Chapter 1

The process of strategy formulation

Chapter learning objectives:

Lead	Component	Indicative syllabus content
B.1 Evaluate the process of strategy formulation.	(a) Evaluate the processes of strategic analysis and strategic options generation.	• Vision and mission statements and their use in orientating the organisation's strategy. • The process of strategy formulation. • Strategic options generation (e.g. using Ansoff's product/market matrix and Porter's generic strategies). • Scenario planning and long-range planning as tools in strategic decision making. • Value drivers (including intangibles) of business and the data needed to describe and measure them. • Game theory approaches to strategic planning and decision making. *Note: Complex numerical questions will not be set.* • Real Options as a tool for strategic analysis. *Note: Complex numerical questions will not be set.* • Acquisition, divestment, rationalisation and relocation strategies in the context of strategic planning.
	(c) Discuss the role and responsibilities of directors in the strategy formulation and implementation process.	• The role and responsibilities of the board of directors and senior managers in making strategic decisions (including issues of due diligence, fiduciary responsibilities and corporate social responsibility). • The role of the Chartered Management Accountant in the strategy development process.

1. What is strategy?

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

Strategy is the direction and scope of an organisation over the long term, which achieves advantage for the organization through its configuration of resources within a changing environment, to meet the needs for markets and to fulfil stakeholders' expectations.
- ***Johnson, Scholes and Whittington (Exploring Corporate Strategy)***

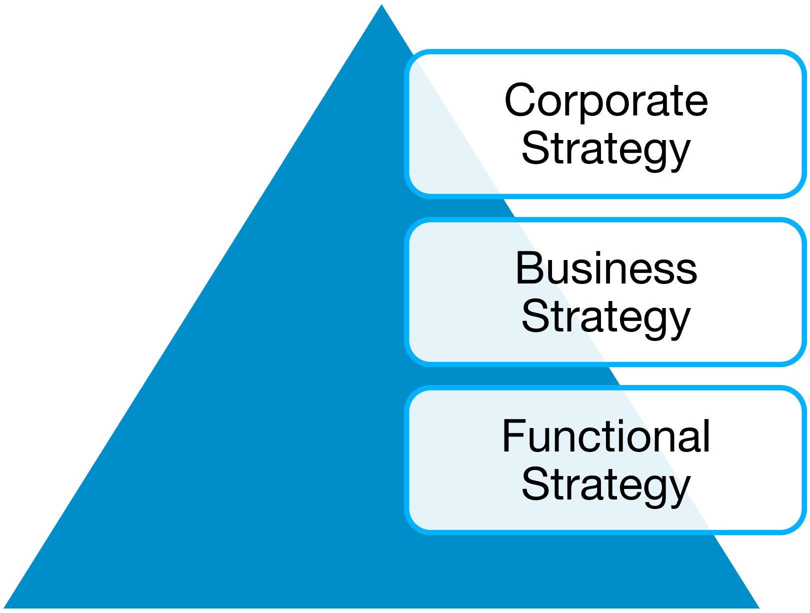
The characteristics of strategic decisions

Johns, Scholes and Whittington defined the characteristics of strategic decisions as follows:

- Strategic decisions are likely to be affected by the scope of an organisation's activities.
- Strategy involves the matching of the activities of an organisation to its environment.
- Strategies need to be considered in terms of the extent to which resources can be obtained, allocated and controlled to develop a strategy for the future.
- Operational decisions will be affected by strategic decisions.
- Strategic decisions are apt to affect the long-term direction of the organisation.

Michael Porter suggests, "The essence of formulating competitive strategy is relating a company to its environment."

2. Levels of strategy



Corporate or strategic level (which)

- Raises the question: which businesses and markets should we be in?
- Involves considering acquisition and diversification and will see the organisation as comprising more than one business.
- Corporate strategy is concerned with:
    - Entering new industries
    - Leaving new industries

Business or management level (how)

- Once the market has been selected, the organisation must develop a plan to be successful in that market.
- The aim is to compete successfully in the individual markets in which the company chooses to operate.
- Business strategy is concerned with:
    - Achieving advantage over competitors.
    - Avoiding competitive disadvantage.

