Business Policy & Strategy

Block

3

Strategy Execution and Control

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BLOCK 3: STRATEGY EXECUTION AND CONTROL

The third block of the course on Business Policy & Strategy deals with strategy execution and control. The block contains six units. The first unit discusses the value chain and competitive scope. The second unit discusses the value chain and generic strategies. The third unit discusses strategy and structure. The fourth and fifth units discuss strategy execution and organizational culture, and strategic and operational control, respectively. The sixth unit discusses the organizational roles in strategic management.

The first unit, *The Value Chain and Competitive Scope*, discusses categories of value activities, that is, primary and support activities. It also discusses how to configure a value chain that would help a firm in identifying its competitive advantage, and the concept of sustainable competitive advantage. The unit describes how the competitive scope influences the competitive advantage by shaping the structure and economics of the value chain. The unit ends with a discussion on the relationship between value chain configuration, industry structure, and departmental structure.

The second unit, *The Value Chain and Generic Strategies*, discusses the value chain for cost analysis and the cost behavior of value activities. It describes the linkages within and across value chains. The unit also discusses cost advantage, the techniques to gain cost advantage, and the different types of errors that may arise while carrying out the cost leadership strategies. The unit ends with a discussion on the differentiation strategies, and about how buyer value is created.

The third unit, *Strategy and Structure*, discusses the different structural dimensions of organization design, and the different types of organization structures. It discusses the responsibility structure, and the concepts of controllability, goal congruence, and transfer pricing, that are integral to its proper functioning. The unit ends with a discussion on how the management can align structure to strategy.

The fourth unit, *Strategy Execution and Organizational Culture*, discusses the significance of organizational culture to strategy execution, and how a desired culture can be institutionalized in an organization. It also discusses the relationship of culture to strategy execution through structure, style of management, and power. The unit ends with a discussion on the interrelationship between culture and change.

The fifth unit, *Strategic and Operational Control*, discusses the concept of control systems in management. It also discusses the specifics of strategic control and operational control. The unit ends with a discussion on the important management tools like balanced scorecard, benchmarking, and re-engineering.

The sixth unit, *Organizational Roles in Strategic Management*, discusses the roles and responsibilities of the strategy team. The unit ends with a discussion on the specific contributions made by the general managers and the board of directors toward strategic management in a corporate context.

Unit 9

The Value Chain and Competitive Scope

Structure

"If you're competitor-focused, you have to wait until there is a competitor doing something. Being customer-focused allows you to be more pioneering."

\- Jeff Bezos

9.1 Introduction

Here, Jeff Bezos is actually bringing the focus from competitor-focused strategic approach to customer focused strategic approach. Waiting for competitor to act who does as per the market/customer needs, is actually losing the company's market opportunity.

In the last unit of the previous block, we have discussed about strategic analysis and choice. In this unit, we shall discuss about value chain and competitive scope.

A value chain is a linked set of value-creating activities that begins with the purchase of basic raw materials from suppliers, and ends with distribution of a product or service. A value chain analysis evaluates the firm in the context of its value-creating activities.

A firm derives its value from value adding activities (value activities) such as designing, producing, marketing, delivering, and supporting activities. Effectiveness and efficiency in one or more than one of these activities can lend either cost advantage or differentiation advantage to the firm. A firm can gain cost advantage from a low-cost physical distribution system, superior sales force utilization, or an efficient assembly process. Similarly, differentiation advantage can be gained by procuring high quality raw materials, having a superior product design, or a responsive order entry system.

This unit will first discuss the categories of value activities, that is, primary and support activities. We shall then move on to discuss how to configure a value chain that would help a firm in identifying its competitive advantage, and discuss the concept of sustainable competitive advantage. We shall also discuss how the competitive scope influences the competitive advantage by shaping the structure and economics of the value chain. Finally, we shall discuss the relationship between value chain configuration, industry structure, and departmental structure.

9.2 Objectives

By the end of this unit, you should be able to:

- Define the two categories of value activities, namely, primary activities and support activities.
- Explain how to configure a value chain that would help a firm in identifying its competitive advantage.
- Discuss the concept of sustainable competitive advantage.
- Find out how the competitive scope influences the competitive advantage by shaping the structure and economics of the value chain.
- Identify relationship between value chain configuration, industry structure, and departmental structure.

9.3 Primary and Support Activities

To create and sustain competitive advantage, it is essential to analyze and understand how various value activities interact. Value activities can be classified into two categories -- primary activities and support activities.

According to Porter’s classification, the primary activities are: inbound logistics, operations, outbound logistics, marketing and sales, and customer service. The support activities are: firm infrastructure, human resource management, technology development, and procurement. However, the following discussion classifies primary and support activities from an alternate perspective.

9.3.1 Primary Activities

These activities encompass designing, producing, marketing, delivering, and providing after-sales service. According to this perspective, primary activities can be classified into four categories -- research and development, production, marketing and sales, and service.

Research and development (R&D)

These activities are related to the designing of products and production processes. The usefulness of a product increases through its superior product design, which in turn increases the probability of huge profits for the firm. Moreover, by designing and developing an efficient production process, production costs can be minimized. This provides competitive advantage to the firm in the long run.

Production

This function is concerned with the manufacturing of a good or a service. The product delivered can be a physical good or a service. The objective of the production department is to manufacture superior quality goods at the lowest possible price.

Marketing and sales

There are several ways in which a firm's marketing and sales functions can create value for a product. Marketing and sales activities help increase the perceived value of a product through brand positioning and advertising. Moreover, the marketing function plays an important role in creating more value by providing customer feedback on the existing products. If the feedback is negative, efforts can be made to improve the product or service.

Service

This function contributes value to the firm by solving product-related problems of the customer.

Example

The journey of Starbucks started in 1971 with a single store in Seattle. Starbucks operates globally in many countries. Starbucks does not outsource its sourcing thus ensuring high quality standards right from the coffee bean choice stage. The company-appointed coffee buyers pick the finest quality beans from Latin American, African and Asian suppliers. They are then roasted, packed and delivered through their inbound logistics to distribution centres. There are very few or no intermediaries in the selling of the item. Most goods are only sold in their own stores or in licensed stores.

Starbucks focuses on superior quality products and only does promotional efforts in the form of testing in locations around the stores during new product releases. Starbucks aims to build customer loyalty through its store-level customer service. To achieve this, it articulates its retail target in its annual report as, "to be the leading retailer and brand of coffee in each of our target markets by selling the finest quality coffee and related products, and by providing each customer a unique Starbucks experience." The instance case of Starbucks, the sourcing to distribution of selected coffee beans reflects on its inbound and outbound logistics activity (primary activity).

Source: ICFAI Research Center

9.3.2 Support Activities

Support activities provide inputs to the primary activities and include activities like materials management. The materials management function, for example, controls the transmission of physical materials throughout the value chain, from procurement to production and distribution. The value creation here depends upon the efficiency with which the material management is carried out in lowering the costs incurred on procuring the inputs (raw materials, consumable store, spares, etc.) and in delivering the final product. The lowering of costs takes place by identifying cheaper sources of supply which meet the quality norms, improving material handling efficiencies, distributing in the right mix at the right time, etc.

Similarly, the human resource function also adds value to an enterprise ensuring the right mix of skilled people to perform value creating activities effectively.

A firm's infrastructure performs the most important supporting function. Infrastructure is important because it provides the basic framework within which all the other value creating activities take place. Organization structure, control systems, and organizational culture together constitute the infrastructure of the firm. The top management should also be considered as a part of firm infrastructure as it influences the structure, control systems, and culture. Strong leaders can consciously shape the infrastructure of a firm, and thus enhance the performance of all other value creating activities that take place within it.

Activity 9.1

Value activities can be classified into primary activities and support activities. With the help of an example of a company, explain the value activities that it carries out.

Answer:

Check Your Progress - 1

1. A firm can gain differentiation advantage by:
   - i. Procuring high quality materi1als.
   - ii. Having a superior product design.
   - iii. Superior sales force utilization.
   - iv. Having a responsive order entry system.
   - a. Only i, ii, and iii
   - b. Only i, ii, and iv
   - c. Only i, iii, and iv
   - d. Only ii, iii, and iv

2. Value addition occurs in four functions, namely, research and development, production, marketing and sales, and service. Which of the following activities denote all those four functions mentioned?
   a. Primary activities
   b. Maintenance activities
   c. Support activities
   d. Secondary activities
3. Which of the following constitute the infrastructure of an organization?
   i. Organization structure
   ii. Operations
   iii. Control systems
   iv. Top management
   a. Only i and iii
   b. Only i and iv
   c. Only i, ii, and iv
   d. Only i, iii, and iv

9.4 Configuring the Value Chain

Value chain analysis assumes that the basic purpose of a business is to create value for its users through its products and/or services.

A value chain segregates the strategically relevant activities of a firm to understand the cost behavior of each activity. Strategic relevance could be in terms of the potential impact on the execution of cost leadership or differentiation strategies. By configuring the value chain appropriately and performing these activities effectively and efficiently, a firm can gain competitive advantage. For example, identifying low cost suppliers and gaining access to their value chain can improve the performance of the firm in the short-term as well as in the long-term.

The level of integration influences the value chain. A firm that serves only a particular segment of the industry can create a value chain which is suitable to that particular segment. This can result in lower costs or differentiation advantage compared to competitors.

Expanding or narrowing the extent of operations also affects the competitive advantage of a firm. Likewise, a firm operating in related industries can create a competitive advantage by exploiting inter-relationships among the industries.

A firm might choose to provide an activity internally or externally based on how one activity influences another activity in the value chain. In the consumer durables market, the Whirlpool Corporation prefers to serve its customer internally. Thus, it seeks to gather valuable information through its service representatives. This feedback helps the firm in rectifying problems in the service and design of new products.

A clear understanding of value chain configuration helps a firm identify its competitive advantage.

Example

Red Bull is an energy drink sold by Red Bull GmbH, an Austrian company created in 1987. Red Bull is sold in most countries in billions of cans annually. Its wall-to-wall manufacturing technique involves manufacturing and filling cans on the same site and saving millions of km of truck travel annually, with highly positive implications from financial and environmental points of view. It uses trucks only when it's absolutely necessary and majority times it delivers the orders to the destinations predominantly by train and ship which is far more cost effective. Thus, it became an important point in Red Bull's outbound logistics.

Compared to glass and pet bottles, Red Bulls cans are 40% and 30% more space effective respectively. The shape and light weight of Red Bull cans makes transportation much easier which is another value addition in outbound logistics operations. To promote the brand in indirect manner, Red Bull Media House has five print magazines, one TV channel and an online TV channel and also owns a number of sports teams such as RB Leipzig, FC Red Bull Salzburg, Red Bull Brasil, and New York Red Bulls. Red Bull sells its energy drinks only via distributors and resellers such as supermarket chains, bars and restaurants and other outlets. It offers a limited scope of post-sale service due to the nature of the industry and the product apart from the Regional Customer Service contact details displayed on its official website through which customers, general public and other stakeholders contact the company regarding various issues.

Red Bull's practice of wall-to-wall manufacturing technique (manufacturing & filling cans) saved millions of km of truck travel annually. The usage of public transport systems, shape and light weight of Red Bull cans makes transportation much easier altogether and has positive implications from financial and environmental points of view (Configuring value chain). Added to this was, Red Bull's media ownership that reflected on its marketing / brand management by selling its energy drinks only via distributors and resellers such as supermarket chains, bars and restaurants and other outlets.

Source: ICFAI Research Center

9.5 Sustainable Competitive Advantage

A firm influences the buyer's performance by influencing its value chain. It does so by providing direct inputs, that is, products and services, to the customer. It also influences the buyer indirectly through its logistical system, sales force, applications engineering group, and order entry system. Although the activities of a firm sometimes represent only a fraction of the buyer's total cost, these activities can determine the extent of value created.

A firm creates value when it creates competitive advantage for its buyer. The competitive advantage can be created in the form of lowering the buyer's cost or raising the buyer's performance. A firm's differentiation depends on how its value chain is related to the buyer's value chain. This, in turn, depends on the way a firm's physical product is used in a particular buyer activity and also the other points of contact between a firm's value chain and the buyer's value chain.

Value creation has to be accompanied by value communication and value capture. That is, the buyer has to perceive and appreciate the value created by the firm. Once this happens, the firm should attempt to capture a portion of the value in terms of better pricing and profit margins, or greater sales volumes. The relationship between value creation and value capture is influenced by the forces of industry structure such as the relative bargaining powers of buyers and suppliers.

A firm that has a competitive advantage in the market place is able to create and capture value. Gaining sustainable competitive advantage is the main objective of many firms. However, it is not easy to attain sustainable competitive advantage. The main problem is to identify the competitive advantage that should be pursued. A competitive advantage has strategic relevance and is sustainable only when it satisfies the following three conditions:

- Customers must find a difference between the firm's product and the products of its competitors. This perceived difference should be in variables that influence their buying behavior.
- The difference must reflect the capability gap between the favored firm and its competitors.
- The difference in the product and the gap in the ability must be sustainable in the long-run.

9.5.1 A Difference that Matters

A firm can build competitive advantage in any segment of the market. But these advantages assume significance only when they can ensure repeat buys. The differentiation advantage to be effective must attract the buyer. A firm can hardly influence the buyer with its plant location and the choice of raw materials unless these advantages result in the price the customer pays, the way customer perceives the product, the convenience customer finds in product use, and the ease with which customer can get access to the product. Different combinations of these aspects are important in different market segments. Any useful differentiation takes the above factors into consideration.

9.5.2 A Gap in Capabilities

Differentiation is generally the result of some concrete gap between the capabilities of a firm and its competitors. Moreover, the gap has to be substantial and difficult to minimize with economically rational effort in the short-term. For leading firms, capability gaps are concrete, specific, and measurable. These capability gaps can be divided into four categories as:

- *Gaps in the business systems*: A firm with superior business systems is able to perform individual functions better than its competitors.
- *Gaps in position*: Reputation, consumer awareness and trust, order backlogs, irreversible investment choices such as better plant locations come under position gaps. These position gaps are result of prior decisions, actions, and circumstances.
- *Regulatory and legal gaps*: Gaps such as import quotas, and consumer safety laws result from government actions.
- *Gaps in R&D and implementation*: These are gaps in a firm's ability to innovate, adapt, and commercialize the technology faster than competition consistently.

Only gaps in business systems can be bridged in the short-term. All other types of gaps are difficult to nullify in the short-term.

9.5.3 Sustainable Differentiation

Differences in products and capabilities must be sustainable in the long-term. Hence, the firm's efforts aimed at ensuring differentiation must focus on adaptations that will be relevant for longer periods and not on attributes that are based on ephemeral trends. A potential threat to competitive advantage comes from a competitor who changes the rules of the competition. This situation makes the competitive advantage of the firm irrelevant.

Example

PepsiCo has been the leading company in the food and beverages industry having more than 100 years of experience in the market. PepsiCo expanded its portfolio beyond soda and potato chips when Indra Nooyi took over as CEO. Pepsi diversified its portfolio by adding healthier brands and products that can be consumed morning, noon, and night. The convenience of purchasing, availability, low-price, favourable taste are some of the things a customer expects in a competitive non-alcoholic beverages market.

Contd….

That's what Pepsi offered. It is a leader in its segment fighting neck- and neck with Coca-Cola. In the given case, Pepsi diversified its portfolio by adding healthier brands and products that can be consumed morning, noon, and night (sustainable differentiation).

Source: ICFAI Research Center

9.5.4 Sustainable Competitive Advantage and Strategy

Generally, it is assumed that competitive advantage automatically leads to success. However, in certain situations this assumption may prove wrong. The market segment in which the firm holds competitive advantage may not be profitable. Similarly, some competitors can inflict tactical damage on the firm by resorting to price cuts that have no relevance to competitive advantage. Though it is essential to gain competitive advantage, creating wealth for shareholders is more important. A strategy that sustains competitive advantage but does not create shareholder wealth is an irrelevant strategy.

Activity 9.2

A competitive advantage has strategic relevance and is sustainable only when it satisfies certain conditions. How can organizations achieve sustainable competitive advantage? Give an example of a company that has achieved sustainable competitive advantage. How did the company achieve it?

Answer:

9.6 Competitive Scope and the Value Chain

Competitive scope influences the competitive advantage by shaping the structure and economics of the value chain. It has different dimensions such as segment scope, vertical scope, geographic scope, and industry scope. Coalitions help broaden the scope of operations without broadening the firm. Further, the basis for defining relevant business unit boundaries is provided by the relationship between competitive scope and the value chain.

9.6.1 Segment Scope

In segment scope, the emphasis is on the variety of products and the types of buyers. If the differences between the segments are great, the firm may gain a competitive advantage by configuring separate value chains for addressing the two segments.

9.6.2 Vertical Scope

This refers to the extent of activities that are performed in-house. Decisions on vertical scope of operations help in streamlining the value activities between a firm and its suppliers, channels, and buyers.

9.6.3 Geographic Scope

This refers to the range of regions, countries, or groups of countries in which a firm operates with a well directed strategy. Geographic scope allows a firm to share value activities across different regions.

9.6.4 Industry Scope

Inter-relationships may exist among the value chains required to compete in related industries. These potential inter-relationships give rise to the choice of industry scope, that is, the firm can gain by operating in various related industries by leveraging on the synergies in the respective value chains. The gains may be in terms of reduced costs and/or better differentiation.

9.6.5 Coalitions and Scope

Sometimes, a firm enters into long-term coalitions to gain certain advantages. Joint ventures, strategic alliances, and technology licenses are examples of coalitions. Without broadening the firm, coalitions broaden the scope of operations either vertically (across firms operating in different stages of a value chain) or horizontally (among firms operating in the same stage of the value chain). Through coalitions, a firm gets an opportunity to share its activities without entering new industry segments, geographic areas, or related industries.

Coalitions bestow the cost and differentiation advantages of vertical linkages without the firm having to go in for vertical integration; at the same time, they help the firm avoid the coordination problems inherent in arm’s length transactions between unrelated firms. Coalitions usually involve both costs and benefits to all the coalition partners. The sharing of benefits between coalition partners depends on their relative bargaining power.

