - consider ways of reducing their strength, for example by discussing the issues and difficulties with the individuals concerned, or by trying to win the support of key individuals who currently oppose the change.

8.3 Lewin: unfreeze, change, re-freeze

Lewin also suggested an approach to introducing planned transformational change, which is sometimes called 'prescriptive planned change theory'.

He suggested that a planned process for change should begin with:

- identifying the cause of the problems, and the reasons why change is needed; and
- identifying the opportunities of making improvements through transformational change.

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The change process then needs to go through three stages:

- unfreeze;
- movement (change); and
- re-freeze.

Unfreeze

The process of 'unfreezing' is persuading employees that change is necessary. Individuals will not want to change anything if they think that the current situation is acceptable. Employees should therefore be encouraged to recognise what is wrong with the current system or current situation and management should encourage employees to feel dissatisfaction. Employees should be 'unfrozen' out of their acceptance of the current situation.

However, this is not enough. It is also necessary to offer employees an attractive alternative for the future that can be reached by changing the current situation.

Management must therefore have a clear vision about what changes they want to make, and they should encourage employees to want these changes to happen.

Management must therefore discuss the problems with the employees affected, and communicate their ideas.

Unfreezing is therefore the process not only of making employees dissatisfied with the current situation, but also persuading them about the nature of the changes that should be made.

Movement (change)

The changes should then be made.

To introduce change successfully, the support for change must be strong enough to overcome the opposition. This is consistent with Lewin's force field analysis.

Management should be given sufficient resources to implement the changes. (Having sufficient resources to make a change can be a driving force for change.)

The change managers should try to involve the employees affected and get them to participate in making the changes. Participation in making changes helps to reduce the resistance to change.

Re-freeze

Lewin argued that even if change is implemented, there is a risk that before long, employees will go back to their old ways of doing things, and the benefits of the change might be lost.

It is therefore essential that once change has happened, employees should be encouraged to carry on with the new way of doing things.

One way of doing this might be to reward employees for performance based on the desired behaviour and results.

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The process of getting employees to carry on with the new system is called re-freezing.

8.4 The 'change agent'

When a transformational change is implemented, there has to be a 'change agent' who drives the change and is responsible for its successful implementation. Often the change agent is an outside consultant. This individual must have certain skills.

- He must explain the reasons for the change, and provide employees with reliable information. This will help to reduce the risk of false rumours spreading.
- As far as possible, he should involve the individuals affected, and get them to participate in making the changes. When individuals are involved in the change process, they are less likely to resist it.
- He should maintain communications with employees at all time, monitoring the progress of the change and providing information to others about the progress.
- Where appropriate, he should provide training to the employees affected.
- He should emphasise the benefits of the change to the individuals affected.

A consultant is often used because:

- An outside consultant is perceived to be independent and fair;
- The consultant will have experience in managing the change process;
- The consultant will have experience of many organisations and should be able to advise on which changes are desirable; and
- Large-scale changes can easily go wrong. Management will want all the help and advice available.

8.5 The Gemini 4Rs

Another model for introducing transformational change was promoted by Gemini Consultants. This is known as the 4Rs model.

The elements of the model are as follows.

Re-frame	Create the desire for change. Create a vision of what the entity is trying to achieve. Create a measurement system to set targets for change and measure performance.

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Re-structure	Examine the organisation structure, and create an economic model showing how value is created by the entity, and therefore where resources should be used. Re-design the processes so that they work better to create more value.
Revitalise	This is the entity's commitment to the future. Find new products and new markets that fit well with the entity's environment. Invent new businesses. Change the rules of competition by making use of new technology.
Renew	Develop individuals within the organisation. Make sure that employees have the skills that are needed and that they support the change process. Create a reward system to motivate individuals to seek change. Develop individual learning and creativity within the entity.

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9 ORGANISATIONAL CHANGE AND ORGANISATIONAL CULTURE

Section overview

- The McKinsey 7 S approach
- Hard and soft factors in the 7 S approach
- Organisation culture and the cultural web

9.1 The McKinsey 7 S approach

The 7 S approach is a model for the successful implementation of strategic change. It is based on the view that there are seven factors that contribute to the effectiveness of an entity, **all of which** must be taken into consideration when implementing change.

All seven factors are inter-related. The 7 S model is therefore often illustrated as a molecule with seven atoms (balls) all joined to each other by molecular bonds (= the 'managerial molecule')

When making strategic change, a failure to take any one of the seven factors into consideration could have adverse implications for the other six factors, and the change will not be successful. All seven factors must therefore be given full consideration when change is planned and implemented.

The 7 S approach can be used to carry out an internal assessment of the capabilities or competencies of an entity. The model has other applications, and in particular it can be used to assess the possible implications of change within an organisation.

9.2 Hard and soft factors in the 7 S approach

The seven 'S' factors consist of three 'hard' factors and four 'soft' factors. These are:

Hard factors

Strategy This consists of the formally stated goals and objectives of the entity, and a plan for allocating the entity's resources to activities in order to achieve those goals.

Structure This is the formal organisation structure of the entity. It is concerned with the division of responsibilities and the allocation of authority for the achievement of the strategic goals.

Systems These are the systems that operate within the organisation, including manufacturing systems, procedures and information systems.

The hard factors are so-called because they are relatively easy to define: strategy can be recorded in a strategic plan, structure on an organisation chart and systems in a procedures manual.

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Soft factors

Staff	These are the people who work for the organisation, and their attributes – numbers, motivation, loyalty, pay rates, working conditions, career advancement, and so on.
Skills	These are the skills of key personnel. What do they do well, and what do they do badly?
Style	Style refers to the cultural characteristics of the entity and the people who work in it, and also the leadership style of its managers.
Shared values	These are the guiding beliefs about the purpose of the entity and why it exists, shared by the individuals who work in it. These might be, for example: 'providing customer service and satisfaction', or 'making profits', or 'providing a service to the community'.

The soft factors are harder to identify and define. Of course there are elements of these factors that are relatively easy to define (such as wage rates) but there are factors that are more difficult to pin down (such as staff motivation and loyalty).

The 7 S model and change management

A change in any one of the S factors will have a knock-on effect, so that there might need to be changes in the other S factors too.

- Changes in 'hard factors' such as operational systems or the management structure will have an impact on 'soft factors'.
- Problems with the soft factors could mean that changes to hard factors are difficult to implement successfully.

When the model was first devised, research showed that in many US corporations managers tended to focus on those factors that they felt they could change – strategy, structure and systems, i.e. the **hard variables**.

However they tended to ignore the other four factors (staff, skills, style and shared values) – i.e. the **soft variables**.

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McKinsey's 7 S Model

Strategy

Systems

structure

Shared values

Skills

Style

Staff

Key:

Soft Hard

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9.3 Organisation culture and the cultural web

As explained above in the context of the 7 S model, planned changes in many organisations focus on the technical changes that are needed, such as changes in structure and systems. By focusing on the practical or technical aspects of change, it is easy to overlook the need to win over employees and get them to support the change.

Employees within an organisation are often reluctant to accept big changes as they develop a collective culture and are reluctant to accept anything that seems to go against their established culture. Big change is a threat to what employees are used to and accept as 'normal'.

Knowledge of the culture within their organisation (or within groups of people within the organisation) can help managers to understand whether a planned change might be unsuccessful because of the resistance they create.

Culture is a difficult concept to understand. One well-known model for understanding the culture within an organisation is the Cultural Web model, devised by Johnson and Scholes in 1992.

Johnson and Scholes argued that the culture within an organisation, and the convictions and assumptions of the people within it, can be defined by six elements. These affect the way that people within the organisation interact with oneanother, the way they do things, and their attitudes to the 'outside world'. The six elements of culture within the cultural web are as follows:

- **Stories**. These are stories of events that have happened in the organisation in the past that are continually re-told amongst employees. They are kept alive by existing employees telling them to newcomers. These stories reveal much about the values that apply within the organisation;

- **Symbols**. These are visible expressions of the organisation that its employees identify with and associate with what the organisation 'is all about' – such as the business premises, the company logo, and the dress code that employees follow;

- **Power structure**. The most powerful and influential people within an organisation have the biggest influence on collective assumptions and ideas;

- **Organisational structure**. This aspect of culture refers to the hierarchical structure (or lack of it) and the way that people at different levels of the hierarchy interact with other people in the organisation;

- **Control systems**. Various systems within the organisation, such as quality systems and reward systems, affect its culture; and

- **Rituals**. Rituals are events or routines that take place and really matter to the people involved in them. They might include a team meeting first thing every Monday morning.

A proposed change may be seen as a 'threat' to any of these elements in the organisation culture. If the change is seen as a threat, individuals collectively will resist it.

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10 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Advise on appropriate organisation structures for effective strategy implementation
- Analyse internal and external relationships for implementing strategy including outsourcing
- Draft and analyse a business plan
- Apply three models for evaluating strategic performance: the balanced scorecard; the performance pyramid; and Fitzgerald and Moon's building block model
- Explain how chosen strategies and performance targets should be communicated to operational and tactical management
- Evaluate and advise on managing change in an organisation including applying Lewin and Gemini theories
- Advise on the cultural aspects of organisational change, and the need to address the possibility of cultural resistance to change

ICAN 2

Skills Level

Corporate Strategic Management and Ethics

CHAPTER 8

Functional strategies

ICAN 2021

Contents

1 Finance strategy
2 Research and development strategy
3 Production strategy
4 IS/IT strategy
5 Human resource strategy
6 Marketing mix strategies
7 Chapter review

INTRODUCTION

Detailed syllabus

Strategic management

B3	**Strategic implementation**
B3 (a)	Discuss and evaluate the alternative functional strategies that are appropriate to deliver a chosen strategy in a given scenario such as production, marketing, finance, IT and human resources.**B3 (g)** Evaluate and explain how information technology and information systems can support the effective implementation of a business strategy including issues of competitive advantage.

Exam context

Having selected its product market strategies an entity must develop functional strategies that will be used to implement the product market strategy for the following:

- Production;
- Marketing;
- Finance;
- product development and innovation;
- IS/IT systems; and
- human resources.

This chapter discusses strategies for each of the above functions.

By the end of this chapter students will be able to:

- Analyse and advise on an appropriate finance strategy;
- Analyse and advise on an appropriate R&D strategy;
- Analyse and advise on an appropriate production strategy;
- Analyse and advise on an appropriate IS/IT strategy;
- Analyse and advise on an appropriate HR strategy; and
- Analyse and advise on an appropriate marketing strategy.

ICAN 2021

1 FINANCE STRATEGY

Section overview

- Financial objective
- Financial performance
- Funding and resource allocation
- Role of the accountant in business strategy

Finance issues are relevant to strategic planning in two ways:

A finance objective is normally the main corporate objective of a business entity. Even for a not-for-profit entity, its main objective will be limited by the availability of finance; and

The finance function within an entity provides a strategic support function to the entity's competitive strategies.

1.1 Financial objective

It is important to remember that a business entity has a financial objective, which might be stated in terms of providing a return to the shareholders. In selecting and implementing its product market strategies, an entity should not lose sight of its financial aims.

Example: William Hill

UK company William Hill is a listed company specialising in gambling, with a chain of betting shops and a business for on-line betting through the Internet.

A UK government policy was announced indicating that a large number of gambling casinos would be allowed to open up and operate. William Hill decided that it should follow a strategy of concentric diversification by entering into this new area of operations. Its intention was to expand into casino operations by means of an acquisition, and it began to accumulate cash to finance it.

However, the UK government changed its policy and chose to restrict the number of casinos it would allow in the country. This change of policy dramatically altered the strategic outlook for William Hill, which now saw 'fewer synergies' between betting and casino operators.

Instead of using its cash to fund other acquisitions, the company recognised its primary objective, to provide a return to its shareholders, and in 2005 it announced an additional dividend of over £450 million.

Having a strong cash position, and no longer expecting to make a takeover bid, it felt that it could support a much higher level of debt finance if necessary, and had no need for the cash to finance growth.

The company still intended to pursue strategies for growth, but these were now expected to be:

Increasing the number of point-of-sale machines in its betting shops;

Buying and opening more betting shops; and

Expanding its on-line betting business.

1.2 Financial performance

The finance function within an organisation provides a system for setting performance targets and measuring actual results against the targets. The finance function therefore allows management to monitor and control actual performance against strategic, as well as shorter-term, financial targets.

If an entity uses a balanced scorecard approach to setting objectives, performance should be measured against the targets of performance for all four aspects of the balanced scorecard.

Analysing financial performance

The techniques and ratios for analysing financial performance should be familiar to you already. Typically, you might be required to analyse:

- Annual sales growth over a period of time. Sales growth may be divided into sales volume growth and sales price growth;
- The gross profit ratio and the net profit ratio;
- The ratio of expenses to sales revenue (for example, the ratio of marketing costs to sales revenue, and the ratio of administration costs to sales revenue);
- The total borrowings of the business entity, measured perhaps as a financial gearing ratio, and the ratio of interest costs to sales revenue;
- The ratio of non-current assets to sales (how efficiently are non-current assets being used to generate sales?);
- The ratio of inventory to sales, or the average inventory turnover time (showing how efficiently inventory is being managed); and
- Investment in innovation (R&D).

If you are required to carry out a financial analysis for a case study in your examination, you must remember that the analysis should be made from a strategic perspective. In particular:

- Look at trends and changes over time. Compare the situation now with the financial position several years earlier;
- If you are given estimated figures for the next year or the next several years, calculate whether historical trends are expected to continue into the future. If historical trends are not expected to continue, you should ask why. Could the estimate for the future be over-optimistic?; and
- Consider the possible implications of any trend or change that you have identified.

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Example: Analysing financial performance

You are given the following information about sales of a product.

	Year 1	Year 2	Year 3	Year 4 (estimate for next year)
Sales revenue	₦12 million	₦14 million	₦15 million	₦16.5 million
Sales volume index	100	115	130	150

This information can be analysed as follows:

	Year 2	Year 3	Year 4 (estimate for next year)
Increase in sales revenue	16.7%	7.1%	10%
Increase in sales volume	15%	13%	15.4%
Therefore increase /(decrease) in prices	1.5%	(5.2%)	(4.7%)
(Workings)	[(1.167/1.15) – 1]	[(1.071/1.13) – 1]	[(1.10/1.154) – 1]

The above information shows that although sales revenue is growing each year, sales volume is growing at an even higher rate. This shows that unit prices for products are falling. This could be the consequence of a market skimming price strategy for a new product: prices will be reduced over time.

Alternatively, the falling prices could indicate strong competition in the market from rival business entities. A consequence of the falling prices, unless unit costs are also falling, is that the gross profit margin (and probably the net profit margin) will be expected to fall.

Financial analysis and strategic analysis

You should also try to put your financial analysis into the context of business strategy. In particular, you should try to assess what the trends in the financial ratios might indicate. For example:

Falling unit prices might be part of a strategy to increase market share. If so, do the sales figures suggest that the strategy is succeeding?

The rate of growth in sales volume, profitability and investment in R&D can all be indications of the current position of a product in its life cycle. For example, little or no growth in annual sales and a high net profit margin could indicate a product that is in the 'maturity' phase of its life cycle (and a product that is a 'cash cow'). It may be possible to link the financial analysis to the **BCG matrix**, especially if you are also given figures for **market share**.

1.3 Funding and resource allocation

Another role of the finance function is to obtain the funding that the entity needs for the implementation of its strategies.

Some entities might have a fixed amount of finance that it is prepared to invest. When there are many different investment opportunities competing for a limited amount of investment funds, finance function will provide information to management to help them to decide how the available resources should be allocated.

1.4 Role of the accountant in business strategy

Accountants and the accounting function have some role in business strategy, but the extent of their involvement will depend to some extent on the attitude of the accountants within a business organisation to strategy development and business growth.

Traditionally, accountants have been associated with a culture of taking the safe option and avoiding risk, whereas successful business strategy depends on being entrepreneurial and taking risks.

Traditionally, accountants have been associated with judging the merits of any investment on the basis of financial return and (often) short-term profitability and cash flow, without taking non-financial factors into consideration. If accountants are to be involved in business strategy, they need to accept the long-term nature of many strategic decisions, and the difficulty of making reliable financial assessments.

Accountants are often reluctant to innovate themselves. Their reporting systems are often based on analysing profits of products, services and business sectors. For the purpose of business strategy, reporting systems are needed for analysing customer profitability and the profitability of distribution channels, and for measuring the effectiveness of marketing strategy. Accountants will not be closely involved in the management of business strategy unless they are able to be innovative with their financial reporting systems, and work closely with colleagues in other disciplines, especially marketing.

The role of the accounting function in corporate strategy includes:

- Providing systems for recording financial transactions and preparing annual financial reports and accounts; and
- Providing management information systems and procedures for decision-making (budgets and budgetary control, capital investment appraisal and DCF analysis, and so on).

The role of the accounting function in corporate strategy might also include (and ideally should include):

- Assisting colleagues in R&D and marketing with new product screening, and decisions about whether to develop and market a product;
- Strategic investment appraisal, which involves a strategic assessment as well as a financial assessment of proposed new investment projects;
- Providing a reporting system for the marketing function, by providing management information on customer profitability and channel of distribution profitability, as well as product profitability;
- Working with marketing colleagues to assess the effectiveness of marketing initiatives and the marketing mix; and
- Helping colleagues to identify and measure added value throughout the value chain.

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2 RESEARCH AND DEVELOPMENT STRATEGY

Section overview

- The need for innovation
- A research and development function
- R&D strategy
- Intrapreneurs

2.1 The need for innovation

Business entities must innovate to survive and grow.

Every product has a life cycle, and eventually even the most successful products reach the end of their economic life.

Innovation is necessary for several reasons:

Product renewal - Changing the design of a product can help to renew or prolong its life. Many products therefore undergo design changes during their life, in order to maintain or increase sales;

Product adaptation - Products can be adapted for a new market segment. For example, a product that is marketed successfully in the US might be adapted by its manufacturer for sale into Europe, where customer needs might be different from those of US customers;

Developing new products - New products are continually being invented and developed. Many new product ideas are unsuccessful. However, when a new product is successful, the first firms to enter the market and develop the product will often be the market leaders throughout the product's life; and

Developing new technology - From time to time, new technology becomes available that creates opportunities for new products and also for new ways of doing things. Changes in information technology and communications technology are the most notable recent examples, but significant changes are also occurring in other industries, such as energy and biochemistry.

If a business entity fails to innovate, it will be at a competitive disadvantage to its rivals.

If a business entity believes that it does not need to innovate, because it can copy the innovations of its competitors, it will always be in a position of 'catch up' – copying competitors who have already established their leading position in the new market.

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2.2 A research and development function

In some industries, business entities establish a research and development department (an R & D function) with research laboratories either at head office or at divisional level. R & D functions normally exist in high-technology industries, where the pace of technological change is rapid (for example, in communications), or where new product innovation is a major strategic objective (for example, in pharmaceuticals and biochemistry).

Some industries do not need a research and development function. However entities within these industries must have a way of developing new products. For example, an entity might use product design teams (for example, for fashion products). In some industries, entities rely on the skills of their employees to provide innovation (for example, in management consultancy, tax consultancy and architecture).

2.3 R&D strategy

There are various issues to resolve in order to achieve successful innovation through R&D.

A decision has to be made about how much should be spent on R&D each year. The need for R&D spending will vary between different industries. High spending is needed in industries that are at the leading edge of scientific or technological developments. A business entity might adopt a general strategy of investing a certain percentage of sales turnover each year in R&D.

Within the overall spending programme for R&D, decisions must be made to allocate the spending between research and more specific project development.

R&D strategy must allow for failures. Research might not lead to any specific product development. Development projects might fail. Successful development projects might happen only occasionally, and failures might be much more common.

Since a large part of R&D spending does not produce a financial return, and since much R&D spending is discretionary, it might be tempting to reduce R&D spending and invest more in established products and markets.

However, in an industry where innovation is vital for long-term success, a strategy of restricting or reducing spending on R&D is likely to result in strategic failure in the long term.

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2.4 Intrapreneurs

Innovation has to come from an individual or a group of individuals.

When a business entity is first established, innovation is provided by the entrepreneur. In larger entities that have out-grown the entrepreneurial stage of their existence, there is no obvious role for the entrepreneur. Its senior managers may be competent in many aspects of management, but do not necessarily have any talent for innovation or entrepreneurship.

This means that there is a strategic risk. If a large entity does not have any entrepreneurs, but its competitors include smaller entrepreneurial entities, there is a risk that the entrepreneurial competitors will be more successful.

A large entity can try to deal with this risk in several ways:

- It can establish a formal research and development function, or a design team, with the specific responsibility for developing new products;
- It can acquire successful entrepreneurial companies, and innovate through a strategy of acquisitions;
- It is also argued that larger companies need intrapreneurs. An **intrapreneur** is a person within a large business entity who takes direct responsibility for converting a new product idea into a profitable finished product, by taking risks and innovating; and
- Companies should try to identify individuals who are capable of being intrapreneurs, and give them the authority and the resources to innovate and take risks.

It has also been argued that to encourage intrapreneurship, the individuals should be expected to invest some of their own money, for example, a proportion of their salary, in the risk-taking ventures, to increase their commitment to the project's success.

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3 PRODUCTION STRATEGY

Section overview

- Capacity planning
- Production resource planning
- Production cost planning: quality, lead time and flexibility

In a manufacturing company, a production strategy involves planning over the long term how the company will be able to produce the output that will be needed to meet its plans for growth and product/market development.

3.1 Capacity planning

A company that is planning to grow must have sufficient capacity to meet the expected demand for its products. This means having sufficient production factories or plants, or production plant of sufficient size. Alternatively, a company may plan to outsource the production of components or even entire products to external producers.

In planning the required production capacity, a decision should also be made about:

- Whether the company will set production levels to meet expected sales demand in each week or month, so that at times of high sales demand, production output is increased, and at times of low sales demand, production output is reduced; or
- Whether there should be a steady level of production output, so that inventory of finished goods builds up during times of low demand, and this inventory is used later to meet demand during times of high demand.

A strategy of setting production to meet demand will require providing a higher level of production capacity, although inventory levels can be kept low.

Strategic decisions will also have to be made about how many factories to operate and where these should be located. If a company is planning to grow, it will need to consider opening new factories to increase output capacity, or to increase capacity at its existing factories.

3.2 Production resource planning

A manufacturing company must also plan to obtain the resources that it will need each year to meet the required capacity levels If the company plans to grow, the required resources will increase each year.

Resource planning involves making decisions about:

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- What production technology will be used: with developments in robotics, a company may need to plan for the introduction of new technology into its operations at some time in the future;
- How much capital equipment will be needed to provide the required capacity;
- How much capital expenditure will be needed to acquire new production equipment;
- How many production employees will be required and what skills they should have: the production function will need to liaise with the Human Resources department to plan recruitment and training requirements over the strategic planning period; and
- What materials and components will be required and where they should be obtained: the production function will need to liaise with the procurement department to plan material supplies.

3.3 Production cost planning: quality, lead time and flexibility

Production cost measurement is a responsibility of the cost accounting function, but the production function is responsible for planning production in a way that optimises costs – consistent with other strategic production objectives.

Cost versus quality - Costs can possibly be reduced by using cheaper materials to make products or by using cheaper unskilled labour to do certain tasks. To obtain better quality output, it may be necessary to spend more. A decision should be made about the quality standards required for production output.

Cost versus lead time - Lead time is the time between receiving an order for an item and the time needed to make it and deliver it to the customer. If the company wants to minimise production lead times, it will probably need to incur higher costs.

Cost versus flexibility - Flexibility is the ability to switch easily from one production operation to another – for example, to switch a production line from making one product to making a different product. Like better quality and shorter lead times, greater flexibility is likely to involve higher production costs.

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4 IS/IT STRATEGY

Section overview

- Information systems (IS)
- IS systems as strategic support
- Information technology (IT)
- IT as strategic support
- Information and organisation structure

4.1 Information systems (IS)

All organisations process and use information.

Basic transactions must be recorded and processed – a bookkeeping system, for example, is a transaction processing system.

Management also use information to make decisions. The quality of their decision-making, from strategic decisions to day-to-day operating decisions, depends on having reliable and relevant information available.

The main types of information system in organisations are as follows:

- **Transaction processing systems**. These are systems for processing routine transactions, such as bookkeeping systems and sales order processing systems;
- **Management information systems**. These are information systems for providing information, mainly of a routine nature, to management. The purpose of a management information system (MIS) is to provide management with the information they need for planning and controlling operations. Typically, a MIS is used to provide control information by measuring actual performance and comparing it against a plan or budget. A budgeting and budgetary control system is an example of an MIS;
- **Decision support systems**. A decision support system (DSS) is used by managers to help them to make decisions of a more complex or 'unstructured' nature. A DSS will include a range of decision models, such as forecasting models, statistical analysis models and linear programming models. A DSS therefore includes facilities to help managers to prepare their own forecasts and to make decisions on the basis of their forecast estimates. Models can also be used for scenario testing;
- **Executive information systems**. An executive information system (EIS) is an information system for senior executives. It gives an executive access to key data at any time, from sources both inside and outside the organisation. An executive can use an EIS to obtain summary information about a range of issues, and also to 'drill down' into greater detail if this is required. The purpose of an EIS is to improve senior management's

ICAN 2021

decision-making by providing continual access to up-to-date information; and

- **Expert systems.** An expert system is a system that is able to provide information, advice and recommendations on matters related to a specific area of expertise. For example, there are expert systems for medical analysis, the law and taxation – used mainly by doctors, solicitors and accountants, respectively.!

4.2 IS systems as strategic support

IS systems provide strategic support within an organisation because the quality of decision making depends on the quality of information to management. In addition, the quality of the service to customers depends on the quality of transaction processing.

An entity should ensure that its IS systems are suitable and will assist the entity in achieving its long-term strategies. It should be remembered that an IS system can give an entity a competitive advantage over its rivals, because they will be making better-informed (and faster) decisions.

If an entity has inadequate IS systems, it will almost certainly be at a serious competitive disadvantage.

4.3 Information technology (IT)

Information technology consists of both computer technology and communications technology. Developments in IT have had an enormous impact on business.

IT developments have resulted in many **new products** (computers, mobile telephones), and improvements in many existing products (televisions and other domestic appliances).

IT developments have also radically altered **methods of communication.** Mobile telephones and e-mail make it possible to communicate instantly with anyone in virtually any part of the world. It is possible to communicate with more people and more quickly.

The **Internet** has emerged as a major source of external and easily accessible information.

Internal databases are a major source of data that can be used by management for obtaining information.

Commercial transactions can be **processed more quickly**.

E-commerce transactions are processed through the Internet.

Changes in IT will continue, and some changes will have a significant impact on business strategy for many entities.

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Example: Music downloads

The ability to download music from the Internet has had a dramatic impact on firms in the music production industry. The major music producers, having initially pursued an unsuccessful strategy of preventing 'music piracy' through the Internet have now developed a strategy for selling music over the Internet.

Another feature of this development has been the introduction of products for playing music that has been downloaded (for example, the Apple iPod).

In the longer term, the growth of downloading music through the Internet could have consequences for other products for selling music, such as DVDs. Already, the product life cycle of CDs (and previously cassettes) are in decline.

4.4 IT as strategic support

IT and changes in IT affect every business entity. Business entities should be prepared to change as IT changes, and to take advantage of new opportunities provided by IT, rather than try to oppose change.

IT should be used constructively as a means of setting strategic targets and implementing product market strategies.

4.5 Information and organisation structure

Changes in IS and IT have an effect on organisation structure.

Databases and intranet systems can make information accessible to any employee. IT systems therefore make it possible for decisions to be taken 'locally' by employees or managers at a local level, using information held on a central database.

Computer networks, databases and intranets also make it possible for senior management and management at head office to obtain information from any part of the organisation. IT therefore makes it possible for head office management to control an organisation centrally.

Information can therefore be made immediately available to local managers and senior managers. The traditional function of middle management, providing a link in the command chain between senior management and local management, might therefore become redundant.

Changes in IS and IT systems have already affected the organisation of many entities.

Many organisations have a 'flatter' management hierarchy, with fewer middle managers. Decisions are taken either centrally by head office management or locally by junior management.

It might be unnecessary for employees to work together in an office, because they can communicate easily and instantly by e-mail or telephone. Already, there are 'virtual organisations' consisting of individuals working on their own, often at home, linked only by IS/IT systems.

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5 HUMAN RESOURCE STRATEGY

Section overview

- The objective of human resource strategy
- Human resource planning

Human resources are a key resource. The success of a business entity depends to a large extent on the skills and experience of its human resources. A critical success factor for an entity might be to have at its disposal sufficient human resources with the necessary skills. Without the key skills, it might be impossible to develop the business successfully.

Human resources are mainly employees (full time, part time, home workers). However, human resources might also be individuals who provide consultancy services or expert services, but are not employed by the entity. Human resources might also be provided by sub-contractors and other organisations to which work is outsourced.

5.1 The objective of human resource strategy

A responsibility of the human resource management function is to:

- assess the quantity and quality of human resources currently available, including numbers and skills;
- estimate the quantity and quality of human resources that will be needed in the future, including numbers and skills; and
- consider ways of 'filling the gap' and ensuring that the entity has the human resources that it needs.

The objective of a human resources strategy is to ensure that the human resources are available, as required. (In some cases, it might also be necessary to consider reducing the numbers of employees whose skills are declining in importance, through programmes of **redundancy** or **re-training** and **re-location**).

5.2 Human resource planning

A human resource plan consists of a forecast of the human resources that will be required at a given time in the future, and plans for ensuring that the required numbers and skills will be available. A plan will typically look forward about three to five years. Beyond five years, it might be difficult to forecast requirements with any accuracy or reliability.

There are four main stages in the planning process:

- **Studying the corporate objectives** of the entity and the strategic objectives of each division and department. This analysis should then be used to estimate the likely total size and organisation structure of the entity.

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Total human resource numbers should be consistent with the corporate and divisional strategies;

- **Demand forecasting**. The required numbers and skills of human resources should be estimated. Estimates of requirements should allow for any expected changes in technology, including the introduction of labour-saving equipment;
- **Assessing current resources**. An assessment should be made of the current human resources, and what might happen to these existing resources each year over the forecast period. The assessment should allow for expected 'wastage rates' or labour turnover rates. For some employees, such as trainee accountants, the estimate might allow for the expected numbers who will pass their professional examinations and obtain a professional qualification during the period; and
- **Preparing policies and plans**. The final stage in the planning cycle is to develop policies and plans to fill the gap between the required numbers and current forecasts of future human resources.

These plans will include plans for:

- recruitment of new staff;
- training and development to improve skills;
- performance appraisal to monitor and control the development of skills;
- promotion; and
- redundancies where some employees will be surplus to requirements or re-training.

The plans should be realistic, and should therefore take into consideration environmental factors such as:

- changes in population trends and the total size of the work force in each country where the entity has its operations;
- changes in government policy, such as changes in the retirement age of workers;
- changes in the educational system and the numbers of students going from school into further education;
- the availability of individuals who are trained in a particular skill or vocation;
- changing patterns of employment, possibly with increasing numbers of part-time workers or home workers;
- competition for human resources from competitors and other businesses;
- trends in sub-contracting and outsourcing; and
- trends in IT and other technological changes that might affect labour requirements.

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Example: HR planning

A basic requirement of a human resources plan is to estimate the future number of employees required for each type of work within the organisation over the planning period. For each year of the planning period, or taking the planning period as a whole, estimates for each type of job can be made as follows:

	Number	Number
Number of employees needed by the end of Year [ ]		1,400
Current number of employees		1,200
Net increase in numbers		200
Estimate of staff turnover in the period		
Employees leaving employment (resignation, retirement etc)	(300)	
Employees moving to another job in the organisation	(150)	
Turnover of employees		(450)
Numbers required (total)		650
Fill from internal promotion or training		350
External recruitment (full-time equivalent)		300

Plans must then be developed to ensure that sufficient numbers of existing staff are given suitable training or personal development for promotion, and for the external recruitment of new full-time and part-time employees to fill the remaining gap.

ICAN 2021

6 MARKETING MIX STRATEGIES

Section overview

- Marketing and the marketing mix
- Product strategy
- Price strategy
- Place strategy
- Promotion strategy

6.1 Marketing and the marketing mix

Marketing can be described as a process of:

- identifying customer needs and wants;
- designing products or services that meet those needs and wants;
- creating customer awareness for these products or services, and an understanding of how they meet those needs and wants (= an understanding of the value they provide);
- creating a desire by potential customers to have the product or service;
- making the products or services available to customers through suitable channels of distribution; and
- persuading customers to buy the product or service.

The philosophy of marketing is that corporate objectives will be achieved by maximising long-term profits, and long-term profits will be achieved by providing customers with products or services that satisfy their needs and wants at a price they are willing to pay.

A marketing strategy should be implemented that will help the entity to implement its competitive strategy.

The 4 Ps of marketing have been described earlier. They are:

- product;
- price;
- place ; and
- promotion.

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6.2 Product strategy

Product strategy is concerned with:

- designing new products; and
- designing new variations of existing products, to sell to a different market segment, or to renew customer interest in a product (if demand is falling), or to create new demand.
- The actual and perceived features of a product are a very important element in the marketing mix, because it provides the value for customers.

There are many different aspects to product design. Some add value to a particular product, others do not. Features of product design that might be relevant to marketing are:

Feature	Comment / example
Its functions	What does it do? Does it do what customers want it to do?
Comfort	For example, some chairs are much more comfortable than others
Convenience	For example, a mobile telephone that fits into a pocket or a small handbag has the attribute of convenience. Ready-to-cook meals are convenient for people who do not want to cook meals themselves, or who do not have time to cook.
The quality of its materials	Customers will pay more for a diamond ring than for a plain gold ring
Useful life	A long-life battery has more value than a short-life battery
Reliability	How often will it break down or fail to function properly? Trust can also be an important perceived quality for many services, such as banking and insurance, and medical services.
Safety	With some products, health and safety issues might be important - for example, some consumers are concerned about the healthiness of food products.
Uniqueness	Some customers will buy an entirely new product, for the prestige of being one of the few owners.
Packaging	For some products, the wrapping or packaging can add to their appeal to consumers.

For marketing purposes, product design should be related to what customers want and need. The starting point for designing a new product or a new design of an existing product might therefore be a market research project.

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It is also important to remember that the product is more than just the actual physical product itself. It also includes other factors such as warranties and guarantees, and after-sales service.

Example: restaurant

A top restaurant offers meals to customers. The product that customers buy is not just the food and drink, but also:

the pleasure or prestige from visiting a top restaurant

the quality of the service

the environment – décor, the layout of the tables

6.3 Price strategy

Customers expect value for money. Pricing is therefore an important element of the marketing mix. In most cases, if the price is too high, customers will not want to buy it. (There might be occasional exceptions, such as the sale of works of art, where buyers are often not price-sensitive).

Pricing can also be used as a means of selling products or services. For example:

- commercial customers might be attracted by good credit terms and bulk purchase price discounts;
- consumers might be attracted by money-back coupons or two-for-the-price-of-one offers, or short-term price discounts in supermarkets and stores; and
- for products such as cars that are often bought with a personal loan (for example on hire purchase), the terms of the finance deal might be important.

Other examples of pricing strategy in the marketing mix are as follows:

A supermarket will usually sell several branded products of the same food item, such as breakfast cereals and ready-made meals. It will also sell own-branded items of the same product (items with the supermarket's own brand), usually at a lower price. The pricing strategy is to attract customers by offering the same/nearly the same quality of product for a lower price; and

When a company launches a **new product** on the market, and there are not yet any rival products on sale, it can choose either of the following pricing strategies:

- To set a 'market penetration price' for the product. This is a low price (or fairly low price). The aim of penetration pricing is to build customer demand quickly by offering an attractive price, so that sales volume is high and the company 'penetrates the market' and wins a large share of the potential market; and

ICAN 2021

- To set a 'market skimming price'. This is a high price (or fairly high price). The aim of market skimming is to maximise the gross profit per unit sold. Gradually, the price will be reduced, and market demand will rise slowly as the price falls. Early customers for a product will often be willing to pay a high price simply because it is 'new' and 'different'. Much of the product's value for the early customers comes from its uniqueness and the fact that most other people do not have a similar product.

6.4 Place strategy

Place strategy is concerned with getting products to the places where customers want to buy them.

For many consumer products, customers expect to find the products whenever they visit a supermarket. A key element of marketing for supermarkets is to ensure that the products are always available on their shelves.

For consumer goods manufacturers, place strategy will involve developing an adequate distribution network for its products, so that customers can easily find a retail outlet that sells its products. (This is important, for example, in the case of motorcar manufacturers, and manufacturers of consumer durable goods such as washing machines).

Some manufacturers might base their place strategy on delivery of the product to the customer's home or office. (For example, Dell computers will deliver and, if required, install PCs at the customer's address).

In recent years, in countries such as the UK, there has been a substantial growth in e-commerce (Internet shopping) and internet banking.

The choice of distribution network can be particularly important for entities that rely on export sales, but do not have foreign subsidiaries or foreign branches. They will rely on agents and distributors in other countries, and the control over the distribution and availability of its products might therefore be restricted.

A 'place strategy' might be used to gain a foothold in a market. A business entity might seek to sell its product by offering it in a place (through a distribution channel) that rival companies do not use. A current example is the development of the market for music, and the use of the Internet by consumers for purchasing and downloading selected music. This new method of selling music is already having significant impact on the music industry.

6.5 Promotion strategy

Promotion is concerned with making the customer conscious of a product and wanting to buy it. There are several different aspects to promotion:

Advertising - Advertising can be by several different media, such as television, radio, magazines, newspapers, and billboards. Brochures are another form of advertising. Brochures and advertising messages might be delivered to

ICAN 2021

consumers by direct mail, or electronically as pop-up ads or advertisements with search engine providers such as Google or Yahoo!

Sales promotions - Sales promotions are activities other than advertising that are designed to prompt customers into buying a product. In supermarkets, promotions are often placed at the end of a line of shelves, or at the checkout counter. Some aspects of price marketing (for example, buy one, get one free) are also sales promotions.

Direct selling (personal selling) - Some entities use direct selling for their products. Direct selling is particularly common for selling to industrial/commercial customers, where the potential value of individual sales orders might be very high.

Some entities use telephone selling, rather than face-to-face selling by sales representatives.

Sponsorship - Some entities use sponsorship to increase public awareness of their product, and improve their general image. For example, many sporting events and sporting teams are sponsored. In addition, entities might use sponsorship of television programmes to ensure that their name appears on television at the same time as a popular television programme that large numbers of viewers will be watching.

Public relations - Public relations is concerned with attracting favourable media attention to an entity and its products.

Push strategy and pull strategy

Manufacturers of consumer products might use a combination of a push strategy and a pull strategy in its promotion strategy mix.

The **push strategy** is aimed at getting distributors to buy the product for resale in their supermarkets or other retail outlets. The aim is to 'push' the product through the distributor to the end consumer. To persuade distributors to buy its products, an entity will need to use a direct sales force, and use marketing tools such as low prices and generous credit terms to persuade the distributor to buy.

The **pull strategy** is aimed at getting the end-consumer to want to buy the product, so that they expect their supermarkets or other retail store to have the product available. If consumers demand the product, distributors will be more willing to stock it because they will expect to sell it easily. Advertising and sales promotions are an important element in a 'pull' strategy.

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7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Analyse and advise an appropriate finance strategy
- Analyse and advise on an appropriate R&D strategy
- Analyse and advise on an appropriate production strategy
- Analyse and advise on an appropriate IS/IT strategy
- Analyse and advise on an appropriate HR strategy
- Analyse and advise on an appropriate marketing strategy

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Skills Level

Corporate Strategic Management and Ethics

CHAPTER 9

Identifying and assessing risk

ICAN 2021

Contents

1 Risk and risk management
2 Categories of risk
3 Concepts in risk management
4 Identification, assessment and measurement of risk
5 Chapter review

INTRODUCTION

Detailed syllabus

Risk management

C1 Explain the meaning of risk, including risks arising internally or externally and relate them to achievement of:

- **C1 (a)** Strategic objectives;
- **C1 (b)** Operational efficiency and effectiveness;
- **C1 (c)** Reliable reporting; and
- **C1 (d)** Legal, regulatory and ethical compliance.

C2 Identify and assess risks in a given scenario in relation to their impact(s) on objectives.

C3 Measure and prioritise risks.

C4 Discuss the role of board of directors in risk identification and assessment.

C5 Minimise risk using the ALARP (As Low As Reasonably Practicable) principle (objective and subjective risk principles; related and correlated risk factors).

C6 Evaluate appropriate responses to risks identified in a given scenario.

C11 Evaluate both inherent and residual risks after mitigation in relation to shareholders' and stakeholders' risk appetites in a given scenario.

C12 Discuss the alternative risk management approaches: risk diversification, risk transfer, risk sharing and risk hedging.

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Exam context

All organisations face risk in some format. The challenge for management is to make decisions regarding risks that are acceptable to the stakeholders.

This is the first of two chapters that address risk in organisations. In this chapter you will focus on identifying and assessing risk before studying risk response and control in the next chapter.

By the end of this chapter students will be able to:

- Discuss the nature of risk, risk management and risk responsibilities;
- Explain and demonstrate the different categories of risk;
- Summarise risk management concepts including exposure, risk appetite and a risk-based approach; and
- Identify, assess, measure and prioritise risk with consideration of the impact of risk on stakeholders.

1 RISK AND RISK MANAGEMENT

Section overview

- The nature of risk
- The nature of risk management
- Responsibilities for risk management
- Elements of a risk management system

1.1 The nature of risk

Risk is usually associated with the possibility that things might go wrong, that events might turn out worse than expected or that something bad might happen.

However, risk has a broader meaning. Risk exists whenever a future outcome or future event cannot be predicted with certainty, and a range of different possible outcomes or events might occur.

Risks can be divided into two categories:

pure risks; and

speculative risks.

Pure risk (downside risk)

Pure risk, also called downside risk, is a risk where there is a possibility that an adverse event might occur. Events might turn out to be worse than expected, but they cannot be better than expected.

For example, there might be a safety risk that employees could be injured by an item of machinery. This is a pure risk, because the expectation is that no-one will be injured but a possibility does exist.

Similarly, there might be a risk for a company that key workers will go on strike and the company will be unable to provide its goods or services to customers. This is a pure risk, because the expected outcome is 'no strike' but the possibility of a strike does exist.

Speculative risk (two-way risk)

Speculative risk, also called two-way risk, exists when the actual future event or outcome might be either better or worse than expected.

An investor in shares is exposed to a speculative risk, because the market price of the shares might go up or down. The investor will gain if prices go up and suffer a loss if prices go down.

An individual might ask his bank for a loan to buy a house, and the bank might offer him a 10-year loan at a fixed rate of interest or at a rate of interest that varies with changes in the official bank rate. The individual takes a risk with his choice of loan. If he chooses a fixed interest loan, there is a risk that interest

ICAN 2021

rates will go up in the next 10 years, in which case he will benefit from the fixed rate on his loan. On the other hand, interest rates might go down, and he might find that he is paying more in interest than he would have done if he had arranged a loan at a variable rate of interest.

Companies face two-way risk whenever they make business investment decisions. For example, a company might invest in the development of a new product, on the basis of sales and profit forecasts. Actual sales and profits might turn out to be higher or lower than forecast, and the investment might provide a high return, moderate return or low return (or even a loss).

Companies face both pure risks and speculative risks.

Pure risks are risks that can often be controlled either by means of internal controls or by insurance. These risks might be called **internal control risks** or **operational risks**.

Speculative risks cannot be avoided because risks must be taken in order to make profits. As a general rule, higher risks should be justified by the expectation of higher profits (although events might turn out worse than expected) and a company needs to decide what level of speculative risks are acceptable. Speculative risks are usually called **business risk**, and might also be called **strategic risk** or **enterprise risk**.

Business decisions taken by management could involve both business risk (strategic risk) and operational risk (downside risk).

Example: Strategic and operational risks

The following examples illustrate how there are both strategic risks and operational risks in many decisions taken by management. The examples relate to a large public company.

Management decision	Comment on the risk
The company has commissioned a software company to design a new information system. The system will be used for marketing analysis and to sell goods to customers on-line.	There are strategic risks with the new system. These include the risk that customers will not want to buy goods on-line, and the risk that a competitor will develop a more popular e-commerce web site. There are also operational risks. These include risks that the new system will fail to function properly, and might suffer from hardware or software faults. These risks can be managed by operational controls.
The company has a large customer service centre where its employees take telephone calls from	There is a strategic risk. The company might lose some customers if the level of service from the service centre

customers and deal with customer complaints. On average, staff are on the telephone talking to customers for 75% of their working time. Management has decided that in order to increase profits, staff levels should be reduced by 10% at the centre. It is estimated that this will have only a small effect on average answering times for customer calls.	deteriorates. Management must judge whether the risk of losing customers is justified by the expected reduction in operating costs. There are also operational risks. If employees have to spend more time on the telephone the risks of making mistakes or providing an unsatisfactory service is likely to increase. There might also be a risk that answering times will be much longer than expected, due to operational inefficiencies.

1.2 The nature of risk management

Risk management is the process of managing both downside risks and business risks. It can be defined as the culture, structures and processes that are focused on achieving possible opportunities yet at the same time control unwanted results.

This definition identifies the connection between risk and returns.

The safest strategy is to take no risks at all. However, this is an unrealistic business strategy. All business activity involves some risk.

Business decisions should be directed towards achieving the objectives of the company. The main objective is (usually) to increase value for shareholders over the long term.

Strategies are devised for achieving this objective and performance targets are set. The strategies should be consistent with the amount of business risk that the company is willing to take, and the targets should be realistic for the chosen strategies.

The strategies are implemented, and management should try to achieve the stated objectives and performance targets, but at the same time should manage the downside risks and try to limit the business risks.

A link between management of operational risk and management of strategic risk can be seen in the following statement from a bank:

'A priority for us is to maintain a strong control framework. This is the key for delivering effective risk management. We have further strengthened risk analysis and reporting so that risks and opportunities are identified, and have put timescales and straightforward responsibilities in place at both group and division level for risk mitigation strategies. Routine management information reporting still has risk at the heart and balanced scorecards are used to ensure this is in the staff objectives.'

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1.3 Responsibilities for risk management

Risk management is a corporate governance issue. The board of directors have a responsibility to safeguard the assets of the company and to protect the investment of the shareholders from loss of value. The board should therefore keep strategic risks within limits that shareholders would expect, and to avoid or control operational risks.

The Cadbury Report (1992) described risk management as 'the process by which executive management, under board supervision, identifies the risk arising from business . . . and establishes the priorities for control and particular objectives'.

The Nigerian (SEC)Code of Corporate Governancefor Public Companies states that the duties of the board shall include among others, the identification of risk and monitoring of risk management systems. It also states that "the Board may establish a Risk Management Committee to assist it in its oversight of the risk profile, risk management framework and the risk-reward strategy determined by the Board". The Board is responsible for defining the company's risk policy, risk appetite and risk limits as well as ensuring that these are integrated into the day-to-day operations of the company's business.

ICGN Corporate Risk Oversight Guidelines

The International Corporate Governance Network (ICGN) has issued guidelines on responsibilities for the oversight and management of corporate risk (2010).

The risk oversight process begins with the board. The board is responsible for deciding the company's risk strategy and business model, and it should understand and agree the level of risk that goes with this. It should then have oversight of the implementation by management of a strategic and operational risk management system.

Management has the responsibility for developing and implementing the company's strategic and routine operational risk management system, within the strategy set by the board and subject to board oversight.

Shareholders have responsibility for assessing the effectiveness of the board in overseeing risk. Investors are not themselves responsible for the oversight of risk in the company.

The ICGN Guidelines provide guidance on processes for the oversight of corporate risk by the board and within the company, for investor responsibility and for disclosures by a company on its risk management oversight processes.

Risk management and internal control

The FRCN Nigerian Code of Corporate Governance states that the Board should "undertake at least annually, a thorough risk assessment covering all aspects of the company's business", and "ensure that the company's risk management policies and practices are disclosed in the annual report". This assessment is likely to be carried out by the Risk Management Committee in collaboration with the Audit Committee, which should then report its findings to the full board.

This means that the responsibilities of the board of directors and management for risk management are the same as their responsibilities for the system of internal control. Many of the comments in the previous chapter on internal control apply to risk management generally.

For example, the Turnbull Guidance stated that in deciding the company's policies with regard to internal control, the board should consider:

- the nature and extent of the risks facing the company;
- the extent and categories of risk which it considers as acceptable for the company to bear;
- the likelihood that the risks will materialise (and events will turn out worse than expected);
- the company's ability to reduce the probability of an adverse event occurring, or reducing the impact of an adverse event when it does occur; and
- the cost of operating the controls relative to the benefits that the company expects to obtain from the control.

These considerations should apply to strategic risks as well as to operational risk and internal control systems.

In the same way, the Nigerian Corporate Governance Code requires the board of directors to maintain a sound system of risk management, and to carry out a review of effectiveness of the risk management system at least once each year

1.4 Elements of a risk management system

The elements of a risk management system should be similar to the elements of an internal control system:

- There should be a culture of risk awareness within the company. Managers and employees should understand the 'risk appetite' of the company, and that excessive risks are not justified in the search for higher profits;
- There should be a system and processes for identifying, assessing and measuring risks. When risks have been measured, they can be prioritised, and measures for controlling or containing the risk can be made;
- There should be an efficient system of communicating information about risk and risk management to managers and the board of directors; and
- Strategies and risks should be monitored, to ensure that strategic objectives are being achieved within acceptable levels of risk.

Organising for risk management

The responsibilities for risk management and the management structures to go with it vary between organisations. Some companies employ risk management specialists and in financial services there is a regulatory requirement in many countries for banks and other financial service organisations to have well-structured risk management systems.

It is useful to be aware of differences in organisation structures and responsibilities.

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The board of directors of large public companies may be expected to review the risk management system within their company on a regular basis, and report to shareholders that the system remains effective. If there are material weaknesses in the risk management system, a company may be required to provide information to shareholders.

For example, the SEC's Code of Corporate Governance for Public Companies states that the board of directors may establish a Risk Management Committee to review the adequacy and effectiveness of risk management and controls at least annually and the board has responsibility to report on the effectiveness of the controls to shareholders

A company may decide that it needs a senior management committee to monitor risks. This management committee may be chaired by the CEO and consist of the other executive directors and some other senior managers. It may also include professional risks managers or the senior internal auditor. The function of this executive committee would be to co-ordinate risk management throughout the organisation.

It would be responsible for identifying and assessing risks, and reporting to the board. It may also formulate possible business risk management strategies, for recommendation to the board.

It should also agree on programmes for the design and implementation of internal controls.

It should monitor the effectiveness of risk management throughout the company (both business risk management and the control of internal control risks).

Risk management should therefore occur at both board (with the involvement of independent NEDs) and operational level (with the involvement of senior executives and risk managers). A risk management committee of executives should be a source of information and advice or recommendations for the board.

ICAN 2021

2 CATEGORIES OF RISK

Section overview

- The need to categorise business/strategic risks
- Categories of risk common to many types of business
- Nature and importance of business and financial risks
- Business risks in different business sectors

2.1 The need to categorise business/strategic risks

A risk management system might be based on a categorisation of risks. There are no standard risk classifications, because the nature of business risks varies between different types of business.

The reason for categorising risks is to **give some structure to the risk management process**. In many large companies, **risk committees** are established, and each committee is responsible for identifying, assessing and measuring business risks in a particular category. The risk committee then provides information on risk to managers in a position of responsibility for taking decisions to control the risk, for example by introducing new risk control measures.

The board of directors might use the same risk categories to provide their report on internal control and risk management, or to discuss risk in their annual business review (narrative report).

2.2 Categories of risk common to many types of business

Some types of business risk are common to many different industries. The Turnbull Report mentioned the following risks that might be significant:

market risk;

credit risk;

liquidity risk;

technological risk

legal risk;

health, safety and environmental risk;

reputation risk; and

business probity risk.

Each of these risks is explained below, with examples. The examples consist of cases where events turned out badly for companies. It is important to remember, however, that risk management is not concerned about adverse events that have happened in the past. It is about managing risks that exist now that could affect events (and profits) in the future.

Market risk

Market risk is the risk from changes in the market price of key items, such as the price of key commodities. Market prices can go up or down, and a company can benefit from a fall in raw material prices or incur a loss from a rise in their prices.

A company might be able to pass on higher prices of raw materials to the customerby raising the prices for its own goods or services. However, if it puts its pricesup, there might be a fall in total demand from customers. Higher prices, leading to falling sales volume could result in lower profits or losses.

Example: Market risk

An oil company described one of its major risks as the risk of rising and falling oil and chemical prices due to factors such as conflicts, political instability and natural disasters.

The term 'market risk' can be applied to any market and the risk of unfavourable price movements. A quoted company may therefore use the term 'market risk' when referring to the risk that its share price may fall.

Similarly a bank includes the risk of movements in interest rates and foreign exchange rates within a broad definition of market risk.

Credit risk

Credit risk is the risk of losses from bad debts or delays by customers in the settlement of their debts. All companies that give credit to customers are exposed to credit risk. The size of the credit risk depends on the amount of receivables owed to the company, and the 'credit quality' of the customers.

Credit risk is a major risk for commercial banks, because lending is a major part of their business operations.

Liquidity risk

Liquidity risk is the risk that the company will be unable to make payments to settle liabilities when payment is due. It can occur when a company has no money in the bank, is unable to borrow more money quickly, and has no assets that it can sell quickly in the market to obtain cash.

Companies can be profitable but still at risk from a liquidity shortage.

Example: Liquidity risk

Long-Term Capital Management (LTCM) was a hedge fund set up in 1994 by a group of traders and academics. It was funded by many large investment banks. The company ran into difficulties in 1998 when it found that it was unable to sell securities that it held in some small financial markets, because there was insufficient demand from investors. This led to a liquidity shortage.

As the hedge fund became desperate to obtain cash, it had to sell its assets at whatever prices it could obtain, and market prices fell. The fall in market prices resulted in big losses, and LTCM was on the verge of collapse.

Fearing that the US banking system would suffer severe damage if LTCM did collapse, the US Federal Reserve Bank organised a $3.5 billion rescue package.

This major crisis happened because of the liquidity risk and market risk that the hedge fund faced and was unable to manage successfully.

Technological risk

Technological risk is the risk that could arise from changes in technology (or inadequacy of technological systems in use). When a major technological change occurs, companies might have to make a decision about whether or not to adopt the new technology.

If they adopt the new technology too soon, they might incur higher costs than if they waited until later.

If they delay adopting the new technology, there is the risk that a competitor will take advantage, and use the technology to gain market share.

Example: Technological risk

There are various examples of technological risk. The development of the internet, for example, created a risk for many companies. Traditional banks were faced with the risk that if they did not develop online banking (at a high cost), non-bank companies might enter the market and take customers away from them.

The internet has also created risks for many retailing companies, which have had to decide whether to sell their goods on the internet, and if so whether to shut down their traditional retail outlets.

A technological risk currently facing manufacturers of televisions and media companies is which format of high definition (HD) television they should support. There are two competing formats, and only one seems likely to succeed in the longer term.

Legal risk

Legal risk, which includes **regulatory risk**, is the risk of losses arising from failure to comply with laws and regulations, and also the risk of losses from legal actions and lawsuits.

Example: Legal risk

An example in 2006 was the decision by the US government to enforce laws against online gambling. US customers were the main customers for on-line gambling companies based in other countries. As a result of the legal action, the on-line gambling companies lost a large proportion of their customer base, and their profits – and share prices – fell sharply.

Health, safety and environmental risk

Health and safety risks are risks to the health and safety of employees, customers and the general public. Environment risks are risks of losses arising, in the short term or long term, from damage to the environment - such as pollution or the destruction of non-renewable raw materials.

The risks faced by companies vary according to the nature of their business.

Companies are required to comply with health and safety regulations. This has a cost. If they fail to comply with regulations, they could be liable to a fine if government inspectors discover the failure to comply. If there is an incident in which employees or customers suffer injury or ill-health as a consequence of a failing in health and safety control measures, the company could be exposed to large fines from government and lawsuits from the individuals affected.

If a company fails to deal with environmental risks in a satisfactory way, it could suffer losses in various ways. For example:

- It might be fined for a breach of anti-pollution regulations; and
- It might suffer a loss of customers, for example if its reputation suffers as a result of an incident in which severe damage is done to the environment, such as a major oil spillage.

Reputation risk

Reputation risk is difficult to measure (quantify). It is the risk that a company's reputation with the general public (and customers), or the reputation of its product 'brand', will suffer damage. Damage to reputation can arise in many different ways: incidents that damage reputation are often reported by the media.

Companies that might suffer losses from damage to their reputation need to be alert to any incident that could create adverse publicity. Public relations consultants might be used to assist with this task.

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Example: Reputation risk

Some years ago, the owner of a popular chain of jewellery shops in the UK criticised the quality of the goods that were sold in his shops. The bad publicity led to a sharp fall in sales and profits. The company had to change its name to end its association in the mind of the public with cheap, low-quality goods.

More recently, a manufacturer of branded leisure footwear suffered damage to its reputation when it was reported that one of its suppliers of manufactured footwear in the Far East used child labour and slave labour. Sales and profits (temporarily) fell.

Many other companies that source their supplies from developing countries have become alert to the risks to their reputation of using suppliers whose employment practices are below the standards that customers in the Western countries would regard as morally acceptable.

The manager of a well-known group of hotels summarised the importance of reputation risk in general terms. He said that managing this type of risk is of top importance for any company that has a well-known brand as the brand is one of the most important assets and reputation is a key issue.

Business probity risk

Probity means honesty and integrity. Business probity risk is the risk of losses from a failure to act in an honest way. Companies in some industries might be exposed to this type of risk.

For some products, there might be a large trade in smuggled goods, such as cigarettes and alcohol products. Companies might be tempted to deal with smugglers in order to increase sales of their products. The consequences if any dishonesty or crime is discovered could be criminal prosecution, fines by government or loss of reputation with the public.

In some countries and some industries, bribery is a problem. Companies might find that in order to win sales in some countries, they have to pay bribes ('commissions') to individuals. By failing to pay bribes, companies would not win sales contracts. By paying bribes, companies act dishonestly, and could be exposed to regulatory action or criminal action by the authorities if evidence of bribery is uncovered. This problem has been reported, for example, in the markets for the sale of military equipment.

In the UK, various banks and insurance companies have been fined heavily by the authorities for mis-selling products to customers that were not appropriate. Many banks and insurance companies in the UK mis-sold endowment policies (life assurance policies) to many customers during the 1980s and were required to pay large amounts of compensation for the losses that those customers suffered.

Derivatives risk

Derivatives risk is another type of risk included in the syllabus for the examination. They include commodity derivatives and financial derivatives.

Commodity derivatives are contracts on the price of certain commodities, such as oil, wheat, metals (gold, tin, copper etc.) and coffee. Derivatives contracts are

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contracts to buy and sell a quantity of commodities at a future date at a fixed price agreed in the contract. In most cases, the buyer and seller of the derivative instrument do not intend to buy and sell the physical commodities. The contract is a contract for the price, and it is settled by the payment of the difference between the fixed price in the contract and the market price at settlement date for the contract.

Financial derivatives are contracts on the price of certain financial instruments or market rates, such as foreign exchange rates, interest rates, bond prices and share prices. Like commodity derivatives, the buyer and seller of financial derivatives do not usually exchange items they have bought or sold. The contract is simply a contract on the price or market rate. It is settled by a payment for the difference between the fixed price in the contract and the market rate at the settlement date.

Derivative instruments include options, futures and swaps. They can be used to control risks by 'hedging' exposures to price risks (market risks). On the other hand, they can be used to speculate on changes in market prices.

There have been incidents where the treasury department of a company or government organisation has used derivatives to speculate on changes in market prices, and suffered heavy losses because market prices moved against its position in the derivative instruments. All companies with a treasury department could be exposed to derivatives risk from trading by its treasury staff in the commodities or financial markets. Risk management and control systems (internal controls) need to be implemented and enforced to control the risk.

Example: Derivatives risk

One type of derivative instrument is a credit default swap (CDS). A CDS can be described as a form of credit 'insurance' or credit protection. It relates to a specific amount of a debt of a 'credit subject' (a bank loan owed by a specific borrower or bonds issued by a specific company). One person can use a CDS to buy credit protection from another person. The seller of the credit protection will be required to make a payment to the buyer if the credit subject defaults on payment of the debt.

For example, Bank XYZ can sell credit protection to Company ABC in the form of a credit default swap. The swap might be for $10 million of government bonds issued by the government of Brazil. Company ABC is not required to hold any Brazilian government bonds in order to buy the CDS. It can speculate on the possibility that the Brazilian government will default, and hope to make a profit.

It seems probable that many organisations have traded credit default swaps, and have speculated on the credit risk of other entities. There are no reliable statistics about the volume and value of CDSs, and no information about who holds them. If there is a major credit crisis in the world – for example if the Brazilian government were to default on the payment of its bonds – the financial consequences for sellers of CDSs could possibly be very damaging.

For any company that trades in CDSs, there is an urgent need for risk

management and suitable internal controls.

2.3 Nature and importance of business and financial risks

The board of directors should consider business risk when it makes strategic decisions. It should choose strategies that are expected to be profitable, but that the business risks should be at a level that it considers acceptable. Consequently, both risk and return should be assessed in strategic decision-making.

Business risks are strategic risks that threaten the health and survival of a business. They vary between companies and over time.

The failure rate is greater for those businesses in cyclical industries like tourism.

The failure rate among new start-up businesses is greater than that amongst more mature businesses.

Note that the banking crisis in 2008 and 2009 showed that business risk can also apply to older and more established companies in more stable industries.

Financial risk is a major cause of business risk. Cash flow and liquidity problems can be very damaging to the financial health of a business. Such problems can be caused by trading fluctuations but working capital management and financial structure also play a significant role.

Whilst debt finance might be preferable when interest rates are low or necessary when equity capital is unavailable it increases financial risk.

Example – Marconi

In the 1990s, GEC was a major UK company, specialising mainly as a defence contractor. It had a reputation as a risk-averse company with a large cash pile. In 1996 a new chief executive led the board into a major change in the company's strategy. GEC sold off its defence interests and switched its business into telecommunications, mainly in the USA, buying large quantities of telecommunications assets. The company also changed its name to Marconi.

A number of factors, including a huge over-capacity in network supply, led to a collapse in the market for telecommunications equipment in 2001. Many of Marconi's competitors saw the downturn coming, but Marconi did not. It assumed, incorrectly, the market downturn would be brief and there would soon be recovery and growth.

Within a year loss of shareholder confidence resulted in a collapse in the Marconi share price, reducing the value of its equity from about £35 billion to just £800 million. In July 2001, the company asked for trading in its shares to be suspended in anticipation of a profits warning. Not long afterwards, Lord

Simpson was forced to resign. In retrospect, investors realised that the Marconi board had not understood the business risks to which their strategy decisions had exposed the business.

Some years later in 2006 the Marconi name and most of the assets were bought by the Swedish firm Ericsson.

A lesson from the Marconi experience is that the board of the company took a strategic risk without being fully aware of the scale of the risk. The risk management systems within the company were also unable to alert management and the board of the increasing risks to the telecommunications industry in 2001. This was poor governance, and as a result the company lost both value for shareholders and its independence.

2.4 Business risks in different business sectors

The major risks facing companies vary over time, and management might have different opinions about which risks are more significant than others. Risks differ between companies in different industries or markets.

Companies in different industries might face the same risks, but in some industries the risk might be much greater than in other industries. For example, credit risk is a very significant risk in the banking industry, but less significant in the oil industry. In contrast, the risks of environmental regulation are much higher for oil companies than for banks.

Risks vary in significance over time, as the business environment changes. Companies need to be alert not only for new risks, but for changes in the significance of existing risks. Are they giving too much attention to risks that are no longer significant? Or have they ignored the growth in significance of any risk that has existed for a long time, but is now much more significant than it used to be.

Example: Business risk

The table below compares the significant risks facing a commercial bank, an international oil company and a large retailing organisation. These are the significant risks identified by three major listed companies (in the UK) in their annual reports and accounts. All three companies have extensive business interests both outside and inside the UK.

Commercial bank	Retailing organisation	Oil company
Strategy risk. The risk of choosing strategies that do not maximise shareholder value.	Business strategy risk. Risk that the business strategy might take the company in the wrong direction, or is not efficiently	Market risk, especially risk of changes in the price of oil and natural gas.

	communicated.	
Product-service risk. The risk of developing products and services for customers that do not meet customer requirements and are worse than the products or services offered by competitors.	Financial strategy and group treasury risk. This covers the risk of not having available funds, credit risk, interest rate risk and currency risk.	Exploration risk. The risk of being unable to find sufficient new reserves of oil and natural gas.
Credit risk.	Risk of under-performance in the UK business. This is dependent largely on economic conditions in the UK.	Reputation risk
Market risk. This includes the risk from variations in interest rates (interest rate risk) and currency exchange rates (currency risk) as well as the risk of changes in market prices of financial products such as shares.	Competition risk. This is the risk of losses due to the activities and successes of competitors.	Security risk (risk from crime, civil wars and terrorism). Environmental risk. The risk from climate change. Economic risk. Risk from changes in the state of national economies and the world economy.
Operational risks. Risks of losses due to human error or fraud, failures in systems (such as IT systems) and unforeseen external events (terrorism attacks, natural disasters).	People capabilities risk. This is the risk of failing to attract 'the best people' to work for the company.	Competition risk Political risk. This is the risk of doing business in politically unstable countries or politically sensitive countries.
People capabilities risk. This is the risk of failing to attract 'the best people' to work for the company.	**Reputation risk. Failure to protect reputation could lead to a loss of trust and confidence by customers.**	**Natural disaster risk**
Risk of inadequate liquidity and inadequate capital.	**Environmental risk. Risks arise from issues such as energy savings, transport efficiency, waste management and the**	**Currency risk** **IT failures risk**

ICAN 2021

	recycling of waste.	
Regulatory risk.	Product safety risk Ethical risks in the supply chain. This is the risk to reputation of dealing with suppliers who do not use ethical business practices. Fraud and compliance risk IT systems risk. This is the risk of a failure in the company's major IT systems. Political risk and terrorism risk Pensions risk. The risk to the company from the costs of meeting its liabilities to the company's pension scheme for its employees.	Regulatory risk Shortage of skilled labour risk, especially a shortage of science graduates.

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3 CONCEPTS IN RISK MANAGEMENT

Section overview

- Exposure to risk
- The dynamic nature of risk assessment
- Risk appetite
- A risk-based approach

To understand risk management, it is necessary to understand a few key concepts.

3.1 Exposure to risk

When a company is exposed to risk, this means that it will suffer a loss if there are unfavourable changes in conditions in the future or unfavourable events occur. For example, if a Nigerian company holds US$2 million, it is exposed to a risk of a fall in the value of the dollar against naira, because the naira value of the dollars will fall.

Companies need to assess the significance of their exposures to risk. If possible, exposures should be measured and quantified.

If a Nigerian company holds US$2 million, its exposure to a fall in the value of the dollar against naira is $2 million.

If an investor holds ₦100 million in shares of Nigerian listed companies, it has a ₦100 million exposure to a fall in the Nigerian stock market.

If a company is owed ₦500,000 by its customers, its exposure to credit risk is ₦500,000.

An exposure is not necessarily the amount that the company will expect to lose if events or conditions turn out unfavourable. For example, an investor holding ₦100 million in shares of Nigerian listed companies is exposed to a fall in the market price of the shares, but he would not expect to lose the entire ₦100 million. Similarly a company with receivables of ₦500, 000 should not expect all its receivables to become bad debts (unless the money is owed by just one or two customers).

Having measured an exposure to risk, a company can estimate what the possible losses might be, realistically. This estimate of the possible losses should help management to assess the significance of the risk.

Some risk exposures cannot be measured, because they are ‘qualitative risks’. It is very difficult, for example, to estimate the possible losses that could arise from damage to a company’s reputation. Qualitative risks must also be assessed, but since the amount of the exposure and the possible losses that might occur cannot be quantified, an assessment of these risks depends on management judgement and opinion.

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Residual risk

Companies control the risks that they face. Controls cannot eliminate risks completely, and even after taking suitable control measures to mitigate a risk, there is some remaining risk exposure.

The remaining exposure to a risk after control measures have been taken is called **residual risk**. If a residual risk is too high for a company to accept, it should implement additional control measures to reduce the residual risk to an acceptable level.

3.2 The dynamic nature of risk assessment

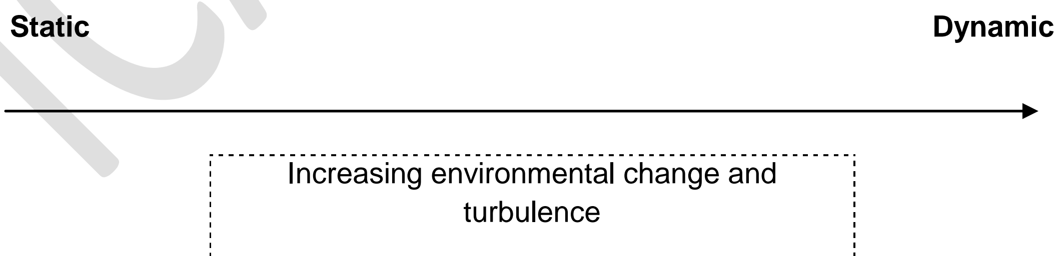
Organisations differ in how exposed they are to changes in internal and external risks. The internal and external factors that affect an organisation might be very changeable. This means that the risks faced by a company do not remain static but change over time and in different situations.

In some situations, environmental factors change relatively little, but in other environments, risk factors can change a great deal. The latter are sometimes called 'turbulent' environments.

The extent of possible exposure to risk due to environmental change can be represented as a scale or continuum between two theoretical extremes that would not be found in practice.

At one end of the scale there is never any change in the external or internal environment of an organisation. This does not mean that there are no risks but, rather that the risks faced do not change. Clearly this cannot exist in practice. All organisations will face a changing risk profile.

At the other extreme the external or internal environment of an organisation changes constantly with the results that all risks are changing all the time. Such a situation does not exist in reality but situations close to it do exist.



Real life situations

Organisations occupy different positions along the static/dynamic scale (continuum). In other words some organisations face very changeable risks whilst those faced by other companies are relatively stable. It is important to note that even static environments might change unexpectedly.

Example: 2008-09 credit crunch

Many financial services organisations rescued by governments in the 2008-09 credit crunch would have been considered low risk only a few years earlier.

Examples at the time included mortgage providers Freddie Mack and Fannie May in the US and Northern Rock and RBS in the UK.

In Nigeria, the Central Bank of Nigeria took firm action against weak banks in 2009, and ten went out of business: this added some stability to the financial system.

However in a commodity-rich country such as Nigeria, the economy and so the financial system is exposed to the consequences of any unexpected fall in commodity prices.

An organisation's risk management approach must meet the demands posed by the complexity of the risks that it faces. Failure to respond appropriately to risk could lead to failure of the organisation's strategy or even of the organisation itself. It follows from this that organisations in more dynamic environments need a greater investment in risk management strategies.

3.3 Risk appetite

A company must accept some risk in order to make profits. This means that a risk of making a loss must be accepted in order to create a chance to make profit. A company will take the risk if its management decides that the risk of loss is justified by the expectation of a gain.

Risk appetite is concerned with how much risk management are willing to take. Management might be willing to accept the risk of loss up to a certain maximum limit if the chance of making profits is sufficiently attractive to them. For a market trader in the financial markets, risk appetite has been defined as 'the amount of capital that a trader is willing to lose in order to generate a potential profit.'

Risk appetite is used to describe how willing a board is to take on risk – on a scale from willing to take on risk through willing to take some risks down to aversion to taking a risk.

A board of directors might also have an appetite for one type of risk but an aversion to a different type of risk. The risk appetite of a board or management in any particular situation will depend on:

- the nature and importance of the decision;
- the nature and amount of the potential gains or losses; and
- the reliability of the information available to help the board or management to make their decision.

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Board policy on risk

The risk appetite of a company should be decided by the board of directors, and a policy on risk should be decided and communicated by the board to its management. Managers need guidance on the levels of risk that would be 'legitimate' for them to take on with any decision that they make.

Managers should not be allowed to take whatever decisions they consider to be suitable, regardless of risk. This would lead to inconsistent decision-making and could expose the company to unacceptable risks. 'Erratic, inopportune risk-taking is an accident waiting to happen' (HM Treasury).

At the other extreme, a risk averse culture is undesirable, in which managers are discouraged from taking any risky decisions, so that business opportunities are not exploited.

3.4 A risk-based approach

The term 'risk-based approach' is often used to describe risk management processes. It is an approach to decision-making based on a detailed evaluation of risks and exposures, and policy guidelines on the level of risk that is acceptable (risk appetite).

The risk-based approach takes the view that some risk must be accepted, but risk exposures should be kept within acceptable limits. Decisions should therefore be based on a consideration of both expected benefit and the risk.

Example: Risk-based approach 1

A company might use discounted cash flow to evaluate capital expenditures. If risk is ignored, the company might have a standard rule that capital investment projects should be undertaken if they are expected to have a positive net present value (NPV) when the forecast cash flows are discounted at the company's cost of capital.

With a risk-based approach, capital investment projects should not be undertaken unless their NPV is positive and the level of risk is acceptable.

ICAN 2021

Example: Risk-based approach 2

A risk-based approach can also be compared with a 'box-ticking' approach. With a box-ticking approach, certain procedures must be carried out every time an item is processed. For example, the customs and immigration department at a country's airports might have a policy of checking the baggage of every passenger arriving in the country by aeroplane, because the policy objective is to eliminate smuggling of prohibited goods into the country by individuals. This would be a 'box-ticking' approach, with standard procedures for every passenger.

With a risk-based approach, the department will take the view that some risk of smuggled goods entering the country is unavoidable. The policy should therefore be to try to limit the risk to a certain level. Instead of checking the baggage of every passenger arriving in the country, customs officials should select passengers whose baggage they wish to search. Their selection of customers for searching should be based on a risk assessment – for example what type of customer is most likely to try to smuggle goods into the country?

ICAN 2021

4 IDENTIFICATION, ASSESSMENT AND MEASUREMENT OF RISK

Section overview

- Risk identification
- The impact of risk on stakeholders
- Assessing risks: impact and probability
- Measuring risks
- Prioritising risks
- Role of the board of directors in identifying and assessing risks
- ALARP (as low as reasonably practicable) principle
- Objective and subjective risk perception
- Related and correlated risk factors

4.1 Risk identification

Risk identification is the initial stage in a system of risk management. A company needs to understand what risks it faces, both in its environment and markets (strategic risks) and internally (operational risks).

There are no standard rules about how risks should be identified.

In a large company, it might be appropriate to identify risks at different levels in the organisation – on a group-wide basis, and for each business division and for each department or function.

Management might be responsible for identifying strategic risks/business risks for the company, but the internal auditors or external auditors might be more efficient at identifying operational risks (and suggesting suitable internal controls to mitigate the risks).

Many large companies set up **risk committees** to identify risks. These are committees of managers from several departments or functions. Each committee is responsible for reporting on a particular category of risk or risks in a particular geographical area of the company's operations. A committee meets regularly to discuss risks and their potential significance, and changes in these risks.

Risks identified by a company will vary in importance. Some risks might be unimportant, or easily controlled. Some risks will be very significant. Having identified risks, it is therefore necessary to assess the importance of each risk, in order to:

- rank the risks in order of significance (order of priority);
- identify the risks that are the most significant; and
- identify the significant risks where control measures are urgently needed.