Corporate strategy affects the organisation as a whole, while business strategy will focus on Strategic Business Units (SBUs).

An SBU is a unit within an organisation for which there is an external market for products distinct from other units.

Functional or operational level (day-to-day)

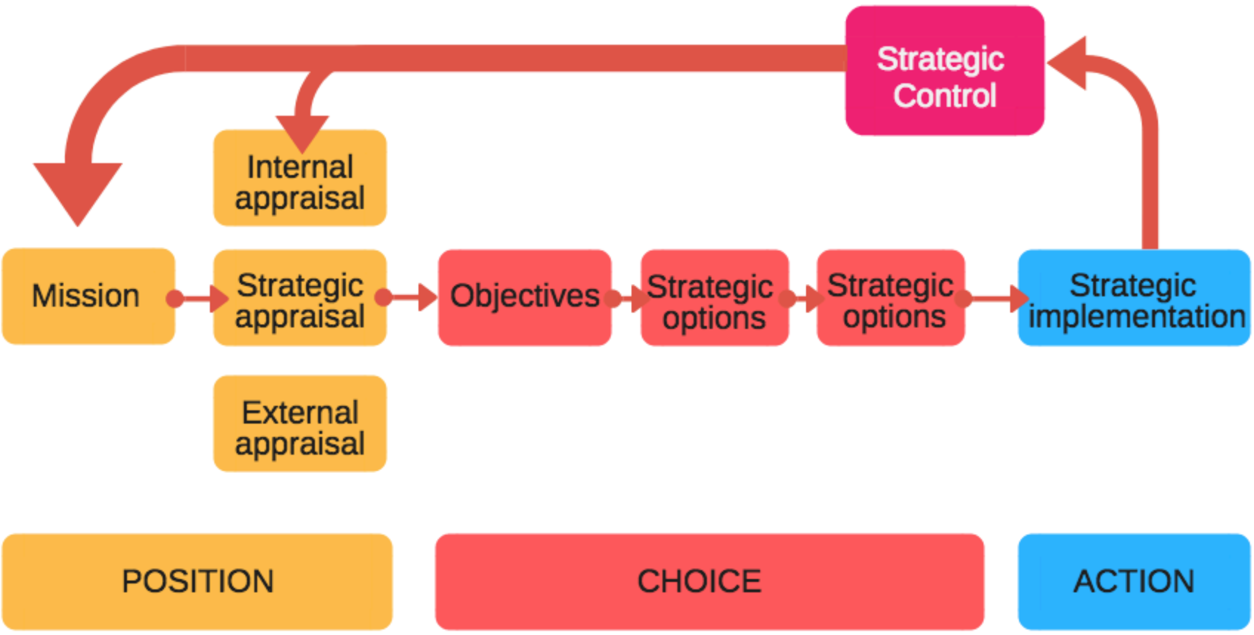
This is concerned with:

- Human resource strategy
- Marketing strategy
- Information systems and technology strategy
- Operations strategy

3. The strategic planning process

THE RATIONAL MODEL

- A logical step-by-step approach.
- Requires the organisation to analyse its existing circumstances.
- Requires the organisation to generate possible strategies.



Johnson, Scholes and Whittington Model

Took the stages of the rational model and grouped them into three main stages:

1 STRATEGIC ANALYSIS

- External analysis to identify opportunities and threats
- Internal analysis to identify strengths and weaknesses
- Stakeholders analysis to identify key objectives and to assess power and interests of different groups
- GAP analysis to identify the difference between desired and expected performance

2 STRATEGIC CHOICE

- Required to close the gap
- Competitive strategy for each business unit
- Directions for growth
- Whether expansion should be achieved by organic growth/ acquisition or some form of joint arrangement