Example

Toyota's Japanese operations comprise Toyota Manufacturing and Toyota Motor Sales. While Toyota Manufacturing takes less than two days to manufacture a car, Toyota Sales takes 15 - 26 days to take a customer order and deliver the car to the customer. This led to more cost which, in turn, exceeded the cost to manufacture the car at Toyota Manufacturing. Since Toyota Sales was a good place to create new sources of low cost competitive advantage, the two companies were merged. Consequent to that Toyota Motor Sales directors retired, and executives of Toyota Motor Manufacturing got into those roles.

Contd….

This resulted in reduction of time to perform the order processing and distribution activities to 6 days and costs decreased significantly. In the present case of Toyota, the vertical merger of Toyota's manufacturing and sales firms broadened the scope of sales and acquired competitive advantage.

Source: ICFAI Research Center

9.6.6 Competitive Scope and Business Definition

The basis for defining relevant business unit boundaries is provided by the relationship between competitive scope and the value chain. The firm may supply products and/or services to multiple customer segments in multiple geographies. These products and/or services may also be supplied to multiple industries. If there are significant differences in the value chain configuration required to handle some or all of these requirements, then these sets of differentiated value activities can be grouped into distinct different business units.

For example, if the similarities and synergies are greater on the geography front and the product/service front, then a distinct business unit can address all the needs -- across products/services and geographies -- of all the customers in one industry. On the other hand, if the similarities and synergies are greater on the industry front and on the product/service front but not on the geography front, then each geographic market can be served by a distinct business unit. For example, a global media business firm that chooses to compete on a 'content localization' strategy may define each country's operations as a distinct business unit.

Similarly, if the firm would significantly benefit from a tight integration of activities in different stages of the value chain, then all these stages can be managed by a single business unit. For example, a sugar mill and its captive power plant can belong to a single business unit.

On the other hand, if the firm would significantly benefit from arm's length transactions between different stages of the value chain, then these stages can be managed by distinct business units. For example, manufacture of paper pulp and design-cum-marketing of greeting cards can be two different business units in a firm.

9.7 The Value Chain, Industry Structure, and Departmental Structure

There is a reciprocal relationship between value chain configuration and industry structure. The industry structure influences the value chain configuration of a firm; for example, a firm may choose to integrate backward and manufacture input components if the bargaining power of suppliers is high.

On the other hand, the set of value chains of the players in the industry influences the industry structure. For example, if the activities in each firm's value chain require a minimum amount of capital, then that becomes the minimum capital investment required for a new entrant into the industry. Thus the value chain configuration can influence entry barriers in an industry.

The value chain can also be used for designing the departmental structure of a firm. Any firm comprises different departments, each of which performs different functions. A key motive for such differentiation is to ensure greater efficiency. However, to achieve the intended effectiveness, all these activities must be integrated.

By using value chain analysis, a firm can demarcate its functional boundaries according to its desired competitive advantage, and make arrangements for proper coordination. Thus, an organization structure that aligns itself with the value chain can ensure enduring competitive advantage to the firm. For example, the structure should ensure that the inbound logistics activities are closely tied in with the production activities and the outbound logistics with the marketing activities. The structure should also ensure that there is a flow of information from the sales and service to the research and development activities so that the feedback can be provided on competitor moves with reference to new product improvement. This will ensure that the various and diverse firm activities are well coordinated and that the firm goes on to become highly responsive to the market. It will also help it to gain and sustain a competitive advantage.

Check Your Progress - 2

4. Which of the following statements is **false**?
   a. A firm creates value when it creates a competitive advantage for the buyer.
   b. A firm's differentiation does not depend on how its value chain is related to the buyer's value chain.
   c. A firm influences the buyer not only through its product but also through its logistical system.
   d. Both (a) and (c)
5. In which of the following scopes, the emphasis is on the variety of products and the types of buyers?
   a. Segment
   b. Vertical
   c. Geographic
   d. Industry

6. Which of the following scopes allows a firm to share value activities across different regions?
   a. Segment
   b. Vertical
   c. Geographic
   d. Industry
7. Which of the following scopes refers to the potential inter-relationships among the value chains required to compete in related industries?
   a. Segment
   b. Vertical
   c. Geographic
   d. Industry
8. Which of the following statements are true?
   i. Through coalitions, a firm gets an opportunity to share its activities without entering new industry segments, geographic areas, or related industries.
   ii. Coalitions broaden the scope of operations without broadening the firm.
   iii. Coalitions bestow the cost and differentiation advantages of vertical linkages without the firm having to go in for vertical integration.
   a. Only i and ii
   b. Only ii and iii
   c. Only i and iii
   d. i, ii, and iii

9.8 Summary

- To create and sustain competitive advantage, it is essential to analyze and understand how various value activities interact.
- Value activities can be classified into two categories -- primary activities (R&D, production, marketing and sales, and service) and support activities (materials management, human resource management, and firm infrastructure).
- A value chain helps segregate the strategically relevant activities of a firm to understand the cost behavior of each activity. By configuring the value chain appropriately and performing these activities effectively and efficiently, a firm can gain competitive advantage.

- A firm influences the buyer's performance by influencing its value chain. It does so by providing direct inputs, that is, products and services, to the customer. It also influences the buyer indirectly through its logistical system, sales force, applications engineering group, and order entry system.
- A firm creates value when it creates competitive advantage for its buyer. The competitive advantage can be created in the form of lowering the buyer's cost or raising the buyer's performance.
- Value creation has to be accompanied by value communication and value capture. The relationship between value creation and value capture is influenced by the forces of industry structure such as the relative bargaining powers of buyers and suppliers.
- Competitive scope influences the competitive advantage by shaping the structure and economics of the value chain. It has different dimensions such as segment scope, vertical scope, geographic scope, and industry scope.
- Coalitions help broaden the scope of operations without broadening the firm. Further, the basis for defining relevant business unit boundaries is provided by the relationship between competitive scope and the value chain.
- There is a reciprocal relationship between value chain configuration and industry structure. The value chain can also be used for designing the departmental structure of a firm.

9.9 Glossary

Primary activities: Value chain analysis divides a firm's activities into two major categories -- primary and support activities. Primary activities are those activities that are involved in the physical creation of the product, marketing, and after-sales support.

Support activities: Value chain analysis divides a firm's activities into two major categories -- primary and support activities. Support activities -- such as technology development, human resource management, procurement, and firm infrastructure -- assist the primary activities by providing support that allows them to take place on an ongoing basis.

Value chain: A value chain is a linked set of value-creating activities that begins with the purchase of basic raw materials from suppliers, and ends with distribution of a product or service. A value chain analysis evaluates the firm in the context of its value-creating activities.

9.10 Self-Assessment Test

1. What are the two categories of value activities?
2. How can a value chain be configured so that it would help a firm in identifying its competitive advantage?

3. Discuss the concept of sustainable competitive advantage.
4. How can the competitive scope influence the competitive advantage of an organization?
5. In what way are value chain configuration, industry structure, and departmental structure related to one another?

9.11 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

9.12 Answers to Check Your Progress Questions

1. (b) Only i, ii, and iv

A firm can gain a differentiation advantage by procuring high quality raw materials, having a superior product design, or a responsive order entry system. The high quality of raw materials used will improve the quality of the product and hence will differentiate the firm's products. A superior product design will make either the product look attractive, add new features, or make it easy to use, thereby differentiating the product. A responsive order entry system will improve the responsiveness of the firm to its customers, thereby differentiating the firm's marketing services. Superior sales force utilization will give a cost advantage to the firm and not a differentiation advantage.

2. (a) Primary activities

Value activities can be classified into two categories: primary and support activities. Primary activities can be further classified into four categories. They are research and development, production, marketing and sales, and service. The contribution of these activities to the value addition of a product is direct and high. Therefore, they are regarded as primary activities. For example, research and development leads to either new features being added to an existing product or new improved products being developed; both provide a higher value to the customers. High volumes of output achieved by production and the lower wastages achieved help in directly lowering the cost per unit of production. Marketing and sales, and service are the functions which are closest to the customer, and the more they are able to satisfy the customers, the greater will be the value attributed to the firm's products by the customers.

3. (d) Only i, iii, and iv

Organization structure, control systems, and the culture of the company together comprise the infrastructure of an organization. The top management should also be considered as a part of the infrastructure of the company as it influences the structure, control systems, and culture of the organization. Operations is a type of primary activity.

4. (b) A firm's differentiation does not depend on how its value chain is related to the buyer's value chain.

A firm influences the buyer not only through its product but also through its logistical system, sales force, applications engineering group, and order entry system. It creates value when it creates a competitive advantage for the buyer. The firm's differentiation depends on how its value chain is related to the buyer's value chain. Here the firm is the supplier. For example, the ability of Sona Koyo Steerings to produce high quality car steerings like power steerings is the differentiation which it provides to companies like Maruti Udyog Ltd. This differentiation will be of use only if Maruti has the ability to adapt the product design of its cars to fit power steerings. The product design activity is a part of Maruti Udyog Ltd's value chain activity. Hence the advantage of differentiation of a supplier firm depends on how its value chain is related to the buyer's value chain. A firm influences the buyer's performance by influencing its value chain.

5. (a) Segment

In segment scope, the emphasis is on the variety of products and the types of buyers. A firm can employ different focus strategies while serving different product or buyer segments. For example, a computer firm may need a particular value chain to serve sophisticated mainframe computer buyers with in-house servicing capabilities, and it might decide on a different value chain to serve Home PC users.

6. (c) Geographic

Geographic scope allows a firm to share value activities across different regions. This refers to the range of regions, countries, or groups of countries in which a firm operates with a well-directed strategy. For example, Canon develops and manufactures copiers primarily in Japan, but sells and services them separately in many countries. Canon's operations in different countries gains cost advantages from sharing technology development and manufacturing instead of performing these activities separately in each country.

7. (d) Industry

Industry scope refers to the potential inter-relationships among the value chains required to compete in related industries. A shared logistical system may allow a firm to reap economies of scale. For example, a shared sale force offering related products like Dabur's Hajmola and Dabur's Chayvanprash can improve the salesperson's effectiveness with the buyer and enhance differentiation. Or a shared sales force of Epson offering printers, scanners, projectors, and point of sales equipment can improve the salesperson's effectiveness.

8. (d) i, ii, and iii

Through coalitions, a firm gets an opportunity to share its activities without entering new industry segments, geographic areas, or related industries. Coalitions broaden the scope of operations without broadening the firm. Coalitions also bestow the cost and differentiation advantages of vertical linkages without the firm having to go in for vertical integration. Coalitions aim at making use of the capabilities of the two partners in the best possible way and achieve synergistic effects through the coalition.

Unit 10

The Value Chain and Generic Strategies

Structure

"If you're watching your competitors, you're unlikely to invent a bunch of stuff on your own."

- Jeff Bezos

10.1 Introduction

Jeff Bezos believes that a company who is watching competitors to add value at each operational activities/stage accordingly, then it is a missing opportunity for the first movers.

In the previous unit, we have discussed value chain and competitive scope. In this unit, we shall discuss value chain and generic strategies.

Cost advantage and differentiation are generic types of competitive advantage a firm may possess. To capture the market, the company should be in a position to differentiate its cost from its competitor's cost, and to fix a price that can lure the customers. A differentiator will fail to achieve superior performance unless the resulting price premium exceeds the cost of differentiating.

However, it is not an easy task to understand cost behavior. Cost studies tend to concentrate on manufacturing costs and overlook the impact of other activities such as marketing, service, and infrastructure on relative cost position. Moreover, the cost of individual activities is analyzed in a stand-alone manner, without the linkages among activities that can affect cost being recognized. Eventually, in assessing the cost positions of competitors, firms face great difficulty and they often resort to simple comparisons of labor rates and raw material costs.

The absence of a systematic framework for cost analysis in most firms leads to problems. Most cost studies address narrow issues and take a short-term viewpoint. Popular tools such as experience curves are often misused in cost analysis. The experience curve can serve as a starting point, but it neglects many of the important drivers of cost behavior and conceals important relationships among them. Cost analysis also tends to rely heavily on the existing accounting systems. If existing accounting systems do not have useful data for cost analysis, they often get in the way of strategic cost analysis. Cost systems usually involve the cost on direct labor, indirect labor, materials, and machines, which must be efficiently managed. Therefore, the basic tool for cost analysis is provided by the value chain. Similarly, the value chain helps understand the determinants of differentiation and how buyer value is created and perceived.

This unit will first discuss the value chain for cost analysis and the cost behavior of value activities. We shall then move on to discuss the linkages within and across value chains. We shall also discuss cost advantage, and the techniques to gain cost advantage. The unit also discusses the different types of errors that may arise while carrying out the cost leadership strategies. Finally, we shall discuss the differentiation strategies, and understand how buyer value is created.

10.2 Objectives

By the end of this unit, you should be able to:

- Define the value chain for cost analysis.
- Discuss the cost behavior of value activities.
- Identify the linkages within and across value chains.
- Explain cost advantage, and techniques to gain cost advantage.
- Recognize the possible errors while pursuing cost leadership strategies.
- Discuss the differentiation strategies, and find out how buyer value is created.

10.3 The Value Chain and Cost Analysis

The behavior of a firm's costs and its relative cost position stems from the value activities the firm performs while competing in an industry. The examining of costs within these activities and not the cost of the firm as a whole constitutes a meaningful cost analysis. Each value activity has its own cost structure and the behavior of its costs may be affected by linkages and interrelationships with other activities both inside and outside the firm. Cost advantage is the outcome of the firm achieving a lower cumulative cost of performing value activities than its competitors.

10.3.1 Defining the Value Chain for Cost Analysis

In cost analysis, the first step is to define a firm's value chain and to assign operating costs and assets to value activities. Both operating costs and assets in the form of fixed cost and working capital are involved in each activity in the value chain. Purchased inputs make up part of the cost of every value activity and can contribute to both operating costs and assets. The amount of assets in an activity and the efficiency of asset utilization are frequently important to co-ordinate the activities in a systematic manner through proper cost analysis. Therefore, there is a need to assign assets to value activities in order to manage properly.

For purposes of cost analysis, the disaggregation of the generic value chain into individual value activities should reflect three principles -- the size and growth of the cost represented by the activity, the cost behavior of the activity, and competitor differences in performing the activity -- that are not mutually exclusive.

Activities representing a significant or rapidly growing percentage of operating costs or assets should be separated for cost analysis. Activities representing a small and stagnant percentage of costs or assets can be grouped together into broader categories. Activities are also separated based on different cost drivers. They can be safely grouped together if they possess similar cost drivers. If the business unit shares an activity with others, then it should also be treated as a separate value activity since conditions in other business units will affect its cost behavior. Similarly, the logic applies to any activity that has important linkages with other activities.

10.3.2 Assigning Costs and Assets

A firm must assign operating costs and assets to value activities after identifying its value chain. Operating costs should be assigned to the activities in which they are incurred. The assigning of the assets should be done to the activities that employ, control, or influence their use. Though the assignment of operating costs is time consuming, it is straightforward. Often, the recasting of the accounting records has to be done to match costs with value activities rather than with accounting classifications, particularly in areas such as overhead and purchased inputs.

As assets are costlier and their selection and use often get entangled with tradeoffs with operating costs, they must be assigned to value activities in some way that will permit an analysis of cost behavior. Assigning assets to activities is more complicated than assigning operating costs. Asset accounts must usually be regrouped to correspond to activities, and assets must be valued in some consistent way.

There are two ways to assign assets. It is done at book value or at replacement value and is compared to the operating costs, or the translation of book value or replacement value into operating costs is done via capital charges. Both the valuation approaches pose difficulties. Book value is sensitive to the timing of initial purchase and to accounting policies. Therefore, it may be meaningless. The frequent calculation of replacement value is also a difficult task. For both fixed and current assets, depreciation schedules are often random in nature and the same is true for capital charges. The industry characteristics should be reflected by the particular method chosen to value assets. This in turn will determine the most significant biases inherent in the data and the practical consideration in collecting it. The biases inherent in whatever method is chosen must be recognized by the analyst. It may prove illuminating for cost analysis to assign assets in several ways.

10.3.3 First Cut Analysis of Costs

The distribution of a firm’s costs can be illustrated graphically using the value chain. The cost of each value activity can be separated into three categories: purchased operating inputs, human resource costs, and assets by major category. The proportions of the value chain can be drawn to reflect the distribution of costs and assets among activities. The areas for cost improvement may be suggested by the initial allocation of operating costs and assets to the value chain. A larger proportion of costs is often represented by purchased operating inputs.

Other insights are the outcome of grouping value activities into direct, indirect, and quality assurance activities, and cumulating costs in each activity. Managers often have a tendency to focus almost exclusively on direct costs, while failing to recognize the rapid growth of indirect costs. Indirect costs in many firms not only represent a large proportion of total cost but also have grown more quickly than other cost elements.

Direct costs are getting reduced by the introduction of sophisticated information systems and automated processes, but indirect costs have increased because such things as sophisticated maintenance and computer programmers are required to prepare machine tapes. The sum of all quality assurance activities in the value chain is strikingly large. This can be analyzed by the firms. In many industries, the other approaches to quality assurance besides inspection, adjusting, and testing can yield large cost savings.

10.4 Cost Behavior

The cost position of the firm results from the cost behavior of its value activities which is influenced by a number of structural factors. The cost of a given activity can be determined by a combination of several cost drivers. The cost drivers that are considered to be important can differ among the firms in the same industry if the value chains employed are different. The relative cost position of a firm in a value activity depends on its standing vis-à-vis important cost drivers.

10.4.1 Cost Drivers – An Introduction

The cost behavior of value activities is determined by ten major cost drivers. They are: economies of scale, learning, the pattern of capacity utilization, linkages, interrelationships, integration, timing, discretionary policies, location, and institutional factors.

Cost drivers are considered the structural causes of the cost of an activity and can be more or less under a firm's control. To determine the cost behavior of a particular activity, drivers often go for interactions and the relative impact of cost drivers will vary widely among value activities. Thus, no single cost driver, such as scale or the learning curve can give an accurate result of the firm's cost position. Diagnosing the cost drivers of each value activity allows a firm to gain an elaborate understanding of the sources of its relative cost position and how it might be changed.

