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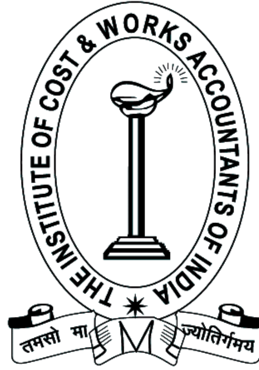
GROUP III



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GROUP - III

Paper-13 : MANAGEMENT ACCOUNTING – STRATEGIC MANAGEMENT

FINAL EXAMINATION

(REVISED SYLLABUS - 2008)

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Paper-13 : MANAGEMENT ACCOUNTING – STRATEGIC MANAGEMENT

Q. 1. Explain the difference between :

(a) Policy and Strategy

(b) Goals and objectives

Answer 1. (a)

In general, policies are drafted to be used as broad guidelines by the organization's decision makers. These general guidelines indicate how an organization should deal with recurring problems in its routine operation. By providing a prescribed path for handling repetitive matters, they save time and effort. Thus, policies streamline and help focus the decisions made and the consequent actions taken by an organization. In theory, these guidelines are used to help organizational leaders make all other decisions; they represent a framework for decision making.

In contrast, strategies represent an organization's specific plans of action. Strategic planning permits the organization to chart a course of action into the future that coordinates and balances all the contributions made by the entire organization, yet strategic planning must be flexible enough to absorb and respond, drive the organization forward, and adapt to the current business environment. Strategies denote a general program of action to achieve long-term objectives of the companies, the deployment of resourcs to attain these objectives, and major policies to be followed in using these resources. We can say that all strategic decisions and subsequent actions of the organization should revolve around and occur in accordance with the guidelines provided by policy.

Answer 1. (b)

Goals are broad statements that present what needs to be pursued in certain areas. Most businesses express their main goal as maximizing stockholder wealth. The focus on maximizing short-term *return on investment (ROI)* will overlook corporate competitiveness.

An organization's goals depend on the nature of its business and will stem from its mission. The organization's market share, technology, productivity, and profitability are all components of a desired goal. Let say X Ltd. a car manufacturing company has a goal is to infiltrate and dominate the market. They want to sell cars at a very affordable price from extremely well-staffed and maintained showrooms, with the auto industry's best after-sales service. They also plan to keep things simple and easy for their customers.

A company always has a large number of objectives, which are stated in a hierarchical fashion, from the most to the least important. They indicate the desired result of planned activity. Not-for-profit organizational objectives might not be specific or measurable. The objectives of for-profit organizaations are the specific intended results. They are measurable and have a time frame. There are three levels of objectives within an organization :

(i) **Strategic or long-term objectives** are usually set for the entire organiization and broadly stated.

(ii) **Intermediate objectives** are usually more specific and increasingly complex and detailed. They are set for various strategic units or functions.

(iii) **Operational or short-term objectives** are more specific than the previious two and should be done on an individual or group level.

Objectives and strategies are formed from strategists' consideration of mission, strategic policy, and appropriate information. When a firm operates outside its parent country, the objectives and other strategies might be different. While the strategic management process is the same for domestic and international management, the environment is often different. For example, companies must adhere to different rules when operating abroad. Therefore, strategies must be altered. Many multinational companies depend on the superiority of some resources abroad such as capital, labor, or technology. These organizations capitalize on advantage in order to overcome weaknesses at home.

Q. 2. Define an intended, an emergent and a realized strategy.

Answer 2.

Strategic management is the process of assessing the corporation and its environment in order to meet the long-term objectives of the organizaation. It refers to the series of decisions taken by management to determine the long-term objectives of the organization and the means to achieve these objectives. Once a mission has been established, strategies are develloped to pursue· it. An organization must develop a form of strategic management to control these strategies.

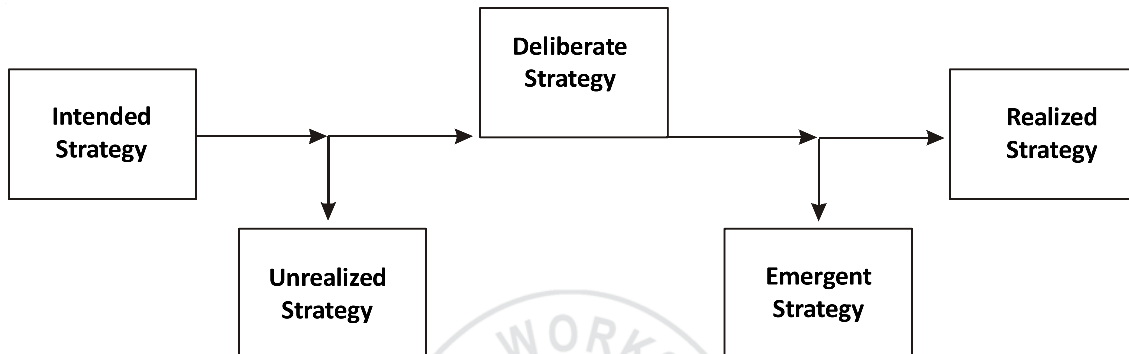
Through strategic management, an organization can handle its mission while at the same time assessing the relationship of the organization to its environment. The *environment*, in this case, means any internal or external force that may cause an organization to stray from the path of its stated misssion. Thus, strategic management becomes a component of an organization's mission. Without it, an organization would have great difficulty implementing and controlling strategies. In addition, one important point to keep in mind is the difference between intended strategy and the strategy actually realized. Peter Wright and colleagues addressed the intended strategy as the one that was originally planned and could be emergent in its original, modified, or an entirely different form. On the other hand, *realized strategy* is what is actually implemented because of changed external or internal events.

An example of intended versus realized strategy is Honda's entrance into the American motorcycle market. When Honda entered the market in 1959, its intended strategy was to market its motorcycles with 250 cc and 305 cc engines even though it was selling the 50 cc model in Japan with great succcess. However, the intended strategy failed because, despite what Honda management believed, the U.S. market preferred the smaller model. It was not until Sears Roebuck expressed an interest in selling the smaller model that Honda changed its mind about the model to sell. So, the intended strategy was modified and the realized strategy met with positive results.

The traditional approach indicates that each of the elements of strategic management constitutes a planned and organized step in the process. The strategic management process begins with defining vision, missions, and goals followed by strategy formulation, strategy implementation, and evaluuation and control.

Proponents of *emergent strategies* believe that the initiation of such strategy does not require going through the steps mentioned above in a sequential fashion. They are usually suggested by operating-level management and/or employees. However, such a strategy does not diminish the role of the strategic (general) management. Management has to evaluate the emergent strategy in the context of the already established strategy (intended strategy) and determine whether it fits the organization's needs, criteria, and capabilities. This will necessitate a thorough evaluation of the organization's internal and external environment. Usually, the formulation of intended strategies is a top-down procedure, whereas the formulation of emerrgent strategies is a bottom-up approach. Therefore, the effectiveness of such a

strategy depends on the type of communication and leadership available in the company. In most cases, strategies are a mix of both intended and emergent strategies.



Q. 3. What are the different policies taken by the Government of India to improve the productivity and competitiveness of the Indian economy ?

Answer 3.

Proactive policy measures taken by the Government of India to improve the productivity and competitiveness of the Indian economy enunciated in the various sectors of the economy – real, fiscal, external, monetary and financial.

(i) Real sector policies

a. Agriculture and allied activities

Agricultural sector has remained a problem area and there has been a declaration in its growth. To arrest this trend and reverse the deceleration, number of policy inputs has been made. A National Rain Fed Area Authority (NRAA) has been created in November 2006 to support up-gradation and management of dry land and rain fed agriculture. The authority would coordinate all schemes relating to watershed development and other aspects of land use. The accelerated irrigation benefit programme is also being revamped to repair, renovate and restore water bodies in various states. The National Agriculture Insurance Scheme (NAIS) and the National Rural Employment Guarantee Scheme (NREGS) are two important schemes which have been implemented. These have been extended to more number of villages, so that the under employment in agriculture sector is mitigated and business risk in agricultural farming due to natural calamities are also taken care of.

b. Manufacturing and infrastructure policies

If the increased activity in the manufacturing sector since 2003-2004 has to be sustained focus on upgrading the infrastructure facilities in the country is the need of the hour. Up gradation of human skills, work on golden quadrilateral, introduction of public private partnership model, increase in the power production capacity, etc, have already been identified as the areas which need robust growth in the immediate future. Spiraling of crude oil prices has had a deleterious impact on production and logistics costs through higher fuel costs. Alternatives to fossil fuel are being looked into. Wind energy is being harnessed increasingly apart from utilizing the large coal reserves available in our country. The credible alternative of producing nuclear power is one of the salient government policy. In regard to the industrial policy, the micro, small and medium enterprises development act 2006 has modified the previous act to increase the threshold investment.

A new national pharmaceutical policy has also been announced during the year 2006 to strengthen drug regulatory system and patent office. The public-private partnership model has enabled greater

private sector participation in the creation and maintenance of infrastructure. Concepts of special economic zone are under introduction and there have been a lot of hiccups in this area. New modifications are on the anvil to take care of the displaced landowners as also protection of the fertile lands. The information technology amendment bill 2006 will put in place technology applications, security practices and procedures relating to such applications.

(ii) Fiscal policy

While preparing a policy to take care of the robust growth of the economy it has also been necessary to introduce fiscal corrections to reduce the fiscal deficit. Government of India subjected itself to a fiscal discipline for reducing deficits in the key areas viz, revenue, fiscal and primary. The tax base is being broadened to include more and more new services in the tax net. Personal taxation is being reduced so that the disposable incomes are bigger and savings grow. Introduction of value added tax (VAT) in various states has been a significant success and is expected to usher price stability as well as improved earnings to the various states through higher volumes.

(iii) External sector policies

Foreign trade policy of 2004-2009 was modified through an annual supplement in 2007 for deepening the incentives provided for focused products and markets. For simplifying and liberalizing the external payments regime and deepen the foreign exchange market the recommendations of the committee of Fuller Capital Account Convertibility have been considered by the Government of India and certain policy initiatives have been undertaken. They relate to increase in overseas investment limits for joint ventures/wholly owned subsidiaries abroad by Indian companies, higher portfolio investment limits for Indian companies/domestic mutual funds, higher ceilings for investments by foreign institutional investors in Government securities and enhanced repayment limits for external commercial borrowings.

(iv) Monetary policies

The necessity to balance the growth of economy with containing inflationary pressures has guided the monetary policy. The Reserve Bank of India (RBI) have taken its stance on the monetary policy to continue to reinforce the emphasis on price stability and well anchored inflation expectations and there by sustain the growth momentum contextually, financial stability may assume greater importance in the near future. RBI has been managing this area with the cash reserve ratio (CRR) on one-hand and Repo rates on the other. The interest rates are being modified whenever necessary on the basis of the monitoring exercise on rates of inflation.

(v) Financial sector policies

In view of the critical role played by the financial sector in supporting the robust growth of economy, RBI have tightened provisioning norms and risk weights to ensure asset quality, strengthened the accounting and disclosure norms for greater transparency and discipline. Final guidelines for the implementation of the new capital adequacy framework have been issued. Alongside its initiatives to strengthen the financial sector the RBI continue to take measures for protecting customers' rights and enhancing the quality of customer service.

Q. 4. Define strategic management. State its characteristics and process.

Answer 4.

Definition and Meaning :

Strategic management is the process of assessing the corporation and its environment in order to meet the firm's long-term objectives of adapting and adjusting to its environment through manipulation of opportunities and reduction of threats. Furthermore, this process requires a careful evaluation of the firm's environment before making managerial decisions and taking actions. This process results in the

formulation and implementation of strategies designed to achieve the objectives of the organization. Other definitions of strategic management include the following :

- **Higgins and Vincze :** "the process of managing the pursuit of the organization's mission while managing the relationship of the organization to its environment, especially with respect to its environmental stakeholders: the major constituents in its internal and external environment affected by its action."
- **Harvey :** "process of formulating, implementing, and evaluating business strategies to achieve future objectives."
- **Pearce :** "the set of decisions and actions resulting in formulation and implementation of strategies designed to achieve the objectives of an organization."
- **Chandler :** "the determination of the basic long-term goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals."
- **Quinn :** "the pattern or plan that integrates an organization's major goals, policies, and action sequences into a cohesive whole."
- **Glueck :** "a unified, comprehensive, and integrated plan designed to ensure that the basic objectives of the enterprise are achieved."

Characteristics :

1. **Futurity :** The process of strategic management deals with future events and their consequences, thus requiring top managers to possess a long-term concept of decision making. Strategic management attempts to scan the broad future of the corporation using a written corporate scenario. In essence, strategic planning involves anticipating future events.
2. **Long-range impact :** Strategic management encompasses long periods of time, often exceeding five years. It attempts to predict events in the long run and analyze the potential impact of such events on the corporation.
3. **Iterative process :** Strategic management must be a continuous and repetitive process to be effective. A new strategic plan is developed while the current plan is in action. New plans are usually adopted and improved based upon the feedback obtained during the implementation phase.
4. **Systematic and rational :** Systematic is characterized by the use of orderly planning or by the use of a methodical approach, whereas rational implies possession of unemotional and logical reasoning ability. Thus, strategic management is a systematic and rational process because it consists of systematically processing decision inputs, which lead to rational and expected outputs.
5. **Integrated function :** Integration encompasses the concept of bringing all the parts together to create a whole, i.e., to establish "a set of policies and methods used by management to facilitate communications and to coordinate the activities of individuals or groups within the company." Thus, the strategic management process serves as a foundation for the other activities and functions of the corporation, such as organization, staffing, and control.
6. **Means to an end :** Strategic management is not an end unto itself. It is a means, or a tool, to be used to achieve corporate objectives.
7. **High stakes :** Due to the long-term nature and the broad organizational scope of strategic management, strategic decisions inherently involve the long-term commitment of a substantial proportion of organizational resources.

Process :

Strategic management is the domain of top-level management, and the process involves four basic components :

1. *Environmental scanning* consists of analyzing internal and external factors that may affect the organization and its ability to pursue a given course of action. Scrutinizing the environment includes the appraisal of the composition of competition within the firm's industry and also involves assessing the impact of globalization on the industry and the company's performance.

2. *Strategy formulation* (strategic planning) involves making strategic decisions concerning the organization's mission, philosophy, objectives, policies, and methods of achieving organizational objectives. Formulating a strategy is an important step to enhancing organizational position and building competitive advantages not only in the national but also in the global arena.
3. *Strategy implementation* is concerned with making a variety of managerial decisions such as the type of organizational structure, the type and source of information systems, leadership “fit,” and the type of control mechanism that should be employed.
4. *Evaluation and control* is concerned with the evaluation systems that are to be used to ensure the operation of strategic planning to effectively achieve the organization’s objectives. Evaluation consists of comparing the predicted results to the actual results. Strategic management is a process of appraising the corporation as a whole, taking the environment into consideration. It usually focuses on opportunities and problems related to the achievement of corporate objectives in the long run.

At the corporate level, the strategic management process involves activities that range from the initial statement of the corporate mission to the evaluation of the firm’s actions to meet the terms of that mission. To determine the corporate mission, top management scans both the internal and external environments, followed by an evaluation of the pertinent strategic factors. This is how the process of strategic management is continuous and repetitive.

Throughout the strategic management process, the organization must focus intently on all its activities, searching for answers to four basic quesstions :

1. *Who are we*? The question is an attempt to identify the company’s competitive position. How do we differentiate ourselves from competitors, focusing on our strengths and weaknesses? What is our natural market? Looking at threats and opportunities, how do we fit in this market? Simply, it is the mission of the company.
2. *Where are we now*? Are we maximizing opportunities and reducing threats to the success of the organization? Where is the company compared to the rest of the industry? Are we leading or lagging behind the industry, or just holding our own? Is our strategy adequate to counter our shortcomings? Where is the company standing right now? Is it an acceptable position? What is our current strategy?
3. *Where do we want to be*? If the current strategy is not appropriate, especially in the long run, what strategy should we adopt? This is simply stating objectives.
4. How do we get there? How can we turn threats into opportunities? This question isolates the means to achieve objectives efficiently and effectively, the choice of new strategy, and how to implement it.

The strategist must analyze corporate objectives in light of the environment. Management must determine the company's strengths, weaknesses, opportunities, and threats (SWOT). Then the strategist will match the corporate strengths to the environmental opportunities available and reduce the corporate weaknesses facing environmental threats. This process is known as *SWOT analysis*. Management uses SWOT analysis to make decisions about developing the overall strategy of the corporation.

Q. 5. List and explain the five categories of strategy formulation.

Answer 5.