3 STRATEGIC IMPLEMENTATION

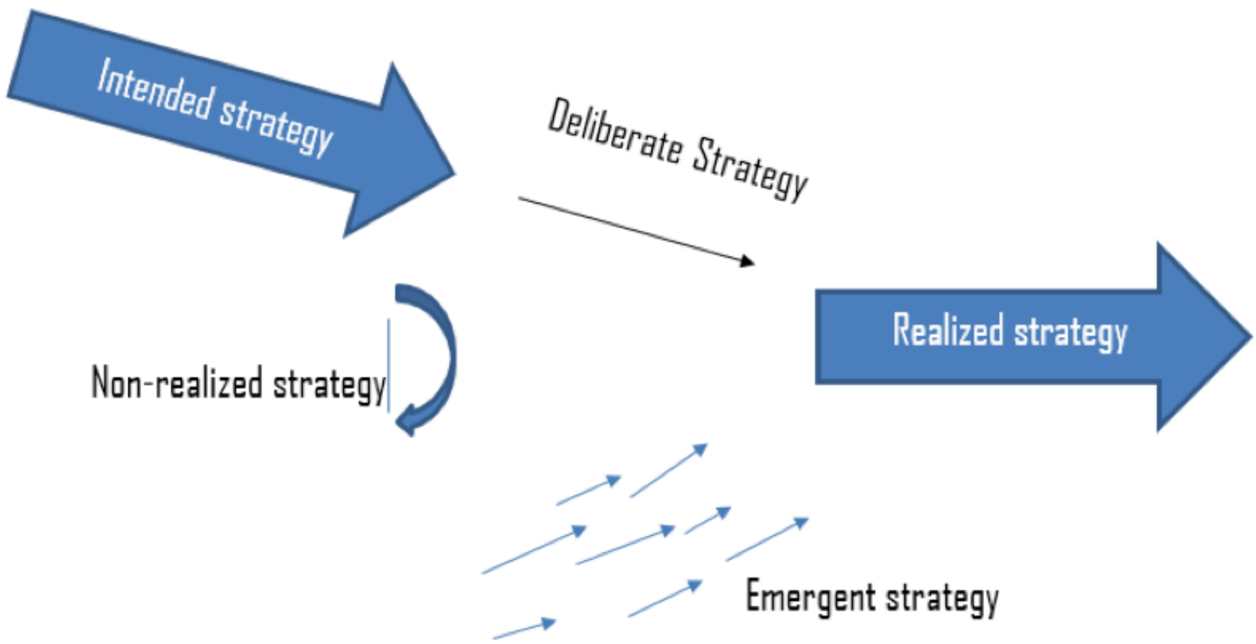
- Formulation of detailed plan and budget
- Target setting for KPIs
- Monitoring and control

Advantages and disadvantages of deliberate long-term planning:

Advantages	Disadvantages
Forces managers to look ahead	Difficulty in setting strategic objectives
Improved control	Short-term pressures
Identifies key risks	Difficulty in forecasting accurately
Encourages creativity	Bounded rationality Rigidity High costs Dishonesty and management distrust

EMERGENT APPROACH (MINTZBERG)

- The rational model quickly becomes outdated.
- Strategy tends to evolve rather than resulting from a logical, formal process.
- An emergent approach is evolving, continuous and incremental.



LESS FORMAL APPROACHES TO STRATEGY

Incrementalism (Lindblom)

- Strategic managers do not evaluate all the possible options open to them but choose between relatively few alternatives.
- Does not normally involve an autonomous strategic planning team that impartially sifts alternative options before choosing the best.
- Strategy-making tends to involve small-scale extensions of past policy.

Freewheeling opportunism

- Freewheeling opportunists do not like planning.
- They prefer to see and take opportunities as they arise.
- It is probable that this approach is adopted more for psychological reasons.
- Some people simply do not like planning.

Problems with a lack of formal planning

- Failure to identify risks.
- The organisation may not have an overall plan for the future.
- Difficulty in raising finance.
- High-level management skills are required.

The three Es approach of the Audit Commission

- **Effectiveness** – looks at the output.
- **Efficiency** – looks at the link between outputs and inputs.
- **Economy** – looks solely at the level of inputs.

4. Approaches to strategic planning

A traditional approach – stakeholders

- Starts by looking at the shareholders and their objectives.
- The emphasis is on formulating plans to achieve these objectives.
- This approach is flawed because the objectives are set in isolation from market consideration and are unrealistic.

- This approach is useful for not-for-profit organisations, where the discussion of mission and objectives is key.