Example

Samsung India is the largest electronics manufacturer in the country. Samsung halted production of TV sets in India when the government raised the import duty on key components like LCD/LED panels and open cells. The manufacturing base was shifted to Vietnam to gain tax benefits. Samsung had to bear the brunt of raised import duties imposed by the center (institutional factor).

Source: ICFAI Research Center

10.4.2 Economies or Diseconomies of Scale

The cost of value activity is often subject to economies or diseconomies of scale. Economies of scale result from the ability to perform activities efficiently at a larger volume, or from the ability to pay off gradually the cost of intangibles such as advertising and R&D over a greater sales volume. Economies of scale can be an outcome of efficiencies in the actual operation of an activity at a higher scale as well as from less than proportional increases in the infrastructure or overhead needed to support an activity as it grows.

There must be a clear difference between economies of scale and capacity utilization. The fixed costs of existing facilities and employees are spread over a large volume by increasing capacity utilization, while economies of scale imply that an activity operating at full capacity is more efficient at a larger scale. If the capacity utilization is mistaken for economies of scale, then the firm may be under the false impression that its costs will continue to fall, if it exceeds its existing capacity.

As scale increases, the complexity and costs of coordination increase thus, leading to diseconomies of scale in a value activity. Diseconomies of scale can also occur if large requirements meet an inelastic supply, forcing input prices up. They are found in many fashion sensitive industries and professional services.

These rely heavily on fast response times and creative individuals who do not function well in large organizations.

There is a wide variation in the scale sensitivity of activities. The expenditure on product development, national advertising, and firm infrastructure will usually be more scale sensitive than the expenditure on activities like procurement and sales force operations. However, in virtually every value activity of a firm, a certain extent of economies and diseconomies of scale can be found.

Economies of scale not only get affected by the technology but also by the manner in which the firm operates in its dealings with various activities. Scale economies in a plant can also get affected by the product varieties produced and by the length of the runs chosen. Similarly, the deployment of a sales force can affect economies of scale in the sales force operation.

In a sales force, organized geographically, the costs fall as the regional sales volume grows because a salesperson can write larger orders on each sales call and/or because travel time between customers is reduced by greater density. If the sales force is organized by product line, diseconomies may be created with an increase in the volume of sales in one region because sales personnel must travel more to that particular region than to other regions closer to home base in order to attain customer satisfaction and maintain their market share in that region.

Economies of scale are not all equivalent. The relevant measure of scale differs among value activities and industries. Firms that overlook this distinction often gradually weaken their relative cost position. The relevant cost driver for some value activities is the global or worldwide scale. For other value activities, national scale, regional scale, local scale, plant scale, project scale, scale per production line, scale per buyer, scale per order, or some other measure of scale may underline the behavior of cost.

Example

United Parcel Company (UPS) is a global leader in logistics. Headquartered in Atlanta, UPS serves more than 220 countries and territories worldwide. Here are some metrics about UPS operation in a given year:

Parameter	Metrics
Global delivery volume	5.2 billion packages and documents
Daily global delivery volume	20.7 million packages and documents
Service area	More than 220 countries and territories. Every address in North America and Europe.
Customers	1.5 million pick-up, 9.1 million delivery.
Online tracking	180 million tracking requests per day.

UPS is fulfilling the demands of millions of customers per day indicating efficiency in its operations leading to economies of scale.

Source: ICFAI Research Center

10.4.3 Learning and Spillovers

The cost of a value activity can decline over time due to learning, which raises the firm’s efficiency of performing that activity. Learning is considered to be very important because it helps in lowering costs. The knowledge that an individual gets from learning can be used in the modification of technology, improved scheduling, labor efficiency improvement, yield improvements, procedures that increase the utilization of assets, and better tailoring of raw materials to the process. The cost of constructing plants, retail outlets, or other facilities can also be reduced by learning. Thus, the possibility of learning in an activity must be given precedence over performing functions more efficiently. The rate of learning differs widely among value activities because each offers differing possibilities for learning improvements. Learning is often the accumulation of many small improvements rather than major breakthroughs. During slack periods, the rate of learning may increase when attention is focused on reducing costs rather than on meeting demand. Moreover, based on the amount of management attention devoted to capture it, learning tends to vary.

Learning can spill over from one firm to another in an industry through mechanisms such as suppliers, consultants, ex-employees, and reverse engineering of products. If the spillover of learning is more in a value activity of a firm, then the learning of the entire industry is essential in order to lower the cost in all aspects. In discovering the relative cost differences among competitors, the analysis of the rate of spillover plays a crucial role. Thus, learning becomes mandatory in this cut-throat competition to make the company reach greater heights.

10.4.4 Pattern of Capacity Utilization

When a value activity has substantial fixed costs and the fixed costs remain constant despite a capacity underutilization, variable costs decide the total cost for that particular value activity. The ratio of fixed to variable cost indicates the sensitivity of a value activity to utilization. The configuration of a value activity, if done differently, will affect its sensitivity to capacity utilization.

Capacity utilization at a given point in time is a function of seasonal, cyclical, and other demand or supply fluctuations unrelated to a competitive position. Thus, the correct cost driver is based on the value activities of the entire cycle. Changes in the level of capacity utilization involve costs of expanding and contracting, leading to higher costs than the firm that keeps the utilization constant, though their capacity utilization on an average is the same. Environmental conditions and competitor behavior partly determine the pattern of capacity utilization of an activity and these are partly under a firm’s control through its policy choices in areas such as marketing and product selection.

Example

P.T. Bogasari Flour Mill is recognized as the world's largest flour milling facility based in Jakarta, Indonesia. Indonesia's flour market is growing with the average 10-years growth rate of 5% per annum, mostly due to population growth, changes in eating habits and the growth of the middle-income class. According to Global Agricultural Information Network report from the U.S. Department of Agriculture, relatively stable macro-economic conditions in Indonesia have allowed middle and upper-middle income consumers to diversify their diets to include more western-style foods like bread and pasta. The mill, which had 15 milling lines, expanded its milling lines further with additional production in each line increasing from 800 tonnes per day to 1,200 tonnes per day. The world's largest flour mill further needs to get bigger to meet consumer demand. P.T. Bogasari Flour Mill needed to meet the increasing demand of wheat production. Hence, it must work on capacity utilisation.

Source: ICFAI Research Center

Check Your Progress - 1

1. For the purpose of cost analysis, the disaggregation of the generic value chain into individual value activities should reflect:
   i. The size and growth of the cost represented by the activity.
   ii. The cost behavior of the activity.
   iii. The competitor differences in performing the activity.
   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii, and iii
2. The cost of each value activity can be separated into which of the following categories?
   i. Purchased operating inputs
   ii. Human resource costs
   iii. Assets by major category
   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii, and iii

3. Which of the following is **not** a cost driver?
   a. Interrelationships
   b. Breadth of product line
   c. Timing
   d. Discretionary policies
4. Which of the following results from the ability to perform activities efficiently at a larger volume, or from the ability to write off gradually the cost of intangibles such as advertising and R&D over a greater sales volume?
   a. Learning
   b. Economies of scale
   c. Diseconomies of scale
   d. Spillovers

10.5 Linkages

The cost of a value activity is frequently affected by how other activities are performed. There are two broad types of linkages -- linkages within the value chain, and vertical linkages with the value chains of suppliers and channels.

The cost behavior of the value activity cannot be understood by examining that activity alone. Linkages create the opportunities to lower the total cost of the linked activities. They provide a potentially powerful source of cost advantage because they are delicate and require joint optimization or coordination of activities across organizational lines. Competitors often fail to recognize their presence or are incapable of harnessing them.

10.5.1 Linkages within the Value Chain

Linkages among value activities spread throughout the value chain. Some of the most common linkages are those between direct and indirect activities (e.g., machining and maintenance), quality assurance and other activities (e.g., inspection and after-sales service), activities that must be coordinated (e.g., inbound logistics and operations), and between activities that are alternative ways of achieving the result (e.g., advertising and direct sales). In identifying linkages, the question to be asked is, "What are all the other activities elsewhere in a firm that have or might have an impact on the cost of performing this activity?"

When two activities in the value chain are linked, changing the way one of them is performed can decrease the total cost of both. Raising the cost deliberately in one activity may not only reduce the cost of another activity but also decrease the total cost. Coordination and optimization are two mechanisms through which linkages lead to opportunities for cost reduction. The need for inventory can be reduced by better coordination of linked activities such as procurement and assembly. The manifestation of a linkage between activities is inventory and reducing inventory is possible by managing the linkage better. The tradeoffs among them should be resolved by jointly optimizing the activities that are linked.

10.5.2 Vertical Linkages

Interdependencies are reflected by vertical linkages between a firm's activities and the value chains of suppliers and channels. The firm can identify the behavior of suppliers or channels that affect the cost of each of its activities and vice versa, through constant monitoring. Identifying vertical linkages requires a sophisticated understanding of supplier and channel value chains.

Linkages with suppliers tend to center on the supplier's product, design characteristics, service, quality assurance procedures, packaging, delivery procedures, and order processing. Supplier linkages also take the form of the supplier performing an activity that the firm might otherwise undertake. The firm's cost can be lowered or raised based on the manner in which a supplier performs activities with its value chain. The linkage between the frequency and timeliness of supplier deliveries and a firm's raw material inventory; the linkage between supplier application, engineering, and a firm's technology development cost; and the linkage between a supplier packaging and a firm's material handling cost are typical examples of supplier linkages important to cost.

The total cost can be lowered by managing supplier linkages through coordination or joint optimization, as in all linkages. The linkages that are easier to exploit are those that cause a fall in both the firm's costs and its supplier's costs. Sometimes, exploiting a linkage may require a supplier's costs to go up in order to achieve a more than compensating fall in the firm's costs. A firm must be in a position to pay a suitably higher price to the supplier to make the linkage sustainable.

A similar analysis applies to linkages with channels. The typical linkages correspond to be the image of those with suppliers. For example, a firm's outbound logistical and packaging cost can be influenced by the location of a channel's warehouses and the channel's materials handling technology. Similarly, the firm's sales cost may be reduced by sales or the promotional activities of channels. Channel linkages with supplier linkages may allow both the firm and its channels to lower costs. However, exploiting channel linkages may require the channel to raise costs for more than offsetting a reduction in the firm's costs.

10.5.3 Interrelationships

Cost is affected by interrelationships with other units within a firm. The most important form of interrelationship is when a value activity can be shared with a sister unit. An intangible interrelationship is another form of interrelationship that involves the sharing of know-how between separate but similar value activities.

Integration

Integration is one of the major factors that help in lowering costs. The cost may be influenced by the level of vertical integration in a value activity. Firms can reduce costs in a number of ways by going in for integration. Integration helps in avoiding the costs of using the market such as procurement and transportation costs. It can also lead to economies of joint operation. However, integration can also result in increased costs by creating inflexibility, bringing activities in-house that suppliers can perform more cheaply, weakening the incentives gradually for efficiency because the relationship with the supplying unit becomes captive, or raising exit barriers.

Timing

The cost of a value activity reflects the timing of the firm's entry into the industry. Sometimes, the first mover gains an advantage from being among the first to take a particular action. The first major brand in the market may have lower costs of establishing and maintaining a brand name. However, first movers also suffer from disadvantages. Late movers may enjoy benefits such as avoiding high product or market development costs or configuring the value chain differently.

Example

Netflix, founded in 1997 headquartered in California, USA, is the world's leading internet entertainment service with over 151 million paid memberships in over 190 countries. Its success has been rapid both in the United States and internationally, where Netflix, emerged a pioneer in Streaming Video-On-Demand (SVOD) via a monthly global subscription reaping the benefits of first mover. The arrival on the international market of Amazon's Prime Video service from 2016 has not changed much for Netflix. Netflix reaped the timing cost value harnessing benefit of first mover.

Source: ICFAI Research Center

Location

The fluctuations in costs are influenced to a great extent by location. The policy choice is frequently reflected by location. It can also stem from history, the location of inputs, and other factors. Hence, location should be treated as a separate cost driver. Location leads to variations in the prevailing costs of labor, management, scientific personnel, raw materials, energy, infrastructure, taxation, and other factors. The important factor in inbound logistical cost is the location relative to suppliers whereas the outbound logistical cost is affected by the location relative to buyers. Location shapes the transportation modes and communication systems available to a firm where cost can be affected. Thus, the cost of almost every value activity is influenced by location.

10.5.4 Institutional Factors

Institutional factors include Government regulations, tax holidays, and other financial incentives; unionization; tariffs and levies; and local content rules which constitute the final major cost drivers. Institutional factors which are propitious can reduce the costs just as unfavorable ones can raise them. While institutional factors often are not under the control of the firm, means may exist to overcome them or minimize their impact.

10.5.5 The Cost of Purchased Inputs

The purchased inputs of some kind are employed by every value activity ranging from raw materials used in component fabrication to professional services, office space, and capital goods. Purchase inputs can be divided into purchased operating inputs and purchased assets. An important indicator of the strategic significance of procurement is provided by the total cost of purchased inputs as a percentage of the firm value.

The cost of purchased inputs is considered more important for a value activity to be performed efficiently, and cost drivers determine the behavior of input costs. However, isolating the purchased inputs for separate analysis will give a detailed idea about the cost behavior. There are three factors which influence the cost of purchased inputs in an activity. They are their unit cost, their rate of utilization in an activity, and their indirect effects on other activities through linkages.

The overall analysis of cost behavior encompasses the utilization of inputs in an activity and linkages with other activities. The unit cost of purchased inputs often has similar drivers across activities. The unit cost of many inputs is also affected by the firm-wide procurement practices. Thus, a firm can become efficient in lowering unit costs by analyzing the unit cost of purchased inputs as a group.

However, a firm must recognize all three factors (unit cost, rate of utilization, and indirect effects on other activities) in separating the unit cost of purchased inputs for analysis. In some instances, a firm can lower the total cost by spending more on purchased inputs. For example, the yield of the forging operation can be improved by better quality steel and also the machining process.

While purchasing, firms typically focus on the most visible items, especially raw materials and components. In purchasing analysis, the purchased services such as maintenance or professional services are often overlooked while purchases from sister units rarely receive the level of examination that is applied to outside purchases. Purchased assets are bought frequently outside the normal procurement system and without the associated expertise. An important tool in gaining cost advantage is a comprehensive analysis of the unit cost of all types of purchased inputs.

10.5.6 Segment Cost Behavior

Practically, the business units usually produce a number of different products and sell them to different buyers. Different distribution channels may also be employed by the business unit. The differences give rise to segments in which the behavior of costs in the value chain may be different. Unless the variations in the cost behavior among the segments are recognized by the firm, there is a significant danger that incorrect or average-cost pricing will provide openings for competitors. Thus, the analysis at the business unit level must often be supplemented by the cost analysis at the segment level.

One of the key bases for the existence of segments is the differences in cost behavior among products, buyers, channels, or geographic areas, and hence cost analysis is a necessary input to segmentation. The value chain for segments generally parallels that of the whole business unit. However, segment value chains may vary in some respects that affect cost. The starting point of segment analysis is the identification of important differences in the value activities for different segments.

A firm should analyze the costs of those product lines, buyer types, or other portions of its activities that have significantly different value chains, appear to have different cost drivers, and employ logical procedures for allocating costs. Practically, in order to illuminate differences among segments, a firm may want to select representative product varieties of buyers rather than analyze every product variety or buyer in complete detail.

The process used to analyze cost behavior for segments is the same as that used for business units. The costs and assets are assigned by identifying the value chain for the segment. Then the cost drivers of each activity are determined and quantified if possible. However, there is a need for allocation of costs among segments. Arbitrary measures are often employed by standard cost systems as the basis for allocating cost to segments such as sales volume or other readily measurable variables. While these measures have the benefit of simplicity, they often have little to do with the true contribution of the segment to overall costs. Misallocation influences costs of support activities and the costs of indirect primary activities. Because of such misallocations, incorrect costs and inappropriate prices result for the product or buyer segments.

10.5.7 Cost Dynamics

In addition to analyzing cost behavior at a point in time, a firm must consider how the absolute and relative cost of value activities will change over time independent of its strategy. This is cost dynamics. An analysis of cost dynamics enables a firm to forecast the change in the cost drivers of value activities and which value activity should increase or decrease in absolute or in relative cost importance. Cost dynamics is the result of the interplay of cost drivers over time, as a firm grows or as industry conditions change. The most common sources of cost dynamics include:

Industry real growth

The growth of an industry as a whole often affects costs in many ways. Growth also depends on the cost of purchased inputs where the price of supplier products is fixed by the supplier industries. By making the introduction of new technologies feasible in value activities, industry growth can also open up the possibilities for scale economies.

Differential scale sensitivity

If the activities have differing scale sensitivity, then the real growth in the sales of a firm can dramatically change the absolute and relative costs of the value activities. For example, the cost of software has become increasingly high relative to the cost of hardware in many electronics related industries such as computers, videogames, and telecommunications equipment.

Different learning rates

Changes can occur in the relative cost of different value activities if learning takes place in them at different rates. The relative costs of the value activities can be reduced by learning. For example, for many electronics firms, rapid learning has dramatically reduced assembly costs as a percentage of sales. As a result, learning has come to influence the relative cost position more than differences among regions and countries in labor rates could do.

Differential technological change

The relative cost of different value activities and their cost drivers can clearly get affected by the technological changes that proceed at different rates. For example, the economies of many distribution industries have been fundamentally shifted by the availability of low cost computers and the development of airfreight. Because of these variations, dramatic reductions have been caused in order processing costs as a percentage of total costs, and these have allowed the restructuring of distributors in the direction of fewer and more centralized warehouses.

Relative inflation of costs

The relative cost can be significantly shifted due to the variation in the rate of inflation in key cost elements in value activities. Differential inflation rates can rapidly turn a value activity of insignificant nature into one of critical strategic importance or a modest cost item within an activity into a dominant one. For example, because of the rapid increase in oil prices relative to salaries and equipment, the cost of fuel has become the most important component of airline operating costs. As a result, the fuel efficiency of the fleet, the inherent efficiency of the route system, and operating procedures have assumed strategic importance.

Aging

The relative cost of value activities can be shifted by an aging capital base or workforce. For example, more maintenance and insurance is required for older offshore drilling rigs and an older workforce typically means higher salary and benefit costs.