(Deciding on suitable control measures will depend on the significance of the risk, and the cost of taking control measures. Control measures are only justified if the cost of the control measures is less than the benefits obtained from reducing the risk.)

4.2 The impact of risk on stakeholders

The process of identifying risks should concentrate on risks to the company, both strategic risks and operational risks. However, the risks for a company also create risks for its stakeholders. Management should be aware of the impact of the company's risks on stakeholders, because the risks for stakeholders could affect the attitude and the behaviour of stakeholders towards the company.

The impact of a company's risks on risks for stakeholders varies and depends on circumstances.

Employees

Employees are exposed to several risks in their job. These include the risk of a loss of job, and the threat to health or safety in the work that they do. Employment benefits might be threatened. These risks to employees can be affected by risks that face their company.

Jobs may be threatened by the strategic choices taken by a company. If a company makes the wrong strategic decisions, and the company loses money, many employees could lose their jobs.

Safety risks for a company might be measured in terms of the risk of serious injuries and minor injuries to employees over a given period of time. (For example, a company might assess its current safety measures in terms of the expected number of serious injuries per 1,000 employees per year.)

The risk appetite of some employees might differ from the risk appetite of the company and the board's policy on risk. For example, a 'rogue trader' working in the financial markets for a bank might be willing to take high risks for the company because the potential benefits for him personally (a large cash bonus for making large trading profits) exceeds the risk (the possible loss of his job).

Investors

When investors buy the shares of a company, they have some expectation of the sort of company it is and the returns they might expect from their investment. For example, an investor might buy shares in a company expecting it to be a high-risk company which could achieve a very high rate of growth in the share price. Or an investor might buy shares in a company because the company is stable and can be expected to pay a regular annual dividend.

The board of directors should try to ensure that the risk appetite of the company is consistent with the risk appetite of its shareholders (and other stock market investors). A company should not expose itself to strategic risks that expose the investors to a risk to their investment that the shareholders would consider excessive.

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When a company increases its exposures to strategic risk, many existing shareholders might decide to sell their shares and switch to investing in a lower-risk company. Investors with a larger risk appetite might buy the shares.

The board of directors should keep shareholders informed about the significant risks that the company faces, so that investors can assess their own investment risk. (In Nigeria and the UK, for example, stock market companies are now required by law to include disclosures about risks in their annual narrative report to shareholders, the business review.)

Creditors

The main risks to a company's creditors and suppliers from the company's own risks are that:

- the company will not pay what they owe; and
- the company will stop buying goods and services from them.

A high-risk company is a high credit risk. The liquidity risk and insolvency risk facing a company has an impact on the credit risk for a supplier or lender. When a company asks a bank for a loan, the bank will assess the credit status of the company, and it will make its decision to lend on the basis of whether it thinks that the company will be able to pay back the loan with interest and on schedule.

Communities and the general public

Communities and the general public are exposed to risks from the actions of companies, and the failure by companies to control their risks.

Risks to the general public include:

- the consequences for the country of a decline in the business activities and profits of a company due to recession, especially when the company is a major employer;
- health and safety risks from failures by a company to supply goods that meet with health and safety standards; and
- risks to the quality of life from environmental pollution, due to a failure by the company to control its environmental/pollution risks.

Risks to a local community also arise from economic risks faced by the company. If a company is forced to close down a production plant in an area where it is a major employer, the economy of the entire community would be affected.

Pressure groups and popular action groups come into existence because 'activist' members of the general public believe that their well-being is threatened. The cause of the perceived threat is often the activities of companies.

Some companies take risk-based decisions that expose them to considerable strategic risk without necessarily considering fully the risk impact on the general public or local communities. For example, an energy company planning to construct a new nuclear power station should consider the long-term risks to the

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community – and the general public – not just their own business risks relating to costs.

Governments

For governments, companies are a source of economic wealth for the country. They create additional economic activity which creates extra wealth, and they provide employment and tax revenues for the government.

A risk for government is that major companies will decide to invest in a different country or move their operations from one country to another.

For example, manufacturing companies in the European Union have been faced with the risk of low-cost competition from suppliers in the Far East, where labour costs in some countries are much lower than in Europe. To overcome this threat, companies might consider relocating their manufacturing operations to the Far East. The strategic threat to these companies has an obvious impact on the governments of European Union countries, because the economies of those countries would be affected by a loss of manufacturing businesses. The relocation of some prominent Nigerian businesses to Ghana is another good example.

Customers

Some risks facing companies also have an impact on their customers.

A company might face operational risks from human error or system breakdown in its operations. Errors and delays in providing goods and services have an impact on business customers. For example, if a company is late in supplying a key component to a business customer, the customer will be late in supplying its own customers. Errors and delays work their way through the entire supply chain.

Product safety risks for a company are also a risk for customers who use them. For example, manufacturers of food products, drink products and medicines and drugs need to consider the potential risk to customers from weaknesses in their own safety controls.

Business partners

There are risks in joint ventures for all the joint venture partners. A company in a joint venture might try to dominate decision-making in order to reduce the risk that the joint venture will not operate in the way that they want it to.

However, by reducing its exposures to risk in a joint venture, a company will affect the risks for the other joint venture partners.

Risks in partnerships can be controlled for all the partners – to some extent – by clear terms in the contract agreement between the partners, and by monitoring performance of the partnership.

A UK public company (with several joint ventures in other countries) has commented on joint venture governance and partnerships as follows: ‘As we continue to enter into new partnerships and grow existing joint ventures, the risk inherent in managing these partnerships increases. It is more difficult to

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guarantee the achievement of joint goals and we rely on partners' reputations. We choose partners with good reputations and set out joint goals and clear contractual arrangements from the outset. We monitor performance and governance of our joint ventures and partnerships.'

4.3 Assessing risks: impact and probability

The assessment of risk is sometimes called '**risk profiling**' or '**risk mapping**'.

To assess each risk, it is necessary to consider the likelihood that losses will occur as a consequence of the risk, and the size or amount of the loss when this happens.

A simple approach to risk mapping involves taking each risk that has been identified and placing it on a map. The map is a 2 × 2 matrix, with:

- one side representing the **frequency** of adverse events or the **probability** that the risk will materialise and an adverse outcome will occur; and
- the other side representing the **impact (loss)** if an adverse event occurs or adverse circumstances arise.

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The format of a simple risk map is shown below.

Impact/size of potential loss		
High impact	**High impact** **Low probability** *Consider the need for control measures, such as insurance*	**High impact** **High probability** *Take immediate action to control the risk*
Low impact	**Low impact** **Low probability** *Review periodically*	**Low impact** **High probability** *Consider the need for control action*
	Low probability/ frequency	High probability/ Frequency

Probability or frequency of the risk materialising

A risk map can help management to identify risks where immediate control measures are required, and where the need for control measures should be considered or reviewed periodically.

'High impact, low probability' risks might include the risks of damage to assets from fire or flooding, the risk of a terrorist attack or the risk of major legislation that will affect the company's business. Some of these risks, such as risks of fire, theft and criminal damage, can be insured. Insurance reduces the residual risk by the amount of the insurance cover obtained.

All key risks should be 'owned' by specific individual managers, who should be required to take the necessary control measures and report to their senior manager about what they have done.

Risk assessment as an ongoing process

It is important to appreciate that organisations differ in their exposure to changes in internal and external risks. Some companies are involved in industries that are subject to a wide range of local and international influences (e.g. shipping, telecommunication and technology) and may, therefore operate in a dynamic risk environment. It is vital that such companies assess the risks faced on an ongoing basis so that they might respond to changes immediately. Risk assessment

ICAN 2021

should be an ongoing process for these companies and risk mapping as illustrated above can be a useful tool in this process.

Example: Risk assessment

A possible financial risk is the risk of changes in interest rate on the cash flows of an organisation.

20X1 An organisation with low gearing operates in an environment where interest rates have been low for some time. This company would identify interest rate risk as low impact/low probability.

20X2 The organisation borrows a large amount (in the context of its capital structure) in order to finance an expansion. The company might now categorise identify interest rate risk as high impact/low probability.

20X3 There is a change in government. The new government enters into financial policies that result in high interest rates compared to those enjoyed previously.

The company might now categorise interest rate risk as high impact/high probability.

In both 20X2 and 20X3 the risk has changed resulting in a repositioning on the risk map. In both cases, the strategy adopted for managing the risk will likely change.

4.4 Measuring risks

Whenever possible, risks should be measured. Measuring risk means quantifying the risk. When risks are quantified, the risk can be managed through setting targets for maximum risk tolerance and measuring actual performance against the target.

Risk measurements can be financial measurements (for example, a measurement of the expected loss) or non-financial (for example, a measurement of expected injuries to employees at work).

However, not all risks can be measured. Where risks are assessed in qualitative terms, risk management decisions become a matter of management judgement.

Example: Measuring risk

Banks use risk modelling to measure their main risks. A commonly-used model for measuring credit risk is called a Value at Risk model (VaR model). This can be used to estimate, at a given level of probability, the expected bad debts from the bank's current borrowers. For example, a VaR model could be used to predict at the 95% level of confidence that the bank's bad debt losses from its current borrowers will not exceed, say, ₦5 million in the next month.

Banks set targets for VaRlimits, and monitor the actual credit risk by comparing

actual value at risk against the maximum or target limit.

4.5 Prioritising risks

Within a system of risk management, companies need to establish a process for deciding which risks are tolerable and which might need more control measures to reduce the risk. (Sometimes, it might be decided that control measures are excessive, and that money can be saved by reducing the controls, without increasing risk above acceptable levels.)

Deciding on priorities for risk management might be a matter of management judgement.

Some companies and non-business entities use formal techniques to help them with the prioritisation of risk. One such technique is a risk dashboard.

Risk dashboard

A risk dashboard can be used to identify which risks need further control measures.

On a simple dashboard, each risk that has been identified is represented by a ‘coloured light’. These are usually green, amber and red, representing the colours of traffic signals. When a risk has a red light, this indicates that further risk measures are needed. A green light indicates that the risk is under control. An amber light indicates that the risk needs to be kept under review.

A more complex risk dashboard can be used, for each risk, to show:

- the total amount of risk, assuming that no control measures are in place to contain the risk;
- the residual risk, which is the remaining exposure to risk after allowing for the control measures that are in place; and
- the risk appetite of the company for that particular risk, which is the exposure to risk that the company is willing to accept in order to obtain the expected benefits from its activities.

Risk appetite may be much higher on the dashboard than the residual risk that exists for a particular risk. This could indicate that controls are excessive for that particular risk. Since controls come at a cost, management may save cost by relaxing some of the controls without exposing the company to greater risk.

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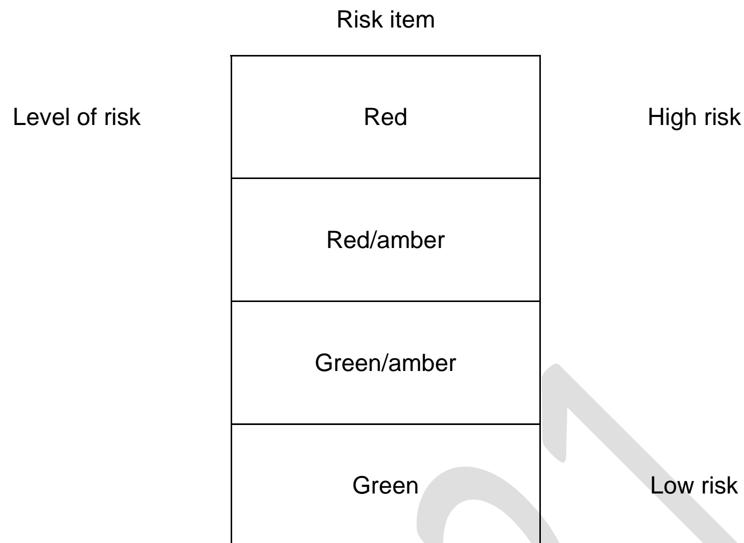
Risk dashboard



Risk appetite and residual risk can both be shown on the dashboard.

The company's risk appetite for a particular risk might be low, in which case it can be recorded in the 'green' section of the dashboard. If the risk appetite is higher, this can be shown in the green-amber or red-amber sections. It is unlikely that a company will have an appetite for a very high risk, so risk appetite is unlikely to be shown in the red section.

Residual risk can also be recorded, in the green, green-amber, red-amber or red sections of the dashboard.

When risk appetite and residual risk are in the same section of the dashboard, this means that current risk management/risk control measures are appropriate for the risk.

When the risk appetite is in a lower-risk section of the dashboard than the residual risk, this indicates that further control action is needed to reduce the residual risk to an acceptable level.

4.6 Role of the board of directors in identifying and assessing risks

As discussed earlier in this chapter, risk management is largely a responsibility for management. Management:

- is normally responsible for identifying key risks (although the board of directors might take on the responsibility, with advice from management and auditors);
- is responsible for assessing risks and for designing and implementing risk controls;
- is responsible for monitoring the effectiveness of risk controls, and keeping risks under review; and

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- should report regularly to the board of directors on risks and risk management.

The board of directors has overall responsibility for risk management, just as it has overall responsibility for the system of internal control.

The board should set the company's policy for risk, and give clear guidance about the company's risk appetite.

The UK Corporate Governance Code states, for example, that the board should conduct a review at least once a year of the effectiveness of internal controls, and this includes the effectiveness of risk management systems.

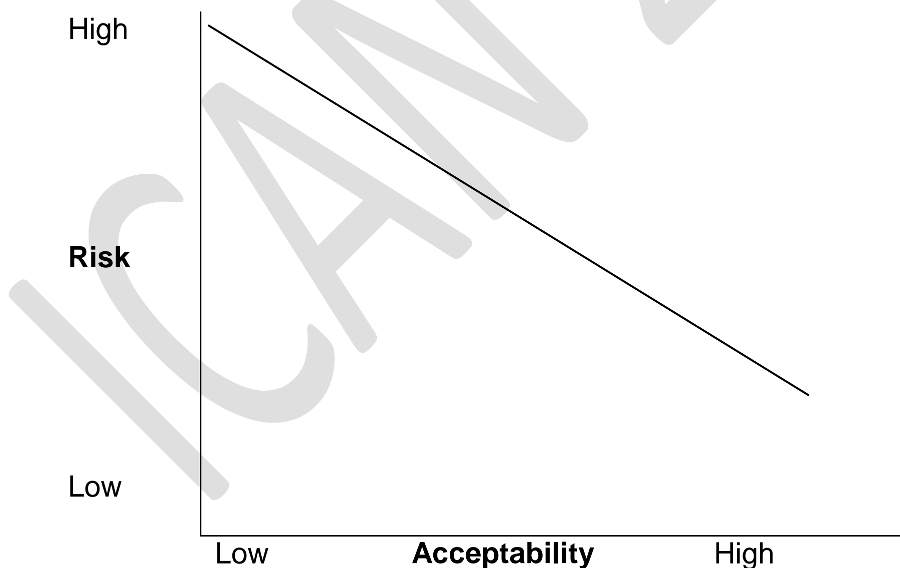
The UK Corporate Governance Code, for example, also requires the board to report to shareholders on its review of internal control.

The requirements of the Financial Reporting Council, Nigeria code of corporate governance for the board of directors are exactly the same as those of the UK.

The evaluation of risk management systems, and the board's responsibilities for reporting to shareholders, are the same as the board's responsibilities for internal controls.

4.7 ALARP (as low as reasonably practicable) principle

Common sense suggests that low risk is more acceptable than high risks. The following diagram illustrates this relationship.



This does not mean that all risk should be avoided. It suggests rather that there is an acceptable level of risk in a given circumstance to achieve a given objective. It is important to remember that risk and return are usually linked in a positive way so that higher return is often associated with higher risk.

ALARP is a term that is associated with safety precautions. It stands for "as low as reasonably practicable" and derives from UK Health and Safety legislation.

The ALARP principle is that it is usually impossible (or if it is possible, it is grossly expensive) to eliminate all risk but that any residual risk should be as low as reasonably practicable. A risk is said to be ALARP when the cost involved in reducing it further would be grossly disproportionate to the benefit gained.

ALARP should not be thought of as simple quantitative measure of cost against benefit because any safety improvement would not be worthwhile only if the costs were disproportionately more than the benefit achieved. This is a matter of judgement and might vary from country to country.

4.8 Objective and subjective risk perception

Risk assessment might be a vitally important activity for an organisation. When this is the case it is important to be able to assign accurate and reliable values to the likelihood and impact of a risk. This can be done with a high degree of certainty for some risks but it can be difficult to do this for others.

If both variables can be measured accurately (where hard information is available) the risk might be described as having been objectively assessed.

In many cases it is difficult to assign a value to either likelihood or impact with any degree of accuracy. In such cases subjective judgements must be used. The following table contains illustrations of risks where impact and likelihood might be objective or subjective.

Objective likelihood measurement	Subjective likelihood measurement
Quality failure in a batch of components (based on previous manufacturing experience)	An oil well disaster occurring this year in Siberia
Objective impact measurement	**Subjective impact measurement**
The change in interest payments as a result of a 1% increase in interest rates.	Change in revenue due to change in consumer taste

Assessment of a risk based on objective measurement of likelihood and impact is more robust than if based on subjective judgement. This will affect the risk management strategy.

4.9 Related and correlated risk factors

Related risks are those that are often present at the same time.

Risks might also be correlated. This means that they vary together. Risks might be positively correlated (both go up or down together) or negatively correlated (one falls as the other increases).

Correlation might be due to the risks having a common cause or because one type of risk might give rise to the other.

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Example: Correlation

Smoking increases the risk of heart disease and the risk of lung cancer.

Both risks rise together when people smoke and fall together when people give up smoking. These risks are therefore, positively correlated as they have a common cause.

Note that correlation is a measure of association but not necessarily causation. If two factors are strongly correlated this suggests that one risk causes the other or that both risks have a common cause but it does not prove either of these to be the case. Factors might show strong correlation due to another unknown connection or by coincidence. In the above example where there is correlation between heart disease and lung cancer it might appear that one causes the other but this is not correct. Both are caused by another factor – smoking.

When two factors appear to be correlated without any direct connection between the two this is known as spurious correlation.

Failure to understand the relationship between risks (if there is one could lead to inappropriate risk response strategies.

Example: BP

Environmental risks and reputation risks might be correlated.

BP is a company engaged in oil and gas exploration and extraction. In 2010, Deepwater Horizon, a BP owned oil platform suffered a catastrophic accident in the Gulf of Mexico. BP is now paying the huge costs associated with the environmental clean-up operation and also the costs of repairing its damaged reputation.

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5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Discuss the nature of risk, risk management and risk responsibilities
- Explain and demonstrate the different categories of risk
- Summarise risk management concepts including exposure, risk appetite and a risk-based approach
- Identify, assess, measure and prioritise risk with consideration of the impact of risk on stakeholders

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CHAPTER 10

Controlling risk

ICAN 2021

Contents

1 Monitoring risk
2 Embedding risk
3 Methods of controlling risk
4 Enterprise risk management
5 Chapter review

INTRODUCTION

Detailed syllabus

C	**Risk management**
C6	Evaluate appropriate responses to risks identified in a given scenario.
C7	Explain the roles of a risk manager and risk committees in risk management.
C8	Discuss risk auditing and monitoring
C9	Identify and explain appropriate high-level procedures to mitigate risks in a given scenario using TARA (transfer, avoidance, reduction and acceptance) framework.
C10	Identify and explain appropriate mechanisms to monitor risk and risk management processes including information and communication systems such as enterprise risk management and ISO 31000 framework on risk management.
C11	Evaluate both inherent and residual risks after mitigation in relation to shareholders' and stakeholders' risk appetites in a given scenario.
C12	Discuss the alternative risk management approaches: risk diversification, risk transfer, risk sharing and risk hedging.

Exam context

All organisations face risk in some form. The challenge for management is to make decisions regarding risks that are acceptable to the stakeholders.

This is the second of two chapters that address risk in organisations. In the previous chapter you focused on identifying and assessing risk. In this chapter you will study risk response and control.

By the end of this chapter students will be able to:

- Explain how risk can be monitored and describe the roles of the risk manager, risk committee and a risk audit;
- Discuss how risk awareness can be embedded throughout an organisation;
- Advise different methods for controlling risk including diversification, hedging and the TARA framework; and
- Summarise ERM and ISO 31000 on risk management.

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1 MONITORING RISK

Section overview

- Role of the risk manager
- The role of risk committees
- The role of risk auditing
- Performing a risk audit

There is no widely-accepted approach to the management of risk. Each business and non-business entity develops its own risk management structure according to its own needs and perceptions. This chapter looks at some of the approaches that might be used.

1.1 Role of the risk manager

Companies and other entities might appoint one or more risk managers. A risk manager might be given responsibility for all aspects of risk. Alternatively, risk managers might be appointed to help with the management of specific risks, such as:

- Insurance;
- Health and safety;
- Information systems and information technology;
- Human resources;
- Financial risk or treasury risk; and
- Compliance (with specific aspects of the law or industry regulations).

A risk manager is not a 'line' manager and is not directly responsible for risk management. His role is to provide information, assistance and advice, and to improve risk awareness within the entity and encourage the adoption of sound risk management practice.

The role of a risk manager might therefore include:

- Helping with the identification of risks;
- Establishing 'tools' to help with the identification of risks;
- Establishing modelling methods for the assessment and measurement of risks;
- Collecting risk incident reports (for example, health and safety incident reports);

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- Assisting heads of departments and other line managers in the review of reports by the internal auditors;
- Preparing regular risk management reports for senior managers or risk committees; and
- Monitoring 'best practice' in risk management and encouraging the adoption of best practice within the entity.

How effective are risk managers?

The effectiveness of risk managers depends partly on the role of the risk manager and partly on the support that the risk manager receives from the board and senior management.

The specific role of the risk manager might give him authority to instruct line managers what to do. For example, a health and safety manager can insist on compliance with health and safety regulations. Some risk managers have the authority to make decisions for the entity: the manager responsible for insurance, for example, might have the authority to buy insurance cover against certain risks.

The status of the risk manager depends on the amount of support he receives from the board and senior management. A culture of risk awareness should be promoted by the board of directors.

1.2 The role of risk committees

Some entities establish one or more risk committees.

A risk committee might be a committee of the board of directors. This committee should be responsible for fulfilling the corporate governance obligations of the board to review the effectiveness of the system of risk management.

A risk committee might be an inter-departmental committee responsible for identifying and monitoring specific aspects of risk, such as:

- strategic risks/business risks (or particular aspects of these risks);
- operational risk (and internal controls);
- financial risk;
- compliance risk; and
- environmental risk.

Risk committees do not have management authority to make decisions about the control of risk. Their function is to identify risks, monitor risks and report on the effectiveness of risk management to the board or senior management.

Internal auditors might be included in the membership of risk committees. Alternatively, the internal auditors should report to the risk committees.

Similarly, risk managers might be included in the membership of risk committees, or might report to the committees.

The boards of directors should receive regular reports from these risk committees, as part of their governance function to monitor the effectiveness of risk management systems.

1.3 The role of risk auditing

Risks should be monitored. The purpose of risk monitoring is to ensure that:

- there are processes and procedures for identifying risk, and that these are effective;
- there are internal controls and other risk management processes in place for managing the risks;
- risk management systems are effective;
- the level of risk faced by the entity is consistent with the policies on risk that are set by the board of directors;
- failures in the control of risk are identified and investigated; and
- weaknesses in risk management processes are identified and corrected.

Risks can be monitored through auditing. Risk auditing involves the investigation by an independent person (the auditor) of an area of risk management. A risk audit and assessment can be defined as 'a systematic way of understanding the risks that an organisation faces. Because the range and types of risk are many and varied, risk assessment and audit can be a complicated and involved process' (David Campbell in ACCA Student Accountant, March 2009).

It is important to recognise however that unlike an external audit, a risk audit is not a mandatory requirement for companies (although regulators do require companies in certain industries such as financial services to carry out regular audits or stress tests).

External auditors should monitor internal controls for financial risks as a part of their annual audit process. Internal auditors might also carry out checks on internal financial controls.

However, risk auditing can be extended to other aspects of risk, such as operational risks, compliance risks and environmental risks. The auditors might be a part of the internal audit function or risk management function within the entity. Alternatively, they might be external investigators and auditors from either an accountancy/consultancy firm or a firm that specialises in the audit of particular types of risk.

1.4 Performing a risk audit

The advantage of having risk audits performed by internal auditors or risk managers is that the individuals who carry out the audit would be very familiar with the company and its systems, procedures and culture. As a result:

The auditor begins with an understanding of relevant technical issues, how the business operates and the legal and regulatory framework and control systems. He should therefore be capable of performing highly context-specific risk audits, at a level of detail that an external auditor may not be able to achieve.

The audit report is likely to be written in a language and using terms that the company's management understand, and so may be easier to comprehend than a report written by an external auditor.

The disadvantage of using internal auditors or risk managers for risk audits is the 'familiarity threat'. Because he is so familiar with the way that systems and procedures operate, and because he knows the management well, a risk manager may fail to identify weaknesses in the system. If an external auditor or specialist consultant carries out a risk assessment, the auditor should be more clearly independent of management and a familiarity threat should not exist.

(Firms of management consultants may be up-to-date with current approaches to risk assessments and audits and so may be highly 'professional'. A potential problem however is that consultancy firms may have a ready-made solution to a risk management problem, which they try to impose on all their clients even when the proposed solution may not be entirely appropriate.).

There are four stages in a risk audit.

Stage 1: Identification. The first step in a risk audit should be to identify what the risks are in a particular situation, strategy, procedure or system. Risks change continually in nature. Existing risks may disappear, and new risks may emerge. It is therefore essential to identify what the current risks are, especially for companies that operate in a volatile business environment.

Stage 2: Assessment. When the risks have been identified, the next step should be to assess them. The probability of an adverse event or outcome, and the impact of an adverse event should be measured. A risk can be assessed by its expected loss. The expected loss = Probability × Impact.

Stage 3: Review. The auditor should look at the controls that are in place to manage the risk in the event that an adverse outcome happens. Management may have taken measures to transfer the risk (for example, to insure certain risks) or to reduce the risks by introducing control systems and monitoring systems. The controls for each material identified risk should be audited.

Stage 4: Report. The risk audit should lead to a report to the board of directors or to management, depending on who commissioned the audit.

2 EMBEDDING RISK

Section overview

- The importance of risk awareness throughout an organisation
- Embedding risk awareness in the culture of an organisation
- Embedding risk awareness in systems and procedures
- The role of risk professionals and the need for embedded risk management

2.1 The importance of risk awareness throughout an organisation

Risk managers, risk committees and risk audits can contribute to a culture of risk awareness, and can help to provide a sound system of risk management. It is important, however, that throughout the organisation managers and employees are aware of risk and the need for appropriate risk control.

Managers take decisions that expose the entity to risk. They need to understand the possible consequences of their decision-making, and should be satisfied that the risks they have 'created' are justified by the expected benefits.

Senior managers are responsible for the management of business risks/strategic risks. Every employee needs to be aware of the need to contain operational risks. For example:

- All employees must be aware of health and safety regulations, and should comply with them. A failure to comply with fire safety regulations could result in serious fire damage. For a manufacturer of food products, a failure in food hygiene regulations could have serious consequences for both public health and the company's reputation;
- All employees and managers should understand the need to report incidents where there have been excessive exposures to risk, and control measures have failed or have not worked properly; and
- In some entities, there could be serious consequences of failure to comply with regulations and procedures. For example in banking, there must be a widespread understanding of anti-money laundering regulations and the rules against mis-selling of banking products. The consequences for a bank of failures in compliance could be fines by the regulator and damage to the bank's reputation.

2.2 Embedding risk awareness in the culture of an organisation

An essential aspect of risk management and control is the culture within the organisation. The culture within the organisation is set by the board of directors and senior management (the 'tone at the top'), but it should be shared by every manager and employee.

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Risk awareness is 'embedded' in the culture of the organisation when thinking about risk and the control of risk is a natural and regular part of employee behaviour.

Creating a culture of risk awareness should be a responsibility of the board of directors and senior management, who should show their own commitment to the management of risk in the things that they say and do.

There should be reporting systems in place for disclosing issues relating to risk. There should be a sharing of risk-related information.

Managers and other employees should recognise the need to disclose information about risks and about failures in risk control.

There should be a general recognition that problems should not be kept hidden. 'Bad news' should be reported as soon as it is identified. The sooner problems are identified, the sooner control measures can be taken (and the less the damage and loss).

To create a culture in which problems are disclosed, there must be openness and transparency. Employees should be willing to admit to mistakes.

Openness and transparency will not exist if there is a 'blame' culture. Individuals should not be criticised for making mistakes, provided that they own up to them promptly.

The attitude should be that problems with risks will always occur. When they do happen, the objective should be to take measures to deal with the problem. Mistake should be analysed in order to find solutions and prevent a repetition of the problem. Risk management should be a constructive process.

2.3 Embedding risk awareness in systems and procedures

In addition to creating a culture of risk awareness within an entity, it is also important to establish systems and procedures in which the management of risk is 'embedded'.

'Embedding' risk in systems and procedures means that risk management should be an integral part of management practice. Risk management must be a core function which managers and other employees consider every day in the normal course of their activities. The concept of embedding risk can be compared with a situation where risk management is treated as an 'add-on' process, outside the normal procedures and systems of management.

There are no standard rules about how risk awareness and risk control can be embedded within systems and procedures. Each organisation needs to consider the most appropriate methods for its own purposes.

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Example: Embedding risk awareness

One system for embedding risk awareness in the planning process is a two-stage process, as follows.

Stage 1. Managers responsible for preparing plans are required to identify the key risks that could prevent the achievement of their planning targets. This requirement makes managers consider risks and the measures that are required to control them, to ensure the achievement of planning targets.

Stage 2. Before plans are finally approved, managers must carry out sensitivity analysis or scenario analysis, to measure the effects of adverse events or circumstances. For example, a sales manager preparing a sales plan would be required to consider the consequences of weak sales demand, or a lack of success in a new product launch. Similarly a research and development director might be required to consider the consequences of a failure in a research project or a delay in the completion of a development project. They must then report the results of their testing.

Sensitivity analysis or scenario tests make managers consider risks and their consequences. In addition, they are made aware of the need to control risks, so that if future events are unfavourable, the risks are contained and the consequences are not worse than those predicted by their scenario testing.

2.4 The role of risk professionals and the need for embedded risk management

Risk managers and risk auditors have a role in risk management, but they cannot be effective unless risk is embedded in the culture of the entity and in its systems and procedures.

The risk management team of an organisation can assist in the development of the risk management framework and policies. They can teach the team about risk management so as to ensure that strong reporting and examining structures exist.

However, there are two things that this risk management team cannot do. They cannot put a corporate culture in place that establishes risk awareness and transparency. The culture needs to be set and then passed on to all members of staff by the board of directors or the senior management team. They also cannot be the only risk managers. The people who created the risks originally – the business managers – need to be responsible. The risk management team's main aims should be to ensure that the right people are managing the right risks and that risk management is always considered.

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3 METHODS OF CONTROLLING RISK

Section overview

- Different approaches to controlling risk
- Diversification
- Risk transfer
- Risk sharing
- Hedging risks
- Risk avoidance and risk retention
- The TARA framework for risk management

3.1 Different approaches to controlling risk

There are several different approaches to controlling risks. In a previous chapter, it was explained how internal controls can be used to control financial risks, operational risks and compliance risks.

Risk management methods are much more sophisticated in some industries (and in some countries) than in others. For example, the financial services and banking industry has developed products (financial derivatives) that can be used to manage financial risks.

Approaches to the management of business risks that are described in this section are:

- diversification of risks;
- risk transfer;
- risk sharing; and
- hedging risks.

3.2 Diversification

Risks can be reduced through diversification. Diversification is also called 'spreading risks'.

The purpose of diversification in business is to invest in a range of different business activities, and build up a portfolio of different business activities. Each individual business activity is risky, but some businesses might perform better than expected just as some might perform worse than expected. Taking the entire portfolio of different businesses, the good performers will offset the bad performers, and the portfolio as a whole might provide, on average, the expected returns.

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Example: Diversification

Investors in shares often diversify their investment risks by investing in a portfolio of shares of different companies in different industries and different countries.

Some investments will perform well and some will perform badly. The losses on poor-performing shares should be offset by higher-than-expected returns on others. Risk is also reduced because if an investor suffers a loss on some shares, the rest of the investment portfolio retains its value. The maximum loss in any single investment is limited to the amount that has been invested in the shares of that company.

When is diversification appropriate?

Diversification is appropriate in some situations, but not in others.

A diversification strategy by a company might be appropriate provided that its management have the skills and experience to manage the portfolio of different business activities. For example, a film studio diversifies into films for the cinema, films for television and other home entertainment products. If there is a decline in the market for cinema films, the market for television programmes or downloading films from the internet might remain strong.

A diversification strategy by a company is much more risky (and less appropriate) when it takes the company into unrelated business activities. For example, a company that diversifies into making tobacco products, selling insurance products and providing consultancy services could be exposed to very large risks, because its senior management might not have the skills or experience to manage all the different businesses. Each business is very different from the others. Investors in the company might also disapprove of such diversification: if investors want to diversify into different businesses, they can do so by buying shares in specialist companies rather than buying shares in a company that diversifies its activities.

Risks are not reduced significantly by diversifying into different activities where the risks are similar, so that if there is an adverse change in one business activity, there is a strong probability that adverse changes will also occur in the other activities. For example, a company that diversifies into house-building, manufacturing windows and manufacturing bricks would be exposed in all three businesses to conditions in the housing market.

3.3 Risk transfer

Risk transfer involves passing some or all of a risk on to someone else, so that the other person has the exposure to the risk.

A common example of risk transfer is insurance. By purchasing insurance, risks are transferred to the insurance company, which will pay for any losses covered by the insurance policy.

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Using insurance to manage risk is appropriate for risks where the potential losses are high, but the probability of a loss occurring is fairly low.

3.4 Risk sharing

Risk sharing involves collaborating with another person and sharing the risks jointly.

Common methods of risk sharing in business are partnerships and joint ventures. In a joint venture, all the joint venture partners share in the investment, the management, the cost of the investment, the risks and the rewards.

Companies pursuing a strategy of developing their business in other countries might use joint ventures as a way of entering the market in a different country. For the 'global' company, the joint venture partner would be a local business whose management have knowledge of the local market. For a local business, a joint venture with a foreign company reduces the financial risk, and also improves the opportunities for expansion and growth.

3.5 Hedging risks

The term 'hedging' risks is used extensively in the financial markets, and hedging is commonly associated with the management of financial risks such as currency risk.

Hedging risk means creating a position (making a transaction) that offsets an exposure to another risk. For example, if a company has an exposure to currency risk, and will lose money if the US dollar falls in value against the euro, a hedge can be created whereby the company will make a profit if the US dollar falls in value against the euro. The loss on the original risk exposure will be offset by a gain on the hedge position.

Risks can be hedged with a variety of derivative instruments, such as futures, options and swaps. A detailed knowledge of these instruments is outside the scope of the syllabus for this examination paper.

3.6 Risk avoidance and risk retention

Measures to control risk through diversification, risk transfer, risk sharing and hedging risks can help to reduce the risks. Similarly, internal controls can reduce risks, prevent problems from happening or identify them when they occur.

Control measures do not eliminate risk. They only reduce them. The risks that remain after risk control measures are implemented are the 'residual risks'.

An entity needs to develop a strategy towards these risks. The basic choice is between risk avoidance and risk retention.

Risk avoidance means not having any exposure to a risk. A business risk can only be avoided by not investing in the business. Risk avoidance therefore means staying out of a business, or leaving a business and pulling out of the market.

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Risk retention means accepting the risk, in the expectation of making a return. When risks are retained, they should be managed, to ensure that unnecessary risks are not taken and that the total exposure to the risk is contained within acceptable limits.

Risk appetite and risk retention

The choice between avoiding risks and accepting risk depends on risk appetite. Risk appetite is the amount of risk that an entity is willing to accept by investing in business activities, in order to obtain the expected returns from the business.

Risk appetite varies from one company to another. Some companies are willing to take fairly large risks whereas others are 'risk averse'. In general, companies expect higher returns by taking larger risks.

Risk appetite should be established by the board of directors, which should formulate a policy for strategic risk/business risk. Limits to strategic risks can be expressed in several ways.

The board of directors might indicate the risks that it is not prepared to accept, where risks should be avoided. For example, a water supply company might establish a policy of not investing in water supply operations in any other country, because it considers the risks too great.

Risk limits can be established in terms of the maximum new investment that will be approved in each area of business activity.

A risk dashboard might be used as a method of establishing appetite for particular risks and for monitoring residual risks.

It is easy to think of 'risk' as something undesirable, to be avoided. This attitude to risk focuses on downside risk. It is important to recognise that risk is unavoidable in business and that risks must be taken in order to make profits and a return on investment.

A key aspect of risk management is therefore managing the level of risk and:

- deciding which risks are acceptable and which are not: setting risk limits;
- communicating the policy on risk; and
- monitoring risks, and taking appropriate measures to prevent the risks from becoming excessive.

Variations in risk appetite between different companies

Risk appetite varies between different companies, and might vary according to the size, structure and development of the business.

Small companies are often more entrepreneurial than larger companies, and are willing to take bigger risks in order to succeed and grow. Entrepreneurial business leaders are associated with risk-taking. The leaders of small businesses might consider that they can take risks because:

- The directors of the company are also its owners; therefore they are not accountable to other investors for the risks that they take;

- In small companies, the risk of loss is limited by the size of the company. The worst that can happen is that the company will fail and go into liquidation. If the company is small and does not have large amounts of financing, this risk might be acceptable; and

- In large companies with a high value, large risks will often be avoided if they threaten to reduce value significantly.

On the other hand, large companies can afford to take bigger risks than small companies when they are well-diversified. For example, a large bank can accept the credit risk from a major borrower, because if the loan turns into a bad debt, the bank's total profits might not be affected significantly.

As companies become larger, with a hierarchical management structure, they might become more bureaucratic. Bureaucracies are often the opposite of entrepreneurial businesses, because they are risk-averse. Managers are unwilling to take on risk, and because of the hierarchical nature of the management structure it might be difficult to promote a culture of risk awareness and embed risk within the management processes.

Business risk is often higher in markets where conditions are volatile and subject to continual and unpredictable change. When a new market emerges, risks are high. Companies investing in the new market must have an appetite for taking on the high risk because they expect the potential benefits to be large. As a market matures, it becomes more stable and more predictable. Volatility falls and there is less risk. As a consequence, the risk appetite of companies operating in a developed and mature market could be fairly low.

3.7 The TARA framework for risk management

Some of the risk management policies described in this section can be seen as four different approaches to risk management, which can be used to identify alternative strategies. These four approaches are known as the TARA framework for risk management.

TARA stands for:

- Transferring risk;
- Avoiding risk;
- Reducing risk; and
- Accepting risk.

Risk transfer has been described: a common method of risk transfer is to buy insurance, and transfer risk to the insurance company.

Risk avoidance usually means ‘not doing’ something or withdrawing from an activity that creates risk. It could make sense to avoid risk if the risk is too high for the expected returns. In order to make entrepreneurial profits however, some business risks have to be taken.

Risks can be reduced by various measures. In particular risks of errors and fraud can be reduced by means of a sound system of internal control.

Accepting risk can be a sensible option. If the risk is not too great, and the cost of reducing or transferring the risk would not be worthwhile, exposure to a risk may be acceptable.

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4 ENTERPRISE RISK MANAGEMENT

Section overview

- Enterprise risk management (ERM)
- ISO 31000 on risk management

This section summarises and adds to many of the risk topics dealt with so far in order to provide an overview of an effective approach to risk management.

4.1 Enterprise risk management (ERM)

The board should ensure that there is a robust framework for risk management. Many companies have established an enterprise-wide risk management framework, so that the approach to risk management is consistent throughout the company/group.

A risk can be defined as any event or action that might result in a failure by the company to achieve its strategic objectives, which in turn will add to stakeholder value. An approach to risk management should start with an understanding of how stakeholders measure value.

A framework for risk management might be applied at three levels or in three stages:

- **Establishing the approach** to risk management and creating a risk management 'vision';
- **Committing resources** to risk management, and ensuring that an infrastructure for risk management is put in place and that the company/group has the capabilities and skills for managing risk; and
- **Implementing systems** for risk assessment, the application of controls and other management systems for risk, and monitoring risks and the effectiveness of the risk management arrangements.

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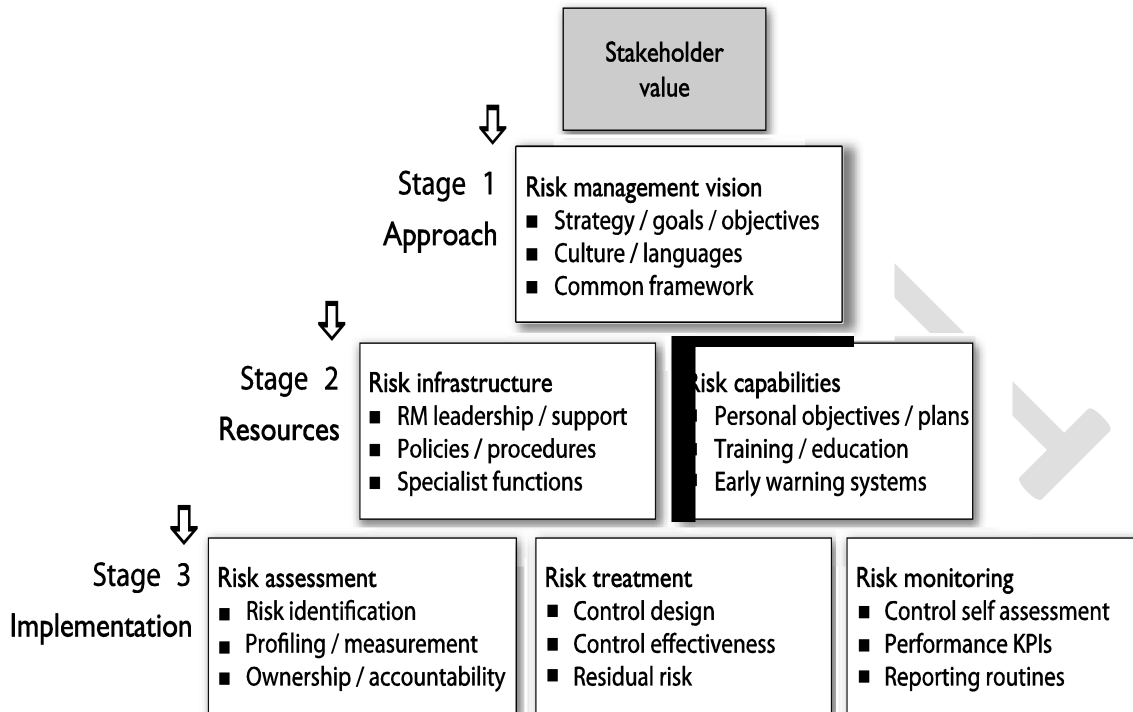
The following is a framework for controlling risk



(Source: Crowe Clark Whitehill LLP)

Approach to risk management

The overall approach to risk management should be established by senior management.

The company/group should have a clear risk strategy. This should be well defined and communicated throughout the company.

There should be a culture of risk management. Consistent definitions should be used throughout the company, providing appropriate and simple terminology to support the risk management process.

A common framework and approach to risk management should be used across the entire company/group.

An infrastructure for risk management

There should be an infrastructure for risk management:

- There should be a risk management structure, providing leadership and support in the area of risk management and internal control;

- There should be appropriate risk management policies and procedures. These should be kept-up-to-date and should be readily available; and

- Appropriate specialist risk management and assurance functions should be established where appropriate, such as capabilities in internal audit, health and safety management, IT assurance, insurance management and environmental risk management functions.

Risk capabilities

The company should have the capabilities for managing risk which might include:

- Employees being given structured training in basic risk management procedures and internal control systems;

- Individuals having personal objectives that make reference to their performance in areas of risk and control; and

- Systems capable of providing early warning of any major control breakdowns or problems.

Risk assessment

To implement risk management systems, there must first be processes or procedures for identifying risks and measuring them and assessing their potential significance. The measuring and assessment of risk is sometimes called 'risk profiling' or 'risk mapping'.

A simple example of risk mapping involves placing each identified risk in an appropriate position in a 2 × 2 matrix, according to:

- the frequency of adverse events or the probability that the risk will materialise and an adverse outcome will occur; and

- the expected loss or impact in the event of an adverse outcome.

Companies in more complex business sectors may need a more sophisticated approach, using scenario analysis and arithmetic calculations.

All critical risks should be 'owned' by designated managers.

The treatment of risk

Controls should be designed to mitigate the risk. There should also be some form of testing controls for both their design and their operating effectiveness.

Controls for significant or 'critical' risks should be reviewed regularly to ensure that they are still appropriate to apply.

The effectiveness of controls in reducing critical risks should be tested.

'Residual risk' is the risk that still remains after the controls have been put in place and implemented. Management should understand and monitor these residual risks, to ensure that they remain at acceptable levels.

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Monitoring risks

Risks should be monitored by managers who have responsibility for those risks. In addition, risks can be monitored at a more senior level through key performance indicators (KPIs) or key risk indicators (KRIs).

The board should be provided regularly by management with clear reports on risk management and internal control, such as reports on:

- the company's risk profile; and
- control testing, the results of those tests and action plans resulting from the test findings.

4.2 ISO 31000 on risk management

In 2009, the International Organization for Standardization issued a Standard on the implementation of risk management systems: ISO 31000. ISO 31000 may be used by any organisation in any industry or sector, and can be applied to any type of risk. Its purpose is to promote international standardisation in risk management systems.

In 2010, the Institute of Risk Management (IRM), in collaboration with the Association of Insurance and Risk Managers (Airmic) and the public risk management association Alarm, issued guidance on ISO 31000.

ISO 31000 puts forward a framework for risk management that has three main elements:

Risk architecture - This consists of the roles and responsibilities for risk management within the organisation and the risk reporting structure. For example it consists of the respective roles and responsibilities of the board, the audit committee, the group risk management committee, the risk disclosures committee, the CEO, business unit managers, individual employees, risk managers, specialist risk management functions and internal auditors;

Risk strategy - The risk strategy of the organisation should be specified, including the risk appetite of the board. There should be a risk management action plan and resources to support risk management activities; and

Risk protocols - These are the rules and procedures for implementing risk management and the risk management methodologies that should be applied. For example there should be rules, procedures and methodologies for risk assessments, risk responses, and incident reporting; a business continuity plan; and arrangements for auditing the efficiency and effectiveness of controls.

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ISO 31000 uses the ‘7Rs and 4Ts’ of risk management as a framework for the implementation of a risk management system:

Recognition/identification of risks;

Ranking or evaluation of risk;

Responding to significant risk;

Risk treatment:

- Tolerate: accept the exposure to risk
- Treat: take measures to control or eliminate the risk
- Transfer: transfer the risk to someone else
- Terminate: terminate the activity that gives rise to the risk;

Resourcing controls;

Reaction planning;

Reporting and monitoring risk performance; and

Reviewing the risk management framework.

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5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain how risk can be monitored and describe the roles of the risk manager, risk committee and a risk audit
- Discuss how risk awareness can be embedded throughout an organisation
- Advise different methods for controlling risk including diversification, hedging and the TARA framework
- Summarise ERM and ISO 31000 on risk management

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CHAPTER 11

The scope of governance

Contents

1 The meaning of governance
2 Concepts of good governance
3 Stakeholders
4 Agency theory
5 Other theories of corporate governance
6 Governance and IT
7 Chapter review

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INTRODUCTION

Detailed syllabus

A **Introduction**

A6 Explain the concept of corporate governance and discuss:

- **A6 (a)** Perspectives on corporate governance; and
- **A6 (c)** Structure, principles, functions and mechanisms of corporate governance.

D **Governance**

D1 Identify the issues and bases of decision making, employing theories and philosophies of corporate governance in a given scenario. These include:

- **D1 (a)** Agency theory;
- **D1 (b)** Transaction cost theory;
- **D1 (c)** Stewardship theory;
- **D1 (d)** Resources dependency theory;
- **D1 (e)** Managerial and class hegemony theory;
- **D1 (f)** Psychological and organisational perspective theory;
- **D1 (g)** Stakeholders' theory; and
- **D1 (h)** Systems theory.

D2 Explain the nature, significance and scope of enterprise governance and threats to effective governance, including:

- **D2 (a)** Concept of good governance

D7 Discuss the importance and implications of probity as a principle of governance

D8 Assess the extent to which a board in the public sector focuses on the value of sustainable long-term success

D9 Assess the extent to which a board in the public sector focuses on: delivery of an effective and appropriate public service and acting in the public interest.

D13 Explain governance and management issues relating to the use of information technology in organisations.

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Exam context

This is the first chapter that addresses governance. In this chapter you will learn the definition of governance and understand some basic traits of both good and bad governance. We also re-visit stakeholders, this time from a governance perspective.

The chapter also includes a detailed analysis of agency theory and other theories of governance.

It also explains issues of governance and management relating to IT.

By the end of this chapter students will be able to:

- Define corporate governance and explain the separation of ownership from control;
- Discuss governance issues for not-for-profit organisations;
- Explain the principles of good governance;
- Identify key stakeholder groups and analyse their influence on corporate governance
- Explain agency theory and other theories of corporate governance; and
- Explain issues relating to responsibilities of the board and management for IT, including IT governance and effective IT control systems.

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1 THE MEANING OF GOVERNANCE

Section overview

- Corporate governance
- The separation of ownership from control
- Corporate governance: laws and guidelines
- Corporate governance issues
- Governance issues for other types of organisations

1.1 Corporate governance

Corporate governance has been defined (in the Cadbury Report, 1992) as follows: 'Corporate governance is the system by which companies are directed and controlled.'

Governance should not be confused with management.

Management is concerned with running the business operations of a company.

Governance is about giving a lead to the company and monitoring and controlling management decisions, so as to ensure that the company achieves its intended purpose and aims.

Management is about making business decisions: governance is about monitoring and controlling decisions, as well as giving leadership and direction. 'If management is about running business, governance is about seeing that it is run properly': (Professor Bob Tricker, 1984). In order to understand what corporate governance is, it might be helpful to think about what it is not.

Corporate governance is not about management activities, and management skills and techniques. The powers of executive management to direct a business is an aspect of governance, but how they use those powers to direct business activities is not.

Corporate governance is not about formulating business strategies for the company. However, the responsibility of the board of directors and other senior managers for deciding strategy is an aspect of governance.

Corporate governance is concerned with matters such as:

In whose interests is a company governed?

Who has the power to make decisions for a company?

For what aims or purposes are those powers used?

In what manner are those powers used?

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Who else might influence the governance of a company?

Are the governors of a company held accountable for the way in which they use their powers?

How are risks managed?

The term 'corporate governance' means the governance of companies (corporate bodies). Similar issues arise for the governance of other entities, such as government bodies, state-owned entities and non-government organisations such as charities.

1.2 The separation of ownership from control

Problems arise with corporate governance because of the separation of ownership of a company from control of the company. This is a basic feature of company law.

A company is a legal person. In law, a company exists independently of its shareholders, who own it.

The constitution of a company usually delegates the powers to manage a company to its board of directors. The board of directors in turn delegates many of these management powers and responsibilities to executive managers.

The directors act as agents for the company. Their responsibilities are to the company, not the company's shareholders.

However, it is widely accepted that companies should be governed in the interests of their owners, the shareholders. However the interests of other groups, such as the company's employees, might also have a strong influence on the directors.

Problems arising from the separation of ownership and control

The separation of ownership and control creates problems for good corporate governance, because:

- the directors of a company might be able to run the company in a way that is not in the best interests of the shareholders; and
- but the shareholder might not be able to prevent the directors from doing this, because the directors have most of the powers to control what the company does.

When the shareholders of a company are also its directors, problems with corporate governance are much less likely to arise.

When a company is controlled by a majority shareholder, problems with governance are also unlikely, because the majority shareholder has the power to remove any director and so can control decisions by the board of directors.

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Problems with corporate governance generally arise when a company has many different shareholders, and there is no majority shareholder. In these companies, the board of directors have extensive powers for controlling the company, but the shareholders are relatively weak. The directors ought to be accountable to the shareholders for the way they are running the company. However in practice the shareholders might have little or no influence and do not have the ability to prevent the directors from running the company in the way that the directors themselves consider to be best.

Problems of corporate governance are therefore particularly severe in large companies where shareholders continually buy and sell their shares, so that many shareholders are not long-term investors in the company that, for a time at least, they partly own. This is why attempts to improve corporate governance have focused mainly on stock market companies (listed companies) and to a lesser extent on smaller public companies and large private companies.

Ownership and control in non-corporate entities

The separation of ownership from control can affect the quality of governance in non-corporate entities, as well as companies.

In any entity, it should be possible to identify owners and controllers:

- The owners might be the government, or the 'public'. In the case of a charity organisation, the owners might be a section of the public; and
- Those in control. The power to govern a non-corporate body might be given to a management committee (or for example in the UK, a board of trustees). Appointments to the management committee might be made by the owners, or by means of a procedure that is specified by the constitutional rules of the entity.

The relationship between owners and controllers is different in a non-corporate entity compared with a company. The aims of a non-corporate entity also differ from the profit-seeking aims of a company. Even so, the possibility of governance problems can arise. There is a risk that the controllers of an entity will not run its affairs in a way that meets the needs or expectations of its owners.

1.3 Corporate governance: laws and guidelines

It is well recognised that there is good governance and bad governance.

Bad governance occurs when an entity is governed in a way that is inconsistent with certain concepts and practices. Often, bad governance means that a company is governed in the interests of its directors personally, rather than in the best interests of its owners (or other important interest groups).

Good governance is based on certain key concepts and practices, which are described later.

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To some extent, good governance is supported by **the law**. In Nigeria, for example, the directors of a company owe certain duties to their company (these duties are included in Companies and Allied Matters Act, 2020). The Act also requires the directors of a company to present an annual report and accounts to the shareholders; this helps to make the directors accountable to the shareholders of their company.

The Sarbanes-Oxley Act 2002 in the USA introduced a range of legal measures designed to improve the quality of corporate governance in the US, following the spectacular collapse of several large corporations (such as Enron and WorldCom) where bad corporate governance was held largely to blame.

In some countries, such as the UK, where laws on corporate governance are not strong, **guidelines or codes of governance principles and practice** have been issued. The guidelines are voluntary, but are backed by major financial institutions, stock exchanges and investment organisations. For example:

- The Nigerian Code of Corporate Governance for the Private Sector (2018), prepared by the Financial Reporting Council of Nigeria, requires that companies should comply with the principles and provision of the Code just as the Code shall form the basis of the minimum standard of their corporate behaviour. This Code applies to all public companies (whether listed or not), all private companies that are holding companies of public companies, concessioned and privatised companies and Regulated Private Companies;
- Listed companies in the UK are required to comply with The UK Corporate Governance Code or explain why they have failed to do so, and other Codes apply to companies in the UK's junior market Alternative Investment Market (AIM) and to large private companies;
- Similarly, Singapore has a Code of Corporate Governance, issued by the Ministry of Finance; and
- A more general set of corporate governance guidelines has been issued by the Organisation for Economic Co-operation and Development (OECD), which all countries are encouraged to adopt as a minimum standard for good corporate governance.

These Codes will be described in more detail later.

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Example: A good company?

What makes a good company?

A good company is not necessarily a company that is well-governed. However, it is useful to think about what you would consider to be a good company. Which of the following characteristics would you consider to be a feature of a 'good' company?

1. A company that earns good profits.
2. A company that responds to the needs of its customers.
3. A company that is a good employer.
4. A company that is environmentally-friendly.

You might think that a good company is any or all of these. Or you might have a different opinion about what makes a good company. However, your views on what makes a good company will probably also affect your opinions about how companies ought to be governed.

The Walker Report and board behaviour

In 2009 the UK government commissioned a review by Sir David Walker into the corporate governance of UK banks and other financial institutions, following the global financial crisis that began in mid-2007.

The Walker Report included the following comments about the contribution of poor corporate governance to the crisis.

Serious deficiencies in prudential oversight and financial regulation in the period before the crisis were accompanied by major governance failures within banks. These contributed materially to excessive risk taking and to the breadth and depth of the crisis…. Board conformity with laid down procedures such as those for enhanced risk oversight will not alone provide better corporate governance overall if the chairman is weak, if the composition and dynamics of the board is inadequate and if there is unsatisfactory or no engagement with major owners.

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1.4 Corporate governance issues

So what are the key issues in corporate governance, which establish how well or badly a company is governed? The main areas covered by codes of corporate governance are as follows:

- **The role and responsibilities of the board of directors**. The board of directors should have a clear understanding of its responsibilities and it should fulfil these responsibilities and provide suitable leadership to the company. Governance is therefore concerned with establishing what the responsibilities of the board should be, and making sure that these are carried out properly;

- **The composition and balance of the board of directors**. A board of directors collectively, and individual directors, should act with integrity, and bring independence of thought and judgment to their role. The board should not be dominated by a powerful chief executive and/or chairman. It is therefore important that the board should have a suitable balance, and consist of individuals with a range of backgrounds and experience;

- **Financial reporting, narrative reporting and auditing**. The board should be properly accountable to its shareholders, and should be open and transparent with investors generally. To make a board properly accountable, high standards of financial reporting (and narrative reporting) and external auditing must be upheld. The major 'scandals' of corporate governance in the past have been characterised by misleading financial information in the company's accounts – in the UK, for example, Maxwell Communications Corporation and Polly Peck International, more recently in Enron and WorldCom in the US and Parmalat in Italy. Enron filed for bankruptcy in 2001 after 'adjusting' its accounts. WorldCom, which collapsed in 2002 admitted to fraud in its accounting and its chief executive officer was subsequently convicted and jailed;

- **Directors' remuneration**. Directors work for a reward. To encourage their commitment to achieving the objectives of their company, they should be given suitable incentives. Linking remuneration to performance is considered essential for successful corporate governance. However, linking directors' pay to performance is complex, and remuneration schemes for directors have not been particularly successful. Directors' pay is an aspect of corporate governance where companies are frequently criticised;

- **Risk management and internal control**. The directors should ensure that their company operates within acceptable levels of risk, and should ensure through a system of internal control that the resources of the company are properly used and its assets are protected; and

- **Shareholders' rights**. Shareholders' rights vary between countries. These rights might be weak, or might not be exercised fully. Another aspect of corporate governance is encouraging the involvement of shareholders in

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the companies in which they invest, through more dialogue with the directors and through greater use of shareholder powers – such as voting powers at general meetings of the company.

Corporate social responsibility and ethical behaviour by companies (**business ethics**) are also issues related to corporate governance.

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All these issues will be explained in more detail in the chapters that follow.

Example: Enron

In 2001, US corporation Enron collapsed unexpectedly. The collapse was blamed to a large extent on poor corporate governance. Failings that occurred in corporate governance included:

False accounting. Executive managers encouraged or allowed incorrect and misleading treatments of transactions in the company's accounts.

The audit committee of the board gave its approval to seriously misleading annual financial statements.

Executives in the company, and professional advisers, profited personally (but secretly) from transactions involving the company.

The board was ineffective in supervising the actions of the company's senior executives.

The board ignored information from 'whistleblowers' about serious problems and dubious transactions.

1.5 Governance issues for other types of organisations

Most of the writing on governance is about corporate governance, i.e. the governance of corporate limited and usually listed companies. This is a very important area as it links to the agency problem (see later) and the need for investors to trust and support the directors that have been appointed as the 'stewards' of their investments. The health of capitalist economic systems including the valuation of securities and the security of long-term shareholder value are all dependent on effective and robust systems of corporate governance.

However, governance issues also apply to other types of organisations. These different types of organisations have different governance issues to profit making companies in private ownership. However, there is an overriding similarity in that in each case the stakeholders will be concerned that the entity is being managed in a way that fulfils its underlying purpose.

Governance in public sector organisations

Public sector organisations are those that are directly controlled by one or more parts of the state and exist to implement specified tasks which serve government policy, for example, in areas like health care, education and defence.

The size of the public sector varies in different countries. In some countries government might retain control of industries which the government deems to be

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of key national interest. Of course governments view on this might change leading to the privatisation of formerly government owned entities. This would require a valuation of the entity for sale to the investment community. The opposite could also occur with a government deciding that an industry should be taken into government ownership (nationalisation).

Public sector organisations include:

- hospitals;
- schools;
- local government authorities;
- nationalised companies; and
- other non-governmental organisations (NGOs).

The public at large is a key stakeholder in public sector entities. Their focus is likely to be on value for money rather than the achievement of profits. The public is often concerned that public sector organisations are over-bureaucratic and unnecessarily costly.

In the UK, a Good Governance Standard was published by the Independent Commission for Good Governance in Public Service. This sets out six core principles of good corporate governance for public service corporations.

1 'Good governance means focusing on the organisation's purpose and on outcomes for citizens and service users'. This means having a clear understanding of the purpose of the organisation, and making sure that users of the service receive high-quality service and that taxpayers (who pay for the service) get value for money.

2 'Good governance means performing effectively in clearly defined functions and roles'. The governing body of the organisation is comparable to the board of directors in a company. It must be clear about what its responsibilities are, and it should carry these out. The responsibilities of executive management should also be clear, and the governing body is responsible for making sure that management fulfils its responsibilities properly.

3 'Good governance means promoting values for the whole organisation and demonstrating the values of good governance through behaviour'. Integrity and ethical behaviour are therefore seen as core governance issues in public sector entities.

4 'Good governance means taking informed, transparent decisions and managing risk'. Risk management and the responsibility of the governing body for the internal control system is as much a core feature of governance in public sector entities as in companies.

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5 'Good governance means developing the capacity and capability of the governing body to be effective'. This issue is concerned with the composition and balance of the governing body.

6 'Good governance means engaging stakeholders and making accountability real'. In companies, the relationship between shareholders and the board of directors is an important aspect of governance, and companies and shareholders are encouraged to engage in constructive dialogue with each other. In public sector organisations, the constructive dialogue should exist between the governing body and the general public and particular interest groups.

Governance in charities

In many countries there are a large number of charities and voluntary organisations. These organisations exist for certain benevolent purposes. Governments often recognise the benefits that these organisations bring to citizens of the state (and sometimes of other states) by granting tax privileges and reduced reporting requirements. However, the organisations would have to demonstrate that they fulfil some sort of recognised benevolent purpose in order to qualify for the more relaxed regulatory regime.

In the UK the Charities Commission oversees and grants charitable status to organisations. In Nigeria, they are usually referred to as non-governmental organisations (NGO's) or civil society organisations (CSO's) and registered with the Corporate Affairs Commission (CAC), the same body that registers companies.

Stakeholders in a charity would include people who donate funds to the charity and the beneficiaries of the charitable purpose. The main concern for a donor is that funds provided are being used as the charity said they would be. If a person gives ₦100 to a famine relief charity, they would perhaps not have done so if they knew that ₦90 went to pay for the charity's administration and only ₦10 relieved famine!

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2 CONCEPTS OF GOOD GOVERNANCE

Section overview

- Fairness
- Openness/transparency
- Independence
- Honesty and integrity (probity)
- Responsibility and accountability
- Reputation
- Judgment
- Nolan's Seven Principles of Public Life

There are several concepts of good governance. In companies, these concepts should be evident in the relationship between the shareholders and the board of directors. Some of these concepts should also apply to the company's dealings with other stakeholders such as its employees, customers, suppliers and the general public.

The concepts described briefly here might seem 'obvious'. However, it is useful to think about what might happen if these concepts are not applied. In particular, how the absence of these concepts might affect the relationship between the board of directors and the shareholders.

2.1 Fairness

In corporate governance, fairness refers to the principle that all shareholders should receive fair treatment from the directors. At a basic level, it means that all the equity shareholders in a company should be entitled to equal treatment, such as one vote per share at general meetings of the company and the right to the same dividend per share.

In the UK for example, the concept of fair treatment for shareholders is supported by the law (which provides some protection for minority shareholders against unjust treatment by the directors or the majority shareholders). However, in some countries, the law provides little or no protection for minority shareholders. For example, in a takeover bid for a company, the law might permit a higher price to be offered to large shareholders than the price offered to small shareholders.

2.2 Openness/transparency

Openness or transparency means 'not hiding anything'. Intentions should be clear, and information should not be withheld from individuals who ought to have a right to receive it.

Transparency means clarity. In corporate governance, it should refer not only to the ability of the shareholders to see what the directors are trying to achieve. It also refers to the ease with which an 'outsider', such as a potential investor or an employee, can make a meaningful analysis of the company and its intentions. Transparency therefore means providing information about what the company has done, what it intends to do in the future, and what risks it faces.

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In public sector organisations and government, openness means telling the public, and not making decisions 'behind closed doors'.

In listed companies (stock market companies) openness includes matters such as:

- requiring major shareholders to declare the size of their shareholding in the company; and
- requiring the board of directors to announce to the stock market information about any major new developments in the company's affairs, so that all shareholders and other investors are kept informed.

2.3 Independence

Independence means freedom from the influence of someone else. A principle of good corporate governance is that a substantial number of the directors of a company should be independent, which means that they are able to make judgements and give opinions that are in the best interests of the company, without bias or pre-conceived ideas.

Similarly, professional advisers to a company such as external auditors and solicitors should be independent of the company, and should give honest and professional opinions and advice.

The independence of a director is threatened by having a connection to a special interest group. Executive directors can never be independent, because their views will represent the opinions of the management team. Similarly, a retired former executive might still be influenced by the views of management, because he or she shares the 'management culture'. Directors who represent the interests of major shareholders are also incapable of being independent.

The independence of external auditors can be threatened by over-reliance on fee income from a client company. When a firm of auditors, or a regional office of a national firm, earns most of its income from one corporate client there is a risk that the auditors might choose to accept what they are told by the company's management, rather than question them rigorously and risk an argument. It has been suggested that this occurred in the Houston office of Andersen's, the audit firm that collapsed in 2002 as a result of the Enron scandal.

Familiarity can also remove an individual's independence, because when one person knows another well he is more likely to accept what that person tells him and support his point of view. Auditors are at risk of losing their independence if they work on the audit of the same corporate client for too many years.

2.4 Honesty and integrity (probity)

Honesty is an essential quality for directors and their advisers. An individual who is honest, and who is known to be honest, is believed by others and is therefore more likely to be trusted.

However, honesty is not as widespread as it might be. Business leaders, as well as political leaders, may prefer to 'put a spin' on the facts, and manipulate facts for the purpose of presenting a more favourable impression.

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Integrity is similar to honesty, but it also means behaving in accordance with high standards of behaviour and a strict moral or ethical code of conduct. Professional accountants, for example, are expected to act with integrity, by being honest and acting in accordance with their professional code of ethics.

If shareholders in a company suspect that the directors are not acting honestly or with integrity, there can be no trust, and good corporate governance is impossible.

2.5 Responsibility and accountability

The directors of a company are given most of the powers for running the company. Many of these powers are delegated to executive managers, but the directors remain responsible for the way in which those powers are used.

An important role of the board of directors is to monitor the decisions of executive management, and to satisfy themselves that the decisions taken by management are in the best interests of the company and its shareholders.

The board of directors should also retain the responsibility for certain key decisions, such as setting strategic objectives for their company and approving major capital investments.

A board of directors should not ignore their responsibilities by delegating too many powers to executive management, and letting the management team 'get on with the job'. The board should accept its responsibilities.

With responsibility, there should also be accountability. In a company, the board of directors should be accountable to the shareholders. Shareholders should be able to consider reports from the directors about what they have done, and how the company has performed under their stewardship, and give their approval or show their disapproval. Some of the ways in which the board are accountable are as follows:

Presenting the annual report and accounts to the shareholders, for the shareholders to consider and discuss with the board. In Nigeria for example, this happens at the annual general meeting of the company.

If shareholders do not approve of a director, they are able to remove him from office. Individual directors may be required to submit themselves for re-election by the shareholders at regular intervals. In Nigeria for example, it is common practice for directors to be required to retire every three years and stand for re-election at the company's annual general meeting.

In the UK, it is recognised that individual directors should be made accountable for the way in which they have acted as a director. The UK Corporate Governance Code includes a provision that all directors should be subject to an annual performance review, and should be accountable for their performance to the chairman of the company.

It might be argued that a board of directors is not sufficiently accountable to the shareholders, and that there should be much more accountability.

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2.6 Reputation

A large company is known widely by its reputation or character. A reputation may be good or bad. The reputation of a company is based on a combination of several qualities, including commercial success and management competence. However, a company might earn a good reputation with investors, employees, customers and suppliers in other ways. As concerns for the environment have grown, companies have recognised the importance of being ‘environment-friendly’ or ‘eco-friendly’. Reputation is also based on honesty and fair dealing, and on being a good employer.

Investors might be more inclined to buy shares and bonds in a company they respect and trust. Some investment institutions are ‘ethical funds’ that are required to invest only in ‘ethical’ companies.

Employees are more likely to want to work for an employer that treats its employees well and fairly. As a result, companies with a high reputation can often choose better-quality employees, because they have more applicants to choose from.

Consumers are more likely to buy goods or services from a company they respect, and that has a reputation for good quality and fair prices, and for being customer-friendly or environment-friendly.

Companies that are badly governed can be at risk of losing goodwill – from investors, employees and customers.

2.7 Judgment

Directors make judgments in reaching their opinions. All directors are expected to have sound judgment and to be objective in making their judgements (avoiding bias and conflicts of interest). In its principles of corporate governance, for example, the OECD states that: ‘the board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.’

Independent non-executive directors are expected to show judgment that is both sound and independent. Rolls Royce, for example, in an annual report on its corporate governance, stated that: ‘The Board applies a rigorous process in order to satisfy itself that its non-executive directors remain independent. Having undertaken this review in [Year], the Board confirms that all the non-executive directors are considered to be independent in character and judgment.’

2.8 Nolan’s Seven Principles of Public Life

The concepts described above apply to public sector entities and not-for-profit entities, as well as to companies. This is evident in Nolan’s Seven Principles of Public Life. These were issued in the UK by the Nolan Committee on Standards in Public Life, which was set up in 1995 to report on standards of behaviour amongst politicians and in the civil service and other public sector bodies.

The seven principles are as follows:

1 **Selflessness** - Holders of public office should not make decisions that are in their personal self-interest. Their decisions should be based entirely on concern for the public interest;

2 **Integrity** - Holders of public office should not put themselves under any financial obligation or other obligation to another individual or organisation that might influence how they act in the course of carrying out their duties;

3 **Objectivity** - Holders of public office, in awarding contracts or making recommendations, should base their decisions on merit;

4 **Accountability** - Holders of public office are accountable to the public and should submit themselves to public scrutiny;

5 **Openness** - Holders of public office should be as open as possible about the decisions they take and the reasons for those decisions. They should only withhold information when this is in the public interest;

6 **Honesty** - Holders of public office have a duty to declare any conflicts of interest they might have, and should take steps to resolve them whenever they arise; and

7 **Leadership** - Holders of public office should promote and support these principles by setting an example with their own behaviour and giving a lead to others.

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3 STAKEHOLDERS

Section overview

- Stakeholders and their influence on corporate governance
- Categories of stakeholders
- Shareholders and directors
- Other internal stakeholders
- External stakeholders
- Institutional investors

We introduced the concept of stakeholders earlier in chapter 1. Now we re-visit this important topic from a governance perspective.

3.1 Stakeholders and their influence on corporate governance

Every organisation has stakeholders. A stakeholder has been defined (by Freeman 1984) as: 'any group or individual who can affect or [be] affected by the achievement of an organisation's objectives.

An important part of this definition is that a stakeholder may:

- be affected by what the organisation does;
- affect what the organisation does; or
- both be affected by and affect what the organisation does.

Companies have stakeholders. A stakeholder in a company is someone who has a 'stake' in the company and an interest in what the company does.

A company must offer something to all its stakeholders. If a company does not give its stakeholders something of what they want, the stakeholders might cease to have an interest in it.

All stakeholders in a company have some expectations from the company.

If a company wishes to remain associated with its stakeholders, it must do something to satisfy these expectations.

The expectations of different groups of stakeholders are not the same, and they are often inconsistent with each other. One of the objectives of corporate governance should be to provide enough satisfaction for each stakeholder group.

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Stakeholder groups in a company include:

The shareholders of the company: shareholders expect a reasonable return on their investment in the company. They may be able to influence what the company does by exercising their right to vote at general meetings of the company;

The company's employees: employees expect a fair wage or salary, and often expect job security or career prospects. They can affect what the company does either positively (for example by being well-motivated and efficient) or negatively (for example, by going on strike, or demanding higher pay);

The directors and management of a company, who need to satisfy the expectations of both shareholders (for high profits and dividends) and employees (for high salaries). In addition, they have their own self-interests, for example in high remuneration and status;

Customers of the company;

Suppliers of the company;

Trade unions;

Communities in which the company operates;

The government; and

Pressure groups and activist groups, such as environmentalists.

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Claims of stakeholders

Each stakeholder or stakeholder group in a company makes demands of the company and wants the company to do something to satisfy these demands. These demands are known as 'claims'. Shareholders want dividends and a higher share price, employees may want job security and higher pay, customers may want better quality goods at lower prices, and so on.

It is not always possible to identify the claims of a particular group of stakeholders. Certain groups of stakeholders may not know that they have a claim against an organisation; others may know that they have a claim but do not know what it is and do not express it openly. This gives rise to a distinction between direct and indirect stakeholder claims.

Direct stakeholder claims are claims made by stakeholders directly, with their 'own voice'. For example, employees may make a direct claim for higher pay. Shareholders, customers, suppliers and (sometimes) local communities may express direct claims to the company.

Indirect stakeholder claims are claims that are not made directly by a stakeholder or stakeholder group, but are made indirectly on their behalf by someone else. For example:

- A small customer of a very large company is too powerless to make claims in his own name.
- Future generations have a claim on what a company does today, for example if the company's operations are capable of preserving or destroying the environment, future generations will be affected. They are not yet alive and able to express their claims directly, and someone else has to think about their interests for them.
- Terrorist groups may claim to represent the interests of people in their region or country.

A problem with indirect stakeholder claims is that it is not always possible to be sure that the stakeholders are being properly represented and their claims correctly expressed. After all, how can we be sure what future generations will want, or whether a terrorist group really does speak in the interests of a wider community?

Stakeholder influence

A feature of corporate governance or strategic analysis in any company is the balance of power between the stakeholder groups and the relative power and influence of each group.

The **Mendelow framework** can be used to understand the influence that each stakeholder group has over a company's strategies and actions. The framework identifies two factors that make up the strength of a stakeholder's influence over a company's strategy, actions or decisions:

the power the stakeholder is capable of exercising; and

the interest that the stakeholder has in the particular issue, and how much the stakeholder cares about it.

Influence over a strategy or action comes from a combination of power and interest:

Influence = Power × Interest

The Mendelow framework can be presented as a 2 × 2 matrix. Each stakeholder group can be placed in one section of the matrix, and the company's strategy for dealing with each particular group will depend on where it is positioned in the matrix.

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Mendelow framework

	Interest: Low	Interest: High
Power: Low	Minimal effort	Keep informed
Power: High	Keep satisfied	Key players

If stakeholders have little power and a low interest in a matter, a company can largely ignore them. (However the Mendelow framework does not consider ethical issues and whether it would be ethically appropriate to ignore the stakeholder group).

Stakeholders with the highest amount of power and interest are the key players, whose influence will be of some significance in making strategic decisions. If there is just one stakeholder group in this section of the matrix – for example the company's senior management – there should be no problem. Difficulties can arise when there are two or more stakeholder groups in this section and they have differing interests and objectives.