Different Types of Strategies :

Enterprise strategy encompasses the dealings of a corporation and its social responsibility such as pollution control, safety measures taken by the company, or its contribution to solve particular problems such as energy shortages or education needs. This strategy is the scope of stakeholder satisfaction achieved by a corporation at anyone time. Enterprise strategy should address the question, "What do we stand for?" This strategy tends to have a positive effect on the overall performance of the organization. The stakeholder relationship is moderated by the firm’s *grand strategy*. The type and range of stakeholder

groups varies from firm to firm and situation to situation, but there are four fundamental stakeholder groups that every organization must consider : (a) owners, (b) employees, (c) major customers, and (4) major creditors. For example, Mentor Graphics Corporation was founded on the principle or long-term vision "build things people will buy." This was a very successful company in the design automation industry in the 1980s. As competition increased and the Daisy Corporation overtook Mentor Graphics as the industry leader, the corporate strategy of Mentor beecame "beat Daisy." Companies must be careful that their grand, abstract viision is not too inspirational, or the company may wind up making more pooetry than product.

(1) **Corporate strategy** describes what business the firm is in, or should be in, and how the corporation intends for its business to be conducted. Corporate strategy includes the overall aspects of integrating its business into a unified position in relation to the environment and competition. There are two main strategic concerns at the corporate level. The first concern is with the executive management and deals with the scope, mix, and emphasis among the various activities. At this level, decisions are concerned with the appropriate strategic approach for each different business unit and the improvement of performance for the overall organization. The second major strategic concern is prioritizing corporate resource allocation across various corporate activities. For example, multiple-SBU organizations must determine in what areas the organization wishes to compete and then arrange the various SBUs to produce a balanced portfolio. Here the corporate strategist's essential task is to determine the business mix, establish investment priorities, and allocate corporate resources among the various SBUs. Thus, in determining corporate strategy, the organization endeavors to coordinate the business portfolio and to provide direction to the individual SBUs. Various generic strategies are labeled *growth, stabilization, investment, reduction, turnaround, and takeover*. Typically, the CEO, the board of directors, owners, corporate staffs, andlor strategic planners are involved in the development of corporate strategy.

Table : Various Strategies

Type of Strategy	Organization Hierarchy	Theme of Strategy
Enterprise strategy	Board of directors	Stakeholder domain, i.e., social responsibility, environment, educaation, etc.
Corporate strategy	CEO of the company	Overall strategy
Business strategy	Various SBUs	How each SBU competes in its industry
Functional strategy	Various functions	Each function, such as production, marketing, public relations, finance, etc., develops its own strategy. It is more specific to support the business strategy.
Operation strategy	Different departments or divisions	More specific and short term in naature. It supports the functional strattegy. It deals with day-to-day operations.

(2) **Business strategy** is management's plan both at the corporate and SBU levels for directing and running a particular business unit of the corporation. The primary focus of business strategy is to assess the strategic advantages of the individual unit. It is also concerned with the issues of (a) how the SBU expects to compete in a specific business, (b) what each SBU must contribbute to achieve success for the organization, and (c) how to obtain resources from the corporation and allocate them to achieve the SBU's objectives. A major component of business strategy at the SBU level is a marketing orientation. It specifies how the individual business unit will compete in the marketplace. At the business level, strategies tend to be action based in an attempt to gain advantage over the competition. As a result, business strategies are built upon market factors (buyer needs, market share, product differentiation, and economic resources) and are of the utmost importance. The owners, directors of SBUs, divisional managers, or divisional staff are involved in the development of business strategy.

(3) **Functional strategy**, which supports business strategy, does so by managing each principal activity within the business. The functional level is more specific than business strategy and assists the organization in performing the critical functions necessary to run efficiently. Functional strategy involves planning for maximum resource utilization. Examples of functional areas affected by this strategy include human resources, marketing, production, finance, public relations, physical resources, and research and development. There should be a functional area strategy for every major functional area. Functional area strategy also indicates how each major sub-activity of the business will contribute to achieving the overall business strategy. Managers at the functional level develop this strategy.

(4) **Operational strategy** is the most detailed of the strategies and breaks down the related plans and practices into departments and supervisory levels. These positions manage the day-to-day requirements of functional-area support strategies—the nuts and bolts of various facets of the organization's functional areas. An example of an operating-level strategy is an inventory control system, Lean just-in-time (JIT).

Strategists must also consider an overall strategy, which is the combinaation of strategic actions that define the direction of the organization. Examples are changes in consumer preferences, product innovations, technologies, and market entries and exits, along with the overall rate of change within the industry. Numerous other substrategies exist within these main strategic categories.

(5) **International strategy**. Companies have been entering the global market for more than two decades. Nike and other shoe manufacturers make shoes in Asia. McDonald's gets more than half of its revenue from outside the United States by selling burgers in large foreign cities such as Moscow and Beijing. Coca-Cola also sells 50 percent of the world's soft drinks. More people all over the world want world-class goods. There have never been as many borders open to free trade as there are today. The North American Free Trade Agreement of 1993 removed trade barriers between the United States, Mexico, and Canada. The General Agreement on Tariffs and Trade (GATT) of 1993 and the World Trade Organization (WTO) have eased trade throughout much of the industrialized world. Europe is now moving toward borderless trade with the implementation of a single currency. Even Japan is now more open to foreign goods than ever before. Peace dividends—the reallocation of resources from military purposes to consumer ones—are major forces behind the escalating globalization of the world today.

Communications technology and falling trade barriers are changing the rules of international strategic management. Companies that operate domestically and abroad have developed new criteria for determining where and how they compete in the twenty-first century. The location of the country where they operate is crucial to their strategic importance. A country's strategic importance is a function of overall market size and its ability to provide easy access to high-value inputs such as labor, energy, capital, etc. Strategy for an international company is a hierarchy that includes corporate-level and business-level strategies. The emphasis of corporate strategy is on selecting the industry in which the company will operate and how the various businesses within the company will coordinate activities. The emphasis of business strategy is on market share and how to compete domestically and internationally. The primary drive of international strategy is determined by business unit strategy.

When a company originates in one country and decides to transfer valuable skills and products to another, it is called an international company. Usually, the company transfers a product that was developed at home to other overseas markets, at the same time maintaining firm control over marketing and product strategies. Sometimes the international company establishes manufacturing and marketing functions in another country in which it operates. These companies are called multinational companies (MNCs). Initially, companies begin with export-import activities (becoming international companies). This can be done either directly, using a sales subsidiary, mail order, and telemarketing, or indirectly, selling through distributors or agents. Companies can also expand their operations through licensing and franchising. Then they expand further through partnerships or joint ventures with foreign companies. This can be done through a distribution alliance, manufacturing alliance, and/or joint venture.

Some companies expand overseas by establishing production pace in response to local demand. This can be accomplished by establishing subsidiaries abroad. Such companies first develop products for their

home market and then offer them overseas. Because of the duplication of production facilities, these companies might incur higher production and marketing costs. Examples are the automobile companies. If the company decides to further penetrate a particular foreign market because of the opportunities and the availability of resources, it might initiate direct investments and establish subsidiaries. This can be done through assembly, complete manufacturing, or acquisitions. This type of company is called a *multinational enterprise*. The subsidiaries of a multinational firm operate independently from one another. Examples are Xerox, IBM, Procter & Gamble, Apple, and Motorola.

A global company is a borderless business with many subsidiaries abroad, which complement each other and have some kind of control with their own operation. They are more sensitive to their localities. This type of company tends to standardize its product worldwide so that the firm can maximize international efficiency by locating activities in low-cost countries and prooducing standardized products from world-scale facilities. When control and research are transferred to the local subsidiary, the company has mov closer to becoming a global company. For example, Intel, Texas Instruments, Motorola, Levi Strauss, all of the watch companies, all brand-name clothes companies, and semiconductor producers have established subsidiaries abroad.

Q. 6. (a) What is 'Situation Audit' in strategic planning?

(b) Discuss its fundamental purposes with a brief description of the contents.

Answer 6. (a)

Strategic planning is the process of making current risk-taking decision with the best possible knowledge of the future consequences and situations. It thus requires sensing of expectations and needs, creating awareness throughout the organization, crystallizing the development focus and making people committed to achievement of specific goals. 'Situation audit' refers to the analysis and appraisal of these basic planning premises and covers the entire process of determining the following pertinent issues –

(i) Expectations of major outside interests in relation to : society, community, stakeholders, customers, suppliers and creditors;

(ii) Expectations of major inside interests in relation to : top managers, senior and middle-level managers, supervisors, staff and workmen;

(iii) Data base with respect to past performance, current situation and forecasts; and

(iv) Evaluation of environment (i.e. opportunities and threats) and of company (i.e. strengths and weaknesses).

Answer 6. (b)

Fundamental purposes of Situation Audit.

(i) A major objective of the situation audit is to identify and analyse the key trends, forces and phenomena that may have a potential impact on the formulation of strategies. This helps a company to identify specific elements in the environment that will be addressed.

(ii) The situation audit serves to emphasise the importance of systematic assessment of environmental impacts.

(iii) The situation audit is a forum for sharing and debating divergent views about relevant environmental changes. The more open the debate about them, the more likely the planning system will be effective.

(iv) Systematic attempts to appraise the environment, through situation audit, help individuals to sharpen vague amorphous attitudes about forces operating in the environment.

(v) Finally, all of the information collected in the situation audit provide a base for completing the strategic planning process in all of its phases, from revaluating missions to formulating strategies and implementing them.

Contents of Situation Audit

(i) **Expectations of outside constituents :** The constituents viz. outside people and groups are interested to understand what a large corporation wants to do. Systematic examination of the attitudes, demands, and expectations of these groups and their considerations in appropriate forms help a corporation in the strategy formulation.

(ii) **Expectations of inside constituents :** The values, attitudes and interests of individuals and groups within a corporation constitute significant premises for planning. The value systems of top management particularly are basic and fundamental premises in any comprehensive corporate planning system. These value systems not only influence objectives but also influence all sorts of decisions made in the planning process.

(iii) **Data base :**

a. *Past performance :* The data about it are useful as a base for assessing the present situation and possible developments in the future. Data about the past covers the basic information as sales, profits, return on investment, productivity, marketing systems, and so on. Current situation – the data about it could include the company's financial position, market share, competition, customers and markets, evaluation of managerial and employee skills, various measures of efficiency (e.g. sales per employee, plant utilization, investment per employee), constituent demands, government regulations, general environmental setting, and so on.

b. *Forecasts :* The data about this would certainly include forecasts of markets, sales, competition and selected economic trends of prime concern to the company. These are traditional projections. But the estimates of future technological developments, changing social expectations, anticipated political and regulatory forces likely to affect the company and other trends of particular concern to the firm (e.g. population, international political turbulence, etc.) are vitally necessary in the situation audit.

(iv) **SWOT analysis :** Environment — This is a critical phase of the situation audit. In this phase, a company seeks to identify the principal opportunities that appear to exist in the environment of the future as well as the threats that may adversely affect the company. The assessment of company strengths and weaknesses in relation to the perceived opportunities and threats affects the strategy formulation and its implementation.

Q. 7. Define TQM. Explain the effect of TQM on Strategic management.

Answer 7.

Total Quality Management :

Total quality management (TQM) refers to the systematic improvement of quality and cultural transformation in management techniques through the involvement of everyone in the organization and in all aspects of the business operation. This concept refers to the philosophy that promoting quality values in all organizations should be the driving force behind managing, planning, designing, and improvement initiatives. TQM is a long-term concept and not a quick fix for corporate problems. Evidence of the importance of TQM can be seen in the enthusiastic response to the Malcolm Baldrige National Quality Award, which was initiated August 20, 1987, to recognize high quality in American industry. Some of the companies that won the Baldrige award include Globe Metallurgical Inc. (1988), Federal Express Corporation (1990), GTE Directories Corporation (1994), and ADAC Laboratories (1996).

Robert C. Stempel, the former chairman of General Motors Corporation, was quoted as saying, "The worldwide quality revolution has permanently changed the way we all do business. Where once quality was limited to technical issues, it is now a dynamic, perpetual improvement process involving people in all aspects of the business." In 1989, the American Society for Quality Control conducted a survey which showed that 54 percent of the executives rated service quality as extremely critical and 51 percent gave

U.S. products less than an 8 on a 10-point scale. Correspondingly, some Fortune 500 executives said U.S. products merited no better than a C^+.

"Total quality" in the business world has become an important and competitive issue. The concern for quality has been around for centuries. However, the emphasis on worldwide quality revolution is permanently changing the way we do business. When Edward Deming and Joseph Juran talked about quality control in the 1950s, few American companies were listening. American businesses at that time were booming. They were the front-runners in innovation and industry. They did not foresee the future consequences of not adopting such a system.

Role of TQM in strategic management :

An organization must apply strategic management plan to be able to implement TQM. Companies might need to change their strategy in order to improve the current system, or re-design the system from scratch. Typically, the TQM process starts with defining a problem, setting objectives, gathering data, setting certain standards, examining the environment, allocating resources, and taking a course of action. Strategic planning is the process of developing and maintaining strategic fit between the organization and its changing environment. Bushnell and Halus argue that the steps involved in designing and implementing a strategic plan can be seen to closely parallel many of the key concepts involved in TQM.

Barrett argues that one aspect of the strategic planning process should be to implement a TQM program. Chalk states that strategic planning is essential for TQM. Henderson argues that the basics of TQM can govern executive-level strategic planning and goal setting. He states that TQM can be reduced to the following strategic management objectives :

1. Continuous improvement in quality goods and services
2. Company responsibility to its customers
3. Flexibility in adjusting to customer needs and expectations
4. Cost reduction through improved quality and non-value-added waste elimination

The TQM approach has companies moving toward *proactive* improvement to match customer needs and provide superior customer value. Managers began to respond and quality improvements proliferated. Organizations that successfully incorporated TQM practices share some common positive effects :

1. When employees are more involved in the process of improvement, productivity and consumer satisfaction will increase. This also gives the employees a sense of importance and leads to higher motivation, reduced employee turnover, increased productivity, and increased profits.
2. Employees gain a personal understanding of TQM, which in turn leads to more effective worker involvement.
3. TQM offers employees greater participation in decision making and thus makes the implementation of company's objectives much faster.
4. TQM allows for in-time consideration of potential problems.
5. TQM reduces management bureaucracy. Teams are self-managing and do their own hiring and firing.3D TQM promotes reduction in the production cycle. Empowered workers feel responsible for the quality of their processes; they strive for defect reduction and delay reduction.

TQM and strategic management are management-led processes. The senior leaders in a company must create clear and visible quality values, as well as high expectations. Reinforcement of the values and expectations requires substantial personal commitment and involvement. Leaders in TQM, as in strategic management, are guided by clear, visible statements of values, usually in the form of mission statements.

Policies that support the goals and objectives of an organization provide the necessary direction for the TQM process. These guidelines ensure that every employee understands and is responsible and accountable for TQM in daily business activities. For example, McDonald's has incorporated environmental policies into its TQM process to emphasize part of its corporate mission. The policy, as stated by Bennet,

Freierman, and George, says, "McDonald's believes it has a special responsibility to protect our environment and future generations .... We will lead in word and in deed." The policy further states that the company is guided by four principles: "effectively managing solid waste, conserving and protecting natural resources, encouraging environmental values and practices, and ensuring accountability procedures."

TQM and the strategic management process are not two separate structures. Quality is made part of the business through integration in the strategic planning process, according to George and Weimerskirch. One of the goals of TQM is continuous improvement toward the ideal of zero defects. This concept plays a major role in the strategic plans that guide a company. Further, strategic management defines policies and ensures the acceptance and implementation of TQM throughout the company.

The TQM approach, like strategic management, involves extending the improvement process into the future. Achieving the highest levels of quality and competitiveness requires a well-defined and well-executed approach to continuous improvement, a process that must contain regular cycles of planning, execution, and evaluation. These same cycles are vital to the strategic management process.

Therefore, the benefits of TQM mirror the overall goals of strategic management. They consist of improved (1) customer satisfaction, (2) organizational effectiveness, and (3) competitiveness.

Q. 8. Discuss Re-engineering in the context of strategic management.

Answer 8.

In today's competitive environment, corporations are being required to find new and improved methods of doing business. Although this may not be that difficult, it adds to the necessity of reducing cost while being innovative and this task becomes extremely difficult. Reengineering is the tenn used to describe the concept and method of radically redesigning business processes.

Reengineering plays a critical role in the strategic management process to help organizations significantly change. The goal is to develop and create superior business processes to produce unique goods and services customers value highly.