Market adjustment

The operation of market forces often works to counteract high or low purchased input costs and to eliminate or decrease cost differentials based on favorable purchasing by individual firms. Therefore, cost dynamics can lead to significant changes in industry structure and relative cost position.

10.6 Cost Advantage

If a firm is able to perform all its value activities at a lower cumulative cost than its competitor, it enjoys a cost advantage with reference to its competitor. The firm's cost advantage, if sustainable, has a strategic value. If the sources of the firm's cost advantage are difficult to duplicate or copy, the cost advantage has sustainability. Due to its cost advantage, a firm can charge a lower price than its competitors and still provide an acceptable level of value to the buyer. Cost advantage, thus leads to the superior performance of the firm. The relative cost position of a firm is determined by the composition of its value chain versus the competitor's and the firm's relative position vis-à-vis the cost drivers of each activity.

A firm's value chain may be similar to or different from the value chains of its competitors. For example, the value chain of a no-frills airline differs from that of a full-service airline. If the value chain of the firm differs from that of its competitors, the relative cost position will be determined by the inherent efficiency of the two chains. Only a subset of value activities is involved in causing differences in value chains. Therefore, by comparing the cost of these differing activities, a firm can identify the effect of different chains on the relative cost position.

The relative cost position of a firm in value activities that are the same as that of its competitors depends on the firm's position vis-à-vis the cost drivers of those activities as compared to its competitors. The relative cost position of common value activities should be assessed one after the other by the firm. These then need to be accumulated together with the relative cost of different activities in order to determine the overall cost position.

10.6.1 Determining the Relative Cost of Competitors

The basic tool for determining competitor costs is the value chain. Identifying competitor value chains and how activities are performed by them is the first step in determining competitor costs, the process being the same as that employed by a firm to analyze its own value chain. Due to the firm lacking direct information, the assessment of a competitor's costs is often extremely difficult in practice. The cost of a competitor's value activities can usually be estimated directly from commonly available public data as well as from interviews with buyers, suppliers, etc. For example, it is possible for a firm to gain information on the number of salespersons a competitor employs as well as their approximate compensation and expense account allowances. Thus, information on the costs of some of the competitor's value activities helps to build an accurate, though often incomplete picture of the competitor's costs.

The firm should employ comparisons between it and the competitor for value activities where a competitor's costs cannot be estimated directly. For doing so, the relative position of the competitor with respect to the cost drivers of the value activities in question needs to be determined. The firm, by using its knowledge of cost behavior, can then estimate differences in the competitor's costs. Logistical costs, for example, are based on local share. If the competitor has a higher local share, it probably possesses a cost advantage in that value activity, namely, logistics. The share difference provides a way of determining the extent of the firm's disadvantage if the firm can estimate the scale curve for logistical costs.

Sometimes, it is only feasible to estimate the direction and not the absolute magnitude of the relative cost difference with a competitor in a value activity, given the extent to which determining a competitor's cost involves estimates and deduction. However, this can still prove extremely useful since it is possible for the firm to develop a general picture of the competitor's relative cost position by combining the direction of difference with knowledge of the proportional size of each value activity.

By examining several competitors simultaneously, a firm can improve the accuracy of estimates of competitors' costs. The consistency of scale curves or other cost models for a particular value activity can be tested by cross-checking the information disclosed by one competitor with the disclosures of other competitors. The process of analyzing a firm's cost behavior and determining the relative costs of competitors is often an iterative one.

10.6.2 Gaining Cost Advantage

The two ways in which a firm can gain a cost advantage are by controlling cost drivers (the cost drivers of value activities representing a significant proportion of total costs can contribute to a firm's cost advantage) and by reconfiguring the value chain (a different and more efficient way of designing, production, distribution, or marketing of the product can be adopted by the firm). Both sources of cost advantage are not mutually exclusive. Some common activities do exist even for a firm with a value chain very different from that of its competitors. The firm's relative cost position in these activities can enhance or detract from the overall cost position.

Multiple sources within the value chain render a cost advantage to successful cost leaders. Several activities, and not simply one activity, are responsible for giving rise to a sustainable cost advantage. The frequent reconfiguration of the value chain, therefore, plays a role in creating a cost advantage. To attain cost leadership, it is necessary to scrutinize every activity in the firm for opportunities to reduce cost and the consistent pursuit of all of them is required. For cost leaders, reinforcement of such behavior is a culture that emanates from the senior management and often includes practices such as spartan facilities and limited perks to executives.

Cost reduction may or may not erode a firm's differentiation, and cost reduction in activities that do not affect the firm's differentiation should be aggressively pursued by it. A firm may also make a conscious choice to sacrifice all or part of the differentiation in favor of improving its relative cost position where activities that contribute to differentiation are involved.

10.6.3 Implementation and Cost Advantage

A firm's skill in implementing its cost leadership on a daily basis actually determines the success of its cost leadership. Costs are reduced as a result of hard work and control attention rather than going down automatically or accidentally. In spite of having similar scale or cumulative volumes or being guided by similar policies, firms differ in their abilities to lower costs. Improving relative cost position requires more of management attention than a major shift in strategy. A firm should never become complacent by assuming that its costs are low enough.

Cost drivers do not work on their own. It is not possible to achieve scale economies in an activity unless there is coordination in a firm's other activities to provide the inputs necessary for it to operate smoothly on a large scale. The advantages of scale must not be lost due to policy choices leading to product proliferation. Unless the affected business units coordinate their behavior, interrelationships among them will not result in the lowering of costs. Similarly, the advantages of the learning curve do not accrue unless a firm's management strives to capture them.

A firm's ability to achieve cost leadership is determined by a number of factors such as training and motivation of employees, the culture of the firm, adoption of formal cost reduction programs, a constant pursuit of automation, and a strong belief in the learning curve. The potential to affect cost lies in everyone in a firm. Cost leaders have cost control programs not only in manufacturing but in every value activity. Symbolic factors also have great importance in creating a climate for cost reduction. In addition to shaping their strategy to achieve minimum operating costs, successful cost leaders usually pay a great deal of attention to discretionary costs.

Activity 10.1

Cost advantage is one of the three types of competitive advantages a firm may possess. To increase its market share, a company should differentiate its cost from that of its competitors. With the help of an example, explain how companies can attain cost leadership.

Answer:

10.7 Pitfalls in Cost Leadership Strategies

In assessing and acting upon the cost position, the common errors made by firms include:

10.7.1 Exclusive Focus on the Cost of Manufacturing Activities

Apart from manufacturing, activities such as marketing, sales, service, technology development, and infrastructure generate a significant, if not overwhelming, share of total cost. These activities, however, often receive very little attention in cost analysis due to excessive focus on the cost of manufacturing activities.

Ignoring Procurement

Many firms consider purchasing a staff function and devote few management resources to it. Though the firms work hard to reduce labor costs, they pay scant attention to purchased inputs. The purchase price of key raw materials is often the central focus of analysis within the purchasing department. Individuals with little expertise or motivation to reduce costs are often allowed by the firm to purchase many items. As a result, the linkage between the purchased inputs and costs of other value activities goes unrecognized. Major cost benefits can ensue for many firms from modest changes in the purchasing practices of the firm.

10.7.2 Overlooking Indirect or Small Activities

Large cost activities and/or direct activities like fabrication and assembly of components are usually the focus of cost reduction programs. Insufficient attention is paid to activities representing a small fraction of total cost, and indirect activities such as maintenance and regulatory costs are often altogether ignored.

10.7.3 False Perception of Cost Drivers

Firms usually misdiagnose their cost drivers. Due to a failure to understand the sources of its cost advantage, a firm may attempt to reduce cost by increasing its national share. This may further worsen its cost position by reducing its focus on regional operations. The firm may also concentrate its defensive strategies on national competitors and ignore the more significant threat posed by powerful regional competitors.

10.7.4 Failure to Exploit Linkages

All the linkages affecting cost, particularly, the linkages with suppliers and the linkages among activities such as quality assurance, inspection, and service, are rarely recognized by firms. Errors such as requiring each department to cut costs by the same amount, even though raising costs in some of the departments may actually lower total costs, result from the failure to recognize linkages.

10.7.5 Contradictory Cost Reduction

Firms often employ contradicting means of reducing cost. For example, a firm, in order to reap the benefits of scale economies, might try to gain market share, while at the same time going in for model proliferation and thus dissipating scale economies. Also, firms may locate close to buyers with a view to reducing freight costs but at the same time emphasize weight reduction in new product development. Sometimes, cost drivers work in opposite directions. This makes it essential for a firm to recognize the tradeoffs.

10.7.6 Unwitting Cross-subsidy

The failure of firms to recognize the existence of segments in which costs behave differently makes them often engage in unwitting cross subsidy. Rarely is it possible to measure the cost difference among products, buyers, channels, or geographic areas by using the conventional accounting systems. Competitors that understand costs may often identify an unwitting cross-subsidy and undercut the firm's prices and improve their market position. A firm may also, as a result of cross subsidy, be exposed to focused competitors who compete only in the overpriced or premium segments.

10.7.7 Thinking Incrementally

Rather than finding ways to reconfigure the existing value chain, firms often strive for incremental cost improvements in the value chain. Incremental cost improvements may result in the point of diminishing returns, while reconfiguring the value chain can result in a whole new cost platform.

10.7.8 Undermining Differentiation

Elimination of a firm's sources of uniqueness to the buyer as a result of a cost reduction can undermine its differentiation. This action of a firm should be the result of a conscious choice even though doing so may be strategically desirable. Activities that do not contribute to a firm's differentiation should form the focus of its cost reduction efforts. Further, if a cost leader differentiates in activities wherever differentiation is not costly, it will result in the cost leader improving its performance.

Example

The Priv was BlackBerry's first foray into the most popular mobile operating system Android. BlackBerry positioned itself as a super secure Android power device along with its signature feature of slide-out physical keyboard. The major problem was the Priv's price tag. BlackBerry kept its premium label for its price tag despite building the Priv for Android - the platform known for yielding affordable phones. In the flurry of phone releases over the few years, BlackBerry tried a lot of things to differentiate itself from its smartphone competition like the touchscreen one must push in to physically click. This was an attempt to make something different, but it felt like different for the sake of being different. Blackberry failed to differentiate its product for features that customer valued.

Source: ICFAI Research Center

Check Your Progress - 2

5. The mechanisms through which linkages within the value chain lead to opportunities for cost reduction are:
   i. Coordination of activities.
   ii. Evaluation of activities.
   iii. Optimization of activities.
   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii, and iii
6. Which of the following are the results of the interplay of cost drivers over time, as a firm grows or as industry conditions change?
   i. Cost behavior
   ii. Cost dynamics
   iii. Cost leadership
   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii, and iii
7. Which of the following is **not** a common source of cost dynamics?
   a. Industry growth
   b. Differential scale sensitivity
   c. Differential technological change
   d. Economies of scale

8. Firms in assessing and acting upon cost position, make common errors, such as:
   i. Ignoring procurement.
   ii. Focusing exclusively on the cost of manufacturing activities.
   iii. Overlooking indirect or small activities.
   iv. Focusing on cross subsidy.
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only i, iii, and iv
   d. i, ii, iii and iv

Activity 10.2

A firm following a cost-leadership strategy outperforms competitors by manufacturing products or services at a low cost. But cost leadership strategy has many disadvantages as well. Explain, with the help of an example, the disadvantages of cost-leadership strategy.

Answer:

10.8 Differentiation Strategies

A firm can differentiate itself from other firms if it can provide something unique that is valuable to the buyers. Often, firms visualize differentiation merely in terms of the physical product or marketing practices rather than potentially arising anywhere in the value chain. Also, firms frequently pay insufficient attention to the cost of differentiation, or to the sustainability of differentiation once achieved. A differentiation strategy can be successfully executed if coordination is achieved from all parts of a firm. The implementation of differentiation strategy is usually costly.

10.8.0 Differentiation and Value Chain

Differentiation is the outcome of specific activities that a firm performs and how they affect the buyer. It grows out of a firm's value chain. The end product gets affected based on the procurement of raw material and other inputs, hence affecting differentiation. Uniqueness is created by successful differentiators through primary and support activities.

The technology development activities of a firm can lead to product designs that possess superior and unique performance over its competitors. In operations activities, uniqueness can be found in product appearance, conformance to specifications, and reliability. The speed and consistence of deliveries can be shaped by the outbound logistical system. Marketing and sales activities also frequently have an impact on differentiation. Even if the physical product is a commodity, other activities can often lead to substantial differentiation. Similarly, maintenance or scheduling which is considered to be an indirect activity can contribute to differentiation just as direct activities such as assembly or order processing do.

Value activities which represent a small amount of total cost can nevertheless have a major impact on differentiation. Value chains developed for the purpose of strategic cost analysis may not separate all activities that are important for differentiation. A finer division of some value activities is required for differential analysis, while others may be combined as a whole if they have little differentiation impact. A firm may also be differentiated based on the breadth of its activities, or its competitive scope. A number of other differentiating factors can result from broad competitive scope.

- Ability to serve buyer needs anywhere.
- Simplified maintenance for the buyer if spare parts and design philosophies are common for a wide line.
- Single point of purchase for the buyer.
- Single point for customer service.
- Superior compatibility among products.

Differentiation can also have its source downstream. A firm’s channels play a vital role in enhancing its reputation, service, and customer training and many other factors.

10.8.2 Drivers of Uniqueness

A series of basic drivers analogous to the cost drivers determine a firm’s uniqueness in a value activity. The drivers of uniqueness include:

Policy choices

Policies are made by firms on what to perform and how to perform them. Such policy choices are perhaps the single most widespread uniqueness drivers. Some of the policy choices that lead to uniqueness are:

- Product features and performance offered.
- Services provided (e.g., credit, delivery, or repair)
- Intensity of an activity adopted (e.g., rate of advertising spending).
- Content of an activity (e.g., the information provided in order processing).

- Technology employed in performing an activity
- Quality of inputs procured for an activity.
- Procedures governing the actions of personnel in an activity (e.g., service procedures, nature of sales calls, and frequency of inspection or sampling).
- Skill, training, and experience level of personnel employed in an activity
- Information employed to control an activity.

Linkages

Uniqueness can also be achieved from linkages within the value chain or with a supplier and channels that a firm exploits, if the performance of one activity affects the performance of another.

Linkages within the value chain

Meeting buyer needs often involves coordinating linked activities. Outbound logistics and also the speed of order processing and frequency of sales force calls to take orders determines the delivery time. A more responsive customer service can be achieved by coordination between the sales force and the service organization. The performance of direct activities such as finishing or printing can be improved by higher investment in indirect activities such as maintenance.

Example

Hero MotoCorp is one of the largest two-wheeler manufacturers in India. The firm created a cloud-based dealer management system (DMS), which created a huge business impact as it gave the firm excellent insights into relevant dealer related data. Earlier, all the dealers had their own way of managing various processes. The project brought consistency in the processes being carried out by the dealers. It also brought transparency into the system as sufficient and relevant data was captured in DMS. Analytical tools were now readily available for the dealer as well as for the organization. This has immensely helped the firm in reducing the turnaround time for information availability and faster decision-making. Hero MotoCorp developed strong linkages with its dealers with the adoption of technology for better performance.

Source: ICFAI Research Center

Supplier linkages

Uniqueness in meeting buyer needs may also be the result of co-ordination with the suppliers. The new model development time can be shortened by having close co-ordination with suppliers.

Channel linkages

Uniqueness can also be achieved by linkages with channels in a number of different ways by proper co-ordination with channels and joint optimization of the division of activities between the firm and the channels. Some examples of how linkages with channels can lead to uniqueness are: training channels in selling and other business practices; joint selling efforts with channels; and subsidizing for channel investments in personnel and facilities and performance of additional activities.

Timing

Uniqueness may be the outcome of the time at which a firm begins to perform an activity. The firm can make itself unique with regard to other firms by creating a product image in the minds of the customers due to its existence over a long time. Or a late entrant can employ advanced technology to differentiate itself from other firms.

Location

Location can also help in creating uniqueness. For example, a retail bank may process the most convenient branch and automatic teller machine location.

Interrelationships

The uniqueness of a value activity may stem from sharing it with sister business units. The salesperson can offer the buyer better service provided there is a sharing of the sales force between insurance and other financial products.

Learning and spillovers

The uniqueness of an activity can be the result of learning to perform better in an appropriate manner with greater efficiency. Sustainable differentiation is led only by proprietary learning that cannot be acquired by competitors.

Integration

A firm may become unique due to its level of integration. The firm can be made unique by integrating new value activities to achieve efficient performance of the activities through proper control and coordination. Integration can also provide for more activities that will be the sources of differentiation. For example, a firm can render service directly to the customers rather than contacting third party suppliers.

The cost of differentiation

Differentiation is usually very expensive. For example, if a firm wants to enhance its growth, it should go in for superior applications. For achieving greater durability of the products than a competitor’s products, a firm may have to order for raw materials of superior quality which makes them more expensive. A firm must try its best to optimize the cost and achieve the targets with greater ease.

Some forms of differentiation are clearly more expensive than others. With superior co-ordination of linked value activities, the differentiation may not add to much cost. Similarly, differentiating through having more product features is likely to be more expensive than differentiating through having varied but more desired features. The cost drivers of the value activities are reflected by the cost of differentiation. What makes an activity unique (uniqueness drivers) can impact cost drivers, and cost drivers can affect the cost of being unique.

The cost drivers of an activity are adversely affected by the firm while pursuing differentiation. The cost is often raised by uniqueness. The cost of a particular differentiation strategy is determined by a firm's position vis-à-vis cost drivers.

The important cost drivers such as scale, interrelationships, learning, and timing affect the cost of differentiation. The cost of differentiation is most often affected by the scale. Also, scale can itself lead to differentiation. The cost of a firm's policy choice to advertise heavily can be determined by scale. The cost of differentiation can also be reduced by sharing. A first-mover or a firm which moves quicker down the learning curve in a differentiating activity will gain a cost advantage in differentiating.