Stakeholders with high interest but low power may try to increase their power by entering into a coalition with one or more other stakeholders. However as long as the group remains in the 'high interest, low power' section of the matrix a company can limit its treatment of the group to keeping it informed about what is happening, but the company's decision-making will not be affected by the group's objectives.

Stakeholders with a lot of power but only limited interest in a matter should be 'kept satisfied' so that they do not exercise their power to affect the company's strategic decision-making. For a large company, the government may be such a stakeholder.

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3.2 Categories of stakeholders

Various writers have identified different ways of categorising stakeholders.

Narrow and wide stakeholders

Evans and Freeman made a distinction between narrow and wide stakeholders.

Narrow stakeholders are those that are the most affected by the actions and decisions of the organisation. Narrow stakeholder groups for a company usually include shareholders, directors, other management, employees, suppliers and those customers who depend on the goods produced by the company.

Wide stakeholders are those groups that are less dependent on the organisation. Wide stakeholders for a company may include customers who are not particularly dependent on the company's goods or services, the government and the wider community (as distinct from local communities in which the company operates, which may be narrow stakeholders).

Evans and Freeman suggested that a company has much more responsibility and accountability to narrow stakeholders than to wide stakeholders.

Primary and secondary stakeholders

Clarkson made a distinction between primary and secondary stakeholders.

A primary stakeholder group for a company is a group that is essential for the continuation of the company as a going concern. Customers, suppliers and employees may be primary stakeholders.

Secondary stakeholders are those that the organisation does not directly rely on for its continued survival, at least in the short term.

According to Clarkson, primary stakeholders have strong influence over a company's decisions and actions.

Active and passive stakeholders

Mahoney (1994) made a distinction between active and passive stakeholders.

Active stakeholders are those that seek to get involved in the company's activities and decisions. These stakeholders may be a part of the company's normal decision-making and operating processes, such as management and employees. Other active stakeholders who are external to the company may include, for example government regulators or environmental pressure groups.

Passive stakeholders are those stakeholders who do not usually try to get involved with a company's policy-making. They may have a strong interest in what the company does, but they do not want to get actively involved in the decision-making. The government and local communities may be examples of passive stakeholders.

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Voluntary and involuntary stakeholders

A distinction can also be made between voluntary and involuntary stakeholders.

A voluntary stakeholder is someone who becomes a stakeholder voluntarily. They include employees (who could move to a job with a different employer), customers (who could buy goods from another company) and shareholders (who could sell their shares).

Involuntary stakeholders are those who do not choose to be stakeholders but have no choice. These include local communities, stakeholders who suffer from the effect of the company's operations on the environment, and future generations. Most competitors are also involuntary stakeholders.

Legitimate and illegitimate stakeholders

Another distinction is between legitimate and illegitimate stakeholders.

Legitimate stakeholders are those with a 'right' to make a claim on the company (a 'legitimate' claim).

Illegitimate stakeholders are those that do not have such a 'right'.

Deciding whether stakeholders have legitimate or illegitimate claims on a company may depend on a person's viewpoint and the distinction is therefore to some extent a matter of judgement. Examples of illegitimate stakeholders may be certain lobby groups or pressure groups (for example, animal rights activists) or charity organisations. In some countries, rebel groups or terrorists may be illegitimate stakeholders with considerable influence over a company's activities.

The main issue with this categorisation is whether a company should acknowledge the claims of a stakeholder group (if it is legitimate') or whether it should ignore them or oppose them (if the group is illegitimate).

Known and unknown stakeholders

A distinction can also be made between known and unknown stakeholders.

Known stakeholders are those that the company knows about.

Unknown stakeholders are those whose existence the company is not aware of.

This distinction may be relevant when a company has operations that affect the environment, or is planning new activities that will have an environmental impact. The company will not necessarily be aware of all the stakeholders that will be affected by its activities – for example animals, insects, sea creatures.

It may be argued that before implementing any new business strategy a company should carry out a thorough investigation in order to identify unknown stakeholders and consider the impact of its strategy on them.

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Internal and external stakeholders

A widely-used distinction is between internal and external stakeholders.

Internal stakeholders of a company are inside the company and a part of it.

External stakeholders are outside the company and are not a part of it.

Two insider stakeholder groups in a company are the equity shareholders and the directors.

3.3 Shareholders and directors

The main stakeholder groups in a company are usually the shareholders and the directors of the company. The shareholders own the company and the directors are its leaders.

The shareholders

The influence of shareholders over their company varies with circumstances.

In a small company the shareholders and directors might be the same individuals.

In some companies, there may be a majority shareholder (controlling shareholder). A majority shareholder should be able to influence the decisions of the board of directors, because he has the power to remove directors who disagree with him.

In quoted companies (stock market companies) the interests of shareholders are likely to be focused on the value of their shares and the size of dividends. However, the shareholders might have little influence over the decisions of the board of directors.

The directors

The board of directors is a significant stakeholder group in a company because they have the power to direct the company. Directors act as agents for the company and represent the interests of the company.

A board of directors consists of both **executive and non-executive directors**. Executive directors have executive responsibilities as managers in the company, in addition to their roles as director. They are usually full-time employees of the company. Non-executives are not involved in executive management and are very much 'part time' and in many countries (for example, Nigeria, the UK and US) they are not company employees. Since executive directors combine their role as director with their full-time job as company employee, their interests are likely to differ from those of the non-executive directors.

On the board of directors, some individuals might have considerably more influence than others. Typically, the most influential members of the board are

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the **company chairman** (board chairman) and the managing director (often called the **chief executive officer** or CEO).

The board of directors take many decisions as a group, but they also have individual interests in the company. Directors are therefore stakeholders in their company both as a unit and as separate individuals.

3.4 Other internal stakeholders

Employees can be an important internal stakeholder group. It might be possible to divide employees into sub-groups, each with a different set of interests and expectations, and each with a different amount of influence over the actions of the company.

It might be appropriate to separate **senior management** and **other employees** into two separate stakeholder groups. Senior management might have a bigger interest in the profits and share price of the company because they belong to a share incentive scheme or share option scheme, or because they receive annual bonus payments based on the company's profitability. Other employees who do not have such incentives will have much less interest in the financial performance of the company or its share price.

Some employees might be able to demand large rewards from the company or might exercise strong influence because of their value to the company. For example, in the UK some individual investment bankers have a strong influence within their bank because of the specialist skills they possess and the income they are able to earn for the bank.

In some companies, there might be a strong **trade union influence**. The ability of a company to alter its working practices, for example, may depend on obtaining the co-operation and support of the trade unions.

3.5 External stakeholders

A company has external stakeholders as well as internal stakeholders. External stakeholders are individuals or groups who do not work for the company but who nevertheless have an interest in what the company does and who might be able to influence the way in which the company is governed.

Lenders have an interest in a company to which they lend money. They expect to be paid what they are owed. Usually a lender will not be closely involved in the governance or management of a company, but they will monitor its financial performance and financial position. Lenders will also become significant stakeholders if the company gets into financial difficulties and is faced with the risk of insolvency.

Suppliers have an interest in companies who are their major customers, although their influence over its governance might be small.

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Regulators have an interest in companies whose activities they are required to regulate. Some aspects of regulation have a major impact on the way in which a company is governed. For example, quoted companies must comply with the rules set by the securities regulator (such as the Securities Exchange Commission in Nigeria and the US, and the Financial Conduct Authority in the UK).

Government has a stake in companies. Companies are a source of tax revenue and also collect tax (income taxes and sales taxes) for the government from employees and customers. For some companies, such as companies that manufacture defence equipment, the government might have an influence as a major customer for the goods that the company produces.

Customers, the general public or special interest groups might have a significant influence over a company, especially a company that relies for success on the high reputation of its products or services.

Stock exchanges have an influence over the governance of quoted companies, because companies must comply with the rules of the stock exchange on which their shares are traded.

A company's **auditors** should also have some influence over the governance of a company, by making sure that the board of directors presents financial statements to the shareholders that present a true and fair view of the company's financial position and performance.

Investors are a major influence over companies whose shares are traded on a stock exchange. Investors decide what the market price of a company's shares should be. A company needs to satisfy the expectations not only of its shareholders, but of the investing community in general, if it wishes to sustain or increase the share price (and so the total value of the company).

3.6 Institutional investors

Institutional investors are entities that specialise in investing, mainly in shares and bonds. There are several types of institutional investor.

Pension funds - These institutions hold funds that will be used to provide pensions to individuals after their retirement. Pension funds may be sponsored by an employer, or may be private pension schemes of individuals. Until the money is needed to pay a pension, it is invested to earn a return.

Insurance companies - The funds of insurance companies come from insurance policy premiums and life assurance premiums. Until the money is needed for payment to the insurance policy holders, it is invested.

Mutual funds - Mutual funds are funds of many individual investors, who invest relatively small amounts of money in the fund. The investments of the many different individuals are combined and invested collectively. In the UK for

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example, the main types of mutual funds are unit trusts and Open-Ended Investment Companies or OEICs.

Institutional investors are significant stakeholders on companies, in any country where they invest large funds. They are particularly influential in the US and UK.

Individually, an institutional investor might hold only a small proportion of the shares in a large public company. However, by joining together and speaking collectively, a group of institutional investors might be able to have some influence over the decisions of a company's board of directors.

Most institutional investors belong to a 'trade association'. In the UK, for example, most pension funds are members of the Pensions and Lifetime Savings Association (PLSA) and most insurance companies are members of the Association of British Insurers (ABI). Each of these trade associations give information and advice to their members about corporate governance matters, and might recommend how they should vote on certain issues at the general meetings of companies. Collectively, bodies such as the PLSA and ABI (and their members) can have a major influence on companies because of the significance of their members as investors and shareholders.

In the UK for example, the influence of institutional investors has been significant in persuading listed companies to adopt (most of) the provisions of the UK Corporate Governance Code. Their role in promoting good corporate governance has therefore been critically important.

The institutional shareholder bodies have issued guidelines on corporate governance to their members, which they encourage their members to apply.

There is a UK Stewardship Code for institutional investors, published to complement the UK Corporate Governance Code to encourage them to engage proactively in the corporate governance of companies in which they hold investments on behalf of others.

The institutional shareholder bodies issue regular advice to members on how they should consider voting on certain issues at general meetings of particular companies. For example, the PLSA or ABI might recommend to their members that they should vote against the re-election of a particular director, or should vote against the directors' remuneration report, or against a proposed takeover bid.

Corporate governance and investor confidence

Institutional investors are also important because their views are a good reflection of investor confidence in the stock market. Bad corporate governance could eventually damage the confidence of investors and make them much less willing to invest in shares. This in turn will keep share prices – and company values – down, and will make it difficult for companies to raise fresh capital in the financial markets when they need it.

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Arthur Levitt, a former chairman of the US Securities and Exchange Commission, made the following comments at the time of the Enron collapse (and a heavy fall in stock market prices generally in the US): 'If a country does not have a reputation for strong corporate governance practice, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country, regardless of how steadfast a particular company's practices, may suffer the consequences…. Markets exist by the grace of investors and it is today's more empowered investors who will determine which companies and which markets will stand the test of time and endure the weight of greater competition. It serves us well to remember that no market has a divine right to investors' capital.'

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4 AGENCY THEORY

Section overview

- The law of agency
- Concepts in agency theory: the agency relationship
- Agency conflicts
- Agency costs
- Reducing the agency problem
- Accountability of agents
- Ethics and agency theory
- Agency conflicts in other types of organisation
- Agency relationships – summary

4.1 The law of agency

An agent is a person who acts on behalf of another person, the principal, in dealing with other people. For example, a selling agent acts on behalf of a principal, a manufacturer of goods, to sell goods on the manufacturer's behalf. Similarly, a stock broker is an agent who acts on behalf of a client (the principal) to buy or sell shares on the client's behalf. The agent acts in the name of the principal, and commits the principal to agreements and transactions.

In company law, the directors act as agents of the company. The board of directors as a whole, and individual directors, have the authority to bind the company to contractual agreements with other parties.

Since most of the powers to act on behalf of the company are given to the board of directors, the directors (and the management of a company) have extensive powers in deciding what the company should do, what its objectives should be, what its business strategies should be, how it should invest and what its targets for performance should be.

The powerful position of the directors raises questions about the use of this power, especially where the owners of the company (its shareholders) and the directors are different individuals.

How can the owners of the company make sure that the directors are acting in the best interests of the shareholders?

If the directors act in ways that the shareholders do not agree with, what can the shareholders do to make the directors act differently?

Fiduciary duty of directors

As agents of the company, directors have a fiduciary duty to the company. A fiduciary duty is a duty of trust. A director must act on behalf of the company in total good faith, and must not put his personal interests before the interests of the company.

If a director is in breach of this fiduciary duty he could be held liable in law, if the company were to take legal action against him. Legal action by a company against a director for breach of fiduciary duty would normally be taken by the rest of the board of directors or, possibly, a majority of the shareholders acting in the name of the company.

Agency law and challenging the actions of directors

In practice, it is very difficult for shareholders to use the law to challenge the decisions and actions of the company's directors. If shareholders believe that the directors are not acting in the best interests of the company, their ability to do something about the problem is restricted.

The shareholders can vote to remove any director from office, but this requires a majority vote by the shareholders, which might be difficult to obtain.

In a court of law, shareholders would have to demonstrate that the directors were actually acting against the interests of the company, or against the clear interests of particular shareholders, in order to persuade the court to take legal measures against the directors.

In summary, although there is a legal relationship between the board of directors and their company, the shareholders cannot easily use the law to control the decisions or actions that the directors take on behalf of the company.

4.2 Concepts in agency theory: the agency relationship

Whereas agency law deals with the legal relationship between a company and its directors, the theory of agency deals with the relationship between:

a company's owners; and

its managers (directors).

Agency theory is based on the idea that when a company is first established, its owners are usually also its managers. As a company grows, the owners appoint managers to run the company. The owners expect the managers to run the company in the best interests of the owners; therefore a form of agency relationship exists between the owners and the managers.

Many companies borrow, and a significant proportion of the long-term capital of a company might come from various sources of debt capital, such as bank loans, lease finance and bond issues (debentures, loan stock and so on). Major lenders also have an interest in how the company is managed, because they want to be sure that the company will be able to repay the debt with interest.

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The agency relationship

Agency theory was developed by **Jensen and Meckling** (1976). They suggested a theory of how the governance of a company is based on the conflicts of interest between the company's owners (shareholders), its managers and major providers of debt finance.

Each of these groups has different interests and objectives.

The **shareholders** want to increase their income and wealth. Their interest is with the returns that the company will provide in the form of dividends, and also in the value of their shares. The value of their shares depends on the long-term financial prospects for the company. Shareholders are therefore concerned about dividends, but they are even more concerned about long-term profitability and financial prospects, because these affect the value of their shares.

The **managers** are employed to run the company on behalf of the shareholders. However, if the managers do not own shares in the company, they have no direct interest in future returns for shareholders, or in the value of the shares. Managers have an employment contract and earn a salary. Unless they own shares, or unless their remuneration is linked to profits or share values, their main interests are likely to be the size of their remuneration package and their status as company managers.

The **major** providers of debt have an interest in sound financial management by the company's managers, so that the company will be able to pay its debts in full and on time.

Jensen and Meckling defined the agency relationship as a form of contract between a company's owners and its managers, where the owners (as principal) appoint an agent (the managers) to manage the company on their behalf. As a part of this arrangement, the owners must delegate decision-making authority to the management.

The owners expect the agents to act in the best interests of the owners. Ideally, the 'contract' between the owners and the managers should ensure that the managers always act in the best interests of the owners. However, it is impossible to arrange the 'perfect contract', because decisions by the managers (agents) affect their own personal welfare as well as the interests of the owners.

This raises a fundamental question. How can managers, as agents of their company, be induced or persuaded to act in the best interests of the shareholders?

4.3 Agency conflicts

Agency conflicts are differences in the interests of a company's owners and managers. They arise in several ways.

Moral hazard - A manager has an interest in receiving benefits from his or her position as a manager. These include all the benefits that come from status, such

as a company car, a private chauffeur, use of a company airplane, lunches, attendance at sponsored sporting events, and so on. Jensen and Meckling suggested that a manager's incentive to obtain these benefits is higher when he has no shares, or only a few shares, in the company. The biggest problem is in large companies.

Effort level - Managers may work less hard than they would if they were the owners of the company. The effect of this 'lack of effort' could be lower profits and a lower share price. The problem will exist in a large company at middle levels of management as well as at senior management level. The interests of middle managers and the interests of senior managers might well be different, especially if senior management are given pay incentives to achieve higher profits, but the middle managers are not.

Earnings retention - The remuneration of directors and senior managers is often related to the size of the company, rather than its profits. This gives managers an incentive to grow the company, and increase its sales turnover and assets, rather than to increase the returns to the company's shareholders. Management are more likely to want to re-invest profits in order to make the company bigger, rather than pay out the profits as dividends. When this happens, companies might invest in capital investment projects where the expected profitability is quite small, and the net present value might be negative.

Risk aversion - Executive directors and senior managers usually earn most of their income from the company they work for. They are therefore interested in the stability of the company, because this will protect their job and their future income. This means that management might be risk-averse, and reluctant to invest in higher-risk projects. In contrast, shareholders might want a company to take bigger risks, if the expected returns are sufficiently high. Shareholders often invest in a portfolio of different companies; therefore it matters less to them if an individual company takes risks.

Time horizon - Shareholders are concerned about the long-term financial prospects of their company, because the value of their shares depends on expectations for the long-term future. In contrast, managers might only be interested in the short-term. This is partly because they might receive annual bonuses based on short-term performance, and partly because they might not expect to be with the company for more than a few years. Managers might therefore have an incentive to increase accounting return on capital employed (or return on investment), whereas shareholders have a greater interest in long-term value as measured by net present value.

4.4 Agency costs

Agency costs are the costs of having an agent to make decisions on behalf of a principal. Applying this to corporate governance, agency costs are the costs that the shareholders incur by having managers to run the company instead of running the company themselves.

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Agency costs do not exist when the owners and the managers are exactly the same individuals.

Agency costs start to arise as soon as some of the shareholders are not also directors of the company.

Agency costs are potentially very high in large companies, where there are many different shareholders and a large professional management.

Agency costs can therefore be defined as the 'value loss' to shareholders that arises from the divergence of interests between the shareholders and the company's management.

There are three aspects to agency costs:

They include the **costs of monitoring**. The owners of a company can establish systems for monitoring the actions and performance of management, to try to ensure that management are acting in their best interests. An example of monitoring is the requirement for the directors to present an annual report and accounts to the shareholders, setting out the financial performance and financial position of the company. These accounts are audited, and the auditors present a report to the shareholders. Preparing accounts and having them audited has a cost;

Agency costs also include the costs to the shareholder that arise when the managers take decisions that are not in the best interests of the shareholders (but are in the interests of the managers themselves). For example, agency costs arise when a company's directors decide to acquire a new subsidiary, and pay more for the acquisition than it is worth. The managers would gain personally from the enhanced status of managing a larger group of companies. The cost to the shareholders comes from the fall in share price that would result from paying too much for the acquisition; and

The third aspect of agency costs is costs that might be incurred to provide incentives to managers to act in the best interests of the shareholders. These are sometimes called **bonding costs**. These costs are intended to reduce the size of the agency problem. Directors and other senior managers might be given incentives in the form of free shares in the company, or share options. In addition, directors and senior managers might be paid cash bonuses if the company achieves certain specified financial targets. The remuneration packages for directors and senior managers are therefore an important element of agency costs.

Agency costs: summary

Agency costs can be summarised as follows:

Monitoring costs	Costs of measuring, observing and controlling the behaviour of management. Some costs are imposed by law (annual accounts, annual audit) and some arise from compliance with codes of corporate governance.

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+ Bonding costs	Costs of arrangements that help to align the interests of the shareholders and managers.
+ Residual loss	Losses occur for the owners, such as the losses arising from a lower share price, because the managers take decisions and actions that are not in the best interests of the shareholders. Monitoring costs and bonding costs will not prevent some residual loss from occurring.

4.5 Reducing the agency problem

Jensen and Meckling argued that when they act in the interest of the shareholders, managers bear the entire cost of failing to pursue goals that are in their own best interests, but gain only a few of the benefits. Incentives should therefore be provided to management to increase their willingness to take 'value-maximising decisions' – in other words, to take decisions that benefit the shareholders by maximising the value of their shares.

Several methods of reducing the agency problem have been suggested. These include:

Devising a remuneration package for executive directors and senior managers, that give them an incentive to act in the best interests of the shareholders. Remuneration packages may therefore provide rewards for achieving a mixture of both long-term and short-term financial targets and non-financial targets;

Having a large proportion of debt on the long-term capital structure of the company; and

Having a board of directors that will monitor the decisions taken for the company by its executive management.

In addition, agents (management) should be held **accountable** to the principal (shareholders).

Providers of debt

Jensen and Meckling argued that the problems of the agency relationship are bigger in companies that are profitable but have low growth in profits. These companies generate a large amount of free cash flow.

Free cash flow is cash that can be spent at the discretion of management, and does not have to be spent on essential items such a payment of debt interest, taxation and the replacement of ageing non-current assets.

It is in the interest of shareholders that free cash flow should be either:

invested in projects that will earn a high return (a positive net present value); or

paid to the shareholders as dividends.

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The directors and other senior managers of a company might want to invest free cash flow in projects that will increase the size of the company. These could be projects that will earn a high return. In a low-growth company, however, it is likely that managers will want to invest in projects that increase the size of the company but are only marginally profitable and would have a negative net present value.

One way of reducing this problem would be to have a high proportion of debt capital in the capital structure of the company. Interest must be paid on debt, and this reduces the free cash flow. Management must also ensure that new investments are sufficiently profitable so that the company can continue to pay the interest costs on its debt capital.

The board of directors

A different method of reducing the agency problem is to make the board of directors more effective at monitoring the decisions of the executive management.

A board will be ineffective at monitoring the decisions of management if it is dominated by the chief executive officer (CEO). This is because the CEO is the head of the executive management team. The board would be especially ineffective in a monitoring role if the CEO is also the chairman of the board.

Fama and Jensen (1983) argued that an effective board must consist largely of **independent non-executive directors**. Independent non-executive directors have no executive role in the company and are not full-time employees. They are able to act in the best interests of the shareholders.

Independent non-executive directors should also take the decisions where there is (or could be) a conflict of interest between executive directors and the best interests of the company. For example, non-executive directors should be responsible for the remuneration packages for executive directors and other senior managers.

Jensen (1993) also argued that the board of directors becomes less effective as it grows in size. This is because a large board is often slow to react to events and will often be incapable of taking action quickly when it is needed. The directors on a large board are also less likely to be critical of each other than directors on small boards.

These ideas for reducing the agency problem are contained in codes of corporate governance, and will be considered in more detail in later chapters.

4.6 Accountability of agents

Agents should be accountable to their principal for their decisions and actions. Accountability means:

Having to report back to the principal and give an account of what has been achieved;

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Having to answer questions from the principal about performance and achievements; and

The principal having power to reward or punish an agent for good or bad performance.

Greater accountability should reduce the agency problem, because it provides management with a greater incentive (obtaining rewards or avoiding punishments) to achieve performance levels that are in the best interests of the shareholders.

However, the costs of accountability (which are monitoring costs) should not be excessive and should not exceed the value of the benefits that the monitoring provides.

Accountability and the source of authority in an entity

Accountability also determines where the centre of authority lies within an entity. Day and Klein (1987) made the following comment about accountability in public services, but the same principle applies to companies: 'The ability to call people to account defines the [centre] of authority in any given society…. But the notion of the **right** to call people to account needs to be complemented by the notion of power in the **ability** to call people to account.'

The accountability of management depends on both the right of the shareholders to call the directors to account, but also on their ability to do so.

4.7 Ethics and agency theory

Agency theory may be summarised as follows:

- In many companies there is a separation of ownership from control. Professional managers are appointed to act as agents for the owners of the company;
- Individuals are driven by self-interest;
- Conflicts of self-interest arise between shareholders and managers;
- Managers, because they are driven by self-interest, cannot be relied on to act in the best interests of the shareholders. This creates problems in the agency relationship between shareholders and management;
- These agency problems create costs for the shareholders. The aim should be to minimise these costs, by improving the monitoring of management and/or providing management with incentives that bring their interests closer to those of the shareholders; and
- Concepts of agency theory are now applied in various codes of corporate governance, in many different countries.

'In brief, agency theory suggests that the prime role of the board is to ensure that executive behaviour is aligned with the interests of the shareholder-owners. Otherwise, self-interested managers will use their superior information to line their own pockets. This is the justification for the separation of the chairman and CEO roles, huge senior executive salaries and the over-riding requirement for

[independence of non-executive directors], and much more' (Simon Caulkin, The Observer, 27 November 2005).

There is an ethical aspect to agency theory. The theory is based on the view that individuals cannot be trusted to act in any way that is not in their own best interests.

4.8 Agency conflicts in other types of organisation

Agency relationship – Public sector

Managers are also agents acting for principals in public sector organisations so once again there is potential for agency conflicts.

The principals in this relationship are the taxpayer and the electorate (often one and the same) and are likely to be concerned with value for money. There are problems associated with making an assessment of whether an organisation is indeed providing value for money:

The principals are a heterogeneous group consisting of a large number of individuals. The group might not agree what actually constitutes value for money or even if the service is required at all. The government must make political decisions as to how public money should be spent in a way that they believe is best for the country. Citizens in a democracy then have an opportunity to vote against a government if they are unsatisfied with its performance in making these decisions.

Another problem in the governance of public sector organisations is how to establish strategic objectives and then monitor the success of the public sector organisation in achieving these.

It is normal in most countries to have a limited audit of public sector organisations to ensure the integrity and transparency of their financial transactions, but this does not always extend to an audit of its performance or 'fitness for purpose'.

Agency relationship - Charities

Managers are also agents acting for principals in charities so once again there is potential for agency conflicts.

Charities often raise money by securing donations from the public. This means that donors are key principals. An important governance issue is whether donations are used for the intended purpose and not wasted, misdirected or embezzled?

Ways to reduce the agency problem include:

A requirement for the charity to be run by a board of directors overseen by a committee of trustees (sometimes called governors). In this case, the board manages the charity and the trustees act as a control on the board to ensure that the board is delivering value to the donors and are acting towards the stated and agreed benevolent aims;

Open and complete financial disclosure; and

Requirement for audits both financial and of effectiveness in achieving the charitable purpose.

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4.9 Agency relationships – summary

	Public listed companies	Public sector	Charities and voluntary organisations
Purpose	Maximisation of shareholder wealth	Implementation of government policy	Achievement of benevolent purpose
Agents	Directors	Managers and sometimes elected representatives.	Directors and managers
Principals	Shareholders	Taxpayers and voters (in a democracy)	Donors and other supporters Service users
Typical governance arrangements	Board of directors monitored by non-executive directors Non-executive chairman.	Complex structures which try to achieve the best way to deliver services.	Executive board accountable to independent trustees.

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5 OTHER THEORIES OF CORPORATE GOVERNANCE

Section overview

- Transaction cost theory
- Stewardship theory
- Resource dependency theory
- Managerial hegemony theory and class hegemony theory
- Psychological and organisational perspective theory
- Stakeholder theory
- System theory

The agency theory of corporate governance is based on the view that the directors of a company are the agents of the company's owners, the shareholders. Since the directors as agents do not have the same attitude as their principals, the shareholders, some measures are necessary to ensure that governance is effective in protecting shareholders' interests.

This involves measures to:

- Monitor directors and apply some control over them; this can be achieved by requiring directors to report on company performance and for external auditors to confirm that their reporting is accurate; and
- Encouraging directors to act in the best interests of shareholders by offering them rewards, such as bonus incentive schemes for achieving or exceeding target levels for profit or return on shareholder capital and open and complete financial disclosure.

Other theories of corporate governance, or ways of looking at corporate governance, have been developed from agency theory.

5.1 Transaction cost theory

Transaction cost theory attempts to explain companies not just as 'economic units', but as organisations consisting of people with differing views and objectives. A large part of the theory is concerned with what makes an organisation grow to the size that it achieves: how many operations does it undertake 'in house' and how much does it buy in from external suppliers.

Logically, a firm's decision about whether to arrange transactions in the open market or whether to do the work 'in-house' (itself) depends on which is cheaper.

When a firm does work 'in-house', it needs a management structure and a hierarchy of authority. Senior management are at the top of this hierarchy. According to the theory of transaction cost economics, the structure of a firm and the relationship between the owners of a firm and its management depends on the extent to which transactions are performed internally.

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From a governance perspective, traditional economic theory is based on the assumption that all behaviour is rational, and that profit maximisation is the rational objective of all businesses. Transaction cost economics changes these assumptions, by trying to allow for human behaviour, and the fact that individuals do not always act rationally. Transaction cost theory is based on two assumptions about behaviour:

- Bounded rationality: humans act rationally, but only within certain limits of understanding. This means for example that the managers of a company will in theory act rationally in seeking to maximise the value of the company for its shareholders, but their 'bounded rationality' might make them act differently. There are limits to rational thinking; and

- Opportunism: individuals act in a self-interested way, and 'with guile'. In other words, people will not always be honest and truthful about their intentions and will sometimes be opportunistic. Opportunism is 'an effort to realise individual gains through a lack of candour or honesty in transactions.' An individual might try to take advantage of an opportunity to gain a benefit at the expense of someone else.

This self-interest needs to be controlled. When managers act in their own interests, they act against the interests of the shareholders. For example, managers will often try to increase the size of their company, even though this is not in the best interests of the shareholders, because they benefit personally from growth in the size of the company.

5.2 Stewardship theory

In the stewardship theory of corporate governance, it is recognised that the directors of a company have a stewardship role. They look after the assets of the company and manage them on behalf of the shareholders.

As stewards of the company and as agents for the shareholders, the board of directors should be accountable to the shareholders. In order for the directors to show their accountability to the shareholders, it is a general principle of company law that the directors are required to prepare annual financial statements, which are presented to the shareholders for their approval.

5.3 Resource dependency theory

Resource dependency theory looks at how the resources of an organisation affect its governance and behaviour. The basic argument of resource dependence theory can be summarised as follows:

- Organisations depend on resources (such as materials, labour and capital), many of which are under the control of other organisations;

- Resources are a basis of power;

- Legally independent organisations may therefore depend on other organisations for the resources they need; and

- Power and dependence on resources are directly linked.

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Within organisations, the personal success of managers is tied to customer demand. Managers are seen to succeed when demand grows, which means that customers are the ultimate resource on which companies depend.

5.4 Managerial hegemony theory and class hegemony theory

Class hegemony theory is a Marxist-based theory that considers the business elite (the 'upper class') as a group of individuals who control the governance of companies to perpetuate their power base.

Managerial hegemony theory is similar to class hegemony theory in that the system of governance under the board of directors is seen as the tool of management. It argues that the real power in corporate governance lies with management and that they can take advantage of shareholder weakness to pursue their self-interest.

5.5 Psychological and organisational perspective theory

A number of behavioural and psychological theories of corporate governance have also been developed. A psychological theory approach takes the view that governance depends largely on informal structures and behaviours within an organisation. Decisions by a board of directors and the performance of the board are influenced by inter-personal tactics and relationships. Outcomes are often the result of a bargaining process between interested parties.

An organisational perspective theory is based on the view that the performance of the board of directors, company ownership and remuneration and other incentives for executives may differ according to the legal system and institutional characteristics in a specific country.

5.6 Stakeholder theory

The stakeholder theory of corporate governance is that governance depends on the inter-relationships and relative strength of the different stakeholders of a company. Stakeholder theory is explained in a previous section.

5.7 System theory

A system theory approach to governance considers a company as an overall system, consisting of inter-linked sub-systems. Governance depends on how these sub-systems (and sub-sub-systems etc) interlink with each other.

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6 GOVERNANCE AND IT

Section overview

- Functional scope of governance
- Delegation
- Governance and IT

6.1 Functional scope of governance

The scope of a system of governance must incorporate all of a business's functions and operations such as:

Finance;

Operations;

Marketing and sales;

Administration;

Human resources management;

Information technology and information systems;

Risk systems and internal controls;

Strategy;

Compliance with laws and regulations;

Financial reporting; and

Policies and procedures.

6.2 Delegation

Whilst directors cannot delegate their governance accountability what happens in practice is that they delegate responsibility for management tasks in order to fulfil their governance duties.

This is achieved through employing senior managers who look after the day to day running of departments and functions and report back frequently to the board through the performance management and information system.

6.3 IT governance

The responsibility of the board of directors for governance should include IT governance. The board's responsibilities for IT include strategic planning for IT and the use of IT systems and development of digital technology within the company. However, the main areas of IT governance (as distinct from IT strategy and strategic management of IT) are with respect to information technology the directors' duties include ensuring that:

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- adequate information technology and information systems are in place to enable the organisation to achieve its objectives;
- adequate funding is available to support the IT and IS capabilities;
- an IT/IS strategy is in place that aligns with the organisation's overall goals, mission and objectives;
- A robust system of internal controls is in place to prevent or detect and correct errors in the systems; and
- IT assets (both tangible and intangible) and data are safeguarded.

Specific aspects of IT governance include:

- Personal data protection;
- Cyber risk; and
- Controls over IT.

Personal data protection

Personal data protection is concerned with the right of private citizens to have personal data about them kept private, and to prevent companies and other organisations exploiting personal data for their commercial advantage, for example through the use of targeted advertising.

The Nigerian Constitution includes a provision for the rights of citizens to privacy, and the National Information Technology Development Agency (NITDA) Act 2019 provides for data protection in Nigeria. NITDA employs the Nigerian Data Protection Regulation (NDPR) and engages the services of data protection compliance organisation (DPCO's) to ensure protection of personal data in Nigeria, as international concern is growing about the exploitation of personal data by companies such as Facebook and Google. In Europe, a General Data Protection Regulation (GDPR) came into force in 2018, aimed at preventing unauthorised storing and use of personal data by organisations.

From an IT governance perspective, a board of directors should consider their company's policy on data protection, and satisfy themselves that the private data of customers (and other individuals) is suitably protected.

Cyber risk

Cyber risk is associated mainly with illegal 'hacking' into IT systems by criminals, with a view to stealing data or disrupting the IT system so that it does not function properly. However, cyber risk also comes from the possibility that disgruntled employees will deliberately steal information or disrupt an IT system, for example by introducing a virus.

The board of directors is responsible for ensuring that, as far as possible, their company's IT systems have adequate controls to prevent cyber-attacks and, where these occur, to detect them and correct them as quickly as possible.

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IT controls

The board of directors has overall responsibility for the effectiveness of internal controls. This includes IT controls – controls over IT operations and procedures, and controls within IT systems and software. The responsibility of a board under the Nigerian Code of Corporate Governance (2018) to monitor the effectiveness of the company's internal control systems includes responsibilities for IT controls. With the increasing use of 'algorithms' in IT systems (programs that process data and produce output or make decisions without the need for human intervention) – for example with artificial intelligence and machine learning – the need for effective IT controls will become ever-more important as an aspect of good governance.

Responsibilities of management for the use of IT

The board of directors has overall responsibility for IT governance within the company. Management is responsible for putting IT policies into effect and for ensuring that IT controls are properly applied. Should there be any failure in IT controls, such as a cyber-attack by an external hacker, management should be accountable to the board.

Example: Airline tickets

An online IT system for selling airline tickets was found to be under-pricing some tickets and giving favourable preference to customers in some areas of the country over customers elsewhere. This was due to a fault in the program algorithm.

It was the responsibility of management to identify the error and its cause, and correct it.

Management would also be responsible for accounting to the board about the problem, and the board in turn might need to offer explanations to the shareholders.

The board's audit committee might instruct the internal audit team to check that the fault in the software has been effectively dealt with.

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7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Define corporate governance and explain the separation of ownership from control
- Discuss governance issues for not-for-profit organisations
- Explain the principles of good governance
- Identify key stakeholder groups and analyse their influence on corporate governance
- Explain agency theory and other theories of corporate governance
- Explain issues relating to responsibilities of the board and management for IT, including IT governance and effective IT control systems

ICAN 20

CHAPTER 12

Different approaches to corporate governance

Contents

1 Rules-based and principles-based approaches
2 International codes and principles of corporate governance
3 Chapter review

ICAN 2021

INTRODUCTION

Detailed syllabus

A **Introduction**

A6 Explain the concept of corporate governance and discuss:

- **A6 (b)** Historical development of corporate governance: global and national
- **A6 (c)** Structure, principles, functions and mechanisms of corporate governance.

D **Governance**

D10 Discuss global developments in enterprise and corporate governance and elucidate the rules-based and principles-based approaches to corporate governance. Also, evaluate relevant national and international codes of corporate governance.

Exam context

In the last chapter, you were introduced to the general principles of corporate governance. You will now study the differences between principles-based and rules-based governance systems with specific reference to the Sarbanes-Oxley Act 2002.

This chapter also includes an international slant with sections on the OECD and ICGN principles of corporate governance.

By the end of this chapter students will be able to:

- Compare and contrast rules-based and principles-based approaches to corporate governance;
- Summarise the key requirements of Sarbanes-Oxley Act 2002; and
- Discuss global developments in corporate governance including the main OECD and ICGN principles of corporate governance.

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1 RULES-BASED AND PRINCIPLES-BASED APPROACHES

Section overview

- Reasons for the development of corporate governance codes
- Corporate governance codes and different models of corporate ownership
- Rules-based approach to corporate governance
- The rules-based approach in the US: Sarbanes-Oxley Act 2002
- Main governance aspects of Sarbanes-Oxley
- Principles-based approach to corporate governance

1.1 Reasons for the development of corporate governance codes

Codes of corporate governance, in different forms, have been developed in most countries where there is a stock exchange. The main reason for codes of good corporate governance is to help and protect investors.

Investors need reliable information about companies, to decide whether to invest in shares or (if they already hold shares) whether to sell them. Financial reporting by companies and external auditing should therefore be reliable. Investors should also be given other information to help them make their investment decisions, such as information about future prospects of the company, internal control and risk management and directors' remuneration.

Investors need to be protected against unethical or dishonest behaviour by company management. For example, there must be strict laws against insider dealing, to prevent managers from making personal profits at the expense of other investors.

Many investment institutions invest in the stock markets of many different countries. They can choose which markets to invest in, and can choose to avoid stock markets where they believe that governance practices are poor and investors are treated badly.

Countries have developed corporate governance codes and practices because they want to attract and keep investment capital, especially from global institutional investors. This is because investment capital helps the country's economy to develop and its companies to prosper. Pressure for better corporate governance has come mainly for two reasons:

- The collapse of major stock market companies in a major financial centre, where investors have lost substantial amounts of money and the cause of the collapse has been largely attributable to bad corporate governance; and
- Pressure from institutional investors in countries with well-developed corporate governance codes or rules.

The International Corporate Governance Network (ICGN) is an entity formed in 1995, whose members consist of major institutional investors, companies, banks and other interested groups. Its aim is to encourage the development of good corporate practices worldwide. It has published a statement on global corporate governance principles (revised 2017), which gives an indication of why corporate governance matters so much to institutional investors.

The statement commented that the governance of a corporation is one of the key factors that investors consider when they decide where to allocate their investment capital. ICGN members considering making investment decisions also consider the market's governance profile.

Ethics and company performance

Other reasons for encouraging the development of good corporate governance are that:

Good corporate governance practices are an application of good business ethics and

It might be argued that good corporate governance contributes to the efficiency and effectiveness of a company's leadership and management. If this view is correct, well-governed companies will be more successful in the long term than badly-governed companies. However, this has not yet been proved, one way or the other.

1.2 Corporate governance codes and different models of corporate ownership

Codes of corporate governance are applied to major stock market companies. Laws and regulations on corporate governance issues are also mainly applied to stock market companies. This is not surprising, as the main reason for codes of governance is to help and protect investors.

Other companies can normally decide what system of corporate governance they want, and they are not required to comply with any established principles or rules. However, these companies might decide to apply these principles or rules because they think that:

it is ethically correct to do so; or

it will improve the performance of the company.

Example: AIM

In the UK, the London Stock Exchange has a stock market for smaller companies, the Alternative Investment Market (AIM). There are fewer regulations for companies in this market, and AIM companies are not required to comply with the UK Corporate Governance Code. However, an unofficial code of governance for AIM companies has been developed, and AIM companies are encouraged to adopt this code.

The board of a family-owned company might be dominated by some of the family members who are also the company's senior executives. The company might decide to appoint a non-executive director to represent the interests of family shareholders or other shareholders who are not on the board. (The director would not be independent, but the appointment of a NED to represent the interests of smaller shareholders might help to ensure that the company is governed in the interests of all the shareholders, not just the owner-directors.)

1.3 Rules-based approach to corporate governance

A rules-based approach to corporate governance is based on the view that companies must be required by law (or by some other form of compulsory regulation) to comply with established principles of good corporate governance.

The rules might apply only to some types of company, such as major stock market companies. However, for the companies to which they apply, the rules must be obeyed and few (if any) exceptions to the rules are allowed.

There are some **advantages** with a rules-based approach:

Companies do not have the choice of ignoring the rules;

All companies are required to meet the same minimum standards of corporate governance; and

Investor confidence in the stock market might be improved if all the stock market companies are required to comply with recognised corporate governance rules.

Some aspects of corporate governance are included in company law, although to a different extent in different countries. For example, company law may specify statutory duties for company directors, basic rights for shareholders or compulsory disclosures that public companies must make in their published annual report and accounts.

There are **disadvantages** with a rules-based approach.

The same rules might not be suitable for every company, because the circumstances of each company are different. A system of corporate governance is too rigid if the same rules are applied to all companies.

There are some aspects of corporate governance that cannot be regulated easily, such as negotiating the remuneration of directors, deciding the most suitable range of skills and experience for the board of directors, and assessing the performance of the board and its directors.

Corporate governance in any country is therefore likely to be based on a combination of rules (legal requirements) and principles.

Corporate governance rules: practical applications

Every country with a stock market should have some rules of corporate governance. The UK for example, which is associated with a principles-based approach to corporate governance, has some statutory rules.

Examples of statutory rules in the UK are as follows:

With some exemptions, mainly for small and medium-sized companies, companies are required to submit a directors' report and financial statements to the shareholders each year. This is a key aspect of accountability of the directors to the company's owners;

The financial statements should be audited;

Quoted companies (companies whose shares are traded on a stock exchange) must prepare a directors' remuneration report each year, and present this to the shareholders; and

The UK Companies Act 2006 specifies duties that the directors owe to their company.

The difference between countries that take a rules-based approach and those that take a principles-based approach to corporate governance is mainly one of emphasis. Some countries have more rules than others, and rely more on the enforcement of rules to achieve the required standard of governance.

The country most associated with a rules-based approach is the USA.

1.4 The rules-based approach in the US: Sarbanes-Oxley Act 2002

In the US, corporate governance was not regarded as important until the collapse of several major companies in 2001 and 2002, and large falls in the stock market prices of shares of all companies. This major setback for the US stock exchanges damaged investor confidence.

It was recognised fairly quickly that one of the reasons for the unexpected collapse of several companies ('corporations') was poor corporate governance. Enron and WorldCom were the two most notorious examples, but there were others too. There were several well-publicised cases where:

A company in serious financial difficulties was dominated by a chief executive and a small number of other senior executives, who appeared to be running the company in their own interests, without concern for the interests of shareholders (other than themselves);

Financial reporting was misleading; and

Financial controls were weak and inadequate to prevent the misleading reporting, and to prevent fraudulent activities by some executives.

Politicians soon became involved in analysing the problems in the stock market and the collapse of companies such as Enron and WorldCom. This involvement of politicians soon led to new legislation to improve standards of corporate governance. This was the Sarbanes-Oxley Act 2002, which was named after its two main sponsors in the US Congress.

1.5 Main governance aspects of Sarbanes-Oxley

The Sarbanes-Oxley Act introduced **corporate accountability legislation**. It includes some specific requirements. In addition, it required the financial markets regulator, the Securities and Exchange Commission (SEC) to issue rules to implement some parts of the legislation.

A regulator, the Public Company Accounting Oversight Board (PCAOB) was established to oversee the audit of public companies that are subject to the securities laws. The PCAOB has inspection and disciplinary powers as well as the power to set auditing, quality control, independence and ethical standards for registered public accounting firms to use in the preparation and issue of audit reports on the financial statements of listed companies.

The Act is very long – some key provisions are described below.

CEO/CFO certifications (section 302 of the Act)

The Act requires all companies in the USA with a stock market listing (both US companies and foreign companies) to include in their annual and quarterly accounts a certificate to the SEC. This certificate should be signed by the chief executive officer and the chief financial officer (finance director) and should

confirm the accuracy of the financial statements. The CEO and CFO are therefore required to take direct personal responsibility for the accuracy of the company accounts.

Assessment of internal controls (section 404 of the Act)

Section 404 is possibly the most notorious part of the Sarbanes-Oxley Act. The Act required the SEC to establish rules that require companies to include an internal control report in each annual statement. This internal control report must:

'state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

contain an assessment … of the effectiveness of the internal control structure and procedures of the [company] for financial reporting.'

The SEC issued rules to implement this requirement of the Act. The management of companies registered with the SEC (stock market companies in the US), with the CEO and CFO, must evaluate the effectiveness of the company's internal control over financial reporting. The rule states that: 'The framework on which management's evaluation of the … internal control over financial reporting is based must be a suitable, recognised control framework.'

Companies are required to maintain evidence, including documentary evidence, to provide reasonable support for management's evaluation of the internal control system. (One of the criticisms of section 404 has been the large amount of work necessary to collect and maintain all this evidence.)

Companies must disclose any material weakness in their internal control system. If more than one material weakness exists, a company is not allowed to conclude that its internal control system is adequate.

1.6 Principles-based approach to corporate governance

A principles-based approach to corporate governance is an alternative to a rules-based approach. It is based on the view that a single set of rules is inappropriate for every company. Circumstances and situations differ between companies. The circumstances of the same company can change over time. This means that:

the most suitable corporate governance practices can differ between companies; and

the best corporate governance practices for a company might change over time, as its circumstances change.

It is therefore argued that a corporate governance code should be applied to all major companies, but this code should consist of principles, not rules.

The principles should be applied by all companies.

Guidelines or provisions should be issued with the code, to suggest how the principles should be applied in practice.

As a general rule, companies should be expected to comply with the guidelines or provisions.

However, the way in which the principles are applied in practice might differ for some companies, at least for some of the time. Companies should be allowed to ignore the guidelines if this is appropriate for their situation and circumstances.

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When a company does not comply with the guidelines or provisions of a code, it should report this fact to the shareholders, and explain its reasons for non-compliance.

Comply or explain

This approach is sometimes called **comply or explain**. It applies in the UK, for example. With a comply or explain approach, stock market companies are required to present a corporate governance statement to their shareholders in which they state that:

they apply the principles in the code of corporate governance (the code that applies to companies in that stock market), and

either the company has:

- complied with all the provisions or guidelines in the code for applying the principles in practice, or
- explain their non-compliance with any specific provision or guideline.

In the UK, the UK Corporate Governance Code ('The Code') is the relevant code of corporate governance for listed companies. All UK listed companies must comply with rules known as the **Listing Rules** and the Disclosure Guidance and Transparency Rules (DTRs), which are issued and enforced by the financial markets regulator (the Financial Conduct Authority or FCA). One of the rules is that companies must comply with all the detailed provisions of the Code, or explain their non-compliance, in an annual corporate governance statement to shareholders. This statement is included in the annual report and accounts.

Which is more effective: a rules-based approach or a principles-based approach?

The advantages and disadvantages of a principles-based approach to corporate governance are the opposite of those for a rules-based approach. There is no conclusive evidence to suggest that one approach is better than the other.

It has been suggested that the burden of the detailed rules in the US, especially the requirements of section 404, has made the US an unattractive country for foreign companies to trade their shares. As a result, many foreign companies have chosen to list their shares in countries outside the US, such as the UK (London Stock Exchange).

However, the relative success or failure of New York and London as centres for listing shares by foreign companies is not the only relevant argument about which method of corporate governance is better. The relative advantages of a rules-based approach and a principles-based approach might become clear only when more corporate governance scandals occur - at some time in the future.

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2 INTERNATIONAL CODES AND PRINCIPLES OF CORPORATE GOVERNANCE

Section overview

- A brief history of corporate governance
- The nature of international codes or statements of principles
- The objectives of international statements of principles
- Content of the OECD Principles
- Content of the ICGN Principles
- Limitations of international codes or statements of principles

2.1 A brief history of corporate governance

When we discuss the history of corporate governance, we really mean the history of attempts to improve perceived weaknesses in corporate governance, especially among large public companies.

The drive for improvements in corporate governance began in the UK. Following a number of high-profile corporate collapses, a committee was established and produced a report (the Cadbury Report, 1992) which recommended, amongst other things, that listed companies should have an audit committee and a minimum number of non-executive directors on their board.

Concerns about excessive or inappropriate remuneration packages for executive directors and senior managers led on to the Greenbury Report (1995). This was followed by the Hampel Report (1998), which among other things raised the matter of board responsibility for risk management and control systems.

The recommendations of these three reports were amalgamated into the first UK Combined Code of corporate governance (1998). This was a principles-based set of principles and provisions, and all listed companies in the UK were required to comply with the code or explain their non-compliance.

The next major advance in corporate governance globally was the adoption of the Sarbanes-Oxley Act (2002), a rules-based governance code introduced following a number of major corporate scandals and failures in the USA.

Since that time, corporate governance codes have been introduced in many other countries, including Nigeria, where there is a 2018 revision of the Nigerian Code of Corporate Governance for private companies. The Nigerian Code, which covers similar areas to other national corporate governance codes, deals with issues such as:

The role of the board;

The structure and composition of the board;

Board meetings and the requirement for board committees (nomination and governance; remuneration; audit; risk management);

Performance evaluation of the board;

Remuneration governance;

Risk management internal audit, whistle-blowing, the external auditors;

Relationship between the board and its shareholders, and shareholder rights;

Business conduct and ethics;

Sustainability; and

Transparency (disclosures).

2.2 The nature of international codes or statements of principles

Some international codes or statements of principles on corporate governance have been issued. The intention of these codes is to provide guidelines or a benchmark that should be adopted in all countries. They are directed at countries that have not yet developed codes of their own. They are therefore common standards of governance that should be applied internationally.

International statements of corporate governance principles include:

the OECD Principles of Corporate Governance;

the ICGN Statement on Global Corporate Governance Principles; and

the Principles for Corporate Governance in the Commonwealth (the CAGC Guidelines).

2.3 The objectives of international statements of principles

An international statement of principles seeks to establish minimum standards of corporate governance that should apply in all countries. Its main aim is therefore to raise standards in the 'worst' countries towards the standards that already exist in the 'best' countries.

The result of encouraging better standards of corporate governance should be that:

better governance will attract more investment from global investors;

companies will benefit from more investment finance, to increase their profits; and

national economies will benefit from having strong and profitable companies.

Objectives of the OECD Principles

The OECD Principles are published by the Organisation for Economic Co-operation and Development, and they are intended to:

assist governments of countries to improve the legal, regulatory and institutional frameworks for corporate governance in their countries; and

ICAN 2021

provide guidance to stock exchanges, investors and companies on how to implement best practice in corporate governance.

The members of the OECD are governments of about 30 economically-developed countries, and its objective is to encourage the development of the world economy. The OECD has recognised that a key to economic development in any country is an efficient market economy in which investors have confidence to invest their money.

The introduction to the OECD Principles makes a link between corporate governance and economic growth:

'Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence…. The presence of an effective corporate governance system, within 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. As a result the cost of capital is lower and firms are encouraged to use resources efficiently, thereby underpinning growth.'

Objectives of the ICGN Principles

The ICGN is the International Corporate Governance Network. It is a voluntary association of major institutional investors, companies, financial intermediaries and other organisations and its aim is to improve corporate governance practices around the world, in all countries where institutional investors seek to invest.

The ICGN Principles are consistent with the OECD Principles, but have the more specific objective of providing information to stock markets and companies around the world about the issues that investors will take into account in deciding how (and where) to invest. The ICGN gives greater emphasis than the OECD to **the right of investors to participate actively** in corporate governance in the companies in which they invest.

The ICGN says that one of its objectives is to aid international discussions about issues that investors are concerned about. ICGN believes that this process enables economies to prosper and companies to be more effective in their competition. According to the ICGN, encouraging and enabling company owners to participate in their governance is in the public interest.

2.4 Content of the OECD Principles

The OECD Principles (2015) provide guidance through recommendations and annotations across six chapters.

(OECD *Principles of Corporate Governance* – 2015 Edition, © OECD 2015)

Principle I: Ensuring the basis for an effective corporate governance framework

"Effective corporate governance requires a sound legal, regulatory and institutional framework that market participants can rely on when they establish their private contractual relations. This corporate governance framework typically comprises elements of legislation, regulation, self-regulatory arrangements,

voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition. The desirable mix between legislation, regulation, self-regulation, voluntary standards, etc., will therefore vary from country to country. The legislative and regulatory elements of the corporate governance framework can usefully be complemented by soft law elements based on the "comply or explain" principle such as corporate governance codes in order to allow for flexibility and address specificities of individual companies."

This principle is concerned with the framework for good corporate governance that is provided by the stock market and financial intermediaries, the regulation of the markets and the information that is available to investors about companies ('transparency' in the markets). It is useful to think about this principle in terms of countries that fail to provide transparency in markets, or stock markets that function efficiently, or markets in which the rule of law is fair and properly applied.

Principle II: The rights and equitable treatment of shareholders and key ownership functions

"The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights." Shareholders have "basic shareholder rights, including the right to information and participation through the shareholder meeting in key company decisions." There should also be disclosure of control structures, such as different voting rights. Issues relating to the rights and equitable treatment of shareholders include the use of information technology at shareholder meetings, and shareholder participation in decisions on executive remuneration. This Principle is concerned with the basic rights of shareholders, which should include the right to transfer the ownership of their shares, the right to receive regular and relevant information about the company, the right to vote at general meetings of company shareholders, the right to share in the company's profits, the right to remove directors from the board and the right to participate in decisions about executives' remuneration.

These basic shareholder rights might seem 'obvious'. However, there are countries in which these rights do not properly exist, especially for foreign shareholders. For example the laws of a country may permit a company to insist that shareholders wishing to vote at a general meeting of the company must attend the meeting and cannot be represented by a proxy. This requirement in effect would remove the right to vote of most foreign investors, who do not have the time to attend general meetings in person in countries around the world.

Principle III: Institutional investors, stock markets, and other intermediaries

"The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance." This Principle is concerned particularly with the responsibilities of institutional investors, such as pension

funds and insurance company funds, to ensure that good corporate governance practice is applied by themselves and by the companies they invest in.

Principle IV: The role of stakeholders in corporate governance

The corporate governance framework should recognise the rights of stakeholders that are established by law, or through mutual agreements. This will include, for example, employment rights and agreements negotiated for employees with trade union representatives.

"The competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, customers and suppliers, and other stakeholders. Corporations should recognise that the contributions of stakeholders constitute a valuable resource for building competitive and profitable companies. It is, therefore, in the long-term interest of corporations to foster wealth-creating co-operation among stakeholders."

Principle V: Disclosure and transparency

'The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the [company], including the financial situation, performance, ownership and governance of the company.'

The disclosure of information to shareholders and investors is a critically important aspect of corporate governance.

Principle VI: The responsibilities of the board

'The corporate governance framework should ensure 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.'

This principle relates to many of the functions of the board. It includes the requirement that 'board members should act on a fully informed basis, in good faith with due diligence and care, and in the best interests of the company and the shareholders.' The board should also apply high ethical standards and take into account the interests of the company's stakeholders.

2.5 Content of the ICGN Principles

The ICGN Principles are consistent with the OECD Principles, and deal with issues such as disclosure and transparency, the rights and responsibilities of shareholders, and the role and structure of boards of directors.

An important objective of the Principles is to encourage the removal of bad corporate governance practices in countries where these still exist. Some of the Principles are listed below. It is useful to remember that the purpose of stating a principle is often to discourage different practices that are currently found in some countries.

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The **objective of a company** - The ICGN Principles begin with a statement that the main objective of a company should be to 'optimise' over time the return to its shareholders and that to achieve this the board needs to develop a long-term strategy that will improve the equity value.

Shareholder rights - The rights of all shareholders should be protected, including the rights of minority shareholders and foreign shareholders. If a company diverges from a 'one share one vote' standard of voting, so that some shareholders have voting power that is disproportionate to the amount of shares they hold, this should be explained and justified by the company. The voting system should enable all shareholders to exercise their votes: the ICGN therefore encourages initiatives to allow voting by telecommunications or other electronic channels.

The board of directors - All directors must act in the best interests of the company and should be accountable to the shareholders as a whole. A well-governed company has independent-minded directors and there should be a strong presence of independent non-executive directors on the board.

Corporate citizenship and the ethical conduct of business - The ICGN Principles support the concept of 'corporate citizenship' and also the ethical conduct of business by companies. Companies should comply with the law and the board of directors is responsible for maintaining a culture of **integrity**.

2.6 Limitations of international codes or statements of principles

International statements of principle about corporate governance establish minimum acceptable standards of corporate governance, but they have several limitations.

Because they apply to all countries, they can only state general principles. They cannot give detailed guidelines, and so are not specific. Since they are not specific, they are possibly of limited practical value.

Their main objective is to raise standards of corporate governance in the 'worst' countries. They have less relevance for countries where corporate governance standards are above the minimum standard.

Unlike national laws and codes of corporate governance, there is no regulatory authority for international statements of principle. The principles therefore lack any 'force'. In specific countries, by contrast, there may be a supervisory body or regulatory body with specific responsibility for encouraging or enforcing corporate governance practices.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Compare and contrast rules-based and principles-based approaches to corporate governance
- Summarise the key requirements of Sarbanes-Oxley Act 2002
- Discuss global developments in corporate governance including the main OECD and ICGN principles of corporate governance

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CHAPTER 13

The board of directors

Contents

1 The role of the board
2 Composition of the board
3 The roles of chairman, chief executive officer and NEDs
4 Directors and the law
5 Induction, training and performance evaluation of directors
6 The need for board committees
7 Audit and corporate governance
8 Chapter review

INTRODUCTION

Detailed syllabus

A	**Introduction**	
A6	Explain the concept of corporate governance and discuss:	
	A6 (c)	Structure, principles, functions and mechanisms of corporate governance.
D	**Governance**	
D2	Explain the nature, significance and scope of enterprise governance and threats to effective governance, including:	
	D2 (b)	Roles of internal and external auditors;
	D2 (c)	Board structure; and
	D2 (d)	Audit committee.
D3	Identify and assess roles and responsibilities of an effective board in a given scenario	
D4	Discuss 'non-compliance with laws and regulations' (NOCLAR) in relation to the responsibilities of the board	
D5	Discuss oversight functions of a board and institutional shareholders over management in a given scenario.	

Exam context

The board of directors is a fundamental component in maintaining good corporate governance. This chapter looks at best practice for a board of directors including composition, roles and responsibilities.

As the landscape and scope of codes of corporate governance remains fluid in Nigeria (although a new code of corporate governance was issued in 2018) this chapter primarily refers mainly to the UK's Code of Corporate Governance to illustrate the teaching points. The UK's code has been developed and refined over more than 20 years and is now arguably the world's leading corporate governance benchmark.

Note that many of the various current Nigerian codes of corporate governance are similar in scope and guidance to the UK code.

By the end of this chapter students will be able to:

- Explain the role of the board;
- Discuss best practice for the composition of the board;
- Define executive, non-executive, independent director and boarddiversity;
- Compare and contrast between the roles of the chairman, CEO, NEDs and other directors;
- Summarise the main laws relating to directors and the responsibilities of the board with regard to NOCLAR;
- Explain best practice guidelines for the induction, training and performance evaluation of directors;
- Discuss the need for and typical composition of board committees; and
- Discuss the relevance of external and internal audit for good corporate governance, and the role of an audit committee.

1 THE ROLE OF THE BOARD

Section overview

- Introductory note: codes of corporate governance
- Delegation of power within a company
- Corporate governance codes on the role of the board
- Decision-making and monitoring roles
- Unitary boards and two-tier board structures

1.1 Introductory note: codes of corporate governance

This chapter looks at various aspects of corporate governance. These are relevant to all companies where there is a separation of the ownership from control, and the shareholders and directors are different individuals.

References will be made to codes of corporate governance, particularly the *UK Corporate Governance Code* ('the Code'*)*. The Code has provided a model for corporate governance codes in other countries.

When a country has a code of corporate governance, the code applies to major stock market companies. In the UK and Nigeria, these are the 'listed' companies. A listed company is a company whose shares are on the Official List of the financial services regulator. A company's shares must be on the Official List before they can be traded on the main market of the London Stock Exchange or the Nigerian Stock Exchange. A listed company is therefore a major stock market company.

You should bear in mind that when references are made to corporate governance codes, these are likely to apply only to major companies. However, other companies (such as private companies or subsidiaries within a group) might choose voluntarily to comply with the principles or provisions of a corporate governance code, as a way of strengthening their corporate governance.

1.2 Delegation of power within a company

Within a company, all the powers are usually given to the board of directors. For example, this is an article in the standard articles of association (constitution) of Nigerian companies. The board of directors then delegates some of its powers to executive management, and executive management are responsible for the day-to-day business operations.

There are no laws or standard rules, however, about what the role of the board of directors should be, or how much authority for decision-making should be retained by the board (and how much should be delegated to executive management).

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The delegation of power within a company may therefore vary between companies.

Students familiar with a unitary board (which is the form of board structure found in many countries) may have difficulty in identifying the difference between:

the role of executive directors as managers of the company; and

the role of the board of directors as a whole in the governance of the company.

The role of the board of directors is **not** to manage the company. This is the role of management.

Specifying the role of the board of directors, and making the board accountable for its performance in the role, is a key aspect of corporate governance.

1.3 Corporate governance codes on the role of the board

The role of the board of directors is specified in codes of corporate governance. There are many different codes or statements of corporate governance principles. This text will refer to some, but others are similar.

The Nigerian Code of Corporate Governance (2018) states that the Board, "being central in corporate governance and the highest governing body in the company", should have a Charter that sets out its responsibilities. This charter includes the following aims:

- exercising leadership, enterprise, integrity and judgment in its oversight and control of the company so as to achieve its continued survival and prosperity;
- ensuring that the Board and its committees act in the best interest of the company;
- ensuring compliance with the laws of the Federal Republic of Nigeria and other applicable regulations;
- considering and approving the long-term and short-term strategies for the company's business and monitoring their implementation by management;
- ensuring the establishment and implementation of a succession plan, appointment process and remuneration structure for the Board and senior management of the company;
- being accountable to the company as well as managing the relationship with shareholders and other stakeholders;
- establishing and maintaining the company's values and standards (including an ethical culture) as well as demonstrating the right tone at the top;

ICAN 2021

- overseeing the internal audit function, approving the internal audit plan, and appointing and removing the head of the internal audit function on the recommendation of the committee responsible for audit;
- establishing the company's risk management framework and monitoring its effectiveness;
- providing oversight over Information Technology governance;
- defining a formal schedule of matters specifically reserved for Board decision and matters delegated to Board committees and management;
- overseeing the effectiveness and adequacy of the internal control system;
- overseeing the company's communication and information dissemination policy;
- performing the appraisal of Board members and senior executives;
- ensuring the integrity of annual reports and accounts and all material information provided to regulators and other stakeholders; and
- ensuring that management systems are in place to identify and manage environmental and social risks and their impact.

1.4 Decision-making and monitoring roles

The role of a board of directors is a combination of decision-making and monitoring.

A board should retain certain responsibilities, and should make decisions in these areas itself.

Where the board delegates responsibilities to executive management, it should monitor the performance of management. For example, the board should expect senior management (usually the Chief Executive Officer) to account to the board for the performance of the company. In addition, the board should be responsible for monitoring the system of internal control that management has put in place.

In addition, the board should be accountable to the shareholders for its performance in carrying out these twin roles of decision-making and monitoring.

ICSA Guidance Note on matters reserved for the board

Corporate governance codes and principles are not specific about what exactly the decision-making responsibilities of the board should be. The Institute of Chartered Secretaries and Administrators (ICSA) has published a Guidance Note, suggesting that in each company there should be a formal, written list of matters for which the board will take the decisions, and will not delegate to management. These include monitoring responsibilities as well as decision-making responsibilities.

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The Guidance Note ('Matters Reserved for the Board') provides a suggested schedule of board responsibilities, that it should not delegate. This is listed under 12 headings or categories.

Responsibility	Comment
Strategy and management	The board is responsible for the overall management of the company or group. This involves: ■ Approving the long-term objectives and commercial strategy ■ Approving the annual budget and capital expenditure budget ■ Oversight of operations ■ Review of the performance of the company or group ■ Decisions about expanding operations into new product areas or new markets, and decisions about closing down any significant part of operations.
Structure and capital	Changes relating to the capital structure of the group, or its management and control structure. Also decisions about any change in the company's status, such as going from private company to public company status.
Financial reporting and controls	Approval of financial statements and results. Approval of dividend policy. Approval of treasury policies, such as foreign currency exposures and the use of financial derivatives.
Internal controls	Ensuring that there is a sound system of internal control and risk management, by monitoring the systems that are in place.
Contracts	Approval of major capital projects and strategically-significant contracts. Approval of loans or foreign currency transactions above a stated amount. Approval of all major acquisitions and disposals.
Communication	Approval of all communications to shareholders and the stock market, and all major press releases.
Board membership and other appointments	Decisions about appointments to the board, appointment of the company secretary and the appointment of the company's auditors.
Remuneration	Decisions about the remuneration of all directors and senior managers, including the approval of major share incentive schemes (which may also

Responsibility	Comment
	require approval by the shareholders).
Delegation of authority	The board is responsible for deciding what responsibilities should be delegated to board committees, and should decide on the division of responsibilities between the chief executive officer and the board chairman.
Corporate governance matters	The board is responsible for corporate governance matters such as communications with the company's shareholders, deciding the balance of interests between the shareholders and other stakeholders and ensuring that independent non-executive directors continue to be independent.
Policies	Approval of company policies, such as health and safety policy and environmental policy.
Other issues	There will probably be a number of other issues that the board should reserve for its own decision-making, such as decisions affecting the company's contributions to its employees' pension fund, the appointment of the company's main professional advisers, and decisions to prosecute, defend or settle major litigation disputes involving costs or payments above a specified amount.

This extract from the Institute of Chartered Secretaries and Administrators' guidance note on 'Matters Reserved for the Board' has been reproduced with the permission of ICSA.

1.5 Unitary boards and two-tier board structures

In most countries, companies have a unitary board. This means that there is a single board of directors, which is responsible for performing all the functions of the board.

Two-tier boards

In some countries (such as Germany and the Netherlands), all or most large companies have a two-tier board. A two-tier board structure consists of:

- a management board; and
- a supervisory board.

The **management board** is responsible for the oversight of management and business operations. It consists entirely of executive directors, and its chairman is the company's chief executive officer.

ICAN 2021

The **supervisory board** is responsible for the general oversight of the company and the management board. It consists entirely of non-executive directors, who have no executive management responsibilities in the company. Its chairman is the chairman of the company, who is the most significant figure in the corporate governance structure.

The responsibilities of the management board and supervisory board should be clearly defined. For example, it is a requirement of Germany's code of corporate governance (the Cromme Code) that the supervisory board should have a list of matters that require its attention.

A function of the chairman of the company (and supervisory board) is to work closely with the CEO. As chairman of the management board, the CEO reports to the chairman of the company. If there is a good relationship between the CEO and chairman, the chairman will speak for the company's management at meetings of the supervisory board.

Germany has been closely associated with a stakeholder approach to corporate governance, and the interests of stakeholder groups are recognised by representation on the supervisory board. Directors on the supervisory board normally include:

- representatives of major shareholders of the company;
- representatives of the employees or a major trade union; and
- former executive managers of the company, possibly former members of the management board who have now retired from the company.

In large companies, the supervisory board can be quite large, in order that it can represent a sufficient number of different stakeholder interests. Directors who represent an interest, such as the interests of a major shareholder or the company's employees, are not 'independent' – unlike most non-executive directors on the unitary boards of listed companies (stock market companies) in other countries.

Comparison of unitary boards and two-tier boards

An obvious question to ask is which type of board structure, a unitary board or a two-tier board structure, provides better corporate governance? Each type of board structure has its strengths and weaknesses. In the analysis below, the strengths of a two-tier board structure are, by implication, weaknesses of a unitary board, and vice versa.

The advantages of a two-tier board structure are as follows:

- It separates two different roles for the board. The management board is responsible for operational issues, whereas the supervisory board is able to monitor the performance of management generally, including the executive directors on the management board;

- It is an appropriate structure for a company that recognises the interests of different stakeholder groups. These stakeholder interests can be represented on the supervisory board, without having a direct impact on the management of the company; and

- The legal duties of non-executive directors on the supervisory board can be different from the legal duties of executive directors on the management board. This is sensible, because independent directors are on part-time appointments and are not involved in the management of the company. In a unitary board, the legal duties of non-executive directors and executive directors are the same.

The advantages of a unitary board are as follows:

- Unitary boards can be small in size, because there is no requirement to appoint directors who represent stakeholder interest groups. Small boards are more likely to act quickly in an emergency or when a fast decision is required;

- In a unitary board structure, it is easier for the non-executive directors and the executive directors to work co-operatively. With a two-tier structure, there is a risk that the two boards will not co-operate fully, especially when the chairman of the company and the CEO do not work well together; and

- Unitary boards work towards a common purpose, which is what the board considers to be the best interests of the shareholders and others. With two-tier boards, there is more opportunity for disagreements on the supervisory board between directors who represent different stakeholder interests.

The remainder of this text on corporate governance will concentrate on companies with a unitary board. However, similar principles and issues arise in companies with a two-tier board structure.

ICAN 2021

2 COMPOSITION OF THE BOARD

Section overview

- Composition and size of the board
- Executive and non-executive directors
- Independence
- Independent directors
- Board balance and independent directors
- Diversity
- The Davies report – Women on boards

2.1 Composition and size of the board

The board is responsible for the long-term success of the company. The composition of the (unitary) board of a major company in many countries consists of:

- A chairman, who may be an executive director but is more usually a non-executive director;;
- (Sometimes) a deputy chairman;
- A chief executive officer, who is an executive director;
- Other executive directors; and
- Other non-executive directors.

The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective responsibilities effectively.

All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.

A board of directors should not be too big.

The code of corporate governance in Nigeria specifies that the size of the board should not be less than five (5) and should not exceed fifteen (15) persons.

The UK Corporate Governance Code states that 'the board should not be so large as to be unwieldy.'

The Singapore code of Corporate Governance states: 'The Board should examine its size and, with a view to determining the impact of the number upon effectiveness, decide on what it considers an appropriate size for the Board, which facilitates effective decision-making.' In deciding what a suitable size of

ICAN 2021

board is for a particular company, 'the Board should take into account the scope and nature of the operations of the company.'

Boards must consider the benefits of diversity – e.g., improving the gender balance – when making appointments – something we look at in more detail below.

2.2 Executive and non-executive directors

A unitary board in large companies consists of executive directors and non-executive directors. Non-executive directors are found on the boards of most stock market companies, but they are also appointed to the boards of subsidiary companies within a group and to the boards of private companies.

(***Note***: UK listed companies may be required to include non-executive directors on their board. Other companies are not required to appoint non-executive directors, but might do so voluntarily.).

Definition: Executive directors

Executive directors are directors who also have executive management responsibilities in the company. They are normally full-time employees of the company. Examples of executive directors are the chief executive officer (CEO) and the finance director (chief finance officer or CFO).

Definition

Non-executive directors or NEDs are directors who do not have any executive management responsibilities in the company. (They might be an executive director in a different company.)

NEDs are not employees of the company.

They are not full-time. When they are appointed there should be a clear understanding about how much time (each month or each year) the NED will probably be required to give to the company's affairs.

However, the status of executive directors and non-executive directors, as directors, is exactly the same.

2.3 Independence

All directors should show independence of character. They should be able to hold their own views and judgements, and should be able to express their personal opinions with conviction. In this sense, 'independence' means having opinions, expressing them and not necessarily agreeing with everything that fellow directors say.

ICAN 2021

These characteristics of independence are mentioned in the Principles for Corporate Governance in the Commonwealth (the CACG Principles). These state that: 'The board should be composed of people of integrity who can bring a blend of knowledge, skills, objectivity, experience and commitment to the board which should be led by a capable Chairman who brings out the best in each director. Crucial to this is having a proper director selection process to avoid the propensity for 'cronyism' and 'tokenism'.'

In corporate governance, however, 'independence' means something much more specific than having an independent mind.

2.4 Independent directors

It is argued that the board of directors should consist partly of independent directors. An **independent director** is an individual who:

- has no link to a special interest group or stakeholder group, such as executive management, other employees of the company, a major shareholder, a supplier or a major supplier or customer of the company; and
- has no significant personal interests in the company, such as a significant contractual relationship with the company.

Given this definition of an independent director, it is impossible for an executive director to be independent, because he or she has a direct link with executive management.

Only non-executive directors can be independent. However, not all NEDs are independent. A NED is not independent when there are relationships with the company or circumstances that would be likely to affect the director's judgement.

Independent directors are defined in various codes and principles of corporate governance. Definitions of 'independent director' vary between countries and codes.

In Nigeria, an independent director is defined as a non-executive director who:

- Is not a substantial shareholder in the company (which means that directly or indirectly, his/her shareholding must not exceed 0.1% of the company's paid up capital);
- Is not a representative of a shareholder who is able to significantly influence management;
- Has not been employed by the company (or group) or has served in any executive capacity in the company (or group) for the preceding three financial years;

- Is not a member of the immediate family of an individual who is or has been employed in an executive capacity in the company (or group) in the past three financial years;
- Is not a professional adviser to the company other than as a director;
- Is not a major/significant supplier or customer of the company;
- Has no significant contractual relationship with the company (or group) that might interfere with his/her independence; and
- Is not a partner or executive of the company's statutory audit firm, internal audit firm or other consulting firm for three financial years preceding his/her appointment as an independent director.

Furthermore, there should be at least one independent director on the board of a public company.

The UK Corporate Governance Code states that in most circumstances, a director is **not independent** when he or she:

- has been an employee of the company within the past five years;
- has (or has had within the previous three years) a material business relationship with the company, either personally or as a partner, shareholder, director or senior employee of another entity;
- receives remuneration in addition to a fee as non-executive director, participates in the company's share incentive scheme or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with a director, senior employee or professional adviser of the company;
- has significant links with other directors through involvement in other companies or entities;
- represents a significant shareholder; and
- has served on the board for more than nine years since the date of his/her election as director.

(The 'nine year rule' on independence for NEDs has been slightly controversial, and some UK listed companies have NEDs who have been in office for over nine years, but who, according to the companies, remain independent.)

In Singapore, the definition is less strict than in the UK. Its Code of Corporate Governance states that examples of relationships where a director is not deemed to be independent are as follows:

ICAN 2021

- Where the director is employed by the company (or any related company) or has been employed by the company at any time during the past three years;

- A close family relative of an individual who is a senior employee of the company, or who has been a senior employee at any time during the past three years;

- A director receiving remuneration from the company in the current or previous financial year, in addition to his fee as non-executive director; and

- A director who has (or has had in the current or previous financial year) a material business relationship with the company, either personally or through a close family member, or as a partner, shareholder, director or senior employee of another for-profit entity.