Some companies have turned to work reengineering to pave the way for TQM. Although

> no single generally accepted definition has yet emerged for the concept...work reengineering [can be defined as] the practice of modifying company policies, procedures, methods, practices, processes, structure, organization, systems and technology to achieve dramatic improvements in performance relative to appropriately defined critical success factors and performance measures.

Work reengineering differs from other process improvement methodologies in that it is typically approached from a project perspective, with process improvement goals and objectives and a limited time frame in mind. This project orientation keeps work reengineering focused on getting real results.

Work reengineering also seeks to attain dramatic step-change increases in performance rather than the incremental change advocated by continuous improvement. This concept helps an organization to revitalize its process. It seeks the optimal solution to operational problems without regard to what exists today. It allows a company to address policies and procedures, organization and structure, people and culture, system and technology, all of which are subject to review and change in the search for improvement. Work reengineering recognizes the risks but seeks the rewards associated with rapid and substantial change.

The success of reengineering depends not only on management's ability to lead the corporation in change, but management's ability to diagnose what that change should be. Before reengineering takes place, management must determine the primary purpose and the focus of the business, the culture, and organizational culture. Before reengineering, Union Carbide made a strategic decision to focus on commodity chemicals and exit from many of its specialty chemical markets. Union Carbide was then able to focus the reengineering to meet its strategic goals. Both Kodak and IBM assumed that their visions were correct and that they could reengineer their way to prosperity. They were wrong and their employees and shareholders have suffered.

Once the vision and strategy are finalized, then companies can begin planning the reengineering. This type of change does not come about from moving a few people around or changing a couple of boxes on the organizational structure. This type of success comes from completely redesigning the organization from scratch. That means beginning with the corporate vision and strategy.

Management needs to start with a blank piece of paper and design the organization that will best accomplish those strategies. Many companies claim they are reengineering when in reality they are squandering corporate resources on projects that have too narrow a scope to have any impact on the bottom line. In order to affect the results of the business unit or corporation, there is a need to restructure the things that are fundamental to the functioning of the unit. Anything less will have little impact on the bottom line.

During this process, it is critical that management not only creates the right vision and the right structure but also is involved in communicating why change is necessary. Management must realize that this type of change is very upsetting to the employees. Failing to provide information only increases anxiety and makes the changes more difficult to implement. Here internal communication through effective public relations is crucial. Re-engineering can be successful when the participants of the company share the vision and the mission of the company and strive diligently to make it succeed.

Strategic management is a process by which an organization keeps itself aligned with changing conditions. Reengineering is linked to strategic management because reengineering is doomed to failure if corporate strategy is not part of the process. Successful reengineering must be aligned with mission and vision, which are part of strategic management, to help an organization change those business processes that are fundamental to the success of the organization.

Q. 9. Name the four major forces of the macro environment. How does each of these external forces affect an organization's strategies and management?

Answer 9.

Macroenvironmentol Forces :

Environmental scanning is usually split into four different major areas: economic, technological, political, and social. Although external environmental information is typically harder to gather, such information is essential to determine the optimal strategy. Therefore, management tends to continuously seek “perfect information.”

The external environment impacts strategy formulation with four major forces : legal-political, economic, sociocultural, and technological forces. These forces can be either interrelated or interdependent. Of these four forces, the economic environment is the most significant for business organizations. The economic forces are the rate of inflation, the interest rate, the value of the currency, the unemployment level, the gross national product, and the business cycle. The economic cycle is usually divided into various stages, including depression, recession, recovery, and prosperity or peak. During any of these stages, the key variables affecting strategic decision making are the levels of unemoloyment corporate interest paid, and consumer income. Since the inflation rate and the gross national product growth rate are significant indicators of the current economic stage, they are the two variables most influencing the strategic planning process.

Economic Forces :

It is commonly agreed that several Governments like the federal government exerts a powerful influence on the U.S. (and thus world) economy through the fiscal or monetary policies of the Federal Reserve Board. Also, the amount of spending by the federal government directly affects the level and composition of business activity within the economy. Where and how the federal government spends its money also influences the business environment. The national economic factors affect even multinational corporations that operate within the United States.Companies are usually affected by the general condition of the national economy, either directly or indirectly. The value of the dollar might affect multinational corporation performance. Therefore, the firm’s strategies are somewhat dependent upon economic conditions.

Technological Forces :

Technology is a second aspect of the external environment that affects the organization in its strategic management process. In the past two decades, technology has changed drastically. Although technology is commonly interpreted as applying to automation, it has a broader meaning and is defined as the systematic application of scientific knowledge to practical purposes, including new ideas, inventions, techniques, and/or materials. The broader concept of technology could include a new method of planting trees. Since most industries' competitive advantages are predicated upon some type of advanced technology that changes rapidly, many industries are highly dynamic, e.g., electronics. Technological advances have in the recent past created entire new industries, such as biomedical genetics. Given the increasing rate of change of technology today, it is an important environmental variable for organizations. Competence and innovation in technology will provide an organization either a strategic advantage or a strategic disadvantage. For example, a firm that does not keep pace with technological development is destined to decline. On the other hand, a company that is a product innovator may become successful in the market by gaining a distinct advantage over the competition.

There are specific disadvantages for management in the area of technological advancement. Taylor and Hawkins believe that automation has a direct, and not necessarily positive, effect on corporate decision makers as "machines tend to duplicate mental as well as manual process." As two examples, they cite (1) middle-aged, experienced, but change-resistant, managers who cannot, or will not, adapt to computer technology, and (2) the redundancy in management caused by "mergers arising from the search for technological economies [of scale]." Furthermore, if a firm does not achieve a technological advantage, this technology gap becomes a major factor in altering the demand for a firm's (or industry's) products or services.

Political and Regulatory Forces :

Political and regulatory forces are the third major area of the external environment. In USA, the political orientation of Congress or the executive branch ranges from conservative to liberal and generally splits down party lines (Republican and Democrat). The current political orientation of each branch of government should be considered in the strategic planning process. For instance, the Republican party is generally considered relatively probusiness, and when this party controls a branch of government, that branch will tend to be more favorably oriented toward business organizations. In June 1998, Republicans in the Congress were able to kill the antitobacco bill that was highly debated and accepted by many as a solution to prevent teenagers from smoking. The tobacco industry lobbied against the bill and succeeded after spending millions of dollars.

Within the regulatory environment, all levels of government enact laws and regulations affecting business organizations. Primarily, regulations involve employment practices, tax revenue generation, or the legal structure within which the organization operates. However, as the government tends to move toward more concern with the physical environment and social issues, businesses will increasingly find themselves concerned with new laws and regulations in these areas.

Although many governmental laws and regulations are restrictive, some have a direct, positive influence upon an organization. During 1980s, greater emphasis was placed on the deregulation of businesses. Budget cuts in many agencies have reduced personnel, which has resulted in much government deregulation. Peter Drucker, in his book *Management in Turbulent Times*, says that ethical investors and public interest groups are moving straategic decision making from being just a private management matter to a more public interactive one. He asserts that in the international arena, multinational corporations must be aware of political risk and instability in forreign countries as well as political changes in the United States.

Socio cultural Forces :

Social and cultural forces are the last major external environmental areas affecting strategic management. Social forces are related to the values, attitudes, and demographic characteristics of an organization's

employees and customers. Dynamic social forces can influence the demand for an organization's products or services, and such forces should modify the organization's strategic decision making.

Bryson states that social values are shifting in our society. For instance, he mentions how the baby-boom generation affected enrollment in universities. Furthermore, women currently comprise about 52 percent of the workforce, and the trend for women to seek employment is forecasted to continue upward. Moreover, today most people desire not only wellpaying, but also personally stimulating jobs. Byars explains that most Americans want a higher quality of life. "To most American families, the balancing of work and leisure is important." Assessing the changing values, attitudes, and demographic characteristics of an organization's customers is essential to establishing the firm's objectives and strategies.

Social responsibility covers a wide range of influences, from government regulation to pressure from organizations that, if not resolved, could lead to more regulations. Due to the threat of added, and sometimes contradictory, regulations, organizations must develop proactive strategies to deal with what others perceive to be the organization's social responsibility. In many instances, some external influences could be neutralized with proactive strategic management. The catalytic converter on cars is a good example of a social trend that affected the political structure, which in turn forced change upon a given industry. External sociocultural environments are reflected in changes in the social or cultural trends of a given population, e.g., lifestyles, consumer activism, career expectations, population growth rates or regional population shifts, age distribution changes; life expectancies, birth rates, etc. Social responsibility is an internal attitude or choice reflected in management attitudes toward the external environment, i.e., whether management has to conform to social norms via regulations, or whether management voluntarily selects to be socially responsible because it is inherently right and inherently good business.

Demographics are a significant social factor. For example, changes in preferences have a penetrating effect on some businesses, as does the average age of the population. The increased buying power of minorities has also had a profound effect on business. Such a change is a result of shifting social and legal forces.

Political, economic, sociocultural, and technological forces have a clear impact on strategic formulation. Managers must cope with change in these external environments to effectively deal with threats and opportunities presented to the organization.

Q. 10. Describe the four modes of external scanning for threats and opportunities.

Answer 10.

Scanning the corporation's external environment prevents surprises and helps ensure a corporation's long-term health. Both the societal and task environments must be monitored to detect strategic factors that are likely to have strong impacts on corporate success or failure. Scanning the external environment supports strategic planning activities in many ways.

1. Data can be used to measure the marketplace by surveying changing tastes and needs, assessing buyers' intentions and perspectives, and evaluating the characteristics of the market.
2. Information is critical for keeping tabs on the competition and staying knowledgeable about developments in new products, changes in market share, individual company performance, and overall industry trends.
3. Information helps managers predict changes in the legal and political environments, including the effect of stipulations, tax laws, and import regulations.
4. Environmental scanning is required to stay knowledgeable about economic conditions including interest rates, foreign exchange rates, and economic growth.
5. Intelligence data can give answers to two key business questions : "How is the business doing?" and "Where is it going?"
6. In decision making, information thwarts uncertainty and indecision. In strategic planning, it decreases skepticism about an unknown future.

Valuable as it is, information carries with it numerous problems and costs :

1. Information is limited by time, cost, and availability; no one can obtain all the information needed. The sheer mass of obtainable data makes research a disheartening task.
2. Much information discovered in analyzing the environment is not pertinent to the user's needs, and such information may be fragmented, disassociated, and rarely found in precisely the required form.
3. Few companies have the luxury of unlimited time frames for research; the range of a search is invariably limited by an established deadline.
4. Planners often do not know what information is lacking until it is actually needed, at which point it may be too late.

Costs involved in acquiring information can be either direct or indirect.

Whether the company hires a consultant, purchases expensive publications, or merely uses its own time to track down the answers, each method has a direct cost. Information also has such indirect costs as delayed decisions, wrong decisions, and lost opportunities.

The most difficult aspect of business research is determining at what point the benefits of the information justify the cost. Benefits may be hard to assess, or may accrue long after the information is first obtained. Perfect information is obviously preferable to imperfect: yet in the real world, perfect information is rarely found. Imperfect information thus is preferable to no information.

The following are factors to consider when determining whether continued searching is no longer prudent.

1. Time constraints can determine when further research is unwarranted for the researcher.
2. When time is not a crucial factor, however, a good indicator is the importance of the consequences of the decisions. The potential size of the profit or loss to the organization is an excellent standard of the importance of the information.
3. Another consideration is whether the information addresses a recurrring problem or can be applied to other situations in the future.
4. The knowledge, skills, and interest of the researcher also determine the route an investigation will take.

In the final analysis, all these factors help determine how much research will be done. Each researcher regularly weighs the costs and benefits of information, if only on an unconscious level. Information can be categorized as internal or external. Internal information is generated within the organization, while external information is gathered from the outside. External information is classified as either primary or secondary. Primary information is produced specifically for the problem at hand. Secondary information is a by-product of some other task that is then applied to the matter under consideration.

Q. 11. Define 'marketing mix' and explain its main features.

Answer 11.

Marketing mix is a term used by Prof. Macarthy in mid 1960's. Some definitions on this term are given below :

a. "Marketing mix refers to the amounts and kinds of marketing variables the firm is using at a particular time." (Philip Kotler)
b. "The marketing mix refers to the apportionment of the effort, the combination, the designing and integration of the elements of marketing into a programme or mix which on the basis of an appraisal of the market force will best achieve the objectives of an enterprise at a given time." (Prof. N.H. Bordon)

c. "Marketing mix is the combination of the four inputs which constitutes the core of a company's marketing system – the product, the price structure, the promotional activities, and the distribution system (place)." (Stanton)

Thus, the term marketing mix refers to a combination of marketing decisions which are aimed at stimulating sales and constitutes a firm's marketing system in a global sense. It denotes and consists of a well-designed plan that analyses the important forces having direct linkage with the firm's marketing operations and that outlines and implements policies relating to the firm's marketing programme through co-ordination of available resources such as sales promotion, advertising, personal sales, service, distribution, etc. The concept includes "Four P's" i.e. right product, right place, right promotion and right price.

Features of marketing mix - A product must be such as to satisfy the needs and wants of the consumer. The price of the product must be reasonable so as to enable the consumer to pay for the product. If it is exorbitant, most of the consumers reject it. Also the promotion such as advertising and personal selling must be right without exaggerating the advantages of the product. And place means transportation and channels of distribution.

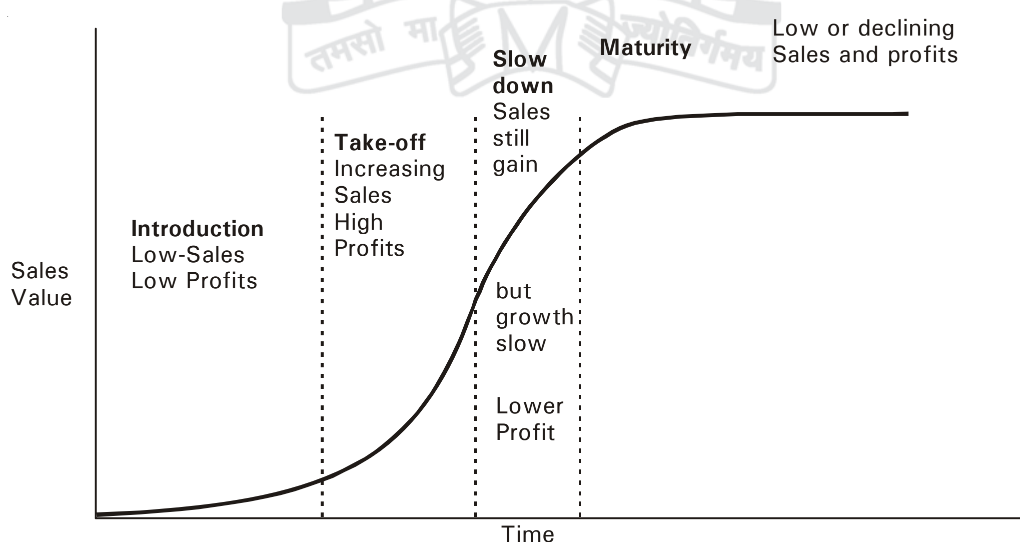
These four P's are now widely discussed by the marketing executives because any one variable of them is of no use. Every element of the marketing mix must be planned with demographic profile in mind. The product design, price, advertising media, sales promotion tools and distribution channels will often be different depending upon whether the target market is young, and so on. Marketing plan must be based on the characteristics of the best planners, thus, look first at demographic characteristics since these are usually more available, reliable, and actionable than other types of characteristics. Changes in one or more demographic characteristics of the population often prompt a business firm or an entrepreneur to offer some new product or service aimed at the changing segment.

The marketing manager in the interest of his business firm has to arrange and co-ordinate the marketing in such a way that would advance harmonise development of each of the above P's.

Q. 12. Elucidate the concept of Product-life Cycle. Show how it is related to marketing planning.

Answer 12.

Product Life Cycle - One concept which is of value in many forecasting situations is that of the product life cycle (PLC). The concept and idea of PLC has been formed to be useful in marketing also. This suggests that all products pass through a series of growth curves (the first part of which is S-shaped), until they reach a point when they either level out or begin to decline.



The curve begins with a period of low sales and low profit as the new product is introduced to the market. This is followed by a period of take-off associated with rapidly increasing sales and relatively high profits, the period during which the product is gaining acceptance and has little competition. At this stage, any competitive product tends to increase the total market. At the same time, unit costs are lower because the benefits of increasing sale of product are achieved.

By the third stage the rate of growth slows down considerably as more competitors enter the market and as, in any case, it becomes more difficult to increase sales penetration. The additional expenditure to increase sales and to meet competitive activity reduces the profit per unit (although it may increase in total).