Example

Lush is a global manufacturer and retailer of fresh handmade cosmetics headquartered in Poole, Dorset, UK. Lush operates in more than 50 countries with a turnover in over 450 million Euros. Lush specializes in handmade products, ethical buying and is obsessed with the purity that comes from a handmade item. The company's biggest success is knowing that its core buyers value social and corporate responsibility over a luxurious and out-of-reach image. Lush's policy of making handmade cosmetics offers its customers a unique offering.

Source: ICFAI Research Center

10.9 Buyer Value and Differentiation

Uniqueness does not lead to differentiation unless the firm's product gives value to the buyer. A successful differentiator puts his efforts into creating value for buyers by providing them with a high quality product that yields a price premium in excess of the extra cost. The buyer's value chain determines exactly that which is valuable to the buyer. A firm's product or service is a purchased input to its buyer's value chain. The buyer's value chain determines the manner in which the firm's products are actually used and the way in which the buyer's activities are affected by the firm. These determine the buyer's requirements and support buyer value and differentiation. Individual consumers also possess value chains just like the buyer's value chains. The buyer's value chain of commercial, institutional, or industrial customers reflects their strategy and approach to implementation whereas the household's value chain reflects its member's habits and needs.

10.9.1 Buyer Value

A firm creates a value for a buyer that justifies a premium price through two mechanisms: by lowering buyer's cost and by raising buyer performance. For industrial, commercial, and institutional buyers, a firm should create a competitive advantage through differentiation by selling its product at a lower price. The buyer will be willing to pay a premium price if the firm is able to lower its buyer's cost or increase its buyer's performance. The same principle applies to households and individual consumers, though the buyer cost measurement may be more sensitive to non-monetary factors such as time and convenience.

10.9.2 The Value Chain and Buyer Value

A firm lowers buyer cost or raises buyer performance through the impact of its value chain on the buyer's value chain. The firm may affect the buyer's chain by simply providing an input to one buyer activity. However, a firm's product will frequently have both direct and indirect impacts on the buyer's chain that go beyond the activity in which the product is actually used. Moreover, a firm not only influences the buyer with its products but also with the logistical system, order entry system, sales force, and applications engineering group. Even firm activities that represent a small fraction of the total cost can have a substantial impact on differentiation. For example, spare parts availability of a truck manufacturer influences the downtime experience of a logistics company that buys it trucks.

Sometimes, the buyer observes individual value activities of the firm (e.g., the sales force) while in other cases, the buyer observes the outcome of a group of activities (e.g., the ultimate on-time or late delivery). Thus, the whole array of links between the firm's value chain and its buyer's value chain determines the value a firm creates for its buyer.

10.9.3 Lowering of Buyer Cost

A firm represents a potential basis for differentiation by lowering the buyer's total cost of using a product or other buyer costs. The most significant opportunities are constituted by the actions that lower the cost of buyer value activities representing a significant fraction of the buyer's cost. The buyer cost can be lowered in many ways if a firm has sophisticated understanding regarding the buyer's usage of product and the ways in which its various activities affect the buyer costs.

A firm can lower the buyer's cost in a number of ways such as: lower the delivery, installation, or financing cost; lower the required rate of product usage; lower the direct cost of product usage such as labor, fuel, maintenance, and required space; lower the indirect cost of product usage or the impact of the product on other value activities; and lower the risk of product failure.

10.9.4 Raising Buyer Performance

Raising buyer performance will depend on understanding what is desirable performance from the buyer's point of view. Raising the performance of industrial, commercial, and institutional buyers depends on the creation of differentiation with their buyers. Thus, the needs of buyers must be properly understood by analyzing the buyer value. By raising the performance of industrial, commercial, or institutional buyers, non-economic goals such as status, image or prestige can also be met. Raising buyer performance will be a function of better satisfying needs through the products which are sold to consumers.

10.9.5 Buyer Perception of Value

Whatever value the firm provides the buyer, it takes a long time for it to be assessed. A buyer cannot assess it in advance. An extensive experience is essential in order to understand the effect of the product on the buyer's cost or performance. The challenge that the buyer faces lies in knowing about the effect of other activities on buyer value. Moreover, even after the purchase of the product, the buyer cannot completely or accurately gauge the performance of the product or the firm.

Buyers cannot understand all the ways in which a supplier actually or potentially might reduce their costs or improve performance: buyers are often not aware of what they should be looking for in a supplier. The buyers are aware of the direct impact of a supplier firm on their value chains but are unsuccessful in recognizing the indirect impact or the ways in which other supplier activities besides the product affect them. Buyers sometimes expect too much value from the suppliers and they also fail to perceive enough.

The buyers while purchasing usually measure value by considering only the price of the product without adding other factors such as freight or installation. The buyer's perception of a firm and its product, therefore, can be as important as the reality of what the firm offers in determining the effective level of differentiation achieved. Moreover, the buyer's ignorance regarding the value that a firm's product can fetch them can be an opportunity for a firm to go in for a differentiation strategy, since the firm may be able to adopt a new form of differentiation preemptively and educate buyers to value it.

A buyer's incomplete knowledge implies that the differentiation actually achieved may well be based on the factors used by the buyer to make an inference or judgment with regard to the firm lowering its costs on its products or to improve its performance relative to competitors. The buyers can get to know about the value that a firm can create for its products through marketing communications, reputation, packaging, professionalism, etc. Buyers will not pay for value that they do not perceive however real it may be. Thus a price premium that is usually commanded by the firm reflects both the value actually delivered to its buyer and the extent to which the buyer perceives this value.

10.9.6 Buyer Value and the Real Buyer

The product is purchased not by a firm or household but by individual decision-makers. These decision-makers assess and interpret both actual value and signals of value. The identity of the specific person or persons who makes or make the purchase decision will influence the product if the value attached to the product is not determined. The decision maker may not necessarily be the person paying for the product (e.g. the doctor, not the patient, chooses drugs) and may be different from the person who uses the product (e.g. the purchasing agent chooses a product used in the plant).

The different things about the supplier will be valued by different decision-makers and different signals will be used to assess them. For example, a purchasing agent may not value reliability as highly as a plant manager does, because the purchasing agent is concerned more about minimizing cost that about product failure. A number of individuals frequently influence the decision-maker though they may not participate in the decision directly. Such individuals may be able to reject a supplier, despite the fact that they do not have the power to select. Therefore, the identity of the real buyer can be determined by identifying the value a firm creates for the buyer and the signals of value used by the buyer.

10.9.7 Buyer Purchase Criteria

The buyer's purchase criteria can be identified by applying the fundamentals of buyer value to a particular industry. The specific qualities of a firm create the actual and perceived value for the buyer. Buyer purchase criteria can be divided into two types.

Use criteria

Purchase criteria that result from the way in which the actual buyer value is affected by the supplier by lowering buyer cost and increasing buyer performance. The factors encompassed in the use criteria are product quality, product features, delivery time, and applications engineering support.

Signaling criteria

Purchasing criteria result from signal values or the means used by the buyer in finding out the actual value of supplier. Signaling criteria encompasses brand image, packaging, advertising, the attractiveness of facilities, and reputation. Use criteria are exact measures of what creates buyer value whereas the perception of buyers about the presence of value is measured by signaling criteria. Use criteria tend to be more oriented to a supplier's product, outbound logistics, and service activities whereas signaling criteria result from marketing activities. Nonetheless, both can be affected by every functional department of a firm.

The price premium a firm can command will be a function of its uniqueness in meeting both use and signaling criteria. If only use criteria are considered without considering signaling criteria, it will gradually weaken a buyer's perception of a firm's value. Similarly, considering signal criteria and neglecting use criteria will also usually not succeed because buyers usually come to know that their substantive needs such as product quality and product features have gone unmet.

9.1 Identifying Purchase Criteria

Identification of purchase criteria begins by identifying the decision-maker for a firm's product, the other individuals who influence the decision-maker, and the channels. The use criteria which measure the sources of buyer value and also often determine signaling criteria should be identified first. The initial source of use criteria is constituted by the internal knowledge of the buyer's needs. However, no internal analysis of buyer purchase criteria should ever be accepted unless it encompasses some direct contact with the buyer. The firm must perform systematic analysis of all potential linkages by identifying the buyer's value chain and comparing it with the firm's value chain. This sort of analysis uncovers unrecognized use criteria and shows how to assess the relative weight of well-known use criteria.

For developing a differentiation strategy, use criteria must be identified precisely in order to make it meaningful. The buyer's use criteria are considered by many firms in vague terms such as 'high quality', 'delivery', or 'service'. At this level, it becomes difficult for a firm to calculate accurately the range of value that can be created for its product because of the changes in the behavior of the buyers. For example, quality could mean higher specifications or better conformance. Service can also mean many things, including backing of claims, repair capability, or delivery time.

Good performance in meeting each use criterion should be quantified if possible. In determining the buyer's value precisely, quantification not only forces careful thinking, but also allows the measurement and tracking of firm performance against a use criterion. The assessment of a firm's position against competitors in meeting criteria is done with the help of quantification. Further, the firm can be in a position to study the practices that bring down competitors' performance.

Check Your Progress - 3

9. Policies are made by firms about what to perform and how to perform them. Policy choices that lead to uniqueness include:
   - i. Product features and performance offered.
   - ii. Services provided.
   - iii. Intensity of an activity adopted.
   - iv. Content of an activity.
   - a. Only i, ii, and iii
   - b. Only i, iii, and iv
   - c. Only ii, iii, and iv
   - d. i, ii, iii, and iv

10. Which of the following statements about drivers of uniqueness is **true**?
    i. A series of basic drivers analogous to the cost drivers determines a firm's uniqueness in a value activity.
    ii. The firm can make itself unique by creating a product image in the minds of the customers due to its existence for a long time.
    iii. The uniqueness of a value activity may stem from sharing it with sister business units.
    a. Only i and ii
    b. Only i and iii
    c. Only ii and iii
    d. i, ii, and iii
11. Use criteria is one of the types of buyer purchase criteria that depend on the actual and perceived value for the buyer. Which of the following options is **not** a use criterion?
    a. Product quality
    b. Product features
    c. Delivery time
    d. Packaging

Activity 10.3

A firm derives competitive advantage from value-creating activities, such as designing, producing, marketing, delivering, and supporting. Efficiency in one, or more than one, of them can lead to competitive advantage. A competitive advantage has strategic relevance only when customers find a difference between the company's product and its competitor's. This perceived difference should be in variables that influence their buying behavior. Give the example of a company that is trying to attract customers by creating this perceived difference.

Answer:

10.10 Summary

- Cost advantage is the result of minimizing the expenditure on a firm's activities, providing quality products and service to the buyer, and reducing the buyer's cost.

- The value chain is a series of value activities the firm performs for competing in an industry. A meaningful cost analysis examines costs within these activities and not the cost of a firm as a whole. Cost analysis of the firm's value chain begins with assigning operating costs and assets to value activities.
- Cost drivers can determine the cost of a given activity. These differ from firm to firm in the same industry, if different value chains are employed. There are ten major cost drivers that determine the cost behavior of value activities.
- The cost dynamics explain the change of cost drivers of value activities and the increase or decrease in absolute or relative cost importance of these activities.
- The basic tool for determining competitor costs is the value chain. The initial step used to determine the competitor's cost is to identify competitor value chains and the way in which the activities are performed by them.
- The buyer value chain comprises activities they perform just as in the case of the firm. A firm should create a valuable product for a buyer by lowering buyer cost and by raising buyer performance.

10.11 Glossary

Differentiation strategy: A generic competitive strategy (as proposed by Michael E. Porter) through which a firm can create sustainable success for itself. The strategy aims at creating products and services that are perceived by the customers and consumers as distinct and unique from its competitor's products and services.

Value chain: A value chain is a linked set of value-creating activities that begins with the purchase of basic raw materials from suppliers, and ends with distribution of a product or service. A value chain analysis evaluates the firm in the context of its value-creating activities.

10.12 Self-Assessment Test

1. Define the value chain for cost analysis. Discuss the cost behavior of value activities.
2. Identify the linkages within and across value chains.
3. What do you understand by cost advantage? Describe the techniques used to gain cost advantage.
4. What are the various types of errors that come up while pursuing cost leadership strategies?
5. What are the differentiation strategies? How can the buyer value be created?

10.13 Suggested Readings/Reference Material

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3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

10.14 Answers to Check Your Progress Questions

1. (d) i, ii, and iii

For the purpose of cost analysis, the disaggregation of the generic value chain into individual value activities should reflect: the size and growth of the cost represented by the activity; the cost behavior of the activity; and the competitor differences in performing the activity. Different activities have different costs associated with them. For example, within the sales activities, the salesman’s commission will have a different percentage contribution to the total costs as compared to the cost of distribution channel partners to the total costs. To exercise cost control, the managers should keep in view the size of the activity cost and the manner in which it is growing with an increase in the associated activity. For example, with increased sales, the salesman’s commission will increase but the money spent on advertising will get spread over a larger volume of output and the per unit cost of advertising will come down.

2. (d) i, ii and iii

The cost of each value activity can be separated into three categories: purchased operating inputs, human resource costs, and assets by major category. The three categories listed are distinct from each other and a cost can be easily classified into any one of these categories. For example, raw materials will get classified into purchased operating input costs, the training imparted to employees will get classified as human resource costs, and any machinery or building purchased will get classified into assets by major category.

3. (b) **Breadth of product line**

The cost behavior of value activities is determined by ten major cost drivers. They are economies of scale, learning, the pattern of capacity utilization, linkages, interrelationships, integration, timing, discretionary policies, location, and institutional factors. The breadth of the product line is not a cost driver. For example, in a biscuit manufacturing company, the same plant and equipment is made use of for manufacturing salt biscuits and sweet biscuits. Similarly, in a soft drinks company like Coca Cola, the same plant is made use of for manufacturing Coca Cola, Fanta, Sprite, Thumps Up, and Limca. As the extension of the product line does not lead to any substantial increase in cost, the breadth of the product line is not a cost driver.

4. (c) **Increases, increase**

As scale increases beyond a point, complexity and costs of coordination increase and that may lead to diseconomies of scale in a value activity. The increased output and sales volume may increase employee compensation or purchased input costs at a rate higher than the increase in the volume of output and sales. If the economies of scale are the result of having plants in multiple locations and an increased breadth of the product line, it may increase the coordination costs substantially and may even result in diseconomies of scale.

5. (b) **Only i and iii**

There are two mechanisms through which linkages within the value chain lead to opportunities for cost reduction. They are coordination and optimization. The manifestation of a linkage between activities is inventory and reducing inventory is possible by managing the linkage better through coordination. Tradeoff problems can be resolved jointly optimizing the activities that are linked.

6. (a) **Cost dynamics, independent of**

According to cost dynamics, in addition to analyzing cost behavior at a point in time, a firm must consider how the absolute and relative cost of value activities will change over time independent of its strategy. For example, the manpower cost of engineers will come down over time, if the number of engineering institutes in the country multiplies fast. This is independent of the strategy adopted by the firm to recruit engineers.

7. (d) **Economies of scale**

Economies of scale is a cost driver that determines cost behavior, and not cost dynamics. The most common sources of cost dynamics include: industry growth, differential scale sensitivity, and differential technological change. The growth of an industry affects cost dynamics in many ways. The expansion in the demand for products and services is synonymous with high industry growth rate, which enables a firm to take advantage of economies of scale, thereby resulting in lower costs. High industry growth rates will attract more firms to enter the supplier industry of the growing industry, thus leading to lower input costs. For example, when the Indian automobile industry experienced a high growth rate, it resulted in the setting up of a large number of input providers, which led to a decline in input prices for the automobile manufacturers. Differential scale sensitivity is the difference between the scale sensitivity of two value chains. For example, the value chain of software is more expensive than the value chain of hardware in industries like videogames and telecommunications. In these industries, the costs of creating hardware comes down substantially with scale but the cost of software in the form of software professionals required stays largely inelastic in response to scale because upgrades and new software are required at a fast pace to stay competitive. Differential scale sensitivity also refers to how sensitive the costs of a firm are to scale as compared to its competitors. Differential technology change refers to the differences in speed and quantum of technology change in relation to the value activities of a firm.

8. (a) Only i, ii, and iii

Firms in assessing and acting upon cost position, make common errors such as: exclusively focusing on the cost of manufacturing activities, ignoring procurement, overlooking indirect or small activities, having a false perception of cost drivers, failing to exploit linkages, going in for contradictory cost reduction and **unwitting cross subsidy**, thinking incrementally, and undermining differentiation. The failure of firms to recognize the existence of segments in which costs behave differently makes them often go unwittingly in for cross subsidy.

9. (d) i, ii, and iii

A series of basic drivers analogous to the cost drivers determines a firm’s uniqueness in a value activity. For example, the quality of inputs used, the level of automation in the production processes, constant development of technology innovations, extent of customization to customer needs, etc., are all drivers of uniqueness which a firm can adopt. The firm can make itself unique by creating a product image in the minds of the customers due to its existence for a long time. For example, Lux soaps are identified as beauty soaps while Dettol is identified as a good antibacterial and disinfectant. The uniqueness of a value activity may stem from sharing it with sister business units.

10. (c) Buyers, high

A successful differentiator puts his/her efforts into creating a value for buyers by providing them with a high quality product that yields a price premium in excess of the extra cost. When a firm differentiates itself by providing a high quality product, it incurs additional costs in terms of higher input costs, additional research and development expenditure, and so on. The firm is able to command a price premium for its high quality product which more than offsets the cost of differentiating. For example, Sony products are perceived as high quality products and they sell at a price premium as compared to the products of competitors.

11. (d) Packaging

Use criteria include product quality, product features, delivery time, and applications engineering support. Packaging aims at ensuring that the material does not get damaged or destroyed during shipment. It is a signaling criterion which indicates focus on quality by the supplier. Signaling criteria also include brand image, advertising, the attractiveness of facilities, and reputation.

Unit 11

Strategy and Structure

Structure

"The chief strategist of an organization has to be the leader - the CEO."

- Michael Porter

11.1 Introduction

Here, Michael Porter has put forth the role of CEO in the organization structure while formulating strategy.

In the previous unit, we have discussed value chain and generic strategies. In this unit, we shall discuss strategy and structure.