2.5 Board balance and independent directors

The status of directors as independent or 'not independent' is significant for companies that are required to comply with a code of corporate governance.

A general principle of good corporate governance is that there should be a suitable balance of individuals on the board.

A board should consist of directors with a suitable range of skills, experience and expertise. However, there should also be a 'balance of power' on the board, so that no individual or small group of individuals can dominate decision-making by the board.

Experience has shown that in the past, a feature of many large public companies that have collapsed dramatically has been a domination of the board's decision-making by an individual or a small group of individuals. In the UK, for example, a link between bad corporate governance and domination by a powerful individual was evident in the cases of the Maxwell Communications Corporation (headed by Robert Maxwell) and Polly Peck International (headed by Asil Nadir). Both these companies collapsed unexpectedly in the early 1990s.

Example: Robert Maxwell

The case of Robert Maxwell is notorious in UK corporate history. During the 1980s, Maxwell built up a major publishing group, which included Mirror Group Newspapers, the US publisher Macmillan and the New York Daily News. Mirror Group Newspapers became a listed UK company, but the other companies in the group remained privately-owned. Maxwell was reported to have been a tyrannical leader of the company, who dominated the board of directors of the companies within the group.

In November 1991, Mr Maxwell died in mysterious circumstances, drowning during a cruise off the Canary Islands. After his death, it was found that he had misappropriated about £900 million from the pension funds of his companies,

ICAN 2021

using the money to fund business expansion and to support group companies that were in financial difficulty. In 1992, the Maxwell companies in the UK and US were forced to file for bankruptcy/insolvency. A subsequent investigation found that 'there were no proper corporate or financial controls' to prevent Maxwell from doing what he had done.

This case was one of several corporate collapses that led to recognition of the need for a balance of power on the boards of major companies.

Definition of a suitable board balance

A previous version of the UK Corporate Governance Code stated: 'The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision-taking.'

It went on to state that: 'To ensure that power and information are not concentrated in one or two individuals, there should be a strong presence on the board of both executive and non-executive directors.'

The current UK Corporate Governance Code (2018) states that "At least half the board, excluding the chair, should be non-executive directors whom the board considers to be independent." Codes of corporate governance in other countries differ. For example, the Singapore Code of Corporate Governance states that independent directors should make up at least one-third of the board.

The Nigerian Code of Corporate Governance (2018) recommends a mix of executive directors (EDs), non-executive directors (NEDs) and independent non-executive directors (INEDs) on the board of a company. Companies can determine the size and composition of their board.

Companies need to adopt policies that ensure review of board composition to ensure it reflects an appropriate balance of competence, independence and integrity.

2.6 Diversity

Acting as agents of shareholders, directors are expected to collectively devise operational and financial strategies and to monitor the effectiveness of the company's practices. In order to do this effectively they must use judgment, accept responsibility and be accountable for their actions (three principles of sound corporate governance).

Recent studies suggest one way of enhancing corporate governance is to diversify the board.

What is board diversity?

In simple terms, diversity means having a range of many people that are different from each other. Categories might include:

Age, race, gender, educational background, professional qualification, experience, personal attitudes, marital status and religion.

Board diversity aims to cultivate a broad spectrum of demographic attributes and characteristics.

Benefits of board diversity

Diversifying the board should have the following benefits:

More effective decision making.

A diverse board should help reduce 'groupthink' and hence result in more objective decisions being made. Groupthink describes the tendency of a group to make collective decisions that minimise conflict rather than critically evaluate alternatives.

Diversity should help the board approach problems from a greater variety of perspectives and raise challenging questions resulting in a more vigorous debate. This will help retain focus on managing and controlling risks and the companies' customers through better quality decisions.

With ever increasing competition in a global environment a more diverse board will be better placed to understand diverse stakeholders' claims. For example, a multinational company might benefit from having a range of foreign nationals on the board. A consumer-facing industry may benefit from having females as well as males on the board.

Better utilisation of talent pool for NEDs

Traditionally the search for non-executive directors (NEDs) has been restricted to male candidates with similar backgrounds to existing members of the board. Broadening the target population by diversifying candidate profiles will foster better use of the available talent pool.

Enhancement of corporate reputation and investor relations by establishing the company as a responsible corporate citizen.

Employing a diverse board is a positive signal to both internal and external stakeholders that the company does not discriminate against minorities. This can enhance corporate reputation through positioning the company as a socially responsible equal-opportunity organisation.

By reflecting the diversity of society and the community with a diverse board the social contract between a business and its stakeholders plus the strategic fit with the environment becomes significantly enhanced.

One key point to recognise is that an increasing number of institutional investors are starting to take into account board diversity as an investment appraisal metric.

ICAN 2021

Drawbacks of diversifying the board

The following drawbacks may arise with greater diversification of the board:

- Increased conflict and friction which may promote cliques or sub-groups and ultimately lead to a resistance to share information and debate effectively; and

- Tokenism – meaning that rather than taking an active role and contributing positively to decision making, board minorities may feel they are only there to 'make up the numbers' and fulfil a quota. This can lead to an undervaluing of skills and suppressed contribution to the organisation.

The risks from tokenism can increase if the board overlooks other more suitable candidates in order to simply fill quota.

Promoting diversity

Diversity can be promoted in a number of ways:

Imposing quotas

The most common legislative diversity quotas are for gender diversity – e.g. the rules in Norway since 2008 have required at least 40% of board members to be female. Public sector organisations are increasingly facing quotas in other areas such as race and disability.

Quotas generally achieve results quicker than voluntary action and also force organisations to address barriers to diversity.

Enhancing transparency and disclosure

This is implemented through corporate governance codes that require companies to disclose their diversity policy and compliance therewith. Supporters of the transparency (rather than legislation/quota route) believe that appointments should be made based on business needs, skills and ability rather than legislative requirements that may be inappropriate in the market.

For example, the UK Corporate Governance Code requires companies to:

- Incorporate diversity as a consideration in making board appointments; and

- Disclose in their annual reports a description of the board's policy on diversity and its progress in achieving the objectives of that policy.

Australia and Hong Kong promote diversity using a similar 'comply or explain' approach.

ICAN 2021

2.7 Davies report – Women on boards

This report was published in 2011. It is an investigation into the proportion of women at board level in UK listed companies.

In 2010 women made up only 12.5% of the members of the corporate boards of FTSE 100 companies.

Lord Davies recommended that UK listed companies in the FTSE 100 should be aiming for a minimum of 25% female board member representation by 2015. In his final summary report in October 2015, Lord Davies was able to state that the target for 2015 had been reached.

A subsequent Hampton-Alexander Review in 2016 was a business-sponsored and government-supported review into women on boards and in senior executive positions in UK listed companies. It specified a target for 33% representation by women on FTSE350 company boards and positions on the company's Executive Committee and positions reporting to the Executive Committee. It also recommended that investors should consider this matter a key governance issue when considering their responsibilities under their Stewardship Code.

ICAN 2021

3 THE ROLES OF CHAIRMAN, CHIEF EXECUTIVE OFFICER AND NEDS

Section overview

- Separation of the roles of chairman and chief executive officer
- Role of the CEO
- Role of the board chairman
- The role of non-executive directors
- The appointment of non-executive directors
- Criticisms of NEDs

3.1 Separation of the roles of chairman and chief executive officer

The two most powerful positions on the board of directors are those of chairman and chief executive officer (CEO).

To avoid the risk that one individual might dominate decision-making by the board, the UK Corporate Governance Code states that:

- The roles of chairman and chief executive officer should not be held by the same person; and
- In addition, a CEO should not go on to be the chairman of the company.

No individual on the Board should have unfettered powers of decision.

In Nigeria, the Code of Corporate Governance states that for all public companies with listed securities, the positions of chairman and chief executive officer shall be separate and held by different individuals. This is to avoid over concentration of powers in one individual.

The Singapore Code of Corporate Governance includes a provision that the chairman and CEO should 'in principle' be different individuals. Obviously, however, there should be a good working relationship between the chairman and the CEO.

In the UK, it is now unusual for the same person to be both chairman and CEO of a listed company. However, the provision in the Code that a CEO should not go on to become the company chairman has caused some controversy. The idea behind the provision in the Code is that a CEO who 'steps up' to become the company chairman might seek to dominate or influence his successor as CEO. However, some companies have argued that when a CEO decides that he wants to do something different, a company might be able to retain his experience and knowledge of the company's affairs by offering him a part-time role as chairman.

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Example: Marks and Spencer

In 2004, Marks and Spencer successfully resisted a takeover bid for the company from Philip Green. The successful takeover defence was organised by the company's new chairman (Paul Myners) and new chief executive (Stuart Rose).

During 2005 the senior independent director (a non-executive director) argued that the chairman and the chief executive were too close to each other, and that there was insufficient independence between them. After strong pressure from Lomax, Myners agreed to step down as chairman and his successor Sir Terry Burns was appointed (initially as deputy chairman in 2005) to take his place.

Critics argued that this change had broken up a highly successful working relationship between the company's chairman and CEO.

3.2 Role of the CEO

The CEO is responsible for the executive management of the company's operations. He or she is the leader of the management team and all senior executive managers report to the CEO. If there is an executive management committee for the company, the CEO should be the chairman of this committee.

Other executive directors may sit on the board of directors, the CEO reports to the board on the activities of the entire management team, and is answerable to the board for the company's operational performance.

3.3 Role of the board chairman

In many public companies, the role of chairman is part-time. The UK Corporate Governance Code states that on appointment to the position, the chairman should be independent. If companies comply with the Code, a chairman will therefore be both independent and non-executive.

The board chairman, or company chairman, is the leader of the board of directors. He or she is responsible for managing the board. Whereas codes of corporate governance have little to say about the responsibilities of the CEO, they have quite a lot to say about the role and functions of the chairman.

A previous version of the UK Corporate Governance Code identified the following responsibilities for the board chairman:

- As leader of the board, the chairman is responsible for its effectiveness in performing all aspects of its role. The chairman also sets the agenda for board discussions;
- The chairman is responsible for ensuring that all directors receive 'accurate, timely and clear information'. This is particularly important for non-executive directors, who rely for most of their information about the

company on what the chairman provides. If they are not well-informed, NEDs are unable to contribute effectively to the discussions of the board or to decision-making;

- The chairman is also responsible for communications between the company and its shareholders; and
- The chairman is responsible for ensuring that the NEDs contribute effectively to the work of the board, and for ensuring co-operative relationships between the NEDs and executive directors.

In 2003, a report on non-executive directors was published in the UK. This was called the Higgs Report (after its author) and some of the recommendations in the report were reproduced in the Higgs Suggestions for Good Practice which was issued as a supplement to the UK Corporate Governance Code.

The Higgs Suggestions include a slightly more detailed list of the functions of the board chairman. The role of the chairman, according to Higgs, should be to:

- Run the board and set its agenda. The agenda should be mainly forward-looking, and should concentrate on strategic matters (not details of management);
- Ensure that all members of the board receive accurate, timely and clear information 'to help them reach well-informed and well-considered decisions';
- Ensure effective communication with the shareholders. The chairman should make sure that the other directors are aware of the views of the major shareholders;
- Manage the board, and make sure that enough time is allowed for the full discussion of complex or controversial issues;
- With the assistance of the company secretary, arrange for the induction of new directors after their appointment, and the continuing training and development of all the board directors;
- Organise the performance evaluation of the board, its main committees and its individual directors; and
- Encourage the active participation in the board's affairs by all the directors.

The responsibilities of the chairman of board of directors in the Nigerian Code of Corporate Governance are similar to the Higg's suggestions. Additional responsibilities in the Nigerian code are:

- Playing a leading role in ensuring that the board and its committees are composed of the relevant skills, competencies and experience; and

ICAN 2021

- Acting as the main link between the board and the CEO; advising the CEO in the effective discharge of his/her duties.

The chairman is responsible for the efficient functioning of the board, and its effectiveness. He (or she) calls board meetings, sets the agenda and leads the board meetings. He decides how much time should be given to each item on the agenda. He should make sure that the board spends its time dealing with strategic matters, and not matters that should be delegated to the executive management.

The chairman also represents the company in its dealings with shareholders and (usually) the media. He is the 'public face' of the company.

Comparison of the roles of CEO and chairman

The roles of CEO and chairman can be summarised as follows:

CEO	Chairman
Executive director. Full-time employee.	Part-time. Usually independent.
Reporting lines	***Reporting lines***
All executive managers report, directly or indirectly, to the CEO.	No executive responsibilities. Only the company secretary and the CEO report to the chairman directly, on matters relating to the board.
The CEO reports to the chairman (as leader of the board) and to the board generally.	The chairman reports to the company's shareholders, as leader of the board.
Main responsibilities	***Main responsibilities***
Head of the executive management team.	Leader of the board, with responsibility for its effectiveness.
To draft proposed plans, budgets and strategies for board approval.	To make sure that the board fulfils its role successfully.
To implement decisions of the board.	To ensure that all directors contribute to the work of the board.

3.4 The role of non-executive directors

One of the reasons for having independent non-executive directors on a board is to give the board a better balance, and to reduce the possibility that the board may be dominated by one individual or a small group of individuals.

The Singapore Code of Corporate Governance identifies two main roles for NEDs:

ICAN 2021

- To challenge 'constructively' and to help to develop proposals on strategy; and

- To review the performance of management in meeting their targets.

The **Higgs Suggestions for Good Practice** stated that NEDs contribute to the board in four ways. Two of these are similar to the roles identified in the Singapore Code of Corporate Governance. The other two point even more strongly to the complex role of NEDs, in having responsibility for matters that should be kept away from the executive directors, due to the risk of a conflict of interests. The four roles identified in the Higgs Guidance are as follows:

Strategy - NEDs should challenge constructively and help to develop proposals on strategy.

Performance - NEDs should monitor the performance of executive management in meeting their agreed targets and goals.

Risk - NEDs should satisfy themselves about the integrity of the financial information produced by the company, and should also satisfy themselves that the company's systems of risk management and internal control are robust.

People - NEDs should be responsible for deciding the remuneration of executive directors and other senior managers, and should have a major role in the appointment of new directors and in the 'succession planning' for the next chairman and CEO of the company.

These roles suggest that NEDs on a unitary board have the complex task of acting partly as colleagues of the executive directors, and partly as 'policemen'. They act as colleagues in discussing strategy and helping to develop strategy. However, they act as a 'policeman' in monitoring the performance of executive management, checking the integrity of financial reporting, evaluating the effectiveness of the risk management system and internal control system, and deciding the remuneration of their executive colleagues.

It can be argued that a function of independent NEDs is to reduce the agency costs arising from the conflict of interests between the shareholders and management, by acting as independent monitors of the company's management and also by negotiating remuneration.

Senior independent director

The UK Corporate Governance Code suggests that one of the independent NEDs should be appointed as senior independent director (SID).

One of the roles of the SID is to act as a leader for the other independent NEDs, for example by calling meetings of the NEDs to discuss matters away from the executive directors.

ICAN 2021

The SID would also be expected to act in unusual circumstances, when the corporate governance of the board is not functioning properly. For example:

- A disagreement might occur between the major shareholders of the company and the chairman which cannot be resolved. The SIDmight be asked to intervene, for example by making sure that the views of the shareholders are conveyed to the rest of the board of directors; and

- The SID might be required to argue with the chairman or chief executive in a situation where the company is failing to apply proper standards of corporate governance. For example, a disagreement between the company chairman and SID was reported in the UK when the supermarket group Morrison's became a listed company. The chairman was apparently reluctant to appoint a sufficient number of independent NEDs to the board, and the SID argued strongly (and eventually successfully) that the company should comply with the provisions of the UK Corporate Governance Code.

3.5 The appointment of non-executive directors

It is generally accepted that the board of directors should collectively possess a suitable combination of experience and skills.

However, in the UK it has been common practice to recruit NEDs to listed companies from a very small circle of possible candidates. The Higgs Report on non-executive directors (2003) found that in UK public companies, only 7% of NEDs were non-British nationals, 6% were women and 1% was from ethnic minority groups. In many cases, individuals appointed as NED of a listed company were already an executive director of another listed company.

Following the Higgs Report, the UK government set up a committee to carry out an investigation into the recruitment and development of NEDs. The resulting **Tyson Report** (2003) reached several conclusions.

The effectiveness of a board of directors would be improved by having a board consisting of directors with a range of experiences and backgrounds, rather than a board whose NEDs all come from the same type of background.

Companies should have a formal system of appointing new NEDs to the board. As part of this formal system, the company should begin by identifying which particular skills were missing from the board, that the board would benefit from having. The company should then seek an individual who has the missing skills or experience that has been identified.

NEDs should be recruited from a wider range of different backgrounds. Individuals who might make excellent NEDs include senior managers in the 'marzipan layer' of corporate management, just below board level but without yet having any board experience. Other sources of NEDs should be individuals in private sector companies, 'professionals' (accountants, solicitors) and business consultants, and individuals working on the public sector or the non-commercial private sector.

ICAN 2021

The Tyson Report attracted a large amount of publicity when it was published, but it is not yet clear that it has had much effect yet on the practice of appointing new NEDs in the UK.

Keeping the board refreshed

There is a need to keep a board 'refreshed' by appointing new directors regularly, to bring fresh experience and skills to the board.

As a company grows or changes, the skills and experience required from its directors might change. This means that some of the directors should probably be changed.

Over time, the independence of a non-executive director is likely to diminish. It is therefore appropriate to replace NEDs after a number of years.

A new NED might be appointed for a three-year term and re-appointed for a further three years if the NED has contributed well to the work of the board in the first three years. After six years, a company should possibly consider whether a NED should be replaced.

Changes to the board, to keep it refreshed, affect NEDs rather than executive directors. This is because executive directors hold senior positions in the management structure of the company. Once appointed to the board, they are likely to retain their position as director as long as they retain their job.

3.6 Criticisms of NEDs

NEDs are often criticised for failing to perform effectively in their role. There are three main criticisms.

Lack of knowledge about the company and the industry or markets it operates in. NEDs often lack the information about the company that they need to make well-informed decisions. The chairman is responsible for ensuring that all directors are properly informed, but this is an 'ideal situation' that does not always exist in practice.

Insufficient time with the company. NEDs might not spend as much time with the company as they need to, in order to perform their role effectively. When a NED is appointed, there should be an understanding about how much time the NED will be expected to spend with the company. Even so, the agreed amount of time might not be sufficient.

Accepting the views of executive directors. The NEDs might be too willing at times to accept the views and opinions of executive directors, because the executives know more about the company's operations. When the NEDs are too willing to agree with the executive directors, they do not contribute as much as they should to discussions on strategy.

In spite of these criticisms of non-executive directors, it is now widely accepted in many countries that major companies should have a strong presence of

ICAN 2021

independent NEDs on the board. When NEDs do not appear to be effective in their role, institutional shareholders might well take action.

Example: PIRC

PIRC (Pensions Investment Research Consultants Ltd), a company providing corporate governance advice to institutional clients, occasionally advises its clients to use their votes as shareholders against a company's board. For example in June 2002, PIRC described Telewest, a cable television company, as a 'corporate basket case'. It recommended to its clients that they should vote against the re-election of four non-executive directors because they were not independent and because the corporate governance of the company was poor.

PIRC argued that the four directors were not independent because one held share options in the company, two represented the interests of a major shareholder and the fourth had been a NED with the company for over nine years.

PIRC also commented that the board, including these NEDs, had allowed large bonus payments to be made to executive directors that were not justified in view of the company's performance. (Telewest was subsequently taken over.)

ICAN 2021

4 DIRECTORS AND THE LAW

Section overview

- The powers and rights of directors
- Appointment, election and removal of directors
- Duties and legal obligations of directors
- Share dealings by directors
- Disqualification of directors
- Changing directors
- The board of directors and NOCLAR

Corporate law varies between countries. However in all countries, directors act within a legal and regulatory framework. They have certain rights as directors, but also certain duties and responsibilities. If they fail to carry out their duties or responsibilities properly, they could become personally liable for their failure.

Various aspects of company law are described in this section. In different ways, each aspect of the law has implications for corporate governance. The section ends with an explanation of the role of the board of directors with regard to NOCLAR – non-compliance with laws and regulations by any director, manager or employee of their company.

4.1 The powers and rights of directors

The powers of the company are given to the board of directors as a whole, although many of these powers are delegated to executive management. Individual directors should normally have the authority to enter into contracts in the company's name. In UK law, individual company directors have an implied power to make legally-binding contracts for the company, even if they have not been given the specific actual authority to do so.

Service contracts

Executive directors are full-time employees of the company. As employees, they have a service contract with the company. A service contract for an executive director is a legally-binding contract of employment. A service contract includes terms such as entitlement to remuneration including pension rights, and a minimum notice period for termination of office.

An executive director, like any other employee of the company, should be protected by the same legal rights that are given to all employees by the employment law of the country.

The service contract of an executive director should specify his role as an executive manager of the company, but might not include any reference to his role as a company director. However, if he is subsequently asked to resign from

ICAN 2021

the board, it is generally-accepted practice that the company is also dismissing him as an executive manager. The director then has all the rights given to him in his service contract in the event of dismissal, as well as rights provided by law relating to unfair or wrongful dismissal by the company.

Fixed-term contracts

Non-executive directors are usually appointed for a fixed term. In Nigeria, as in the UK, normal practice is to appoint a NED for a three-year term. At the end of this term, the appointment might be renewed (subject to shareholder approval) for a further three years. This cycle of three-year appointments continues until the NED eventually retires or is asked to retire.

4.2 Appointment, election and removal of directors

An aspect of corporate governance is the power of the shareholders to appoint directors and remove them from office. Practice in the UK is fairly typical of other countries.

When a vacancy occurs in the board of directors during the course of a year, the vacancy is filled by an individual who is nominated and then appointed by the board of directors.

However, at the next meeting of the company's shareholders (the next annual general meeting), the director stands for election. In Nigeria, as in the UK, the director is proposed for election, and is elected if he or she obtains a simple majority (over 50%) of the votes of the shareholders.

Existing directors are required to stand for re-election at regular intervals. In Nigeria, as in the UK, most companies include in their constitution (articles of association) a requirement that one-third of directors should retire each year by rotation and stand for re-election. This means that each director stands for re-election every three years. (This is why appointments of NEDs are for periods of three years.)

It is usual for directors who retire by rotation and stand for re-election to be re-elected by a very large majority. However, when shareholders are concerned about the corporate governance of a company, or about its financial performance, there might be a substantial vote against the re-election of particular directors.

When a director performs badly, it should be expected that he or she will be asked by the board or the company chairman to resign. This is the most common method by which directors who have 'failed' are removed from office.

Occasionally, a director might have the support of the board, when the shareholders want to get rid of him. UK company law allows shareholders (with at least a specified minimum holding of shares in the company) to call a meeting of the company to vote on a proposal to remove the director. A director can be removed by a simple majority vote of the shareholders.

ICAN 2021

When a director is removed from office, he retains his contractual rights, as specified in his contract of employment. This could involve a very large payment.

4.3 Duties and legal obligations of directors

Directors have certain legal duties to their company. If they fail in these duties, they could become personally liable for the consequences of their breach of duty.

In the UK for example, the Companies Act 2006 introduced statutory duties for directors. These are duties to:

- act within their powers;
- promote the success of the company for the benefit of its shareholders;
- exercise independent judgement;
- exercise reasonable skill, care and diligence;
- avoid conflicts of interest;
- not to accept benefits from a third party; and
- declare any interest in a proposed transaction with the company.

Prior to the Companies Act 2006, the legal duties of UK company directors to their company have been:

- a **duty of skill and care; and**
- a '**fiduciary duty**': this is a duty to act in the utmost good faith in the interests of the company.

Two examples of a breach of fiduciary duty are putting personal interests ahead of the interests of the company (when there is a conflict of interest) and failure to disclose a personal interest in a contract with the company. Both of these breaches of duty are agency problems, identified in agency theory.

Conflicts of interest

A director would be in breach of his fiduciary duty to the company, for example, if he puts his own interests first, ahead of the interests of the company.

One example from UK law is the case of an individual who was the managing director of a company that provided consultancy services. One client decided that it would not use the company for planned consultancy services, but indicated that if the managing director applied for the contract personally, it might be willing to give the consultancy work to him. The managing director informed his fellow directors that he was ill, and persuaded the company to release him from his contract of employment. On ceasing to be a director of the company, he applied for the consultancy work with the client, and was given the work. His former company successfully sued him to recover the profits from the contract.

ICAN 2021

The court decided that the former managing director was in breach of his fiduciary duty to the company, because he had put his own interests first, ahead of the interests of the company in obtaining the contract work for himself.

Disclosure of interests

A breach of fiduciary duty would also occur if a director has an **interest in a contract** with the company but fails to disclose this interest to the rest of the board and obtain their approval.

Typically, a company director might be a major shareholder in another company which is about to enter into a supply contract with the company. When this situation occurs, the director must disclose his interest as soon as possible to the rest of the board, and obtain their approval. Failure to disclose the interest would make the director liable to hand over to the company all his secret profits from the contract.

In Nigeria, as in the UK, it is also a criminal offence for a director to fail to disclose an interest, and the punishment for a breach of this law is a fine.

4.4 Share dealings by directors

It is common for directors of stock market companies to own some shares in their company.

Because they work inside the company, directors will occasionally obtain information about the company (or another company) that:

- has not yet been made public, and is still confidential; and
- when it is eventually made public, it is likely to have a significant effect on the price of the company's shares (or the price of the other company's shares).

An example is obtaining information about a planned takeover bid involving the company. When one company wants to take over another, it will make a private approach to the board of the other company, indicating its wish to buy the shares in that company. If the board of the target company is willing to negotiate terms, there is a period during which secret discussions take place. Inevitably, the directors of both companies will be aware of the discussions. During this period, the information about the probable takeover bid remains confidential, but when the information becomes public (after the terms of the takeover are agreed and announced to the stock market) the share price of the target company normally rises substantially, up to the price of the takeover bid.

It should be apparent that a director could use the confidential price-sensitive information about the takeover bid to buy shares in the target company, before the takeover is announced. By purchasing the shares, the director would expect to make a substantial profit by selling the shares in the takeover. The profit of the director, however, would be obtained at the expense of the shareholder who sold him the shares.

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Taking advantage of price-sensitive information about a company to buy or sell shares, or to encourage anyone else to buy or sell shares, is a criminal offence, known as insider dealing.

When an individual such as a director is found to have carried out insider dealing (or insider trading):

- he might be found to have committed a criminal offence, and face a fine and imprisonment; and/or
- he might be found liable in civil law to the individuals at whose expense he made his profit.

Example: Directors' share dealings

At the end of its financial year, a major stock market company (not named here) found that its profits would be much lower than stock market investors were expecting. In addition, it was probable that news of an anti-competitive arrangement with a major supplier might be made public in the near future.

Most of the directors and many senior executives in the company sold substantial quantities of shares in the company that they owned, before these items of news were released to the stock market. In doing so, they avoided losses that they would otherwise have suffered; when the information was released to the public, the company's share price fell.

The directors and senior managers of the company made themselves liable to a charge of insider dealing, avoiding losses at the expense of the investors who bought their shares. In addition, the directors who sold their shares in the company were in breach of their fiduciary duty, because they put their interests first, ahead of the interests of the other shareholders.

Stock market restrictions on share dealings by directors

Insider dealing is an offence. However, directors of a company will often be in a position to judge how well or badly the company is performing when other investors are not in a position to make the same judgement. If they buy or sell shares in their company, they might be suspected of insider dealing and putting their own interests first.

In the UK, the law on insider dealing has been supplemented by rules known as the Market Abuse Regulations. In Nigeria, insider dealing is prohibited by the Investment and Securities Act 2007

The main requirements of the Regulations are as follows;

- Directors must not deal in shares of their company during a 'close period'. A close period is the period before the announcement to the stock market of the company's interim and final financial results;
- A director must not deal in shares of the company at any time that he has price-sensitive information; and

ICAN 2021

- Before dealing in the company's shares at any other time, a director must obtain the prior permission of the chairman.

4.5 Disqualification of directors

The corporate law of a country might provide for the disqualification of any individual from acting as a director of any company, where the individual is guilty of behaviour that is totally unacceptable from a director.

To some extent, laws on the disqualification of directors might possibly provide some protection to the shareholders of a company. However, disqualification only occurs after the unacceptable behaviour has occurred.

In Nigeria, as in the UK, for example, the law allows a court to disqualify an individual from acting as a director of any company in a variety of circumstances. These include:

- when a director is bankrupt;
- when a director is suffering from a mental disorder; and
- when a director has been found guilty of a crime in connection with the formation or management of a company (such as the misappropriation of company funds).

However, the disqualification of an individual from acting as a director is more likely after a company has become insolvent, rather than whilst the company is still operational and solvent.

4.6 Changing directors

Directors should not expect to serve as directors of the same company for ever. In a well-governed company, there should be a process of 'renewal' over time with new directors coming on to the board to bring a fresh outlook and other directors leaving.

A system of good governance should provide for changes to the membership of a board of directors over time.

On some occasions, a director may retire voluntarily. He can do so at any time. His reasons for retiring may be to take a job somewhere else, or because he has reached retirement age, or simply because he does not want to serve as a director any more.

A company may have a requirement in its constitution for directors to retire by rotation, typically every three years. . The code of corporate governance in Nigeria states that all directors should be submitted for re-election at regular intervals of at least once every three years.The UK Corporate Governance Code also states that directors should retire by rotation at least every three years. Directors retiring by rotation do so at the company's Annual General Meeting.

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When a director retires by rotation, he or she can stand again for re-election at the AGM. To get re-elected, they need votes in favour from a majority of the shareholders.

In theory this means that shareholders get an opportunity to remove any director they do not like, but only in a year when the director retires by rotation and stands for re-election. For example the shareholders may try to prevent the re-election of the chairman of the remuneration committee (or any other member of the remuneration committee) if they think that remuneration for senior executives is too generous.

In practice, it is difficult for 'dissident' shareholders in a large company to obtain a majority of votes to prevent the re-election of a director, if they are voting against the wishes of the rest of the board.

Changes in a board of directors are often decided by a majority of the board itself.

The board may decide that the contract of a non-executive director should not be renewed. Contracts for NEDs are usually for a three-year period, and if the board decides that it wants to let a NED go (perhaps in order to recruit a new person to the board), it can simply tell the outgoing NED that his contract will not be renewed for a further three years.

The board may decide that it will not recommend the re-election of a director, who stands for re-election against its wishes. Shareholders are normally unlikely to re-elect a director who does not have the support of his board colleagues.

When a director is performing badly in his job, the rest of the board may decide that he must be forced to resign. The director is informed that he has lost the confidence of his board colleagues, and must go.

On leaving the board, the individual may also be required to resign from his job, if he is an executive director. When this happens he negotiates compensation for loss of office. (There have been many cases where a CEO has been 'sacked' from the board and has received very high compensation, seen as a 'reward for failure'. A notable example in the UK was the money paid to Sir Fred Goodwin, CEO of the Royal Bank of Scotland, when he was forced out of the company after its collapse in 2009 and the UK government took a majority shareholding.).

4.7 The board of directors and NOCLAR

Under the Non-compliance with laws and regulations (NOCLAR) regulations, now introduced into ICAN's professional Code of Conduct, professional accountants are permitted to set aside their duty of confidentiality in order to disclose instances of NOCLAR to appropriate public authorities in certain circumstances. The introduction of NOCLAR requirements into the ICAN Code follows its earlier introduction to the IESBA Code.

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NOCLAR is defined as:

- Any act of omission or commission;
- Intentional or unintentional;
- Committed by a client, an employer, or an employee of an employer; and
- That is contrary to the law or regulations concerning matters that directly affect the client's or the employer's financial statements or business in a material or fundamental way.

NOCLAR includes breaches of the law or regulations concerning:

- Fraud, corruption or bribery;
- Money laundering, terrorist financing or proceeds from crime;
- Securities markets trading;
- Banking services;
- Data protection;
- Tax;
- Environment protection; and
- Public health and safety.

The NOCLAR regulations were introduced because the duty of confidentiality was preventing professional accountants from disclosing illegal acts by clients or employers.

Although the NOCLAR regulations apply primarily to professional accountants, they have implications for a board of directors and senior management in companies. The board must take strong measures to encourage a culture of regulatory compliance into their organisation. If they do not, professional accountants within the company will be expected to report cases of NOCLAR that occur.

Boards of directors should therefore be taking proactive measures to ensure that their system of internal controls, particularly financial controls and compliance controls, are effective (using the internal audit function, perhaps to keep this under regular review). They should also ensure that an effective system of whistle blowing is in place, to enable employees to report anonymously cases of NOCLAR that they become aware of.

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5 INDUCTION, TRAINING AND PERFORMANCE EVALUATION OF DIRECTORS

Section overview

- Induction for new directors
- Training and professional development for directors
- Performance evaluation
- Assessments of performance

5.1 Induction for new directors

Induction is a form of training. In a company, its purpose is to make a new person familiar with what the company does, how it operates, how it is organised, who the senior managers are and so on. New non-executive directors need induction training so that they can learn much more about the company that they are now helping to govern. Unless they know about the company in some detail, their views and opinions might be misinformed.

Executive managers who are appointed to a board of directors for the first time might also need induction training, to improve their familiarity with aspects of the company that they do not know much about. Executive managers should know more about the company than new non-executive directors, but this does not mean that they know everything that they should know about the company.

The Code of Corporate Governance in Nigeria states that the board should establish a formal orientation programme to:

- Familiarise new directors with the company's operations, strategic plan, senior management and its business environment; and
- Induct the new directors in their fiduciary duties and responsibilities.

Induction to gain familiarity with the company

The Higgs Guidance suggested that the purpose of induction should be to help the new director to:

- develop an understanding of the company, its business and the markets in which it operates;
- get to know the people who work for the company; and
- develop an understanding of the company's main relationships, for example with key suppliers or customers.

An induction programme might therefore include:

- visits to important sites/locations where the company carries out its operations;

- demonstrations of the company's products;
- meetings with senior managers and staff;
- possibly, meetings with professional advisers of the company; and
- possibly, meetings with major shareholders (but only if the shareholder wishes to meet the new director).

Induction to gain familiarity with being a director of the company

Another aspect of induction is helping a new director to become familiar with the duties of being a director in the company. This can be particularly important for individuals who have never been a company director before.

A new director should be given:

- information about the matters that are reserved for the board (what the board does);
- guidance on the rules on share dealings by directors (including the law on insider dealing) ;
- copies of the minutes of recent board meetings;
- a schedule of dates for future board meetings; and
- details of the committees of the board, and their responsibilities.

5.2 Training and professional development for directors

All directors should update and refresh their skills and knowledge on a regular basis, and the chairman should ensure that they do so.

In Nigeria it is mandatory for all directors to participate in periodic, relevant continuing education programmes (at the company's expense) designed to update their knowledge and skills and keep them informed of new developments in the company's business and operating environment.

The exact nature of the training and professional development that should be provided will vary with the company and the requirements of the individual director.

Deciding on the training or development that a director should receive might be discussed each year, as a part of the performance review of the director.

Subject areas for training and development might include formal training in business strategy, corporate governance issues or developments in financial reporting. Directors should also be given demonstrations of new products, services or processes that the company has developed.

The Higgs Report on non-executive directors (2003), commenting on development and training, stated that non-executive directors, on appointment, will already have some relevant knowledge, skills, abilities and experience.

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However, the non-executive director's effectiveness on the board will depend on far more than their existing skills; they need to have the ability to extend their skills further and refresh their knowledge. They therefore need to take some sort of 'training' – not formal, classroom training, but continued professional development tailored to the individual.

5.3 Performance evaluation

The board is expected to perform a particular role for the company. Effective corporate governance depends on having an effective board. It would therefore be appropriate to carry out regular reviews, to assess how well the board has performed.

The board is accountable to the shareholders, and it might therefore be argued that the performance of the board should be judged by the shareholders. However, in practice this would be difficult to achieve.

In some countries, codes of corporate governance include a requirement that the performance of the board and its individual directors should be reviewed regularly, and the review should be carried out by the board itself. The chairman should have the responsibility for the performance evaluation.

The purpose of the performance review should be to ensure that:

- the board is fulfilling its role and carrying out its responsibilities effectively;
- the board committees are also fulfilling their roles effectively;
- individual directors are contributing effectively to the work of the board and its committees; and
- the collective skills and experience of the board members remain appropriate for the needs of the company.

Nigeria Corporate Governance Code on performance evaluation.

The Corporate Governance Code in Nigeria states that the board should establish a system to undertake formal and rigorous annual evaluation of its own performance, the performance of committees, the chairman and individual directors.

The board is expected to state the criteria and key performance indicators as well as targets to be used in the evaluation of the board, its committees, the chairman and individual committee members.

To facilitate the performance evaluation of the board, its committees or individual directors, the board may engage the services of external consultants.

The chairman has responsibility to oversee the performance evaluation of the chief executive officer (CEO). In turn, and based on agreed criteria or performance indicators, the CEO carries out the evaluation of executive directors.

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Any director whose performance is determined to be unsatisfactory may either undergo further training or may be removed in accordance with established procedures.

UK Corporate Governance Code on performance evaluation

The UK Corporate Governance Code states that:"There should be a formal and rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors…. The chair should act on the results of the evaluation by recognising the strengths and addressing any weaknesses of the board." In FTSE 350 companies, this formal performance evaluation should be facilitated by an independent external firm at least every three years. Individual evaluation should aim to show whether each director continues to contribute effectively and demonstrate commitment to the role, including commitment of time. …). Where appropriate, the chair should propose that new members should be appointed to the board or should seek the resignation of one or more directors.

The performance review of the chairman should be carried out by the NEDs, under the leadership of the senior independent director.

The directors' report in the annual report and accounts should state how the performance evaluation of the board as a whole, its committees and its individual directors has been conducted.

Singapore Code of Corporate Governance on performance evaluation

The requirement for annual performance evaluation was introduced into the UK Code in 2003. The UK Code is not unique in requiring performance evaluation. The Singapore Code of Corporate Governance includes similar requirements, although the responsibility for carrying out the review is given to the Nominations Committee of the board, not the board chairman. The Code includes the following guidelines:

- The Nominations Committee should decide how the performance of the board should be evaluated and should suggest objective criteria for assessment;
- The performance evaluation of the board should also consider the changes in the company's share price over a five-year period; and
- There should also be evaluation of the performance of individual directors.

The use of external consultants for performance evaluation

In most UK listed companies, the annual performance review is carried out by the chairman, with the assistance of the company secretary.

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The chairman might use the services of specialist external consultants. The Higgs Guidance comments that 'the use of an external third party to conduct the evaluation will bring objectivity to the process.'

However, companies may combine performance evaluation by the chairman personally with the use of external consultants, for example by alternating the use of external consultants in one year with internal review by the chairman the next year.

5.4 Assessments of performance

Assessing the performance of the board as a whole

Questions that might be asked to assess the performance of the board as a whole include the following:

- How well has the board performed against specific objectives or performance targets that were set?
- What has been the contribution of the board to the development of strategy?
- What has been the contribution of the board to ensuring effective risk management?
- Is the composition of the board and its committees suitable? Is there a suitable balance of knowledge, experience and skills?
- How well (or badly) did the board respond to any crisis that occurred during the year?

There should also be an **evaluation of the procedures of the board** and its committees, to ensure that they use effective working practices. This should include an assessment of the length and frequency of board meetings, whether important issues were given the full amount of time and consideration that they needed, and what the meetings have achieved.

Assessing the performance of individual non-executive directors

Questions that might be asked to assess the performance of individual non-executive directors include the following:

- Has the attendance of the NED at meetings been satisfactory? Was he (or she) properly prepared for the meetings?
- Does he show a willingness to spend time and effort with the company?
- What has been the quality and value of his contributions to meetings?
- What has he contributed to the development of (1) strategy and (2) risk management?
- How successfully have they brought their knowledge and skills to the discussions and decision-making of the board?
- How has he refreshed his knowledge and skills during the year?
- Does he give in too easily to the opinions of other directors?
- How good (or bad) are his relationships with other board members?
- Does he communicate effectively with anyone in management other than the executive directors on the board?

6 THE NEED FOR BOARD COMMITTEES

Section overview

- The nature of a board committee
- The main board committees
- The reasons for having board committees

6.1 The nature of a board committee

A board committee is a committee set up by the board consisting of selected directors which is given responsibility for monitoring a particular aspect of the company's affairs for which the board has reserved the power of decision-making.

A committee is not given decision-making powers. Its role is to monitor an aspect of the company's affairs; and:

- report back to the board; and
- make recommendations to the board.

The full board of directors should make a decision based on the committee's recommendations. When the full board rejects a recommendation from a committee, there should be a very good reason for doing so.

A board committee will meet with sufficient frequency to enable it to carry out its responsibilities. It is important to remember, however, that **a board committee is not a substitute for executive management** and **a board committee does not have executive powers**. A committee might monitor activities of executive managers, but it does not take over the job of running the company from the management.

6.2 The main board committees

Within a system of corporate governance, a company might have at least three or possibly four major committees. These are:

- a **remuneration committee**, whose responsibility is to consider and negotiate the remuneration of executive directors and senior managers;
- an **audit committee**, whose responsibility is to monitor financial reporting and auditing within the company;
- a **nominations committee**, whose responsibility is to identify and recommend individuals for appointment to the board of directors; and
- a **risk management committee**, where the responsibility for the review of risk management has not been delegated to the audit committee.

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6.3 The reasons for having board committees

There are two main reasons for having board committees:

The board can use a committee to delegate time-consuming and detailed work to some of the board members. Committees can help the board to use its resources and the time of its members more efficiently; and

The board can delegate to a committee aspects of its work where there is an actual or a possible conflict of interests between executive directors (management) and the interests of the company and its shareholders. However, to avoid a conflict of interests, board committees should consist wholly or largely of independent directors. This means independent non-executive directors.

- A remuneration committee of independent non-executive directors negotiates and recommends remuneration packages for executive directors or senior managers. The committee members do not have a personal interest in the remuneration structure for senior executives, because they are not remunerated in the same way as executives. They receive a fixed annual fee.

- An audit committee of independent non-executive directors can monitor financial reporting and auditing, to ensure that these are carried out to a satisfactory standard, and that executive management are not 'hiding' information or presenting a misleading picture of the company's financial affairs.

  The work of the audit committee therefore provides a check on the work of executive managers, such as the finance director. The committee can also monitor the effectiveness of the auditors, to satisfy themselves that the auditors carry out their work to a suitable standard.

- Similarly, the work of a risk committee of the board should be to satisfy itself that executive management have a suitable system of risk management and internal control in place, and that these systems function effectively. This is another check on executive management.

- A nominations committee makes recommendations about new appointments to the board. The views of executive directors are important in this aspect of the board's work, particularly when a vacancy for a new executive director occurs. However, independent non-executives should have some influence in the nominations process, to make sure that new appointments to the board will not be selected 'yes men' and supporters of the CEO or chairman.

Through the work of the board committees, independent non-executive directors therefore have a very important role to play in providing good corporate governance.

7 AUDIT AND CORPORATE GOVERNANCE

Section overview

- External audit and corporate governance
- Internal audit and corporate governance
- The audit committee

A key requirement for good corporate governance is that a company must have a robust system of internal controls, including financial and accounting controls. Both internal and external audit have a role in corporate governance, by providing assurance about the reliability of financial reporting and the effectiveness of internal controls.

7.1 External audit and corporate governance

Shareholders, creditors and other stakeholders in a public company rely on the information contained in its annual report and accounts, which are audited each year by a firm of independent auditors. The purpose of an independent (external) audit is to give a professional and independent opinion:

- on whether the financial statements give a true and fair view of the financial position of the company as at the end of the financial year covered by the report, and of its financial performance during the year; and
- about some other disclosures in the annual report.

The external audit and external audit report are therefore intended to provide reassurance to stakeholders, and the shareholders in particular, about the stewardship of the company by the board of directors.

It is not the purpose of an external audit to discover any fraud within the company. The board of directors is responsible for preventing fraud in their company or detecting fraud, if it occurs.

The company's system of internal control should be designed to limit the risk of fraud and error, and the board is responsible for monitoring the effectiveness of the internal control system. This is a core principle of corporate governance. The directors are fully accountable to the shareholders and so are fully responsible for the information in the annual report and accounts.

It is not the primary responsibility of the external auditors to detect fraud. The auditors will assess the risk or possibility that fraud or error might have caused the financial statements to be materially misleading. If they find weaknesses in the company's financial controls, they will report these to the board (audit committee). They might discover fraud during the course of their audit work, in which case it would be their responsibility to report the matter to the board of directors.

An area for dispute, however, is whether the auditors ought to be able to identify fraud or a significant error during the course of their audit work, whenever a fraud or error occurs. Although they are not responsible for the financial statements, it can be argued that a failure by the auditors to discover a major fraud or material

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error might be the result of professional negligence. If they are negligent, they should be held liable to the company and its shareholders.

7.2 Internal audit and corporate governance

A company may have its own internal audit team, or it might appoint an external firm of accountants to carry out internal audits. Internal audit is a form of check or monitoring system on the company's systems of controls.

The internal audit function is a part of the risk management and control function of corporate governance. Internal audit has been defined as: 'an appraisal system established by management for the review of the accounting and internal control systems [of the entity].'

Although often associated with reviews of financial controls within an entity, internal audit can be applied to operational controls and compliance controls as well as financial controls.

Internal audit helps management to monitor the controls within their entity. As entities grow in size and complexity, and become global in nature, the task of monitoring controls becomes more difficult.

Similarly, as markets become increasingly competitive, it is important that entities should be very competitive themselves. This means using resources efficiently and effectively. An internal audit function can be used to monitor the efficiency of operations.

In many countries there is a large amount of statutory and accounting regulation, including corporate governance regulation. An internal audit function can be used by management to check on compliance with laws and regulations.

Many entities use complex IT systems. Specialist internal auditors can help management to review the effectiveness of controls within IT systems (by means of IT audits).

There is no legal requirement for an entity to establish an internal audit function. The fact that many companies do so indicates that there are significant benefits to be gained. In particular, since risk management is considered to be a critically important element of corporate governance, internal audit helps to provide assurance that risks are being well managed and controlled.

Internal audit activities typically include one or more of the following:

- **Monitoring of internal control** - Senior management need to reassure themselves that internal controls are functioning effectively. An internal audit department is usually given the specific responsibility for reviewing controls, monitoring their operation and recommending improvements;

- **Examination of financial and operating information** - An internal audit department might be given the responsibility for a detailed examination of financial and operating information, and in particular, its reliability and usefulness;

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- **Review of the economy, efficiency and effectiveness of operations**, including non-financial controls of an entity. Audits of economy, efficiency and effectiveness can be carried out on any aspect of operations and are usually called value for money (VFM) audits; and

- **Review of compliance.** Senior management may ask the internal auditors to check that operational departments are complying properly with certain laws, regulations and other external requirements, or with management policies and directives and other internal requirements. These investigations are often called 'compliance audits'.

7.3 The audit committee

The Nigerian Code of Corporate Governance calls for the establishment of several board committees, including an audit committee. The purpose of board committees is to have oversight of aspects of the company's business over which executive directors and senior management should not have control, due to conflicts of interest. Members of an audit committee should be non-executive directors, with a majority of them independent NEDs, if possible.

The Nigerian Code goes into extensive detail about the responsibilities of an audit committee, which cover oversight of both external and internal audit. These include the following responsibilities:

- To ascertain whether the accounting policies of the company are in accordance with the law;

- To review the scope and planning of external audit requirements;

- To review the findings of the management letter from the external auditors to the board of directors, pointing to any weaknesses in the system of accounting controls;

- Recommend to the board the appointment, removal and remuneration of the external auditors;

- To keep under review the effectiveness of the company's system of accounting and other internal controls;

- To authorise the internal auditors to carry out investigations into any aspect of the company's systems and procedures; and

- To review regularly the effectiveness of the system of internal controls, and receive quarterly reports from the internal auditors on this subject.

8 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain the role of the board
- Discuss best practice for the composition of the board
- Define executive, non-executive, independent director and board diversity
- Compare and contrast between the roles of the chairman, CEO, NEDs and other directors
- Summarise the main laws relating to directors and the responsibilities of the board with regard to NOCLAR
- Explain best practice guidelines for the induction, training and performance evaluation of directors
- Discuss the need for and typical composition of board committees
- Discuss the relevance of external and internal audit for good corporate governance, and the role of an audit committee

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CHAPTER 14

Directors' remuneration

Contents

1 Principles of directors' remuneration
2 Remuneration package structures
3 Performance-related incentive schemes
4 Other remuneration issues
5 Chapter review

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INTRODUCTION

Detailed syllabus

A	**Introduction**
A6 (c)	Explain the concept of corporate governance and discuss: Structure, principles, functions and mechanisms of corporate governance.
D	**Governance**
D2	Explain the nature, significance and scope of enterprise governance and threats to effective governance
D3	Identify and assess roles and responsibilities of an effective board in a given scenario.

Exam context

In the previous chapter you were introduced to the principles of an effective board of directors. You also learnt about the composition and role of the board.

In this chapter you will learn more about what the remuneration package of a director should be and the reasons for the different component elements of a remuneration package.

By the end of this chapter students will be able to:

- Summarise the purpose of a remuneration package and explain the general principles of directors' remuneration;
- Discuss the structure of directors' remuneration packages, differentiating between short- and long-term incentives;
- Explain how performance-related incentive schemes work; and
- Comment on other remuneration issues such as reporting, service contracts, compensation for loss of office, ethics and competition.

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1 PRINCIPLES OF DIRECTORS' REMUNERATION

Section overview

- Remuneration: executive and non-executive directors
- Components of a remuneration package
- The purpose of a remuneration package

1.1 Remuneration: executive and non-executive directors

In some countries, for example the USA, it is common for most senior executives to be excluded from the board of directors. References in this chapter to 'directors' remuneration' mean the remuneration of executive directors and other senior managers. The term 'directors' pay' will be used as a convenient general term.

Non-executive directors are paid an annual fee for their services. This is usually a fixed amount, based on the estimated number of days that the director will spend with the company during the year, for example attending board meetings and meetings of board committees.

A general principle of corporate governance is that the non-executives probably cannot be considered properly independent if they receive any additional remuneration from the company other than a basic fee. Additional remuneration could take the form of:

- fees for additional consultancy services;
- membership of the company's share incentive scheme; and
- membership of the company's pension scheme.

1.2 Components of a remuneration package

The remuneration package for an executive director is a part of the director's contract of service. Remuneration is reviewed regularly, typically each year. The broad framework of a remuneration package is agreed through negotiation between the individual director and the remuneration committee. The package is negotiated when the director first joins the company, and might be re-structured at any subsequent time.

The components of a remuneration package are commonly:

- a basic salary;
- one or more annual cash bonuses, linked to the achievement of specific performance targets;
- free shares in the company or share options; and
- pension rights or a contribution to a pension fund for the director.

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A director will often receive additional benefits such as free medical insurance, a company car, use of a company aeroplane or helicopter, and so on. Occasionally, a director might be paid a 'joining fee' to persuade him to join the company.

1.3 The purpose of a remuneration package

A remuneration package should attract individuals to a company, and persuade them to work for the company. The size of the remuneration package that is needed to attract 'top quality' individuals depends largely on conditions in the labour market. In other words, the amount that a company must offer its directors depends on:

- what other companies are paying; and
- how many suitable candidates are available.

The Corporate Governance Code in Nigeria states that the levels of remuneration should be sufficient to attract, motivate and retain skilled and qualified persons needed to run the company successfully. However, a company should avoid paying more than is necessary for this purpose.

The UK Corporate Governance Code states: "Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy."

One purpose of a remuneration package is to provide incentives for the director. Directors should be rewarded with incentives, so that they are motivated to achieve performance targets.

A generally-accepted view is that unless a director is rewarded for achieving targets, he or she has no incentive to improve the company's performance. (This view is based on the conflict of interest between management and shareholders.)

It can also be argued that companies have to offer incentives to their directors because other companies do so. Directors usually expect cash bonuses and equity awards.

If suitable performance targets are selected, and the targets are made sufficiently challenging, the rewards for directors will be made dependent on achieving performance targets for the company that are in the best interests of the shareholders.

However, a major difficulty in practice is finding suitable performance measures and performance targets as a basis for the payment of incentives.

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2 REMUNERATION PACKAGE STRUCTURES

Section overview

- Finding a balance between the different components of remuneration
- Basic salary
- Short-term incentives: bonus
- Long-term incentives: share plans
- Pensions
- The purpose of each component of a remuneration package

2.1 Finding a balance between the different components of remuneration

When a remuneration committee designs a remuneration package for a director or senior manager, it should consider:

each separate element in the package; and also

all the elements in the package as a whole.

There are two issues to consider: the total size of the package and how it should be divided into its different components, between short-term and long-term incentives, between cash and equity and between current pay and pension rights. For example, a director may be paid an average basic salary, but may receive a generous pension entitlement and an attractive long-term incentive scheme. Another director may receive a low basic salary but a very attractive short-term cash bonus incentive scheme.

The relative proportions can vary significantly between companies, although the incentive element should be high.

2.2 Basic salary

The purpose of a basic salary is to give the director a guaranteed minimum amount of pay. If a director does not receive a basic salary, he will depend entirely on incentive payments. It could be argued that this would not be fair on the director, and would put him or her under stress.

The size of basic salaries varies between companies, and depends to some extent on the salaries paid to similar directors in comparable companies. However, salaries are also dependant on the extent to which directors and senior executives have an opportunity to boost their earnings through incentive schemes. A lower basic salary might be acceptable to a director who expects to receive large cash bonuses or equity awards.

2.3 Short-term incentives: bonus

Many companies have an incentive scheme for its senior executives that offers directors and other senior managers in the scheme an annual cash bonus for meeting or exceeding target performance levels. The bonus scheme may be on a

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sliding scale, with a bonus for meeting target and higher bonuses for exceeding targets by a certain amount.

It is widely believed that the nature and potential size of annual bonuses can drive the behaviour of senior executives. Executives will possibly be much more concerned about short-term targets and annual cash bonuses than about longer-term share incentives and bonuses.

There may be a cap on the maximum bonus that any individual may earn. For example, an incentive scheme may provide for a bonus equal to 25% of basic salary for meeting performance targets, with a maximum bonus of 50% of salary for exceeding targets.

The bonus payments will be linked to one or more key performance indicators, possibly using a balanced scorecard approach. The targets may include:

- performance indicators for the business as a whole (such as a target for earnings per share); and/or
- personal targets for the individual executive. These might be financial targets, but might also be non-financial targets.

For example a sales director might receive a cash bonus of 15% of his basic salary if the company achieves its target profit for the year, and an additional 15% cash bonus if annual sales increase by at least 5% above the previous year.

2.4 Long-term incentives: share plans

Long-term incentive schemes usually take the form of awards of either:

- share options; or
- fully-paid shares in the company.

A company might have several different share schemes, and individuals may participate in several or all of them. For example, there may be a share scheme or share option scheme for all employees, and a separate (additional) equity reward scheme for top executives.

Share options

A share option gives its holder the right, at a future date, to buy shares in the company at a fixed price. For example, a director might be given 20,000 share options, giving him the right to buy 20,000 new shares in the company at a fixed 'exercise price' of, say, ₦1,000 on or after a specified date in the future.

If the company's share price increases, the director will be able to exercise the share options and buy new shares in the company at a price below their current market price. If he wishes to do so, he can sell his new shares, and make an immediate profit.

A company will appoint a committee to decide how many share options should be granted to each individual. In the case of share option schemes for senior executives, this might be a responsibility of the remuneration committee.

In the UK, the earliest time that share options can be exercised is three years after they have been awarded. In Nigeria, share options should not be

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exercisable until one year after the expiration of the minimum tenor of directorship. The option holder will make a profit if the share price rises above the exercise price during that time. The individual therefore has an incentive to want the share price to rise over the period. This is why share options are a long-term incentive.

The exercise price for the share options should not be lower than the market price of the shares at the time the share options were awarded. For example, if the share price is ₦960, a company should not issue share options with an exercise price of, say, ₦875. The code of Corporate Governance in Nigeria states that except with the authorization of SEC, the board should ensure that share options are not priced at a discount. (In the US, several companies were accused in 2006 of back-dating share options for executives and awarding options at an exercise price equal to the market price at an earlier date, when the share price was lower.).

Under-water share options

A problem with share options as a long-term incentive for directors is that the share price can go down as well as up. If the share price falls below the exercise price for a directors' share options, the share options are said to be 'out-of-the-money' or 'under water'. Unless there is a reasonable chance that the share price will recover strongly, the share options will therefore have no value. If they have no value, or very little value, they cannot provide an incentive to the option holder.

Companies faced with this problem in the past have tried to maintain the incentive for a director, after the share price has fallen, by:

- cancelling the existing share options; and
- awarding new share options to the executive, at a lower exercise price.

The executive will then be rewarded if the share price rises above its new, lower level.

However, there are critics of this practice of cancelling share options that are under water and replacing them with new options. They argue that share options are awarded as a long-term incentive to executives, to link their personal interests more closely to the interests of the shareholders. If the share price goes up, the executive and the shareholders benefit. If the share price goes down, the executive and the shareholders should suffer together. However, if share options are replaced when they are under water, the executive benefits from a rise in the share price but does not suffer when the share price falls. This means that the interests of the executive and the shareholders are not the same – the executive is protected against bad results.

The award of fully-paid shares

An alternative to share options is the award of fully-paid shares in the company. This avoids much of the problem of a fall in the share price. Whereas share options under water have no value at all, fully-paid shares retain some value, even when the share price falls. The award of fully-paid shares might therefore

be more successful in linking the personal interests of the executive with the interests of the shareholders.

In order to award free fully-paid shares to executives, the company will buy its own shares. It can do this either by making purchases of shares in the stock market, or by giving existing shareholders an opportunity to sell some of their shares to the company, in a tender or auction process.

Share plans and performance targets

The award of shares or share options should be conditional on the director or senior executive meeting certain performance targets. For example, a scheme might award free shares to executive directors for achieving Total Shareholder Return (TSR) targets over a three-year period, relative to comparator companies. Each director may be awarded up to 40% of the awards available to him if the company meets the TSR average for comparator companies, and 100% of the available awards for being in the top 25% ('top quartile') of comparator companies.

2.5 Pensions

Executive directors will also receive certain pension benefits. They may be members of a company pension scheme. In addition, there may be 'unfunded' pension arrangements for individual directors.

2.6 The purpose of each component of a remuneration package

Each element in a remuneration package has a purpose. In its 2006 directors' remuneration report, Tesco set out the elements of executive director remuneration and their purpose as follows:

Component of remuneration	Performance measure	Purpose
Base salary	Individual contribution to the business success	To attract and retain talented people
Annual cash bonus (up to 100% of salary)	Earnings per share and specified corporate objectives	Motivates year-on-year earnings growth and the delivery of business priorities
Annual deferred share element of bonus (up to 100% of salary)	Total shareholder return, earnings per shares and specified corporate objectives	Generates focus on medium-term targets. By incentivising share price and dividend growth, it ensures alignment with shareholder interests
Performance Share Plan (up to 150% of salary)	Return on capital employed over a three-year period	Assures a focus on long-term business success and shareholder returns
Share options	Earnings per share relative to retail prices index	Incentivises earnings growth and shareholdings by directors
Reproduced by kind permission. © Tesco plc, 2006		

3 PERFORMANCE-RELATED INCENTIVE SCHEMES

Section overview

- Linking rewards to performance
- The UK Corporate Governance Code on performance-related schemes
- Performance targets
- Share option schemes and restricted stock awards
- Equity incentive schemes: a financial reporting problem

3.1 Linking rewards to performance

When a remuneration package contains an incentive element, the potential rewards for the executive should be linked to company performance, so that executives are rewarded for achieving or exceeding agreed targets. In principle, this gives an incentive to the executive to ensure that the targets are achieved.

If the performance targets are properly selected, incentive schemes should link rewards for executives with benefits for the company and its shareholders. In this way the directors share an interest with the shareholders in the financial success (long-term or short-term) of the company.

Problems with linking rewards to performance

In practice, however, linking the interest of directors and shareholders through remuneration incentives has not worked out well. In many cases the remuneration of directors and the best interests of the company and its shareholders have not been linked properly. There are several reasons why this might happen.

There may be disagreement about what the performance targets should be. Should the executive have a performance target for company performance, or should he be rewarded for achieving personal targets? Should there be financial targets only, or should there be non-financial targets? Should there be just one target or several different targets? How can incentives and rewards for short-term targets be reconciled with incentives and rewards for longer-term targets?

Executives may be rewarded with a large bonus for meeting an annual profit target. This will almost certainly motivate the director to achieve the target. However, a consequence of maximising the current year's profit might be that long-term profits will be lower. For example, profits in the current year might be improved by deferring much-needed capital expenditure, or by deciding not to invest in new research or development work. An executive might have much less concern for the longer-term performance of the company, partly because short-term incentives are usually paid in cash and partly because the director might not expect to remain with the company for the long term.

Executives may have expectations that they will receive rewards, even when the company does not perform particularly well. The effect of an incentive scheme might therefore be to annoy a director when the bonus is less than expected, rather than give him an incentive to improve performance.

Executives are often protected against the 'downside'. Like the shareholders, they benefit when company performance is good. However they do not suffer

significantly when performance is poor. The example of replacing under water share options was referred to earlier.

There may be a 'legacy effect' for new senior executives. For some time after a new senior executive is appointed, the financial performance and competitive performance of the company might be affected by decisions taken in the past by the executive's predecessor. Rewards for the new executive may therefore be the result of past actions by another person.

On the other hand, a new executive might find that he (or she) has inherited a range of problems from his predecessor, which the predecessor had managed to keep hidden. The new executive might therefore receive low bonuses even though he has the task of sorting out the problems.

Occasionally, incentive schemes are criticised for rewarding an executive for doing something that ought to be a part of his normal responsibilities. There have been cases, for example, where an executive has been rewarded for finding a successor and recommending the successor to the nominations committee. It could be argued that finding a successor is a part of the executive's normal job.

3.2 The UK Corporate Governance Code on performance-related schemes

A previous version of the UK Corporate Governance Code had an appendix containing recommended provisions for the design of performance-related remuneration.

Short-term incentives - The remuneration committee should consider whether directors should be eligible for annual bonuses. If it decides that a director should be eligible, the performance targets should be 'relevant, stretching and designed to enhance shareholder value'. There should be an upper limit to bonuses each year. There may also be a case for paying a part of the annual bonus in shares of the company, and requiring the individual to hold them for a 'significant period' after receiving them.

Long-term incentives - The remuneration committee should also consider whether directors should be eligible for rewards under long-term equity incentive schemes. If share options are granted, the earliest exercise date should normally be not less than three years from the date of the grant. Directors should be encouraged to hold their shares for a further period after they have been granted or after the share options have been exercised, except to the extent that the director might need to sell some of the shares to finance the costs of buying them, or to meet any tax liabilities in connection with receiving the shares.

Any proposed new long-term incentive scheme **should be submitted to the shareholders for approval**. Any new scheme should form part of a well-considered overall remuneration plan that incorporate all other existing incentive schemes (and may replace an 'old' existing scheme). The total rewards that are potentially available to directors should not be excessive.

Grants under executive share options schemes and other long-term incentive schemes should normally be phased rather than awarded in a single large block.

Performance criteria - Payments or grants under all incentive schemes should be subject to 'challenging performance criteria' that reflect the company's objectives. The committee should give consideration to performance criteria that reflect the company's performance relative to a group of other, similar companies in some key variables such as Total Shareholder Return (TSR).

The remuneration committee should consider the consequences for the company's pension costs of awarding any basic salary increase to directors, especially directors who are approaching their retirement.

Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct.

3.3 Performance targets

Annual bonuses

An annual bonus scheme may base the award of a bonus on achieving or exceeding an annual profit target. This target might be for:

- profit after taxation;
- profit before interest and taxation (PBIT); or
- earnings before interest, taxation, depreciation and amortisation (EBITDA).

The target might be a specific money value, or it might possibly be expressed in growth in profit relative to other similar companies. However, there are several problems with using profit targets as a basis for the payment of bonuses.

Annual profits might be manipulated in order to increase the current year's profits. As stated earlier, a major capital expenditure or other large planned expenditure might be deferred to the next year.

Achieving a profit target does not necessarily mean that the company's shareholders will benefit. Higher profits do not necessarily mean higher dividends or a higher share price. If higher profits are obtained, but investors consider the company to face much higher risks, the share price might fall.

A remuneration committee might recommend that bonuses should be based on the benefits obtained by shareholders during the period, measured perhaps as Total Shareholder Return (TSR). TSR is simply the sum of the dividends to shareholders plus the increase in the share price during the period (or minus the fall in the share price). This might be expressed as a percentage of the share price at the beginning of the year.

However, a problem with schemes that link bonus payments in TSR is that share prices are often volatile, so that the measurement of TSR for any year may be affected by relatively short-term movements in the share price that do not reflect underlying performance.

Personal targets

Within an incentive scheme for senior executives, each individual may be given 'personal' non-financial targets for achievement.

A range of non-financial targets might be used, depending on the area of operations for which the executive is responsible. For example, a sales or marketing executive might have personal performance targets for customer satisfaction (provided that customer satisfaction can be measured objectively).

Personal targets might also be linked to a longer-term plan, such as a five-year business plan for the company. The executive might be rewarded for achieving specified targets within this longer-term plan.

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Long-term incentives

Long-term incentive schemes for executives may set a target for profitability, possibly over a period of three years. Alternatively, they may set:

- a non-financial target;
- a strategic objective; and
- several different targets, with the total reward based on the extent to which each different target is achieved.

3.4 Share option schemes and restricted stock awards

Share incentive schemes can be used to link the long-term interests of individual directors with the long-term interests of shareholders, because both the director and the shareholders will benefit from a rising share price.

However, a remuneration committee needs to be aware of the potential problems with such schemes.

With share option schemes, options should not be granted occasionally, in large amounts. They should be granted regularly, in smaller amounts. If options are granted in large blocks, the director might have an incentive to do his best to ensure that the share price is as high as possible at the earliest date that the options can be exercised. What happens to the share price later is of much less importance to the director, who is able to take his profit at the earliest exercise date. If the director is not then given new share options, his incentive to remain with the company is reduced.

Some companies place a restriction on sales of shares by directors or executives after they have been awarded free shares or have exercised share options. These are commonly specified in Share Ownership Guidelines, which are the terms and conditions of the equity incentive scheme. The restriction may be in the form of a **minimum retention ratio**. This requires the director to retain a minimum percentage of the shares he has acquired, and not to sell them before the end of a specified minimum period. For example, a share option scheme might require an individual to retain at least 25% of the shares acquired by exercising share options, for at least three years after the shares have been acquired. The purpose of a minimum retention ratio is to ensure that the director continues to have a personal interest in the share price.

This same argument applies to the award of shares to executives. When executives are given shares in their company, they may be required to retain them for a minimum number of years before they are able to sell them or dispose of them in any other way.

The size of option awards - There should be a limit to the quantity of share options granted. Share options 'dilute' the interest of existing shareholders in the company when the options are exercised.

3.5 Equity incentive schemes: a financial reporting problem

The board of directors (and the remuneration committee) needs to recognise the possible effect of equity incentive schemes on the company's financial statements. The award of shares and share options affects the company's reported profits each year. This might also affect the share price.

The problem arises because International Financial Reporting Standard 2 (IFRS 2) requires companies to recognise the award of share options as an expense in the company's annual income statements, from the time that the share options are granted.

Why are share options an expense?

The award of fully-paid shares in the company is an expense because the company pays money to buy the shares, and this spending is for the benefit of its executive directors. It is therefore an employment cost, and as such should be included as a cost in the income statement.

It might not be so clear why share options are an expense, because the option holder pays cash to buy new shares in the company.

IFRS 2 is based on the view that when a company issues share options, it incurs an expense. It gives employees the right to subscribe for new shares at a future date, at a price that is expected to be lower than the market price of the shares when the options are exercised.

Share options therefore have a value. When share options are awarded to an employee, the employee is therefore given something of value (a cost) in return for the benefit. This is an employment cost. Employment costs should be reported as an expense in the income statement.

Accounting for equity-settled share-based payment transactions

The method of accounting for equity incentives is not explained here, because it is not in the syllabus. It is sufficient to be aware of the consequences for these schemes on reported profits.

ICAN 2021

4 OTHER REMUNERATION ISSUES

Section overview

- Legal and regulatory issues: reporting on directors' remuneration
- Legal issues: service contracts and compensation for loss of office
- Ethical issues about remuneration
- Remuneration and competition issues
- Remuneration and shareholder attitudes

4.1 Legal and regulatory issues: reporting on directors' remuneration

It should be a principle of corporate governance that the shareholders of a company should be given full information about the remuneration of the company's directors. This information should help shareholders and other investors to understand the link between directors' remuneration and company performance.

The requirement to publish remuneration details varies between countries. You do not need to know the details of disclosure requirements in each country. The following examples are provided to show:

- how disclosure requirements might vary;
- the sort of information that might be provided by companies; and
- whether the disclosure requirements might be voluntary or compulsory.

The Singapore Code of Corporate Governance and remuneration disclosures

The Singapore Code of Corporate Governance, which does not have the force of law, requires companies to disclose details of their remuneration policy and the procedure they use to set remuneration for directors and senior executives. The specific guidelines in the Singapore Code are as follows:

- In its annual directors' report, a company should report to its shareholders on the remuneration of directors and at least the top five key executives who are not directors;
- The report should give the names of the directors and at least the top five key executives earning remuneration within bands of S$250,000. The remuneration of each should be analysed, in percentage terms into the amount earned as (1) base salary, (2) performance-related bonuses, (3) benefits in kind and (4) stock options and other long-term incentives. As best practice, companies are encouraged to disclose fully the remuneration of each individual director, but this is not a requirement of the Code;
- The same details should be provided (on a no-name basis) for immediate family members of a director or the CEO; and

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- The report should give details of employee share schemes, so that shareholders can assess the cost and potential benefit of these schemes to the company. These details should include details of the number of options issued and not yet exercised, and their exercise price(s).

Law on disclosure of directors' remuneration

In the UK and Nigeria, quoted companies are required by law (the Companies Act) to prepare a directors' remuneration report each year. The report must contain extensive disclosures about directors' remuneration. It is normal practice to include this remuneration report in the annual report and accounts.

Some of the information in the remuneration report must be audited by the company's auditors. Other parts of the report are not subject to audit.

Shareholders must vote at the company's annual general meeting on a resolution to approve the report. This is an advisory vote only, and the shareholders do not have the power to reject the report or amend the remuneration of any director or senior executive.

Information not subject to audit

Information in the directors' remuneration report that is not subject to audit is as follows:

- The names of the members of the remuneration committee, and details about any remuneration consultants that were used by the committee;

- The company's policy on directors' remuneration. (This should be a forward-looking policy statement, not an explanation of policy in the past.);

- A graph showing the Total Shareholder Return (TSR) on the company's shares over a five-year period, and the TSR over the same period on a portfolio of shares representing a named broad equity market index. This graph can be used to compare shareholder returns on the company's shares with those of a market index; and

- Information about the service contract for each director: the date of the contract, its unexpired term and details of any notice periods; any compensation payable for early termination of the contract and any other provisions in the contract affecting the liability of the company in the event of early termination.

Information subject to audit

The remuneration report must contain the following information which is subject to audit:

- The total remuneration for the year for each director, analysed into salary and fees, bonuses, expenses received, compensation for loss of office and other severance payments, and non-cash benefits;

- For each director, details of interests in share options, including details of options awarded or exercised during the year, options that expired during the year without being exercised, and any variations to the terms and conditions relating to the award or exercise of options;

ICAN 2021

- For options exercised during the year, the market price of the shares when the options were exercised should also be shown;
- For options not yet expired, the report should show the exercise price, the date from which the options may be exercised and the date they expire. To allow shareholders to assess the value of the options to the directors, the report should also show the market price of the company's shares at the end of the year, and the highest and lowest market prices reached during the year;
- For each director, details should be given of any long-term incentive schemes other than share options;
- For each director, details should be given of pension contributions or entitlements; and
- Details should also be provided of any large payments made during the year to former directors of the company.

4.2 Legal issues: service contracts and compensation for loss of office

Service contracts

The point has been made in an earlier chapter that executive directors and other senior managers are full-time employees with a service contract. As full-time employees they have the rights given to all employees by the country's employment law.

One of the major concerns of shareholders about service contracts, other than the remuneration package itself, is the notice period. This is the minimum period of time that an employer must give between dismissing an employee and the employee actually leaving employment.

In the UK in the 1980s, it was standard practice for directors to have a notice period of three years in their contract of employment. As a result, if a company wished to dismiss one of its directors, it had to give three years' notice. More usually, the company would pay the director three years of remuneration to leave the company immediately.

Three-year notice periods are now rare in the UK. Pressure was exerted on listed companies by the UK codes of corporate governance. The current UK Corporate Governance Code specifies that notice periods should be set at one year or less.

Even so, when a director is dismissed the payment on termination of employment can be very high, since it might include one year's base salary, pension entitlements, shares and bonuses that the director might be entitled to under the terms of his various incentive schemes.

Compensation on loss of office

In the UK, institutional investors have stated their expectation that companies will seek to limit payments of compensation on loss of office of a director or senior executive. Since a director is protected legally by the terms of his (or her) service contract, it is therefore essential that the remuneration committee should negotiate contract terms with a new director that will limit the potential size of compensation payments.

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When a remuneration committee negotiates the terms of a service contract with a new director, it should consider what the compensation payments might be in the event that the individual is dismissed. The committee should seek to avoid agreeing terms of employment that would reward a director for poor performance and dismissal. The committee should therefore take a 'robust line' on reducing compensation to reflect departing directors' obligations to mitigate loss.

A director dismissed by a company should be required, by the terms of his service contract, to try to mitigate the losses he suffers as a result of the dismissal. He can do this, for example, by finding new employment as soon as possible. A service contract may therefore provide for the total compensation on loss of office to be payable in several stages (instead of in full at the time of dismissal) and for these payments to be stopped if the individual finds a new job.

4.3 Ethical issues about remuneration

There is an ethical aspect to directors' remuneration, which has attracted some publicity as the rate of increase in directors' pay has been much greater than the rate of increase in the pay of other employees.

A trade union spokesman (the Trades Union Congress general secretary) is reported to have commented: 'It is hard not to conclude that this further huge rise in executive pay is more about greed than performance…. The stratospheric levels of directors' pay compared to average wages mean that executives now live in a class apart, even from employees in their own companies. It is not just socially divisive, but bad for the economy.'

4.4 Remuneration and competition issues

Although there might be ethical reasons for arguing that directors' remuneration is too high, there are competitive reasons for explaining the increase.

Directors' remuneration has risen because there appears to be a shortage of individuals who are considered to have the ability to lead major stock market companies. Given a shortage in the supply of talented individuals, general levels of remuneration for top executives have risen.

4.5 Remuneration and shareholder attitudes

Shareholders, particularly institutional investors, have shown a strong interest in remuneration as an issue in corporate governance. The views of insurance companies and pension funds are most often expressed by their trade associations, the Association of British Insurers (ABI) and the Pensions and Lifetime Savings Association (PLSA), which provide guidance to their members and may sometimes co-ordinate their activities.

The Association of British Insurers has issued guidelines for its members on executive remuneration, directed at:

- remuneration committees, because they indicate the aspects of remuneration that their shareholders will consider; and
- their members, by indicating what they should consider when deciding whether or not to show their approval of the remuneration policy of any company in which they invest.