The product moves to maturity, where it reaches a situation of low or declining sales growth, and a fall-off in profitability. Yet another and final stage may result, where the product declines rapidly to obscurity.

Relation between PLC and marketing planning :

a. Introductory stage begins with new products. In this stage, there is delay in consumer acceptance because the product is new and the expansion of facilities takes time. In the case of expensive products, the number of buyers is small. In other words, the sales are low and the profits are low. Thus, money is needed to develop the market through promotion as the customers are unknown.

b. Growth stage opens more opportunities for the new products because by now the consumers will have heard about the product and became interested in it. They will buy it. The market share increases and the profits also grow up. The economies of scales are introduces, costs go down, and the market segmentation is possible to be adopted.

c. At maturity stage, sales continue to increase but at a lesser rate than before and the price competition increases. This stage is characterized by over-capacity, product improvement, new uses of products, and more market segmentation.

d. At declining stage, the market demand slackens because of market saturation. The weak products are dropped if they do not meet profit target.

The interesting thing about PLC is that it occupies an important place in long-term planning for marketing. When the product reaches growth stage, economies of scale are realized and the costs go down.

At maturity stage the products need constant improvement of functions style, design, packaging, etc. If the competitors adopt intensification of advertising, the management concerned must also follow the same policy.

Philip Kotler observes that PLC must be considered in relation to marketing strategy and so all the four stages of PLC must have strategy. Especially pricing strategy must be different from one stage to another. Depending upon the stages of PLC, strategies of promotion/ product modification/ product improvement/ advertising, etc. must have to be carefully formulated and adopted.

PLC, marketing strategy and marketing planning are interrelated and go hand in hand. The external environment variables such as competition, technology changes, consumer perception and behaviour, population changes, international environment, etc. are needed to be considered for marketing planning and for understanding of their impacts on PLC. These can be done by proper marketing research and market surveys. Thus, we find a correlation between PLC and planning for marketing operations and actions.

Q. 13. What are the two phases of the turnaround strategy?

Answer 13.

Turnaround Strategy :

Turnaround best occurs when a corporation's problems are pervasive, but not yet critical. Two phases of turnaround strategy are (1) contraction, which is a quickfix through an across-the-board cutback in size

and costs; and (2) consolidation; the implementation of a program to stabilize the non-linear corporation. Reducing overhead and justifying functional activities are the main goals.

The economic environment and competitive pressures force corporations into this strategy of looking at internal business processes and assessing the alignment of these processes to achieve new competitive advantages. One such corporation is John Deere, among the world's largest farm, industrial, and lawn-care equipment companies. The crisis of the early 1980s' disastrous downturn in the farm economy and the parallel downturn in construction forced John Deere to change its internal business processes to survive. The difference in John Deere's approach was not to take the quick-fix approach; but to look at long-term solutions. A new strategic vision was developed at the 'corporate level. The vision focus was on downsizing, cost cutting, and fundamental business-process changes. The corporate office allowed the decentralized product divisions the latitude to find their own ways to meet the corporate vision. The primary challenge was to do away with the step-by-step functional approach to new product development. Design teams across functional groups were put in place. These teams began to have a stake in 'the product development effort, with employees who were never asked before contributing to the design. Subteams grew out of the team concept. Much of the hierarchical organization was eliminated with the managers now playing the roles of strategic guides and facilitators. Strategy bridged the gap between traditional, technically driven product development and the more inclusive, integrated-team approach to developing products. The integration process not only broke down functional walls but also smoothed production startups and shortened the turnaround time needed to make changes in tooling or in part design. A sense of ownership by employees was born along with a feeling of participation in the flow of products from concept to customer. The integrated approach provided better technical performance and buy-in and commitment to continuous improvement of the product line.

Q. 14. What are the strengths of the BCG approach?

Answer 14.

The BCG Matrix :

The most publicized matrix is a four-square grid developed by the Boston Consulting Group. It treats the development of corporate strategy as a problem that can be researched, mainly by examining economic, financial, and marketing data. The BCG matrix evaluates two variiables: (1) the growth rate of the industry on the vertical axis, and (2) the firm's relative competitive position in the industry, or its market share, on the horizontal axis. The market-share leadership is directly related to profitability. Based upon these two criteria, a business is plotted on the matrix by drawing a circle in one of four possible quadrants, or cells. Hence, a specific function for each product or market segment is represented on the finished matrix allowing the strategists to integrate each unit's position into a total company strategy.

The matrix is divided into four cells, with each cell representing the desirability of the combination of competitive position and growth. The four cells are labeled stars, cash cows, question marks, and dogs. Strategists will plot their SBU in one of the four cells, and then pursue the appropriate strategic action.

Relative Market Share

(Strengths and Weaknesses)

		H	L
Market	H	Stars	Question Marks
Growth	L	Cash Cows	Dogs

1. The "stars" cell (upper left) represents businesses in a high-growth industry, with a high market share. Businesses in this quadrant offer excellent profit and growth opportunities. A good strategy

for a firm in this position would be to continue its current course of action and make every effort to maintain the status quo even though this may require substantial investment. Stars usually require considerable cash to support expansion of production facilities and working capital needs. They also tend to generate a large internal cash flow. These businesses are the ones the corporation will depend upon to boost performance of the overall portfolio.

2. The "cash cows" cell (lower left) represents businesses in a low growth industry, but that have a relatively good competitive position in that industry. These businesses are able to generate good cash flow with relatively little investment. A typical strategy for these businesses is to maintain them as cash cows for as long as possible, using the profits to finance other endeavors. Thus, a business in this cell will be "milked" of its cash to support other SBUs within the organization. A firm must guard against a cash cow turning into a dog. The suggested strategy for an organization with an SBU in this cell is to acquire cash cows, if possible.

3. The "dogs" cell (lower right) represents the least desirable position of low industry growth and low market share. These businesses produce low, if any, profits. Businesses in the dog quadrant should be harvested, divested, or liquidated, depending on which alternative gives the most positive cash flow. Occasionally, a turnaround strategy can be used to make these busiinesses profitable. They are in weak competitive positions and have low profit potential associated with slow growth or impending market decline. Dogs usually cannot generate cash flows on a long-term basis.

4. The "question mark" or "problem child" cell (upper right) represents businesses with high growth potential but low market share. Profit potential in this quadrant is questionable. A company can move to either star or dog status from this tenuous position; but creating a star may require considerable investment. However, the potential reward may be well worth the investment risk. Businesses in this cell must be carefully monitored. These businesses are usually "cash dogs" because they require high investment levels to ensure rapid growth and product development. Their internal cash generation is low because their low market share gives less access to experience-curve effects and economies of scale, thus resulting in thinner margins than the market leader. The corporation has to decide whether it is worthwhile to invest in the question-mark business. The BCG matrix was designed to draw attention to various business units cash flows and investment levels, and to aid in the allocation of overall financial resources. The goal of using the BCG matrix is to enhance the entire portfolio. Two disastrous sequences in the BCG scheme can occur: (a) a business in the star quadrant can decline into a question-mark position and then into a dog position, or (b) a cash cow business can lose market share and eventually become a dog.

The most stringent BCG standard calls for the dividing line between high and low relative market share to be placed at 1.0. Relative market share is the ratio of a business's market share to the market share held by the largest rival firm in the industry, with market share being measured in terms of unit volume, not in currency. Business units that fall to the left of this line are leaders in their industries, while those falling to the right trail the market share leader. A less stringent criterion is to fix the boundary so that businesses to the left enjoy positions as market leaders (but not necessarily the leader), while those to the right are considered in underdog market-share positions.

Relative market share is used rather than actual market share because the relative position is a better indicator of comparative market strength and competitive position. An actual market share of 10 percent can be very good if the market leader has only 12 percent, but the same 10 percent actual share can be bad if the market leader has 50 percent. The basic assumption of the BCG analysis is the learning-curve effect: total cost per unit will decline (perhaps by 20 to 30 percent) every time total production is doubled.

The BCG approach is seen to have several **strengths**, but it also poses a number of **weaknesses**. **First, the strengths**: The BCG approach allows the organization's various businesses to be viewed as a collection of cash flows, and it is a major step forward in understanding the financial aspects of corporate strategy. The matrix highlights the financial interactions in a corporate portfolio to show the kinds of considerations with which an organization must deal. This explains why the priorities for corporate-resource allocations

can be different from business to business. The matrix also provides good rationalization for both investment and divestitures.

The BCG also has a number of **weaknesses**. First, the matrix works better in a growing economy than in a declining economy. Second, a four-cell matrix hides the fact that many businesses are in average growth markets or average share positions. Third, although the categories can be useful, they can lead to oversimplification. Not all businesses with low relative market share are truly dogs or question marks—some have proven track records for growth and profitability. Fourth, the matrix is not a reliable indicator of relative investment opportunities across business units. The matrix does not show whether a question-mark business is a potential winner or a potential loser.

Q. 15. What advantages does the GE matrix model have over the BCG matrix?

Answer 15.

The GE Business Screen :

The GE Business Screen is an advanced portfolio matrix developed by General Electric for its use in determining which SBUs or major products to keep in GE's portfolio and which to delete. The GE matrix can also be used to evaluate possible acquisitions, mergers, and/or new product development.

The GE matrix eliminates the majority of the inherent weaknesses of the BCG matrix by employing composite measures of business strengths and industry attractiveness. With the GE matrix, a strategist may plot a business in any of nine positions, as opposed to the BCG's four positions. GE's matrix also includes a corresponding increase in the number of advisable strategies identified. The GE matrix consists of nine cells of different colors that indicate appropriate strategies for different businesses or products. The vertical axis represents industry attractiveness while the horizontal axis represents the strength of the business or product. Both axes have high, medium, and low locations.

Within the GE matrix, there are three grids labeled G, R, and Y. If a firm or product under analysis falls in an intersection within Grid G, or a "green" cell, then an invest-and-grow strategy should be used. An organization or product falling in an intersection within Grid R, or a "red" cell, should either (1) be harvested and ultimately divested or (2) employ a retrenchment and turnaround strategy, curtail or reduce investment in the business, and extract as much as possible before the business is divested. Grid Y portrays a firm that intersects in a "yellow" cell, where the firm or product has low business strengths but high industry attractiveness. Here, the organization should employ a selectivity/earnings strategy. If this demonstrates good earning potential for the busines, it should received an invest-and-grow strategy and be monitored continually. If it does not prove worthwhile, it should be divested.

Business strength (controllable dimensions) :

The ability of the company to compete effectively in its industry or market includes knowledge about industry, customers, market share, financial performance, quality of its marketing personnel, and production capacity.

Market or industry attractiveness (uncontrollable dimension) :

These include market growth rate, competitive industry factors, legal constraints, plus opportunities and threats from the SBU's external environment.

G	G	Y	High
G	Y	R	Moderate
Y	R	R	Low
High	Medium	Low	

G = High Priority for Investment
Y = Moderate Priority for Investment
R = Low Priority for Investment

The GE model has several advantages over the BCG matrix. First, it allows for intermediate rankings between high and low. Second, it incorporates a variety of strategically relevant variables. Third, it emphasizes channeling corporate resources to those businesses that combine market attractiveness with business strength.

The GE model shares some weaknesses with the BCG model. It yields only general prescriptions as opposed to specific strategies. Although a strategy such as "hold and maintain" may be useful as a starting point, specific approaches to implement the strategy remain wide open. Further, the model fails to show when businesses are about to emerge as winners because the product is entering the takeoff stage. It is therefore recommended to utilize more than one model to overcome some of these problems. Using one model might help managers to solve a particular problem but overlook other possibilities.

Q. 16. What are the principle tasks of corporate strategists in multiple SBU firms?

Answer 16.

STRATEGY IN MULTIPLE-SBU FIRMS :

Strategy for multiple-SBU organizations is commonly referred to as corporate strategy or grand strategy. Such strategy concentrates on portfolio management techniques and policy guidelines. After the Industrial Revolution, the market witnessed the emergence of fierce competitors that resulted in many new products and technologies. This level of competition and increasing demand forced companies to evaluate how and where to invest. More scientific strategic approaches emerged in the late 1960s and 1970s. These strategies granted companies new methods to evaluate the market and their resources. The use of SBUs was established, initiated by the Boston Consulting Group (BCG) and enhanced later by General Electric Corrporation. These methods described the strength of product businesses by the attractiveness of the market and the strength of the firm. Both approaches worked well for basic markets with limited competition and less diversified product technologies. During the 1980s and 1990s, information technology developed more rapidly, which invited many new competitors and created access to new markets. In such markets the static approach of SBU analysis proved to be insufficient as a sole guide to performance.

Corporate strategy is mainly concerned with the management of a portfolio of businesses, and with providing each SBU proper direction and corporate service. Corporate strategy is the primary concern of multiple-SBU headquarters where corporate strategists are responsible for ensuring that all SBUs of an organization function in harmony. Corporate headquarters also provide functional services and related policies for marketing, manufacturing, finance, personnel, and planning. Corporate strategists must answer the following questions in relation to the overall organization: "Where are we now?"; "Where do we want to be?"; and "How do we get there?"

A typical grand strategy for many corporations is to grow through diversification. In multiple-SBU firms, each SBU usually operates independ ently with little guidance from higher levels. The principal tasks of the corporate strategists in multiple-SBU finns are :

1. to establish stragetic objectives,
2. to determine whether current businesses are helping to achieve those objectives and what the appropriate actions are in regard to those business,
3. to determine the remaining objectives left to be accomplished, and
4. to determine the appropriate actions to achieve the remaining objectives.

A *portfolio matrix* is one of the most important of several portfolio-management techniques used by multiple-SBU firms. Several of the more commonly used matrices are the (1) BCG Business Portfolio Matrix, (2) the GE Business Screen, and (3) the Product/Market/Industry Matrix. Strategists will utilize a specific matrix depending upon the circumstances encountered. The BCG matrix has been, for the most part, superseded by more advanced techniques. The GE-style matrix is primarily used when the products and market segments are diverse. The Product/Market/Industry Portfolio Evolution Matrix is used when the products and market segments are limited in type.

Q. 17. According to Porter, what are the three generic strategists in multiple SBU firms? Also discuss the areas of concern.

Answer 17.

Porter's Generic Strategies :

There are many sources of a sustainable competitive advantage, and many ways to achieve one. Porter shows that low cost, differentiation, and focus are three generic strategies available to fIrms to achieve a sustainable competitive advantage.

The overall cost leadership position can be achieved through a large market share or through other advantages such as favorable access to raw materials or state-of-the-art manufacturing equipment. The differentiation strategy can be implemented by creating a higher quality image through technology, innovation, features, a customer service dealer network, and so on.

The third strategy involves focusing the business upon either a relatively small buyer group or a restricted portion of the product line. Even with the focus strategy, however, the fIrm still must apply either a differentiation or a low-cost strategy. Thus focusing is not so much a different strategy, but restricting or focusing the husiness can sometimes be central to success. and it is worth explicitly identifying it as a distinct strategy.

Cost-leadership strategy. This strategy is also known as low-cost strategy. It is designed to outperform competitors by producing goods and rendering services at a lower price than the competitors can. It is an advisable strategy when you are an industry leader or the product differences in the market are not clear to consumers. This strategy will produce larger profits than the competition makes and will put the business in a position to fight off price wars. As development costs go down, the sales volume goes up. For example, Southwest Airlines, which traditionally served a limited market, adopted this strategy. The company uses one type of airplane (Boeing 737) and provides no meals, no assigned seating, and reusable boarding passes. Other company examples are McDonald's, Burger King, Kmart, Lowe's, and Wal-Mart. Some of the high-tech companies adopted low cost strategies because of the continuous changes and breakthroughs in that industry. The prices of semiconductors, computers, and other communication devices (such as satellites) have been dramatically decreasing over the years.

Cost leaders offer to customers only products that are proven to be wanted and therefore the company seeks to gain market share. These businesses do not spend large amounts for development but do develop unique ways to produce the products or services that will result in reduced costs. Examples of such cost reductions are: large sales orders, which would allow for longer production runs and allow for volume buying of materials at discounts; a stable customer base, allowing for planning of production runs; and the use of tight budget controls in the production process. Businesses using this strategy make all efforts to contain their costs in production, marketing, and distinctiveness through a mind-set of cost minimization.

The idea behind an overall cost leadership strategy is to be able to produce and deliver the product or service at a lower cost than the competitors. Cost leadership is usually attained through a combination of experience and efficiency. More specifically, cost leadership requires close attention to production methods, marginal overhead costs, and overall cost minimization in areas such as sales and research and development. A cost leadership strattegy is attractive for a number of reasons, including the following :

1. Giving the firm above-average returns even in the face of strong competitive force
2. Defending the firm against rivalry from competitors because it is difficult for competitors to force the firm out on the basis of price
3. Guarding the firm against powerful suppliers by providing flexibility to deal with input cost increases
4. Defending the firm against powerful buyers because buyers can exert pressure only to drive prices down to the level of the next most efficient competitor
5. Providing substantial barriers to entry (such as expensive production equipment)
6. Putting the firm in a favorable position to defend against substitutes from the firm's competitors.