A market-led or positioning approach

- Starts with an analysis of markets and competitors' actions before objectives are set and strategies developed.
- The essence of strategic planning is to ensure that the firm is a good fit with its environment.
- The idea is to be able to predict changes sufficiently far in advance to control change rather than always having to react to it.
- The main problem with this approach lies in predicting the future, since some markets are so volatile that it is impossible to estimate further ahead than the immediate short term.

A resource-based or competence-led approach

- Many firms that have found anticipating the environment to be difficult have switched to a competence- or resource-based approach, where the emphasis of the strategy is to look at what the firm is good at – its core competences.
- Ideally, these correlate to the areas that the firm has to be good at in order to succeed in its chosen markets.

5. Roles and responsibilities of the directors & senior managers

- Directors have a fiduciary duty to the shareholders.
- They also have a duty to exercise care and skills.

Directors' duties in the UK

The Companies Act 2006 codifies seven duties

- The duty to act within powers.
- The duty to promote the success of the company.
- The duty to exercise independent judgement.
- The duty to exercise reasonable care, skill and diligence.
- The duty to avoid conflict of interest and of duties.
- The duty not to accept benefits from a third party.
- The duty to declare interest in proposed transactions or arrangements.

Wider stakeholder concerns – corporate social responsibility

Within the second duty listed above, "To promote the success of the company", the act highlights that the directors must have regard for certain specific matters, i.e.

- The likely consequences of any decision in the long term.
- The interests of the company's employees.
- The need to foster the company's business relationship with suppliers, customers and others.
- The desirability of the company maintaining a reputation for high standards of business conduct.

6. Corporate governance

In the Cadbury Report, governance is defined as, ***"the system by which companies are directed and controlled".***

This definition has subsequently been expanded to, "the system by which companies are directed and controlled in the interests of shareholders and other stakeholders."

Purpose and objectives of corporate governance

Purpose:

The main purpose of governance is to monitor those parties within the company that control the resources owned by the investors.

Objective:

The main objective of governance is to contribute to improved performance and accountability in creating long-term shareholder value.

Relevant aims of corporate governance:

- To increase disclosure to stakeholders' in general.
- To ensure that companies are run on ethical grounds and do not operate illegally.
- To provide increased confidence in the company.
- To increase transparency at the board level of operations.

The principles of the UK Corporate Governance Code:

Leadership:

- Every company should be headed by an effective board.
- There should be a clear division of responsibility between running the board (the role of chairman) and running the company's business (the role of CEO). These roles should not be held by one person.
- The board should include non-executive directors.

Effectiveness:

- The board and its committee should have an appropriate balance of skills, experience, independence and knowledge.
- Companies are to explain, and report on progress with, their policies on boardroom diversity.
- There should be a formal, rigorous, and transparent procedure for the appointment of a new director to the board.

Accountability:

- The board should present a balanced and understandable assessment of the company's position and prospects.
- Directors must publish a statement of their responsibility for preparing the accounts, affirming that the report and account are fair, balanced, understandable and provide all necessary information to the shareholders.

Remuneration:

- There should be formal and transparent procedures for developing policy on executive remuneration.
- Executive rewards are subject to the recommendations of a remuneration committee.

Relations with shareholders:

- The board as a whole has a responsibility for ensuring that a satisfactory dialogue with shareholders takes place.
- The board should use the AGM to communicate with the investors and to encourage their participation.

7. The role of the management accountant

> Strategic management accounting is a form of management accounting in which emphasis is placed on information which relates to factors external to the entity, as well as non-financial information and internally generated information. - ***CIMA Official Terminology***

This highlights some key differences between strategic and traditional management accountants.

External focus:

Traditional management accountants tend to focus on internal company issues; this is because their role is:

- To aid in the creation of operational strategies for the business.
- To safeguard company assets.
- To measure and report both financial and non-financial performance to the managers.
- To ensure efficient use of assets and resources.

Forward-looking:

- A large part of a traditional management accountant's role is to do with the measurement of the historic performance of a business and its division.
- Strategic management accountants need to be more forward-looking.

Information provided by strategic management accountants:

- Competitor analysis.
- Customer profitability.
- Pricing decisions.
- Portfolio analysis.
- Corporate decision support.

Value for strategic management:

- More effective strategic planning.
- Increased awareness of the business and its environment.
- Increased control over business performance.
- Better decision-making.

9. Chapter summary