Institutional investors do not argue in favour of lower remuneration. They believe that:

- directors should be paid a fair remuneration, but not excessive amounts;
- a large part of a directors' remuneration package should consist of incentives; and
- performance targets for incentives should be relevant and challenging.

The ABI's guidelines on executive remuneration are about 10 pages long. A few guidelines are shown below, to illustrate the approach that institutional investors take to the assessment of remuneration policy:

- Remuneration committees should communicate their policy on base salaries to shareholders. If it seeks to pay salaries at the median (average) level or above, the committee should provide a justification;
- When a director is paid a bonus for achieving a performance target, the directors' remuneration report should give a full analysis of which performance targets were met;
- If performance is subsequently found to have been over-stated by management, the remuneration committee should have the right to reduce or reclaim the bonus payments to executives;
- When preparing the contract for a director, the remuneration committee should calculate the likely cost of any severance payment on dismissal, and whether this is acceptable; and
- Where companies have share-based incentive schemes, executives should be encouraged to build up 'meaningful' holdings of shares in the company.

The significance of shareholder attitudes

Shareholder views on remuneration packages can be important. Institutional investors might act together and use their votes at general meetings.

The power of individual shareholders in large companies is usually restricted. Even the largest shareholders usually do not own a large proportion of the shares in their company, and it can be very difficult for shareholders to act together to obtain a majority of votes at any general meeting of the company.

However, institutional investors are increasingly active, and remuneration committees need to be aware that proposed incentive schemes, or the remuneration package of a senior executive such as the CEO, may arouse strong opposition.

Shareholders can express their displeasure with remuneration policy and remuneration packages by voting collectively in any of the following ways:

- to vote against a proposed new incentive scheme;
- to vote their disapproval of the directors' remuneration report; and
- to vote against the re-election of a director who is retiring by rotation, particularly if the director is a member of the remuneration committee or is a beneficiary of a generous remuneration package.

ICAN 2021

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Summarise the purpose of a remuneration package and explain the general principles of directors' remuneration
- Discuss the structure of directors' remuneration packages, differentiating between short- and long-term incentives
- Explain how performance-related incentive schemes work
- Comment on other remuneration issues such as reporting, service contracts, compensation for loss of office, ethics and competition

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Skills Level

Corporate Strategic Management and Ethics

CHAPTER 15

Governance: reporting and disclosure

Contents

1 General principles of disclosure
2 'Best practice' disclosures about corporate governance
3 Dialogue with shareholders: general meetings
4 Corporate social responsibility
5 Chapter review

ICAN 2021

INTRODUCTION

Detailed syllabus

A	**Introduction**
A6 (c)	Explain the concept of corporate governance and discuss: Structure, principles, functions and mechanisms of corporate governance.
D	**Governance**
D6	Assess transparency of an entity through the quality of its disclosures
D11	Discuss the concept of corporate social responsibility and specify its background and scope.

Exam context

One of the fundamental objectives of a system of corporate governance is to address the agency problem and protect shareholders (and other stakeholders) from directors' self-interest. In order to demonstrate this is the case it is important that transparency is maintained and stakeholders are informed of the corporate governance systems and procedures in place to protect them.

This chapter addresses the concept of transparency which you will see is largely achieved through effective communication.

By the end of this chapter students will be able to:

- Explain the general principles of disclosure including the need for transparency;
- Summarise best practice disclosures about corporate governance differentiating between the concepts of mandatory and voluntary disclosures;
- Discuss an organisation's dialogue with shareholders and the fundamentals involving shareholder voting rights; and
- Explain the concepts of corporate social responsibility and sustainability.

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1 GENERAL PRINCIPLES OF DISCLOSURE

Section overview

- The meaning of transparency and disclosure
- Corporate governance: the need for transparency and disclosure
- Principles of disclosure and communication

1.1 The meaning of transparency and disclosure

The directors of a company are responsible for running the company in the interests of its stakeholders, particularly its shareholders. In most large companies the major shareholders are not also directors, and it is therefore important that there should be good communications between the two groups. The shareholders need to be informed about how the company is performing, and the directors need to know the views of their shareholders.

Transparency in stock markets and other financial markets means that information about conditions in the markets is clear and well understood. For example, transparency exists when investors understand about the financial situation of companies, and the future plans and prospects for those companies, so that they can make well-informed investment decisions.

Investors need information about companies to make their investment decisions. Shareholders need information about the companies they have invested in, to assess the financial performance of the company and its future prospects, and to decide whether to hold on to their shares, sell them or buy more shares. Other investors need information about companies in order to decide which companies they should invest in, and how much to invest.

Disclosure means making information available, so that there is transparency. Companies have the main responsibility for disclosure in the stock markets. They provide regular reports to shareholders and other investors, and it is from these reports that investors obtain most of their information.

Transparency and disclosure are key issues in corporate governance.

1.2 Corporate governance: the need for transparency and disclosure

The need for transparency and disclosures in the financial markets is recognised in codes and statements of principles on corporate governance.

The board has a responsibility to present 'a balanced and understandable assessment' of the company's position and prospects in its financial reporting.

A Principle of the Nigerian Code of Corporate Governance is that "Full and comprehensive disclosure of all matters material to investors and stakeholders, and of matters set out in this Code ensures proper monitoring of its implementation which engenders good corporate governance practice."

A list of Recommended Practices goes on to state that: “The Board should ensure that the Company’s annual report includes a corporate governance report that provides clear information on the Company’s governance structures, policies and practices as well as environmental and social risks and opportunities.”

The OECD Principles state the requirement with greater force. They state that companies should provide ‘timely and accurate disclosure’ about their financial performance and position, and also about the ownership of shares in the company and also about other corporate governance issues.

The ICGN Principles emphasise the need for information so that investors can make investment decisions, and state that companies should, on a timely basis, disclose the relevant information about the company to enable informed decisions about the acquisition obligations and rights, ownership and sale of shares to be made by investors.

What information should be disclosed?

There are three main categories of information that investors need from a company:

- Financial information about the past performance of the company, its financial position and its future prospects;
- Information about the ownership of shares in the company, and voting rights associated with the shares. This is important for global investors, who may have problems with investing in companies where there is a majority shareholder, or where there is a complex structure of share ownership, or where some shareholders have more voting rights than other shareholders (for the same class of shares); and
- Corporate governance information. This is explained in more detail later.

1.3 Principles of disclosure and communication

There are several basic principles for disclosure and communication of information.

The information should be **reliable**. Reliable information is information that is sufficiently accurate for investors to trust it when making their investment decisions. The OECD Principles, for example, state that information should be prepared and disclosed with high quality standards of accounting and high standards for both financial and non-financial disclosures.

Information should be **understandable**. One of the criticisms of international financial standards (IFRSs) is that financial reporting in accordance with IFRSs can be very complex, and some investors might not properly understand the information that they provide. Many investors support the idea that companies should provide information about themselves in a narrative form, in addition to providing financial statements. **Narrative statements** are explained in more detail later.

Information should be **timely**. In the financial markets, 'timely' often means 'communicated as soon as possible'. Information should be made available to all investors as soon as possible after it becomes 'public'. Efficient stock markets should ensure that information announced by companies is made available to everyone quickly after the announcement. In the European Union, for example, one of the aims of the **Transparency Directive** (introduced in 2007) is to communicate information available quickly to investors as soon as companies make announcements to the stock market.

When information is disclosed by companies, it should be equally available to all investors. The OECD Principles state that the way information is distributed should enable users to access relevant information in an **equal**, timely and cost-efficient manner.

Information should be made available by **convenient channels of communication**. Companies should be encouraged to make it available in electronic form to investors who want to receive it in that form. For example, companies should use their web sites for making disclosures.

The opportunities for exploiting confidential information to make a personal profit should be minimised. By making information available to investors quickly, **opportunities for insider dealing** should be reduced.

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2 'BEST PRACTICE' DISCLOSURES ABOUT CORPORATE GOVERNANCE

Section overview

- Requirements for disclosures about corporate governance
- The content of 'best practice' disclosures
- Mandatory and voluntary disclosures
- Narrative reports: business reviews and interim management statements

2.1 Requirements for disclosures about corporate governance

Institutional investors expect to be given information about corporate governance by companies, because this information helps them to make their investment decisions.

In the European Union and in other countries, the principle of 'comply or explain' is applied. Major companies are required to comply with a recognised code of corporate governance, or explain their non-compliance. However, this on its own does not provide all the corporate governance information that investors want.

In countries of the European Union, major companies are required to prepare a corporate governance statement each year. This is included in their annual report and accounts. In the UK for example, the Listing Rules require a statement in the annual report and accounts (of listed companies) relating to compliance with the UK Corporate Governance Code.

In Nigeria, all public companies are required to state in their annual reports how they have applied the Code of Corporate Governance and the extent of their compliance with the code.

Similarly, the Singapore Exchange Listing Rules require similar disclosures from listed companies, in relation to the Singapore Code of Corporate Governance.

The OECD Principles call for disclosures by companies about governance issues.

2.2 The content of 'best practice' disclosures

Corporate governance statements by listed companies are often quite long. Typically, they fill five or six pages in the annual report and accounts. (In addition, UK listed companies include a lengthy directors' remuneration report and a strategy report, in addition to their corporate governance disclosures.).

The specific content of a corporate governance statement may vary. In the UK, statements by listed companies are required to contain the following information.

A statement of how the board operates, including a high level statement about which matters are reserved for the board and which decisions are delegated to management. For example, a report might state: 'The Board has set out clearly

the Schedule of Matters Reserved for Board Decision in order to ensure overall control of the Group's affairs. These include the approval of financial statements, major acquisitions and disposals, authority levels for expenditure, treasury policies, risk management, Group governance policies and succession plans for senior executives.'

Names of the chairman, CEO, senior independent director and chairmen of the nominations, audit and remuneration committees.

The number of board meetings and board committee meetings during the year, and the attendance record of each director at those meetings. This information might be presented in a table as follows:

	Board meetings	**Nominations committee**	**Remuneration committee**	**Audit committee**
Number of meetings held	8	1	4	4
Attendance				
Non-executive directors				
Mr S Lee (Chairman)	8	1	n/a	n/a
Mr J Glover	6	1	4	n/a
Mrs T Potter	8	1	4	4
Mr R Robinson	7	n/a	4	3
Mr A Timms	7	1	n/a	4
Executive directors				
Mr D Watts (CEO)	8	1	n/a	n/a
Ms G Hobbs	8	n/a	n/a	n/a
Mr B Lam	8	n/a	n/a	n/a
n/a = not applicable				

- The names of the non-executive directors that the board considers to be independent. Reasons should be given where this is appropriate;
- The other significant commitments of the chairman, and changes in these commitments during the year;
- A statement about the performance evaluation of the board, and how this has been conducted; and
- A statement about the steps the board has taken to ensure that the directors (especially the non-executive directors) are informed about the opinions of the company's major shareholders. This statement might be quite brief. For example: 'Shareholders are offered the opportunity to meet

with the Senior Independent Non-Executive Director. The Board is kept informed of the view of major shareholders through regular updates.'

Somewhere within the annual report and accounts, the following information should also be provided:

- A separate section describing the work of the nominations committee;
- A description of the work of the remuneration committee. (In the UK for example this is required as part of the Directors Remuneration Report Regulations, and is likely to be contained within the Directors Remuneration Report.);
- An explanation of the directors' responsibility for preparing the financial statements;
- A statement by the directors that the company is a going concern;
- A report that the board has carried out a review of the company's system (and group's system) of internal controls;
- A separate section describing the work of the audit committee;
- If the company does not have an internal audit department, the reasons why it does not; and
- If the company's auditors provide non-audit services to the company, an explanation of how the auditors' objectivity and independence are safeguarded.

Other information that should be provided by companies includes:

- The terms of reference for the nominations committee, remuneration committee and audit committee. These can be made available on the company's website;
- The terms and conditions of appointment of NEDs (which can also be made available on the website); and
- When papers are sent to shareholders for a general meeting where there will be a proposal to elect or re-elect a non-executive director, a statement by the board of why the individual should be elected. When a NED is proposed for re-election, the chairman should also confirm that the NED continues to be effective and the individual continues to commit the necessary amount of time to the company.

2.3 Mandatory and voluntary disclosures

Disclosures about corporate governance may be a mandatory requirement of the law or other regulations, or they may be provided as voluntary disclosures by a company. In practice, the disclosures by a company are likely to be a mixture of mandatory and voluntary items.

ICAN 2021

The nature and amount of **mandatory disclosures** depends on the laws and regulations of the country.

Some disclosures are required by law. For example, companies are required to prepare an annual report and accounts, and present these to the shareholders. Company law specifies what the directors' report and the accounts must contain, and in addition other regulations about content apply such as the requirements of financial reporting standards. In the UK, there is a legal requirement for quoted companies to include a directors' remuneration report in their annual report and accounts.

Some disclosures are required by stock market rules. For example, the UK Disclosure and Transparency Rules require listed companies to provide some information relating to corporate governance in their annual report and accounts. There are also stock market rules about other announcements by the company, such as profit warnings and announcements of proposed takeovers.

In addition to the mandatory disclosures required by law or regulation, many companies provide additional information, as part of their normal reporting cycle. Typically, these include:

- a chairman's report describing the activities of the company and its different operating divisions: alternatively, an operating and financial review by the CEO; and
- a social and environmental report, or a corporate social responsibility report: these reports are described later.

The reasons for voluntary disclosures

Companies are not required to provide voluntary disclosures, but there are several reasons why they choose to do so.

Some voluntary information might be provided as a **public relations** or **marketing** exercise, to present 'good news' about the company to investors and other users of the company's published reports. For example, this might be the purpose of a chairman's report. It could be argued that social and environmental reporting has been used by some companies to promote their 'green' image and strengthen their reputation with customers.

Providing information on a voluntary basis might persuade the government or financial service regulator that compulsory disclosures and regulation are not necessary.

Companies might publish social and environmental reports out of a genuine **ethical and cultural belief** in the responsibilities of the company to society and the environment. If a company believes that it has social and environmental responsibilities, publishing a report on these issues is a way of making itself accountable.

A company might use voluntary disclosures as a way of **improving communications with its shareholders**. By giving more disclosures to

shareholders, companies might encourage shareholders to respond, and enter into a dialogue with the company about its strategies and plans for the future.

2.4 Narrative reports: business reviews and interim management statements

As mentioned earlier, there is a view that companies should provide information in a narrative form about their financial performance and prospects for the future, in addition to providing financial statements. This view is based on the belief that narrative reports can be much easier to understand than financial statements and notes to the financial statements.

There is also a demand from investors for non-financial information, in addition to financial information.

Many major companies have provided **narrative reports on a voluntary basis**, usually in a chairman's report or an operating and financial review. However, these voluntary statements have limitations. The main limitations are that:

- the company can decide what to include in the report and what to leave out; and
- the information is often presented in a very positive form, as public relations for investors, and might not be entirely reliable.

Business review

The demand for narrative reporting and the limitations of voluntary narrative reporting have led to **mandatory narrative reporting** in some countries. In the European Union, the Accounts Modernisation Directive introduced a requirement for companies to include a **business review** in their annual report and accounts.

Example: UK requirement for a business review

The legal requirement for a business review (now known as a strategic review) was introduced in the UK by the Companies Act 2006 (section 417). The Act states that the purpose of the review is to inform shareholders and help them to assess how the directors have performed their legal duty to promote the success of the company.

The business review should contain:

- a fair review of the company's business, and
- a description of the main risks and uncertainties facing the company.

The review should provide a 'balanced and comprehensive analysis' of:

- the development and performance of the company's business during the year and
- the position of the company's business at the end of the year.

With the exception of small companies (which are not required to prepare a business review at all) and medium-sized companies, the business review must include:

- an analysis of key **financial** performance indicators (KPIs), and

- where appropriate, other key performance indicators including KPIs relating to environmental matters and employee matters.

In addition, quoted companies are required to include in their business review, information about:

- the main trends and factors likely to affect the future development and performance of the company's business
- environmental matters (including the impact of the company's business on the environment), the company's employees and social and community issues
- 'persons with whom the company has contractual or other arrangements which are essential to the business of the company' – unless disclosure of this information would, in the opinion of the directors, be seriously prejudicial to that person or against the public interest.

The Act gives some exemption from the requirement to provide this information. Disclosures of 'impending developments or matters in the course of negotiation' do not have to be disclosed if this would be prejudicial to the interests of the company.

Interim management statements (IMSs)

The demand for more and better transparency and disclosures by listed companies has also led to a requirement in the European Union for major stock market companies to issue an interim management statement (IMS) each year. This is a requirement of the EU Transparency Directive, which came into force from January 2007.

An IMS is required in addition to the company's interim financial statements for the first six months of the financial year. The purpose of an IMS is to explain material events and transactions that have taken place in the (six-month) period, and their financial effect. It must also include a description of the principal risks and uncertainties that the company will face for the remaining six months of the year.

ICAN 2021

3 DIALOGUE WITH SHAREHOLDERS: GENERAL MEETINGS

Section overview

- The need for dialogue between companies and their shareholders
- Shareholder activism
- General meetings of the company and voting by shareholders
- Problems with the use of voting rights
- Institutional investor guidelines: the UK Stewardship Code

3.1 The need for dialogue between companies and their shareholders

Constructive dialogue between the board of directors and the main shareholders of the company should help to improve the quality of corporate governance. Dialogue between the directors and the main shareholders should reduce the problems in the principal-agent relationship between them.

Through dialogue, the shareholders can tell the directors what they are hoping the company will achieve or any concerns they might have (for example, about the risks faced by the company, about the dividends they hope to receive or about the succession for the position of chairman or CEO, and so on).

Similarly, the directors can explain their plans and intentions in more detail than through formal reports.

For a company, most of the dialogue with its shareholders is conducted by the chairman, the CEO and the finance director. These are the individuals, for example, who normally make presentations about the company to institutional investors. The chairman should discuss, amongst other things, governance and strategy.

It is the responsibility of the chairman to make sure that other members of the board are informed about the views and concerns of the major shareholders.

Major shareholders should be given the opportunity to meet with the company's non-executive directors, if they wish to do so. However, with the exception of the senior independent director, it is unlikely that institutional investors will want to meet a company's NEDs, simply because their time can be used better in other ways.

Senior independent director (SID)

A role of the senior independent non-executive director is to listen to the concerns of shareholders, when shareholders have concerns that have not been resolved through their normal channel of communication with the chairman, CEO or finance director. The senior independent director might then be asked to discuss the concerns of the shareholders with the rest of the board – in effect, to challenge the views of the chairman and CEO.

ICAN 2021

In order to perform this role, the senior executive director must be known to the major shareholders. Some meetings between the SID and shareholders are therefore desirable.

3.2 Shareholder activism

When a shareholder is dissatisfied with the performance of a company, he can sell his shares. There is no requirement for a shareholder to continue investing in a company. This is probably a reasonable description of the 'traditional' approach of institutional investors to the companies in which they invested.

An alternative approach to selling shares in under-performing companies is to:

- monitor companies closely;
- enter into a dialogue with a company when it is under-performing, and express the concerns that the shareholder has about the company; and
- use voting rights to put pressure on a company's management.

This approach is called shareholder activism or shareholder engagement.

Purpose of shareholder activism

The purpose of shareholder activism is to try to improve the performance of under-performing companies. This purpose is explained in a Statement of Principles of the Institutional Shareholders Committee (ISC), a joint body in the UK representing all institutional investor associations. The ISC Principles state:

'The policies of activism … do not constitute an obligation to micro-manage the affairs of … companies, but rather relate to procedures designed to ensure that shareholders derive value from their investments by dealing effectively with concerns about under-performance.'

The Principles also state that although institutional investors are encouraged to become 'active' investors, they should still use their right to sell their shares, if this is what they would prefer to do in the case of some companies.

The nature of shareholder activism

Shareholder activism consists of the following activities:

- Shareholders should monitor the companies in which they invest. Effective monitoring requires an active dialogue between the shareholder and the company. The ISC Principles state that institutional shareholders should 'endeavour to identify problems at an early stage to minimise any loss in shareholder value. If they have any concerns and do not propose to sell [their shares], they will seek to ensure that the … company's board are made aware of them';
- Shareholders' associations. There are numerous shareholders' associations which protect the interests of minority shareholders;

- Shareholders should have a policy about when they will intervene in a company by expressing their concerns. Concerns may relate to the company's strategy, operational performance, ineffectiveness of the company's independent NEDs, failures in the company's internal controls, directors' remuneration packages or the company's social and environmental policies;

- Shareholders should then assess the effectiveness of their intervention; and

- If a shareholder is still concerned, and dissatisfied with the company's response to the concerns, the shareholder should consider using his vote against the board of directors on selected matters at the company's next general meeting. Institutional investors are encouraged to practice 'responsible voting'. **Responsible voting** can be defined as taking informed decisions about how to vote at company general meetings, within the framework of a well-considered corporate governance policy.

3.3 General meetings of the company and voting by shareholders

A general meeting of the company is a meeting of the company's owners (shareholders) to discuss and vote on certain items. The company's board also attends general meetings, and the auditors and company advisers might also attend. There are two types of general meeting:

- The annual general meeting (AGM) which is held each year to vote on 'routine' proposals; and

- An extraordinary general meeting (EGM) is any general meeting that is not an AGM. An EGM might be called to consider specific issues, such as a proposal to approve a major takeover of another company.

The voting rights of shareholders

In a well-governed company all ordinary shareholders should have equal voting rights. In principle, this means one share, one vote.

The matters that shareholders have the right to vote on are fairly limited. They include votes on:

- the election or re-election of directors;

- the re-appointment of the company's auditors for another year;

- approving a dividend proposed by the directors;

- in the UK for example, approval of the directors remuneration report;

- approval of new share incentive schemes; and

- approval of proposed major transactions, such as a takeover.

Shareholder activism and voting rights

In principle, shareholders can use their votes against the board of directors when they have concerns about the company and they are not satisfied with the response from the board of directors. Shareholders might therefore:

- vote against the re-election of a director whose conduct or opinions they dislike; and
- vote against the proposal to approve the director's remuneration report, for example when they have concerns about the remuneration policy of the company or about the remuneration packages of directors.

Votes against the board of directors at a general meeting will attract press comment and adverse opinion from investors. The company's board of directors, after suffering defeat in a vote at a general meeting, or wishing to avoid the risk of defeat, might make concessions and do something to deal with the concerns that the shareholders have expressed.

3.4 Problems with the use of voting rights

Although shareholders can use their voting rights, or threaten to use their voting rights, to put pressure on a board of directors, there are limitations and problems with the use of voting.

Individual shareholders, even major shareholders, might own only a small proportion of the company's shares. In the UK for example, the stock market considers any shareholder to be 'significant' if it owns more than 3% of the shares in a company. To win a vote at a general meeting requires a majority of the votes (and sometimes even more). Many shareholders need to organise themselves to use their votes in concert to have any chance of obtaining a majority of the votes.

Some institutional shareholders might fail to use their votes in a responsible way. There are several reasons for this:

- An institutional investor might own shares, but hand the management of the shares to a different organisation (a fund manager). It might be difficult for the institutional shareholder to give instructions to a fund manager on how to vote at a general meeting of each company in which it holds shares;
- Institutional shareholders might engage in stock lending. Stock lending involves lending shares to another entity for an agreed period of time, in return for a fee. The benefit of stock lending is that it increases income from shares. A disadvantage of stock lending is that during the time that stock is being lent, the borrower has the voting rights, not the lender. The practice of stock lending makes it more difficult for institutional investors to vote, because they do not always know how many shares they currently hold;
- Many shareholders, including some institutional shareholders, might arrange for the company chairman to vote on their behalf at the general meeting, as a 'proxy'. A shareholder can instruct a proxy on how to cast its

ICAN 2021

votes on each specific proposal at the meeting. However, many shareholders give the chairman their proxy votes, and allow the chairman to decide how to use the votes. Giving proxy votes to the chairman can therefore make the chairman – and so the board as a whole – a very powerful voting force in a general meeting. It is then very difficult to vote successfully against any proposal from the board of directors; and

- In some countries, there are restrictions on the ability of foreign shareholders to vote at general meetings of the company. Global investors are often unable to use their shares to vote on proposals at general meetings, for example because of restrictions on proxy voting.

These problems with voting are well recognised, and some measures have been taken to reduce them.

Institutional investors might be advised on voting by their association. In the UK for example the Association of British Insurers issues advice to its members to vote against a particular proposal by a company at a general meeting to be held in the near future. These warnings, known as **red tops**, are normally issued when the institutional investors have concerns about specific governance matters, such as the remuneration of the company's executives.

Associations such as the ICGN (the International Corporate Governance Network) continue to argue in favour of more voting rights for foreign shareholders, and the removal of laws or rules in a company's constitution that make it difficult for foreign shareholders to exercise their voting rights.

In some countries, including the UK, there have been initiatives to remove some of the inefficiencies and difficulties in voting for institutional investors.

A feature of voting at general meetings in UK companies is that the chairman can decide whether a vote should be taken by a show of hands of the shareholders present at the meeting, or by a 'poll vote'. With a show of hands, a majority vote means the vote of more than one half of the shareholders present at the meeting, regardless of how many shareholders attend the meeting and how few shares they hold between them. A poll vote is a count of all votes submitted, including proxy votes, on the basis of one share, one vote. Myners argued that in order to encourage proxy voting, **all decisions at general meetings should be made by a poll vote**, not a show of hands. Companies should also disclose in their website the results of all the poll votes at general meetings.

Proxy voting forms allowed a shareholder to indicate how to vote his shares, for or against a proposed resolution. Myners recommended that a third option should be added to proxy voting forms – the option to '**consciously withhold the votes**'. In other words, shareholders should be allowed to abstain from voting, and indicate to the company that this is a conscious decision, not a failure to vote at all. Abstaining from voting is a sensible option where a shareholder disapproves of a proposal but the disapproval is not strong enough for the shareholder to want to vote against the board of directors.

In the UK, most (if not all) large companies now permit **electronic voting**. Company chairmen are much more conscious of the need to take proxy votes into consideration: although most decisions are still taken by a show of hands (for convenience and to save time at the meeting), the chairman usually announces the total numbers of votes submitted as proxy votes, for and against the proposal and as abstentions. The option to make a conscious decision to withhold a vote has been adopted.

3.5 Institutional investor guidelines: the UK Stewardship Code

Shareholders can exert influence over their company by engaging with them more. In addition there is an argument that institutional investors own their shares in the interests of other beneficiaries, such as members of pension funds, holders of life assurance policies and other investment clients. As 'stewards' for the investments of other beneficiaries, they should try to ensure that companies are governed in the interests of shareholders, by engaging constructively with those companies.

This view led to the issue of the UK Stewardship Code (2010) by the Financial Reporting Council. It is complementary to the UK Corporate Governance Code, and just as the Governance Code requires directors to seek good relations with shareholders, the Stewardship Code requires institutional investors to engage constructively with companies in which they hold shares. Engagement includes getting involved in constructive dialogue with companies on matters such as strategy, corporate performance and the management of risk and on other governance issues.

The Stewardship Code is aimed 'in the first instance' at UK fund managers ('asset managers'), who make investments on behalf of clients, and who are therefore the legal owners of the shares. They are required to comply with the Stewardship Code or explain their non-compliance.

Clients of fund managers include pension funds and insurance companies. These are also encouraged by the FRC to apply the Stewardship Code on the same basis as asset managers. Even if a pension fund does not want to engage directly with companies, they can seek to apply the Code by requiring their appointed asset managers to do so.

The FRC has expressed its hope that the Code will also be applied by foreign investors in UK company shares.

The Institutional Shareholders Committee (ISC), a collective body for UK institutional investors, established the Institutional Investor Council in 2010, whose brief is to work with the FRC in promoting the UK Stewardship Code.

The Stewardship Code consists of seven principles, each with supporting guidance.

1 Disclosure of policy on stewardship. Institutional investors and their agents should make a public disclosure of their policy on engagement with companies and how they will discharge their stewardship responsibilities.

This should include disclosures of how they will monitor companies and their strategy for intervention in the affairs of the companies in which they invest.

2 Managing conflicts of interest. Institutional investors should have a robust policy for managing conflicts of interest that arise through their holding of shares in many different companies.

3 Monitoring companies. Institutional investors should monitor the companies in which they invest, to decide when it may be appropriate to initiate dialogue with their board of directors. The Code recognises however that investors may not want to run the risk of becoming 'insiders' through dialogue with a company, so that they obtain price-sensitive information and are consequently unable to deal in the shares of the company without breaching the law on insider dealing.

4 Escalating shareholder activism. Institutional investors should have clear guidelines on when to escalate their actions to bring more pressure to bear on a company's board, and what the nature of the action should be in a variety of different circumstances.

5 Acting with other shareholders. Institutional shareholders should be prepared to collaborate and act together, for example when some escalation in the nature of their activism is considered appropriate.

6 Policy on voting and disclosure of voting activity. Institutional investors should have a clear policy on voting at general meetings and should disclose how they have voted on resolutions.

7 Reporting periodically on stewardship. Institutional investors should report periodically on their stewardship and their voting activities. For example, asset managers should report to the institutions who are their clients, and pension funds should report to the pension fund beneficiaries (at least annually).

4 CORPORATE SOCIAL RESPONSIBILITY

Section overview

- Definition of corporate social responsibility (CSR)
- Principles of CSR
- CSR and stakeholders in the company
- The effect of CSR on company strategy
- CSR reporting
- CSR and institutional investors

4.1 Definition of corporate social responsibility (CSR)

Corporate social responsibility refers to the responsibilities that a company has towards society. CSR can be described as decision-making by a business that is linked to ethical values and respect for individuals, society and the environment, as well as compliance with legal requirements.

CSR is based on the concept that a company is a citizen of the society in which it exists and operates.

As a corporate citizen of society, it owes the same sort of responsibilities to society at large that other citizens should owe.

There is a social contract between a company and the society in which it operates. As the owner or user of large amounts of property and other resources, companies as corporate citizens also owe a duty to society to use its property and resources in a responsible way. In return, society allows the company to operate and remain in existence.

Corporate Social Responsibility is related to the idea that as well as their responsibilities to shareholders, boards of companies are also responsible to the general public and other stakeholder groups. There are two key areas of responsibility:

(i) general responsibilities that are a key part of the board's duties which need to be completed in order to succeed in their industry and/or are regulatory/legal requirements that are imposed on them; and

(ii) duties that some people feel go beyond these general responsibilities.

4.2 Principles of CSR

Corporate social responsibility has five main aspects. For any company, some of these aspects might be more significant than others;

A company should operate in an ethical way, and with integrity. A company should have a recognised code of ethical behaviour and should expect everyone in the company to act in accordance with the ethical guidelines in that code;

A company should treat its employees fairly and with respect. The fair treatment of employees can be assessed by the company's employment policies, such as providing good working conditions and providing education and training to employees;

A company should demonstrate respect for basic human rights. For example, it should not tolerate child labour;

ICAN 2021

A company should be a responsible citizen in its community. Responsibility to the community might be shown in the form of investing in local communities, such as local schools or hospitals. This can be an important aspect of CSR for companies that operate in developing countries or regions of the world; and

A company should do what it can to sustain the environment for future generations. This could take the form of:

- reducing pollution of the air, land or rivers and seas;
- developing a sustainable business, whereby all the resources used by the company are replaced;
- cutting down the use of non-renewable (and polluting) energy resources such as oil and coal and increasing the use of renewable energy sources (water, wind); and
- re-cycling of waste materials.

4.3 CSR and stakeholders in the company

The concept of corporate citizenship and corporate social responsibility is consistent with a stakeholder view of how a company should be governed. A company has responsibilities not only to its shareholders, but also to its employees, all its customers and suppliers, and to society as a whole.

In developing strategies for the future, a company should recognise these responsibilities. The objective of profit maximisation without regard for social and environmental responsibilities should not be acceptable.

Example: CSR

When a company promotes itself as a company with strong ethical views and a considered policy on CSR, it exposes itself to reputation risk. This is the risk that its reputation with the general public and customers will be damaged by an unexpected event or disclosure.

For example, an ethical company might find that one or more of its major suppliers, based in a foreign country, is using forced labour or child labour in the production of goods that the company buys.

4.4 The effect of CSR on company strategy

The awareness of CSR varies between different countries. To remain successful in business, companies must respond to changes in the expectations of its customers. In many countries, there has been a significant increase in public awareness of environmental problems, such as global warming (pollution and energy consumption) and the potential for natural disasters that this creates. There is also concern about the irreplaceable loss of many natural resources and the failure to re-cycle many raw materials that could be used again in products or services.

If companies fail to respond to growing public concern about social and environmental issues, they will suffer a damage to their reputation and the possible loss (long term) of sales and profits. This is the problem for companies of **reputation risk**.

Unfortunately, although there is genuine concern by some companies for CSR issues, other companies express concerns about CSR issues in order to improve

their public relations image with the public, and as a way of marketing their products.

Formulating a CSR policy

The following steps might be taken by a company to implement a CSR policy:

It should decide its code of ethical values, and possibly publish these as a Code of Ethics;

It should establish the company's current position with regard to its CSR values, and decide the position it would like to reach in the future. The gap between the current position and the target position provides a basis for developing CSR strategies;

The company should develop realistic targets and strategies for its CSR policies;

These strategies should be implemented;

Key stakeholders in the company should be identified, whose views the company wishes to influence (employees, pressure groups, customers);

The company's CSR achievements should be communicated to the key stakeholders. This is the main purpose of **CSR reporting**; and

The company's CSR achievements should be monitored, and actual achievements compared with (1) the targets and (2) the CSR achievements of similar companies (including business competitors).

4.5 CSR reporting

In some countries, stock market companies have published annual reports on their corporate social responsibility. These reports have been voluntary, and have usually been published separately from the annual report and accounts.

CSR reports are also called **social and environmental reports**, and CSR reporting is sometimes called **sustainability reporting**, when its main focus is on environmental issues.

The purpose of CSR reports is to inform key stakeholders about the CSR policy objectives of the company and how successful it has been in achieving them.

CSR reports in the UK originally developed out of Health, Safety and Environmental Reports, which reported on health and safety at work, accident rates, volumes of waste and pollution, and so on, and actions taken by the company to deal with problems.

CSR reporting is broader in scope than health, safety and environmental reporting, because it includes social issues and more employee issues, such as ethical employment practices, education and training and investments by the company in community projects.

A weakness with many CSR reports was their lack of structure, and (in many cases) a lack of facts and figures.

ICAN 2021

Global Reporting Initiative (GRI)

The Global Reporting Initiative is a US-based initiative that encourages companies world-wide to publish **sustainability reports** that are prepared using a common reporting framework.

The GRI defines sustainability reporting as 'the practice of measuring, disclosing and being accountable to internal and external stakeholders for performance towards the goal of sustainable development. Sustainable development is a broad term [meaning the same as other terms used] to describe economic, environmental and social impacts (such as triple bottom line, corporate responsibility reporting, etc.).

The GRI promotes the view that to be a sustainable business in the long-term, companies will benefit by giving attention to environmental and social issues, as well as financial issues. Sustainability reporting within the GRI guidelines is based on measuring three areas of performance, sometimes called the 'triple bottom line'. These are:

- financial performance;
- impacts on the environment and natural resources; and
- social benefits and costs.

Adverse effects and costs should be reported, as well as financial and non-financial benefits.

The GRI approach is also based on quantifiable measurements of performance, in preference to qualitative statements, so that progress towards 'sustainability' can be measured. There are GRI 'technical protocols' explaining the methods for measuring social and environmental (as well as financial) performance. There are also sector supplements, which deal with measurement problems in specific industry sectors, such as mining, car manufacture, financial services and telecommunications.

Mandatory reporting on CSR issues

In some countries, such as the countries of the European Union, some reporting on CSR issues is required by companies in their annual business review. Business reviews were explained earlier in this chapter. It is not yet clear whether mandatory reporting in business reviews will replace voluntary sustainability reports.

4.6 CSR and institutional investors

Pressure on companies to show greater CSR awareness has come from institutional investors, as well as the general public and consumers. There are some '**ethical investors**', including some investment institutions, that choose to invest only in companies that meet certain minimum standards of social and environmental behaviour.

In the UK for example, the National Association of Pension Funds (NAPF) published a policy document on CSR in 2005. This stated that it did not consider CSR to be a corporate governance issue, since corporate governance is concerned mainly with how to handle the potential conflicts of interest between shareholders and management. The NAPF suggested that CSR issues are an issue for the management of a company rather than its governance.

However, the NAPF policy document stated that the board and managers should remember the company's wider role in society; the longer-term prospects of a company can be damaged by maximising short-term gain in a manner that society finds unacceptable and this can lead to shareholders suffering real financial losses. These losses could be due to consumer preferences changing or new legislation adding more costs to the company.

Example UN initiative

In 2005, the UN Global Compact launched the UNEP Finance Initiative. (UNEP is the United Nations Environment Program.) The aim of this initiative is to promote a set of principles that define best practice for responsible investment by institutional investors that have the full support of the UN and also of leading institutional investors worldwide.

The initiative is based on the view that institutional investors should consider sustainable development when making their decisions on investment in companies.

In 2006, the UN published six 'Principles for Responsible Investment', which provide a framework for institutional investors to use when considering CSR issues. These principles, which are 'voluntary and aspirational' are as follows.

1. CSR issues should be considered in investment analysis and decision-making processes by investment institutions.
2. Institutional investors will include CSR issues into its policies and practices on share ownership.
3. Institutional investors will seek appropriate disclosure on CSR issues by the companies in which they invest.
4. Investment institutions that subscribe to the Principles will promote their acceptance and implementation within the investment industry.
5. Investment institutions will work together to increase their effectiveness in implementing the Principles.
6. Investment institutions will each report on their activities and progress towards implementing the Principles.

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5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain the general principles of disclosure including the need for transparency
- Summarise best practice disclosures about corporate governance differentiating between the concepts of mandatory and voluntary disclosures
- Discuss an organisations' dialogue with shareholders and the fundamentals involving shareholder voting rights
- Explain the concepts of corporate social responsibility and sustainability

ICAN 2021

CHAPTER 16

Ethical theories

ICAN 2021

Contents

1 Ethics and accountants
2 Consequential and non-consequential theories of ethics
3 Ethical theories of relativism and absolutism
4 Kohlberg's stages of moral development
5 Ethical decision-making models
6 Chapter review

INTRODUCTION

Detailed syllabus

E	**Ethics**
E1	Explain the nature, scope and sub-divisions of ethics (descriptive, normative and meta-ethics, professional ethics and business ethics), and the relationship between
	E1 (a) morality and ethics; and
	E1 (b) ethics and law.
E2	Explain and illustrate, using information in a given scenario, the importance of professional and business ethics in the public and private sectors.
E3	Discuss and apply ethical theories to decision-making in professional practice: consequential or teleological theories (egoism and utilitarianism), non–consequential or deontological theories (ethics of duties and ethics of rights and justice), ethical relativism, ethical absolutism, ethical subjectivism and situation ethics.
E4	Discuss influences (individual, situational, cultural and religious), stages (Kohlberg's stages of moral development and the Heinz's dilemma) and models for ethical decision-making (Tucker's five question model, American Accounting Association (AAA) model, systems development ethics).

Exam context

Ethics is an important topic for all accountants, whether employed in practice or in industry. This chapter introduces a number of theoretical perspectives on ethics and ethical models.

By the end of this chapter students will be able to:

- Define ethics and explain the descriptive, normative and meta-ethics approaches to ethical behaviour;
- Distinguish between personal ethics, business ethics and professional ethics;
- Understand the importance of the study of ethics for accountants;
- Explain and distinguish between consequential and non-consequential theories of ethics;
- Explain the ethical theories of relativism and absolutism;
- Summarise Kohlberg's stages of moral development;
- Differentiate between deontological and teleological approaches to ethics; and
- Apply Tucker's 5 question model and the American Accounting Association model for ethical decision making.

ICAN 2021

1 ETHICS AND ACCOUNTANTS

Section overview

- Descriptive ethics, normative ethics and meta-ethics
- Personal ethics, business ethics and professional ethics
- Moral dilemmas
- Acting in an ethical way: moral philosophy

1.1 Descriptive ethics, normative ethics and meta-ethics

Ethics is about morality, and acting in a way that is morally justified. It is concerned with the difference between 'right' and 'wrong'. There are three broad approaches to the study and analysis of ethics and ethical behaviour:

- Descriptive ethics;
- Normative ethics; and
- Meta-ethics, also known as analytic ethics.

Descriptive ethics

Descriptive ethics involves research into the moral attitudes or positions of individuals and groups and their beliefs about what is right and wrong. As the term suggests, it describes ethical beliefs, without trying to suggest what ethical values ought to be.

Normative ethics

This is probably the approach to ethics that most people are familiar with. It involves establishing moral standards, and indicating what people should do that is 'right' and why, and what aspects of behaviour are 'wrong'. It is an approach to ethics that takes a view about 'good 'and 'bad', and what is of overriding importance in deciding how people should act in any give situation.

Meta-ethics

'Metaethics is a branch of analytic philosophy that explores the status, foundations, and scope of moral values, properties, and words. Whereas the fields of applied ethics and normative theory focus on what is moral, metaethics focuses on what morality itself is.

Just as two people may disagree about the ethics of, for example, physician-assisted suicide, while nonetheless agreeing at the more abstract level of a general normative theory such as Utilitarianism, so too many people who disagree at the level of a general normative theory nonetheless agree about the fundamental existence and status of morality itself, or vice versa.

In this way, metaethics may be thought of as a highly abstract way of thinking philosophically about morality. For this reason, metaethics is also occasionally referred to as "second-order" moral theorizing, to distinguish it from the "first-order" level of normative theory.' *[Internet encyclopaedia of philosophy]*

1.2 Personal ethics, business ethics and professional ethics

Most individuals develop a sense of morality (in a 'normative' view of ethics), and act in accordance with what they consider 'right' and 'wrong'.

However, opinions about what is 'right' and 'wrong' can differ enormously.

As an accountant you need to be aware of:

- Personal ethics;
- Business ethics; and
- Professional ethics.

Definition: Personal ethics

'Personal ethics' describes the intrinsic moral principles and values that govern an individual's interactions with others. Personal ethics is neither enforced nor required by a prescriptive code – it reflects one's inner views on morality, that is, what is right and wrong.

Personal ethics are typically influenced by people's family, friends, experiences, culture and religion.

Definition: Business ethics

'Business ethics' describes the moral principles and values that guide how people and institutions behave in the world of commerce. Business ethics considers how the pursuit of self-interest (e.g. profits) impacts others through the actions of individuals or firms within business.

Some businesses (particularly large multinationals) develop a formal corporate code of ethics that provides a reference point for employees' and other stakeholders' behaviour.

A business code of ethics will apply to all employees whether they are members of a professional body (and therefore subject to a code of professional ethics too) or not.

Definition: Professional ethics

'Professional ethics' describes the moral principles and values that govern behaviour in the context of a particular profession such as lawyers, doctors, architects and accountants.

Professional ethics are normally specified in a professional code of conduct that all members (and students) professing to be part of that profession must abide by. Adherence to an institute's professional code of conduct such as ICAN's Code of Professional Conduct is normally a requirement of membership and remains relevant throughout the professional's life, not just in the work environment.

As noted above ethics apply to organisations as well as to individuals and groups of people. Companies might be driven purely by the profit motive with all their actions determined by doing whatever is necessary to maximise profits. However, this may result in unethical behaviour such as breaking the law (e.g. breach of

ICAN 2021

copyright, using child labour, paying bribes) or disregarding employees' religious beliefs (e.g. requiring staff to work 'overtime' on holy days).

On the other hand, companies might recognise the need – and the benefits – of acting in an ethical way which could lead to an improved reputation and increased sales. For example a company may limit its supply chain to organisations that adhere to minimum ethical standards relating to the fair treatment of employees.

Accountants – both students and qualified professionals – are expected to behave in accordance with professional codes of ethics, and to maintain standards of moral behaviour that are 'expected' from a professional body. This remains fundamental to protecting the reputation of the profession which ultimately is in the public interest.

Personal ethics, business ethics and professional ethics are all therefore relevant to how an accountant should behave:

- Typically a professional code of ethics is the most onerous reference that an accountant must comply with at all times;
- Business ethics may help define the clients that an accountant is willing to deal with or the business they may wish to be employed by outside of professional practice; and
- As personal ethics are intrinsically ever-present awareness of an individual's morals and ethics will help them understand whether they are suited to a particular profession, industry or company. For example views differ around the morality and acceptability of gambling, the adult entertainment industry, tobacco, pharmaceutical companies that employ testing on animals and nuclear power.

1.3 Moral dilemmas

In practice, there are often pressures on an individual at work to 'bend the rules' and act in a way that is not ethical. Unethical behaviour might be illegal, but it is sometimes 'legal but immoral'. Pressures to act unethically can create a moral dilemma – what is the right thing to do?

Sometimes it is not clear what the right course of action should be. When an individual thinks that something might be 'wrong', he could be faced with a decision about what to do. Making a moral or ethical decision might not be easy, especially when colleagues or bosses do not agree with you and will not listen to what you have to say.

Some individuals might take the view that when they are at work, they act according to a different set of rules and with a different moral outlook, compared to the way they think and behave in their private life. This view can be used to justify decisions or actions at work that are unethical, on the grounds that 'business is different'.

However, this is not a view that accountants should necessarily take because accountants (including students and qualified accountants) are bound by professional codes of conduct such as the ICAN Code of Professional Conduct at all times, not just in the work environment.

In complying with codes of professional ethics, accountants should be prepared to make difficult choices (if necessary) when faced with an ethical (moral) dilemma.

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Example: Moral dilemma

Two examples of moral dilemmas are:

- You know that a close colleague at work steals small items from the office and takes them home, such as a box of pens. Do you turn a blind eye because it is your colleague, or do you report the thefts to your boss?
- There is an urgent job that must be completed very quickly. You know that there should be a final check of the work before it is declared 'finished', but there is no time to carry out the check if the work is to be completed within the required time. What do you do? Say that the checks have been carried out, or admit that the deadline for completion has not been met because the checks have not yet been carried out?

Definition: Ethical dilemma

An ethical (moral) dilemma involves a conflict between two moral principles whereby it can be argued that both perspectives are fair and reasonable. Ethical dilemmas typically arise in situations whereby a particular action is likely to benefit one stakeholder whilst harming another.

For example a private hospital may need to close a particular department in order to save costs and increase profits (thus benefitting the shareholders). However, the patients and community would suffer through the removal of the service.

In summary then, an ethical dilemma is a situation where guiding moral principles cannot unequivocally resolve the conflict and determine which course of action is right or wrong. It arises when there is a difficulty in determining what the morally right or good course of action is.

Example: Electronics exporter

You work as an accountant for a company that exports electronic equipment. You have been asked to prepare the export documents and invoice for an export order to a customer in Country X. You are aware that the customer in Country X is an agent for an organisation in Country Y. Because of a civil war in Country Y, your country's government has placed a complete ban on exports of goods to Country Y. What should you do?

The problem here is that you know, or have a strong suspicion, that your company is acting illegally. But the decision to sell the equipment was taken by someone else in your company, and the company's management presumably know what they are doing.

You are an employee of the company, so you might think that you should get on with your job and do what you have been ordered.

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However, the action by your company in exporting goods to Country Y (through Country X) would probably be illegal, and would certainly be unethical. Whatever action is appropriate for you to take, the option of doing nothing, because it is 'none of your business', is unsuitable and inappropriate.

Accountants must deal with moral dilemmas when they arise, and doing nothing is not normally a satisfactory option.

1.4 Acting in an ethical way: moral philosophy

As an accountant, you need to recognise the need to behave in an ethical way. If you do not intend to act ethically in your work, you do not deserve to be an accountant!

There is a difference between facing a moral dilemma, where you have a choice between two courses of action and both can be justified morally, and a moral duty. Professional accountants have a moral duty to comply with their professional code of ethics.

To understand how to act ethically, it is necessary to have some understanding of ethics, how ethical codes of behaviour are established and maintained.

It is also useful to recognise a link between ethical behaviour and good corporate governance. Good corporate governance is associated with integrity, honesty and transparency. These are ethical qualities in business.

Morality and ethics

It is also important to recognise that individuals – and businesses – have differing views about 'right' and 'wrong'. We might think that we know what is right, but others might disagree strongly. Differences in ethical views can be very large between different communities and cultures.

There is general agreement that some actions are 'wrong' and unethical. It is wrong to steal and wrong to commit murder.

Many individuals take the view that war is 'wrong', but others might think that war is sometimes necessary to achieve a desirable and morally-worthwhile objective.

There are strong differences of opinion on difficult moral issues such as abortion, euthanasia and medical research on animals.

There are probably strong differences on opinion on many other issues. Is it wrong for a government to torture a 'terrorist' in order to obtain information that might reduce the risk of more terrorist attacks and deaths of civilians? Is it wrong to tell a lie to your boss at work in order to protect a colleague from dismissal for a minor disciplinary offence?

These examples might help to illustrate that what individuals might personally consider 'immoral' might not be considered unethical from a different point of view. For example you might believe that it is immoral for employers to make any

employee redundant, but making workers redundant is not unethical in terms of business ethics.

Ethics and the law

A distinction should also be made between ethics and the law. Breaking the law is generally considered unethical (although there may be an unpopular law that people in society think should be broken in some circumstances). However, unethical actions might not be illegal.

For example, telling an untruth to your boss is unethical business practice, but in most cases it will not be illegal. Making employees work excessive hours every week will probably be judged unethical, but it is illegal only if there is a law setting maximum limits on the number of hours that employees can be made to work.

Why the study of ethics is important for today's accountants

The study of ethics is important to today's accountants due to the following:

- Accountants must abide by professional codes of ethics due to membership of a professional accountancy body;
- It is in the public interest that members of the public have confidence in the accountancy profession. This is necessary to help facilitate commerce and industry, promote growth and prosperity and to help sustain a reliable and trustworthy economic mechanism;
- Accountants must continue to be seen as ethical and independent for their opinions to be valued both within audit and advisory roles;
- The study of ethics will help promote consistency in the ethical values and principles that can be expected of accountants; and
- Adherence to professional codes of ethics remains ever critical in protecting the reputation of the accountancy profession in the light of the recent corporate scandals (such as Enron and WorldCom) and the global financial crisis.

Moral philosophy

Moral philosophy is concerned with explaining the nature of ethics and morality and with providing a moral justification for actions that are taken by individuals (and organisations). The remainder of this chapter describes briefly the differing views of some moral philosophers.

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2 CONSEQUENTIAL AND NON-CONSEQUENTIAL THEORIES OF ETHICS

Section overview

- Consequential theories (teleological theories) of ethics
- Non-consequential theories deontological theories) of ethics
- Situational ethics

Professional accountants may be faced with ethical or moral decisions many times during their career, and it is important to understand the issues that may be involved, so that an appropriate decision is taken in each situation, and the accountant understands the ethical reason for the decision. There is an important distinction between:

- Consequential theories of ethics, also known as teleological theories; and
- Non-consequential theories or deontological theories of ethics.

2.1 Consequential theories (teleological theories) of ethics

Consequential theories of ethics are also known as teleological theories or results-based theory. This is the theory that "of all the things that a person might do at any given moment, the morally right action is the one with the best overall consequences" (Internet Encyclopaedia of Philosophy).

According to this view, nothing is inherently 'wrong': it all depends on the outcomes or consequences. Whether something is right or wrong depends only on results. This means that faced with a moral dilemma, an individual should choose the action that will provide the best possible consequences (or the 'least worst' consequences).

Individuals may not think about the consequences of their decisions or actions every time they are faced with a moral dilemma, because they do not have the time. Instead they might rely on a generally-accepted view of what is right, based on the normal outcomes from similar situations. For example, a person may choose not to tell a lie because there is a generally accepted view that telling lies is 'bad', based on experience that lying usually has bad consequences.

Utilitarianism

One theory of consequential ethics is utilitarianism. Utilitarianism is the view that the morally correct decision in any situation is one that produces the best possible outcomes for people as a whole (for 'mankind'). The aim should be to maximise well-being or 'utility' for people.

Ethical egoism

Ethical egoism is another theory of consequential ethics, but this takes the view that people should always do what is in their own best interests, not what is in the best interests of people generally.

Consequential/teleological ethics and the profit motive

Teleological ethics can be used to justify the profit motive in business. It can be argued that when a business is profitable, many people benefit. Shareholders benefit from higher returns and dividends; employees benefit from the employment that a profitable business provides; customers benefit from the

ICAN 2021

goods and services that a profitable business is able to provide (that it would not be able to provide if it did not make a profit); the general public benefits from the benefits to the economy from profitable businesses and additional economic activity.

Teleological ethics can also be used to justify actions in business that might otherwise seem morally 'dubious' or 'wrong', such as:

- cutting costs (including making employees redundant);
- down-sizing (which involves making people redundant); and
- doing business in a country with a dubious political system, such as a tyrannical government.

Main criticisms of consequential theories

The main criticisms of the consequential theory of ethics are that:

- It is difficult often to predict in advance what the consequences of a decision or action might be; and
- It is a theory that can be used to justify acting in self-interest.

2.2 Non-consequential theories deontological theories) of ethics

Non-consequential theories of ethics are theories based on the view that what is right or wrong does not depend at all on the consequences of the action or decision. The term 'deontological' theory of ethics is commonly used: 'deon' is a Greek word for 'duty'.

This approach to ethics is a duty-based approach. It is based on the view that certain moral obligations are self-evident and need no further justification. Actions are inherently 'good' or 'bad', regardless of their consequences, and a clear distinction can be made between 'right' and 'wrong' without considering consequences or utility.

There are no exceptions to this view. The German philosopher Kant went as far as to say that it is wrong to lie even if the lie would save a friend from a murderer.

The deontological approach is therefore;

Always do the right thing;

Do the right thing because it is right, regardless of the consequences; and

Do not do the wrong thing, because it is always wrong.

Ethics of duties

One aspect of the deontological approach to ethics is that a person has certain fundamental duties that he or she must always uphold, and there are no circumstances when breaching those duties is morally correct.

This view is important for professional accountants, because they are required to uphold the principles in their professional code of ethics.

ICAN 2021

(A professional code of ethics may allow some exceptions to a rule, but globally, professional accountants are expected to act in accordance with their ethical code.)

Ethics of rights and justice

Another aspect of the deontological approach to ethics is the view that the rights of an individual in any situation should be protected and upheld, and the law should always be respected. For example, the rights of each party to a contract should always be upheld, and each party should carry out their undertakings under the terms of their contract.

It is always 'right' to comply with the law and it is always wrong to break the law.

Again, this is a view of ethics that many professional accountants will be familiar with.

Main criticisms of non-consequential theories

The main criticisms of the non-consequential theory of ethics are that:

- It can be difficult to accept that a decision or action is morally 'right' if it has undesirable consequences, when an alternative course of action might offer beneficial consequences; and
- There may be situations when an individual's duties are in conflict with each other. For example, what should a professional accountant do when the principles of his or her professional code of ethics conflict with the company's code of corporate ethics?

2.3 Situational ethics

Situational ethics is based on the view that what is right or wrong in any given situation depends on the circumstances of the situation. There are no 'universal' rules of morality: each situation is unique. Ethical decisions should therefore be taken on a case-by-case basis.

There may be accepted general moral principles, such as the principles that it is wrong to kill or steal, but these should not be applied rigorously in all situations.

The main criticisms of the situational theory of ethics are that:

- There is a lack of consistency in decisions about what is right or wrong; and
- As a result it can be argued that there are no ethical or moral guidelines at all.

ICAN 2021

3 ETHICAL THEORIES OF RELATIVISM AND ABSOLUTISM

Section overview

- Absolutism
- Relativism
- Ethical subjectivism

Moral philosophers do not agree on the nature of morality. Two opposing views are 'absolutism' and 'relativism'.

3.1 Absolutism

The ethical theory of absolutism, or moral absolutism, is that there are absolute moral standards against which the morality of actions can be judged. 'Right' and 'wrong' are recognised by objective standards that apply universally, to everyone. Plato was a philosopher who argued in favour of moral absolutism and in 'good' that always holds its value.

Absolutism might be associated with religious morality, but an individual can have an absolutist view of morality without being religious. For example, an individual might believe that slavery, war, child abuse and the death penalty are all morally wrong and cannot be justified under any circumstances.

A person who takes an ethical absolutist view of a situation will judge 'right' or 'wrong' according to a clearly defined set of ethical principles, that apply in all circumstances. For example, a person might consider that stealing money is always wrong, even if the amount stolen is quite small and the money is used to buy food for a starving family.

3.2 Relativism

The ethical theory of relativism rejects the absolutist view. It states that there is no objective or absolute moral truth, and there are no universal standards of moral behaviour. Morality is relative to the ethical norms that are accepted by society at the time, and the culture of society. What is 'right' in one society may be considered 'wrong' in another. And what is considered 'wrong' at one moment in time might be considered 'right' several years later. There are several aspects to relativism:

- **Descriptive ethical relativism** - This is the view that different cultures and societies have different ethical systems and cultures. 'Right' and 'wrong' are concepts that relate to the particular culture. (There is no universal rule about right and wrong.);
- **Normative ethical relativism** - The beliefs or moral values within each culture are right within that culture. It is impossible to judge the values of another culture externally or objectively. Moral values of a culture can only be judged from within the culture;
- **Religious moral relativism** is an example of normative ethical relativism and maintains that morality is determined and dependent on religious

ICAN 2021

standpoints. However, it recognises that no single religion is universally or exclusively true.

- **Historical relativism** is another example of normative ethical relativism and provides context for ethical views to vary over periods of time. For example the elimination of suspected witches or the widespread adoption of slavery in the past may not be acceptable in today's society. Similarly trends may move in the opposite direction – for example the liberalisation of clothing fashions or the changing role of women in society.

Relativism accepts that ethical behaviour cannot be judged objectively. What is right and what is wrong can also vary according to circumstances.

J L Mackie is a fairly recent moral philosopher who supported the relativist view. He argued that ethical values and moral judgements are a human invention, which is imposed on society by 'institutions'.

Example: Absolutism vs. Relativism

You might have your own view about which of these different approaches to making moral judgements is correct, absolutism or relativism.

Suppose that a manager is given confidential information by an employee which he promises to keep confidential and not to disclose to anyone else.

In your opinion, would there be any circumstances in which the manager might break his promise and disclose the confidential information to someone else, without the permission of the employee?

The manager might take the view that having given a promise, he must keep it. A promise is given with the intention of keeping it, and there are no circumstances in which the manager would disclose the information to anyone else, without the prior permission of the employee. This would be an absolutist view of ethics.

The manager might take the view that, having given his promise, there could be situations in which the information could be given to someone else, without permission from the employee. This would be unethical behaviour.

The manager might give a promise not to disclose the confidential information to anyone else, but in giving his promise he might tell the employee that there are certain circumstances in which he might feel obliged to give the information to someone else (and give an indication of what those circumstances might be, such as legal reasons). In this situation, the manager would be saying that the right thing to do could depend on the circumstances and situation. This would be a relativist view of ethics.

It is therefore possible to take a moral position based on either an absolutist or a relativist view of morality. It is also possible to act unethically, from both an absolutist and a relativist point of view.

3.3 Ethical subjectivism

Ethical subjectivism is a meta-ethical approach to morality. This is the view that what is right or wrong in any given situation is simply dependent on what people think about it. If society thinks that something is 'right', then it is 'right'. And if society thinks that something is 'wrong', then it is 'wrong'.

ICAN 2021

4 KOHLBERG'S STAGES OF MORAL DEVELOPMENT

Section overview

- The six stages of moral reasoning and development
- Pre-conventional level of morality
- Conventional level of morality
- Post-conventional level of morality
- The Heinz dilemma
- Criticisms of Kohlberg's ideas

4.1 The six stages of moral reasoning and development

Kohlberg is an American moral philosopher who developed a theory of moral behaviour, which was first published 1958. His theory attempted to explain the reasoning that makes individuals make their decisions when faced with a moral dilemma.

He argued that all individuals go through stages in their moral development. He identified six development stages that an individual might go through, although most individuals do not go through all six in their life.

The six stages are progressive. Individuals start at Stage 1 and work upwards through higher stages as their lives progress.

Each higher stage of moral reasoning is better at dealing with moral dilemmas than earlier stages.

It is extremely rare for an individual, having reached one stage, to fall back to a lower stage of moral reasoning.

However, individuals do not act at all times at the highest stage of moral development that they have reached.

Individuals cannot 'jump' stages, or miss any stage of development. For example, an individual cannot go from Stage 3 to Stage 5 without first going through Stage 4.

Kohlberg argued that the moral response of an individual to any moral dilemma or decision can be identified with one of the six stages.

He divided the six stages of moral development into three levels, as follows.

Level of morality	Stage	
Pre-Conventional	**1**	Obedience and punishment
	2	Self-interest: individualism and exchange
Conventional	**3**	Inter-personal accord and conformity: good boy, nice girl attitude
	4	Maintaining social order
Post-conventional	**5**	Social contract
	6	Universal ethical principles

Each of these stages will be explained in more detail.

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4.2 Pre-conventional level of morality

A pre-conventional level of moral reasoning is common in children, although it can also be found in adults. Kohlberg called this level of reasoning pre-conventional because individuals at Stages 1 and 2 do not yet see themselves as members of society, and their moral reasoning is based entirely on 'self'.

Stage 1: Obedience and punishment orientation

At Stage 1, individuals judge right and wrong on the basis of the direct consequences for them of the actions they take.

An action is bad if the individual knows that he (or she) will be punished for it. The worse the punishment, the greater the moral wrong.

An action is good if the individual knows that he will receive some benefit.

The individual believes that there are powerful authorities who are able to give rewards and punishments for behaviour.

Stage 2: Individualism and exchange

At Stage 2, the individual (often a child) recognises that there is no single view of what is right and what is wrong. Different individuals have different points of view. Each individual is also free to pursue his or her own personal interests, and will therefore want to do what is in his or her own **best interest**.

When faced with a moral dilemma, the individual's decision is based on: 'What's in it for me?'

The individual might show an interest in other people, but only to the extent that other people might help to further his own interests. A typical view in dealing with other people is; 'You help me and I will help you'. ('You scratch my back and I'll scratch yours.')

Concern for others has nothing to do with loyalty to the other person, respect or wanting to help them. It is based entirely on concern for oneself.

4.3 Conventional level of morality

The conventional level of moral reasoning is typical of adolescents and adults. When individuals think in a conventional way, they judge the morality of actions by comparing the actions with the conventional views and expectations of society.

Stage 3: Good interpersonal relationships

Individuals now enter society and see morality as more than making deals for personal benefit. They believe that they should live up to the expectations of family, friends and the community. They are aware of the approval or disapproval that they receive from other people, and try to live up to their expectations. They enjoy respect and gratitude, and their moral outlook is based on how this will be obtained. They want to be a 'good boy' or a 'nice girl'.

Good behaviour means having good motives and feelings of love, trust and concern for others. The actions of another person are often judged by the reasoning: 'He means well….'

ICAN 2021

Stage 4: Maintaining social order

The moral reasoning at Stage 3 is based largely on interpersonal relationships and feelings, with family members and close friends, where it is possible to get to know the feelings and opinions of the other person very well, and try to help them.

At Stage 4, the individual is concerned with society as a whole, and the need to maintain social order. The focus is on respect for social conventions, authority and obeying the law, because these are important for maintaining society.

4.4 Post-conventional level of morality

The post-conventional level of morality is also called the 'principled' level. The individual now realises that he is a person with his own views, and not just a member of society. The individual does not accept that social conventions are necessarily correct. However, this is a higher level of moral development than the pre-conventional level, because the individual takes a principled view, not a purely selfish view of right and wrong.

Stage 5: Social contract orientation

At Stage 5, individuals think about society differently from the conventional way. They take the view that a good society is one in which there is a 'social contract' in which everyone works towards the common benefit of society. They recognise that people are different and have the right to their own views and opinions. However, all rational-minded people should agree about two things:

- All people should have certain basic rights that society will protect, such as life and freedom; and
- There should be some form of democratic procedure for changing laws that are unfair and for improving society.

At Stage 5 people talk about 'morality' and 'rights' from their own individual perspective, recognising that other people might disagree (subject to the two points above). In contrast, individuals at Stage 4 might talk about 'morality' and 'rights' because they belong to a social group (such as a religious group) that supports these concepts. Stage 4 individuals believe in 'rights' because they are conforming to their group, not because they have reached their moral viewpoint individually.

Stage 6: Universal ethical principles

Kohlberg suggested that individuals **very rarely** reach Stage 6 of moral development. At this stage, moral reasoning is based on abstract 'universal' ethical principles. The individual queries the validity of laws, and considers that laws are only valid if they are based on justice. Individuals have an obligation to disobey unjust laws.

An individual makes moral decisions because they are right, not because they are a means to an end, or because the action is legal or expected.

There are universal principles of justice requiring that all people should be treated impartially, in an equal manner and with dignity. For example, it is morally wrong to vote for a law that helps some people but hurts others.

4.5 The Heinz dilemma

Kohlberg used a number of fictional case studies involving a moral dilemma, to establish the stage of moral development and reasoning that an individual had reached. One of these case studies, the Heinz dilemma, provides a good illustration of Kohlberg's analysis.

In this example, you should note that individuals at the same stage of moral development can reach differing views of 'right' and 'wrong'. Kohlberg was interested in the moral reasoning that individuals use to justify their opinions, rather than the actual decision that they reach through their reasoning.

The case study

The Heinz dilemma is based on the fictional case of a man, Heinz, whose wife is suffering from cancer and close to death. There is one drug that doctors think might save her. This is a drug that a scientist in the same town has recently discovered. The drug is expensive to produce, but the price charged for the drug by the scientist is ten times its production cost. The scientist paid $200 to make the drug and was charging $2,000 for a small dose.

Heinz wanted to buy the drug for his wife, but had very little money. He went to everyone he knew to obtain the money to buy the drug, but could raise only $1,000. He told the scientist about his wife's medical condition and that he could raise $1,000. He asked the scientist to let him buy the drug at that price, or let him pay the rest of the money later. The scientist refused, saying that he had discovered the drug and intended to make money from producing it. Heinz, in desperation, broke into the scientist's premises to steal the drug for his wife.

The questions asked by Kohlberg were:

(1) Should Heinz have broken into the scientist's premises to steal the drug?

(2) Why, or why not?

Analysis of the case study

For Kohlberg, it was not important what an individual would do in the situation faced by Heinz, but how he or she reached an opinion. The moral reasoning was more important than the decision or action that results from it.

Examples of some of the arguments that might be used by individuals at each stage of moral development are set out below.

Stage of moral development	Possible reasoning
1. Obedience and punishment	Heinz should not steal the drug because if he does he will be put in prison. This would be very bad. *Or* Heinz should steal the drug. It only cost $200 and he offered to pay a lot more. He was only stealing the drug, nothing else.

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Stage of moral development	Possible reasoning
2. Self-interest	Heinz should not steal the drug, because if he does he will go to prison. Prison is a terrible place and he will suffer a lot if he goes there, more than if his wife dies. *Or* Heinz should steal the drug, because if he does he will be very happy, even if he has to spend some time in jail.
3. Interpersonal accord	Heinz should not steal the drug because stealing is bad and Heinz is not a criminal. *Or* You can't blame him. He did everything he could first without breaking the law. *Or* Heinz should steal the drug. He is a good husband and his wife will expect him to do it.
4. Maintaining social order	Heinz should not steal the drug because stealing is against the law. *Or* Heinz should steal the drug, but he should also face up to the consequences and take the punishment for the crime. You can see why he did it, but breaking the law has its consequences. You can't let criminals go around doing whatever they want.
5. Social contract	Heinz should not steal the drug because the scientist has a right to fair compensation. Even though his wife is near death, Heinz is not justified in stealing. *Or* Heinz should steal the drug, regardless of the law, because everyone has a right to life.
6. Universal ethical principles	Heinz should not steal the drug. If he does, this means that someone else will not be able to buy it and that person might need it just as much as Heinz's wife. Their lives are just as important. *Or* Heinz should steal the drug, because saving a human life is much more important than respect for someone's property rights.

4.6 Criticisms of Kohlberg's ideas

Some of the criticisms of Kohlberg's ideas are interesting, and have relevance to concepts of business ethics (especially for global companies) and professional ethics (especially for professional bodies with global membership).

Some critics have argued against the view that post-conventional morality exists or is at a higher level of moral development. At Stages 5 and 6, individuals put their own principles above society and the law, which is a dangerous moral stance to take.

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Other critics have argued that Kohlberg's views have a cultural bias, because his ideas are based on Western philosophy. His views might not apply to non-Western philosophies and cultures.

Carol Gilligan (1982) argued that Kohlberg's views had a gender bias, and were based on a male view of the world. Kohlberg argued that moral thinking is based on reasoning linked to a sense of justice – rules, rights and abstract principles. Gilligan argued that for women, morality and ethical views are not based on these concepts of justice, but on concern for interpersonal relationships and the ethics of care and compassion.

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5 ETHICAL DECISION-MAKING MODELS

Section overview

- System development ethics
- The purpose of ethical decision-making models
- Tucker's 5 question model
- The American Accounting Association model

5.1 System development ethics

Business entities and non-business entities are exposed to ethical risk. This is the risk that some of its managers or employees will act in a way that is unethical, and the entity will suffer some loss or harm as a consequence. There is a risk to the entity itself from deception or fraud by employees. In addition, there is a risk of unethical action by some individuals causing harm to other – customers, other employees, suppliers, the community, and so on.

It might be argued that ethical risk can be minimised by recruiting and training individuals with strong moral character.

System development ethics, however, is based on the view that recruiting and training morally-strong individuals is not sufficient. In order to act in a moral way, individuals need support from the systems they work in, and the environment provided by their employer.

The employer should give clear guidance and moral support to its employees. 'Personal improvement and character-building can only occur in morally-supportive environments that are rationally-planned and maintained.'

Codes of corporate ethics and codes of professional conduct help to provide the environment that individuals need.

5.2 The purpose of ethical decision-making models

Guidance about ethical decision-making can also be provided by a decision-making model. The purpose of an ethical decision-making model is to help individuals to assess, before they make a decision, whether the decision is ethically correct.

These models do not deal with the problem of what is right or wrong. They assume that the basis for judging right and wrong is understood. This means that they could be used with either a deontological or a teleological approach to ethics, although a teleological approach is much more common in business.

Several ethical decision-making models have been developed for use in a business context, and can also be applied to professional activities such as accounting. Two such models are:

- Tucker's 5 question model; and
- the American Accounting Association model.

ICAN 2024

5.3 Tucker's 5 question model

Tucker's 5 question model for ethical decision-making in business is based on the view that the profit motive is justified, and the purpose of decision-making in business should be to make a profit. However, profits should be made in an ethical way.

In order to be ethically correct, business decisions and actions should be legal. Activities outside the law by a business cannot be correct. Business should also be conducted in a fair way, without deception or other 'under-hand' acts. For example, competitors should be treated with respect, and customers and employees should be treated in a fair way. Tucker's model is also based on the view that decisions should not be taken in business if they do not support sustainable business or could be damaging to the environment.

The 5 question model involves asking five questions before making a business decision. If the answer to all five questions is 'Yes', the decision is ethically sound. The five questions about a decision are:

(1) Is it profitable?

(2) Is it legal?

(3) Is it fair?

(4) Is it right?

(5) Is it sustainable or environmentally sound?

Example: Tucker

An international company is planning to build a new manufacturing plant in a developing country. The country was chosen because costs of land and labour are low, so the forecast profits are high. The plant will be built on a 'brown field' site just outside the country's capital city, which used to be the site of another factory that has now been closed down. The company intends to build a plant that will use modern technology that keeps environmental emissions at a low level.

The country's government has approved the building of the new plant, and the local population is eagerly waiting for construction to begin, bringing with it much-needed commercial activity – and jobs. The government believes that the plant will bring economic growth to the country's economy.

Required

Is the decision to build the plant an ethical one? Use the Tucker 5 question model to reach an answer.

ICAN 2021

Answer

Question 1. Is it profitable? The answer seems to be Yes. The country was chosen because of its low cost of land and labour.

Question 2. Is it legal? The answer seems to be Yes, because the government has given permission for the plant to be built.

Question 3. Is it fair? There is no reason to suppose that it is not fair. The only stakeholders in the example are the government and the local population. Both seem to support the building of the plant, and this suggests that the project is fair.

Question 4. Is it right? The answer seems to be Yes. The project will bring jobs, wealth and economic growth. There are no obvious reasons why the project is 'Not right'.

Question 5. Is it sustainable or economically sound? The answer seems to be Yes, because the plant will be built using modern technology that keeps environmental emissions at a low level.

In this simple case, the decision to build the plant would be ethical.

5.4 The American Accounting Association model

The American Accounting Association developed a model for ethical decision-making in 1990. It is based on a teleological approach, and is consistent with professional ethical guidelines.

The AAA model is based on a seven-step approach to decision-making.

Step	Question to ask	Comment
1	What are the facts?	It is important to establish all the relevant facts. It is difficult to make a correct decision without having a clear understanding of the facts.
2	What are the ethical issues?	The decision-maker should identify what moral issues are involved (if any). What is the moral dilemma?
3	What moral principles, values or 'norms' are relevant to the decision?	The decision-maker should consider the ethical principles or values that ought to be considered in reaching the decision.
4	What are the alternative courses of action for the decision-maker?	
5	Which course of action (or courses of action) seems best, because it is consistent	Each course of action should be assessed according to whether it is morally correct. Each choice is judged

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Step	Question to ask	Comment
	with the moral principles and values identified in Step 3?	against the principles and values that should be applied in the case.
6	What are the consequences of each possible course of action?	
7	What is the decision?	The decision-maker makes an ethical choice.

Example: Tucker and AAA

A company makes and sells a range of products. One product, the mega-widget, has been produced for about ten years and has been very successful. It is still popular with customers, but profits have fallen to the point where the company is now losing money on the product.

The fall in profits has been due to rising costs. Due to competitive pressures in the market, increases in the selling price of the mega-widget have not kept pace with the increases in cost.

At a management meeting to discuss the problem, it was suggested that some technical alterations could be made to the mega-widget that would reduce costs substantially, but the expected useful life of the product would fall by over 25%. It would be necessary to prevent customers from finding out about any reduction in product quality, because they might switch to buying the products of competitors.

It was agreed that if the technical alterations are not made, the company would have to cease production and sales of the mega-widget. If the technical alterations are made, the product should become profitable again, at least for the next few years.

Required

What decision should management take: should the technical alterations be made to the product, or not? Management are expected to act in an ethical way by the company's board of directors. (You should ignore reputational risk in this example.)

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Answer

We could use an ethical decision-making model to help with making a decision.

Tucker's 5 question model

(1) Is the decision profitable? Making technical alterations to the product would improve profits, so the answer is: Yes.

(2) Is the decision legal? There is no law against making technical alterations to the product. As long as the company does not deceive customers with its advertising and marketing, making the technical alterations would be within the law.

(3) Is the decision fair? It is fair in the sense that all customers would be treated in the same way, and customers would have the choice to buy the products of competitors. However, it is not fair in the sense that customers would be encouraged to buy an inferior product, without knowing about the reduction in quality, at the same price as before when the product was better.

(4) Is the decision sustainable and environmentally sound? There are no indications to suggest that there is a problem with the environment or sustainable business.

(5) Is the decision right? The moral problem is that the company would be making changes to the product without informing customers. Managers might think that this is wrong, but at the same time they would be under pressure to make profits for the company.

Answer (continued)

Using the Tucker model, the issue in this case might concern whether it is morally acceptable to withhold product information from customers. It would help managers in making their decision to know the ethical stance of the company towards its treatment of customers. If the company had a code of corporate ethics, this might help them to reach their decision.