Achieving an overall low-cost position usually requires that the company develop some unique advantage or advantages over its competitors. Examples include a high market share, favorable access to raw materials, use of state-of-the-art equipment, or special design features that make the product easy to manufacture.

Differentiation strategy :

This strategy attempts to make products or services seem unique in the customer's eyes. This perceived uniqueness will enable the business to charge premium prices when customers are deemed to be satisfied. Premium prices mean that the business should have above-average returns and outperform its competition. The less the product resembles others, the more it is protected from competition and the wider its market appeal is. An example of this strategy is to have the customer perceive that the luxury automobile Lexus is far superior to Honda automobiles. Other examples include the following :

- Superiority brand image (Izod or Polo in sportswear)
- Design image (Tiffany in glassware)
- Technology (Hewlett-Packard in small computers)
- Quality image (Mercedes, BMW, or Rolls-Royce in cars; May tag quality and dependability; KitchenAid appliances; Coca-Cola and the positive image that firm is associated with; Xerox and its high-quality image)
- Customer service (IBM in office equipment and computers, Sears in home appliances)
- Dealer network (Caterpillar and John Deere)
- Any combination of these

In the differentiation strategy, the company will still attempt to control costs of production, although marketing costs may be significantly higher in order to develop brand loyalty. The main problem for this type of business is to maintain its perceived uniqueness in customers' eyes in an age when uniqueness is imitated and copied by competitors.

Following a differentiation strategy does not imply that the business should have little concern for costs, but rather that the major competitive advantage is sought through differentiation. Differentiation has several potential advantages:

1. It can provide protection against competition because of brand loyalty by customers and their resulting willingness to support higher prices for brand items.
2. It can increase margins because of the ability to charge a higher price.
3. Through higher margins, it can provide flexibility for dealing with supplier power (such as raising the cost of raw materials).
4. It can mitigate buyer power because there are no comparable alternatives.
5. It can provide entry barriers for competitors as a result of customer loyalty and the need for a competitor to overcome product or service uniqueness.
6. Because of customer loyalty, it can put the company in a favorable position to defend against substitutes from competitors.

Depending on what is required to achieve differentiation, a company may or may not find it necessary to incur relatively high costs. For example, if high-quality materials or extensive research is necessary, the resulting product or service will create a willingness on the part of the customers to pay the premium price. While such a strategy can be very profitable, it may or may not preclude gaining a large share of the market. For example, Rolex demands a very high price for its watches and makes a profit, but it has a very small share of the market. In contrast, IBM generally demands some higher prices than its competitors and still maintains a large market share.

Focus strategy : A third generic competitive strategy is to focus on a particular market segment. A particular buyer group, a geographic market segment, or a certain part of the product line may define the segment

sought. As opposed to low cost and differentiation strategies, which have an industry-wide appeal, a focus strategy is based on the premise that the firm is able to serve a well-defined but narrow market better than competitors who serve a broader market. The basic idea of a focus strategy is to achieve a least-cost position or differentiation, or both, within a narrow market. The company in this strategy focuses on small-volume custom products or services and leaves the large-volume standardized market to the cost leader. Small speciality companies exploit a gap in the market and develop a product the customers want. These companies may eventually become large companies using the cost leadership strategy.

Gucci has followed a focus strategy by targeting that segment of the ladies' handbag industry that is attracted by exclusivity. In the automobile industry, Lamborghini has focused on the sports car market.

After a company has decided on its market segment, it can use either a differentiation or a low-cost marketing approach. The differentiation approach means that the organization competes on the key differentiation in its industry, but in just one or a few aspects. The focused organization can only compete on a limited number of aspects because competing on numerous aspects would bring it into direct competition with stronger key differentiators.

In the low-cost approach, the focused company competes with the cost leader of the industry in one of two ways. First, the focuser may be able to sell locally produced products to its small segment at a lower cost than the industry's cost leader. The focused company could also compete by offering custom-made products that the cost leader is unable to supply.

The three generic strategies each provide defenses against forces in the economic environment. The firms that develop one of these strategies will earn higher than average returns in their industries. The implication is that firms that do not develop one of the basic strategies will earn lower than average returns in their industries. Porter calls this being "stuck in the middle." Such a firm lacks the market share, capital investment, and resolve to use the low-cost strategy or the industry-wide differentiation necessary for low-cost position in a more limited sphere.

If some of the firms in an industry follow one of the three basic strategies and earn higher than average returns, then some firms in the industry must be earning lower than average returns (not all firms can perform above average). The in-between firms lose all the high-margin business. They cannot compete well for high-volume business from customers who demand low prices, for the high-margin business of the differentiated fmns, nor for the low-cost or focus-differentiated businesses.

The high returns are earned by the industry-wide firms with large market shares (the low cost and differentiated firms) and the firms that are focused with small market shares. Those firms in between, in terms of market share, earn lower than average returns. The result is a U-shaped curve. John Deere is the industry leader and earns high returns. However, small specialty manufacturers such as Hesston and New Holland also earn high returns. Massey Ferguson and J.1 Case are trapped in the valley, and International Harvester has a substantial market share, but earns low returns.

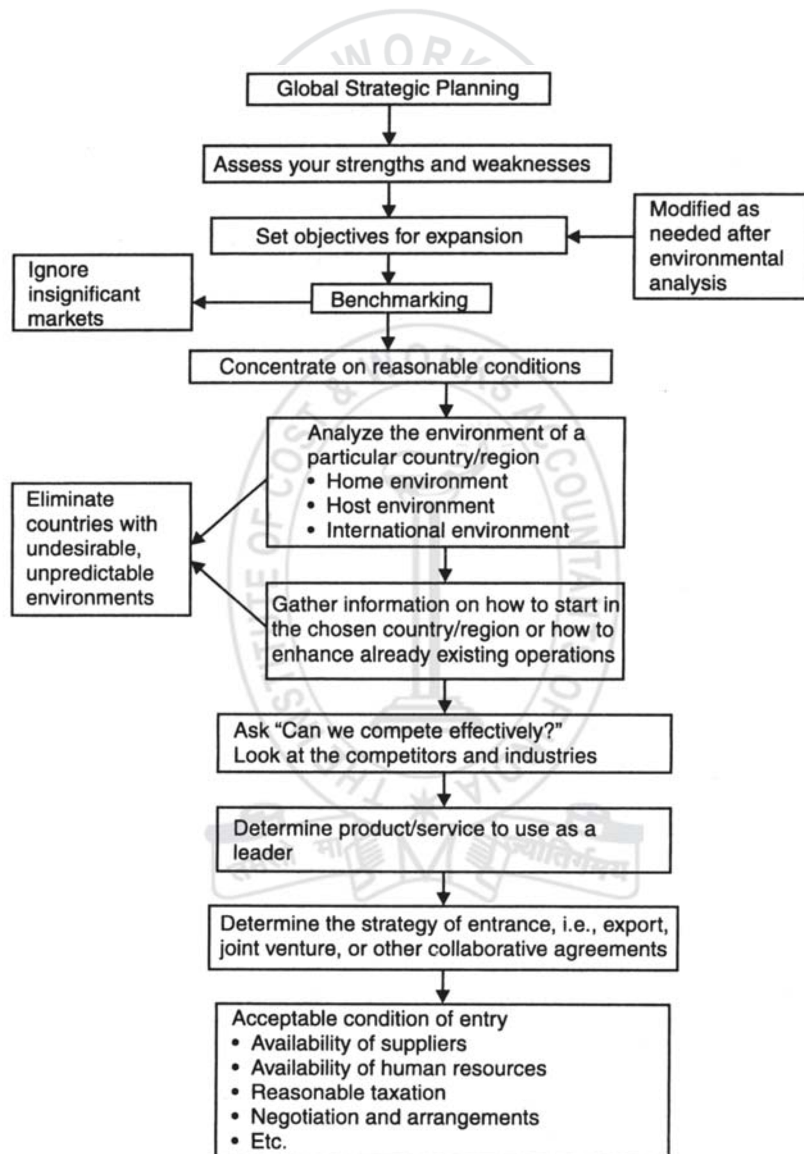
Areas of Concern :

At the conceptual level, Porter's theory of generic strategy can be condensed into two propositions : (1) there are only three generic and comprehensive strategies, and (2) success depends upon using only one of the three generic strategies. Although generic strategy is valuable to many organizations and has provided a real contribution to business literature, several questions arise. First, the generics are viewed as separate and completely distinct from one another (each strategy is mutually exclusive). Second, the framework fails to show techniques that could be employed to shift from one strategy to another. Third, although Porter's generic strategies are based on earlier work, they lack theoretical or empirical substantiation. Fourth, Porter, along with others, believes that competing simultaneously with low cost and differentiation is inconsistent. This means that when a business emphasizes differentiation, it cannot maintain low cost at the same time. Also, a business that keeps costs low cannot produce significantly differentiated outputs.

The fact is that many empirical and theoretical studies demonstrate that a dual emphasis on low costs and differentiation can result in high performance. A low-cost differentiation strategy can be effective if the company provides an environment in which the strategy begins with an organizational commitment to quality process, products, and services. When a company provides high-quality output, it immediately differentiates itself from its competitors. Inevitably, customers are drawn to high-quality products and services. This will result in a higher demand for the company's output. It follows an increase in market share leading to economies of scale, thereby permitting lower per-unit cost in the company's overall cost structure. The successes of Anheuser-Busch, General Electric, Coca-Cola, and Pepsi-Cola support this scenario. All of these companies have differentiated their outputs through offering high-quality products while simultaneously maintaining low per-unit cost operations.

Q. 18. Discuss the steps involved in Global Strategic Planning.

Answer 18.



Q. 19. What are the conflicts that arise between MNCs and the local environment? How can relations be harmonized?

Answer 19.

MNCs' operations in foreign countries often give rise to conflicts between the MNC and the host country with regard to business, developmental, environmental, health, and safety protection issues. MNCs have been frequently subject to charges of exploitation and colonization in third world countries. The sources of these conflicts are mainly the divergence of goals and the abuse of power both by MNCs and the host countries. For instance, increased automation aimed at promoting safety may run counter to host policies for promoting local employment; location in a densely populated area with a large pool of potential workers may be incompatible with safety; and reliance on trained foreign experts may conflict with the desire for local control.

Organizational routines that differ across national cultures also contribute to the conflicts between MNCs and host countries. For example, the expatriate Japanese practice of tapping inattentive American factory workers on the head with long wooden sticks led to escalating resentment and violence before Mazda stopped the practice. To lessen the conflicts, role-based routines must be painstakingly taught to workers. Unfortunately, many MNC managers are often insulated from clearly seeing potential in understanding the cultures of nations, too. Rather than imposing their will on company units overseas, leaders of MNCs should give up the mind-set and adapt to the different environment.

To maintain a lasting, harmonized relationship with the local environment, MNCs should have an ethical commitment to providing the host country workforce with adequate training to prepare expatriate managers for their new assignment. Others suggest MNCs should allow the local population greater access to ownership and control of productive assets, sharing surpluses with local employees and impacted communities, and decentralizing decision making concerning activities that affect the local quality of life.

Multinational corporations must operate in a two-way open system. This means it welcomes inputs from the host government and provides information about its operation to the public. The expectation from the MNC abroad is to act ethically and in a socially responsible way. Ethical practices can enhance overall corporate health and improve relationships with the stake-holders. Therefore, cooperation between the MNC and the host country's government is highly recommended.

> MNCs share information based on global experiences, provide input into host-government developmental policies, and aid in their implementation; the government, in turn, would provide a reasonable regulatory environment. Such a relationship calls for ongoing interactions among officials at all levels of both parties, with the local corporate subsidiary playing a critical role.

The host government has a responsibility to set rules that are clear, consistent, and economically and technically feasible.

Q. 20. Discuss Corporate culture and strategy implementation.

Answer 20.

Strategy outlines the tasks that must be performed and structure coordinates the people who perform those tasks. Therefore, strategy and structure must have a proper fit. The right type of employee at an appropriate number ensures that tasks can be carried out in a manner consistent with overall strategy if situated in the proper place within an organization. One of the most important aspects of organizational structure is the way the company decides to divide itself into different divisions or departments. This division is based on people skills and experience as well as the match between the human resources, the task, and the equipment available. The next important aspect of the structuring is how to create an environment for all those divisions or departments so that they can work together efficiently and achieve the company's objectives.

In the first aspect, the company tries to allocate people and resources to organizational tasks. This requires management to decide how to delegate decision-making authority in the organization. (Management chooses the appropriate number of hierarchical levels and the correct span of controls.) It also requires management to decide the way labor should be divided in the organization and the appropriate matching with organizational tasks. Management must decide how much authority should be delegated to managers at the divisional or functional level as well as how to divide up people and tasks into functions and divisions to ensure their ability to create value for the organization. For example, should there be separate R&D and marketing departments or should they be combined?

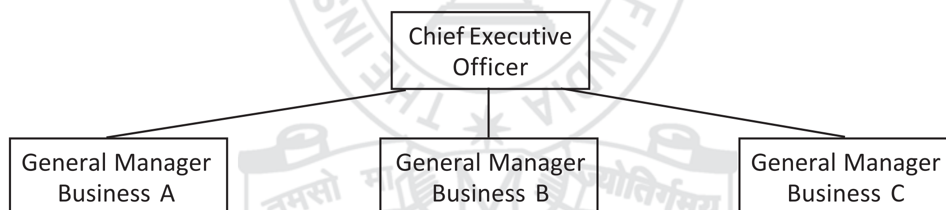
In the second aspect, management attempts to obtain an acceptable level of coordination between human resources and their functions to accomplish the required assignment. These two aspects of implementation determine how an organizational structure operates and assists in the mechanism of organizational control.

Essentially, both strategy and structure should vary according to the type of organization being studied. For a single-SBU furn, both strategy and structure might be very simple. In a conglomerate corporation, both should reflect the complexity of the situation.

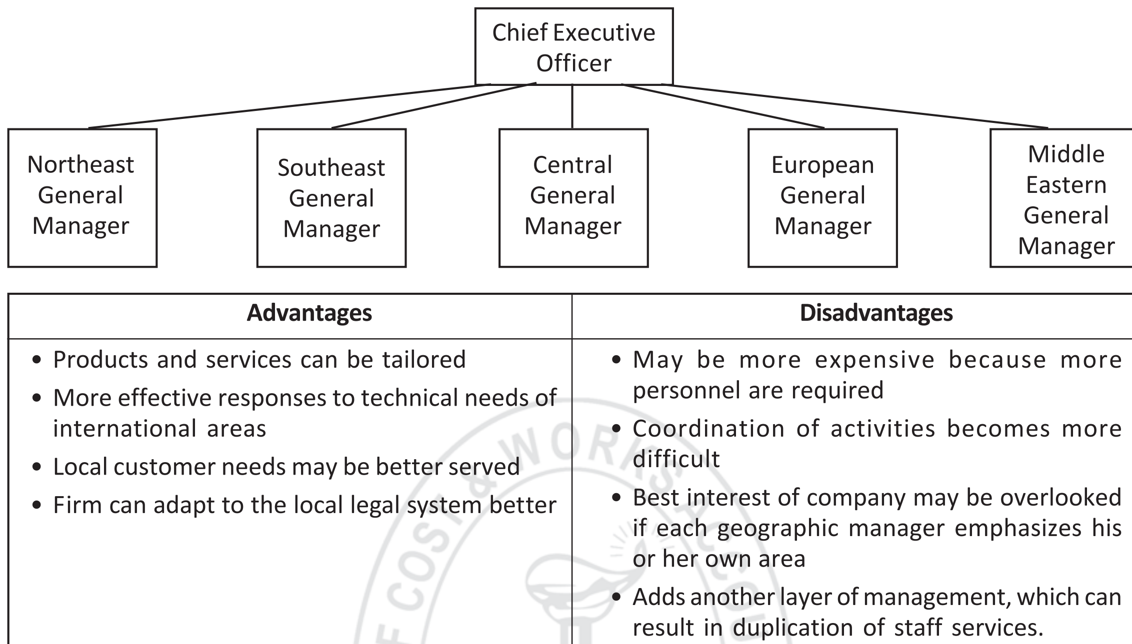
Corporate Culture and Strategy Implementation :

The corporate culture is a pattern of norms, attitudes, values, beliefs, and customs that governs the behavior of people within the organization. It is pervasive and refers to how people within the corporation think and act as members of the organization. Culture, by its very natrure, is (1) intertwined in the fabric of the organization, (2) passed on form year to year, and (3) very resistant to change.