For a strategy to be successfully executed, it should be supported by an appropriate organization structure that facilitates the accomplishment of the objectives. Moreover, for the organization to function effectively and efficiently, its strategy, structure, culture, and control systems should be aligned and should constitute a good fit for the organization and its business environment. As the organization and its environment evolve over time, this would necessitate the realignment of the strategy-structure-culture-control systems combination.

This unit will first discuss the different structural dimensions of organization design, and the different types of organization structures. We shall then move on to discuss the responsibility structure, and the concepts of controllability, goal congruence, and transfer pricing, that are integral to its proper functioning. Finally, we shall discuss how the management can align structure to strategy.

11.2 Objectives

By the end of this unit, you should be able to:

- Explain the different structural dimensions of organization design, and the different types of organization structures.
- Discuss the concepts of controllability and goal congruence, and the transfer pricing technique, which are integral to the proper functioning of the responsibility structure, and the various types of responsibility centers.
- Find out how the management can align structure to strategy.

11.3 Organization Structure

Organization structure refers to the role-responsibility relationships of individuals in an organization along with their pre-defined interaction patterns. It defines the formation of sub-groups within the organization, along with the formal techniques and methods of communication and coordination to be used. It facilitates both vertical (downward and upward communication between different hierarchical levels) and horizontal (between different people at the same hierarchical level) information flow in the organization.

From a strategy execution perspective, the organization design selected should promote communication, cooperation, teamwork, motivation, and performance, and should be the one best suited for the organization and its external and internal environment.

11.3.1 Structural Dimensions of Organization Design

Organizations in the past existed in a stable environment. 'Efficiency of performance' was the main consideration while choosing an organization structure. Today's environment, however, is dynamic and chaotic and requires the organization to survive amidst intense competition. Communication, alliance, and cooperation should be encouraged in organization through management control of areas such as strategy, investments, marketing, internal processes, and human resources.

Structural dimensions, which are the internal dimensions in the organization, are used as a basis for formally describing the organization structure. These dimensions are shaped based on the contextual dimensions that have a wider scope and include both internal and external factors like organization size, technology used, environment in which it operates, culture, and objectives. Richard L. Daft proposed six structural dimensions -- formalization, specialization, hierarchy of authority, centralization, professionalism, and personnel ratios. These dimensions are described in Table 1.

Example

Hero Moto Corp Ltd. (HMCL) is India's leading two-wheeler company. HMCL has its presence in 37 countries across Asia, Africa, and South & Central America. The company mentioned the organizational rules and policies, and employment principles in its business code. Some of the points mentioned in business code are: "employees of the company shall not maintain parallel employment with any other company while working for HMCL, without the prior approval of the managing director of the company, as the same may have effect on the performance of the employees." Employees must not do business on behalf of HMCL with a member of his/her household or a close relative, unless the transaction is disclosed in writing and has approval from the senior management. The given case of Hero Moto Corp reflects the degree of centralization in the structural dimension of the organization design wherein the organizational set rules and policies, and employment principles in its business code are to be followed by all its employees.

Source: ICFAI Research Center

Table 1: Structural Dimensions of Organization Design

Dimensions	Description
Degree of formalization	**Definition** It refers to the extent to which written rules and records are maintained in the organization. **Description** It is maintained to document employees' activities and related behavior. The number of pages of written records is one of the indicators of the degree of formalization. In highly formalized organizations, detailed reports are prepared containing information about activities and outcomes; periodic comparisons are made and detailed variances measured to assess progress; and formal reward systems are put in place to motivate contributions toward achievement of objectives. In less formal organizations, the control mechanism is more implicit. The degree of formalization can be high in jobs of routine nature so that coordination is facilitated. Professionals performing complex non-routine jobs may be de-motivated if they are bound by too many formal rules and procedures.

Dimensions	Description
	As organizations grow larger, one of the challenges in executing strategy is how not to become too formal or bureaucratic.
Degree of specialization	**Definition** It refers to the extent of dividing the organizational activities into sub-groups, in which each employee performs only a small range of activities in which he/she is a specialist. **Description** The higher the number of sub-groups, the fewer the activities an employee performs and vice versa. Also called as division of labor or functional specialization in which a job is broken down into several parts. It is useful in overcoming restrictions of time and knowledge in performing complex jobs. In organizations with a high degree of specialization, the job performed by individual employees is of a routine nature. So, explicit rules and procedures can be easily laid down to help establish certain standard actions and results.
Hierarchy of authority	**Definition** It refers to the reporting relationships prevalent in the organization and the span of control (number of subordinates who report to a supervisor). **Description** The hierarchy of authority is flatter in organizations with a wide span of control (where a large number of people report to a particular manager) than in organizations with a narrow span of control. The management needs to determine an optimal span of control for the organization depending on certain factors which include the complexity of the tasks performed by subordinates; the extent and nature of intervention required from the manager; whether tasks being performed by subordinates are identical or varied; and whether tasks being performed are inter-dependent or may be performed independently of each other. Tall structures provide closer supervision and tighter control by supervisors as there are only a few people reporting to a supervisor, while in flat organizations, supervision is less tight as a supervisor has a larger number of subordinates to supervise and the communication channel is simpler.

Dimensions	Description
Degree of centralization	**Definition** It refers to the level in the hierarchy which has the decision-making authority. **Description** When the decision-making authority lies with the top management, the organization is said to have a high degree of centralization, and when the decision-making authority is distributed among the lower levels of the hierarchy, the organization is said to be decentralized. Decentralization gives the individual business managers the right to take decisions for their respective business units. While a decentralized structure fosters innovation and entrepreneurship, and responsiveness to customer needs, centralization helps in strict adherence to plans. Coordination at the lower levels of the organization may be lower in a centralized organization, resulting in loss of effectiveness, bottlenecks, and lack of responsiveness to market demands.
Degree of professionalism	**Definition** It refers to the level of formal education of the employees. **Description** The higher the number of years of formal education and training, the higher the professionalism. In organizations with a high level of professionalism, the organization structure and control systems may be designed in such a way as to provide an environment which encourages accomplishment of objectives. While professional individuals may not require very close supervision of actions and results, they need to be placed in the right jobs to feel sufficiently motivated. Close supervision of actions and results is more useful where the level of professionalism is low.
Personnel ratios	**Definition** It refers to the distribution of people into different functions and departments. **Description** In a specific function, it is calculated as the ratio of the number of people in the function to the total number of people in the organization.

Dimensions	Description
	Personnel ratios indicate the management's priorities and judgments regarding the deployment of people. Examples of personnel ratios are administrative ratio, sales force ratio, etc.

Check Your Progress - 1

1. Given the dynamic and competitive business environment, which of the following statements is **incorrect?**
   a. Organization structure facilitates both vertical and horizontal flow of information.
   b. Organization structure decides how individual employees should be teamed to form sub-groups.
   c. Organization structure should be designed with efficiency of performance as the sole aim.
   d. Organization structure is affected by both contextual and structural dimensions of the organization.
2. Match the following structural dimensions of organization design with their respective definitions.

   Structural dimensions

   i. Formalization
   ii. Specialization
   iii. Professionalism
   iv. Centralization

   Definitions

   p. The extent of dividing the organizational activities into sub-groups
   q. The level of formal education of the employees
   r. The extent to which written rules and records are maintained in the organization
   s. The level in the hierarchy which has the decision-making authority
   t. The distribution of people into different functions and departments

   a. i/p, ii/t, iii/r, iv/q
   b. i/q, ii/r, iii/s, iv/p
   c. i/r, ii/p, iii/q, iv/s
   d. i/s, ii/q, iii/t, iv/r

11.3.2 Types of Organization Structures

Organization structure decisions relate to division of labor and the formation of departments, divisions, or units; hierarchy, reporting relationships, and span of control of supervisors; and coordination mechanisms. The organization structure should encourage participation and innovation over and above maximization of performance levels and effectiveness of operations throughout the organization. The various types of organization structures include functional, divisional, matrix, horizontal, and hybrid structures. The advantages and disadvantages of these structures are given in Table 2.

Functional structure

The functional structure is characterized by people being grouped based on their expertise and skills (such as the R&D department looks after the research and development function). It is used when the requirement for expertise in a specific field is important. In this structure, the vertical hierarchy is stronger than the horizontal hierarchy. It calls for centralization as the decisions regarding resolution of issues are generally made by the top management.

Divisional structure

The divisional structure is also called a product structure; the divisions may be referred to as strategic business units (SBUs). The divisions are formed based on an organization's product range, the specific markets which the organization caters to, or the geographic locations in which it operates. This structure fosters higher adaptability to change due to the small size of each division and also better interaction between the various functions within a division. It is characterized by higher decentralization as the decision-making authority rests with business unit managers rather than the top management.

When an organization is divided into small business units, the authority and responsibility of decision making for that unit is placed with unit-level managers. This delegation acts as an inherent motivator for them as they can clearly understand the impact of the choices made and actions taken on the performance of their unit.

Matrix structure

The matrix structure tries to integrate the salient features of the functional structure (say, technical specialization) and those of the divisional structure (say, market responsiveness, product innovation, or project delivery). In this structure, an employee reports simultaneously to two different supervisors, one supervisor representing a functional department and the other representing the division, product, market, geography, or project. This structure is commonly used in project-based organizations and for new product development. It is useful in organizations which have a limited product range and/or when a high degree of interaction is required between the functions. The matrix structure requires a high degree of cooperation and coordination among managers.

Horizontal structure

Frank Ostroff proposed the ‘horizontal structure’ as the structure that prevents the rigidity and departmentalization existing in a vertical system by grouping managers and employees into synergistic teams for problem-solving. Organizations move toward the horizontal structure through business process re-engineering. Here, process stands for ‘an organized group of related tasks and activities that work together to transform inputs into outputs that create value for customers’. The owner of a process is responsible for coordinating and controlling the process in its entirety.

In a horizontal structure, the emphasis is on teams which direct themselves. Team members are provided with resources, motivation, and the authority to take core decisions. They are also ‘cross-trained’ so that they can substitute for each other if required. Creativity, flexibility, trust, cooperation, employee empowerment, and a customer-centric approach characterize horizontal structures. In a horizontal structure, the people carrying out activities in a single process have better coordination with others in the same process.

Hybrid structure

Hybrid structures are formed as a combination of the functional, divisional, or horizontal structures. They help organizations combine the strengths of different structures while eliminating the weaknesses of each. In an extremely volatile environment, it has become very important for organizations to quickly adapt to changes. This is an important characteristic seen in the hybrid structure, also called the flexible or adaptive organization.

Two important characteristics of a hybrid organization are that there is scope for different ways of thinking and a participative style of management. For such organizations, organizational design is decided based on which structure is appropriate in a specific situation and at a particular point in time. Flexible organizations continuously assess and modify their structure so that the employees are best aligned to the strategic changes.

Example

An article “The five trademarks of agile organizations” published by McKinsey stated the example of agile organizations like Gore, ING, and Spotify. These firms implement clear, flat structures that reflect and support the way in which the organization creates value. For instance, teams can be clustered into focused performance groups (for example, “tribes,” or a “lattice”) that share a common mission. These groups vary in size, typically with a maximum of 150 people. This number reflects both practical experience and Dunbar’s research (Rule of 150) on the number of people with whom one can maintain personal relationships and effectively collaborate.

Contd….

The number of teams within each group can be adapted or scaled to meet changing needs. They ensure clear, accountable roles so that people can interact across the organization and focus on getting work done, rather than lose time and energy because of unclear or duplicated roles, or the need to wait for manager approvals. Here, people proactively and immediately address any lack of clarity about roles with one another. The article represented a horizontal type of organizational structure where firms implement flat structures and where teams can be clustered into focused performance groups to support the way in which the organization creates value.

Source: ICFAI Research Center

There are two types of hybrid structures.

The first type combines the functional and divisional structures. When an organization with a functional-divisional matrix structure grows in size, it is generally divided into smaller divisions which have their own functional setup.

The second type of hybrid structure combines the functional and horizontal structures.

Table 2: Advantages and Limitations of Various Organization Structures

Organization Structure	**Advantages and Limitations**
Functional structure	**Advantages** There is more emphasis on efficiency. Employees are segregated based on their expertise and are able to specialize in the jobs assigned to their respective departments. **Limitations** Difficulty in adapting to environmental changes. Most of the decision-making power is concentrated at the top that leads to delay in decision making. Lack of coordination between various departments and a myopic view prevailing among employees regarding organizational objectives lead to restrictions in innovation and creativity.
Divisional structure	**Advantages** It is easy to measure the performance of each small unit and to reward commendable performance with more accuracy. Increase in financial incentives and other rewards in the form of promotions, expressed praise, etc. can be directed at individuals and groups who actually deserve them.

Organization Structure	Advantages and Limitations
	Increased speed of communication, understanding, analysis, processing and acclimatizing to new information (such as changes in customer preferences, supplier behavior, and change in risk profile due to the changed nature of competition). Such information is first available to the individual divisions/units (closer to the source of the information) rather than the top-level management which is more concerned with broader issues affecting the organization as a whole. **Limitations** Negative impact of some decisions (made by a business unit manager who is responsible for the performance of only his/her division/unit) on other divisions. A business unit manager may ignore the repercussion of, or may not have sufficient information required to assess the ripple effect of, a decision made for his/her unit, on other units.
Matrix structure	**Advantages** Retention of the functional aspect helps retain economies of scale and that of the divisional aspects helps in incorporating customers' preferences, thus improving their own profitability. Economical sharing of resources among the various departments so as to achieve the organization's goals and objectives. Presence of dual authority leading to greater communication between managers. Capability of adapting to changes in the environment through better allocation of resources. **Limitations** Presence of dual authority leads to a higher chance of conflicts arising and so a lot of time is consumed in conflict resolution. Requirement of strong interpersonal skills in individuals within the structure Meetings between participants take up a lot of time. Requirement of mutual respect among participants.

Organization Structure	Advantages and Limitations
Horizontal structure	**Advantages** Enables the organization to adapt easily to a changing environment, and it ensures that satisfaction and value addition for the customer are the main goals. Employee satisfaction due to shared responsibilities, enhanced authority for decision-making, and a clear understanding of an employer's contribution toward organizational goals. **Limitations** More time taken to identify core processes; it becomes necessary to change the organizational culture, job structure and function, and performance measurement system; and there is the possibility that the employees' specialization in specific functions may be hampered. Employees also require a great deal of training in varied areas in order to be effective in a horizontal structure.
Hybrid structure	**Advantages** Scope for different ways of thinking and a participative style of management. Aids quick decision-making, quick adaptability to market changes, increased spending on R&D. **Limitations** Difficulty in identifying the environmental changes, deciding on the strategic modifications required for such changes, and the trickle down effect of such decisions.

Check Your Progress - 2

3. Identify the characteristics of a divisional organization structure.
   i. Each business unit independently handles a separate product, market, or geographic location.
   ii. An employee reports simultaneously to two different supervisors.
   iii. There is higher adaptability to change due to the small size of each business unit.
   iv. The structure is characterized by higher decentralization as the decision-making authority rests with the business unit managers.

   a. Only i, ii, and iii
   b. Only i, iii, and iv
   c. Only ii, iii, and iv
   d. i, ii, iii, and iv

4. Horizontal organization structure helps in preventing rigidity and departmentalization existing in traditional vertical structures by grouping managers and employees into synergistic teams for problem-solving. Which of the following is **not** a drawback of this structure?
   a. More time is taken by the organization to identify core processes.
   b. It becomes necessary to change the organizational culture, job structure and function, and performance measurement system.
   c. Due to the presence of dual authority, there is a higher chance of conflicts arising.
   d. There is the possibility that specialization of employees in specific functions may be hampered.

5. The organization structure which combines the features of functional, divisional, and horizontal structures is called a hybrid structure. Which of the following are the characteristics of a hybrid organization?
   i. It gives scope for different ways of thinking.
   ii. It leads to rigidity and thus fails in adapting to changes in the market.
   iii. It promotes a participative style of management.
   iv. It leads to a slowdown in the decision-making process.
   a. Only i and ii
   b. Only i and iii
   c. Only ii, iii, and iv
   d. Only iii and iv

Activity 11.1 An organization's structure should be designed keeping in mind its chosen strategies. For an organization that is pursuing cost leadership, what are the advantages and disadvantages of a functional structure? **Answer:**

11.4 Responsibility Structure

A responsibility structure is a collection of responsibility centers. Each responsibility center is a function, division, or unit of an organization under a specified authority with a specified responsibility. Performance evaluation of each of these responsibility centers is done based on certain criteria (specific to each type of center) to assess its contribution to the organization as a whole using responsibility accounting. According to the Institute of Cost and Works Accountants of India (ICWAI), responsibility accounting is 'a system of management accounting' under which accountability is determined according to the responsibility allotted to various levels of management.

11.4.1 Controllability, Goal Congruence, and Transfer Pricing

Organizations should consider controllability and goal congruence while designing responsibility structures. Transfer pricing is used to measure the individual centers' contribution to the overall organizational goals, and to ensure that fair performance measurement systems are designed.

Controllability – According to this concept, each manager should be assessed and rewarded only for those factors that are under his/her control. For example, uncontrollable costs are those which the manager incurring the cost cannot influence over the relevant time period.

Goal congruence – It is achieved when managers (and employees), while working toward their best self-interest, as perceived by themselves, take decisions that are successful in attaining the organization goals. Performance measurement systems should be designed so that the set organization objectives and the employee's objectives are properly aligned.

Transfer pricing – A transfer price is the internal price charged by a selling department, division, or subsidiary of an organization for a raw material, component, or finished good or service which is supplied to a buying department, division, or subsidiary of the same organization. It is the monetary value assigned in responsibility accounting for exchanges that take place between the responsibility centers of an organization. This value is treated as the revenue of the selling center and the cost of the buying center. Therefore, it is essential that transfer pricing is correctly done to provide a fair picture of the contribution of different responsibility centers.

11.4.2 Responsibility Centers

Responsibility center, according to the Chartered Institute of Management Accountants, UK, is 'a segment of the organization where an individual manager is held responsible for the segment's performance'. It is a department, function, or unit of an organization headed by a manager who is directly answerable for its performance. Responsibility centers facilitate management control and help in implementing the strategies chosen to achieve the organization's goals.