American Accounting Association model

A similar conclusion might be reached using the American Accounting Association model.

(1) The facts are given in the question.

(2) The ethical issue is whether to reduce the quality of a product without informing customers.

(3) What are the ethical principles and values that are relevant to the moral dilemma? A key principle here relates to the treatment of customers.

(4) What are the alternative courses of action? These are to make the technical alterations to the product, or to stop making it. We do not know what the consequences of shutting down production might be (for example, whether it might lead to redundancies amongst employees).

(5) Which actions are consistent with the principles and values in (3)? Ceasing to produce the mega-widget would be consistent with the principle of fair dealing for the customer.

(6) The consequence of the decision to make the change is to increase profits. Ceasing production of the product should result in no further losses. However, it is more likely that in the long run the trust of customers in the company would be maintained. (There is a reputational risk to consider, in the event that customers find out about the technical alteration, or find that the items that they buy have a shorter useful life than before.)

(7) What is the decision? Management would be assisted by clear guidance from the company on its ethical stance. If the company has a code of ethics that insists on fair treatment and due consideration for customers, the technical alteration should not be made. Production of the product should be brought to an end.

This is just one example to illustrate how ethical decision-making models might be applied to reach an ethical business decision. You might find that in your examination, you are required to apply an ethical decision-making model to another case or problem in order to make a recommendation about what a particular decision should be.

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6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Define ethics and explain the descriptive, normative and meta-ethics approaches to ethical behaviour
- Distinguish between personal ethics, business ethics and professional ethics
- Understand the importance of the study of ethics for accountants
- Explain and distinguish between consequential and non-consequential theories of ethics
- Explain the ethical theories of relativism and absolutism
- Summarise Kohlberg's stages of moral development
- Differentiate between deontological and teleological approaches to ethics
- Apply Tucker's 5 question model and the American Accounting Association model for ethical decision making

ICAN 20

CHAPTER 17

Ethics and social responsibility

Contents

1 Models of the professional client relationship
2 Ethics, governance and social responsibility
3 Seven positions on social responsibility
4 The cultural context of ethics
5 Chapter review

ICAN 2021

INTRODUCTION

Detailed syllabus

E	**Ethics**
E5	Discuss the alternative models of professional-client relationship; agency, contract, paternalism and fiduciary.
E6	Identify and explain in the context of a given scenario, how the issues of moral duties and moral dilemma may arise in professional and business ethics.
E9	Discuss the alternative ethical stances and culture of an entity (personal versus corporate ethical stance), using:

E9 (a)	Johnson and Scholes four ethical stances
E9 (b)	Gray, Owen and Adam's seven-level classification of social responsibilities
E9 (c)	Johnson and Scholes conception of the cultural web
E9 (d)	Edgar Schein's three levels of culture.

Exam context

Having introduced basic ethical philosophies in the last chapter we now extend our studies to the areas of social responsibility and culture in a business context. The first section however considers four models of the relationship between a professional accountant and a client.

By the end of this chapter students will be able to:

- Describe the agency, contract, paternalistic and fiduciary models of a professional accountant-client relationship;
- Explain the link between ethics, governance and social responsibility;
- Describe Johnson and Scholes' four ethical stances for a business entity;
- Summarise Gray, Owen and Adams' 7-level classification of social responsibility; and
- Discuss the cultural context of ethics using Johnson and Scholes and Schein as examples.

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1 MODELS OF THE PROFESSIONAL-CLIENT RELATIONSHIP

Section overview

- Introduction
- Agency relationship
- Contractual relationship
- Paternalism
- Fiduciary relationship

1.1 Introduction

There are several different views about the relationship that should or does exist between a professional accountant and a client. The relationship that does apply will depend on circumstances.

There are several models for a professional accountant-client relationship. These differ in the extent to which the client or the professional has most authority and responsibility for decision-making. Essentially, there are four models.

- Agency relationship
- Contractual relationship
- Paternalism
- Fiduciary relationship.

Each model is likely to be the most appropriate indifferent circumstances.

1.2 Agency relationship

In an agency relationship, the client has most of the authority and responsibility for decision-making. The professional is an expert acting on behalf of a client, but under instructions from the client. The client knows what is wanted and instructs the professional to do it.

A good example of an agency relationship is the relationship between a client and the client's lawyer: the lawyer acts under the client's instructions.

A similar situation would apply in an agency relationship between a professional accountant and a client. For this sort of relationship to exist, the client must have a reasonable amount of technical knowledge and must understand what the accountant is being asked to do.

The accountant carries out the client's instructions, and provides information and possibly advice, but the client makes the decisions.

An agency relationship exists between external auditors and a company. The auditor is asked to undertake an independent audit and prepare an audit report, but the company's board of directors makes the decisions about what the financial statements should contain.

An agency relationship can exist when the accountant is not independent but is acting on the client's instructions and on behalf of the client. For example, an accountant who is asked to prepare a tax return for a client should try to minimise the tax bill (within the law).

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1.3 Contractual relationship

In a contractual relationship, the client and professional are 'equals' in terms of authority and responsibility for decisions. There is a contract between them, in which the client arranges for the accountant to carry out some work, and the accountant undertakes to do the work.

This kind of relationship will exist when the accountant has some expertise or technical knowledge that the client does not have, and the client hires the accountant to provide it. For example, a firm of accountants may be asked to provide advice to a company on the implementation of a new law or set of regulations. The accountant provides the technical advice and the client acts on the advice given.

1.4 Paternalism

To understand paternalism, it helps to think of the relationship between parents and their children. Parents have much more knowledge and experience than their children, and they act and make decisions on behalf of their children that are in the children's best interests.

A comparable situation may exist between a professional accountant and a client. For this situation to exist, the professional accountant must have experience and knowledge, and the client should be inexperienced and without much knowledge of the matters that the accountant deals with.

In a paternalistic relationship, the accountant has most of the decision-making authority and responsibility, and can make decisions without the client's knowledge or consent. The accountant exercises his or her judgement in what are considered to be the client's best interests.

Paternalistic relationships between a professional and a client can be the relationship model that causes greatest concern, because the professional will be virtually taking over the client's affairs.

1.5 Fiduciary relationship

In a fiduciary relationship between a professional and a client, the professional (as a 'fiduciary') has an obligation to act in the best interests of the client. The professional has superior technical knowledge and greater expertise than the client. However, unlike a paternalistic relationship, in a fiduciary relationship the client retains significant authority and responsibility for making decisions.

Both parties in the relationship have responsibilities and the judgements of both carry weight. The client depends on the accountant for much information and advice, but the client's consent is needed for any decision, and in many instances the client is involved in reaching decisions and also makes the final decision.

For some issues, the client may recognise the technical knowledge of the accountant, and allow the accountant to make the decisions. However, this is not the norm.

2 ETHICS, GOVERNANCE AND SOCIAL RESPONSIBILITY

Section overview

- Introduction
- Shareholder theory
- Stakeholder theory
- Social contract theory
- Johnson and Scholes: four possible ethical stances for a business entity
- Ethical stance: personal and corporate

2.1 Introduction

Business entities operate within society. They interact with their local communities. Their employees, customers and suppliers are all members of the society in which the entity operates.

The responsibilities of a business entity towards society were considered in earlier chapters on corporate governance. There is a link between ethics, corporate governance and social responsibility.

2.2 Shareholder theory

The shareholder theory of corporate governance is based on the view that the objective of a company is to maximise value for its shareholders. It was suggested in the previous chapter that a teleological approach to ethics can be used to justify the profit motive in business, so that the objective of maximising shareholder wealth (within constraints of ethical behaviour) is perfectly legitimate.

Shareholders, especially shareholders of large stock market companies, often trade their shares. Some are investors in the company for the long term and others invest only for the short term, hoping to make a quick profit from a favourable movement in the share price.

Long-term shareholders are likely to support the view that the company should invest for long-term growth. If necessary, short-term profits should be sacrificed in order to invest more retained profits in the business.

Short-term shareholders are likely to support a policy of high dividend payments and measures to boost short term profits (in the hope that this will lead to a higher share price).

2.3 Stakeholder theory

The stakeholder theory of corporate governance is that a company's directors owe a duty to all major stakeholders in the company, including not just employees and customers, but also communities and society as a whole. According to the normative view, a company has a moral duty to consider the concerns of various stakeholder groups.

This concept of governance can be linked to a deontological approach to business ethics. This would argue that all individuals have a basic moral right to be treated by business entities in a way that respects their interests and

ICAN 2021

concerns. Employees should not be treated simply as a means to achieving the end of higher company profits.

The rights of stakeholders can be analysed in terms of stakeholder groups (employees, customers, shareholders and so on) rather than considering each stakeholder individually. The possession of intrinsic moral rights by stakeholders creates corresponding ethical duties for a company to respect those rights.

2.4 Social contract theory

There is also a social contract theory of corporate governance. This is based on the view that members of society give legal recognition to a company. They allow the company to exist and act as a legal person within society. They also allow a company to use land and resources, and to hire members of society as employees.

The company therefore has an obligation to pursue the objective of making profits only in ways that will also enhance the material well-being of society as a whole. Profit-making must be ethical and a company must consider the interests of society in the decisions and actions that it takes.

2.5 Johnson and Scholes: four possible ethical stances for a business entity

Johnson and Scholes (2002) have suggested that companies can take any of four possible ethical stances. These are consistent with the differing views of corporate governance. The four ethical stances are to focus on:

- Maximising short-term shareholder interests (the 'least ethical' of the four stances);
- Maximising long-term shareholder interests;
- Multiple stakeholder obligations: recognising obligations to different stakeholder groups; and
- Being a shaper of society.

Shaper of society

'Shaping society' means changing conditions in society and altering the way that society operates and perceives itself. In the past (and probably also the present), technology has been a significant shaper of society, affecting how and where we all live. Media companies have also been cited as important shapers of society in the past 100 years or so, because film has changed the way in which society viewed itself.

Companies control resources and make decisions about the future of technology. They are instrumental in shaping society.

Johnson and Scholes argued that ethical companies recognise this role that they have, and their decisions and actions are taken with a view to creating benefits for society and improving the well-being of society.

2.6 Ethical stance: personal and corporate

An ethical stance or posture is a position that someone takes on an ethical issue. Both individuals and organisations can develop a conscious ethical stance on certain issues, their decisions and actions are affected by it. For example, a

company might take the view that it will not do business with certain types of customer or supplier. Here are just two examples.

Some retailers in the UK refuse to buy goods from suppliers in other countries that use slave labour or child labour. This ethical stance might be taken partly out of self-interest (reputation risk), but it might also be guided by ethical concerns.

In 2006, the British Jewellers Association took an ethical stance against the sourcing of diamonds from countries (such as the Congo and Sierra Leone) where fighting over diamonds has led to civil war and widespread killing. It calls these diamonds 'blood diamonds' and is attempting to eliminate the trade in these diamonds in the UK.

The ethical stance in a company comes from the moral values and ethical stance of key individuals who work within the company, and from the corporate culture. The ethical aspects of culture are discussed later.

The fictitious example below shows how personal ethics can influence the ethical stance of a company, which in turn might have an effect on its overall business and marketing strategies.

Example: Rick and Tina

Rick and Tina used to be executives in a large company that made soft drinks. They have now set up their own company to make fruit drinks using a recipe devised by Tina.

They wanted to set up their own company so that they could do something that they enjoyed and believed in. During their time working for the large company, each of them accumulated substantial personal wealth; so from their own company all they wanted to do was avoid heavy losses after the initial set-up costs and earn a reasonable living. They were more interested in building the business than in making quick profits and returns.

Each of them had strong moral views about showing respect to other people and protecting the environment.

As owner-founders of the company, they had a vital role in establishing the general culture of the company, and its ethical stance on various issues.

They devised a mission statement for the company. This was to produce a healthy drink product that would contain only natural ingredients, and to operate as an ethical company with concern for its employees and the environment.

The business strategies of the company were based on the production of a healthy food drink in a way that is 'friendly' to the environment.

- The company invested in technology that enabled them to produce their own cartons and bottles from recycled plastic and glass. About 60% of the raw materials in the bottles and cartons for the drinks came from recycled materials.

ICAN 2021

- The company uses a van for deliveries that can run on bio-fuel.
- The company sources its energy from a renewable energy supplier.

Example: Rick and Tina (continued)

Employment policies were also driven by ethical concerns. Rick and Tina wanted their company to be a 'good employer to work for'. They have a small work force, but they promote teamwork, and provide generous pay, good working conditions and holiday entitlements.

The company also contributes in small ways to charity groups. For example, it provides drinks free of charge to local sports events run by different groups for handicapped people and young prison offenders.

A consequence of the strategies and policies of the company is that production costs are fairly high – higher than for the fruit drinks of competitors. However, the company is able to promote itself as a provider of healthy drinks with an ethical environmental policy. It was therefore able to position itself in a niche in the market as a 'high quality, high-price' brand.

ICAN 2021

3 SEVEN POSITIONS ON SOCIAL RESPONSIBILITY

Section overview
■ Responsibilities to society and to the environment ■ 7-level classification by Gray, Owen and Adams

3.1 Responsibilities to society and to the environment

Traditional moral philosophy has been divided between the deontological and teleological approaches, which were introduced in chapter 16. A more recent philosophy is the environmental philosophy. This looks at the different ways in which different individuals and groups view society (and their responsibilities) and accept moral responsibility towards society.

Some individuals focus on ethical responsibilities towards other people. Others argue that individuals and entities have responsibilities not only towards other people in society, but also towards the earth and its environment.

3.2 7-level classification by Gray, Owen and Adams

Gray, Owen and Adams (1996) provided a framework for classifying different groups of people and their views of the relationship between business organisations and society. These can be used to analyse the ethical stance of business entities and their members (managers, employees, shareholders) towards society and social responsibility.

They identified seven levels or positions on social responsibility.

Level	Comment
1 Pristine capitalists	This position is dominant in the world of accounting and finance. The only responsibility of a company is to make money for its shareholders and to maximise shareholder wealth. Shareholders have invested the risk capital and are the legal owners of their company. It therefore follows that only the shareholders should have any right to decide the strategies and policies of the company. This pristine capitalist view is based on rational self-interest, and putting individual self-interest before the collective benefits of society as a whole. The market economy is a good thing. There are no environmental problems because human beings are inventive and adaptable: the market economy will find solutions to the world's environmental problems.

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Level	Comment
2 **Expedients**	Individuals who have an ‘expedient’ view also believe that the main aim of a company is to maximise the wealth of its shareholders. However some concessions have to be made at times to other stakeholders in order to put the company in a stronger position strategically. By doing so it is more likely to maximise shareholder wealth. A simple example may be that a company may pursue a policy to protect the environment, or may support a charity, in order to improve its reputation and customer loyalty. This ‘expedient’ position is taken by people with a longer-term view than pristine capitalists, who recognise that economic success can only be achieved by companies by accepting certain social responsibilities.
3 **Proponents of the social contract**	These individuals believe that companies and other organisations exist at the will of society, and there is a ‘social contract’ between the company and the society in which it operates. Companies therefore have a responsibility and an obligation to respond to the needs of society. A company must therefore act in accordance with standards of behaviour that society finds acceptable. If it does not, society will not allow the company to continue. This is a right-based perspective in which the rights of all human beings are considered significant. Holders of this view would argue that government regulation might be necessary for the market economy, because free market prices do not properly reflect all the effects that companies have on society and its environment (for example, pollution and other environmental damage).
4 **Social ecologists**	Individuals taking this position are concerned for the social environment. They believe that companies and other large organisations have been responsible for creating social and environmental problems. They should therefore be held responsible for dealing with those problems and finding solutions to them.

ICAN 2021

Level	Comment
5 Socialists	These individuals believe that there should be a significant re-adjustment in the ownership of assets and in the structure of society. They criticise all forms of domination, including the governments of a nation state, concentrated economic power (large companies) and authoritarianism.
6 Radical feminists	These individuals believe that society and social systems are dominated by an aggressive masculine view of the world. This is harmful and wrong. There is an urgent need for more feminine values to guide attitudes, such as care, compassion and co-operation.
7 Deep ecologists/ deep greens	These individuals are at the opposite extreme to pristine capitalists. They believe that human beings have no greater right to existence than any other form of life. Ethical decisions should be based on concerns for all forms of life.

To a greater or lesser extent, there is an acceptance of the views in positions 1 to 3 within business. Positions 4 to 7 are all based on a view that the world should be made into a better place, but to do this there must be a radical re-assessment of basic assumptions in society.

ICAN 2021

4 THE CULTURAL CONTEXT OF ETHICS

Section overview

- Culture and ethics
- Johnson and Scholes: the cultural web
- Edgar Schein: three levels of culture
- Culture, ethics and global companies

4.1 Culture and ethics

Culture has been defined as the 'shared beliefs, attitudes, norms, values and behaviour found among speakers of one language in one time period and in one geographical region.' This definition suggests that in order to share a common culture, people must speak a common language and live in the same geographical area. Culture might also change over time.

Companies (and other entities) also develop their own culture. The individuals who work in a company often develop cultural attitudes and habits that are unique to that company. Even global companies, in which employees do not share the same language or live in the same geographical area, can develop a culture of shared beliefs and attitudes.

There is a link between culture and ethics, because the culture in which people live shapes their ethical beliefs, attitudes and values.

Culture, ethics and corporate social responsibility

Corporate social responsibility (CSR) was described in an earlier chapter within the context of corporate governance, and the responsibilities of the board of directors (and a company) towards society. CSR is concerned with issues such as the interests and welfare of:

- Employees;
- Customers;
- communities in which the company operates; and
- the general public, and society as a whole.

Well-governed companies take a stand against crime and do not sanction criminal activities by their employees, in any country in which they operate.

In recent years there has been much greater awareness of environmental issues, and the role of companies in both damaging the environment and acting to protect the environment and create sustainable businesses.

Attitudes to CSR are evident in the ethical stance that many companies now take on these issues, and ethical stance in turn is affected by the corporate culture.

ICAN 2021

4.2 Johnson and Scholes: the cultural web

Johnson and Scholes suggested that there is a cultural web within any organisation, which affects the way in which individuals understand the organisation in which they work. This understanding of their organisation is called their 'paradigm' of the organisation. Employees find it difficult to think and act outside this paradigm.

The cultural web consists of six inter-related elements of culture within an organisation:

- **Routines and rituals** - Routines and rituals are 'the ways things are done around here'. Individuals get used to established ways of doing things;
- **Stories and myths** - Stories and myths are used to describe the history of an organisation, and to suggest the importance of certain individuals or events. They are passed by word of mouth. They help to create an impression of how the organisation got to where it is, and it can be difficult to challenge established myths and consider a need for a change of direction in the future;
- **Symbols** - Symbols can become a representation of the nature of the organisation. Examples of symbols might be a company car or helicopter, an office or building, a logo or a style of language;
- **Power structure** - Organisations are influenced by the individuals who are in a position of power. In many business organisations, power is obtained from management position. However, power can also come from personal influence, or experience and expertise;
- **Organisation structure** - The culture of an organisation is affected by its organisation and management structure. Hierarchical and bureaucratic organisations might find it particularly difficult to adapt to change and are often conservative in their outlook; and
- **Control systems** - Performance measurement and reward systems within an organisation establish the views about what is important and what is not so important. Individuals will focus on performance that earns rewards. For example, it has been suggested that cash bonus systems help to create the profit-driven culture in investment banks.

The cultural web within a company shapes its corporate ethics.

4.3 Edgar Schein: three levels of culture

Schein had similar views about corporate culture. He suggested that employees working within a company have shared values, beliefs and ways of thinking: these interact with the policies, organisation structure and politics of the company's management system to create a corporate culture.

Schein also argued that organisation culture is strong because it is regarded as something that helps the company to succeed. An organisation culture is a set of

ICAN 2021

assumptions that a group of people working together have invented or discovered by learning how to deal with problems that the organisation faces, internally and in its external environment. These assumptions work well enough to be considered valid; they are therefore 'taught' to individuals who join the organisation. New entrants therefore learn the culture of the organisation and become a part of that culture.

According to Schein, there are three levels of culture that members of an organisation acquire.

The outer skin - At one level, the culture of a company is evident in what an observer can see by visiting the company, and in the values that it states. The facilities and surroundings in which employees work help to create culture. So too does the way that employees dress. Culture is also seen in the way that employees talk to each other and interact with each other. A company might have a formal code of ethical behaviour, which is intended to shape the attitudes of all its members. However, stated values and mission statements are often expressed in general terms, such as 'providing a service to the community' and 'providing the best quality of service to customers'.

An inner layer - At this second level, the employees in a company share common views on specific issues. This layer of culture can be seen in the ethical stance that the company takes. Whereas the outer layer of culture is expressed in general terms, this inner layer is expressed in relation to specific issues, such as:

- Should we trade with companies or governments in politically repressive countries?
- Should we buy goods from suppliers who use slave labour or child labour?

The heart - The third level of culture is the company's **paradigm**. This is a term for the shared assumptions and attitudes about what really matters, that are taken for granted and rarely discussed. These affect the way that the organisation sees itself and the environment in which it operates, and is the real 'core' culture of the organisation. Unlike mission statements and codes of ethics, a paradigm is not written down, and it is difficult to identify or explain. The 'paradigm' has also been described as the reason why the organisation exists. A police force exists to catch criminals, and a school exists as a place for learning.

Schein argued that changing corporate culture is very difficult. The 'outer skin' can be changed fairly easily, with a determined effort by management, but it is very difficult to change the paradigm.

The following example suggests that codes of corporate ethics cannot be made to work unless senior management enforces them and ensures that they are applied. The example can also be used as an illustration of how it is much more difficult to alter the paradigm of a company than the 'outer skin' of its culture.

Example: Bank ethics

In 2004 when James Young became CEO of a UK bank, the bank's reputation had been damaged by its associations with companies such as Enron and WorldCom, as a provider of both on-balance sheet and off-balance sheet finance.

Mr Young wanted to improve the image of the bank, which meant improving its cultural and ethical outlook. He introduced a code of conduct and the bank's executives world-wide were asked to adhere to this code. The code stated that the bank should aspire to be a company with the highest standards of ethical conduct and an organisation that people could trust.

In June 2005, there was a problem in Edinburgh on the bank's trading desk for European government bonds. The desk was under pressure to increase its profits, and the management decided to exploit a weakness in a Spanish-based electronic trading system for government bonds called PPQ. The trade involved selling a very large quantity of bonds early in the morning, sufficient to send bond prices falling sharply, then buying the bonds back at much lower prices later the same morning. The trade earned a profit of €23.7 million at the expense of other participants in the bond market.

Example: Bank ethics (continued)

Following this event, some banks refused to honour their commitment to make a market in the bonds on PPQ, and in the next three months, daily trading volumes on PPQ fell by 35%. This led to worries by European governments about whether they would be able to continue issuing bonds (to raise new finance) at a reasonable rate of interest.

Some governments reacted with anger against the bank and withdrew their business. In the UK, the Financial Services Authority (now the 'Financial Conduct Authority') fined the bank £12 million for failing to exercise due skill, care and diligence. The traders responsible for the trade were suspended.

In the bank, there had been a serious breach of its new code of conduct that customers, suppliers and competitors would be treated fairly. The change in culture that the code of conduct was intended to introduce had not reached the heart of the cultural thinking within the bank. The traders, after a brief suspension from work, returned to work. The bank admitted to bad ethical behaviour and poor professionalism, but top management did nothing, and no one within the bank was held responsible.

4.4 Culture, ethics and global companies

Global companies operate in many different countries and employ managers and other employees from diverse cultures.

It can be difficult for global companies to develop a single corporate culture. It is therefore difficult for the senior management of global companies to 'enforce' their view of business ethics on the entire organisation.

ICAN 2021

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Describe the agency, contract, paternalistic and fiduciary models of a professional accountant-client relationship
- Explain the link between ethics, governance and social responsibility
- Describe Johnson and Scholes' four ethical stances for a business entity
- Summarise Gray, Owen and Adams' 7-level classification of social responsibility
- Discuss the cultural context of ethics using Johnson and Scholes and Schein as examples

ICAN 2021

CHAPTER 18

Professional practice and codes of ethics

Contents

1 Professions and the public interest
2 Corporate codes of ethics
3 Codes of ethics for accountants
4 Chapter review

ICAN 2021

INTRODUCTION

Detailed syllabus

Ethics

E7	Discuss the nature of ethical conflicts and ethical threats confronting the accountant in a professional practice, ethical safeguards and tests for resolving the conflicts.
E8	Examine the nature, procedure and challenges of whistle-blowing in the accountancy profession.
E10	Identify and assess issues of professional ethics and corporate governance as they may arise within the context of ICAN code of professional conduct and IFAC code of ethics for professional accountants in a given scenario.

Exam context

After two largely theoretical chapters, we now focus on codes of ethics in public practice and the private sector. This chapter begins with a discussion on 'public interest' and explains why accountants must act in the public interest before moving on to specifically look at corporate codes of ethics and codes of ethics in public practice.

By the end of this chapter students will be able to:

- Explain what is meant by 'public interest' and discuss the link with ethics;
- Summarise the nature, purpose and content of a corporate code of ethics;
- Define whistleblowing;
- Identify and discuss the application of the IFAC and ICAN codes of ethics; and
- Explain the NOCLAR amendment to the code of ethics.

ICAN 2021

1 PROFESSIONS AND THE PUBLIC INTEREST

Section overview

- The nature of a profession
- Acting professionally
- Acting in the public interest
- Influence of the accounting profession in business and government
- Public expectations of the accountancy profession
- Ethics and accountants: critical theory
- Accountants and acting against the public interest

1.1 The nature of a profession

The word 'professional' is associated with a highly-qualified group of individuals who carry out a particular type of highly-skilled work. Examples of professional are doctors and surgeons, dentists, lawyers, actuaries and accountants.

Each professional group is organised and regulated by a professional body. (In the UK for example, the professional bodies often have a royal charter. The accountancy profession has several different professional bodies.) The professional body has the power to:

- admit new members to the profession;
- award qualifications to individuals who achieve a required standard of skill or competence; and
- expel members from the profession, for unprofessional conduct.

It is often a legal requirement that certain aspects of the work of professionals must be performed by professionally-qualified people.

Professionals and their clients

The relationship between professionals and their clients is based on several perceptions of the nature of a professional person.

There is a **relationship of trust**. The client can trust the professional to act in a proper way, in accordance with a professional code of conduct. In return, the professional expects the client to place its trust in him (or her). For example, a client should not withhold relevant information from a professional that would affect his decisions or judgements.

There is an assurance that the professional has attained a minimum level of **expertise and competence**. This assurance is provided, in accountancy, by the requirements to (1) pass formal examinations in order to obtain a qualification, (2)

ICAN 2021

have relevant work experience and (3) continue with professional development and training throughout the accountant's professional career.

There is also an implication in the professional-client relationship that the professional has more concern for the client than for his own self-interest. **The professional puts the client before himself**.

1.2 Acting professionally

Professionals are expected to act in a professional way. Professional behaviour means complying with relevant laws and obligations, including compliance with the code of conduct (including the code of ethics) of the relevant professional body.

Professional behaviour is commonly associated with:

- acting with integrity, and being honest and straight-dealing;
- providing objective opinions and advice, free from bias, influence or conflicts of interest;
- using specialist knowledge and skill at an appropriate level for the work;
- confidentiality: respecting the confidentiality of information provided by clients;
- avoiding any action that brings the profession into disrepute; and
- compliance with all relevant laws and regulations.

The ICAN Code of Conduct states that 'the principle of professional behaviour imposes an obligation on Chartered Accountants to comply with relevant laws and regulations and avoid any action that may bring discredit to the profession.'

Example: Anton Rivers

Anton Rivers is the senior partner in a firm of accountants that specialises in preparing financial statements for clients, tax work and auditing. Mr Rivers has decided to advertise the services of his firm in the local newspaper.

The advertisement states that Rivers and Co is a highly experienced firm with numerous clients, including foreign and domestic companies. It adds that the services of the firm are of the highest standard, unrivalled by any other local firm of accountants.

His colleague challenges him by commenting that Rivers and Co does not have any foreign companies as a client. Mr Rivers replies that it is only an advertisement, and no one ever believes the marketing claims in advertisements.

Has Anton Rivers acted in a professional way? If not, why not?

Answer

Anton Rivers has breached the code of conduct of his profession, by:

failing to act honestly (and with integrity), and

by implication, criticising the work of other professionals.

The advertisement contains an untrue statement, that the firm has foreign companies as clients. This is dishonest.

The advertisement also states that the standards of service from the firm are better than those of any other firm in the area. This is a criticism of other accountancy professionals, and is not permitted by the professional codes of ethics.

1.3 Acting in the public interest

An aspect of professional bodies, which separates a profession from a trade, is that members of the profession are expected to act in the public interest. It is therefore a responsibility of the accountancy profession '**not to act exclusively to satisfy the needs of a particular client or employer**'.

When the demands or needs of a client or employer appear to be contrary to the public interest, accountants should consider the public interest.

So what is the public interest? Professional codes of ethics do not provide a clear definition, but it is usual to associate the public interest with matters such as:

- detecting and reporting any serious misdemeanour or crime;
- protecting health and public safety;
- preventing the public from being misled by a statement or action by an individual or an organisation;
- exposing the misuse of public funds and corruption in government; and
- revealing the existence of any conflict of interests of those individuals who are in a position of power or influence.

1.4 Influence of the accountancy profession in business and government

A function of the accountancy profession is to record financial transactions and to report the financial performance and financial position of business entities and other organisations. Information about business and other organisations comes largely from accountants. Arguably, accountancy has an influence on business and government that is both:

- continuous; and
- more extensive than any other profession.

Financial reporting

Accountants are involved in the preparation of financial statements, which are used by shareholders and other investors to assess companies and make their investment decisions. Financial reports are often used to prepare information about companies for other interested parties, such as the government (for tax purposes) and employees.

Auditing

Accountants also check the financial statements of companies (and government organisations), and report on their 'accuracy' to shareholders or government. Shareholders rely on the opinion of the auditors to obtain reassurance that the financial statements give a true and fair view.

The need by investors for reliable financial reporting and auditing was discussed in an earlier chapter, in the context of corporate governance.

Management accounting

Management accountants provide information to management, to assist managers with decision-making. In many organisations, management accountants have extended their involvement with management information systems to the provision of strategic as well as shorter-term management information, and non-financial as well as financial information.

Tax

As tax advisers, accountants can help corporate clients to avoid payment of tax through tax avoidance schemes. A criticism of tax avoidance schemes is that they enable wealthy individuals and profitable companies to avoid paying tax, which means that the tax burden is shared by the poorer members of society.

Consultancy

Accountancy firms may provide consultancy services to a range of different clients. Major strategic decisions by government and companies might be influenced by the advice and recommendations from consultants. In the UK for example, the major accountancy firms have been involved in providing advice to the government on the privatisation of public services and the introduction of private capital into financing public investments.

Public sector accounting

Accountants within the public sector are responsible for recording financial transactions within government departments and government-owned organisations, and for financial reporting and auditing within the government sector.

ICAN 2021

1.5 Public expectations of the accountancy profession

The general public has high expectations of the accountancy profession.

Many non-accountants do not have much understanding of accounting issues, but they rely on accountants to ensure that financial reporting is reliable and 'fair', and that management is not 'cheating' by presenting misleading and inaccurate figures in their accounts.

Auditors are also seen, by many members of the public (rightly or wrongly), as a safeguard against fraud.

The public continues to believe that the accountancy profession is an ethical profession that offers some protection to society against the 'excesses' of capitalism.

A role of the accountancy bodies should be to reinforce this public perception of an ethical profession. They do this by issuing codes of conduct, including codes of ethics, and expecting all their members to comply.

1.6 Ethics and accountants: critical theory

The ethical codes of accountancy bodies are described in more detail later in this chapter.

First, however, it might be useful to consider some differing views about accountants, that accountants and the accountancy profession do not necessarily act in the public interest and in some ways they might act against it. The perception that the accountancy profession has of itself, that it is a defender of ethical principles in business and government, might not be correct.

The nature of critical theory

Critical theory is an approach to research and investigation used by many universities for many different academic disciplines, including accountancy. Critical theory originated with the Frankfurt School in the mid-20th Century. It is an approach to analysing aspects of society (such as accounting and the accountancy profession) based on an ethical view and a belief that there is a need for improvement and change. The original inspiration for critical theory was the work of Marx and Hegel. For example, some critical theorists argue that an organisation's culture can be seen as a tool for repression, and domination (by managers and owners), and for the maintenance and reproduction of a dominant group. One aim of critical theory is to make people think again about their perceptions and attitudes, and the ways in which they think.

Critical theory and accounting ('critical accounting')

Critical theory in accounting (sometimes called 'critical accounting') challenges the traditional view that accountants are objective individuals, free from bias and influence ('value-free') and with technical expertise, who are able to present reality in the information they provide.

ICAN 2021

Critical accountants would make the following arguments, in support of their view that accounting is not objective.

Accounting information is not objective and value-free. It was developed as a tool for government and business leaders, to help them maintain their position of power within society. Traditional financial reporting, for example, helps business leaders to retain control over the companies they run. Its main focus is on shareholders and profits. Different interest groups (such as shareholders and employees) are treated differently and some individuals have more and better access to accounting information than others.

Accounting is not objective because it is a social as well as a technical process. In any given situation or context, different accountants may have different views, arising from their cultural differences. All such social attitudes are based on historical conditioning and development of culture, and these attitudes cannot be changed easily because they are deep-rooted in the past.

The accountancy profession has created the concept of 'truth' in financial reporting, although the meaning of 'truth' (as in 'true and fair view') is uncertain and subject to different interpretations.

ICAN 2021

Example: Auditing

The popular view of auditing is that it provides confirmation or reassurance that financial statements present a true and fair view. This might seem to provide an objective and value-free opinion, but the reality is very different.

(1) In an audit check, the auditors check only a sample of transactions or items, not every transaction.

(2) The auditors are concerned only with **significant** errors. Errors that are not significant do not matter.

(3) The auditors confirm that the financial statements present **a** true and fair view. This indicates that although the accounts present one true and fair view, there are other views that are equally true and fair.

Morgan (1986), a critical accountant, commented that accountants often believe that they represent reality as it really is, but in actual fact they present situations from a limited, one-sided viewpoint.

Accounting has shaped our perceptions of how performance should be reported.

Accountants make extensive use of numbers as a means of expression and presenting information. Numbers might seem to be 'correct', which makes it difficult to argue against them. However, numbers should not be confused with reality. They are a way of condensing, representing and summarising information, and need not be exact or complete.

Accounting processes de-humanise human beings and society, by reducing social relations to measurable numbers – or ignoring them and not measuring them at all.

There is bias in accounting, and accountancy helps to protect the interests of business and government leaders by providing only a restricted amount of information to the public, on selected topics.

The moral development of accountants: accountants as 'rule-followers'

The traditional view of accountancy is that it is a moral and ethical profession. Academic research in the US suggests that this might not be the case. Research has started from a four-step model of moral behaviour. If a person is moral and ethical, he will take moral decisions in the following ways:

Step 1. The individual must be able to recognise the moral issue or moral dilemma, whenever there is an ethical aspect to a situation. He or she must be able to recognise that a moral decision has to be taken;

Step 2. The decision-maker must be able to recognise and select the course of action that is morally correct;

Step 3. The decision-maker must give priority to the moral issue above all other considerations (for example, self-interest); and

Step 4. The decision-maker must have enough moral strength to implement the decision that he selects in Steps 2 and 3.

Some research has indicated that accountants, on the whole, are poor at taking ethical decisions. In many cases, they treat a problem as a technical accounting issue and fail to see any ethical implications at all.

Many accountants see their role in technical terms, without concern for values or moral issues. They are **rule-followers**, more concerned with identifying what the technical rules are and following them, rather than applying their own personal values to resolve moral dilemmas.

Critical theory and accounting: a summary

It has been argued that traditional accounting supports ethical reporting and decision-making, and promotes economic and social well-being through its provision of information to users.

The views of critical accountants can be summarised as follows:

'**If** all agents [groups] were equal and **if** markets were information-efficient and **if** this led to allocative efficiency and **if** this led, in turn, to economic growth and **if** this ensured maximum social welfare and **if** maximum social welfare were the aim of society, **then** accounting is morally, economically and socially justifiable and may lay claim to an intellectual framework. Of course, this is not the case' (Gray, Owen and Adams: 'Accounting and Accountability: Changes and Challenges in corporate Social and Environmental Reporting').

1.7 Accountants and acting against the public interest

As stated earlier, accountants may be rule-followers. Technical rules are provided by financial reporting standards and other reporting regulations.

A function of the professional accountancy bodies is to provide rules of conduct and ethical behaviour, with the expectation that all members should follow the rules. Accountants might not be moral by nature, but they can be taught to think and act ethically.

Occasional problems will inevitably arise when some accountants choose a different set of rules, or deliberately break the rules. The consequences depend on the nature of the rule-breaking. In an extreme case such as Enron, breaking the rules by accountants contributed significantly to the collapse of the company. Even in the Enron case, the accountants who were prosecuted and imprisoned did not necessarily understand what they had done wrong. They were simply doing the same as other people, and adopting the culture of the company.

Alvesson and Willmott (1996) have argued that employees come into a company bringing a notion of fairness and justice with them, which they expect to see within the company. However, different people have different views of right and

ICAN 2021

wrong. Fairness and justice are abstract concepts and values that mean different things to different employees and in different work situations. This is how different cultures (and different sets of rules) arise.

So how do companies and accountancy firms apply ethical rules of conduct? One approach is to develop and implement business codes or professional codes of ethics. If consistently applied, these can help to create a better understanding by accountants of what is right and wrong, how to identify moral dilemmas, and how to act whenever an ethical problem arises.

ICAN 2021

2 CORPORATE CODES OF ETHICS

Section overview

- The nature and purpose of a corporate code of ethics
- The content of a corporate code of ethics
- Whistleblowing

2.1 The nature and purpose of a corporate code of ethics

A corporate code of ethics is a code of ethical behaviour, issued by the board of directors of a company. It is a formal written statement, and should be distributed or easily available to all employees. The decisions and actions of all employees in the company must be guided by the code.

The effectiveness of a code of ethics depends on the leadership of the company – its directors and senior managers. These individuals must be seen to comply themselves with the ethical code; otherwise other employees will see no purpose in complying with the code themselves. The culture of a company drives its ethical behaviour, and a code of ethics provides useful guidance.

It has been suggested that there are three reasons why companies might develop a code of ethics. These reasons are progressive, which means that companies might begin by having a code of ethics for the first reason, but then progress to the second and third reasons as they gain experience with implementing the code and appreciating its potential benefits.

Reason 1: **Managing for compliance** - The company wants to ensure that all its employees comply with relevant laws and regulations, and conduct themselves in a way that the public expects. For example, companies providing a service to the general public need to ensure that their employees are polite and well-behaved in their dealings with customers.

Reason 2: **Managing stakeholder relations** - A code of ethics can help to improve and develop the relations between the company and its stakeholders, by improving the trust that stakeholders have in the company. The code might therefore include the ethical stance of the company on disclosing information to stakeholders and the investing public (openness and transparency) and on respecting the rights of stakeholders.

Reason 3: **Creating a value-based organisation** - A company might recognise the long-term benefits of creating an ethical culture, and encouraging employees to act and think in a way that is consistent with the values in its code of ethics. (It could be argued that an ethical company, like a well-governed company, is more likely to be successful in business in the long term. However, there is no firm evidence to prove this point, and it is therefore a matter of opinion.)

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Note on global organisations - Global companies might have difficulty in developing and implementing a code of ethics for the entire organisation world-wide, because of differences in ethical values in different cultures in different parts of the world. A criticism of codes of ethics of global companies is that they often focus on the company's relationships with stakeholders in their 'home country' and do not give enough thought to their operations in other countries.

2.2 The content of a corporate code of ethics

A corporate code of ethics is normally quite short, dealing with each point in just a few sentences, and sometimes in just one sentence.

There is no standard format or content for a code of ethics, but a typical code contains:

- general statements about ethical conduct by employees; and
- specific reference to the company's dealings with each stakeholder group, such as employees, customers, shareholders and local communities.

General statements about ethical conduct

A code of conduct should specify that **compliance with local laws** is essential. In addition, employees should **comply with the policies and procedures** of the company. There might be a statement that any employee who fails to comply with the company's code of conduct will face disciplinary action.

The code might also include an **overview of business conduct**, and the need to protect the company's reputation and 'good name'.

It might also contain statements about the values of the company, such as:

- acting at all times with integrity;
- protecting the environment;
- the 'pursuit of excellence'; and
- respect for the individual.

Dealings with stakeholder groups

A code of conduct might address its main concerns about its dealings with stakeholder groups and its ethical treatment of each group.

Employees. A code of ethics might include statements about:

- human rights, including the right of all employees to join legally-authorised organisations such as a trade union or political party;
- equal opportunities for all employees, regardless of gender, race, ethnic origin, religion, age, disability or sexual orientation;

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- refusal to tolerate harassment of employees by colleagues or managers;
- concern for the health and safety of employees;
- respect for the privacy of confidential information about each employee; and
- company policy on giving or receiving entertainment or bribes.

Customers. A code of ethics might include statements about:

- fair dealing with customers;
- product safety and/or product quality;
- the truthfulness of advertisements; and
- respect for the privacy of confidential information about each customer.

Competitors. A code of ethics might include statements about:

- fair dealing with competitors; and
- the use of techniques for obtaining information about competitors (industrial spying).

Shareholders. A code of ethics might not include much about shareholders, because the relationship between a company and its shareholders might be contained in a code of corporate governance that the company follows. The key issue with shareholders is to maintain and develop trust and confidence, which might be achieved through disclosure of information (openness and transparency).

Example:

The Institute of Business Ethics (www.ibe.org.uk) provides the following broad guidelines to the content of a code of corporate ethics. (*This material is © The Institute of Business Ethics and has been reproduced by kind permission*)

1 **Preface or Introduction**

(signed by the Chairman or Chief Executive Officer or both)

Start with a sentence on the purpose of the Statement. Mention the values that are important to senior management in the conduct of the business - such as integrity, responsibility and reputation. Describe the commitment of the company's leaders to maintaining high standards both within the company and in its dealings with others.

Set out the role of the company in the community and end with a personal endorsement of the code (by the chairman or CEO, or both)

and the expectation that the standard set out in it will be maintained by all involved in the organisation.

2 **Key areas of the code should include:**

(a) The purpose and values of the business

- The service that the company is providing - a group of products or set of services.
- The financial objectives of the company.
- The role of the company in society (as the company sees it).

(b) Employees

- How the business values its employees.
- The company's policies on: working conditions, recruitment, development and training, rewards, health, safety and security, equal opportunities, diversity, retirement, redundancy, discrimination and harassment.
- Use of company assets by employees.

(c) Customer relations

- The importance of customer satisfaction and good faith in all agreements, quality, fair pricing and after-sales service.

ICAN 2021

(d) **Shareholders and other providers of money**

- The protection of investment made in the company and proper 'return' on money lent.
- A commitment to accurate and timely communication on achievements and prospects.

(e) **Suppliers**

- Prompt settling of bills.
- Co-operation to achieve quality and efficiency.
- No bribery or excess hospitality accepted or given.

(f) **Society or the wider community**

- Compliance with the spirit as well as the letter of laws.
- The company's obligations to protect and preserve the environment.
- The involvement of the company and its staff in local affairs.
- The corporate policy on sponsorship as well as giving to education and charitable appeals.

(g) **Implementation**

- The process by which the code is issued and used.
- Means to obtain advice.
- Awareness raising examples (Q & As)
- Training programmes for all staff.

(h) **Assurance, reporting and reviews**

- Suggest ways of knowing the code is effective
- Report to the board or board committee at least annually
- Review the procedures for updating the code

Breaching a corporate code of ethics

In a normal situation, employees report to their supervisor or manager. If an employee has concerns about a transaction or a plan of action, and thinks that it might be unethical (illegal or against the company's code of ethical conduct) he or she should normally report the concern to the supervisor or manager.

Ordinarily, breaching a company's code of ethical conduct would be a disciplinary offence. An initial breach might result in a verbal warning with subsequent breaches being addressed with written warnings and ultimately suspension or redundancy.

A problem arises however when:

- an employee's supervisor or manager is involved in the illegal or unethical activity; or

- the employee has spoken to the supervisor or manager about the problem, but the supervisor or manager has taken no action and has ignored the matter, or dismissed it as something that is not important.

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In these situations, the employee would have to report his or her concerns through a different reporting channel. In practice, this could mean reporting the matter to a director or a committee of the board of directors. Some companies have established procedures that allow employees to report their concerns. These are called 'whistleblowing' procedures, or 'blowing the whistle'.

2.3 Whistleblowing

Definition

Definition: Whistleblowing

'Whistleblowing' means reporting suspicions of illegal or improper behaviour to a person in authority.

Practical considerations

An employee considering 'blowing the whistle' should consider the following before deciding to actually blow the whistle:

Are all the facts correct? Could they have misinterpreted something or mistakenly drawn the wrong conclusion?

Is there sufficient evidence to justify blowing the whistle?

They should double-check they have thought about the situation objectively and with neutral emotion (rather than, say, at a time of anger).

Consider discussing events in confidence with an independent confidential third party e.g. a professional helpline or legal advisor.

Think about the impact that blowing the whistle may have on the whistleblower's career. Is the risk of being victimised and bullied outweighed by the benefits of proceeding with blowing the whistle?

Double-check company policy and whistleblowing procedures in the staff handbook. The whistleblower must ensure they follow company procedures at all times.

Establish whether there is scope to discuss events confidentially with the human resources department.

Is there an internal audit department who could be made aware of relevant events and take ownership of reporting any issues?

Consider if there is a legal obligation to report – for example in many countries there is a legal obligation to report the discovery of money-laundering or terrorism activities.

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Problems with whistleblowing

There are several problems with whistleblowing.

Experience in many organisations has shown that when an individual reports concerns about illegal or unethical conduct, the individual is often victimised, by colleagues and management. If the allegations by the individual are rejected, the individual might find that he (or she) does not receive the same salary increases as colleagues, and is overlooked for promotion. At work, colleagues and managers might treat the individual with hostility, making it difficult for the individual to continue in the job.

On the other hand, some individuals make allegations about colleagues or managers that are unfounded. The allegations might be made for reasons of malice and dislike, or because there has been an argument at work. Malicious allegations about colleagues and managers should not be tolerated.

A problem facing companies is therefore not just:

- how to encourage reports of illegal or unethical behaviour, by protecting honest whistleblowers; but also
- how to discourage malicious and unfounded allegations.

A company might state its policy on whistleblowing within its code of conduct. For example, a corporate code of ethics might include the following statements:

i. Every employee should make known their concerns about illegal or unethical behaviour in the work place. If there are doubts, the employee should ask first, because incorrect behaviour might not be intentionally dishonest. It might be caused by a lack of information or by trying to get a job done too quickly. This aspect of a code of ethics is to encourage employees to speak about their concerns and try to resolve them first by discussion with colleagues and managers.

ii. An employee is **doing the right thing** if, **in good faith**, he seeks advice about improper behaviour or reports improper behaviour. Whistleblowing is the correct thing to do, if the employee does it in good faith and is not being malicious.

iii. The company will not tolerate any action taken by anyone in the company against an individual who has reported in good faith their concerns about illegal or unethical behaviour. This is a statement that whistleblowers will be protected, if they have made their report in good faith.

iv. Disciplinary action will be taken against any employee who **knowingly** makes a false report of illegal or improper behaviour by someone else. Malicious reporting will not be tolerated.

v. Unfortunately, in practice, it seems that in many cases whistleblowers are not given adequate protection by their employers.

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3 CODES OF ETHICS FOR ACCOUNTANTS

Section overview

- The need for a professional code of ethics for accountants
- The IESBA (IFAC) Code of Ethics for Professional Accountants and ICAN Code
- Fundamental principles

3.1 The need for a professional code of ethics for accountants

Every professional accountancy body has a code of conduct and code of ethics for its members and student members.

Even when an individual works for a company or a firm of accountants that has its own code of ethics, there is a need for a professional code of conduct. This is because accountants have a professional **duty to act in the public interest**, and this aspect of professional behaviour is not covered by corporate ethical codes.

3.2 The IESBA (IFAC) Code of Ethics for Professional Accountants and ICAN Code

The IESBA (IFAC) Code of Ethics for Professional Accountants

Although each professional accountancy body has its own code of ethics, all codes are similar, because they are based on the IESBA (IFAC) Code. The IESBA Code is issued by the Ethics Committee of the International Federation of Accountants, whose members include the professional accountancy bodies of most countries.

The IESBA Code sets out the ethical requirements for professional accountants and states that any member body of IFAC (such as ICAN) or any individual firm of accountants may not apply ethical standards that are less strict than those in the IESBA Code.

The IESBA Code therefore establishes a minimum world-wide code of ethical conduct for accountants. The IESBA Code is divided into three parts:

- general principles and application of the code;
- guidelines for accountants in public practice; and
- guidelines for accountants in business.

The same general ethical principles apply to all accountants. The circumstances in which ethical problems arise are different between accountants in practice and accountants in business. Accountants in practice have to deal in an ethical way with issues arising from the **client relationship**. Accountants in business have to deal with ethical issues where they are **employees** of the organisation in which the ethical problem has occurred.

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Principles-based ethics codes and rules-based ethics codes

It would be possible for a regulatory body to issue a code of ethics for accountants that contains specific rules about how they should act in specific situations. This would be a rules-based code of ethics.

Rules-based codes have several weaknesses:

- There are many different situations that an accountant might face where an ethical decision must be made. Circumstances can be complex and varied, and it is impossible to plan for every type of ethical problem that will arise, and make a rule in advance (without knowing the exact details of the situation) of what course of action the accountant must take.

- Over time, the type of situations (ethical dilemmas) that an accountant might face could change, as the business environment changes. It might therefore be necessary to review and update the rule book regularly.

- Ethical views differ between countries and cultures. Behaviour that might be considered slightly unethical in one country might be perfectly normal and acceptable in another country. A rule book cannot easily make allowances for national and cultural differences in ethical viewpoint.

A principles-based code of ethics for accountants is a code that specifies general principles of ethical behaviour, and requires the professional accountant to act in accordance with the principles. The accountant is required to use judgement in deciding whether in each case a particular course of action is a 'proper' or 'ethical' one.

The main reason for having a principles-based code of ethics is that it is impossible for a rules-based code to cover every possible ethical situation that may occur. There will be occasions when judgement has to be used to decide what the appropriate application of the ethics code should be. In other words, the key principles can be applied to decide what an appropriate ethical decision should be.

Since it is not possible to cover every possible ethical problem that might occur, a rules-based ethical code would sometimes fail to provide guidance on how a particular situation should be dealt with. In the absence of rules to cover the situation, how should the ethical problem be resolved?

In summary, a rules-based code might seem desirable, so that the 'correct' course of action is clear; but it is not practical.

ICAN's Professional Code of Conduct and Guide for Members

ICAN's 'Professional Code of Conduct and Guide for Members' ('the Code') is the code of ethics applicable to members and students of ICAN. The Code contains similar provisions to the IESBA Code of Ethics for Professional Accountants (which you would expect because ICAN has adopted the IESBA Code). For example:

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Both codes are principles-based codes;

Both codes are based on the same five fundamental ethical principles (see below);

Both codes advocate a system of identifying threats to the fundamental ethical principles and responding to those threats with safeguards;

Both codes include guidance for:

- Professional Accountants in Public Practice; and
- Professional Accountants in Business.

The description of professional ethics that follows is based on both the IESBA and ICAN codes. You will study both codes in much greater detail in the Audit and Assurance modules.

3.3 Fundamental principles

Both the IESBA and ICAN codes state that professional accountants are required to comply with the following fundamental principles:

- Integrity;
- objectivity
- professional competence and due care;
- confidentiality; and
- professional behaviour.

Integrity

A Chartered Accountant should be straightforward and honest in all professional and business relationships. Integrity implies not merely honesty but fair dealing and truthfulness.

Illustration: Integrity

Simply put, accountants should not lie! So for example, when an accountant in public practice claims (to a client) that they can perform a certain task such as provide specialist corporate finance advice then they should have the necessary skills and resource to be able to perform that work.

An example of a lack of integrity in business might be where an accountant helps to cover up a fraud with false accounting entries.

Objectivity

An accountant must not allow his professional or business judgement to be affected by:

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- bias (personal prejudice);
- conflicts of interest; and
- undue influence from others: for accountants in business, this includes undue pressure from the employer (senior management).

A very important aspect of integrity is that an accountant should not be associated with reports or any other provision of information where he or she believes that:

- the information contains a **materially** false or misleading statement;
- the information contains a statement that has been prepared and provided recklessly, without proper care or consideration for its accuracy; and
- there are omissions or the information is presented in a way that makes the relevant information difficult to see, with the effect that the information could be seriously misleading.

For accountants in public practice, 'objectvity' is often associated with independence of mind and judgement. For accountants in business, however, the concept of independence is not relevant in the same way as it is for independent auditors. This is because accountants in business are simply not independent due to the fact they are employees and frequently shareholders or recipients of other benefits such as healthcare and pension contributions. All these mean that employed accountants in business have significant self-interest in their employment and are therefore not independent.

However, accountants in business should still try to apply the principle of objectivity in all the work that they do with the aim of being balanced, fair and unbiased.

For accountants in business, the concept of integrity also means observing the terms of his or her employment, but avoiding involvement in any activity that is illegal. If asked or encouraged to become involved in unlawful activity, the accountant must say no.

Illustration: Objectivity

Accountants in public practice must be independent from their audit clients. This means, for example, that auditors cannot hold shares or other direct financial interests in their audit clients and should not accept significant gifts or hospitality from their audit clients.

An example of an accountant in business being objective is in the preparation of prepayment, accrual and provision journals at month- or year-end. They should reflect reality rather than an attempt to manage earnings and manipulate profit or tax figures.

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Professional competence and due care

An accountant has a duty to maintain his professional knowledge and skills at a level that enables him to provide a competent professional service to his clients or employer. This includes a requirement to keep up to date with developments in areas of accounting that are relevant to the work that he does.

Accountants should also act diligently in accordance with relevant technical and professional standards when doing their work for clients or employer.

Technical and professional standards include:

- standards issued by IFAC (such as International Standards on Auditing) or a similar national regulatory body;
- financial reporting standards (IFRSs);
- standards and regulations of the member's professional accountancy body; and
- relevant legislation.

Professional accountants have a duty to carry out with care and skill the instructions of an employer or client, insofar as these are compatible with the ethical requirements for integrity, objectivity and (in the case of accountants in public practice) independence.

Illustration: Professional competence and due care

Accountants in public practice must keep up to date with developments in auditing and financial reporting standards necessary to perform their jobs. This might require attending monthly technical briefings or reading and interpreting new standards as they are published.

Audit standards are significantly less likely to be relevant to accountants in business. However, if they are employed in a financial reporting role then they would still need to keep up-to-date with changes in financial reporting standards to enable them to prepare financial statements that comply with an applicable financial reporting framework.

Confidentiality

Accountants must respect the confidentiality of information obtained in the course of their work. This applies to the confidentiality of information within the firm or employer's organisation, as well as to confidentiality of information about clients (for accountants in professional practice).

The requirement to keep information confidential applies:

- in a social environment as well as at work: for example, an accountant must be careful of what he says to a good friend who also happens to be a

business associate, or to a wife or husband who is also a professional accountant; and

- after the accountant has moved to another job – confidentiality applies to information obtained when working for a former employer.

In addition, confidential information must never be used to obtain a personal benefit or a benefit for a third party.

There are some circumstances when the disclosure of confidential information is permitted or even required by law.

Confidential information about a client (or employee) can be disclosed if the client (or employee) has given permission. Before disclosing the information, however, the accountant should consider whether the disclosure might harm a third party.

Confidential information must be disclosed to the authorities in certain circumstances. These circumstances depend on the laws of the country. In the UK, for example, tax inspectors or the police might obtain a court order (warrant) to take away files relating to a client.

The law might also require the disclosure of confidential information to the appropriate authorities. For example, firms of accountants are expected to disclose suspicions of money laundering by a client to the appropriate authorities. (The details of anti-money laundering laws may very between countries). In addition, tax evasion is a crime and accountants are required to report tax evasion by clients to the authorities. However, accountants are not expected to disclose client information to the authorities where the work for the client is covered by legal professional privilege.

Disclosure is also permitted when the accountant has a professional right or duty, and disclosure is not prohibited by law.

Example: Confidentiality

You are an accountant working in public practice. You receive a visit from two police officers, who ask to see the files for one of your clients, a small import-export company. They show you a warrant that authorises them to take away the client files.

What should you do?

Answer

The requirement to maintain confidentiality of client information does not apply when authorities such as the police have a warrant to inspect or take files relating to the specific client.

You should be polite to the police in responding to their request, and you should check the details of the warrant before providing the files that are required. If there is any doubt about the details in the warrant, you might wish to ask for a legal opinion before handing over the files.

You should not tell the client what has happened.

Example: Fraud

You are an accountant responsible for the audit of a business client. During the course of your audit work you discover that an employee of the client has probably been engaged in a fraudulent activity. You are not entirely certain that fraud has occurred.

What should you do?

Answer

The issue of confidentiality does not arise here, because the problem relates to an employee of the client. You should report your suspicions to a person of authority in the client organisation.

If the fraud appears to be minor, you might decide to leave the matter in the hands of the client. If the fraud appears to be a major crime, you should check what actions the client takes in reporting the matter to the police authorities, to satisfy yourself that appropriate action has been taken.

Professional behaviour

Accountants are required to observe relevant laws and regulations, and to avoid any actions that would discredit the accountancy profession.

Illustration: Professional behaviour

In professional practice, practitioners must be truthful when advertising and must not disparage the services provided by 'rival' firms.

In both professional practice and business, accountants must obey the law. If an accountant was convicted of a serious crime such as murder or money laundering they would probably be expelled from membership of their accountancy institute for unprofessional behaviour.

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3.4 NOCLAR

There has now been an important amendment to the code of ethics, affecting the principle of confidentiality.

In 2017, ICAN adopted a recommendation by the International Ethics Board for Accountants (IESBA) on Non-Compliance with Laws and Regulations (NOCLAR), and added it to the ICAN Code of Ethics.

An act of NOCLAR by a client or an employer (or by a manager or other employee of an employer) is an act that is contrary to prevailing laws and regulations. The laws and regulations to which this NOCLAR rule applies are those that directly affect the client's or employer's financial statements, or its business in a material or fundamental way. Acts of NOCLAR can include bribery, fraud or false accounting.

When a professional accountant becomes aware of an act of NOCLAR, he or she must report it to the appropriate authorities, and is not constrained in such cases by the principle of confidentiality. Accountants can no longer turn a blind eye to NOCLAR: doing nothing when made aware of such an act is no longer acceptable.

However, there is a balance to be made between the principle of confidentiality and the requirement to override this in the public interest in the case of NOCLAR.

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4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain what is meant by ‘public interest’ and discuss the link with ethics
- Summarise the nature, purpose and content of a corporate code of ethics
- Define whistleblowing
- Identify and discuss the application of the IFAC and ICAN codes of ethics
- Explain the NOCLAR amendment to the code of ethics

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CHAPTER 19

Conflicts of interest and ethical conflict resolution

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Contents

1 Ethical threats and safeguards
2 A model for resolving ethical conflicts
3 Corruption
4 Chapter review

INTRODUCTION

Detailed syllabus

E	**Ethics**
E7	Discuss the nature of ethical conflicts and ethical threats confronting the accountant in a professional practice, ethical safeguards and tests for resolving the conflicts.
E10	Identify and assess issues of professional ethics and corporate governance as they may arise within the context of ICAN code of professional conduct and IFAC code of ethics for professional accountants in a given scenario.
E11	Discuss the ethical dimension of corruption (bribery, money laundering, embezzlement, theft, fraud, extortion, and blackmail).

Exam context

In this chapter, you will learn about safeguarding against ethical threats and other methods of resolving ethical conflicts of interest as they arise. It also defines various forms of corruption in business; as corruption is criminal activity, accountants must avoid involvement in all circumstances.

By the end of this chapter, students will be able to:

- Explain ethical conflict;
- Explain the threats and safeguards approach to dealing with ethical conflicts;
- Describe the model for resolving ethical conflicts and apply the mirror test;
- Identify ethical threats and suggest practical safeguards in common situations;
- Define corruption;
- Explain the nature of bribery;
- Summarise measures to reduce and combat bribery; and
- Explain the nature of other types of corruption found in business.

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1 ETHICAL THREATS AND SAFEGUARDS

Section overview

- Ethical conflicts
- Rules-based and principles-based approaches to ethical conflicts
- Nature of ethical threats
- Nature of ethical safeguards
- Ethical threats to accountants in business

1.1 Ethical conflicts

Definition: Ethical conflict

An ethical conflict (also known as an ethical dilemma) is when two ethical principles demand opposite results in the same situation.

In order to resolve an ethical conflict, a choice must be made that by definition will leave at least one of the ethical principles compromised.

A key reason behind many ethical conflicts is a conflict of interest between taking decisions in one's own self-interest versus making decisions in the best interest of a client.

For example an auditor has a moral obligation to earn money to feed, clothe and house his family. To purely satisfy this obligation they may take decisions that are not in the best interest of a client – for example reducing the extent of audit work and using more junior staff to save money on costs and generate bigger profits for the audit firm. However, the reduction in audit work and use of more junior staff would mean that the auditor has not complied with audit standards nor delivered the statutory audit that the client has paid for.

An ethical conflict may arise with confidential information that an accountant encounters, for example on the discovery of a fraud. The defrauded party (which may for example be the client company, an employee, a supplier, the shareholders or perhaps a bank) has suffered in some way and the auditor is aware of this. The auditor's primary responsibility is to provide an opinion on whether the financial statements provide a true and fair view not to report fraud to the plaintiff - it is normally the choice of the company how to proceed (unless crimes such as terrorism or money laundering are involved).

With both of the above examples numerous different courses of action could be justified using the theories you have encountered in the previous three chapters. However, professional codes of ethics are employed in the accountancy profession in order to establish consistent behaviour and a robust ethical conflict resolution process.

In the last chapter you were briefly introduced to the IESBA and ICAN codes of ethics. In this chapter you will learn how these codes are applied in practice to resolve practical ethical conflicts.

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1.2 Rules-based and principles-based approaches to ethical conflicts

When accountants are faced with an ethical conflict they need to know what to do. If there is a threat to their compliance with the fundamental principles of the ethical code, how should they ensure their compliance and deal with the threat?

There are two possible approaches that the professional accountancy bodies could take, a rules-based approach and a principles-based approach.

A rules-based approach is to identify each possible ethical problem or ethical dilemma that could arise in the work of an accountant, and specify what the accountant must do in each situation.

A principles-based approach is to specify the principles that should be applied when trying to resolve an ethical problem, offer some general guidelines, but leave it to the judgement of the accountant to apply the principles sensibly in each particular situation.

The IESBA (IFAC) Code (and other codes of accountancy ethics, including the ICAN Code) takes a principles-based approach, with some guidelines.

The main reason for taking a principles-based approach is that it is impossible to identify every ethical dilemma that accountants might face, with differing circumstances in each case. Since it is impossible to identify every problem that might arise, rules could only be provided for some problems but not others.

The IESBA (IFAC) Code makes this point, saying that it is exceedingly difficult to predict all situations that create threats to compliance with the fundamental principles and the suitable course of action. Threats needing different safeguards may exist depending on the work assignment or engagement. It is in the public interest, therefore, to have a conceptual framework for the accountants to follow, rather than a set of strict rules.

It is interesting to note that IESBA (IFAC) considers the public interest when choosing a principles-based approach in preference to a rules-based approach.

The nature of a principles-based approach

The recommended approach to resolving ethical problems, which will be considered in more detail later, is based on the following steps:

Identify threats to compliance with the fundamental principles. Accountants have an obligation to identify any threat to their compliance with the fundamental principles, when it could reasonably be expected that they should be able to identify it.

Evaluate the threat - Qualitative factors as well as quantitative factors should be considered in the assessment of a threat to compliance. Insignificant threats may be ignored but others should be dealt with.

Respond to the threat - If it is 'not insignificant', the accountant should apply **appropriate safeguards**, if he can, to eliminate the threat or reduce the threat to an insignificant level.

If suitable safeguards cannot be applied, more drastic action will be needed, such as refusing to carry out a professional service, ending the relationship with a client or resigning from the job.

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1.3 Nature of ethical threats

Threats to compliance with the fundamental ethical principles are grouped into five broad categories:

Self-interest threats, or **conflicts of interest** - These occur when the personal interests of the professional accountant, or a close family member, are (or could be) affected by the accountant's decisions or actions.

Self-review threats - This type of threat occurs when a professional accountant is responsible for reviewing some work or a judgement that he was responsible for originally. An extreme example would be a situation where a professional accountant prepares the annual financial statements for a corporate client and then is appointed to do the audit.

Advocacy threats - This type of threat can occur when an accountant promotes the point of view of a client, for example by acting as a professional witness in a legal dispute. Acting as an advocate for the client can reach the point where the objectivity of the accountant is compromised.

Familiarity threats - A familiarity threat arises from knowing someone very well, possibly through a long association in business. The risk is that an accountant might become too familiar with a client and therefore becomes more sympathetic to the client and more willing to accept the client's point of view.

Intimidation threats - A professional accountant might find that his objectivity and independence is threatened by intimidation, either real or imagined.

These threats to compliance with the fundamental ethical principles apply to firms of accountants in their dealings with clients as well as to individual accountants.

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Example: Ethical threats

Examples of ethical threats are listed below. Some apply to accountants in public practice, and some apply to accountants in business. Some apply to both types of accountancy work.

Threats from a conflict of interest

Accountants in public practice	**Accountants in business**
The accountant has a financial interest in the client.	The accountant has a financial interest (for example, holds shares or share options in the employer company).
The accountant has a joint financial interest with the client in a business venture.	
The competence of the accountant to do the work is in question.	The competence of the accountant to do the work is in question.
The accountant is offered gifts or hospitality by a client.	The accountant is offered gifts or hospitality by a customer or a supplier.
There is a risk of losing the client, and the client taking his business somewhere else.	There is the risk that the accountant might lose his job.
Contingency fees. The client will pay a fee to the accountant only if a particular event occurs or a particular outcome is achieved. (The fee is dependent on the achievement of the desired outcome.) The accountant has a financial interest in achieving the outcome.	The accountant's basic pay or bonus might be affected.
There is a possibility that the client will offer a job to the accountant.	

Self-review threats	**Familiarity threats**
The accountant discovers a significant error on checking some work, and he was responsible for making the original error.	A member of the audit team has a close family relationship with a director or senior officer of the client company, or with an employee of the company who is in a position to influence significantly the subject matter of the audit
The accountant is asked to report on the operation of a system that he was responsible for designing and implementing.	Accepting gifts or hospitality from a client, customer or supplier. (This is both a self-interest threat and a familiarity threat).
A member of the audit team was recently an employee of the client and involved in the work subject to audit.	The senior personnel in an audit team have a long association with the client company.
The accountant is assigned to check any work that he did previously for the client as a professional service.	An accountant in business has along business association with another person, who might therefore be able to influence his judgement (integrity).

Advocacy threats	**Intimidation threats**
The accountant is involved in providing a professional opinion in support of a client, in a case involving a dispute with a third party (possibly litigation).	The accountant is threatened with dismissal or a loss of benefits (pay, bonus, promotion) for failing to agree to the demands of management colleagues. The accountant has to deal with a dominant personality who expects everyone else to do what he tells them to. An accountant in public practice is threatened with litigation by a client. An accountant in public practice is under pressure from a client to reduce the amount of work in an audit, in order to reduce the audit fee. (This is a threat to the integrity of the audit work.)
There are some threats to compliance with the fundamental ethical principles, particularly a threat to integrity and professional conduct that are not easily categorised as any of the five threats listed above. Threats to integrity and professional conduct can be classified as threats to self-interest.	

Example: Foreign parent

You are an accountant working in public practice. You are approached by a subsidiary company of a foreign parent company. This company would like you to provide a number of professional services. The parent company is based in a country where you have no professional contacts.

What are the ethical risks?

Answer

There are ethical risks in taking on an unknown new client. The new client might be involved in illegal activities, such as money laundering or drug trafficking.

As an accountant, you might become involved in providing services in support of criminal activities, which would threaten your integrity and professional conduct.

There must be ethical safeguards to ensure that you do not take on a new client without first 'getting to know' the client and satisfying yourself that there are no ethical concerns.

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Example: Tax work

You are an accountant working in public practice. A client has asked you to do some tax work, for which the fee would be quite high. You are keen to do the work in order to earn the fee, but you are aware that your knowledge of the relevant tax law is not up to date and there is no one else in the firm with suitable knowledge and experience in tax.

The same client has also asked your firm to perform a value for money audit on one of its operations. To do the work, you have estimated the amount of time and resource that would be needed and you have quoted a fee to the client. The client says that the fee is too high, and should be reduced by at least 50%.

What are the ethical risks?

Answer

In both cases, the risk is that you will not have sufficient competence to do the work. A lack of competence can be classified as a threat to self-interest.

You must not take on work for a client without having the competence to do the work to the required professional standard. You might be able to resolve the problem by going on a training course to update your tax knowledge, or you might apply to outsource the work to another accountant who has the appropriate tax knowledge.

If you cannot provide the service to the client to a suitable standard of competence, you should refuse to take on the work.

Providing a service with suitable competence is also the issue with the value for money audit (although you could argue that there is also the threat of not getting the work and the fee). By insisting that the fee should be reduced by 50%, the client is asking you to provide the service with only one half of the planned resources. You will probably be unable to provide the agreed service with sufficient competence with such limited resources.

You need to renegotiate the work with the client, who might agree to an audit that is less extensive. Alternatively you might try to explain to the client what the fee covers and why it is so high, in the hope that the client will agree to pay a higher amount. If the client refuses to agree to less work in the audit or a higher fee, you should refuse to accept the work.

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Example: Mortgage

You are an accountant working in public practice and you have been assigned to the audit team to do the annual audit of Big Bank. You have a large mortgage loan from Big Bank that you obtained six months ago to buy your new house.

What is the ethical risk?

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Answer

The IESBA (IFAC) Code and ICAN Code are specific on this point. If an accountant has a loan from a client (or employer) the financial interest could in some cases create a conflict of interest.

However, if the loan from the bank has been provided on normal commercial terms, no conflict of interest exists. There is no ethical reason preventing you from working on the Big Bank audit.

1.4 Nature of ethical safeguards

When there are threats to compliance with the fundamental ethical principles, the accountant should assess the safeguards against the threat.

There might already be safeguards in place that eliminate the possibility that the risk will ever materialise, or that reduce the risk to an acceptable level.

If the safeguards that exist are not sufficient, the accountant should try to introduce new safeguards to eliminate or reduce the risk to an insignificant level.

Ethical safeguards can be grouped into two broad categories:

- safeguards created externally, by legislation, regulation or the accountancy profession; and
- safeguards established within the work environment.

Safeguards created by legislation, regulation or the accountancy profession

Safeguards that are created externally, by legislation, regulation or the profession, include the following:

- The requirements for individuals to have education and training and work experience, as a pre-condition for membership of the professional body;
- The continuing professional development (CPD) requirements for qualified members, to ensure that they maintain a suitable level of competence;
- Corporate governance regulations, particularly those relating to auditing, financial reporting and internal control;
- Professional standards, such as financial reporting standards and auditing standards;
- Monitoring procedures and disciplinary procedures; and
- External review by a legally-empowered third party.

Safeguards in the work environment

A variety of safeguards can be applied within the work environment. These can be categorised into:

- safeguards that apply across the entire firm or company; and
- safeguards that are specific to a particular item of work.

Safeguards that apply across the entire firm or company might include the following:

- a code of ethics for the company or firm and suitable ethical leadership from senior management;
- a sound system of internal control, with strong internal controls;
- the application of appropriate policies and procedures for monitoring the quality of work done for clients;
- policies that limit the reliance of the firm on the fee income from a single client;
- procedures for identifying personal interests and family relationships between employees and partners of the firm and key staff in client organisations; and
- whistle blowing procedures for reporting illegal or unethical behaviour.

Safeguards that might be applied to particular jobs or work procedures include the following:

- keeping individuals away from work where there might be a threat to their compliance with the fundamental principles (for example where a conflict of interests or a conflict of familiarity might exist);
- in the case of audit firms, rotating the audit partner so that the same audit partner is not responsible for the audit of the same client company for more than a specified maximum number of years;
- the application of strong internal controls;
- using another accountant to review the work that has been done by a colleague; and
- discussing ethical issues with those people in the company who are responsible for governance issues, such as the audit committee, senior non-executive director, or board of directors.

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Example: Inheritance

A member of the audit team working on the audit of ABC Company has just received an inheritance that includes a large number of ABC Company shares.

What is the ethical risk and what safeguards against the risk might be appropriate?

Answer

The risk is that the member of the audit team has a financial interest in the client, by owning a large number of the client company shares. There is a potential conflict of interest, which will threaten his or her integrity.

Suitable safeguards would be either:

to persuade the individual to sell the shares; or

to remove the individual from the audit of ABC Company.

Example: Partner and director

A senior partner in an audit firm is also a director of XYZ Company. XYZ Company has approached the audit firm, and asked it to become the company's auditors.

What is the ethical risk and what safeguards against the risk might be appropriate?

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Answer

The risk is that the senior partner has a financial interest in the client company, and presumably also has a familiarity risk.

The IESBA (IFAC) Code and ICAN Code state that in this situation, there are no safeguards that are strong enough to reduce the threat from the conflict of interest to an insignificant level. The firm must refuse to take on the audit work.

Example: Foreign parent – safeguards

You are an accountant working in public practice in Nigeria. You are approached by a subsidiary company of a foreign parent company. This company would like you to provide a number of professional services. The parent company is based in a country where you have no professional contacts. The ethical risks in taking on a new client were described in a previous example.

Required

What are the safeguards against the risk that should reduce the risk to an acceptable, insignificant level?

Answer

A key safeguard is to obtain information that verifies the ownership of the parent company and shows who has ultimate control over the group, including the Nigerian subsidiary.

Before accepting the Nigerian subsidiary as a client, enquiries should be made in the country of the parent company. The enquiry might be made through an ICAN (or other reputable accountancy institute) member in that country, or an ICAN member might be asked to recommend a local lawyer who could do the work.

You would want to receive certified copies of original documentation relating to the structure of the parent company, evidence of its registration as a company (including the details registered on its incorporation), a list of the members of its board of directors and any other information about the company that is available to the public in that country.

If you are satisfied with the information you receive, you should feel able to take on the subsidiary company as a client. If you are not satisfied, and are unable to obtain any other information that provides the safeguards you are looking for, you should inform the company that you are not able to provide the services that the company requires.

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1.5 Ethical threats to accountants in business

You should be aware that accountants who work in business can be placed under serious pressure by an employer to act in an unethical way. A problem could arise when senior management wants to 'bend the rules' in financial reporting and expect compliance from their accounting staff. Accountants might therefore be asked to:

- break a law or regulation: illegal activity is always unethical;
- ignore technical standards, such as financial reporting standards or auditing standards;
- lie to the external auditors or regulators; and
- issue a report that is misleading and misrepresents the facts.