When organizational strategy is compatible with corporate culture, startegy implementation is facilitated. However, when strategy and culture are incompatible, implementation often suffers from "strategy sabotage." In this difficult situation, efforts must be made to close the gap between the corporate culture and the proposed strategy. Since it is very difficult to change culture, a modification or complete change of strategy may be deemed necessary.



Advantages	Disadvantages
• Makes planning and controlling by the corporate staff more manageable • Decentralizes responsibility, putting it in closer proximity to each business environment • Enables the CEO to handle other important corporate issues • Makes for better coordination among divisions with similar products	• The additional levels of management increae the number of personel and overhead expenses, and may make communication slower • Sometimes leads to excessive rivalry for resources and attention • Creates problems determining which decisions to centralize and which to decentralize



Advantages	Disadvantages
• Products and services can be tailored • More effective responses to technical needs of international areas • Local customer needs may be better served • Firm can adapt to the local legal system better	• May be more expensive because more personnel are required • Coordination of activities becomes more difficult • Best interest of company may be overlooked if each geographic manager emphasizes his or her own area • Adds another layer of management, which can result in duplication of staff services.

Q. 21. Discuss various pricing methods based on competition.

Answer 21.

The various pricing methods are as follows :

(i) **Skimming pricing method :** This refers to a pricing policy which sets relatively high prices at the outset and successively offers lower prices as the market expands at later stages.

The idea behind this pricing policy is that the introduction of a new product with a high price is an efficient way to segment the markets with different price elasticities of demand. The initial high price can serve to skim the cream off those segments which are less sensitive to price. Subsequent price reductions reach customers with higher elasticities and enlarge the size of the market.

A higher price at the initial stage of market penetration can achieve a larger sales volume and a higher sales revenue. This higher sales revenue ensures profit maximization and provides a good base for sound financing necessary for the production expansion and promotional activities during the later stages of the market development.

(ii) **Penetration pricing method :** This method refers to a pricing policy of setting a relatively low initial price with an intention to help the product penetrate into the markets to hold a position. This method is just opposite to the skimming pricing method. This pricing strategy is adopted when there seems to be no distinctive classes of customers with different price elasticities, and when advantages of mass production drastically reduce costs, and when the product's distinctiveness i.e. protection from the competitors is likely to be short-lived. This strategy aims at capturing the market at the very outset and in case of a competitive product, aims at capturing the major share of the market, and discourages the competitors to enter.

(iii) **Seasonal discount pricing method :** This is a type of pricing strategy to promote sales by offering special discounts during certain seasons. This policy is found to be followed by the manufacturers of air conditioners, refrigerators, electric fans, etc.

(iv) **Going-rate pricing method :** This method refers to a pricing policy whereby the prices are fixed in consideration of the prices of competitors and the firm's costs. This is like 'follow the leader' i.e. price leadership. It is quite popular because it is easy to avoid competition and make reasonable profits. Under this method, prices are fixed near about the prices of the leaders. This pricing policy does not have any scientific basis like considerations of cost and marketing factors. Small firms usually determined this pricing strategy on the considerations that the big firms have determined the prices carefully and scientifically, and that the general consumers are price conscious.

(v) **Discriminatory pricing method :** This method of pricing refers to a policy of following different prices for different customers based on their ability to pay or place of customers. It involves 'selling a product or service at two or more prices and the difference in price is not base don difference in costs', according to Philip Kotler.

(vi) **Oligopolistic pricing :** An oligopolistic competition, by definition, refers to 'a market in which there are a few sellers who are highly sensitive to each other's pricing and marketing strategies'. In other words, each seller in the market has a significant effect on the market price and each seller considers the likely effect of price changes on the competitors. The life cycle of a product and corresponding market stage play a great role in this pricing policy. During the later stage of market growth or early stage of market maturity of a product of perishable distinctiveness, an oligopolistic pricing situation develops.

(vii) **Monopolistic pricing :** A monopolistic competition, by definition, refers to "a market in which many buyers and sellers trade over a range of prices rather than a single market price" (Philip Kotler). This state of competition offers a greater degree of flexibility in the pricing strategy as such market is characterized by : (a) large number of competitors, and (b) price change by any one competitor tends to have little effect on other competitors. While pursuing a price reduction strategy under monopolistic competition, the marketing management of a company must consider the possibility that too drastic a reduction may set off a price war throughout the whole industry.

Q. 22. Discuss Strategic alliances. What are its advantages and disadvantages?

Answer 22.

Strategic alliances are distinguished from joint ventures because the companies involved do not take an equity position in one another. In many instances, strategic alliances are partnerships that exist for a defined period during which partners contribute their skills and expertise to a cooperative project. For example, one partner provides manufacturing capabilities while a second partner provides marketing expertise. Many times, such alliances are undertaken because the partners want to develop in-house capabilities to supplant the partner when the contractual arrange-ment between them reaches its termination date. Such relationships are tricky because, in a sense, the part-ners are attempting to "steal" each other's know-how.

In other instances, strategic alliances are synonymous with licensing agreements. Licensing involves the transfer of some industrial property right from the U.S. licensor to a motivated licensee in a foreign country. Most tend to be patents, trademarks, or technical know-how that are granted to the licensee for a specified time in return for a royalty and for avoiding tariffs or import quotas. Bell South and U.S. West, with various marketing and service competitive advantages valuable to Europe, have extended a number of licenses to create personal computer network in the United Kingdom (U.K.).

Objective	Major Questions
1. Assess and value partner knowledge	• What were the strategic objectives in forming the alliance? • What are the core competencies of our alliance partner? • What specific knowledge does the partner have that could enhance our competitive strategy?
2. Determine knowledge accessibility	• How have key alliance responsibilities been allocated to the partners? • Which partner controls key managerial responsibilities? • Does the alliance agreement specify restrictions on our access to the alliance operations?
3. Evaluate knowledge tacitness and ease of transfer	• Is our learning objective focused on explicit operational knowledge? • Where in the alliance does the knowledge reside? • What we are trying to learn and how we can use the knowledge?
4. Establish knowledge connections between the alliance and the partner	• Are parent managers in regular contact with senior alliance managers? • Has the alliance been incorporated into parent strategic plans? • What is the level of trust between parent and alliance managers?
5. Draw on existing knowledge to facilitate learning	• In the learning process, have efforts been made to involve managers with prior experience in either/both alliance management and partner ties[7] • Are experiences with other alliances being used as the basis for managing the current alliance?
6. Ensure that partner and alliance managerial cultures are in alignment	• Is the alliance viewed as a threat or an asset by parent managers? • In the parent, is there agreement on the strategic rationale for the alliance? • In the alliance, do managers understand the importance of the parent's learning objective?

[**Adapted :** From Academy of Management Executive: "The Thinking Manager's Source" by Andrew C. Inkpen.]

Advantages :

1. **Leverages several firms' core competencies.**

   This allows alliance members to be more competitive in seeking certain project work or input.

2. **Limits capital investment.**

   One partner firm does not have to have all the resources necessary to do the work of the alliance.

3. **Is flexible.**

   Alliances allows a firm to be involved yet continue to pursue its other, "regular" business opportunities.

4. **Leads to networking and relationship building.**

   Alliances get companies together, sometimes even competitors. They allow key players to build relationships that are valuable, even if the present alliance doesn't "plan out." Alliance partners learn more about each others' capabilities and gain advantage or benefit from referrals and other similar behaviors, creating win—win situations.

Disadvantages :

1. **Can result in loss of control.**

   A firm in an alliance by definition cedes ultimate control to the broader alliance for the undertaking for which the alliance is formed. This can prove problematic if the alliance doesn't work out as planned—or is not well planned.

2. **Can be hard to establish good management control of the project-loss of operational control.**

   Where multiple firms have interrelated responsibilities for a sizable joint project, it should not be difficult to imagine problems arising as the players go about implementing a major project as in the example of EDS and its Dutch and British partners in the Atlas Consortium. It requires good up-front planning and use of intercompany project team groups early on in the bidding process.

3. **Can distract a participating company:S- management and key players.**

   One strategic alliance can consume the majority attention of key players essential to the overall success of the "home" company. Whether because of their technical skills, managerial skills, key roles all three, the potential for lost focus or time to devote to key responsibilities exists.

4. **Raises issues of control of proprietary information and intellectual property.**

   Where technology development is the focus of the alliance, or maybe part of it, firms partnered together may also compete in other circumstances. Or they may have the potential to do so. So partnering together gives each the opportunity to learn much more about the other, their contacts, capabilities and unique skills or trade secrets.

Strategic alliances have proven a very popular mechanism for many companies seeking to become more agile competitors in today's dynamic global economy. They have proven a major way for small companies to become involved with large players to the benefit of both-allowing the smaller player to grow in a way that builds its future survival possibilities and the larger player to tap expertise and knowledge it can no longer afford to retain or develop in-house.

Q. 23. Discuss DMAIC (define, measure, analyse, improve, control) Six Sigma Approach

Answer 23.

The DMAIC- Six Sigma Approach :

Define

- Project definition
- Project charter
- Gathering voice of the customer
- Translating customer needs into specific requirements

Measure

- Process mapping (as-is process)
- Data attributes (continuous vs. discrete)
- Measurement system analysis

- Gauge repeatability and reproducibility
- Measuring process capability
- Calculating process sigma level
- Visually displaying baseline performance

Analyze

- Visually displaying data (histogram, run chart, pareto chart, scatter diagram)
- Value-added analysis
- Cause and effect analysis
- Verification of root causes
- Determining opportunity (defects and financial) for improvement
- Project chart review and revision
- Translating customer needs into specific requirements

Improve

- Brainstorming
- Quality function deployment (house of quality)
- Failure modes and effects analysis (FMEA)
- Piloting your solution
- Implementation planning
- Culture modification planning for your organization

Control

- Statistical proces control (SPC) overview
- Developing a process control plan
- Documenting the process

Q. 24. What is the difference between incremental and breakthrough innovation? What are the risks associated with each approach?

Answer 24.

Incremental Innovation :

Incremental innovation refers to simple changes or adjustments in existing products, services, or processes. There is growing evidence that companies seeking to increase the payoff from innovation investments best do so by focusing on increamental innovations. We will examine the payoff research more completely in a subsequent section on risks associated with innovation. First, however, we need to examine how companies are seeking incremental innovation. A major drive of incremental innovation in many companies the last several years has come from programs aimed at continuous improvement, cost reduction and quality management.

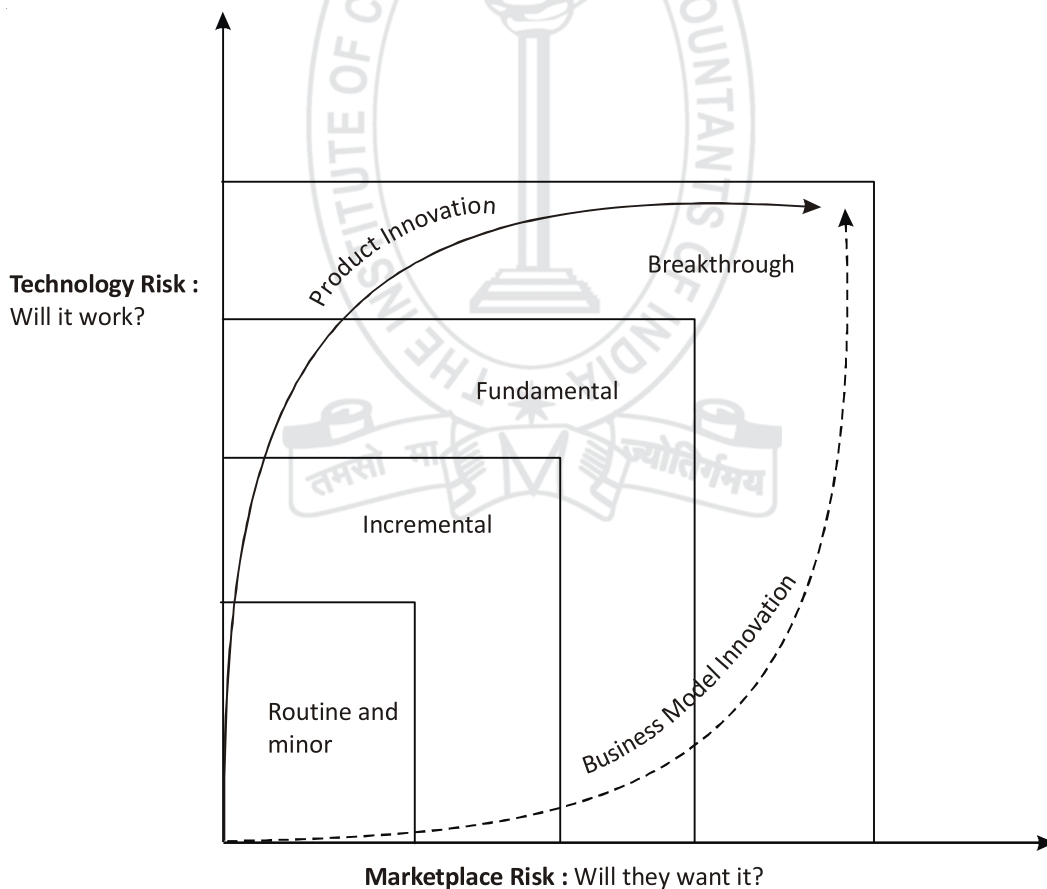
Incremental innovation via continuous improvement progrems is viewed by most proponents as virtually a new organizational cultur ad way of thining. It is built around an intense focus on customer satisfaction; on accurate measurement of every critical variable in a business's operation; on continuous improvement of products, services, and processes; and an work relationships based on trust and teamwork.

Breakthrough Innovation :

Clayton Christensen of Harvard Business School makes the distinction between “sustaining” technologies, which are incremental innovations that improve product or process performance, and “disruptive” technologies, which revolutionize industries and create new ones, is rather than an innovation that reduces the cost of a mirror on a car by 40 percent, Christensen is focusing when speaking of disruptive technologies on the product idea that works 10 times better than existing ones or costs less than half what the existing ones do to make—a breakthrough innovation. A breakthrough innovation, then, is an innovation in a product, process, technology, or the cost associated with it that represents a quantum leap forward in one or more of those ways.

Apple’s innovation with iPod and iTunes is a breakthough innovation. It was not an incremental improvement in Apple’s computer offerings. It was an application of the microprocessor technology associated with Apple’s computers, applied in a totally different industry. Apple, which only has a 2 percent market share in the personal computer industry, now has positioned itself as a dominant force in the emerging digital music and entertainment industries based on this breakthrough innovation.

Breakthrough innovations, which Christensen calls “disruptive,” often shake up the industries with which they are associated, even though many times they may come from totally different origins or industry settings than the industry to start with.



Q. 25. Write short notes on :

(a) Differentiation

(b) Joint venture

(c) Leveraged buyout

Answer 25. (a)

Differentiation : Strategies dependent on differentiation are designed to appeal to customers with a special sensitivity for a particular product attribute. By stressing the attribute above other product qualities, the firm attempts to build customer loyalty. Often such loyalty translates into a firm's ability to charge a premium price for its product. Cross-brand pens, Brooks Brothers suits, Porsche automobiles, and Chivas Regal Scotch whiskey are all examples.

The product attribute also can be the marketing channels through which it is delivered, its image for excellence, the futures it includes, and the service network that supports it. As a result of the importance of thse attributes, competitors often face "perceptual" barriers to entry when customers of a successfully differentiated firm fail to see largely identical products as being interchangeable. For example, General Motors hopes that customers will accept "only genuine GM replacement parts."

Answer 25. (b)

Joint Venture : Joint venture is a popular strategy that occurs when two or more companies form a tempo rary partnership or consortium for the purpose of capitalizing on some opportunity. Often, the two or more sponsoring firms form a separate organization and have shared equity ownership in the new entity. Other types of **cooperative arrangements** include research and development partnerships, cross-distribution agreements, cross-licensing agreements, cross-manufacturing agreements, and joint-bidding consortia. Burger King recently formed a "conceptual agreement" with its fierce rival, Hungry Jacks, in Australia, whereby the two firms will join forces against market leader McDonald's. All Burger Kings in Australia are being renamed Hungry Jacks, but Burger King retains ownership under the unusual agreement. With this agreement, Australia becomes Burger King's fourth-largest country market, tied with Spain.