For a responsibility center, the accounting system generates information on the basis of managerial responsibility, allowing that information to be used directly in motivating and controlling the action of the manager in charge of the responsibility center. Every responsibility center uses inputs (material, labor, etc.) and needs working capital, equipment, and other assets to function effectively. While the costs of inputs can be easily measured, outputs are not always easy to measure.

The responsibility center's performance can be judged using the effectiveness and efficiency criteria. Based on the nature of monetary inputs and outputs, responsibility centers can be classified into cost centers, revenue centers, profit centers, and investment centers.

Cost centers

Cost centers are held responsible for the costs incurred. According to the cost center manager, either the costs or the level of outputs can be independently controlled, but not both. A cost center can operate in two ways -- either the cost budget is specified and the goal is to maximize the output, or the expected output is specified and the goal is to minimize the cost. In the first case, a certain fixed budget is allocated to the cost center, and it is expected to achieve the best possible result within the allocated budget. In the second case, the goal is to achieve the required level of output at minimum cost; the performance level depends on the cost incurred by that center.

Responsibility center managers are expected to maximize the services offered while keeping within the budgeted limits. In the control of cost centers, managers make mistakes by evaluating performance with a view to only minimize costs and may ignore important non-financial indicators of performance such as output quality, safety issues, or ethical and environmental issues. The control system in a cost center should therefore be designed so that it recognizes the role of all factors that have an impact on organizational goals.

Cost centers are of two types -- standard cost centers and discretionary expense centers.

Standard cost centers are also known as an engineered expense centers; standard cost centers are usually found where a standard cost system is in place or in organizations that have a repetitive task to be performed. The manager's aim is to prevent or reduce unfavorable variance between the actual and budgeted costs, while maintaining the quality and quantity of outputs at the desired levels.

Example

Mahindra & Mahindra Ltd., the Indian automobile company rolled out million vehicles from each of its three automotive manufacturing plants in Chakan, Zaheerabad and Haridwar.

Contd….

These automotive plants are fully equipped with end-to-end press, body and paint shops and assembly lines, and have won several accolades since their inception. Mahindra & Mahindra worked on reducing cost and was able to produce the vehicles at the budgeted cost (10-12% lower than competitors). In this case, the three manufacturing units of Mahindra are able to produce a certain level of output within budgeted cost, one that is lower than the competitor.

Source: ICFAI Research Center

For a discretionary expense center such as a corporate communications department, it is difficult to measure the outputs in monetary terms against a given level of inputs. Generally, a budget is decided upon for the chosen time period, say, a financial year. Responsibility center managers are expected to maximize the services offered while keeping within the budgeted limits. Corporate functions such as accounting, human resources, and corporate communications; and departments involved in scientific research or new technologies are examples of discretionary expense centers.

Revenue centers

Managers of revenue centers are held responsible for the revenues (outputs) but are not directly responsible for profits. Costs traceable to a revenue center are normally adjusted with the sales revenue to calculate the net revenue of the revenue center. In many organizations, revenue centers are the points of contact closest to existing and potential customers. The main objective of these centers is to maximize net revenues and assume no responsibility for production.

Profit centers

Profit centers are responsible for profits. The profit center manager has control over both the input as well as the output, while he/she does not have control over the level of investment. A profit center aims to achieve profit targets by focusing on both cost reduction and revenue maximization. The manager cannot afford to reduce quality to reduce cost as that would lead to reduced sales revenue and profit. However, the profit center manager may not optimally utilize the capital employed if there is over-emphasis on maximizing profit.

Traditional cost centers are now being converted into profit centers. For example, IT departments earlier provided services to other departments (internal customers) free of cost. But now, they are being charged a transfer price. In this scenario, the buying center and the selling center (earlier a cost center) have the option of contracting with an external firm that can provide similar services.

Investment centers

Investment centers are responsible for the overall economic performance in terms of the cost incurred, the revenue generated, as well as the associated investment.

Performance of investment centers is measured with respect to Return on Investment (ROI) or Return on Capital Employed (ROCE) (profit divided by the capital employed in making that profit), and Economic Value Added (EVA). These centers have a drawback - since the value of capital employed is taken from the balance sheet, the value of ROI or ROCE may depend on the accounting technique followed by the organization. Also, the investment center may postpone new investments like purchasing new equipment, as the ROCE will decrease in the short run, though the organization may benefit from these investments in the long run.

11.5 Aligning Structure to Strategy

There is no such thing as an ideal organizational design or structure. Each structure has its own advantages and disadvantages. The key activities and resources of an organization are tied together by its structure. Therefore, the structure must be closely aligned with the needs/demands of the strategy.

At the macro-level, the organization has to choose what activities it should perform from among the activities in its value chain. At the micro-level, it should design an internal structure to perform the chosen set of activities.

11.5.1 Choice of Activities

First, the organization has to classify the activities in the value chain as strategy-critical or not. Every value chain has activities which are more critical than others to the organization. Among the value chain activities, these strategy-critical activities have to be executed exceedingly well or in closely coordinated fashion for the organization to deliver on the capabilities needed for strategic success.

Strategy-critical activities should be the main building blocks around which the structure is developed. Implementing a new strategy may warrant a different set of key activities, competencies, or capabilities and therefore requires a different organizational structure.

The value chain of a firm has many non-critical activities over which managers of an organization often spend an inordinate amount of time and money. The organization should consider outsourcing such activities. Outsourcing non-critical activities will lead to a flat organization structure, decrease internal bureaucracies, speed up decision making, improve the innovative capacity of the organization, and increase its competitive advantage.

Another important reason to look outside for resources is the role of partnerships for competing effectively. Partnerships can add to an organization's capabilities and contribute to better strategy execution. The relationship with the strategic partners will influence the organizational structure of the firm as partners take up certain critical activities and perform them.

11.5.2 Choice of Internal Structure

Aligning the internal structure of the organization to its strategy involves three steps: choosing one of the various forms of organization structure, modifying it as needed, and supplementing it with mechanisms for communication and coordination.

For example, a functional structure may not suit a financial institution which has adopted the strategy of being a financial supermarket, providing a diverse set of financial products and services to multiple customer segments in multiple geographic markets. To address this issue, one option would be to create strategic business units that address different products or markets or product-market combinations. Another option would be create organizational roles that provide single point contact for customers by internally coordinating with multiple functions. A third option would be to create a matrix structure.

In practice, the management should keep in mind the existing reporting relationships, personalities, and internal politics, and judiciously choose an organization structure. Additionally, the responsibility structure should be clearly delineated.

A landmark study in understanding the choice of structure as a function of strategy has been provided by Alfred Chandler. Over an extended time period, Chandler studied large corporations and found a common strategy-structure sequence.

1. Choice of new strategy.
2. Emergence of administrative problems; decline in performance.
3. A shift to an organizational structure more in line with the strategy's needs.
4. Improved profitability and strategy execution.

Research on corporate stages of development provides further understanding of the structure and strategy relationship. Based on research studies conducted on numerous business firms, a widely-accepted conclusion is that organizations move through several stages as there is an increase in size and diversity in terms of products/services offered and markets served. For competing effectively at different stages, they require different structures.

Check Your Progress - 3

6. For the research and development (R&D) department of a fast moving consumer goods company, a budget is decided each year but costs tend to vary every year depending on the volume of tasks. While keeping within the budgetary limits, the R&D head tries to maximize the services offered to the production and marketing departments of the company. In this case, for which of the following centers the R&D department is a typical example?
   a. Investment center
   b. Standard cost center

   c. Discretionary expense center
   d. Revenue center

7. HotMobile Telecom is one of the leading telecom service providers in India. It operates exclusive retail stores under the brand name The Hot Shoppe. The Hot Shoppe managers are responsible for the level of revenue, but are not responsible for the costs of the phones and services offered to the customer. These stores are a vital contact point between the customer and the company and they provide valuable customer feedback. As a part of the responsibility structure within HotMobile Telecom, which of the following centers denotes The Hot Shoppe stores?
   a. Cost
   b. Profit
   c. Revenue
   d. Investment

8. With regard to the relationship between strategy and structure, which of the following statements is **true**?
   a. For every industry, there is an ideal organizational design or structure.
   b. The strategy of a firm must be closely aligned with the needs/demands of its structure.
   c. At a macro-level, the organization has to choose what activities it should perform among the activities in its value chain.
   d. In practice, the management should ignore the existing reporting relationships, personalities, and internal politics, and choose an organization structure.

9. Alfred Chandler did a landmark study in understanding the choice of structure as a function of strategy. He studied large corporations over an extended time period and found a common strategy-structure sequence which is:
   i. Improved profitability and strategy execution.
   ii. A shift to an organizational structure more in line with the strategy's needs.
   iii. Choice of a new strategy.
   iv. Emergence of administrative problems; decline in performance.

   a. i, ii, iii, iv
   b. iii, iv, ii, i
   c. ii, i, iv, iii
   d. iv, ii, iii, i

Activity 11.2

Lack of co-ordination between organizational structure and strategy leads to inefficiency, misdirection, and fragmented efforts. All the activities, responsibilities, and interrelationships of a company need to be organized in a manner that is consistent with its strategy. Give an example of an organization that conforms to this view of aligning structure to strategy.

Answer:

11.6 Summary

- Organization structure refers to the role-responsibility relationships of different employees in an organization along with their pre-defined interaction patterns.
- The structural dimensions of organization design are degree of formalization, degree of specialization, hierarchy of authority, degree of centralization, degree of professionalism, and personnel ratios.
- The various types of organization structures include functional, divisional, matrix, horizontal, and hybrid structures.
- A responsibility structure is a collection of responsibility centers. A responsibility center is a function, division, or unit of an organization under a specified authority with a specified responsibility.
- In an organizational setting, it is necessary that the performance measurement systems are designed to be fair. Two major aspects to be considered are controllability and goal congruence. Transfer pricing is a tool used in responsibility accounting to assign monetary values to transactions taking place between two or more responsibility centers.
- According to the nature of monetary inputs and outputs, responsibility centers can be classified into four types -- cost centers (further divided into standard cost centers and discretionary expense centers), revenue centers, profit centers, and investment centers.
- The structure must be closely aligned with the needs/demands of the strategy. Aligning the internal structure of the organization to its strategy involves three steps: choosing one of the various forms of organization structure, modifying it as needed, and supplementing it with mechanisms for communication and coordination.

11.7 Glossary

Cost center: A type of responsibility center that is held responsible for the costs incurred but not for generating revenue. A cost center can operate in two ways: either the cost budget is specified and the goal is to maximize the output, or the expected output is specified and the goal is to minimize the cost. Cost centers are further divided into standard cost centers and discretionary expense centers.

Degree of centralization (structural dimensions of organization design): It refers to the level in the hierarchy which has the decision-making authority.

Degree of formalization (structural dimensions of organization design): It refers to the extent to which written rules and records are maintained in the organization.

Degree of professionalism (structural dimensions of organization design): It refers to the level of formal education of the employees.

Degree of specialization (structural dimensions of organization design): It refers to the extent of dividing the organizational activities into sub-groups, in which each employee performs only a small range of activities in which he/she is a specialist.

Divisional structure (or product structure): The divisions are formed based on an organization's product range, the specific markets which the organization caters to, or the geographic locations in which it operates. The divisions may be referred to as strategic business units (SBUs).

Functional structure: It is characterized by people being grouped based on their expertise and skills (such as the R&D department looks after the research and development function). It is used when the requirement for expertise in a specific field is important.

Hierarchy of authority (structural dimensions of organization design): It refers to the reporting relationships prevalent in the organization and the span of control (number of subordinates who report to a supervisor).

Horizontal structure: This structure prevents the rigidity and departmentalization existing in a vertical system by grouping managers and employees into synergistic teams for problem-solving.

Hybrid structure: These are formed as a combination of the functional, divisional, or horizontal structures. They help organizations combine the strengths of different structures while eliminating the weaknesses of each.

Investment center: A type of responsibility center that is held responsible for the overall economic performance in terms of the cost incurred, the revenue generated, as well as the associated investment. The performance of investment centers is measured with respect to Return on Investment (ROI) or Return on Capital Employed (ROCE), (which is arrived at by dividing profit by the capital employed in making that profit), and Economic Value Added (EVA).

Matrix structure: It tries to integrate the salient features of the functional structure (say, technical specialization) and those of the divisional structure (say, market responsiveness, product innovation, or project delivery). In this structure, an employee reports simultaneously to two different supervisors, one supervisor representing a functional department and the other representing the division, product, market, geography, or project.

Personnel ratios (structural dimensions of organization design): It refers to the distribution of people into different functions and departments.

Profit center: A type of responsibility center that is held responsible for profits. The manager of a profit center has control over both the input (cost of resources) as well as the output (revenue earned).

Responsibility center: A responsibility center can be defined as a segment of the organization where an individual manager is held responsible for the segment's performance. It is a department, function, or unit of an organization headed by a manager who is directly answerable for its performance.

Revenue center: A type of responsibility center that is held responsible for the revenues (outputs). Generally, revenue centers are not directly responsible for profits. Their main objective is to maximize net revenues.

Structure: Organization structure refers to the role-responsibility relationships of different employees in an organization along with their pre-defined interaction patterns. It specifies how individual employees should be teamed together to form sub-groups within the organization, and the formal techniques and methods of communication and coordination to be used in the organization. It facilitates the flow of information both vertically, that is, downward and upward communication between different hierarchical levels, and horizontally, that is, between different people at the same hierarchical level in the organization.

11.8 Self-Assessment Test

1. Explain the structural dimensions of organization design. What are the different types of organization structures?
2. Discuss the concepts of controllability and goal congruence and the transfer pricing technique. What are the various types of responsibility centers?
3. How can the management align structure to strategy?

11.9 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019

3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

11.10 Answers to Check Your Progress Questions

1. (c) Organization structure should be designed with efficiency of performance as the sole aim.

Organizations in the past existed in a stable environment when they had to perform themselves in the long run. Efficiency of performance was the main aim around which the organizations were designed. But, today's environment is dynamic and chaotic which requires the organization to survive in intense competition. Apart from efficiency, modern organizations should also aim at effectiveness and continuous learning.

2. (c) i/r, ii/p, iii/q, iv/s

Formalization, specialization, hierarchy of authority, centralization, professionalism, and personnel ratios are the various structural dimensions of organization design. Formalization refers to the extent to which written rules and records are maintained in the organization. Specialization refers to the extent of dividing the organizational activities into sub-groups. Professionalism refers to the level of formal education of the employees. Centralization refers to the level in the hierarchy which has the decision-making authority. Personnel ratio refers to the distribution of people into different functions and departments. It is calculated as the ratio of the number of people in a specific function to the total number of people in the organization.

3. (b) Only i, iii, and iv

In a divisional structure, the divisions are formed based on a company's product range, the specific markets which the company caters to, or the geographic locations in which the company operates. In such a structure, each division independently handles a separate product, market, or geographic location. In a matrix structure, an employee reports simultaneously to two different supervisors; one is the supervisor representing the functional department while the other is the supervisor representing the division, product, market, geography, or project.

4. (c) **Due to the presence of dual authority, there is a higher chance of conflicts arising.**

Some of the drawbacks of the organization structure are: it takes more time for the organization to identify core processes; it necessitates the change of organization's culture, job structure and function, and performance measurement system; it hampers the possibility of employee specialization in specific functions; and it mandates employees to get trained in varied areas in order to be effective in a horizontal structure. The matrix structure calls for a high degree of cooperation and coordination among managers. Due to the presence of dual authority, there is a higher chance of conflicts arising and so a lot of time is consumed in conflict resolution.

5. (b) **Only i and iii**

Two important characteristics of a hybrid organization are that there is scope for different ways of thinking and a participative style of management. These organizations are characterized by quick decision making; quick adaptability to market changes; and increased spending on research and development.

6. (c) **Discretionary expense center**

The cost centers of the organization are divided into standard cost centers and discretionary expense centers. Discretionary expense center is a type of responsibility center usually found in administrative or R&D departments. The costs in the discretionary expense center tend to vary from one year to another according to the volume. In the given situation, the R&D department is an example of a discretionary expense center.

7. (c) **Revenue**

Company-owned retail outlets like The Hot Shoppe stores are a good example of revenue centers. Such a center is devoted to increasing the net revenue and assumes no responsibility for production. In this center, the outlet manager is responsible for the level of revenue or output measured in monetary terms, but is not responsible for the costs of the goods sold through the outlet.

8. (c) **At a macro-level, the organization has to choose what activities it should perform among the activities in its value chain.**

There is no such thing as an ideal organizational design or structure. Each structure has its own advantages and disadvantages. The key activities and resources of an organization are tied together by its structure. Therefore, the structure must be closely aligned with the needs/demands of the strategy. At a macro-level, the organization has to choose what activities it should perform among the activities in its value chain. At the micro-level, it should design an internal structure to perform the chosen set of activities. In practice, the management should keep in mind the existing reporting relationships, personalities, and internal politics, and judiciously choose an organization structure.

9. (b) iii, iv, ii, i

Over an extended time period, Chandler studied large corporations and found a common strategy-structure sequence which is: choice of new strategy; emergence of administrative problems; decline in performance; a shift to an organizational structure more in line with the strategy's needs; and improved profitability and strategy execution.

Unit 12

Strategy Execution and Organizational Culture

Structure

"Corporate culture is the only sustainable competitive advantage that is completely within the control of the entrepreneur."

- David Cummings, (Co-Founder, Pardot)

12.1 Introduction

Here, David believes that the entrepreneur or the founder is the main source of creating a good organizational culture, which in turn is the source for sustainable competitive advantage.

In the previous unit, we have discussed strategy and structure. In this unit, we shall discuss strategy execution and organizational culture.

An organization's culture is equivalent to an individual's personality. It is an intangible, ever-present theme that provides meaning, direction, and the basis for action. As personality influences the behavior of an individual, the shared assumptions of beliefs and values among an organization's members influence opinions and actions within an organization.

This unit will first discuss the significance of organizational culture to strategy execution, and how a desired culture can be institutionalized in an organization. We shall then move on to discuss the relationship of culture to strategy execution through structure, style of management, and power. Finally, we shall discuss the interrelationship between culture and change.