When an accountant is put under pressure to act in these ways, the threats could be classified as:

- self-interest threats: by doing what senior management expect, the accountant might expect to benefit from personal rewards, such as a bonus, a higher salary or promotion;
- intimidation threats: there might also be a threat from senior management that the accountant might not receive a bonus or might be expected to resign unless he agrees to do what senior management ask; and
- familiarity threats: in some cases, an accountant might be expected to agree to what senior management ask because he has known them for a long time and should be expected to trust them to do 'what is right' for the company.

However, threats of this nature are very serious. Breaking a law, ignoring a technical standard, hiding information from the auditors or lying to them and providing misleading information could all have serious consequences. There is a threat to the accountant's compliance with the fundamental principles of:

- integrity;
- objectivity;
- professional competence and due care; and
- professional behaviour.

Finding a solution to ethical problems can be very difficult. The extreme option (or 'nuclear option') is resignation, but this is something that should be avoided where possible. A better solution can often be found.

A model for dealing with ethical problems is suggested in the next section.

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2 A MODEL FOR RESOLVING ETHICAL CONFLICTS

Section overview

- A model based on threats and safeguards
- The mirror test
- Applying the model in practice

2.1 A model based on threats and safeguards

ICAN has suggested a model for dealing with ethical conflicts, and using judgement to decide how the conflict should be resolved. It is based on recognising threats to compliance with the fundamental principles, and assessing safeguards to eliminate the threats.

The model is in several logical stages, as follows:

Stage 1. Recognise and define the ethical issues.

Stage 2. Identify the threats to compliance.

Stage 3. Assess the significance of the threats.

Stage 4. If the threats are 'not insignificant', consider the additional safeguards that could be used.

Stage 5. Re-assess the threats to compliance after additional safeguards. Do the additional safeguards eliminate the risk or reduce it to an insignificant level?

Stage 6. Make the decision about what to do.

Define the issues

Accountants are expected to identify potential threats to their compliance with the fundamental ethical principles. To do this, they must be able to recognise the ethical issues that exist, or might possibly exist, in a particular situation. The first step is therefore to define the issues.

In order to do this, it might be necessary to **establish the facts**. An accountant might suspect that an ethical issue exists, but cannot be sure because he does not have enough facts to inform him about the situation.

In addition, the accountant should ask whether he has considered all the possible alternative courses of action, and whether there are any courses of action that avoid the threats.

Yet another question the accountant should ask is whether the problem is his, or whether it is the problem of someone else. An accountant does not have a duty to take on the ethical responsibilities of another person. He must consider his own actions, and whether these are ethical and acceptable.

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Identify the threats to compliance with ethical principles

Having established the facts and defined the ethical issues, the accountant must next think about his own involvement. The concern for the accountant should be whether his compliance with the fundamental ethical principles is under threat, and if so, what is the nature of the threat.

Is there a self-interest threat, a self-review threat, an advocacy threat, a familiarity threat or a threat from intimidation?

How does this threaten the accountant's ability to comply with the requirements for integrity, objectivity, professional competence and due care, confidentiality and professional behaviour?

Assess the significance of the threats

The next stage is to identify the significance of the threats to compliance with the fundamental ethical principles. If existing controls are sufficient to eliminate the risk of non-compliance, or if the existing controls are sufficient to reduce the risk to an insignificant level, no further action is needed.

If the threats to compliance with fundamental ethical principles are higher than insignificant, additional safeguards should be considered in order to eliminate or reduce the threats.

Introducing safeguards

Safeguards, or additional safeguards, can be introduced to reduce the threats to compliance with the fundamental ethical principles. These threats must be eliminated entirely or reduced to an insignificant level.

Taking action

Introducing additional safeguards might be sufficient to deal with the problem.

However, if the threats to compliance with the fundamental ethical principles cannot be eliminated or reduced to an insignificant level, more extreme measures are necessary.

For accountants in public practice, an extreme measure is to decline to work for a particular client, or to cease working for a client.

For accountants working in industry and commerce, an extreme measure would be to become a 'whistleblower', and to report concerns to an appropriate authority. In an extreme case, the appropriate action might be for the accountant to resign from his or her job.

Members of ICAN are able to obtain confidential advice about the appropriate course of action from ICAN.ICAN has also set up a whistleblower's fund to assist members who may suffer economic loss due to whistleblowing activities.

2.2 The mirror test

When an ethical issue is involved, an accountant should carry out a mirror test.

To carry out a mirror test, you have to answer a basic question about the ethics of a course of action. If you choose a course of action, are you able to look yourself in the mirror and see a person who has acted in a moral and ethical way. Can you justify the decision you have taken from an ethical perspective?

Three questions that you can ask when carrying out the mirror test are as follows.

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For the course of action you have chosen, the three questions are:

Is it legal? If it is not legal, you should not be doing it;

What will other people think? Think about the opinion of people whose views matter to you, such as close family members (a parent, spouse, or close friend) or the media. Are you satisfied with the effect of your action on these people?

Even if the action is legal, it is ethically correct? A problem for accountants is often that an action is legal (or not illegal) but is nevertheless unethical and should be avoided.

2.3 Applying the model in practice

You need to be able to identify ethical problems that could face an accountant, and suggest a way of resolving the problem in a way that is consistent with ethical principles. The model described above provides a useful framework for doing this.

Remember that the aim should be to find a sensible solution to each ethical problem. The solution can often be reached through agreement with other people, and through discussions. It is not always necessary to opt for an extreme solution, such as reporting a problem to an external authority, resigning from a job or declining to work for a client.

Here are a few examples to show how the model might be applied.

Example: Medical services

Until recently you were a senior accountant working for the state hospital service and you have now left to work for a company that is applying to take over some aspects of the treatment of patients with eye problems. Until now this work has been performed by specialist state-owned hospitals. The government has a policy of transferring a considerable proportion of medical services to private sector companies, and it wants to transfer the responsibility for eye treatment to the private sector.

Your new employer has asked you to lead a team that will make the company's application to the government. Your boss is aware that when you were working for the state hospital service, you worked closely with the management responsible for the eye hospitals and you are familiar with many of the senior figures in both hospital management and the government department responsible for public health. From your experience in your previous job, you know a lot about the reasons why the government wants to transfer this work from the state-owned hospitals to a private sector company.

Your company pays large bonuses to employees in teams that successfully apply to take over work from hospitals in the state sector.

Required

Consider whether you are faced with an ethical problem, and if so how it might be resolved.

Answer

Step 1

The first step is to identify the ethical issue. You are being asked to lead a team that will apply to provide medical services for the government. The reason why you have been selected is probably your knowledge and experience of the medical services for eye patients, and your familiarity with senior managers in the hospitals and government department.

Step 2

Consider the threat that this creates for your compliance with the fundamental ethical principles.

In this case, there is a threat to the ethical requirement to respect the confidentiality of information obtained from a previous employer. You should not use confidential information obtained in a previous job for the benefit of a new employer.

On the other hand, you have an ethical duty to assist your new employer in achieving its legitimate business aims.

Step 3

You need to consider the significance of the threat to your compliance with the fundamental principles.

The significance of the threat will depend on how much confidential information you would use in carrying out the work for your employer. If there is no threat to confidentiality, there is no problem. However in this case it seems likely that you would inevitably be using information that you acquired when you worked for your previous employer, and this information should be treated as confidential.

Step 4

You should therefore consider safeguards to the ethical threat and find a solution to your problem.

The first step should be to discuss your ethical problem with your boss. If your employer is sympathetic to ethical issues your boss is likely to agree that you should not be asked to lead the team that applies to do the work. Another colleague should be appointed to lead the team on this occasion.

However, you might agree to be involved with the team, on work where you can use your experience and knowledge where there is no threat to confidentiality. If this is possible, you will be working to promote the legitimate interests of your employer without any threat to your compliance with the fundamental principles.

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Example: Slow-moving inventory

You are an accountant working for a medium-sized public company. You report to the chief accountant, who is preparing the annual accounts.

You have been involved in preparing valuations for inventory, and you have identified a substantial amount of slow-moving inventory that, in your opinion, should be written down in value, or even written off altogether.

The chief accountant has called you in for a meeting. He thanks you for the work you have done, and comments that he is hoping that you can expect to earn a bonus at the year end when the financial statements are approved and published. He then adds that before he discusses the accounts with the finance director and the auditors, he thinks that there is a problem with the write-down of the inventory. He thinks that it would be premature to write down the inventory this year, and he does not want to create a problem by drawing the matter to the attention of the auditors.

He goes on to say that he thinks the matter is important, but he is sure that you will show good professional judgement by agreeing with his point of view and that you will alter the figures for inventory valuation in your report. He hints that if you do not agree with his request, he will have to reconsider his recommendation to the finance director about your annual bonus and that he will find it difficult in the future to work with you on a constructive professional basis.

How should you deal with this situation?

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Answer

Step 1

The first step here is to identify the issue. First, the valuation of inventory is your problem, because you have prepared a report on the subject and you are being asked to reconsider your professional opinion.

You might think that your initial opinion about the inventory valuation is too cautious. It would therefore be appropriate to ask for time to re-assess your valuation. However, this should not be an excuse for accepting the opinion of the chief accountant. You should re-assess your valuation objectively. There might be more up-to-date information that will help with your re-assessment.

Step 2

If you consider that there is an ethical problem, you need to identify the nature of the threats and assess how serious they are.

There is a conflict of interest (self-interest) threat, because a suggestion has been put to you that your annual bonus depends on your willingness to accept the views of the chief accountant. There is also an intimidation threat, in the sense that your future career might be affected by hostility from the chief accountant. You might also think that there is pressure to accept the view of the chief accountant, because you are familiar with him and are willing to accept his opinion.

These create threats to your integrity, if you believe that your assessment of the inventory valuation is correct. There are also threats to your objectivity and to the requirement for you to act with professional competence and due care.

Step 3

The next step is to assess how serious the threats are. The scale of the threat might depend to some extent on the significance of the write-down in inventory, and the effect this would have on the reported profits for the year. A minor difference might be overlooked, but anything more serious should not be ignored.

Step 4

You need to consider safeguards to protect yourself against the ethical threat. As an initial course of action, after you have re-assessed the inventory valuation, you should be able to discuss your concerns with the chief accountant. If the chief accountant has not changed his opinion, you can ask for some time to think about what you should do.

If you disagree with the chief accountant and you consider the problem to be serious, it would be inappropriate for you to decide that it is no longer your problem and you will simply do what you are told.

It would also be inappropriate to decide that you can wait and see what the auditors have to say about inventory valuation. This is shifting the responsibility to the auditors, when the responsibility is initially yours. You cannot be sure that the auditors will identify the problem during the course of their audit.

Safeguards to the ethical threats you are facing can possibly be obtained by informing other people within the company to the nature of the problem. You can consider arranging a meeting with the finance director or the chairman of the audit committee to discuss your concerns.

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If you find that the finance director or audit committee are not willing to listen to your views, you might consider informing the auditors about your concern. However, before you do this you might wish to ask ICAN for confidential advice on the matter.

If these measures fail to remove your concerns about the ethical risk, you might need to consider resignation from the company.

Example: Trade sanctions

You are a senior accountant working for a public company that produces sophisticated telecommunications equipment.

For political reasons, the government has placed a total ban on exports of all goods to Country X, where there is a repressive dictatorship and a civil war in one region.

You have been asked to prepare the documentation for the sale of a large quantity of equipment to a customer in Country Y, and arrange the method of payment. There is no ban on exports to Country Y, but the customer has acted in the past as a buying agent for the government in Country X. You are therefore aware of the fact that the equipment exported to Country Y will soon find its way into Country X.

You have discussed your concern with the finance director, who told you that there was no ban on sales to Country Y, and what happened to the equipment after that was none of his concern and should be none of your concern either.

What should you do?

Answer

Step 1

The first step here is to identify the issue. The problem here is your involvement in an export transaction which is not strictly illegal, but is probably intended to have the same end result as an illegal action.

The export is not strictly illegal, so you are not under a legal obligation to report your concerns.

Step 2

You should assess the threat to your compliance with the fundamental ethical principles. The threat here is to your integrity. You are under pressure from the finance director to keep quiet and get on with your job, suggesting perhaps that action will be taken against you if you fail to comply. This is a form of intimidation threat.

Step 3

You should assess the significance of the ethical issue. In this case, it is probably sufficiently significant for you to consider an appropriate response to the problem.

Step 4

When problems arise of an ethical nature, the first course of action should be to find a way to resolve the matter through internal procedures. Since the

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finance director will not listen to your concerns, you might consider using the arrangements that the company has for internal 'whistle blowing'. If there are no formal arrangements for whistle blowing, you might consider reporting your concerns to the senior independent director.

If no-one in the company takes up your concerns and tries to deal with the problem, you might consider, as a final resort, reporting the matter to someone in authority.

However, before you become an external whistle blower, you should consider the following matters:

What will be the effect on the public interest if the unethical transaction goes ahead? Is there a sufficiently strong public interest concern to justify informing an external authority?

The answer to this question depends partly on the gravity or significance of the matter. Is a serious ethical problem involved, to justify you informing the authorities?

Is there a probability of a repetition of the problem in the future? In this case, is it probable that there will be more export orders from the same customer in the future?

What is the quality of the information that you have? In this case, how certain are you that the equipment will be transferred to Country X after it has been sold to the customer in Country Y?

What is the reason for your employer's refusal to act?

All these matters could affect your decision on whether or not to report your suspicions to an external authority. If you decide that you must 'blow the whistle', you should keep documentary records to provide evidence of your concerns and of your attempts to resolve the problem internally.

This is a problem where different individuals might reach a different conclusion about the appropriate action to take.

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3 CORRUPTION

Section overview

- Corruption
- Bribery
- Societal impact of bribery
- Measures to reduce and combat bribery
- Anti-bribery legislation
- Other forms of corruption

3.1 Corruption

Definition: Corruption

The term corruption covers a large range of illicit or illegal activities. There is no universal or comprehensive definition of corruption.

The World Bank defines it as:

The abuse of public office for private gain.

A definition derived from that used by Transparency International (a leading non-governmental body that campaigns against corruption) is the following:

Corruption involves behaviour on the part of officials in the public and private sectors, in which they improperly and unlawfully enrich themselves and/or those close to them, or induce others to do so, by misusing the position in which they are placed.

3.2 Bribery

Bribery is a form of corruption. A bribe is a gift bestowed to influence the recipient's conduct.

Bribery around the world is estimated at over $1 trillion. Bribery undermines corporate governance, the rule of law and damages economic development.

Bribery and corruption result in conflict of interest between a person’s self-interest and that person’s duty to perform a task. A bribe that secures a course of action that a person would not necessarily have taken is against the interests of those on behalf of whom a person should be acting.

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Example: Bribery

A company might choose a supplier as a result of a bribe taken and buy goods at a higher price or lower quality than it would have if the decision had been taken in a fair and proper way.

A government department might enter into a contract as a result of a bribe taken and that might result in the purchase of a service which might be to the detriment of the public served in terms of the service quality and the cost paid.

3.3 Societal impact of bribery

Political costs

Corruption constitutes a major obstacle to democracy and the rule of law. Offices and institutions lose their legitimacy when they are misused for private advantage. Accountable political leadership cannot develop in a corrupt climate.

Economic costs

Scarce public resources might be diverted to high-profile, status projects at the expense of fundamental infrastructure projects such as schools, hospitals and roads, etc.

Inappropriate spending decisions lead to waste of tax revenues.

More efficient but honest companies lose out and in the long run this leads to slower growth in the economy. This leads to less tax revenue and fewer employment opportunities.

Corruption can hinder the development of fair market structures, distorting competition and deterring investment.

Corruption can lead to the depletion of national wealth when national resources are placed in the control of a small number of individuals for less than their true value.

Social costs

Corruption undermines people's trust in the political system and leads to frustration of the population. The sense of disillusionment engendered results in a weak civil society where demanding and paying bribes becomes the norm.

This might lead to emigration of the most able members of the population to the detriment of the future development of the country.

Environmental costs

Corruption might lead to a blind eye being turned to breach of environmental legislation and health and safety law.

Lack of proper government oversight can lead to careless exploitation of natural resources and pollution.

The preface to the UK Bribery Act (2011) includes the following statement:

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> *"Bribery blights lives. Its immediate victims include firms that lose out unfairly. The wider victims are government and society, undermined by a weakened rule of law and damaged social and economic development. At stake is the principle of free and fair competition, which stands diminished by each bribe offered or accepted.*
>
> *Tackling this scourge is a priority for anyone who cares about the future of business, the developing world or international trade."*
>
> *Kenneth Clarke UK Secretary of State for Justice*

3.4 Measures to reduce and combat bribery

There is no single way to combat bribery. The fight against bribery is built on a wide foundation.

Much of what has been covered earlier is important in combating bribery. Bribery will fail to distort the fair running of business and society when there is:

- a strong sense of fairness in participants in transactions;
- fair reward for job performance;
- transparency of decision making;
- strong leadership;
- clear policies and procedures;
- strong candidate selection procedures with good education and training processes; and
- strong and enforceable laws.

Many countries are cooperating in introducing legislation to try to reduce the occurrence of bribery.

The UK Government has published The Bribery Act 2010 which aims to combat bribery in order to encourage free and fair competition.

In Nigeria the **Independent Corrupt Practices & Other Related Offences Act 2000 (ICPC)** was issued in 2000 with some success. Subsequently the **Economic and Financial Crimes Commission (EFCC)** was established in 2003 following pressure from the **Financial Action Task Force on Money Laundering (FATF)**. This led to the "**EFCC Establishment Act 2004**" being issued mandating the EFCC to prevent, investigate, prosecute and penalise financial and economic crimes (including bribery).

3.5 Anti-bribery legislation

OECD Anti-Bribery convention

Many countries around the world have introduced specific anti-bribery legislation. For example:

UK: the UK Bribery Act 2011

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USA: the Foreign Corrupt Practices Act

Canada: Corruption of Foreign Public Officials Act

A key driver for the recent flow of new legislation is the OECD Anti-Bribery Convention, first signed in 1997. To date 34 OECD countries plus seven non-OECD countries (Argentina, Brazil, Bulgaria, Colombia, Latvia, Russia and South Africa) have enforced the convention. Notable exceptions include India and China. Similarly, Nigeria is yet to ratify the convention into legislation.

The central thrust of the OECD Anti-Bribery Convention is to combat corruption in developing countries by cutting off the flow of money from companies operating out of developing countries. To accomplish this, the convention requires signatories to make it a criminal offence under their municipal (that is, domestic) laws to bribe officials of other states. Signatories are also expressly required to take measures to establish jurisdiction to prosecute its nationals for bribery offences committed abroad.

The example below demonstrates how the UK has implemented the guidelines into statute.

Example: UK Bribery Act 2011

The Bribery Act sets out four offences of bribery:

s.1 Offences of bribing another person

s.2 Offences relating to being bribed

s.6 Bribery of foreign public officials

s.7 Failure of commercial organisations to prevent bribery

An organisation has a defence under s.7, if it can prove that it had adequate procedures in place designed to prevent bribery.

What counts as adequate will depend on the bribery risks faced by an organisation, and the nature, size and complexity of the business. If there is no risk of bribery, then an organisation will not require any procedures to prevent bribery.

The guidance is not prescriptive and is based on the following six guiding principles.

Proportionate procedures

A commercial organisation's procedures to prevent bribery by persons associated with it should be proportionate to the risks it faces and the nature, scale and complexity of its activities. They are also clear, practical, accessible, effectively implemented and enforced.

A large multinational organisation would require more sophisticated procedures to those of a small private business.

Top-level commitment

The top-level management should be committed to preventing bribery and fostering a culture within the organisation in which bribery is unacceptable.

Such top-level management commitment should include:

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- communication of the organisation's anti-bribery stance; and
- an appropriate degree of involvement in developing bribery prevention procedures.

Risk assessment

Organisations should assess the nature and extent of its exposure to potential internal and external risks of bribery on its behalf by persons associated with it.

The assessment should be performed periodically and documented.

Due diligence

The organisation should apply due diligence procedures, taking a proportionate and risk based approach, in respect of persons who perform services for (or on behalf of) the organisation in order to mitigate bribery risks.

Communication

The organisation should ensure its bribery prevention policies and procedures are embedded and understood throughout the organisation through internal and external communication, including training, proportionate to the risks it faces.

Monitoring and review

The organisation should monitor and review procedures designed to prevent bribery and make improvements where necessary.

Nigerian law relating to bribery and corruption

Whilst not yet a full signatory to the OECD Anti-Bribery Convention described above, there are still a number of relevant laws that address bribery and corruption in Nigeria including:

The Independent Corrupt Practices & Other Related Offences Act 2000 (ICPC)

The EFCC Establishment Act 2004

The Criminal Code. Law of Federation of Nigeria 2004

Illustration: The Corrupt Practices & Other Related Offences Act 2000

The Act establishes a number of offences including:

The offence of accepting gratification (s8)

The offence of giving or accepting gratification through an agent (s9)

Counselling offences relating to corruption (s11)

Fraudulent acquisition of property (s12)

Fraudulent receipt of property (s13)

Deliberate frustration of investigation by the Commission (s15)

Making false statements or returns (s16)

Bribery of Public Officer (s18)

The offence of using office or position for gratification (s19)

Bribery in relation to auctions (s21)

Bribery for giving assistance in regard to contracts (s22)

The Act requires anyone who receives, is promised or offered such gifts in contravention of the Act to report it to the nearest officer of the Commission or a police officer.

Punishment for offences committed under the Act can include:

Imprisonment (in many cases for up to 7 years)

Forfeiture of any gratification received

Payment of fines of up to five times the amount corruptly received

The Act also establishes that an attempt to commit any of the offences created by the Act attracts the same punishment as that prescribed for the offence, if the offence is actually carried out.

Illustration: The EFCC Establishment Act 2004

The EFCC Establishment Act mandates the EFCC (Economic and Financial Crimes Commission) to combat financial and economic crimes. The Commission is empowered to prevent, investigate, prosecute and penalise economic and financial crimes and is charged with the responsibility of enforcing the provisions of other laws and regulations relating to economic and financial crimes including:

The EFCC Establishment Act 2004

The Money Laundering (Prohibition) Act 2004

The Advance Fee Fraud and Other Fraud Related Offences Act 1995

The Failed Banks (Recovery of Debts) and Financial Malpractices in Banks Act 1994

The Banks and other Financial Institutions Act 1991; and

Miscellaneous Offences Act

Any other law or regulations relating to economic and financial crimes, including the Criminal code or Penal code.

The EFCC Establishment Act 2004 is the main legal instrument that empowers the EFCC to investigate all financial crimes including advance fee fraud, money laundering, counterfeiting, illegal charge transfers, futures market fraud, computer credit card fraud and similar.

Bribery is specifically mentioned in paragraph 46 of the Act as being included within the definition of ‘economic and financial crimes’.

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Illustration: The Criminal Code - Law of Federation of Nigeria 2004

The Criminal Code makes it an offence for an agent to accept any gift or consideration as an inducement or reward for doing or not doing any act in relation to their principal's affairs or business.

Breach of the Criminal Code can result in fines and/or imprisonment.

3.6 Other forms of corruption

Professional accountants must avoid involvement in any form of corruption. Some acts of corruption will fall within the NOCLAR regulations, and accountants will be expected to report incidents to the relevant authorities.

Other examples of corruption are explained briefly below:

Money laundering - This is the crime of concealing the origins of money that has been obtained illegally, from criminal activities. The process of money laundering usually involves getting illegally-obtained money into the banking system, moving money around within the banking system to cover traces of where it originated, and eventually to use the money to acquire 'legitimate' assets, so that its illegal origins cannot be detected at all. Experience has shown that dishonest accountants are often involved in the money laundering process.

Embezzlement - This is the act of secretly and illegally stealing funds that have been placed in the individual's trust, or money belonging to a person's employer. With their close contact with an employer's money, accountants are sometimes the perpetrators of acts of embezzlement.

Theft - This is the criminal act of stealing money or other assets from their legitimate owner.

Fraud - Fraud is a general term for the crime of gaining money or financial benefits by means of a trick or by lying. It has been defined as

> *"Any intentional false representation, including failure to declare information or abuse of position that is carried out to make gain, cause loss or expose another to the risk of loss" (CIPFA).*

Extortion - Extortion is the crime of obtaining money through threats or force. An example of extortion money is protection money, whereby a gang of criminals demand money from local traders in exchange for not damaging their property or by threatening individuals with personal harm and injury.

Blackmail Blackmail is a form of extortion. A blackmailer demands money (usually from an individual, but it could also be from an organisation) in return for not revealing compromising information about the blackmail victim.

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4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain ethical conflict
- Explain the threats and safeguards approach to dealing with ethical conflicts
- Describe the model for resolving ethical conflicts and apply the mirror test
- Identify ethical threats and suggest practical safeguards in common situations
- Define corruption
- Explain the nature of bribery
- Summarise measures to reduce and combat bribery
- Explain the nature of other types of corruption found in business

ICAN 20

CHAPTER 20

Social and environmental issues in ethics and business

Contents

1 Social and environmental footprints
2 Sustainability and accounting for sustainability
3 Environmental management systems, environmental management accounting and environmental audit
4 Chapter review

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INTRODUCTION

Detailed syllabus

D **Governance**

D12 Discuss the concept of sustainability in business, sustainable asset management (SAM) and full cost analysis (FCA).

Exam context

Ethics and corporate social responsibility are closely linked. This chapter addresses contemporary positions on social and environmental issues and corporate social responsibility.

By the end of this chapter students will be able to:

- Explain the concept of social and environmental footprints;
- Identify and assess in a given scenario issues of ethics and corporate social responsibility;
- Define triple bottom line reporting; and
- Discuss approaches to environmental management systems, management accounting and audit.

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1 SOCIAL AND ENVIRONMENTAL FOOTPRINTS

Section overview

- Introduction
- Environmental footprint (ecological footprint)
- Carbon neutrality
- Social footprint
- Social ecology
- Towards the measurement of social and environmental effects

1.1 Introduction

The purpose of economic activity is to create economic wealth. It is now recognised, much more than in the past, that economic activity also has an environmental impact and a social effect. An organisation is said to create an 'environmental footprint' and a 'social footprint' - a visible mark on the environment and on society. (The word 'footprint' is intended to have the same meaning as in everyday use, when we speak of leaving a footprint in the sand, as a mark that we leave behind where we have been.)

The social footprint may be either beneficial or damaging. The environmental footprint is almost inevitably damaging.

1.2 Environmental footprint (ecological footprint)

An environmental footprint, also called an ecological footprint, is a term that means the impact that an entity has on the environment, in terms of:

the amount of raw materials that it uses to make its products or services, where the raw materials are subject to depletion (see note);

non-renewable resources that it uses to make its products or services; and

the quantity of wastes and emissions that it creates in the process.

Note: Raw materials subject to depletion are raw materials that can be renewed, but where the current total rate of consumption exceeds the total current rate of renewal. Fish stocks and hard wood timber are examples.

In the past, it was accepted that in order to grow, companies (and economic activity as a whole) had to increase their environmental footprint. With the recognition today that the world cannot go on increasing its environmental footprint, many leading companies are looking for ways to reduce the size of their own particular footprint and 'tread more softly'.

Reducing an environmental footprint involves the development and implementation of policies for:

- better (more efficient) resource management, and using different resources;
- 'green' procurement policies; and
- waste minimisation and waste management (for example, policies on reducing pollution and recycling waste).

The measurement of environmental footprint

There have been attempts to measure environmental footprint, using a common measure for all activities. It can be measured in terms of the area of productive land and aquatic ecosystems that have been used, from whatever global source. An environmental footprint for any economic activity or any company can therefore be measured in terms of hectares of productive land or aquatic ecosystems.

One widely-used method of footprint analysis for the economic activity of nation states is to identify four methods of environmental consumption:

- energy use;
- the built environment (land covered by a human settlement and its connecting infrastructure, such as roadways);
- food products; and
- forestry products.

For each category, it is possible to measure the land area used for these activities within the country, in global hectares, to obtain a total environmental footprint for the country. This is then converted into an environmental footprint per head of the population.

Countries that consume most environmental resources and create most environmental damage relative to other countries are those with the highest environmental footprint per head of the population.

1.3 Carbon neutrality

The effect on the environment of economic activities by individual companies may be measured in terms of emissions of carbon-based pollutants, such as the release of carbon dioxide into the atmosphere.

Some environmentally-conscious companies already measure their impact on carbon pollution, and might have a stated environmental policy of being 'carbon neutral'.

Carbon neutrality exists when a company is able to counterbalance its use of carbon products, and particularly its carbon dioxide emissions, with activities that reduce the amount of carbon dioxide in the atmosphere such as growing trees or plants (which absorb carbon dioxide from the atmosphere). Some companies

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have also tried to reduce their impact on carbon dioxide pollution by switching to the use of fuel and energy that does not involve carbon consumption.

Example: Environmental conscience

There are many examples of large environmentally-conscious companies.

One company has listed some of the initiatives it has taken to create a sustainable business as:

Setting a target of zero waste generation and zero waste emissions

Conserving energy and resources such as oil, coal, natural gas, water and minerals

Recycling materials to reduce the need for disposals

Reducing packaging waste

Example: Environmental conscience (continued)

Making, using, handling and transporting materials safely and in an environmentally-friendly way and in compliance with local regulations

Managing land efficiently to increase habitats for wild life

Developing new products and processes that reduce the environmental risks.

1.4 Social footprint

A social footprint is the effect of economic activity on society and people. In general, economic activity is seen as providing benefits for society, although some companies are much more 'people-friendly' than others. Some companies, for example, use child labour and/or pay subsistence-level wages to their workers.

Companies might seek to measure the contribution of their activities towards society in terms of:

- Total numbers employed or increase in the total number of employees;
- The proportion of the total work force employed in different parts of the world;
- The proportion of the total work force that is female or from different ethnic groups; and
- Health and safety at work (for example, numbers of employees injured each year per 1,000 of the work force).

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1.5 Social ecology

There are critics of the Western capitalist approach to environmentalism. Social ecologists argue that the environmental crisis has been caused by companies seeking growth, profits and economic self-interest. Nothing fundamental has changed. Companies are still trying to get bigger and more profitable, even though they use environmental ideology to express their plans and ambitions. They argue that the environmental crisis cannot be averted without a radical change in human society.

The following comments are illustrative of the thinking of social ecologists:

- Environmental problems are caused by companies that seek continued growth in size and profits;
- Social ecologists also argue that the structure of society and the future of the environment are closely linked;
- They argue that most environmentalists focus, wrongly, on improving technology to improve the environment, or even on restricting population size. These environmentalists are focusing on symptoms of the environmental problems, not its root causes; so they will not find any lasting solution; and
- A truly 'green' entrepreneur cannot possibly survive in today's capitalist culture, because by using ecologically/environmentally sound methods they would be at a disadvantage to more ruthless rivals who will produce at a lower cost.

1.6 Towards the measurement of social and environmental effects

So what is the relevance of social and environmental issues to the accountancy profession?

The answer to this question is that, setting the arguments of social ecologists to one side, many companies are becoming increasingly aware of environmental and social issues, and their responsibility for preserving the environment and developing society, as well as for making a profit.

In order to help companies to set targets for achievement and assess their actual performance, there should be measurement. Environmental and social effects should be quantified, because managers find it easier to plan and control using numbers than using more general qualitative assessments.

Some accountancy bodies are contributing towards efforts to establish measurement and reporting systems for social and environmental issues, to complement traditional financial reporting. As it is increasingly recognised that conventional financial accounting and financial reporting systems might contribute to non-sustainability, sustainability has become a key issue for accountants. There is now important progress in exploring how financial accounting and financial reporting can play a part in a more sustainable future.

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These initiatives may become linked to the developments in corporate governance and reporting to shareholders. In the European Union for example, listed companies are now required to provide information about social and environmental risks in an annual business review for shareholders.

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2 SUSTAINABILITY AND ACCOUNTING FOR SUSTAINABILITY

Section overview

- Accounting, the economic model and sustainability reporting
- Sustainable development
- Reporting by companies on sustainable development
- 'Environmental footprint' for individual companies
- Triple bottom line reporting
- Balanced scorecard and sustainable balanced scorecard
- Sustainability Assessment Model (SAM) and full-cost accounting (FCA)
- Sustainability reporting: concluding remarks

2.1 Accounting, the economic model and sustainability reporting

The capitalist system creates incentives for maximising wealth, and it is based on the assumption that wealth can only be increased through continual economic growth. This is the 'economic model' of society. As a result, growth-seeking economic activities continue, in spite of growing concerns for the environment, and recognition that continual growth in its current form cannot be sustained.

Accounting has developed in support of the economic model. Financial reporting measures the consequences of a company's activities in terms of the use of the assets that it owns and the liabilities for which it has the direct responsibility for payment. Current accounting practice does not allow companies to report the consequences of their actions on external assets that it does not own, and the creation of liabilities for which it does not have to pay directly.

Investment decisions by large companies are made using accounting techniques such as discounted cash flow analysis, which focuses exclusively on economic consequences of investment, and does not measure or evaluate the environmental and social impacts.

In the past, companies ignored their consumption of natural resources such as air and water because they assumed that supplies of these items were both limitless and free. This is no longer the case. It can now be argued that whereas companies are increasing economic wealth through growth and the search for profit maximisation, society may well be getting poorer because of the damage that economic activity is having on the environment and society.

As companies have become increasingly aware of environmental issues, and begin to accept that economic growth might not be sustainable, they have become more interested in measuring sustainability and environmental impact.

Traditional accounting methods do not provide for this type of measurement, and to the extent that companies (and society) want environmental and social impacts to be measured, traditional accounting is inadequate. Alternative measurement

and reporting systems that recognise the need for economic activity to be **sustainable** have therefore been considered, although there is as yet no widely-accepted standard measurement and reporting system.

It seems quite possible that as systems for reporting sustainability are developed, the accountancy profession will be closely involved, because of its long experience with measurement and performance reporting systems.

2.2 Sustainable development

Definition: Sustainable development 1

A problem with accounting for sustainable development is to identify what 'sustainable development' actually means. A generally-accepted definition provided by the Brundtland Report (for the World Commission on Environment and Development, 1987) is:

"development that meets the needs of the present without compromising the ability of future generations to meet their own needs."

However, there are practical difficulties with the above definition:

What are the needs of the present? Presumably, these are more than simply survival needs, because current levels of consumption are, in many parts of the world, well above survival level;

What are the needs of future generations? Are these just survival needs? If so, there is presumably an assumption that economic wealth will decline;

Over what time period should the needs of future generations be measured? In theory, future needs should be measured into the long-term future. However, companies and governments plan for the future over much shorter time frames; and

Do we mean the needs of all people in all societies, or is sustainability measured in terms of individual countries or regions of the world?

Since companies plan for the future and report their performance within fairly short time frames, reporting for sustainable development by companies is likely to focus on relatively short-term measures of sustainability.

Definition: Sustainable development 2

An alternative definition of sustainable development is:

"A dynamic process which enables all people to realise their potential and improve their quality of life in ways which simultaneously protect and enhance the Earth's life support system" (Forum for the Future)

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2.3 Reporting by companies on sustainable development

The previous section of this chapter suggested that the environmental footprint (or ecological footprint) can be measured for countries and governments in terms of geographical area per head of the population. Companies need something different.

Several techniques have been used by companies to plan and report their sustainable development, or the impact of their activities on society and the environment. These include:

- measures of the 'environmental footprint' for individual companies;
- triple bottom line reporting;
- the balanced scorecard and sustainability balanced scorecard; and
- the sustainability assessment model (SAM) and full-cost accounting (FCA).

2.4 'Environmental footprint' for individual companies

It is possible to talk about an environmental footprint for individual companies rather than countries, although not as common. A company can measure its environmental footprint through a series of measurements. The measurements appropriate for each individual company might vary according to the nature of its operations, but should relate to the following environmental issues:

- the company's consumption of materials subject to depletion (such as quantities of livestock, timber or non-farmed fish) and non-renewable resources (such as oil, natural gas and coal): also the company's use of other key resources such as land;
- the pollution created by the company's activities, measured for example in terms of emissions of carbon dioxide, chemical waste or spillages of oil; and
- an assessment, in either qualitative or quantitative terms, of the broader effect of the company's resource consumption and pollution on the environment.

2.5 Triple bottom line reporting

Triple bottom line

The term 'triple bottom line' was 'invented' in 1994 by J Elkington. Its aim is to encourage companies to recognise social and environmental issues in their business models and reporting systems. This method of reporting is encouraged by the Global Reporting Initiative (GRI), an internationally-recognised non-profit body that promotes sustainability reporting. Note that some companies explicitly refer to having complied with GRI in their annual reports.

The 'triple bottom line' gets its name because companies report their performance not simple in terms of profit: they provide key measurements for three aspects of performance:

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- economic indicators;
- environmental indicators; and
- social indicators.

Triple bottom line reporting is therefore providing a quantitative summary of a company's economic, environmental and social performance over the previous year.

Economic indicators will include measurements relating to:

- sales revenue;
- profits, earnings and earnings per share;
- dividends per share;
- global market share (as a % of the total market); and
- in some industries, such as car production, units of sale worldwide.

Environmental indicators might include measurements relating to:

- reducing the 'intensity' of materials in products and services;
- reducing energy intensity;
- minimising the release of toxic materials/pollutants
- improving the ability to recycle materials
- maximising the use of renewable resources; and
- extending the life of a product.

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FTSE4Good index

Another system similar to Global Reporting Initiative (GRI) is the FTSE4Good index which includes companies who demonstrate commitment to supply chain labour rights, countering bribery, environmental management, upholding human and labour rights and climate change mitigation and adaption.

Some sectors are excluded from the index including weapons manufacturers (traditional and nuclear) and tobacco producers. However, for non-excluded members, inclusion in the list aims to appeal to investors looking to invest in companies that demonstrate good standards in corporate social responsibility and who want to minimise social and environmental risks in their portfolios.

Triple bottom line example

One major global company using triple bottom line reporting reported its

environmental performance in terms of:

global energy use, measured in thousands of GWh

global carbon dioxide emissions, measured in metric tons

production of non-recycled waste, measured in metric tonnes

the number of manufacturing sites that had been awarded an ISO 14000 certificate (which is explained later).

The same company reported, as social indicators:

its donations to communities and sponsorships, measured in US dollars

diversity: the percentage of its employees who were female and the percentage who came from minority groups

the number of discrimination charges brought against the company during the year

employee satisfaction, based on a census of employee opinion

the recordable injury rate per 1,000 employees.

Weaknesses of triple bottom line reporting

There are several weaknesses with triple bottom line reporting.

There are no widely-established standards for triple bottom line reporting, and no standard methods for measuring social and environmental impacts. It is therefore usual to compare the sustainability of one company with the sustainability of another. (The work of the Global Reporting Initiative or GRI is to standardise measurements for the triple bottom line. It has been publishing Sustainability Reporting Guidelines since 1999. These were updated and amended in 2002.)

If the social and environmental measures are not subject to independent audit, there might be doubts about the reliability of the data presented in a company's report.

2.6 Balanced scorecard and sustainable balanced scorecard

The concept of the balanced scorecard was suggested by Kaplan and Norton in the 1990s, as a method of setting targets and measuring performance, for both entire companies and individual managers within a company.

The balanced scorecard is a 'strategy map' divided into four elements or perspectives:

- a financial perspective;
- a customer perspective;
- an internal perspective (operations); and
- an innovation and learning perspective.

For each perspective, goals, targets and tasks are established, with indicators of performance for comparing actual results against the target. The purpose of a balanced scorecard is to prevent management from directing all their attention to

short-term financial considerations. The four perspectives give suitable importance to short-term profitability, but also provide for non-financial and longer-term strategic issues.

A sustainable balanced scorecard has been developed by Moller and Schaltegger. This adds a 'non-market' perspective to the balanced scorecard, for the environmental and social impacts of the company's operations or the manager's activities. This type of scorecard therefore includes an element of accounting for sustainability.

2.7 Sustainability Assessment Model (SAM) and full-cost accounting (FCA)

The Sustainability Assessment Model (SAM) measures the impacts on sustainability of a product over its full life cycle, from raw material extraction through the production process to its final consumption. These impacts:

- the direct economic cost of the product; but also
- the direct impact of the company's operations on society and the environment; and also
- the broader social costs and benefits.

The total impacts are measured as a cost, known as **full cost**, and the measurement system supporting the Sustainability Assessment Model is called full-cost accounting or FCA, because it includes environmental and social costs as well as economic costs.

The SAM is also used to measure the performance of a company on an index of sustainability (SAMi). This measures the percentage distance that the company is from achieving sustainability.

The SAM and FCA approach

The SAM is a four-step approach to measuring the impacts of a project or product over its entire life cycle, from cradle to grave.

Step 1. A SAM exercise is established. The object of the exercise is identified, that which will be subjected to evaluation. This might be a product, a process, a part of an entity's operations or the whole of its operations.

Step 2. The boundaries of the SAM evaluation are defined. All the costs and benefits to be included, including environmental and social costs or benefits, are identified over the full life cycle of the product (or other object of the exercise).

Step 3. The impacts of the product are measured under four headings:

- Economic;
- resource use;
- environmental; and
- social.

Some of these measurements might be in money terms, but many of the costs and benefits will be non-monetary measures, including physical (environmental) measures.

Typically, the economic impacts and social impacts should normally be positive (benefits), whereas the resource use and environmental impacts are negative.

Step 4. These non-monetary measures are converted into a common basis of measurement: money. This total money measurement provides the full cost analysis of the product, process or operation.

'None of these steps is easy to do and a great deal of judgement will be exercised at each stage…. While at some levels FCA appears to be conceptually straightforward, it is not aneasy technique to develop and use in practice. In particular, FCA requires substantial amounts of physical data about the object of the exercise and requires extensive modelling of complex real-world relationships. The data required for FCA is usually only available in organisations that are at the forefront in responding to the environmental agenda' (Bebbington, Gray, Hibbitt and Kirk, 2001). The main problem is deciding how to convert the physical measurements of environmental impacts into money measures.

Making use of FCA

Full-cost analysis might show the entire cost of a product or an activity, including its social and environmental impacts (or '**externalities**'). However, it might have benefits for strategic planning in companies where it might be expected that in future companies might be required to pay for its 'externalities', so that the 'externalities' become internal costs.

For example, companies might in the future be required to pay for their impact on the environment by:

- paying a carbon tax for their carbon emissions;
- having to take back products from customers at the end of their useful life, for recycling or disposing of the materials; and
- having to comply with stricter environmental standards.

Companies that are aware of the full costs incurred by their products should be in a better position than other companies to plan reductions in those costs, by acting now to reduce carbon emissions, improve environmental standards and so on.

2.8 Sustainability reporting: concluding remarks

For various reasons, companies are increasingly producing sustainability reports in one form or another. The reasons that seem to be persuading companies to report on sustainability include competition, risk management, emerging markets, corporate reputation and, in some countries, mandatory minimum reporting requirements.

However, there is (as yet) no universal agreement about the meaning of sustainability, which acts as a restraint on the development of suitable reporting.

3 ENVIRONMENTAL MANAGEMENT SYSTEMS, ENVIRONMENTAL MANAGEMENT ACCOUNTING AND ENVIRONMENTAL AUDIT

Section overview
■ Environmental management systems: ISO 14000 and EMAS ■ Environmental management accounting (EMA) ■ EMA techniques ■ Social and environmental reporting ■ Environmental reporting in practice ■ Social and environmental audit ('environmental audit')

3.1 Environmental management systems: ISO 14000 and EMAS

An environmental management system is a broad term for any system used by an entity to monitor and manage the impact that its products and operations have on the environment. The aims of an environmental management system might be to:

- minimise the negative impact of operations on the environment (damage to air, water or land);
- comply with environmental laws and regulations; and
- make continual improvements in either or both of the above areas.

An environmental management system includes an environmental information system. Information is needed to:

- monitor compliance with environmental laws and regulations; and/or
- monitor the implementation of the company's own environmental policies.

An information system may provide, for example, information about physical quantities of emissions of waste or toxic materials, resources in the environment, the environmental characteristics of the company's products or services, information about environmental 'incidents' such as spillages of waste or toxic materials.

Guidance for companies in the structuring and operating of an environment management system is provided by a number of international institutions.

ISO 14000

The International Standards Organisation (ISO) has issued a series of standards on environmental management systems, known as the ISO 14000 series of standards. They are standards that specify a process for managing, controlling and improving an entity's environmental performance.

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They specify an environmental management system, provide guidance for using the system and explain how a company's environmental management system can be audited and receive an ISO 14000 certification.

ISO 14001, one of the standards in the 14000 series, provides general guidance on:

- the general requirements for an environmental management system;
- environmental policy: an entity must have an environmental policy in existence, as a condition of meeting ISO 14000 requirements;
- planning: an entity should declare its main environmental objectives, which should be primary areas of planning the company's environmental programme and improvement process ;
- implementation and operation: a system must establish procedures, work instructions and controls to ensure that the environmental policy is implemented and the planning targets are achieved;
- checking and corrective/control actions; and
- management review: there should be a regular review of the environmental management system to ensure that it is suitable (for the entity and its objectives) and effective in operation.

The standard can be applied by any company in any industry, anywhere in the world. Companies wishing to obtain ISO 14000certification will be audited against the requirements of this standard. Having obtained the certificate, companies will be subject to regular audits to ensure that they are maintaining compliance with the requirements of ISO 14000.

Another standard in the series, ISO 14004, provides more detailed guidance, including guidance on how to take a structured approach to setting environmental targets and objectives and establishing and implementing a system for monitoring and control.

Companies that apply ISO 14000 and obtain ISO 14000 certification will therefore have a management system for:

- identifying the aspects of its business that have an impact on the environment;
- monitoring changes in legislation and regulation on environmental issues;
- producing objectives/targets for improvement;
- planning to achieve these improvements; and
- conducting regular reviews for continual improvement.

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ISO 14000 does not specify targets for achievement or standards of environmental performance. It provides guidance on a management system for the management of environmental issues.

The benefits of obtaining an ISO 14000 certificate

Companies must be 'audited' by an independent external expert before they are awarded an ISO 14000 certificate. Having obtained a certificate, they are therefore able to provide an assurance that the company has an active concern for environmental issues to:

- employees; and
- individuals and groups outside the company, such as the government, the public, customers and investors/shareholders.

Certification also allows companies to make validated claims about the environmental effect ('environmental-friendliness') of their products.

EMAS

EMAS is the Eco-Management and Audit Scheme. It is a scheme operated by the European Union which recognises companies that are continually improving their environmental performance. Organisations registered with EMAS comply with law, run an environment management system and publish environmental statements which are independently-verified.

EMAS is very similar in concept to ISO 14000.

3.2 Environmental management accounting (EMA)

Management accounting is concerned with the provision of information to management, to help management make decisions. Environmental management accounting has the same purpose, but it identifies environmental costs and benefits, which might be measured in either physical or monetary terms.

Environmental management accounting (EMA) provides information that supports the operation of an environmental management system. It provides managers with financial and non-financial information to support their environmental management decision-making. EMA complements other 'conventional' management accounting methods, and does not replace them.

The main applications of EMA are for:

- estimating annual environmental costs (for example, costs of waste control);
- budgeting and setting targets for improvements in environmental performance;
- product pricing;
- investment appraisal (for example, estimating clean-up costs at the end of a project life and assessing the environmental costs of a project);

- identifying opportunities for cost savings; and
- estimating savings from environmental projects.

Although environmental management accounting information is intended for use mainly by management, it is also included in reports that the entity publishes externally, such as sustainability reports/environment reports.

Example: EMA

Environmental management accounting can be used to identify opportunities for cost savings.

An example might be the assessment of a proposal to replace the use of toxic materials with a non-toxic alternative material that has a higher purchase cost from the supplier.

An analysis of environmental costs might show that the company would benefit from a switch to non-toxic materials in the form of:

removing the cost of having to make reports to the regulatory authorities on toxic materials, and

a reduction in materials handling costs.

The benefits might exceed the higher costs of the non-toxic materials.

Environmental management accounting is also used in the assessment of using recycled materials and making constructive use of 'waste' materials.

A framework for environmental management accounting

Burritt et al (2001) suggested a framework for EMA based on providing information to management:

- that is gathered from internal or external sources;
- as monetary or physical measurements: physical measures of energy consumption, pollution and so on can be converted into a monetary measure;
- as historical or forward-looking information;
- where the focus is short-term or longer-term; and
- that consists of routine reports or ad hoc information.

Four of these elements of EMA are shown in the following table.

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Environmental management accounting (EMA)					
		Monetary EMA		**Physical EMA**	
		Short-term focus	**Long-term focus**	**Short-term focus**	**Long-term focus**
Historical orientation	Routine reporting	Environmental cost accounting	Analysis of environmentally-induced capital expenditures	Material and energy flow accounting	Accounting for environmental capital impacts
	Ad hoc (one-off) information	Historical assessment of environmental decisions	Environmental life cycle costing, environmental target costing	Historical assessment of short-term environmental impacts, e.g. of a site or product	Post-investment assessment of environmental impacts of capital expenditures
Future orientation	Routine reporting	Environmental operational budgets and capital budgets (monetary reporting)	Environmental long-term financial planning		Environmental long-term physical planning
	Ad hoc (one-off) information	Relevant environmental costing (e.g. special orders)	Environmental life cycle budgeting and target costing	Assessment of environmental impacts	Physical environmental investment appraisal. Specific project life cycle analysis

3.3 EMA techniques

Environmental management accounting techniques include:

- re-defining costs;
- input-output analysis;
- environmental activity-based accounting; and
- environmental life cycle costing.

Re-defining costs

The US Environmental Protection Agency (1998) suggested terminology for environmental costing that distinguishes between:

- conventional costs: these are environmental costs of materials and energy that have environmental relevance and that can be 'captured' in costing systems;

- potentially hidden costs: these are environmental costs that might get lost within the general heading of ‘overheads’;
- contingent costs: these are costs that might be incurred at a future date, such as clean-up costs; and
- image and relationship costs: these are costs associated with promoting an environmental image, such as the cost of producing environmental reports. There are also costs of behaving in an environmentally irresponsible way, such as the costs of lost sales as a result of causing a major environmental disaster.

In traditional management accounting systems, environmental costs (and benefits) are often hidden. EMA attempts to identify these costs and bring them to the attention of management.

Input-output analysis

Input-output analysis is a method of analysing what goes into a process and what comes out. It is based on the concept that what goes into a process must come out or be stored. Any difference is residual, which is regarded as waste.

Inputs and outputs are measured initially in physical quantities, including quantities of energy and water. They are then given a monetary value.

Inputs	Outputs
Inputs 100%	Output product: 60%
	Scrap sold for re-cycling: 20%
	Disposed of as waste: 15%
	Unaccounted for: 5%

Environmental activity-based accounting

Environmental activity-based accounting is the application of environmental costs to activity-based accounting. A distinction is made between:

- environmental-related costs: these are costs that are attributable to cost centres involved in environmental-related activities, such as an incinerator or a waste recycling plant; and
- environmental-driven costs: these are overhead costs resulting from environment-related factors, such as higher costs of labour or depreciation.

The cost drivers for environment-related costs may be:

- the volume of emissions or waste;
- the toxicity of emissions or waste;
- ‘environmental impact added’ (units multiplied by environmental impact per unit); and
- the volume of emissions or waste treated.

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Environmental life cycle costing

Life cycle costing is a method of costing that looks at the costs of a product over its entire life cycle. Life cycle costing can help a company to establish how costs are likely to change as a product goes through the stages of its life (introduction, growth, maturity, decline and withdrawal from the market). This analysis of costs should include environmental costs.

Xerox provides a good example of the environmental aspect of life cycle costing. Xerox manufactures photocopiers, which it leases rather than sells. At the end of a lease period, the photocopiers are returned from the customer to Xerox. At one time, photocopiers were delivered to customers in packaging that could not be re-used for sending the machines back at the end of the lease period. Customers disposed of the old packaging and had to provide their own new packaging to return the machines to Xerox. Xerox then disposed of this packaging. The company therefore incurred two costs: the cost of packaging to deliver machines and the cost of disposal of the packaging for returned machines.

By looking at the costs of photocopiers over their full life cycle, Xerox found that money could be saved by manufacturing standard re-usable packaging. The same packaging could be used to deliver and return machines, and could also be re-used. At the same time, the company created benefits for the environment by reducing disposals of packaging materials.

3.4 Social and environmental reporting

Reporting on social and environmental issues is a major feature of corporate social responsibility reporting (CSR reporting). Some companies publish social and environment reports, often called sustainability reports, as a separate document each year. It is usually published at the same time as the annual report and accounts, but as a separate booklet.

These reports are entirely voluntary (although in the EU companies are now required to include some social and environmental information in their annual business review). Companies can therefore choose what to put in and what to leave out.

This, for example, is where companies that use triple bottom line reporting might publish their triple bottom line results.

There could be several reasons why a company chooses to publish a social and environmental report:

i. The board of directors and senior management might have a genuine ethical wish to achieve a sustainable business, and consider that reporting on social and environmental issues is extremely important. For example, a company with an ISO 14000 certificate should want to provide information about its achievements;

ii. The company might want to publicise its ‘green credentials’ to investors. This is particularly important as institutional investors expect to see information about a company’s social and environmental policies and achievements; and

iii. There could be some element of competition. A company might see a competitive advantage in explaining its social and environmental achievements to customers, for comparison with rival companies.

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3.5 Environmental reporting in practice

Inputs and outputs, direct and indirect reporting

The environmental footprint is normally considered for environmental reporting as the environmental consequences of an organisations inputs and outputs.

Inputs include the measurement of key environmental resources such as energy, water, inventories and land use.

Outputs include the efficiency of internal processes and impact of outputs, for example the proportion of product recyclability, tonnes of carbon or other gases produced, waste or pollution.

These inputs and outputs can be considered both directly and indirectly:

- Direct environmental accounting measures only that within the reporting entity; and
- Indirect environmental accounting also reports on the forward and backward supply chains which the company incurs in bringing the products to market – i.e. externalities.

So for example a furniture maker could discuss the volume of waste and carbon emissions produced by its factory (direct). However, it could extend the analysis to include the footprint of the forestry harvesting and retail and distribution components of its supply chain (indirect).

In practice most organisations restrict their reporting to the direct environmental consequences as it is so difficult to measure environmental impacts outside the reporting company.

What is environmental reporting?

Environmental reporting is now widely accepted as being the production of narrative and numerical information on an organisation's environmental footprint for the accounting period under review.

The narrative is used to convey objectives, explanations, aspirations, reasons for success or failure against targets and addressing specific stakeholder concerns.

Numerical information is used to convey messages in areas that can be tangibly measured, such as pollution amounts (tonnes or cubic metres), resources consumed (tonnes, litres, kWh) or land use (square metres or hectares).

Mandatory (statute) or voluntary

In most countries environmental reporting remains entirely voluntary in terms of statute or listing rules. In practice most large companies adopt some kind of environmental reporting driven by reputational and political motivations. Note that references to the environment and sustainability have existed in annual reports for many years but its reporting has become much more formal in recent years.

A number of voluntary reporting frameworks exist, the most common of these being the Global Reporting Initiative (GRI) as discussed above.

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Reporting media

Companies typically embed a 'social and environmental' section into their annual report. Some companies even commission the production of a stand-alone report dedicated to environmental, and sometimes, social issues. These can be expensive to produce, particularly if an audit firm is employed to provide some kind of assurance report.

Terminology used in describing environmental report is normally linked to the company's marketing and public relations efforts, for example:

- Citizenship report (Barclays bank);
- Corporate responsibility report (GlaxoSmithKline);
- Sustainability and corporate responsibility report (Ericsson); and
- Sustainable business (Vodafone)

Advantages of environmental reporting

A number of advantages can be enjoyed by companies who embrace environmental reporting such as:

- Reporting companies can discharge their accountabilities to society and future generations;
- Strengthens accountability to shareholders and reduces the agency gap between directors and shareholders through wider information disclosure;
- Companies can respond to certain issues that may threaten the perception of their ethics and/or competence (for example oil companies)
- Shareholders are better able to manage their exposure to environmental risk and make more informed decisions ; and
- Companies use the process and output of environmental reporting as a lever to improve internal efficiencies of operations. Subsequent technical advancements can help save costs, increase operational efficiency and reduce waste.

3.6 Social and environmental audit ('environmental audit')

What is a social and environmental audit?

The social and environmental accounting 'movement' began in the 1980's when it was first coherently argued that there was a moral case for businesses, in addition to reporting on their use of shareholders' funds, to account for their impact on social and natural environments. Accounting instruments have existed for many years for reporting financial performance but none existed for accounting for social and environmental footprints. This provided the platform for the recent growth in social and environmental reporting and audit.

A social and environmental audit, or simply an environmental audit, can have several meanings.

It can mean a formal audit of an environmental management system, to check that the system operates effectively. Companies with an ISO 14000 certificate are required to have an audit each year of their system, undertaken by an independent external expert.

It could be an internal check of a particular aspect of the company's environment management system, such as its system for measuring the environmental costs of waste, or the methods used to measure the cost of site contamination at a

particular manufacturing site. This audit might be carried out by members of the company's own internal audit team (who might be an environmental expert rather than an accountant).

There may be a check on the company's compliance with environmental and social legislation and regulations.

It could involve a verification of social and environmental information that will be included in a published report, such as an environmental performance report.

Similarly it might be a check on the accuracy of figures supplied by the company to the government authorities responsible for environment regulation.

It could also refer to the checks that the company's external auditors need to carry out on the company's financial statements, insofar as they relate to environmental issues. For example the introduction of new environmental laws might have an impact on the impairment of non-current assets, and a failure by the company to carry out environmental improvements required by law might create a requirement to make an accrual for remedial costs or a provision for the payment of a fine.

Environmental audits are performed at the discretion of the company's management and can be performed by internal or external experts. The use of independent external auditors will add more credibility to the report than would be added by internal auditors. However, the value of such audits continues to be disputed due to the lack of mandatory standards.

Engagement characteristics

An environmental audit will result in the production of an assurance report that enhances the credibility (or not!) of the subject matter on which the auditor is reporting. The engagement will typically contain three elements:

- Agreed metrics (i.e. what should be measured and how) – typically emissions (e.g. pollution, waste and greenhouse gases) and consumption (e.g. energy, water and non-renewable feedstock);
- Performance measured against those metrics; and
- Reporting on the levels of compliance or variance.

The challenge lies in deciding what to measure and how to measure it. In the absence of mandatory regulatory requirements the company is free to design any metrics it wishes the auditor to review.

There are not yet any formal audit standards that specifically govern the audit of social and environmental reports. However, some guidance is provided by standards covering reviews and assurance engagements other than the audit of historical financial information.

How can environmental audits contribute to environmental accounting?

At the moment there is no legal requirement in any country for environmental audits. This type of audit is voluntary.

Similarly there is no legal requirement for environmental accounting, although professional accounting bodies are encouraging more research by academics and practice by companies.

It seems quite possible however, that environmental audits and environmental accounting will both become more common, as companies become increasingly aware of the problems of sustainability and sustainable growth.

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The development of environmental accounting and environmental auditing will depend to a large extent on the development of environmental management systems, and how soon more companies establish environmental management systems. When environmental management systems are established:

- management needs reliable environmental information;
- in general, managers prefer information in a quantified/measured form rather than in qualitative and descriptive terms; and
- as environmental management systems develop, with measurement systems for setting targets and monitoring performance, it seems likely that the need for audits of the information system will be necessary, to reassure management that the information systems are sound.

The link between environmental audits and environmental reporting

Environmental audits are becoming more important because investors are increasingly interested in the environmental footprint of a company as well as its economic performance.

There is a growing opinion amongst investors that environmental issues are a potential source of risk to a company's business and reputation, and environmental issues must therefore be managed.

There may also be increasing numbers of 'ethical' investors, who prefer to invest in companies with strategies for sustainable development.

Consumers may gradually be moving towards a preference for purchasing 'environment-friendly' products rather than cheaper alternatives. This means that companies should possibly be developing strategies that position themselves as 'environmentally friendly' businesses within the industry or market.

Since there is growing interest in environmental issues, there is a growing demand for environmental reports from companies. Companies are better able to produce environmental reports if they carry out regular environmental audits.

However, there still seems a long way to go before social and environmental reporting rivals financial reporting (economic reporting) as the main method of reporting by companies.

The elements of an environmental audit

An environmental audit typically has three elements:

- Metrics. These are agreed aspects of performance that are measured (quantified). For example, there may be an agreed metric for measuring emissions into the atmosphere, or for pollution of rivers;
- Setting targets for achievement and measuring actual performance. Performance should be measured in terms of the agreed metrics; and
- Reporting on achievement of targets or variances/non-compliance with targets, with reasons for any non-compliance.

In practice the metrics used in an environmental audit tend to be context-specific and somewhat contested. Typical measures, however, include measures of emissions (e.g. pollution, waste and greenhouse gases) and consumption (e.g. of energy, water, non-renewable feedstock). Together, these comprise the organisation's environmental footprint.

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One of the assumptions of environmental management is that the reduction of footprint is desirable, or possibly of ‘unit footprint’: the footprint attributable to each unit of output.

A point to note is the trend towards quantitative measurements in environmental audits.

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4 CHAPTER REVIEW

Chapter review

To conclude the study of this chapter check that you can:

- Explain the concept of social and environmental footprints
- Identify and assess in a given scenario issues of ethics and corporate social responsibility
- Define triple bottom line reporting
- Discuss approaches to environmental management systems, management accounting and audit

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Skills Level

Corporate Strategic Management and Ethics

CHAPTER 21

Soft skills for accountants

Contents

21.0 Introduction to soft skills
21.1 Leadership
21.3 Emotional intelligence
21.4 Social thinking
21.5 Creative thinking
21.6 Service orientation
21.7 Cognitive flexibility
21.8 Negotiation
21.9 Chapter review

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INTRODUCTION

Detailed syllabus

	Introduction	
D	**Governance**	
D14	Discuss the following soft skills relevant to accountants:	
	D14 (a)	Leadership
	D14 (b)	Emotional Intelligence
	D14 (c)	Social thinking
	D14 (d)	Creative thinking
	D14 (e)	Service orientation
	D14 (f)	Cognitive flexibility
	D14 (g)	Negotiation

Exam context

This chapter addresses soft skills as important tools to chartered accountants in their day-to-day operations. In this chapter you will be introduced to the concept of soft skills. We shall also make a distinction between soft skills and hard skills.

The chapter also includes a detailed discussion of some soft skills relevant to the accountant.

By the end of this chapter students will be able to:

- Define soft skills and differentiate between hard skills and soft skills;
- Discuss the importance of soft skills; and
- Discuss the following soft skills with relevance to accountants:
  - Leadership;
  - Emotional Intelligence;
  - Social thinking;
  - Creative thinking;
  - Service orientation;
  - Cognitive flexibility;
  - Negotiation.

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21.0 INTRODUCTION

Section overview
■ Definition of soft skills
■ Soft skills vs hard skills
■ Importance of soft skills to the accountant
■ Learning soft skills

21.0 Introduction to soft skills

The term 'soft skills' was first introduced into management and leadership lexicon by the US Army in the late 1960s. The term was initially used to refer to those skills that did not require use of machinery. They were identified to include interpersonal skills required to provide leadership and motivation to men of the force to accomplish their objectives.

P.G. Whitmore, citing CON Reg 350-100-1 defined soft skills as

"important job-related skills that involve little or no interaction with machines and whose application on the job is quite generalised."

This definition is not clear, nor identified the skills referred to. Hence, the term remained hazy.

To explain the term 'Soft skills', it can be taken as a composite of 'soft' and 'skills'.

Skills can be defined as a set of capabilities, competences and abilities that can be deployed to achieve clearly defined objectives. They can also refer to a person's ability to perform certain tasks or the knowledge required to perform those tasks.

Soft " on the other hand, concerns the non-technical skills, abilities, traits that workers need to function in a specific employment environment.

Therefore, soft skills relate to those skills not directly related to the core (hard) skills required to discharge a responsibility or a function. For example, the core skills of an engineer will include quantitative skills, those of an architect will include appreciation and manipulation of space, while accountants will require the core ability to generate and interpret financial information.

According to Lecis, Fournet, Cottin, Buirel and Clobanu (n.d), Soft skills have the following characteristics:

(a) They include interpersonal qualities and personal attributes;

(b) They are rather transversal [Robles, 2012] and are generally not job-specific;

(c) They are traditionally not formally taught in the standard education curricula [Graham, 2015].

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Al Duncan gave a practical definition of soft skills as:

> Personal abilities that improve human performance and facilitate effective interaction amongst people. They may also be seen as personal abilities that help one perform better and interact with other people.

Marcel M. Robles grouped soft skills into three broad categories of:

(a) People skills

(b) Social skills

(c) Career attributes

They include:

(a) Leadership style

(b) Communication skills

(c) Social skills

(d) Personality traits

(e) Cognitive skill

(f) Empathy

(g) Teamwork

(h) Time management.

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21.0.1 Hard skills, also referred to as core or knowledge and technical skills, are job-specific, relevant to each position and seniority level. For example, an entry-level accountant needs to know how to prepare the books of accounts, prepare and interpret ratios, and report to management. For a higher-level accountant, the core skills will be different as he/she will be required to exercise professional judgment, rather than keeping books. The senior accountant will be expected to finalise the financial statements, prepare budgets and present memoranda to the board to evaluate various options. Also, the core skills for a marketer in the same organisation are different. They may include ability to conduct market surveys, organise sales promotions and establish consumer brand preferences.

21.0.2 Soft skills are general characteristics involving personality traits, habits and interpersonal relationships. They are personal attributes that enhance an individual's interactions, career prospects and job performance. Soft skills can also be described as a combination of interpersonal people skills, social skills, communication skills, character traits, attitudes, career attributes and emotional intelligence among others. Their use in organisations is more pervasive. Virtually all departments and cadres of an organisation require people to deploy soft skills for the smooth-running of the organisation. Though most soft skills are applicable to all units and levels of an organisation, some of them are more important to higher levels in the hierarchy of the organisation.

Example 1: Hard skills for an entry-level accountant in Finance Department

An advertisement for an entry-level accountant in the finance department of an organisation may specify the following hard skills:

Ability to

- Effectively use of accounting packages;
- Maintain electronic cashbook;
- Prepare bank reconciliation statements;
- Extract trial balances from ledgers;
- Maintain debtors' ledger; and
- Maintain inventory records.

Example 2: Hard skills for an entry-level accountant in Costing Department

An advertisement for an entry-level accountant in the costing department of an organisation may specify the following hard skills:

Ability to

- Compile product costs;
- Prepare variances for various elements of cost;
- Identify and explain causes of variances;
- Prepare contribution statements for each product; and
- Breakeven analyses for products.

Though these two positions are at entry level in the same organisation, their hard skills requirements are different as their job specifications are different. Hard skills are job specific.

Example 3: Hard skills for a senior-level accountant in Finance Department

An advertisement for a senior-level accountant in the finance department of an organisation may specify the following hard skills:

Ability to

- Analyse, interpret and evaluate financial information and disclosures;
- Prepare and analyse financial statements to show position, performance, prospect and risks of business;
- Select, assess and present suitable accounting policies; and
- Display understanding of current issues in the reporting framework and corporate reporting.

Though the senior accountant and the entry-level accountant are in the same department, because of the difference in their levels, their hard shills are radically different.

Example 4 Soft skills for an entry-level accountant in Finance Department An advertisement for an entry-level accountant in the finance department of an organisation may specify the following soft skills: • Integrity; • Self-motivation • Hard-work; • Service orientation; • Time management; and • Eye for detail.

Example 5: Soft skills for a senior-level accountant in Finance Department An advertisement for a senior-level accountant in the finance department of an organisation may specify the following soft skills: • Integrity; • Leadership • Self-motivation • Emotional intelligence • Strategic thinking • Service orientation; • Time management; and • Eye for detail.

The overlap in the soft skills for entry-level and senior accountants indicate that soft skills are not job specific, but tend to be universal in nature.

21.0.4 Learning soft skills

Research by Stanford Research Institute and Carnegie Mellon Foundation amongst Chief Executive Officers of Fortune 500 established that 75% of long-term job success depends on possession of soft skills while only 25% depends on possession of technical or core skills.

Hard skills are more amenable to quantitative measurement, hence, can easily be identified and developed or acquired in classroom environment or on-the-job training.

However, because soft skills relate more to personality trait, habits and behavioural patterns, they are more difficult to measure and cultivate in individuals. Soft skills are related with insights, emotions, feelings, gut-instinct and an inner knowing. Because of this they are not taught passively as in the way of "hard skills". Hence soft skills are associated with Emotional Quotient (EQ) and Emotional Intelligence (EI) rather than with Intelligence Quotient (IQ).

Recent OECD studies have revealed that soft skills can be effectively measured within cultural and linguistic boundaries. Methods adopted combine self-reported personality traits, behavioural surveys and objective psychological assessment. The results can be further improved by collecting data from multiple sources across learning contexts such as school environment, family context and the wider community, and triangulating the data (OECD, 2015)

The OECD 'Future of Education and Skills 2030' report brought to the fore the growing importance of soft skills in education and career success. These are attributable to globalisation, technology disruptions and artificial intelligence, which require new skills set for optimal performance in the workplace of the future. (OECD, 2019).

Soft skills could be acquired or developed through:

(a) Role playing (DeKorver, Choi and Town, 2017); and

(b) Project-based learning (Lee and Tsai, 2004)

Heckman and Kautz (2012) stated that soft skills should be inculcated in young children to maximise their benefits in them in the long term. They also discovered that personality traits in these children can be changed for beneficial outcomes.

21.0.5 Importance of soft skills

Soft skills have been identified as the most critical skills in the current global job market, especially in a fast-moving era of technology disruptions. Therefore, the reorientation of education, which is one thrust of education for sustainability, also relates to the importance of these soft skills.

(a) Many employers of labour have recently discovered that soft skills are equally as important, if not more important, in the successful discharge of some responsibilities, especially at the pinnacle of the organisation. Today's employers in the global market need employees who are reliable, responsible problem-solvers with good social skills who have the ability to work on a team so they seek graduates with soft skills obtained during study and work experience rather than degree-specific knowledge and often opt to hire graduates from any discipline. Therefore, the skills most demanded by today's employers are soft skills, such as the ability to work with others, to communicate effectively, to demonstrate initiative and self-direction, to solve problems, and to demonstrate positive work ethics. Soft skills are very important as they help job holders to:

(b) Handle interpersonal relations;

(c) Take appropriate decisions;

(d) Communicate effectively; and

(e) Have good impression and impact to gain professional development.

(f) According to Cinda Daly (2018), soft skills result in the following organisational benefits:

(g) Stronger customer relationships

(h) More cohesive and creative teams

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(i) Greater organisational productivity and effectiveness

(j) More engaged and motivated employees

(k) Deeper commitment to shared goals

(l) At the World Economic Forum 2018, a report, *Future of Jobs 2018*, was produced to identify the trends in skills requirements over several industries and jurisdictions. The report also identified the drivers of these trends in changes in required skills sets. Below are tables showing the current skills requirements, those that will be relevant and those that would have become irrelevant by 2022. Many soft skills are amongst those that will be in high demand from 2022 and beyond.

Table : Examples of stable, new and redundant roles, all industries

Stable Roles	New Roles	Redundant Roles
Managing Directors and Chief Executives General and Operations Managers* Software and Applications Developers and Analysts* Data Analysts and Scientists* Sales and Marketing Professionals* Sales Representatives, Wholesale and Manufacturing, Technical and Scientific Products Human Resources Specialists Financial and Investment Advisers Database and Network Professionals Supply Chain and Logistics Specialists Risk Management Specialists Information Security Analysts* Management and Organization Analysts Electrotechnology Engineers Organizational Development Specialists* Chemical Processing Plant Operators University and Higher Education	Data Analysts and Scientists* AI and Machine Learning Specialists General and Operations Managers* Big Data Specialists Digital Transformation Specialists Sales and Marketing Professionals* New Technology Specialists Organizational Development Specialists* Software and Applications Developers and Analysts* Information Technology Services Process Automation Specialists Innovation Professionals Information Security Analysts* Ecommerce and Social Media Specialists User Experience and Human-Machine Interaction Designers Training and	Data Entry Clerks Accounting, Bookkeeping and Payroll Clerks Administrative and Executive Secretaries Assembly and Factory Workers Client Information and Customer Service Workers* Business Services and Administration Managers Accountants and Auditors Material-Recording and Stock-Keeping Clerks General and Operations Managers* Postal Service Clerks Financial Analysts Cashiers and Ticket Clerks Mechanics and Machinery Repairers Telemarketers Electronics and Telecommunications Installers and Repairers Bank Tellers and Related Clerks Car, Van and

Stable Roles	New Roles	Redundant Roles
Teachers Compliance Officers Energy and Petroleum Engineers Robotics Specialists and Engineers Petroleum and Natural Gas Refining Plant Operators	Development Specialists Robotics Specialists and Engineers People and Culture Specialists Client Information and Customer Service Workers* Service and Solutions Designers Digital Marketing and Strategy Specialists	Motorcycle Drivers Sales and Purchasing Agents and Brokers Door-To-Door Sales Workers, News and Street Vendors, and Related Workers Statistical, Finance and Insurance Clerks Lawyers

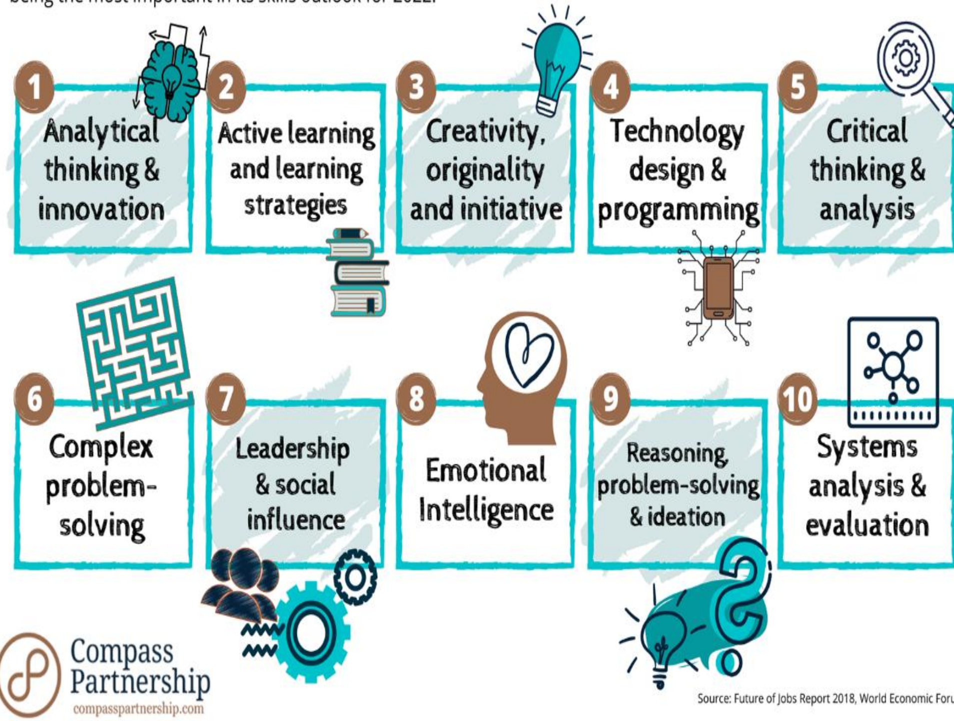
Source: Future of Jobs Survey 2018, World Economic Forum.