U.S. regional airline operator Mesa Air Group, based in Phoenix, Arizona, recently formed a joint venture with Chinese carrier Shenzhen Airlines, based in Shenzhen, China, to create China's first commuter airline. The first joint venture ever between U.S. and Chinese passenger airlines, Bejing Airlines now links Beijing with many poorly or non served cities in China and Southeast Asia. One of China's largest privately owned carriers, Shenzhen Airlines aims to expand its fleet to 80 planes by 2008 and 160 planes by 2015.

Joint ventures and cooperative arrangements are being used increasingly because they allow companies to improve communications and networking, to globalize operations, and to minimize risk. Joint ventures and partnerships are often used to pursue an opportunity that is too complex, uneconomical, or risky for a single fIrm to pursue alone. Such business creations also are used when achieving and sustaining competitive advantage when an industry requires a broader range of competencies and know-how than anyone fIrm can marshal. Arrnani's joint venture is with Emaar Hotels & Resorts LLC to create, among others, the tallest building in the world in 2008: a 2,000-foot-tall hotel in Dubai's Burj Dubai. Kathryn Rudie Harrigan, professor of strategic management at Columbia University, summarizes the trend toward increased joint venturing :

> In today's global business environment of scarce resources, rapid rates of technological change, and rising capital requirements, the important question is no longer "Shall we form a joint venture?" Now the question is "Which joint ventures and cooperative arrangements are most appropriate for our needs and expectations?" followed by "How do we manage these ventures most effectively?,,

Joint ventures among once rival firms are commonly being used to pursue strategies ranging from retrenchment to market development.

A few common problems that cause joint venture to fail are as follows :

1. Managers who must collaborate daily in operating the venture are not involved in forming or shaping the venture.
2. The venture may benefit the partnering companies but may not benefit customers, who then complain about poorer service or criticize the companies in other ways.
3. The venture may not be supported equally by both partners. If supported unequally, problems arise.
4. The venture may begin to compete more with one of the partners than the other.

Six guidelines for when a joint venture may be an especially effective strategy to pursue are :

- When a privately-owned organization is forming ajoint venture with a publicly owned organization; there are some advantages to being privately held, such as closed ownership; there are some advantages of being publicly held, such as access to stock issuances as a source of capital. Sometimes, the unique advantages of being privately and publicly held can be synergistically combined in a joint venture.
- When a domestic organization is forming a joint venture with a foreign company; a joint venture can provide a domestic company with the opportunity for obtaining local management in a foreign country, thereby reducing risks such as expropriation and harassment by host country officials.
- When the distinct competencies of two or more firms complement each other especially well.
- When some project is potentially very profitable but requires overwhelming resources and risks; the Alaskan pipeline is an example.
- When two or more smaller firms have trouble competing with a large firm. When there exists a need to quickly introduce a new technology.

Answer 25. (c)

Leveraged buyout : A leveraged buyout (LBO) occurs when a corporation's shareholders are bought (hence buyout) by the company's management and other private investors using borrowed funds (hence *leverage*). Besides trying to avoid a hostile takeover, other reasons for initiating an LBO are senior management decisions that particular divisions do not fit into an overall corporate strategy of must be sold to raise cash, or receipt of an attractive offering price. An LBO takes a corporation private.

Q. 26. What is risk ? Discuss different types of risk. How do you measure physical risk?

Answer 26.

Uncertainty and risk are two terms which are anathema to every manager. Certainty and uncertainty are the two extremities on a continuous platform and risk is identified somewhere between the two extremes. Uncertainty is a totally indefinable happening and is also unexpected. An uncertain situation is faced when the variables are many and their interaction can be innumerable. For example different people behave and react differently to the same situation and uncertainty arises.

Risk expressed mathematically is the dispersion of a probability distribution: how much do individual outcomes deviate from the expected outcome. A simple measure of dispersion is a range of possible outcomes, which is simply the difference between upper most and the lowest outcomes. This is mathematically measured as standard deviation. Physically, risk can be identified as an event which has different probabilities of happening, but the time of the event is not known as also the impact of such risk can vary. While uncertainty cannot be quantified a risk can be quantified though mathematical models, probability models, correlation, etc. and also measured through quantitative models and technological tools.

Types of Risk :

Mark Dorfman has defined "risk management as the logical development and execution of a plan to deal with potential losses". The risk can include both upside and downside. Potential risk management often refers to reducing downside potential and enhances the returns on topside.
Risks are of many types as follows:

1. **Physical Risk** like natural calamities: fire, tsunami, floods, earthquake, etc.
2. **Business Risk** which is inherent to a business due to its nature and susceptibility to environment, e.g., change of fashion, business cycles, conflicts like war, insurgency, cross border terrorism, technological obsolescence, etc.
3. **Financial Risk** arising out of the nature of financial transactions and conduct of business and investment.

Measurement of risk :

Physical Risk :

Physical risks are measured by the application of technological tools. Earthquakes are measured in the Richter scale. Floods are measured through level monitoring and marking danger levels. Risk of fire is often monitored through measurement of flash point, fire point, ignition temperatures and propulsion temperatures. Spontaneous ignition temperatures are yet another measurement to identify fire risk, e.g., coal dumps, oil installations, explosive godowns, etc.

Physical risk arising out of Social, Political, Economic and Legal Environments are often identified through the performance of lead indicators. In the Social arena lead indicators can be pestilence, expediencies, social upheavals, etc., measurement of these social risk are done on the basis of the impact on the Society, i.e., increase in crimes, violence and accidents, etc.

Political risk is often identified with the change in Government policy capitalistic, democratic or totalitarian and can be measured by the impact of such government policy on the economic activity, e.g., Government Industrial Policy and Labor Policy.

Economic risk may arise out of commercial transactions, foreign exchange currency variation, capital market fluctuations, trade cycles, etc. The lead indicators risks are like variation in GDF, IIP, Balance of Payments, Stock Market Indices, etc.

Legal Risk arises out of the implication of various statutes affecting business, Anti Trust Bills, Factory Acts, Industrial Disputes Act, and Foreign Exchange Management Act (FEMA).

Q. 27. What is Risk Management ? Discuss the strategies involved in risk management.

Answer 27.

Risk management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events. Risks can come from uncertainty in financial markets, project failures, legal liabilities, credit risk, accidents, natural causes and disasters as well as deliberate attacks from an adversary.

In ideal risk management, a prioritization process is followed whereby the risks with the greatest loss and the greatest probability of occurring are handled first, and risks with lower probability of occurrence and lower loss are handled in descending order. In practice the process can be very difficult, and balancing between risks with a high probability of occurrence but lower loss versus a risk with high loss but lower probability of occurrence can often be mishandled.

The International Organistaion for Standardisation identifies the following principles of risk management :

- Risk management should create value.
- Risk management should be an integral part of organizational processes.
- Risk management should be part of decision making.
- Risk management should explicitly address uncertainty.
- Risk management should be systematic and structured.
- Risk management should be based on the best available information.
- Risk management should be tailored.
- Risk management should take into account human factors.
- Risk management should be transparent and inclusive.
- Risk management should be dynamic, iterative and responsive to change.
- Risk management should be capable of continual improvement and enhancement.

Strategy for risk management

Risk management strategies are seven fold and they are: Avoid Risk, Reduce Risk, Retain Risk, Combine Risks, Transfer Risk, Share Risk and Hedge Risk.

Avoid Risk :

Avoid risk is the prevention method and proven method. This method results in complete elimination of exposure to loss due to a specific risk. It may involve avoidance of an activity which is risky. This can be approached in two ways

(i) Do not assume risk: This means that no risky projects are undertaken. E.g., the Government has clearly mandated that no hazardous chemical industry can be put up near a populated area. This is a proactive avoidance.

(ii) Discontinuance of an activity to avoid risk: While a proactive avoidance follows a sound decision knowing fully the perils of the risk, abandoning a project to avoid risk midway is a decision taken while handling the project. E.g., A PVC plant was being put up on the basis of alcohol as a raw material to be converted to an intermediate product known as ethylene-di-chloride. Unpredictability of alcohol supplies suddenly became risk due to a distillery which was supposed to come up in this area did not materialize. So the root of using alcohol was abandoned half way through the PVC product and ethylene-di-chloride was imported to be processed to PVC.

Reducing Risk :

Reduction of risk is attempted to decrease the quantum of losses arising out of a risky happening e.g., earthquake, storm, floods, etc. Risk reduction can be achieved through Loss Prevention and Loss Control.

Loss Prevention: Prevention of loss is the most insignificant of dealing with the risk, prevention systems like fire sprinkler systems, burglar alarms, etc., are typical prevention measures to reduce the risk of fire burglary. Other measures are the understanding of the risk or the comprehension of the risk arising out of an activity is environment and relationship between the activity and the environment. This will help in the following way:

Modify the risk involved in the activity itself through improved design or technology;

Tailor the surroundings where the risky activity is to take place by isolation or notification or proper layout;

Identify the linkage between the activity and the environment and institute suitable safe guards through training of people, safety devices and providing knowledge and institute mock exercises, etc.

Loss Control: Is accomplished through measures which will dowse the fire in the case of fire accident, e.g. using fire hydrants, fire extinguishers. Loss control is also accomplished by on line process control which operates in the event of a risky happening, e.g., Gas leaks fires.

Retain Risk :

Risk retention is adopted when it cannot be avoided, reduced or transferred. It can be a voluntary or involuntary action. When it is voluntary it is retained through implied agreements, involuntary retention ensures when the organization is unaware of the risk and faces it when it come up.

Combine Risks :

When the business faces two or three risks the over all risk is reduced by a combination. This strategy is prevalent mainly in the area of financial risk. Different financial instruments being negative risk return of co relation like Bonds and Shares are taken in a single port folio to reduce the risk. A physical risk of non-availability of a particular material is often solved by having more than one supplier.

Transfer Risk :

Normally in projects assignments or multifaceted exercises, execution is fought with risks. Different agencies work together and these agencies take care to transfer risk in their areas to another agency which is better equipped to take care of a risk for a consideration. Here the concept of core competence curves in and whenever a particular agency, individual or a firm finds that it is dealing in a area where it does not have the core competence to deal with it seeks the help of another agency which has the specific core competence to transfer its own risk. The risk may be in the form of loss of reputation or sub quality performance and this risk is taken care of through transfer.

Sharing Risk :

Insurance is a method of sharing risk for a consideration, viz., premium insurance loss, undertakes to share the risk with the companies and share their own risk through re-insurance with other companies. Some times big conglomerates share risk among their own group of companies in proportion to their risk bearing strengths by creating a corpus instead of paying premium to insurance companies.

Hedging Risk :

Exposures of funds to fluctuations in foreign exchange rates, interest rates, prices, etc. bring about financial risks resulting in losses or gains. The downside risk is often taken care of by hedging. Hedging is done by an agency taking over the risk for a consideration for a period and select band of fluctuation.

Risk optimization :

Risk optimization means utilizing information on risk to compute precisely what types and combinations of risk to take. It also develops the precise trade off between risk and reward and the corresponding appropriate product pricing to reflect the risk taken.

Q28. Write short notes on :

- **a. Probability of ruin**
- **b. DCF analysis**
- **c. Monte Carlo simulation analysis**
- **d. Risk adjusted performance measurement**

Answer 28.

(a) Probability of ruin

Probability of ruin is essentially a study of risk of insolvency for a company with multiple business activity facing heavy claims from creditors. For this purpose, the company is permitted to transfer resources

between business lines. But such transfers are restricted by transaction costs. Insolvency or ruin occurs when the negative positions in one or more business lines cannot be compensated by capital transfers. Such problems are normally solved on the basis of intermittent or continuous process. Mathematically, actuarial calculations are involved in such exercise. A clear expression of Laplace transformation of the finite type, for computing ruin probability is one such method. Another model developed by Clayton Levy Copulas takes into consideration the interdependence of components of risk.

(b) DCF analysis

This financial tool computes the present value of future cash flows over multiple periods using a discount factor. The formula for net present value of alternative decisions can be computed as below:

$$NPV = \sum_{t=0}^{n} \frac{E(NCF_t)}{(1+r)^t}$$

Where

$E(NCF_t)$ = Expected net cash flow in year *t*

r = opportunity cost of capital (reflects the risk of the cash flows)

For example, consider a compound wall's

Upfront cost = Rs.1,50,000

Compound will reduce theft loss by Rs.55,000 each year for 3 years

Security expenses will be reduced by Rs.15,000 each year for 3 years

Discount rate = 10%

NPV = (1, 50,000 – [1x 70,000 + 0.909 x 70,000 + 0.826 x 70,000]) = +12936

Thus NPV is positive.

(c) Monte Carlo simulation analysis

Monte Carlo simulation is a process of deriving a simulated distribution of an output variable (like cash flow or firm value) by randomly combining values of input variables in repeated drawings. It involves the following steps :

- Model the firm's value or cash flow as a function of macro-economic variables (exchange rate, interest rate, inflation rate and so on).
- Specify the probability distribution of each of the macroeconomic variables.
- Select a value, at random, from the probability distributions of each of the macro economic variables.
- Determine the firm's value or cash flow corresponding to the randomly generated values of exogenous variables.
- Repeat steps (3) and (4) a number of times to get a large number of values of the firm or cash flow so that the simulated distribution of firm's value or cash flow can be defined.

(d) Risk adjusted performance measurement

The best practice recommendation on risk management was enunciated in the G30 report on derivatives. The recommendations have been considered very sound and are very much in use currently. They include: Involve senior management

a. Establish independent risk managers for market and credit risk
b. Market to Market on a daily basis with consistent valuation measures
c. Measure and limit market and credit risk rating using value at risk (VaR) techniques to estimate probable loss over a period of time
d. Strengthen operational controls, systems and training

e. Make investment and funding forecasts
f. Identify revenue sources and next conduct stress testing

The above recommendations ensure that adequate information could be available for the management to manage risk and avoid nasty surprises. RAPM framework brings together and measures the trade off between risks and rewards.

Q29. What are the characteristics of insurance exposures? Discuss the relationship relative importance of identified risk and probability of occurrence of loss.

Answer 29.

The characteristics for an exposure to be covered by Insurance are as follows:

(i) Pure Risk: These are classified into *personal risk*, *property risk*, *liability risk and loss of income risk.*

a. Personal Risk – Can happen due to premature death, old age, sickness or disability and unemployment.

b. Property Risk – Can be classified as loss of property, loss of use of property, additional expenses arising out of loss of property.

c. Liability Risk – Can arise as injury to people or damage to property or negligence or carelessness.

d. Loss of Income Risk – Consequential loss of income arising out of personal or property losses.

(ii) Similar Exposures: Prediction of losses through application of statistical computations with the help of theory of probability require a sizeable population of similar exposures. This is particularly important in that estimation of probabilities for the happening of an event needs an adequate large sample, as accuracy increases with bigger sample.

(iii) Accidental Losses: Insurance contracts allow payments only for a accidental losses which beyond the insured's control. Losses taking place unintentionally alone are covered by Insurance. Suppression of information of a known risk will not entitle for compensation.

(iv) Definite Loss: A definite loss has three facets. It should be recognizable and should be susceptible to verification. The loss should be measurable. This is particularly important in that premium are computed mainly on the estimated quantification of losses.

(v) Large Loss: As there is always a consideration in the form of a premium for receiving a compensation for a loss, care should be taken that the premium to loss ratio is sufficiently favorable. Insurance tariffs normally form a very small percentage sometime even less than a per cent.

(vi) Catastrophic Losses: Catastrophic losses from natural disasters have two main characteristics :

a. They are limited to geographic area where the impact has taken place.

b. Prediction of the event is very difficult. For example storms and floods or earthquakes etc. can create catastrophic losses as such an Insurer will have to take special precautions of calculating the premiums. Even then the loss may be so huge that the consumers normally resort to sharing the risks through reinsurance as also ensures dispersion of risks over a larger geographical area. To estimate the frequency and severity of the catastrophic losses probability analysis is resorted to.

Q. 30. Write short notes on :

- **a. Re-insurance**
- **b. Pricing**
- **c. I R D A**
- **d. Utility Theory**

Answer 30.

(a) Re-insurance :

All insurance companies have a risk appetite i.e. a limit on the amounts that they can settle for any given claim that is made by the Insured. Any claims made beyond this specified limit by the insured is settled by another company referred to as a Reinsurance company.

Thus, Reinsurance is insurance for insurance companies. Reinsurance is the transfer of part of the risk that a direct insurer assumes by way of an insurance contract on behalf of the insured, to a second insurance carrier, the Re-insurer who has no direct contractual relationship with the insured. Direct insurers need reinsurance to limit annual fluctuations in the losses they must bear on their accounts and to protect the assets of the company in the event of a catastrophe. Direct insurers take on hazards and risks from the policy holders. Re-insurers take on hazards and risks from the direct insurer.

Insurance companies typically enter into an agreement with the Re-insurer and sign a Reinsurance Treaty which states all the terms and conditions of the agreement. The Re-insurer agrees to accept a certain fixed share of risk upon terms as set in the agreement. The well known Reinsurance companies in the world are Swiss Re, Munich Re, and Zurich Re. For example, an Insurance company has a risk appetite of Rs.1 million. but has issued a general insurance policy for an engineering project where the sum insured is Rs.4 million. If a claim is made on this particular policy, the claim will be settled for Rs.4 million. Rs. 1 million will be paid by the Insurance Company that issued the policy and the remaining 3 million will be paid by the Re-insurer.

(b) Pricing :

The process of determining or fixing the rates of premium for a particular product is known as pricing. Traditionally, premiums have been calculated based on tariffs set by the Insurance Regulatory Authority. The rates are derived based on various factors like past loss ratio, location of the asset, type of asset, as well as exposure to the risks. Rate is the pricing factor upon which the premium is based. For example, car insurance policies are priced based on factors such as make and model of the car, purpose for which the car is used, etc. Where SI is Sum insured.

Traditionally, for motor insurance, the parameters that are used to price a policy have been model of the car, age of the driver, location of the car and purpose for which the car is driven, etc. The industry will eventually move from price rating to risk rating. The pricing for each individual will be based on their track record. For example, for 'own damage' in a car insurance policy, the pricing parameters will be the model of the car, driver's age and engine capacity.

This is of particular importance to a management accountant as it is in the nature of pricing a product. The insurance premium can be broken up into four parts:

Cost of payment for losses

Cost of operation and maintenance of insurance pool

Reserve for contingencies

Return on Investment.

In the life insurance, calculation of insurance premium is very complicated exercise as the variables involve are many, e.g., factors aggravating mortality rates, like smoking, drinking, drugs and other habits,

age of the insured, occupational hazard, etc. This computation is normally through actuarial computations involving mortality rates. Premium rate is often referred as rate per unit of exposure.

(c) IRDA :

This institution came into existence on the basis of Insurance Regulatory and Development Authority Act (IRDA), 1999. Providing Licenses for transacting insurance business and reviewing premium rates are the twin activities of IRDA. IRDA is consumer friendly and protects the interests of the consumer through adequate checks, premium rates, products, procedures and investments made by the insurance companies.

The Insurance Regulatory Authority of India (IRDA) regulated the general insurance covers for over a decade. Owing to the increase in the number of players in the Indian insurance market in the last few years and the fierce competition in the General Insurance segment, IRDA wanted to de tariff the market in January 2007 and Insurers were given greater freedom to price the three insurance covers that were still regulated by IRDA: fire, engineering and motor. Policies can now be priced on a standalone basis, and therefore match the risk.

The second phase of de tariffing will allow the Insurers to structure their products as well where they may be allowed to offer some optional covers in addition to the compulsory covers. In other countries like U.S.A. where product structuring is allowed, factors like the colour of the car also can influence premiums.

De tariffing would allow Insurers to lower premiums. For policyholders, de tariffing is always beneficial. For the same amount of premium, customers can get a higher sum insured. The industry can also benefit from this, since lower premiums will lead to increased sales and thus product penetration.

(d) Utility Theory :

The destruction caused by any unforeseen event is referred to as “Risk”. In the insurance business, people exposed to the same risk form a group and share the loss together. Insurance companies collect the shares (Premiums) in advance from the group and create a fund. This fund is utilized to pay for the loss (Claims) that is incurred by any member of the group.
Risks can be classified into various types:

a) Financial and non-financial risks
b) Dynamic risks
c) Speculative risks

Risk cannot be avoided through insurance but may be considered as a means to transfer the risk. It is also a mechanism to compensate the financial and economic loss due to risk. Safety measures and damage control management can be adopted to mitigate or eliminate the magnitude of risk. The fundamental principle of insurance is to share the losses and to substitute uncertainty with certainty. Expected utility theory emphasizes that the demand for insurance is a demand for certainty. The conventional specification of the theory perceives that the buyers of insurance prefer certain losses to actuarially equivalent uncertain losses. But certain other surveys indicate that individuals actually prefer uncertain losses to actuarially equivalent certain losses. This can be explained by saying that “the purpose of any insurance policy is to convert an uncertain, but potentially large loss into a certain small loss. Such a conversion benefits the consumer, if greater losses cause progressively larger declines in utility (i.e., if there is diminishing marginal utility of wealth)” – Newhouse, 1978, page.19. For example, insurance against fire peril where the bigger part of the loss will be insured that is uncertain for a specific premium today.

Another approach evaluates a conventional expected utility theory explaining the demand for insurance by an individuals demand for an uncertain *payoff* of income in a pre specified state. This can be explained through the demand for health insurance. According to this theory, becoming ill fundamentally changes preferences. Thus an insured customer is able to transfer income into the ill state where the marginal utility of income is greater.

Q. 31. What is Insurance ? What are the requirements & characteristics of an insurance contract?

Answer 31.

Insurance can be defined as transferring or lifting of risk from one individual to a group and sharing of losses on an equitable basis by all members of the group. In legal terms insurance is a contract (policy) in which one party (insurer) agrees to compensate another party (insured) of its losses for a consideration (premium). Exposure to loss is the insured's possibility of loss.

Insurance is a means whereby a large number of people agree to share the loss which a few of them are likely to incur in the future. Insurance is also a means for handling risk. There is an uncertainty related to the risk. The business of Insurance is related to the protection of the economic value of any asset. So, every asset that has a value needs to be insured. Both tangible goods and intangibles can be insured.

Requirements of an insurance contract

Four requirements are laid down for a valid insurance contract as below:

Agreement must be for a legal purpose, i.e., the contract of Insurance should not violate the principle of Insurable Interest and it is a contract of Uberrimae Faide (Utmost Good Faith)

Parties must have legal capacity to contract; Minors, Lunatics, Insolvents, Intoxicated persons, etc. do not have the legal capacity and cannot enter into an insurance contract

There should be a **valid offer** and **acceptance** and

There must be **exchange of consideration** in response to an agreement which defines the quantum of possible loss to the insured. The premium amount is paid by the Insured by way of consideration on the basis of the policy risk insured. The Insurer's consideration will be a promise to indemnify the loss of the insured on the occurrence of the insured's risk.

Characteristics of insurance contract

Following are the unique characteristics which are distinct from other forms of contract.

Aleatory contract (Dependent on chance): The values exchanged by the contracting parties in an insurance contract are unequal as they are dependent on chance or in other words in an insurance contract result depends entirely as risk. If the loss arises, compensation is paid by the Insurer on the occurrence of peril. If it doesn't occur insurer does not pay any compensation while the premium gets paid to the insurer. The question of paying compensation does not arise.

Conditional Contract: Insurance contracts lay down conditions like providing proof of insurable interest, immediate communication of loss, proof of loss, and payment of premium by the insured.

Contract of Adhesion: Legally obligatory on the part of the insurer to explain the terms of contract fully to all the parties. This is particularly important as under contract of adhesion, any ambiguity in the wording of the agreement will be interpreted against the insurer as he had laid down the terms.

Unilateral Contract: Insurer is the only party to the contract who makes promises that can be legally enforced.

Generally, Non life insurance contracts are usually annual contracts and have to be renewed each year. Each time the policy is renewed a new contract is issued by the Insurer.

Q. 32. Write short notes on :

a. CAPM

b. APT

Answer 32.

(a) CAPM :

Harry Markowitz developed an approach that helps an investor to achieve his optimal portfolio position.

Hence, portfolio theory, in essence, has a normative character as it prescribes what a rational investor should do.

William Sharpe and others asked the follow up question : If rational investors follow the Markowitizian prescription , what kind of relationship exists between risk and return ? essentially, the Capital Asset Pricing Model (CAPM) developed by them is an exercise in positive economics. It is concerned with two key questions :

- What is the relationship between risk and return for an efficient portfolio ?
- What is the relationship between risk and return for an individual security?

The CAPM, in essence, predicts the relationship between the risk of an asset and its expected return. This relationship is very useful in two important ways. First, it produces a benchmark for evaluating various investments. For example, when we are analyzing a security we are interested in knowing whether the expected return from it is in line with its fair return as per the CAPM. Second, it helps us to make an informed guess about the return that can be expected from an asset that has not yet been traded in the market. For example, how should a firm price its initial public offering of stock?

Although the empirical evidence on the CAPM is mixed, it is widely used because of the valuable insight it offers and its accuracy is deemed satisfactory for most practical applications.

CAPM is based on the following assumptions :

- Investors are risk averse.
- Security returns are normally distributed,
- The utility function of investors is quadratic,
- Investors have homogeneous expectations – they have identical subjective estimates of the means, variances and co-variances among returns,
- The market is perfect: there are no taxes; there are no transactions costs; securities are completely divisible; the market is competitive,
- The quantity of risky securities in the market is given.

Looking at these assumptions, one may feel that the CAPM is unrealistic. However, the value of a model depends not on the realism of its assumptions, but on the validity of its conclusions. Extensive empirical analysis suggests that there is a lot of merit in the CAPM.

(b) APT

While the CAPM represents a seminal contribution to the field of finance, many empirical studies have pointed towards its deficiencies in explaining the relationship between risk and return.

A key challenge to the CAPM came from a set of studies that have suggested that it is possible to rely on certain firm or security characteristics and earn superior returns even after adjustments for risk as measured by beta. Examples : Banz found that small cap stocks outperformed large cap stocks on a risk-adjusted basis; Basu found that low P/E stocks outperformed high P/E stocks, after adjustment for risk; more recently, Fama and French documented that ‘ value stocks’ (stocks with high book-to-market price ratios) generated larger returns than ‘growth stocks’ (stocks with low book-to-market ratios), on a risk-adjusted basis.

In an efficient market such return differentials should not exist. Does it mean that the markets are not particularly efficient for long periods of time ? Or, does it mean that the markets are efficient but a single – factor model such as the CAPM does not capture risk adequately?

Since it is unlikely that markets are inefficient for extended periods of time, financial economists began looking for alternative risk-return models, beyond the CAPM. In the mid-1970s, Stephen Ross developed an alternative model called the Arbitrage Pricing Theory (APT) which is reasonably intuitive, requires only limited assumptions, and allows for multiple risk factors.

The APT does not require the following assumptions (which under gird the CAPM):the utility function of investors are quadratic; security returns are normally distributed; the market portfolio that contains all risky assets is mean-variance efficient.

The APT only assumes that the capital markets are perfectly competitive and that investors always prefer more wealth to less wealth with certainty.

Q. 33. How is project management done in practice?

Answer 33.

In reality, the risk assessment is done through considering the various components of the financial estimates and developing certain judgmental approaches:

Estimation of revenues : Revenues projected for a project need to be justified on the basis of real data available and then the projections are made conservatively. This avoids optimistic projections of income.

Cost estimates : Always include a margin of safety to take care of impact of inflation over the time horizon for which the projections are being made. Here again the margin of safety is computed on the basis of trend analysis of inflation over the recent past and the lead indicators that are available from fundamental analysis.

Acceptable return on investment : This is the prime measure and as such it should be arrived at on the basis of certain consensus. It will depend on the payback period to be assumed, the industry experience and the company's norm for return on any new project on the basis of the current experience.

Overall certainty index : The critical risks of the project are identified and the certainty index of each of these risks is quantified. Then the overall certainty index is developed as an average of the critical indices already computed. For instance, raw material availability, power availability, intensity of competition is a few of the risks, which are quantified in terms of certainty indices. The cumulative average is the overall certainty index.

Judgmental perceptions : Three different estimates of return on the investment are developed – pessimistic, most likely and optimistic on the basis of the stage at which the particular industry is in its life cycle. On the basis of the three estimates and comparing them with the earlier methods available on certainty equivalent coefficient, a judgmental decision can be taken.

Q. 34. What is systematic risk and what is unsystematic risk? Discuss the further classification of systematic and unsystematic risk.

Answer 34.

The risk is understood as the sacrifice made by an individual by deferring the use of money to a future day by investing that money in a venture promising a higher return which has uncertainty. The forces that contribute to the variations in return can both be external or internal to a company in which an individual has invested. These forces can partly be controllable and the remaining uncontrollable. The uncontrollable portion, which is essentially external, is known as systematic risk and the controllable internal risk is known as unsystematic risk.

The external or systematic risk can be classified as three types of risk:

Market Risk: Variability in return on investments in the market is referred to as market risk. This is caused by investor reaction to the tangible as well as intangible events. Tangible events like economic, political, social events and intangible events arising out of a market psychology or the other factors like interest rates and inflation also form part of the forces behind market risk.

Interest Rate Risk: This risk refers to the uncertainty of market volumes in the future and the quantum of future income caused by the variations in the interest rates. These interest rates are normally controlled by the Reserve Bank of India in our country and the exigencies for changing the interest rates arise out of

many economic factors which are monitored by the central bank i.e, R.B.I. Normally, when the interest rates increase the companies with higher quantum of borrowed money will have to pay out higher quantum of interest reducing their earnings and vice versa.

Purchasing Power Risk: Purchasing power risk is the uncertainty of the purchasing power of the monies to be received, in the future. In short purchasing power risks refers to the impact of inflation or deflation on an investment. Prudent investors normally include a premium for purchasing power risk in their estimate of expected return.

Exchange Risk: With the globalization of market cross border transactions are on the increase. Balance of payments comprising the net effect of exports and imports are subject to fluctuation in the various currencies. As recently, the strengthening of Rupee against the Dollar imports has made imports cheaper and exports costlier. The need to recognize this exchange risk is obvious as the international trade operations may be profitable or loss-making unless this risk is taken care of.

Unsystematic Risk: Unsystematic Risk is that fraction of total risk which is unique to a company or an Industry due to inherent internal factors like managerial capabilities, consumer responsiveness, labour unrest, etc. The operating environment of the business and the financing modalities involve this unsystematic risk. The first one is known as the *Business Risk* and the second is the *Financial Risk*.

Business risks can be again divided into internal and external business risks. Internal business risk is mainly due to the variations in the operational efficiency of the company. The external business risks arise out of circumstances imposed on the company by external forces like business cycle, certain statutory restrictions or sops.

Financial risk is associated with the modalities adopted by a company to finance its activities. For instance the financial leverage like the Debt Equity Ratio or the type of borrowings and the variations thereof introduce financial risk. Lower the debt less is the financial risk

Q. 35. (a) What are solvency related measures for risk management?
(b) What are performance related measure for risk management?

Answer 35. (a)

Solvency-related measures (these measures concentrate on the adverse "trail" of the probability distribution – and are relevant for determining economic capital requirements)

Probability of ruin – the percentile of the probability distribution corresponding to the point at which the capital is exhausted.

Shortfall risk – the probability that a random variable falls below some specified threshold level. (Probability of ruin is a special case of shortfall risk in which the threshold level is the point at which capital is exhausted.)

Value at risk (VAR) – the maximum loss an organization can suffer, under normal market conditions, over a given period of time at a given probability level. VaR is a common measure of risk in the banking sector, where it typically calculated daily and used to monitor trading activity.

Expected policy holder deficit (EPD) or economic cost of ruin (ECOR) – an enhancement to the probability of ruin concept (and thus shortfall risk and VaR) in which the severity of ruin is also reflected. Technically, it is the expected value of the shortfall.

Tail Value at Risk (Tail VaR) or Tail Conditional Expectation (TCE) – an ECOR-like measure in the sense that both the probability and the cost of "tail events" are considered.

Tail events – unlikely but extreme events, usually from a skewed distribution. Rare outcomes, usually representing large monetary losses.

Answer 35.(b)

Performance-related measures (these measures concentrate on the mid-region of the probability distribution –see "risk profile" above – i.e., the region near the mean, and are relevant for determination of the volatility around expected results):

- Return on equity (ROE) – net income divided by net worth
- Operating earnings – net income from continuing operations, excluding realized investment gains
- Earnings before interest, dividends, taxes, depreciation and amortization (EBITDA) – a form of cash flow measure, useful for evaluating the operating performance of companies with high levels of debt (when the debt service costs may overwhelm other measures such as net income).
- Cash flow return on investments (CFROI) – EBITDA divided by tangible assets.
- Weighted average cost of capital (WACC) – the sum of the required market returns of each component of corporate capitalization, weighted by that component's share of the total capitalization.
- Economic value added (EVA) – a corporate performance measure that stresses the ability to achieve returns above the firm's cost of capital. It is often stated as net operated profits after tax less the product of required capital times the firm's weighted average cost of capital.