Table 4: Comparing skills demand, 2018 vs. 2022, top ten

Today, 2018	Trending, 2022	Declining, 2022
Analytical thinking and innovation Complex problem-solving Critical thinking and analysis Active learning and learning strategies Creativity, originality and initiative Attention to detail, trustworthiness Emotional intelligence Reasoning, problem-solving and ideation Leadership and social influence Coordination and time management	Analytical thinking and innovation Active learning and learning strategies Creativity, originality and initiative Technology design and programming Critical thinking and analysis Complex problem solving Leadership and social influence Emotional intelligence Reasoning, problem-solving and ideation Systems analysis and evaluation	Manual dexterity, endurance and precision Memory, verbal, auditory and spatial abilities Management of financial, material resources Technology installation and maintenance Reading, writing, math and active listening Management of personnel Quality control and safety awareness Coordination and time management Visual, auditory and speech abilities Technology use, monitoring and control

Source: Future of Jobs Survey 2018, World Economic Forum.

Graphical representation of the skills outlook 2022



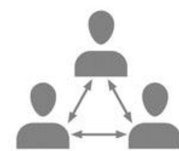
The Top 10 Soft Skills

Communication

Self-motivation

Leadership

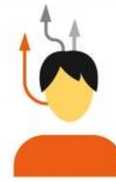
Responsibility


Teamwork

Problem solving

Decisiveness

Ability to Work Under Pressure and Time Management


Flexibility

Negotiation and Conflict Resolution

21.0.6 Comparison between hard and soft skills

To enhance the understanding of soft and hard skills, we compare them in the table below.

Hard skills	Soft skills
Technical or professional skills. Usually, tangible.	Consist of personal traits, self-perception interpersonal skills. Often intangible.
Can be easily defined and measured	Not easily defined or measured
Can be quantitatively measured	Measurement is qualitative
Can be acquired through education and on-the-job training	Mainly innate. Learned through life-long professional and personal experience
Usually, job and industry specific in application	Not limited to job or industry in application
Enable one to perform specific tasks well	Enable self-perception and enhance relationship with others
Once acquired, last a career. Needs to be developed due to new developments	Need reinforcement and renewal all life-long or career-long
Required more at the lower and middle levels of organisational structure	Required more at the top hierarchy of the organisation

For excellent performance in given roles, a good blend of soft and hard skills is required.

21.0.7 Examples of Soft skills

The following are some examples of soft skills. Students should please note that this list is not exhaustive and a more detailed study of some of them is in subsequent sections of this chapter, as they relate to the work of an accountant:

(i) Leadership;
(ii) Emotional intelligence;
(iii) Social thinking;
(iv) Communication;
(v) Cognitive flexibility;
(vi) Adaptability;
(vii) Problem-solving;
(viii) Negotiation;
(ix) Service orientation;
(x) Listening;
(xi) Strong work ethic;
(xii) Decision making;

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(xiii) Strategic thinking;
(xiv) Collaboration;
(xv) Time management;
(xvi) Self-motivation;
(xvii) Multitasking;
(xviii) Conflict resolution;
(xix) Responsibility;
(xx) Organisation;
(xxi) Ability to handle pressure;
(xxii) Competitive;
(xxiii) Entrepreneurial;
(xxiv) Integrity;
(xxv) Hands-on;
(xxvi) Innovation;
(xxvii) Consistency;
(xxviii) Creative;
(xxix) Enthusiastic; and
(xxx) Attention to detail.

21.1 Leadership

21.1.1 Introduction

Leadership is a process by which a person influences others to accomplish an objective and directs the organisation in a way that makes it more cohesive, coherent, effective and efficient. The study of leadership is as old as human civilisation. History is replete with various concepts and principles of leadership, some of which have evolved over centuries. Organisations are established to achieve objectives. These objectives vary from organisation to organisation. Below are examples of objectives of organisations:

a. Business organisations

i. Manufacturing concern: To produce and sell goods;
ii. Retail outfit: To buy and sell products at a profit;
iii. Financial institution: To provide financial intermediation for a margin; and
iv. Insurance companies: To assume risks from third parties for a premium.

b. Not-for-profit organisations

i. Government agency: To provide a service to the society or government;
ii. Hospital: To provide healthcare services;
iii. Military formation: To attain military objectives;
iv. Political party: To seek power; and
v. Non-governmental organisations: To meet specific objectives of the founders.

From this list, it is obvious that different organisations are set up for different purposes or objective. Irrespective of the objective of an organisation, its promoters will provide resources to enable it to attain its set goals.

Organisations are usually run by managers and leaders to efficiently and effectively utilise the available resources to attain organisational objectives.

The concepts of leadership and management vary with organisations. However, we shall concentrate mainly on leadership in a business environment.

As pervasive and historical as the idea of leadership is, the concept and definition of leadership is only crystallising in recent times.

Leading writers on business management have contributed various definitions of leadership, some of these are:

Peter Drucker:

"The only definition of a leader is someone who has followers."

This definition is brief, but gives very little insight into leadership as it just uses the complement to define the concept. It gives no insight as to the elements or process of leadership.

Warren Bennis:

"Leadership is the capacity to translate vision into reality."

This definition captures the purpose of leadership, but gives no insight into its components or process.

Bill Gates:

"As we look ahead into the next century, leaders will be those who empower others."

This definition indicates an element of leadership, which is empowerment, but did not state the objective of the empowerment. It also left out other elements and process of leadership.

John Maxwell:

"Leadership is influence - nothing more, nothing less."

This definition stated the essence of leadership, but did not indicate the purpose of the influence, nor its process.

Dwight D. Eisenhower:

"*Leadership is the art of getting someone else to do something you want done because he wants to do it."*

This definition articulates leadership to:

(a) Be a process (art);
(b) Involve other people;
(c) Be for a purpose; and
(d) Motivate the people towards accomplishing the goal.

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Keith Davis:

"Leadership is the ability to persuade others to seek defined objectives enthusiastically. It is the human factor which binds a group together and motivates it towards goals."

This definition has the following elements:

i. Persuasion – influence;
ii. Defined objectives;
iii. Human factor, including group; and
iv. Motivation towards the goal.

Kevin Kruse:

Leadership is a process of social influence, which maximizes the efforts of others, towards the achievement of a goal.

This definition has the following components:

i. A process;
ii. Employs social influence;
iii. Other people involved
iv. Maximises the efforts of the other people; and
v. A goal.

c. Characteristics of leadership

Characteristics of leadership include:

i. It is an interpersonal process (i.e. interaction of individuals) to accomplish some goals and objectives. Therefore, it is a group process, though championed by the leader. Hence, group dynamics come into play.
ii. It involves influencing people behaviour towards accomplishing the set objectives.
iii. It involves deployment of social skills, including some personality traits of the leader to achieve the set objectives.
iv. It is situational, i.e., there is no best leadership style that is best for every situation. The converse is also true, as more than one style may be effective for the same situation.

d. Leadership factors

According to U. S. Army (1893), there are four major factors in leadership, these are:

i. Leader: A leader must have an understanding of who he is, what he knows and what he can do, so as to be able to convince his followers that he is worthy of being followed;
ii. Followers: A leader needs to have a good understanding of human nature, which includes needs, emotions, and motivations. This will enable the leader to know what motivates his followers and how to lead them;
iii. Communication: A leader is involved in two-way communication, which are mostly non – verbal. The way a leader communicates with his followers will either build or harm the relationship between him and his followers. A leader mostly communicates by example; and
iv. Situation: A leader must be able to determine the best course of action to take under each situation. This is often referred to as situation leadership.

e. Transformational Leadership

Transformational leadership was enunciated by James MacGregor Burns and further developed by Bernard Bass. It highlights visionary thinking and bringing about radical change, instead of usual management processes designed to maintain and incrementally improve current level of performance.

Transformational leadership defines an effective leader as a person who does the following:

i. Envisioning an inspiring picture of the future;
ii. Motivates and inspires people to buy into the vision;
iii. Manages the process of realising the vision;
iv. Coaches and builds a team, to effectively achieve the vision; and
v. Deploys the skills required to implement these processes.

f. Leadership principles

The U. S. Army (1983) gave the following leadership principles:

i. Know yourself and seek self-improvement - In order to know yourself, you have to understand your be, know, and do, attributes. Seeking self-improvement means continually strengthening your attributes. This can be accomplished through self-study, formal classes, reflection, and interacting with others;
ii. Be technically proficient - As a leader, you must know your job and have a solid familiarity with your employees' tasks;
iii. Seek responsibility and take responsibility for your actions - Search for ways to guide your organisation to new heights. And when things go wrong, as they often tend to do sooner or later — do not blame others. Analyse the situation, take corrective action, and move on to the next challenge;
iv. Make sound and timely decisions - Use good problem solving, decision making, and planning tools;
v. Set the example - Be a good role model for your employees. They must not only hear what they are expected to do, but also see. We must become the change we want to see - Mahatma Gandhi;
vi. Know your people and look out for their well-being - Know human nature and the importance of sincerely caring for your workers;
vii. Keep your workers informed - Know how to communicate with not only them, but also seniors and other key people;
viii. Develop a sense of responsibility in your workers - Help to develop good character traits that will help them carry out their professional responsibilities; and
ix. Ensure that tasks are understood, supervised, and accomplished - Communication is the key to this responsibility.

g. The process of great leadership

Kouzes & Posner (1987), identified the following process for great leadership:

i. Challenge the process - First, find a process that you believe needs to be improved the most.
ii. Inspire a shared vision - Next, share your vision in words that can be understood by your followers.
iii. Enable others to act - Give them the tools and methods to solve the problem.
iv. Model the way - When the process gets tough, get your hands dirty. A boss tells others what to do; a leader shows that it can be done.
v. Encourage the heart - Share the glory with your followers' hearts, while keeping the pains within your own.

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The process of transformational leadership involves the following steps:

21.1.2 Envisioning the future

A vision is a clear, concise and beautiful representation of the future of an organisation. It motivates towards its attainment and sets standards against which performance is measured.

To accomplish the set objectives, the leader uses the following tools and techniques to align the organisation's internal resources with the external environment:

a. PESTEL Analysis

i. This analysis concentrates on the external environment of the business comprising the following elements:
ii. Political;
iii. Economical;
iv. Social;
v. Technological
vi. Ecological (Environmental; and
vii. Legal.

b. SWOT Analysis

This analysis involves evaluation of both the internal and external environments of the business:

It evaluates internal resources and competences to identify:

i. Strength; and
ii. Weaknesses.

It assesses the external environment to identify:

i. Opportunities; and
ii. Threats.

c. SOAR analysis

This is similar to SWOT analysis, but varies in its components.

It comprises:

i. Strengths;
ii. Opportunities;
iii. Aspirations; and
iv. Results.

It aims at aligning the internal strengths with the opportunities in the external environment and relating the aspirations with the results obtained.

These analyses are discussed in more detail in other chapters of this Study Text.

d. Core competence analysis

This is a process of identifying and evaluating the core competences in an organisation which gives it competitive advantage over its competitors in the market.

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e. Porter's five forces

The five forces which shape the nature and strength of competition in a market or industry, as identified by Michael Porter are:

i. Threats from potential entrants;
ii. Threats from substitutes;
iii. Suppliers' bargaining power;
iv. Customers' bargaining power; and
v. Competitive rivalry amongst the firms.

f. Porter's Value Chain Analysis

Value is the benefit a consumer derives from a product or service. This framework is for analysing how value can be added to a product or service. It identifies the primary value chain and supporting services for a product. Most value is usually added to the product within the value chain.

g. Unique selling proposition analysis

This is a process of identifying and evaluating the unique qualities of the company's products which give them competitive advantage over the products of the competitors in the marketplace.

These models are discussed in more details in chapter 4 of this study Text.

From the results of these analyses, leaders are able to evaluate:

i. The resources available in the organisation;
ii. The organisation's core competences;
iii. The trends in the external environment; and
iv. The strength of the competition within the market or industry.

h. Innovation

Innovation is a veritable skill employed by leaders to organise their businesses and implement their strategies to succeed in envisaged markets. At this stage, leaders must employ their creative and originality thinking to generate new ideas.

i. Validation

Leaders must evaluate the vision and the related assumptions about the environment and competition using:

a. Risk assessment techniques;
b. Scenario analysis; and
c. Market research techniques

j. Leadership therefore requires inquisitive mind and social skills to create the vision.

After generating the vision, the leader must paint a vivid and motivating picture of it, to inspire other members of the group to aspire to its accomplishment. Inspiring stories must be built around the vision. The vision should also be fully understandable to all members of the group.

21.1.2 Motivating and inspiring people

A fascinating vision forms the basis for motivation towards the accomplishment of organisational purpose. There is a lot of excitement at the commencement of the process, thus, galvanising members towards attainment of the set objectives. However, as time goes on the effect wears off and the commitment to the process begins to wane. This is more so if the process requires significant changes to behaviour within the organisation.

At this stage and at subsequent stages in the process, the leader must find ways to create a link between group members' needs, goals and aspirations with the vision.

The leader stimulates interest in the vision by restating the vision in forms that emphasises the benefits of the vision to the customer. By repackaging the vision and reinforcing it with frequent restatement at every given opportunity, the leader motivates the people towards attainment of the vision.

a. Expectancy theory

The leader may use Victor Vroom's Expectancy Theory to link the personal goals and aspirations of group members with the attainment of the vision. This theory is based on these three premises:

i. Effort-performance relationship: linkage of effort of people with the result attained by the group;

ii. Performance-reward relationship: the expectation of reward for good performance; and

iii. Rewards-personal goals relationship: link of rewards with satisfaction of personal needs.

The reward system will comprise of positive and negative incentives. Incentives are rewards or sanctions for good or poor performance, respectively.

b. Positive incentives

Positive incentives are rewards for good performance and are aimed at encouraging even better performance in future.

These incentives or factors of motivation could be intrinsic or extrinsic.

i. Intrinsic incentives (factors)

Intrinsic incentives (factors) are those that are not necessarily financial, but appeal to the self-esteem needs of the individual. They include:

- Recognition;
- Public appreciation;
- Promotion;
- Status enhancement;
- Job enhancement; and
- Job security.

These forms of incentive are usually more attractive to more senior officers, most of who have met their lower order needs on the Maslow's Needs Hierarchy.

ii. Extrinsic incentives

These are rewards in monetary terms. They enable the recipient to satisfy lower order needs and social needs, such as rent, children school fees, etc.

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They include:

- Wage plans;
- Bonus schemes; and
- Cash awards.

These financial incentives (extrinsic factors) are usually more attractive to relatively junior employees, most of who are yet to satisfy lower order needs (Abraham Maslow's Need Hierarchy).

iii. Negative incentives

These are punitive actions taken to discourage poor performance. They are usually aimed at correcting mistakes. They are also most often applied after positive incentives have failed to motivate towards good performance.

They include:

- Wage deduction;
- Increment denial;
- Promotion denial;
- Demotion; and
- Suspension.

iv. Expert power

Expert power derives from the specialist skills that the leader has, that is not available in anyone else in the organisation. Expert power bestows influence and respect on the leader. It commands attention to the leader, hence, others are willing to listen to and follow the leader. The leader can therefore utilise this power to motivate and inspire the group towards the vision.

v. Other powers

Where the leader has some other powers, such as ability to award bonuses, promote, allocate people to groups and assignments, they command respect and have a lot of influence.

These powers should be sparingly used, if the leader is not to become just another manager, whose powers derive mainly from the hierarchical authority and position.

21.1.3 Anchoring the vision

After the introduction of the vision, the leader needs to ensure that it is established in the culture of the organisation, otherwise, its effects would soon fizzle out and the vision becomes blurred.

To anchor the vision, the leader needs management skills as well as different leadership skills. At this point, the leaders may have to deploy these skills themselves or delegate the driving of the process to a group of dedicated, tested and trusted managers. Along with this responsibility, appropriate authority must be delegated to these managers for effective performance.

Goals with key performance indicators (KPI's) that meet the following criteria should be set for these managers:

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The goals must be

a. Specific;
b. Measurable;
c. Achievable;
d. Realistic; and
e. Time-bound.

Project management skills may also be adopted to implement this phase of the process.

To ensure effective implementation and monitoring of the process, the leaders may adopt change management and management by wandering around (MBWA) techniques.

21.1.4 Building a team to entrench the vision

Transformational leadership is a group activity. Visioning is also a collective activity in an organisation. Hence, to embed the vision in the organisational culture, the process leaders must build teams that will champion the cause of the vision and sustain its continued relevance.

Team building is therefore a prominent responsibility of transformational leaders. To accomplish this, they could adopt

Bruce Tuckman's team building model, comprising the following steps:

a. Forming;
b. Storming;
c. Norming; and
d. Performing.

In discharging this responsibility, leaders must

a. Identify leadership potentials in others;
b. Give and receive prompt feedbacks from others; and
c. Embark on coaching and training of group members to improve individual and group leadership skills.

This will enhance team efficiency, cohesion and loyalty.

Skills for effective leadership

The following skills are essential for effective leadership:

(a) Effective communication;
(b) Proactivity;
(c) Ability to motivate;
(d) Organisation;
(e) Confidence;
(f) Analytical;
(g) Decision-making;
(h) Creativity;
(i) Delegation;
(j) Flexibility;
(k) Honesty;
(l) Negotiation;

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(m) Positivity;
(n) Industry expertise;
(o) Trustworthiness;
(p) Time management;
(q) Problem-solving; and
(r) Feedback.

Personality traits common amongst transformational leaders include:

(a) Integrity;
(b) Effective communication skills;
(c) Managerial competence;
(d) Charisma;
(e) Decisiveness;
(f) Trust in others; and
(g) Loyalty.

Difference between a leader and a manager

Many writers and even organisations use management and leadership as if they are synonyms. This has led to the dearth of definitions for leadership. Many organisations also designate some offices and officers as 'Leaders' without them performing any leadership role.

The table below summarises some differences between management and leadership to highlight the distinction.

Management	**Leadership**
Managers give directions.	Leaders ask questions and paint pictures of the future.
Managers have subordinates.	Leaders have followers.
Managers derive authority form hierarchical positions.	Leaders use influence, not derivable from hierarchical positions.
Managers use an authoritarian style.	Leaders have a motivational style.
Managers tell people what to do.	Leaders show people what to do.
Managers have good ideas.	Leaders implement good ideas.
Managers respond to change.	Leaders create change.
Managers attempt to be great.	Leaders make their followers great.
Managers exercise power over people.	Leaders derive their power from people.
Managers focus more on efficiency.	Leaders focus more on effectiveness.

Adapted from: Mark Suster, One Thing That Great Leaders Understand

Despite these distinctions between a manager and a leader, it must be appreciated that an organisation requires a blend of management and leaders skills to operate optimally. It is for this reason and to enhance good corporate governance that all public limited liability companies (Plc's) are required to have boards different from management.

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The boards provide leadership (i.e. direction) to the organisation, while, management is responsible for the day-to-day running of the company.

The board is usually headed by a chairman, while the management is headed by a Chief Executive Officer or Managing Director.

To emphasise the need for interaction, key members of management are also members of or present on the board.

21.2 Emotional intelligence

21.2.1 Introduction

Emotional intelligence (EI) was first coined in a paper written by Michael Beldoch[1] in 1964. The term 'emotional quotient (EQ) was used in an article by Keith Beasley[2] in 1987. In 1989, Stanley Greenspan[3] proposed the trait model, thereafter, Peter Salovey and John Mayer[4] independently put forward ability model of emotional intelligence. However, the term emotional intelligence was made popular by Daniel Goleman[5] in his book, "*Emotional Intelligence – Why it can matter more than IQ".* He also presented the mixed model of emotional intelligence.

Goleman described emotional intelligence as a person's ability to manage his feelings so that those feelings are expressed appropriately and effectively. According to Goleman, emotional intelligence is the largest single predictor of success in the workplace. It is the measure of an individual's abilities to recognise and manage their emotions, and the emotions of other people, both individually and in groups.

21.2.2 Importance of emotional intelligence

Emotional Intelligence has been proven to be important to an organisation in the following ways:

a. Increases productivity in workplace;
b. Helps to reduce stress;
c. Moderates the impact of conflict-related situation;
d. Promotes relationships and understanding;
e. Fosters stability and continuity; and
f. Heightens self of awareness.

21.2.3 Components of emotional intelligence

According to Goleman, emotional intelligence has five components which include:

a. **Self-awareness:** This is recognising and understanding our own moods and motivations and their effect on others, which involves the ability to monitor our own emotional state and identify our own emotions. This trait shows confidence, sense of humour (can laugh at self), awareness of your impression on others (can read the reactions of others to know how you are perceived). Self-awareness encompasses emotional awareness, accurate self-assessment and self-confidence

b. **Self-regulation:** Emotional intelligence helps us to be able to regulate and manage our emotions in an appropriate way. This is not the same thing with hiding our true feelings and locking our emotions. It is the ability to wait to express our emotion at the right time, place, and avenue.

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Self-regulation includes:

i. Self-control: This is the ability to recognise and control our emotions appropriately rather than masking or hiding our emotions;
ii. Trustworthiness: This is the ability to maintain our integrity, which means ensuring that what we do is consistent with our personal values. People who are trustworthy always act ethically;
iii. Conscientiousness: This is taking responsibility for our own personal performance, and making sure that it matches up to our ability and our values;
iv. Adaptability: This is the ability to change and adapt ourselves to the changing environment; and
v. Innovation: This is deliberate application of information, imagination and initiative in deriving greater or different values from resources, and includes all processes by which new ideas are generated and converted into useful products.

c. Motivation: This is defined as actions or strategies that will elicit a desired behaviour or response by a stakeholder (Alison Doyle).

Motivational process involves:

i. Assessing the preferences and personality characteristics of the individual or group to be motivated;
ii. Defining motivational strategies appropriate for that target;
iii. Conveying expectations for performance to or achieving desired outcomes from the object of the motivation;
iv. Communicating benefits, rewards, or sanctions, if expectations are (or are not) met.
v. Providing feedback regarding progress or lack of progress towards desired outcomes;
vi. Addressing problems or obstacles that are limiting success;
vii. Providing rewards for desired outcomes; and
viii. Issuing warnings prior to enacting sanctions.

d. Empathy: This is the awareness of the feelings and emotions of other people.

Goleman identified five key elements of empathy, as follows:

i. Understanding others;
ii. Developing others;
iii. Having a service orientation;
iv. Leveraging diversity; and
v. Political awareness.

e. Social skills: These are the skills used to communicate and interact with each other, both verbally and nonverbally, through gestures, body language and our personal appearance.

i. Self-awareness:
ii. Self-regulation
iii. Motivation
iv. Empathy
v. Social skill

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21.2.4 Models of emotional intelligence

There are three models of emotional intelligence, These are:

(a) Ability;
(b) Mixed; and
(c) Trait.

Different instruments have been developed to assess the different constructs of these models.

a. Ability model

i. Definitions

Peter Salovey and John Mayer defined emotional intelligence as "the ability to monitor one's own and other people's emotions, to discriminate between different emotions and label them appropriately, and to use emotional information to guide thinking and behaviour".

This definition proposed four emotional abilities:

- perceiving,
- using,
- understanding, and
- managing.

The model also states that these abilities are distinct, but, related.

Emotional intelligence also reflects abilities to join intelligence, empathy and emotions to enhance thought and understanding of interpersonal dynamics.

This model addresses how emotion affects thought and understanding. It views emotions as useful sources of information by which individuals understand and navigate their social environment. The model proposes that individuals vary in their ability to process information of an emotional nature and in their ability to relate emotional processing to a wider cognition. This ability is seen to manifest itself in certain adaptive behaviours.

ii. Abilities

We shall now discuss the four abilities identified in the ability model.

- Perceiving emotions – This is the ability to perceive and interpret emotions in faces, pictures, voices, and cultural artifacts—including the ability to identify one's own emotions. Perceiving emotions represents a basic aspect of emotional intelligence, as it makes all other processing of emotional information possible.
- Using emotions – This is the ability to harness emotions to facilitate various reasoning activities, such as thinking and problem-solving. The emotionally intelligent person can utilise his or her changing moods to best fit the task at hand.
- Understanding emotions – This is the ability to comprehend emotional language and to appreciate complicated relationships among emotions.
- Managing emotions – This is the ability to regulate emotions in both ourselves and in others. Therefore, the emotionally intelligent person can harness emotions, even negative ones, and manage them to achieve intended goals.

iii. Measurement

The ability emotional intelligence is measured using the following test instruments:

Mayer-Salovey-Caruso Emotional Intelligence Test (MSCEIT) which is based on a series of emotion-based problem-solving items. By testing a person's abilities on each of the four branches of emotional intelligence, it generates scores for each of the branches as well as a total score. It is structured after the ability-based IQ tests.

- Diagnostic Analysis of Non-verbal Accuracy: This test displays faces of 12 males and 12 females expressing different emotions such as happiness, fear, anger in high and low levels. Participants are required to identify these stimuli.
- Japanese and Caucasian Brief Affect Recognition Test: This test requires participants to recognise 7 emotions on the faces of Japanese and Caucasian individuals.
- Levels of Emotional Awareness Scale: Participants are exposed to 26 social scenes and required to state the feelings displayed on a continuum of low to high.

b. Mixed model

i. Definition

This model presented by Daniel Goleman[4] defines emotional intelligence as a wide array of competencies and skills that drive leadership performance.

It recognises 5 main emotional constructs, as follows:

- Self-awareness – the ability to know one's emotions, strengths, weaknesses, drives, values and goals and recognise their impact on others while using gut feelings to guide decisions;
- Self-regulation – ability to control or redirect one's disruptive emotions and impulses and adapting to changing circumstances or environments;
- Social skill – managing relationships to get along with others;
- Empathy – considering other people's feelings, especially when making decisions; and
- Motivation – being aware of what motivates them.

ii. The model

- Identifies a set of emotional competencies within each of the constructs.
- Defines emotional competencies as learned capabilities that can be developed to achieve outstanding performance, rather than innate talents.
- States that individuals are born with a general emotional intelligence that determines their potential for learning emotional competencies.

iii. Measurement

There are 2 main measurement tools based on the mixed model. These are:

- The Emotional Competence Inventory (ECI), which was created in 1999, and the Emotional and Social Competence Inventory (ESCI), a newer version of the ECI developed in 2007, provide a behavioural measure of the emotional and social competencies; and
- The Emotional Intelligence Appraisal which was created in 2001. It may be used as a self-report or 360-degree assessment.

c. Trait model

i. Definition

Trait model defines Trait Emotional Intelligence as "a constellation of emotional self-perceptions located at the lower levels of personality".

Trait emotional intelligence refers to individuals' self-perception of their emotional abilities.

This definition identified two constructs, as follows:

- Behavioural dispositions; and
- Self-perceived abilities.

It is measured by self-report, as against the ability-based model which aims at measuring actual abilities, which have been difficult to measure scientifically. It is recommended to be taken within a personality framework. An alternative label for the same construct is trait emotional self-efficacy.

The trait emotional intelligence (EI) model is broad based and is inclusive of the mixed model discussed above. It presents emotional intelligence as a personality trait, with its implications.

ii. Measurement

There are many self-report measures of EI, including:

- The EQ-I – there are several of these emotion quotient tests. They are widely used in several jurisdictions, hence, presented in many languages.
- The TEIQue - The test has 15 subscales grouped under four factors: well-being, self-control, emotionality, and sociability. They are found reliable and follow normal distribution.

d. The Big Five Personality Traits theory

The theory states that personality can be categorised into five factors as follows:

(a) Conscientiousness;
(b) Agreeableness;
(c) Neuroticism;
(d) Openness; and
(e) Extraversion.

This theory provides a basis for understanding and improving relationships with others. It helps to rationalise human behaviour. The theory may also be used to better understand oneself and thus facilitate relationships with others.

The Big Five Model, also known as the Five Factor Model, is the most widely accepted personality theory. Unlike other trait theories which factors can only take either of two values such as introvert or extrovert, the Big Five Model states that each personality trait is a spectrum. Individuals are therefore awarded scores on a continuum, based on the degree of manifestation of the traits.

21.2. 5 General effects

A review published in the journal of *Annual Psychology*[7] found that higher emotional intelligence is positively correlated with the following:

(a) Better social relations for children;

(b) Better social relations for adults;

(c) Highly emotionally intelligent individuals are perceived more positively by others;

(d) Better family and intimate relationships;

(e) Better academic achievement;

(f) Better social relations during work performance and in negotiations;

(g) Better psychological well-being;

(h) Allows for self-understanding, leading to self-actualisation; and

(i) A person with a good understanding of emotional quotient, EQ, can build more meaningful connections, boost self-confidence, have a positive attitude, and face challenges enthusiastically, leading to success in life. This is referred to as the EQ edge.

21.2.6 Criticism of Emotional Intelligence

Despite its usefulness, emotional intelligence has received some severe criticisms[6]. Below are some of them:

(a) Predictive power: Researchers challenge that emotional intelligence measures have not been subjected to enough rigorous statistical tests to establish that high emotional intelligence score correlate with effective leadership and high academic performance as postulated by proponents of emotional intelligence as a good predictor of these performances;

(b) Correlation with personality: EI measures by self-report approach are dimensions of personality trait, hence they correlate e.g., neuroticism and extraversion;

(c) Socially desirable responding: Socially desirable responding (SDR), or "faking good", is defined as a response pattern in which test-takers systematically represent themselves with an excessive positive bias. This bias is manifest in the tests;

(d) Emotional intelligence as behaviour rather than intelligence: That EI is only a measure of behaviour rather than an intelligence. That it does not fit the construct of an intelligence, but a skill;

(e) Emotional intelligence as skill rather than moral quality: That Emotional intelligence may just be a skill rather than a moral quality or personality trait;

(f) Emotional intelligence – a measure of conformity: that by adoption of consensus, the EI may just be a measure of conformity, rather than a factor; and

(g) Emotional intelligence – a form of knowledge: That MSCEIT tests knowledge of emotions, which may not reflect his/her response in actual situations.

21.2.7 Uses of emotional intelligence

Emotional intelligence has been used to explain some phenomena. These include the following:

(a) Bullying: Bullying is an abusive social interaction between peers which can include aggression, harassment, and violence. Bullying is typically repetitive and enacted by those who are in a position of power over the victim. A growing body of research illustrates a significant relationship between bullying and emotional intelligence;

(b) Job performance: Though there are conflicting report of correlation between EI and job performance, recent findings have shown that EI contributes to performance in emotionally demanding job situations, leading to the concept of emotional exhaustion (burn out) contributing negatively to performance;

(c) Leadership: Although EI plays a positive role in leadership effectiveness, what actually makes a leader effective is what he/she does with his role, rather than his interpersonal skills and abilities;

(d) Health:

(e) Recent studies have shown that people with higher emotional intelligence enjoyed better physical and mental health; and

(f) Self-esteem and drug dependence: Researchers discovered that subjects with low emotional intelligence scores had low self-esteem and a high incidence of drug dependence.

21.2.8 Applications of emotional intelligence

Below are some applications of emotional intelligence:

(a) Being considerate about feelings;
(b) Pausing to think;
(c) Ability to control one's thoughts;
(d) Deriving benefit from criticism;
(e) Being authentic;
(f) Demonstration of empathy;
(g) Praising others;
(h) Giving helpful feedback;
(i) Apologising when in error;
(j) Ability to forgive and forget;
(k) Ability to keep commitments;
(l) Helping others; and
(m) Ability to protect oneself from emotional sabotage.

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21.2.9 Advantages of high emotional intelligence

According to Cooper and Sawaf (1997), in their book, Executive EQ, having high EQ has the following advantages:

a. A high IQ can help an individual for getting hired in a reputed organisation, but with a high EQ a person will get promoted and be sustained in an organisation;

b. With a high IQ, a person can master daily routine work, but with a high EQ he/she can thrive during times of changes and uncertainty; and

c. With a high IQ, a person can be an efficient professional but with a high EQ the same can become a great leader.

21.3 Social thinking

21.3.1 Introduction

Social thinking or social cognition or 'thinking socially' is a mental process people go through to make sense of their own and others' thoughts, feelings, and intentions in context, whether co-existing, actively interacting, or figuring out what is happening from a distance (e.g., through media, literature, etc.). It commences at birth and continues all through life. Social thinking is based on the work of Michelle Garcia Winner who created the Center for Social Thinking. Social thinking is a methodology that is used to help children effectively interact with others, helping them figure out the best way to think when they are in social situations. Social thinking trains your brain to figure out what people around you might be thinking. It helps one to realize that each time one is around others, your behaviour will cause them to think a certain way about you. Social thinking teaches our brain to do and say the things that will make others feel positive thoughts about us, and make them feel good as well (Child NEXUS, 2017).

Aristotle said that "man is a social animal", as a result, man likes to live in a society. Study lecture notes, (n. d.), therefore, opines that man living in a society is affected by others and he affects others. These individuals living together develop their own opinions, thinking, ideas, imagination, attitudes, aspirations and out look towards society. These ideas are moulded in a scientific and systematic manner which gives far-reaching results and become a social thought. In social thoughts, firstly an individual is thinking about the past and present social problems and secondly the body of thought is developed in a systematic manner. According to Winner (n.d.), we are social thinkers every day, whether it is at home or at work. We should be aware that people around us have thoughts and feelings. It includes sharing a space with others effectively and understanding the perspective and intentions of others. Although it is abstract, the vocabulary and lessons are concrete and talk about how the social world works. Also, fundamental to social thinking is the recognition that everyone has thoughts and feelings about one another's social behaviour, e.g., social skills (Goleman, 2006).

21.3.2 Importance of social thinking

Rhoads (n. d.) gives three reasons why social thinking is so important, as follows:

a. Using appropriate social skills tend to make people feel comfortable around us which helps us better co-exist and interact with those we share space with;

b. Most of us want to make connections and make friends with our family, peers, boss or colleagues; and

c. The core concepts of social thinking help us develop insights and socially based critical thinking in the workplace. For example, anytime a person is asked to:
   i. work in a group;
   ii. solve a problem;
   iii. write an email;
   iv. express their ideas;
   v. answer questions;
   vi. understand a video clip; and
   vii. critically think about an issue,

   he is using his social thinking mind!

21.3.3 Concepts associated with social thinking

Winner and Crooke (2009) have identified the following concepts (vocabulary) in social thinking:

a. **Think with your eyes**: This is a statement used in lieu of saying "use good eye contact" or "look at me." This involves "thinking with their eyes", which means that eyes are not just for looking at another person during an interaction. The eyes are powerful tools to be used for gaining information in almost any situation. The concept of "thinking with your eyes" is also relevant in problem solving and perspective taking.

b. **Expected/unexpected behaviour**: Social and communicative expectations are contextually sensitive. In fact, for every situation there are a set of expected and unexpected behaviours that generate different types of thoughts. When a behaviour is expected for a situation, it encourages us to have good or okay or normal thoughts and feelings; when a behaviour is unexpected, we tend to have uncomfortable or weird thoughts and related feelings. How we think about someone over time affects our "social memory" of them. (Note: This is not the same as thinking a person is "weird." Instead, we have a weird thought based on the behaviour within that situation.)

c. **Smart guess/wacky guess:** This concept has to do with "reading the situation" before deciding what actions to take based on the situation. Social inferencing is at the heart of determining what to say or do and occurs at a rapid-fire pace in everyday social communication as well as when comprehending text. The process of inferencing involves becoming aware of words and nonverbal cues to "take what you (think, know, see and hear) to make a guess."

d. **Social Fake:** This is a concept is about how we feel in reality as we engage in a social interaction with others. Most of the time, we are interested in getting to know one another, even though we are not always interested by exactly what they say. We simply tolerate other's conversational topic in order to maintain the social-emotional connection. How we make each other feel is more important than the exact words used to sustain the relationship.

Also, Winner and Crooke (2009) stated that social thinking includes constant infusion of "good social skills"? Social thinking precedes the use of good social skills, because we have to be aware of the people and the situation before we select which sets of social behaviours (social skills) to employ. While sharing space with others, we are constantly aware of people (social thinking) and then monitor and modify our behaviour accordingly to encourage people to think about us the way we want them to perceive us. Majority of times we are socially thinking in the presence of others, we are not actually interacting with these people, rather we are co-existing.

21.3.4 Social thinking methodology

The social thinking methodology is a developmental, language-based and thinking-based (metacognitive) methodology that uses the following:

a. visual frameworks;
b. unique vocabulary;
c. strategies; and
d. activities to foster social competence.

The methodology has assessment and treatment components for both interventionists and social learners.

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The methodology includes components of other well-known and evidence-based interventions such as:

a. Social stories

Carol Gray's definition of social story

A Social Story accurately describes a context, skill, achievement, or concept according to 10 defining criteria. These criteria guide Story research, development, and implementation to ensure an overall patient and supportive quality, and a format, "voice", content, and learning experience that is descriptive, meaningful, and physically, socially, and emotionally safe for the people with autism.

The objective is to share information, which is often through a description of the events occurring around the subject and also state the rationale.

b. Hidden curriculum

Philip .W. Jackson (Life in Classrooms, 1968) coined the phrase 'Hidden Curriculum'. Hidden curriculum is a concept that describes the often unarticulated and unacknowledged things students are taught in school and that may affect their learning experience. These are often unspoken and implied lessons unrelated to the academic courses they're taking — things learned from simply *being* in school. However, autistic people have to learn things expressly.

c. 5-point scale

The 5-point scale is a visual system that can help to organise a person's thinking when working through difficult moments, particularly those that require social understanding.

Social thinking shares ideals with:

i. Self-regulation

This is control or supervision from within instead of by an external authority.

ii. Executive functioning

Executive function is **a set of mental skills that include working memory, flexible thinking, and self-control.** They are used for learning, working, and daily living.

iii. Central coherence issues

Central coherence is seeing how many component parts fit together to make a coherent whole. Central coherence difficulties could be related to attention, visual processing, or rigidity.

iv. Shifting attention

Regarding attention, a child may have difficulty shifting attention, that is, the ability to shift focus back and forth between stimuli.

v. Perspective-taking

Perspective-taking is the act of perceiving a situation or understanding a concept from an alternative point of view, such as that of another individual.

21.3.5 Evidence-base for social thinking

Social Thinking theorises that successful social thinkers are able to consider the points of view, emotions, thoughts, beliefs, prior knowledge and intentions of others (this is often called perspective-taking). Social Thinking™ also demonstrates the link between one's social learning abilities and his or her related ability (or disability) when processing and responding to school curriculum based in the use of the social mind (e.g., reading comprehension of literature, some aspects of written expression, etc.). Winner and colleagues argue that individuals who share a diagnostic label (e.g., autism spectrum disorder) nonetheless exhibit extremely different social learning traits, or social mind profiles, and should have unique treatment trajectories, such as those based in cognitive-behavioural therapy (CBT).

Social Thinking is a language and cognitive-based methodology that focuses on the dynamic and synergistic nature of social interpretation and social communication skills, both of which require social problem solving. The methodology is developmental, utilizing aspects of behavioural and cognitive behavioural principles, as well as stakeholder input as a way to translate evidence-based concepts into conceptual frameworks, strategy-based frameworks, curricula, activities, and motivational tools.

ICAN 2021

21.4 Creative thinking

21.4.1 Introduction

Creative thinking is the ability to consider something in a new way. It might be a new approach to a problem, a resolution to a conflict between employees, or a new result from a data set. Employers in all industries want employees who can think creatively and bring new perspectives to the workplace.

Psychologically, creative thinking is a process of producing a composition, product or idea that is essentially new, that is, previously unknown and original. Creativity refers to the ability to produce a composition, product or idea that is essentially new, previously unknown and original. Creativity can be artistic, literary, scientific or product, and can be procedural or methodical. It is a mental process that is unique for the purpose of producing something new, different from the original that includes a specific thought which constitutes different ideas and thoughts freely, that is, convergent thinking (Nurlela, 2015).

Creative thinking means thinking outside the box. Often, creativity involves lateral thinking, which is the ability to perceive patterns that are not obvious. It is breaking out of established patterns to look at things in a different way. It is the skill pf being able to produce something new which has some value. It can also be seen as the ability to acquire knowledge, break it down, and rearrange it in an altogether different manner to generate something new and valuable. It arises out of skilful restructuring of our thoughts to allow novel ideas about a given subject or situation (Aravind, n. d.).

Creative thinking might mean devising new ways to carry out tasks, solve problems, and meet challenges. It means bringing a fresh, and sometimes unorthodox, perspective to tasks, inventing something new, thinking up something from scratch and putting things together in a new way. Creative thinking helps a person to solve problems and make decisions (Ruggiero, 1993). It is an important ingredient in corporate strategic formulation process. This way of thinking can help departments and organisations be more productive.

Creativity is the ability to think laterally, imaginatively and to make connections. Creative thinking is a skill that can be nurtured and developed.

Aravind (n.d.) points out what makes a creative person different and special as follows:

a. Sensitivity to the existence of problems, opportunities, gaps in knowledge, inconsistencies, and lack of harmony;
b. Ability to use existing knowledge in new ways to search for solutions; and
c. Make guesses and test their validity "since knowledge is not always gained through language alone", creative feelings also cannot always be expressed in words."

Some attributes of creative thinkers, are:

a. Being able to articulate ideas;
b. Working independently;
c. Exploring alternatives;
d. Taking the risk to try out ideas;
e. Flexibility and adaptability; and

f. Thinking outside the box.

21.4.2 Critical thinking

Creative thinking should, however, be differentiated from critical thinking. Both creative and critical thinking involve the use of high order thinking skills. Critical thinking is thinking that interrogates information to evaluate in and judge whether it is true or false; whether it should be believed or not; and how one should act on it. While creative thinking is, on the other hand, thinking that produces the material that critical thinking evaluates. It is generative thinking. Therefore, one phase, creative thinking, produces ideas while the other phase, critical thinking, judges them. Creative people are dynamic, daring, resourceful, independent and hard working. These characteristics enable them to solve problems in unacceptable situation that challenge thinking without having any apparent ready way out.

The two phases of critical and creative thinking (CCT) are intertwined. The thinking moves back and forth especially in the process of solving a problem each phase reinforcing the other. When critical thinking judges that something wants in what is generated by creative thinking, further generation is called forth to improve the situation. This goes on and on many times. This continuous alternating activity between critical and creative thinking is especially important in intellectual matters where excellence is the goal (Musyoka, 2016)

Aravind (n.d.) differentiated between creative and critical thing as follows:

Creative thinking is described as:

a. making and communicating connections to think of many possibilities;
b. thinking and experiencing in various ways and use different points of view;
c. thinking of new and unusual possibilities; and
d. giving guidance in generating and selecting alternatives.

Critical thinking is described as:

a. analysing and developing possibilities to compare and contrast many ideas;
b. improve and refine ideas;
c. make effective decisions and judgments; and
d. provide a sound foundation for effective action.

21.4.3 Learning creativity skill

Cambridge (2011, p. 56) stated the following character traits and learning habits that affect a learner's personal disposition, motivation and confidence to be creative:

a. resilience: an ability to tolerate uncertainty and persevere at a task to overcome obstacles;
b. not being afraid to make and learn from mistakes;
c. an ability to suspend judgement while generating ideas; and
d. willingness to take sensible risks or go out of their comfort zone in their work.

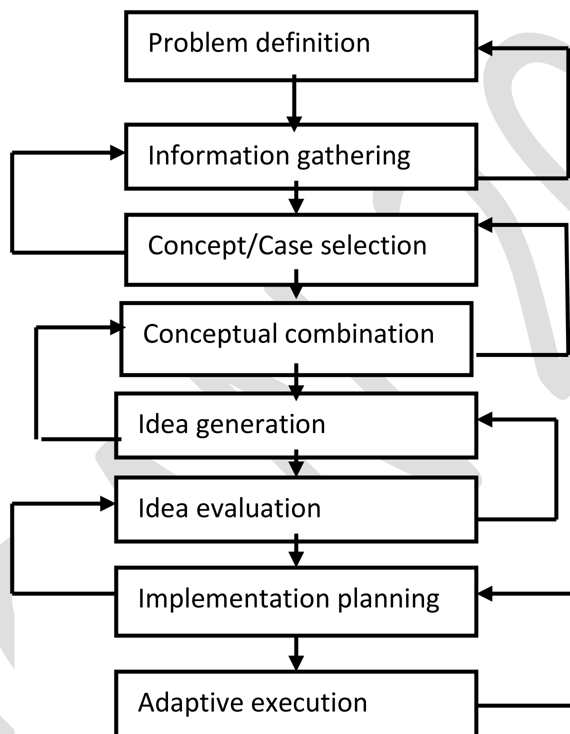
Cambridge (2011 p. 56), states that a creative learner needs to be able to develop and apply a set of skills that they can use in the creative process. These include being able to:

a. clarify, analyse and re-define the problem or question to uncover new ways of looking at it;
b. ask thoughtful questions;
c. notice connections between seemingly unrelated subject matter;
d. challenge established wisdom by asking: how would I improve this?
e. recognise alternative possibilities; and
f. look at things from different perspectives.

24.4.4 Creative thinking process

a. Model of creative thinking

Mumford, Medeiros and Partlow (2017), developed a model of creative thinking process, which is shown below:



Source: **Mumford and Mcintosh - Creative Thinking Processes: The Past and the Future**

b. Modes of creative thinking

Creative thinking is expressed in diverse situations, varying from artistic work to technical and scientific engagements. Below are some examples creative thinking in various situations.

21.4.5 Artistic creativity

One does not have to be an artist to express artistic creativity. A good example is a sales staff who displays merchandise on a retail store stand to attract customers.

Other cases include creating cartoon characters, designing of logos, writing of advertising copy, creating the packaging for a product or writing drama stories.

21.4.6 Creative problem-solving

Creative problem-solving requires innovation. A creative problem-solver will find new solutions rather than simply identifying and implementing the usual protocols. This might be used to cut costs, increase income or device more efficient modes of service delivery.

21.4.7 Creativity in science and technology

The fields of science and technology require immense creativity. For example, designing space crafts and robots, writing efficient computer programs or simulating complex entities require a lot of creative thinking.

History is replete with failure of many science and technology projects mainly due to dogma, biases and assumption from which the scientists and technologies could not extricate themselves.

21.4.8 Expressions of creative thinking

Creative thinking is expressed in several ways. Here are some of the types of creative thinking you might see in the workplace.

a. Analysis

Creative thinking usually starts with a clear understanding of the matter at hand. Many problems are usually complex, hence, requires a process of analysis to break them down to simpler units which can be easily managed.

This requires critical examination of materials, including texts, data, plans, designs, budgets, etc.

b. Open-mindedness

To think creatively, one must remove any preconceived ideas, assumptions or biases to provide opportunities for fresh ideas and perspectives. This requires open mindedness.

c. Problem-solving

One of the main benefits of creative thinking is in problem-solving, most especially, when the problem is not following a usual trend or pattern. New models or thoughts may be required to address them.

d. Organisation

Organisation is an essential part of creativity. To be creative one must be able to thread patterns which may not be easily discernible by all to form a logical or physical whole. A creative mind will be able to put together the pieces of a jig saw puzzle to form a whole picture. This is organisation. Though at the analytical stage it seems the pieces are disorganised as they are dissembled, thus creating a similitude or disorganisation usually associated with creative people.

e. Communication

People will only appreciate your creative idea or solution if you communicate it effectively. You need to have strong written and oral communication skills.

Creative thinking requires effective listening to fully understand the issues involved.

21.4.9 Benefits of creative thinking

Organisations encourage and reward creative thinking as it:

a. Generate new sources of income or enhance existing source, through innovation;
b. Creates new products;
c. Finds new uses for existing products; and
d. New markets.

Leading to improved bottom lines.

Thus, many organisations go a long way to device an organisational structure that stimulates and encourage creative thinking.

21.4.10 Summary

a. Creative thinking is the ability to consider something in a new way.

b. Creative thinking includes analysis, open-mindedness, problem-solving, organization, and communication.

c. Many employers value creative thinkers.

ICAN 2021

21.5 Service Orientation

21.5.1 Introduction

In the general business environment, the following are some definitions of service orientation:

a. Service orientation is a predisposition to being helpful, thoughtful, considerate, and cooperative.

b. Saxe and Weitz defined service orientation as a willingness to treat co-workers and clients with courtesy, consideration and tact combined with the ability to perceive a customer's needs and communicate effectively.[2]

   It was initially conceived as a concern for others, then, it became a set of attitudes and behaviours that affects the quality of interaction between the organisation's staff and its customers.

c. In information technology (IT), service-orientation is defined as a design paradigm for computer software in the form of services[1].

The principles of service-oriented design stress the separation of concerns in the software. Applying service-orientation results in units of software partitioned into discrete, autonomous, and network-accessible units or modules, each designed to solve an individual concern. These units are regarded as services.

However, our focus is the general business usage of service orientation.

To appreciate the importance of service orientation, particularly in the service industry, we may consider the cases of some prominent airlines which hinge the fulcrum of their competitive advantage around service orientation. They pride themselves as meeting and exceeding their customers' expectation. They give attention to the smallest details of the customers' desire. For this, they charge premium fares, which the customers are willing to pay.

To maintain their competitive advantage, such organisations do the following:

a. Constantly research their target market to enable them respond to ever-changing customer desires;

b. Offer tremendous perceived value to their customers;

c. Work assiduously to serve their customers; and

d. Give employees power to maintain their service standard.

21.5.2 Soft skills required for service orientation

The following are the skills required when adopting service orientation as a business model:

a. Effective communication

Effective communication is essential to identify the customer's wants and propose solutions. This skill is essential in verbal communication and written communication. The language employed must show positivity and emotional intelligence.

b. **Listening skill**

Listening skill is essential to appreciate the customer's needs. Activel listening skill must be displayed through the use of body language and responses. It also involves courtesy and asking insightful questions to clarify issues.

c. Self control

This is the ability to maintain one's calmness irrespective of the situation or attitude of the customer. This skill is needed in dousing tense situations by showing empathy to the client.

d. Positive attitude

A positive attitude is when one shows conviction in the performance of the product or service delivery. It is infectious as the customer goes along the same path.

e. Assertiveness

Assertiveness is taking charge of the situation without getting aggressive or provocative. It demonstrates confidence to the customer.

f. Conflict resolution

Conflict resolution is the skill employed to find solution to any point of disagreement between the organisation and its client. It is necessary to fully understand all the issues in dispute and offer feasible and realistic solutions. There may be need to seek additional help, if no solution is found.

Examples of skills required in conflict resolution include:

i. Intelligence;
ii. Mediation;
iii. Creative thinking;
iv. Diplomacy;
v. Emotional facilitation; and
vi. Negotiation.

g. Empathy

Empathy is ability to understand and manage the emotional state of the customer, so as to meet his/her needs. It involves:

i. Emotional intelligence;
ii. Compassion;
iii. Open-mindedness; and
iv. Encouragement.

h. Depersonalisation

This is the ability to remove oneself from the issues at stake. The matters are official, so they should not be personalised. This way tension in the situation is reduced, giving way to a more conducive environment. Relevant skills required include:

i. Stress tolerance;
ii. Forbearance;
iii. Leadership; and
iv. Emotional stability.

i. Taking responsibility

This is a big part of working in customer service, and it includes being able to say, "I'm sorry," whether it's for a late shipment or the poor quality of a product. You have to be able to sincerely apologise to a customer on behalf of your company even when the problem was not your fault. Hearing an apology

almost always makes a customer feel better. The skills required in taking responsibility include:

i. Approachability;
ii. Humility;
iii. Active listening;
iv. Repeating the customer's words back to them;
v. Empathy;
vi. Integrity;
vii. A sense of humour
viii. Problem sensitivity;
ix. Imagination; and
x. Stress tolerance.

j. Other soft skills required for service orientation

The following are the other skills required to be able to become a service-oriented person:

i. Persuasion;
ii. Motivation;
iii. Initiative;
iv. Diligence;
v. Critical thinking;
vi. Collaboration;
vii. Attentiveness;
viii. Calmness;
ix. Tact;
x. Flexibility;
xi. Giving and receiving feedback;
xii. Attention to details;
xiii. Teamwork; and
xiv. Tenacity.

21.5.3 Service orientation in organisations

A company with service orientation focusses all its resources on meeting the needs of its customers efficiently and effectively.

Customer service orientation in organisations can be divided into three proficiency levels:

a. Basic level: At this level, support representatives should be able to 'know the profiles of customers and respond to their requests in an informed, knowledgeable, and polite manner';
b. Intermediate level: At this level, customer service orientation level, the organisation actively cooperates with customers to resolve all their issues and in-depth knowledge of its products and services; and
c. Highest level: At this level of customer orientation, the organisation engages its stakeholders proactively and makes the necessary changes to its organisation and products before problems emanate.

Below is a diagrammatic representation of the three level.

Source: https://helpcrunch.com

21.5.4 Improving organisational service orientation

Service orientation involves committing resources to meeting the needs and satisfaction of customers and clients. Hence, to improve service orientation, the organisation has to undertake the following:

a. Define the set of value proposition to its customers. The company gets customer loyalty if value is delivered;
b. Clearly identify the primary value chain of the organisation;
c. Assemble a passionate team;
d. Invest in training and development to develop soft skills;
e. Empower team for service delivery; and
f. Deploy resources for service orientation.

21.5.5 The benefits of customer service

Benefits that can accrue to organisations from service orientation include:

a. Customer satisfaction

This leads to:

i. Exciting customer experience: Exciting customer experience arising from great customer orientation;
ii. Brand loyalty: Customers become attached to the organisation's products in preference to competitors' products; and
iii. Positive reviews: The company and its products receive positive review from customers.

b. Customer retention

i. Lower churn rate: Churn rate is the rate customer to the organisation.

ii. The higher it is, the higher the customer to the firm.

iii. Lower marketing costs: Less effort is required to sell the company's products, leading to lower the marketing costs.

c. Word of mouth publicity

i. Employee satisfaction: Employees derive satisfaction from the positive response of customers, leading to increased productivity.

ii. Valuable feedback: Customers give valuable feedback to the organisations, thus helping the company further in its service orientation.

iii. Brand ambassadors: Customers become brand ambassadors of the company's products, thus, helping to boost sales.

d. Increased sales

This arises from:

i. Cross sales: Customers buying items related to the ones they have bought;

ii. Up sales: Customers buying higher products to the ones they intended to purchase; and

iii. Higher conversion rate: This is higher conversion of prospects to actual sales.

21.5.6 Channels of customer service

These are means of delivering customer service. In today's global economy, customer service delivery is predominantly through electronic media. Below are a few examples:

a. Phone customer service**;**

b. Email customer service;

c. Live chat customer service;

d. Social media customer service;

e. On-site customer service**; and**

f. Customer self-service.

21.5.7 Proactive vs reactive customer service

Proactive customer service organisations are those which anticipate the needs of customers and develop means of meeting them, while, reactive customer organisations respond to the issues raised by customers.

Progressive organisations adopt proactive customer service strategies to succeed.

These include:

a. Utilising a proactive chat feature;

b. Building a well-thought-out knowledge base;

c. Setting up in-app notifications;

d. Collecting customer feedback; and

e. Offering loyalty programs.

Below is a graphic representation of six levels of proactive customer service.

Source: https://helpcrunch.com

21.5.8 Attributes of good customer service

Below are some of these attributes:

a. Timely response to customers;

b. Passionate and skilled staff;

c. Soft skills training;

d. Appropriate targets and key performance indices for service staff;

e. One-stop service point;

f. Loyalty reward programme; and

g. A clear service orientation philosophy.

21.6 Cognitive flexibility

21.6.1 Introduction

According to Marianne Stenger[1], cognitive flexibility refers to ability to disengage from one task and respond to another or think about multiple concepts at the same time. Someone who is cognitively flexible will be able to learn more quickly, solve problems more creatively, and adapt and respond to new situations more effectively, which is why it is important in both the educational settings and in the workplace.

Cognitive flexibility has been described as the mental ability to switch between thinking about two different concepts, and to think about multiple concepts simultaneously. Cognitive flexibility is usually described as one of the executive functions.

Two subcategories of cognitive flexibility are task switching and cognitive shifting, depending on whether the change happens unconsciously or consciously, respectively.

Cognitive flexibility varies during the lifespan of an individual.[3] In addition, certain conditions such as obsessive–compulsive disorder are associated with reduced cognitive flexibility. Since cognitive flexibility is a vital component of learning deficits in this area might have other implications.[4]

Cognitive flexibility is an intrinsic property of a cognitive system often associated with the mental ability to adjust its activity and content, switch between different task rules and corresponding behavioural responses, maintain multiple concepts simultaneously and shift internal attention between them. [5]

21.6.2 **Importance of cognitive flexibility**

According to a 2016 report from the World Economic Forum[12] that looked at the future of jobs across nine different industries in 15 of the world's largest economies, employers will soon be placing more emphasis on cognitive abilities like creativity and adaptability.

Building cognitive flexibility is a great way to develop professionally and keep up with the ever-changing work environment of the future.

One of the best ways to become more cognitively flexible is to expose oneself to new experiences and ways of doing things. Below are some ways to develop cognitive flexibility:

a. **Altering daily routine**

A simple way to build cognitive flexibility is by periodically changing regular routines and doing things differently. This may include regular routines such as modes and routes of transportation, daily chores and exercise routines.

Simple changes such as changing one's siting position and switching hands in performing some chores can help to build and strengthen new neural pathways;

b. **Seeking new experiences.**

Learning new things or going through new experiences stimulates the brain to develop new synaptic connections. New and interesting experiences have also been shown to trigger the release of dopamine, which not only increases motivation but also enhances memory and learning.

This includes activities such as

i. Travelling to new places;

ii. Learning new languages;

ICAN 2021

iii. Learning to play new musical instruments; or

iv. Engaging in new sports;

c. **Practising creative thinking**

Another way to build cognitive flexibility is to endeavour to think in unconventional and creative ways or practice divergent thinking.[13] Robert Steinberg showed that when students were taught to think in both creative and practical ways, their grades improved, and they were also able to transfer the knowledge they gained to entirely different areas of learning.

Divergent thinking usually occurs in a spontaneous and free-flowing manner and involves thinking in terms of unlimited possibilities rather than a limited set of choices;

d. **Embracing 'desirable difficulties'**

Research shows that introducing 'desirable difficulties' lead to deeper learning. Desirable difficulties are those unfamiliar challenges, which when overcome, have positive effects on the individual. By endeavouring not always to choose the easiest way of doing things, minds are sharpened. This research shows that successfully going through some changing experiences enhance cognitive flexibility;

e. **Developing new networks**

Meeting people from different cultures and walks of life whose perspectives and view points are different helps one to be less rigid in ways of thinking and be more receptive to other viewpoints, thus, enhancing cognitive flexibility.

A study showed that students exposed to diverse environments and cultures are more likely to reach an advanced stage of moral reasoning;

f. **Transferring learning**

Learning to transfer knowledge in one context into a new context is an essential element of developing cognitive flexibility. This ensures the formation of new connections between previously unconnected networks of knowledge and thinking more creatively.

Without the ability to transfer skills and knowledge to new contexts, learning will not have good impact. A study found that though street children were able to perform complex mathematical computations when selling their wares, but they were not able to solve equivalent problems that were presented to them in a school context.

Research also shows that explaining a new concept in one's own words helps identify any incorrect assumptions, and also helps to generalise a concept for future application. New concepts learnt should be applied to real-life situations to be fully internalised;

g. **Moral challenge**

Research shows that, through seeking new experiences that test morals and expose one to a variety of beliefs, values, and expectations one can demonstrate better understanding of culturally different perspectives and, as such show cognitive flexibility.

Cognitive flexibility ensures that when one disagrees with another's point of view, the person will be able to rationalise the opposing point of view.

This ability will facilitate the following:

i. Communication with people;

ICAN 2021

ii. Resolve conflicts; and

iii. Adaptation of thinking to various situations.

21.6.3 Cognitive flexibility theory and its application

The Cognitive Flexibility Theory was introduced by Spiro and Jehng in 1990 [3]. They stated that cognitive flexibility is the ability to restructure knowledge so as to adapt and make use of it in different settings and situations. They also proposed that the way the knowledge is represented as well as the mental processes that are stimulated by this knowledge play a key role.

The theory relies on knowledge transfer and skills that extend beyond the learning environment. In other words, learners must be able to apply knowledge in the real world.

The cognitive flexibility theory relies upon the idea that learners must not only be able to manipulate how knowledge and content are being represented, but also the processes for operating those representations.

The main principles of the cognitive flexibility theory are:

a. Knowledge is "context-dependent". Knowledge cannot be perceived out of context. It is the context that allows learners to see any possible relationships between various components of the subject matter presented. In addition, learning activities in any educational setting should be able to provide several different representations of the same instructional objectives in different contexts. Cognitive flexibility theory postulates that, by doing so, learners have the opportunity to better understand the specific concept or idea because its practical application is clear to them. This is very important, especially for adult learners who usually want to know not only "what", that is new information, but also "why" they learn something, as well as "how to apply" it in real-life settings

   The Cognitive Flexibility Theory claims that learners' multiple exposures to the same concept in different contexts facilitates the learning process. Furthermore, offering many different ways to represent the same concepts is of extreme value to learners. Repetition would facilitate the process of mastering the content, as increased exposure and practice would have positive effects on the learning process;

b. Knowledge cannot be oversimplified. Instructional materials to be used must not oversimplify a topic neither in terms of content, nor in terms of structure. Simply stated, knowledge cannot be reduced to its basics. The content should be challenging enough in order to engage the audience in the learning process. Oversimplification of concepts gives adult learners a sense that they already know the material and therefore, they may consider the specific course as a waste of time. In terms of structure, problems should be presented to students in more complex and involving structures, rather than linear or simplified ones. Therefore, it is better for instructional designers to provide learners with opportunities to make their own connections between concepts and principles that are being explored, even if these concepts may be of high complexity;

c. Knowledge is constructed. The instruction that takes place should be "case-based", wherein there is an emphasis on the construction of knowledge rather than on how it is transmitted to learners. The cognitive flexibility theory follows a constructivist approach to learning, according to which learners are actively engaged in the learning process and they are responsible for their own learning. This principle is particularly applicable when students are allowed to learn

ICAN 2021

through multiple case studies and real-life interactive scenarios that expose them to how a particular concept or idea can be applied in different practical settings; and

d. Knowledge is interconnected. In order for the learner to grasp what is being taught, the knowledge sources that are used should be "interconnected", rather than separated and "compartmentalised". In other words, this means that knowledge should never be isolated from what learners already know; far from previous experience. A quick and easy tip to do so is by presenting a brief summary of prerequisite knowledge before presenting new information. This may serve two ways: first, it reminds learners what they may already know, but they may not remember; and second, this summary may make some learners realise that it might be better for them to acquire prerequisite knowledge first, before attending the course.

The foundation of the cognitive flexibility theory is that learners are better able to acquire and retain knowledge if they are encouraged to develop their own representation of it.

21.6.4 Contributing factors to cognitive flexibility

Studies have shown that cognitive flexibility relates to some other factors and cognitions. They include the following:

a. Executive functioning

Researchers have generally agreed that cognitive flexibility is a component of executive functioning, higher-order cognition involving the ability to control one's thinking.[14]

Executive functioning includes other aspects of cognition, such as:

i. Inhibition;
ii. Memory;
iii. Emotional stability;
iv. Planning; and
v. Organisation.

Cognitive flexibility is highly related to several abilities, including:

i. Inhibition;
ii. Planning; and
iii. Working memory.

Thus, when an individual is better able to suppress aspects of a stimulus to focus on more important aspects (i.e., inhibit colour of object to focus on kind of object), they are also more cognitively flexible;

b. Multiple classification

Researchers have posited that cognitive flexibility is also a component of multiple classification. In multiple classification tasks, participants must classify objects in several different ways at once, thereby thinking flexibly about them.[15]

Similarly, in order to be cognitively flexible, they must overcome centration, which is the tendency for young children to solely focus on one aspect of an object or situation.[16] Thus, research suggests, if an individual is centrated in their thinking, then they will be more cognitively inflexible;

c. Fluid intelligence

Research has suggested that cognitive flexibility is related to other cognitive abilities, such as fluid intelligence, reading fluency, and reading comprehension.[15,17] Fluid intelligence, described as the ability to solve problems in new situations, enables fluid reasoning ability. When one is able to reason fluidly, they are in turn more likely to be cognitively flexible. Furthermore, those who are able to be cognitively flexible have been shown to have the ability to switch between and/or simultaneously think about sounds and meanings, which increases their reading fluency and comprehension; and

d. Ability to cope with situations

Cognitive flexibility has also been shown to be related to one's ability to cope with particular situations. For example, when individuals are better able to shift their thinking from situation to situation they will focus less on stressors within these situations.[18]

21.6.5 Measurement/assessment of cognitive flexibility

The following tests and tasks are used to assess cognitive flexibility:

a. A-not-B task
Children are shown an object hidden at location A within their reach and are then prompted to search for the object at location A, where they find it. This activity is repeated several times, with the hidden object at location A. Then, in the critical trial and while the child is watching, the object is hidden in location B, a second location within easy reach of child. Researchers have agreed that the A-not-B task is a simple task that effectively measures cognitive flexibility during infancy;[7]

b. Dimensional change card sorting task
In the dimensional change card sorting task (DCCS), children are initially asked to sort cards by a single dimension (such as colour), and are subsequently required to alter their strategy to sort cards based on a second dimension (such as shape);[8]

c. Multiple classification card sorting task
In the multiple classification card sorting task, children are shown cards and asked to sort them based on two different dimensions (e.g., by colour, such as yellow and blue, and object type, such as animals and food) simultaneously into four piles within a matrix (e.g., yellow animals, yellow foods, blue animals and blue foods). This task appears to be more difficult as research has shown that seven-year-old children were incapable of sorting cards based on the two dimensions simultaneously. These children focused on the two dimensions separately, whereas at the age of eleven, children were capable of sorting cards based on these two dimensions simultaneously. This demonstrates an increase in cognitive flexibility between the ages of seven and eleven;

d. Wisconsin card sorting test
The Wisconsin card sorting test (WCST) is used to determine an individual's competence in abstract reasoning, and the ability to change problem-solving strategies when needed.[11]

In this test, some cards are presented to the participants. The figures on the cards differ with respect to colour, quantity, and shape. The participants are then given a pile of additional cards and are asked to match each one to one of the previous cards. Typically, children between ages nine and eleven demonstrate the cognitive flexibility needed for this test[7]; and

e. Stroop Test

The Stroop test is also known as the colour-word naming test. In this measure, there are three types of cards in the deck. The "colour card" displays patches of different colours, which participants are asked to identify as quickly as possible. The "word card," displays the names of colours printed in black and white ink, which participants are again asked to name as quickly as possible. The final card type is the "colour-word card", which displays the names of the colours printed in an ink of a conflicting colour (e.g., the word RED would be printed in yellow), and requires participants to name the ink colours while ignoring the conflicting colour names. The basic score on each card is the total time (in seconds) that the participant takes to respond verbally.[11] Typically, naming the colour of the word takes longer and results in more errors when the colour of the ink does not match the name of the colour. In this situation, adults tend to take longer to respond than children because adults are more sensitive to the actual colour of the word and thus are more likely to be influenced by it when naming the conflicting colour word printed.

ICAN 2021

21.7 Negotiation Skills

21.7.1 Introduction

Negotiation is a process aimed at settling disputes or disagreements with a view of reaching agreements between two or more parties. It usually involves making compromises by which parties make concessions to the benefit of all involved in the process. It is aimed at avoiding rancour and blow-outs.

Stolz defines negotiation as the process of evolving communication to get from opposition to consensus, manage conflict and reach agreement.

Negotiation is a dialogue between two or more people or parties intended to reach a beneficial outcome over one or more issues where a conflict exists with respect to at least one of these issues.

Negotiation is an interaction and process between entities who aspire to agree on matters of mutual interest, while optimising their individual utilities. This beneficial outcome can be for all of the parties involved, or just for one or some of them.[1]

Negotiation involves a back-and-forth communication designed to reach agreement while leaving the other side intact and positive (Mylona,).

21.7.2 Environments of negotiation

Negotiations take place in various environments, including:

a. Organisations
   i. Divisions, departments and units;
   ii. Management and unions; and
   iii. Staffs, etc.

b. Communities
   i. Governments and communities;
   ii. Government and labour unions;
   iii. Between litigants;
   iv. Family members;
   v. Higher institutions;
   vi. Hostage situations; and
   vii. Religious institutions, etc.

21.7.3 Types of negotiation

There are two types of negotiation based on the possible outcomes of the negotiation. These are:

a. Distributive negotiation

This is also called positional, hard-bargaining or win-lose negotiation because one party's gain is a loss to the other party, as there is a fixed prize in the negotiation. It is a zero-sum game situation. Parties to the negotiation therefore seek to minimise their losses by taking hard-line positions during the negotiation process.[2]

Examples of distributive negotiation include:

   i. Negotiation between buyer and seller of a property;
   ii. Negotiation of a disputed property amongst individuals; and
   iii. Negotiation of disputed lands between communities.

b. Integrative negotiation

This type of negotiation is also called principled negotiation, interest-based negotiation, merit-based or win-win negotiation.[3]

All parties in the negotiation derive some benefits from the exercise. Compromises are usually made to achieve this situation. There are trade-offs by the parties.[4] It is not a zero-sum game situation. The parties usually share a common interest.

Negotiators would normally endeavour to move the environment of the negotiation from a winner-takes-all to a win-win situation to facilitate attainment of compromise, otherwise, the perceived loser will not cooperate. To achieve this, the negotiator must spare no effort in identifying and articulating the benefits accruing to each of the parties in the negotiation process to encourage them to agree to the proposal.

Examples include:

i. Allocation of resources or revenue of government between various units of a country or jurisdiction; and
ii. Budget debates at the National and State Assemblies.

From the foregoing, it is easy to appreciate the importance of negotiation in society and the need for negotiation skills.

21.7.4 Common forms of negotiation within organisations

a. Management negotiations

One of the major responsibilities of management is to negotiate with various stakeholder groups of the company. This form of negotiation takes many forms because of involvement of different groups. These negotiations include those with the following groups, identifying issues that require negotiation:

i. Shareholder groups
- Support for policies; and
- Benefits to shareholders.

ii. Customer groups
- Prices;
- Product quality; and
- Sales terms.

iii. Governments and regulatory authorities
- Taxes;
- Corporate social responsibility;
- Social Infrastructure; and
- Incentives.

iv. Suppliers and creditors
- Terms of credit.

v. Debtors
- Terms of payment.

vi. Staff and their unions
- Work environment, and collective bargaining of conditions of service.
- Salaries.

ICAN 2021

vii. Prospective staff
- Remuneration; and
- Placement.

viii. Host communities
- Corporate social responsibility; and
- Access to natural resources, like water and raw materials.

b. Internal negotiations

Within organisations, workers or groups of workers may often need to negotiate various issues, like:

i. Allocation of work within groups and teams;
ii. Roles within teams;
iii. Allocation to teams; and
iv. Bases of sharing group bonuses.

21.7.5 Skills required for effective negotiation

These are skills required to facilitate achievement of compromise or consensus between two or more parties. These are usually various skills that the facilitator may deploy to diffuse tense situations and encourage agreement and compromise. They are required by negotiators for success. The skills required vary with the environment of negotiation and the parties involved. It takes the creativity and experience of the negotiator to determine what skills will be required.

Some of the skills relating to negotiation are discussed in more details elsewhere in this chapter. They include:

e. Effective communication

Communication skills include:

i. Active listening skill;
ii. Clear language;
iii. Nonverbal cues; and
iv. Feedback.

f. Persuasion

This is the ability to influence others to support your position and agree that your proposals are beneficial to all parties.

g. Planning and organising

Planning and organising skills are essential to reaching agreement and compromise in negotiation. It is important to prepare a conducive environment and consider the long-term impact of the proposals on each of the parties. These skills will also assist in developing implementation programme for the agreement.

h. Strategising

Negotiators usually prepare different options and scenarios and rank them in order of preference after considering all possible outcomes. This way, there are alternatives to negotiate.

ICAN 2021

21.7.6 Essentials of effective negotiation

a. Measurement

Effectiveness of a negotiation process can only be evaluated by measuring the final agreement against the planned outcome. The evaluation score depends on who is making the assessment, the negotiator or any of the interested parties as their objectives are different.

Considerations for successful negotiation include the following:

i. Clear identification of the issues and final goal: It is essential to clearly identify all the issues involved and articulate the objective of the negotiation process, as this motivates action towards its accomplishment. The goal should be acceptable to the parties. This will also enable the negotiator or other stakeholders to access the extent of success attained at the end of the exercise;

ii. Establish the limits of acceptable compromise: The negotiator should establish the limits of compromise that could be agreed to during the negotiation process;

iii. Identify unacceptable terms: Establish those terms of the negotiation that are unacceptable, hence cannot be compromised;

iv. Articulate your best alternative to negotiated agreement (BATNA): The negotiator has to determine the BATNA. This involves considering the worst-case scenario if the negotiation fails, what is the next best alternative;

v. Consensus building: The negotiator must build consensus and cooperation amongst the parties to reduce tension and facilitate attainment of set goal. It is essential to find common ground amongst the parties;

vi. Eliciting compromise: The negotiator must develop a process of encouraging the parties to compromise and thus create semblance of a win-win situation for all of them;

vii. Placing a time restriction on the process: Placing a time restriction on the process will put pressure on all parties to compromise and reach agreement. To achieve this objective, the allotted time should be realistic for the goal set. Attention of all parties should be drawn to the time limit when the negotiator notices distractions;

viii. Generation of many options for consideration: The negotiator must be ready with alternative courses of action, in case the process runs into a hitch. This will avoid premature abortion of the process and give the process a better chance of success.

ix. Display of confidence throughout the process: The negotiator must continue to display confidence throughout the process so as to, continue to earn the trust and respect of all parties. During stormy sessions, the negotiator should endeavour to restore calm and continue the process;

x. Ability to remove one's personality from the process: The negotiator should not personalise any disagreements or objections during the process.

xi. Assess the opposition: The negotiator must assess the strengths and weaknesses of the opposition to decide what will be acceptable to them. There is also a need to assess emotions and sentiments of the opposition. These factors affect those options that will be attractive to them;

xii. Understanding one's weaknesses: The negotiator must identify personal weaknesses and take steps to mitigate their impact on the process; and

xiii. Regular practice of the negotiation process: Familiarity with the process and tools of negotiation engenders confidence in the negotiator, an essential ingredient for success. This will enable the negotiators to hone their negotiation skills.

21.7.7 Challenges to negotiating in an organisation

Corporate environments are rapidly changing, hence corporate strategies and other responses are frequently changing to catch up and even predict these changes to retain their competitive advantage. Professional accountants must keep developing their core skills, but also their soft skills to enhance their performance.

In the post pandemic corporate environment, the modes of operation have changed significantly, thus heightening the rate of change. For example, negotiation meetings can hold on virtual platforms, through emails and other electronic media, which may not give opportunity for evaluation of non-verbal cues, which are critical in negotiation.

Other challenges to negotiations within organisations include:

a. Group influence;
b. Biases from previous exercises;
c. Perception of the negotiator as an interested party;
d. Misconception from poor communication;
e. Lack of trust;
f. Cultural differences;
g. Gender differences;
h. Religious differences;
i. Structural impediments; and
j. Spoilers.

21.7.8 Mediation and Arbitration

Mediation and arbitration are types negotiation.

Mediation is a form of negotiation with the negotiator as a third-party catalyst who helps the conflicting parties negotiate when they cannot do so by themselves.

Negotiation can be contrasted with arbitration, where the decision lies with the third party, which the conflicting parties are committed to accept.[6]

21.8 Chapter review

At the end of this chapter, readers should be able to understand:

a. Concept of soft skills;
b. Leadership;
c. Emotional intelligence;
d. Social thinking;
e. Creative thinking;
f. Service orientation;
g. Cognitive flexibility; and
h. Negotiation.

ICAN 2021

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