12.2 Objectives

By the end of this unit, you should be able to:

- Identify the significance of organizational culture to strategy execution.
- Find out how a desired culture can be institutionalized in an organization.
- Discuss the relationship of culture to strategy execution through structure, style of management, and power.
- Explain the interrelationship between culture and change.

12.3 The Significance of Organizational Culture

The McKinsey 7-S model highlights the importance of shared values leading to culture of the organization as a whole. It forms the nucleus of the framework. The seven S's are the organization's strategic levers -- structure, strategy, systems, skills, style, staff, and shared values. Shared values are the values common to the members of the organization. The 7-S model provides a framework for studying the interrelationship of strategy formulation and implementation. The model negates the traditional view that strategy implementation is the function of structure and strategy alone. Rather the model proposes that both strategy formulation and implementation should take the organization's culture into consideration.

Organizational culture is the set of important assumptions (often unstated) that members of an organization share in common. Fundamental commitment through internalization of the beliefs and values of the organization by members result in corresponding behavior that is intrinsically rewarding for the members. The members derive immense personal satisfaction from their actions in the organization since they are congruent with their personal beliefs and values. The assumptions become shared assumptions through internalization among an organization's individual members. Those shared internalized beliefs and values shape the content and account for major strength of an organization's culture.

Example

An article "Getting organizational redesign right", published by McKinsey stated a case of a Consumer-Packaged-Goods (CPG) company that chose to expand outside its US home base. Under the group's previous organizational design, the global brand team responsible for marketing was not only located in the United States but had also been rewarded largely on the performance of US operations. It had no systems for monitoring the performance of products elsewhere.

Contd….

To support a new global move and to develop truly international brands and products, the company separated US marketing from its global counterpart and put in place a new design (including changes to the top team), new processes, and a new approach to performance management. This intensive redesign helped promote international growth, especially in key emerging markets such as Russia (where sales tripled) and China (where sales nearly doubled). The case represented shows how the redesigning of structure, strategy, and system levers of McKinsey 7-S framework helped the CPF company in promoting its international growth.

Source; ICFAI Research Center

12.3.1 The Purpose of Organizational Culture

According to Richard L. Daft, the purpose of organizational culture is to enable internal integration and external adaptation. Refer to Table 1 to understand how organizational culture contributes to internal integration and external adaptation.

Table 1: Culture, Internal Integration, and External Adaptation

Purpose	Contribution Mechanism
Internal integration	• Gives a collective identity to employees and clarifies how employees relate to each other • Contributes to effectiveness of performance by guiding working relationships, communication among employees, allocation of power and status • Determines the acceptable norms of behavior at the workplace • Guides decision making by employees if policies and procedures are not laid down clearly on how a particular situation should be addressed
External adaptation	• Helps the organization respond to customer needs • Helps the organization respond to competitors' strategies and tactics

Adapted from Daft, Richard L. Organization Theory and Design. 12th ed. Thomson-Southwestern. 2015.

12.3.2 Culture, Values, and Value Systems

Values are basic assumptions about which ideals are desirable or worth striving for. They derive from personal experience and identification with those who have had an important influence on one's personal development since early childhood.

Values represent preferences for ultimate end-states, such as striving for success or avoiding debt at all costs.

It is important to note that these definitions do not refer to what people say are their beliefs and values but rather to the beliefs and values they actually hold, whether consciously or otherwise. For instance, an important professional assumption for a banker is client confidentiality. This value is taken for granted, and a banker may become conscious of it only if it is challenged or violated. For example, a client might question the banker about it, or a fellow banker might violate it, either of which would draw attention to this important value. Even after drawing attention to it, this value remains present and potent. It is usually hard to change, as are other beliefs and values that the individual actually holds, consciously (openly) or otherwise.

With this definition of culture as assumptions involving personal beliefs and values, the meaning of ‘shared’ in the definition of culture can be made more explicit with the discussion of value systems in organizations.

Shared assumptions are internalized beliefs and values that organizational members hold in common. A member of an organization can simply be aware of the organization’s beliefs and values without sharing them in a personally significant way. Values and beliefs have more personal meaning if an individual complies with the set of values as a guide to appropriate behavior in the organization.

The individual becomes fundamentally committed to the organization’s beliefs and values when that individual internalizes such beliefs and values, that is, when he/she comes to hold them as personal beliefs and values. When such beliefs and values are shared across the organization, they constitute a meaningful value system of an organization.

For example, successful companies have a culture that promotes a *bias for action*. The emphasis is on autonomy and entrepreneurship. Employees are encouraged to take risks. For instance, to create new products even though there is no assurance that these products will be the winners. In such an organizational culture, managers are closely involved in the day-to-day operations of the organization, and do not simply make strategic decisions isolated in some ivory tower, and employees have a ‘hands-on, value driven approach’.

Similarly, many successful organizations have a culture that promotes customer-centricity. The organization establishes close relationships with customers as a way of improving its competitive position. It emphasizes customer-oriented values, learns customer needs, and improves abilities to develop products and services that the customers desire.

Check Your Progress - 1

1. For which of the following an organization's culture is an intangible, ever-present theme that provides meaning, direction, and the basis?
   a. Action
   b. Reaction
   c. Mission
   d. Vision
2. Which of the following is highlighted by the McKinsey 7-S framework that leads to the culture of the organization as a whole?
   a. Skills
   b. Systems
   c. Strategy
   d. Shared values
3. The purpose(s) of organizational culture is/are:
   a. Only internal integration
   b. Only external adaptation
   c. Both internal integration and external adaptation
   d. None of the above

Activity 12.1

Organizational culture is the set of important assumptions, (often unstated) that its members share in common. An organization's culture is equivalent to an individual's personality. It is an intangible, ever-present theme that provides meaning, direction, and the basis for action. Culture often makes the difference between success and failure. Using an example, examine the role of culture in the growth and success of an organization.

Answer:

12.4 Institutionalization of Organizational Culture

Strategic managers need to establish the values and norms that will help the organization create and maintain a sustainable competitive advantage. When the culture is strong, only those people who fit the values are recruited into the organization and through orientation and socialization, they completely imbibe the organization's culture.

12.4.1 Determinants of Organizational Culture

There are three basic determinants of organizational culture.

First, the influence of the business environment in general and the industry in particular. For instance, companies in industries characterized by rapid technological change, such as software, electronic, and computer companies normally have cultures that strongly value innovation.

Second, founders, leaders, and managers bring a pattern of assumptions with them when they join the organization. These assumptions often depend on those individuals' own experiences in the culture of the national, regional, ethnic, religious, occupational, and professional communities to which they belong.

Third, the actual experience people in the organization have had in working out solutions for coping with the basic problems the organization encounters molds shared assumptions. For instance, two organizations may each value cooperation and internal competition, but one organization may emphasize cooperation more in decision making and resource allocation, while internal competition may predominate in the other. The cultures of these two organizations consequently are quite different even though some of their basic assumptions about cooperation and internal competition are the same.

Taken together, these three principal sources suggest that a combination of prior assumptions and new learning experiences determines the contents of a culture.

12.4.2 Methods to Institutionalize Organizational Culture

For successful execution of strategy, leaders typically attempt to manage and create a distinct culture within their organizations through a variety of ways. Some common methods for this institutionalization are described here.

Emphasize key themes or dominant values

Throughout the world, businesses build strategies around distinct competitive advantages they possess or seek. These competitive advantages are achieved through quality, differentiation, cost advantages, speed, etc. Insightful leaders nurture these key themes or dominant values within their organizations and reinforce competitive advantages that they seek to maintain or build. The key themes or dominant values may center on some wordings in the organization's advertisements. They are also often found in internal corporate communications. For instance, McDonald's uncompromising emphasis on QSCV – Quality, Service, Cleanliness, and Value – through meticulous attention to detail is legendary.

Encourage dissemination of stories and legends about core values

Companies with strong cultures are enthusiastic collectors and tellers of stories, anecdotes, and legends in support of basic beliefs. Some companies emphasize on customer service that they uphold the 99.5 percent service level to customers.

Some others share stories and ideas with the entire organization by way of rallies designed around some major theme such as quality, cost reduction, and ethical issues. A few major global giants like 3M and P&G that value innovation developed organizational cultures around those themes that members identify strongly and share those beliefs and values with others.

Institutionalize practices that systematically reinforce desired beliefs and values

Companies with strong cultures are clear about their beliefs and values that keep them together and also take the process of shaping those beliefs and values very seriously. Many organizations institutionalize yearly contests that reinforce the desired beliefs and values throughout the organization.

Example

Amazon (a popular e-commerce company) is one of the largest and most customer-centric companies in the world. Jeff Bezos, CEO, gives a strong message about its organizational culture and value by leaving an empty chair at every meeting to represent the customer as the most important person. Every employee, including Bezos himself, also has to spend time working in the call center so that they can communicate with customers and have a better understanding of their experiences. Much of what is developed by Amazon comes from feedback and desires of the customers instead of the development team simply creating whatever they want or whatever is trendy. The case of Amazon represented the method of institutionalize practices that systematically reinforce desired beliefs and values.

Source; ICFAI Research Center

Adopt very common themes in unique ways

The following are the most typical beliefs that shape organizational culture:

- A belief in being the best.
- A belief that growth and profits are essential to an organization's healthy financial position.
- A belief in superior quality and service.
- A belief in the importance of informal communication.
- A belief in the importance of people as individuals and a faith in their ability to make a strong and effective contribution.
- A belief in inspiring people to do their best, whatever their ability.
- A belief in the importance of the details of execution – the nuts and bolts of doing the job well.
- A belief that customers should reign supreme.

Every organization implements these beliefs differently to fit a particular situation. Every organization's values are the handiwork of one or two legendary leaders. Therefore, every organization has a distinct culture that it believes no other organization can copy successfully. Hence, in organizations with very strong cultures, employees either accept the norms laid out by such cultures or opt out from that culture by leaving the organization.

The stronger an organization's culture becomes and the more that culture is directed towards the organizational stakeholders, the less the organization uses policy manuals, organizational charts, and detailed rules, procedures, and regulations to enforce discipline and norms. The main reason is that the guiding values inherent in the culture convey in a clear fashion what every employee is supported to do in most situations.

12.4.3 Organizational Culture and Cultural Diversity

Organizational culture must recognize cultural diversity – the reality of present global organizations. Social norms create differences, across national boundaries that influence people's interaction, read personal cues, and otherwise interrelate socially. Values and attitudes under similar circumstances also vary among countries. For instance, individualism forms the central core to the value structure of North American countries whereas group needs dominate the value structure of Japan. Similarly, family needs gain importance in the value structure of the Indian subcontinent. Moreover, the ways people are accustomed to learning differ across national borders. The process of shaping an organizational culture often involves considerable 'learning', and the organizational leaders should be sensitive to global differences in approaches to learning. This would make sure that the cultural learning efforts are effective.

Therefore, cultural diversity, both domestically and internationally, is something that most managers will experience due to differing backgrounds. Many managers face the situation in global companies located world over employing many people with different countries of origin having many languages and moreover find it all the more difficult to manage many cultures that these people represent.

Activity 12.2 An organization's culture is the equivalent of an individual's personality. It is an intangible, ever-present theme that provides meaning, direction, and the basis for action. Discuss, with an example, how an organization promotes its unique culture. **Answer:**

12.5 Culture and Organization Structure

The design of the organization should keep in mind the importance of closely aligning the structure to the needs/demands of the strategy, and the implication on culture. For example, an emphasis on entrepreneurship and respect for the employee leads to the establishment of a structure that gives employees the freedom to make decisions and motivates them to succeed. A simple structure and a lean staff best fit this situation. The belief inherent in this level of culture is that productivity is obtained through people and that the respect for the individual is the primary means by which an organization can create the right atmosphere for productive behavior. Such organizations are sufficiently decentralized to permit employees' participation but centralized enough for management to make sure that the organization pursues its strategic mission.

There are four important observations which link an organization structure to strategy and culture.

1. All forms of organization structures are not equally effective in the implementation of a strategy due to many cultural differences.
2. Structures seem to have a life of their own, particularly in large organizations. As a result, the need for immediate and radical changes is not immediately perceived. Even if the need is perceived, lagging performance may be necessary before culturally politicized sensitive structure is changed or organizational power redistributed.
3. Sheer growth can make restructuring necessary leading to readjustment of all cultural forms to unify and coordinate with the current requirements.
4. As organizations diversify into numerous related or unrelated products and markets, structural and cultural change appears to be essential if the organization has to perform effectively.

Organizational culture cannot by itself make the structure work. It must be backed by output and behavior controls, and matched to a reward system so that all employees cultivate organizational norms and values and pursue organizational goals.

12.6 Culture and Style of Management

In general, organizational culture is the product of the style of leadership/management. First, organizational culture is created by the strategic leadership provided by an organization's founder and top managers. The organization's founder is particularly important in determining culture because the founder imprints his or her values and style of management on the organization.

Second, the leadership style established by the founder is transmitted to the organization's managers, and as the organization grows, it typically attracts new managers and employees who share the same values. Moreover, members of the organization typically recruit and select only those who do share their values. Therefore, an organization’s culture becomes more and more unique as its members become more similar.

The virtue of these shared values and common culture is that it increases integration, improves coordination, and bonds a unique style of management among organizational members. For instance, the common cultural language that typically emerges in an organization because people share the same beliefs and values facilitates cooperation among managers. Similarly, rules and procedures, and supervision are less important when shared values and norms control behavior and motivate employees.

When organizational members internalize the cultural norms and values that bond them to the organization and increase their commitment, they find new ways to help the organization succeed. That is, employees are more likely to commit themselves to organizational goals and work actively to develop new skills and competencies to help achieve those goals.

Check Your Progress - 2

4. From the following options, identify the three basic determinants of organizational culture.
   i. The influence of the business environment in general and the industry in particular
   ii. The pattern of assumptions brought by leaders and managers who join the organization
   iii. The actual experience that people have had in the organization
   iv. Attention to the details of execution
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only i, iii, and iv
   d. Only ii, iii, and iv
5. Which of the following aspects of an organization have more personal meaning if a member views them as the guiding principles for appropriate behavior in the organization by complying with them?
   a. System, strategy
   b. Style, staff
   c. Beliefs, values
   d. Style, strategy

6. Which of the following are typical beliefs that shape organizational culture?
   i. A belief in being the best.
   ii. A belief in superior quality and service.
   iii. A belief in the importance of people as individuals and a faith in their abilities to make a strong and effective contribution.
   iv. A belief in the importance of the details of execution – the nuts and bolts of doing the job well.
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only ii, iii, and iv
   d. i, ii, iii, and iv
7. Which of the following diversities that is something that most managers will experience due to the differing backgrounds of the employees?
   a. Cultural diversity
   b. Social diversity
   c. Economical diversity
   d. Similarity diversity
8. Which of the following statements is **false** with regard to the linkage of an organization’s structure to its strategy and culture?
   a. All forms of organization structures are equally effective in the implementation of a strategy due to many cultural diversifications.
   b. Structures seem to have a life of their own, particularly in large organizations.
   c. Sheer growth can make restructuring necessary leading to readjustment of all cultural forms to unify and coordinate with the current requirements.
   d. As firms diversify into numerous related or unrelated products and markets, structural and cultural change appears to be essential if the organization has to perform effectively.

12.7 Culture and Power

Power, from the viewpoint of strategic management and specifically organizational culture, is an extent to which an individual or a group is able to persuade, induce, or coerce others into following certain courses of actions. It would be highly helpful to know the sources of power to understand and assess the importance of power in relation to culture within strategic management. The sources of power can be divided into two broad categories -- internal sources and sources for external stakeholders.

12.7.1 Internal Sources

The important internal sources of power include hierarchy; influence / charisma; control of strategic resources; expertise / knowledge / skill; control over the environment; and the exercise of discretion.

Hierarchy

Hierarchical positions in the organizational structure provide formal authority to the managers at higher levels. The managers with more formal authority influence the policy formulation and implementation extensively. Managers should use this power along with other types of power to make their influence efficient.

Influence / charisma

Influence is an important source of power. This arises from personal qualities like charisma of the leader. Charisma is the leader's ability to influence others through personal magnetism, enthusiasm, and strongly held convictions. Leaders communicate these convictions and their vision for the future through a dramatic, persuasive manner of speaking.

Charismatic leaders create an image of competence and success. Their personal magnetism makes them role models for their employees, thus influencing the overall organizational culture. The more the followers admire their leaders, the more likely they are to accept their leader's values and beliefs. This acceptance makes the leaders to exert significant influence over their followers' behaviors. The charismatic leaders are more powerful during the periods of organizational crisis and transition.

Control of strategic resources

Control of strategic resources is an important source of power. The relative importance of different resources changes depending upon the strategy and situation. The leader can gain power by possessing or controlling the strategic resources.

Expertise / knowledge / skill

Expertise or knowledge is a crucial source of power for top management. Managers acquire power through achievement and performance. The better the achievement and performance, the greater will be the power of the managers. Expertise refers to a manager's ability to influence the behavior of others. The subordinates follow the managers as they believe that their managers have command and knowledge of the situation. Thus, norms are informally established leading to a definite organizational culture.

Control of the environment

Usually, events internally in the organization affect the external view of the organization's performance. Some individuals or groups have more influence over events and the organization's internal environmental factors.

This can be a source of power within the organization. In many organizations, marketing and finance managers control the important internal environmental factors; therefore, they play a dominant role in cultural settings of strategic management whereas the managers from other departments take a back seat.

Discretion

Exercising discretion is a most significant source of power within an organization. Individuals or groups, due to the nature and levels of their jobs, derive power. Normally, strategy is to be implemented by a number of individuals across the organization. These individuals use the power so derived in the process of strategy implementation, thus, making the organization stand unique in its cultural transition.

Example

Zappos.com is a US-based online shoe and clothing company. Since January 2014, Zappos has been officially using Holacracy Organizational Structure Model. Holacracy is like an operating system for an organization. It is a pre-defined set of rules and processes, checks and balances, and guidelines that an organization can use to help them become self-managed and self-organized by giving every employee (instead of just management) the power to innovate, make changes, and have a voice.

Zappos has always been focused on delivering exceptional customer service – what it calls WOW service. To provide WOW service, it is important that every employee understands its customers' needs, and has the ability to improve the customer experience whenever possible. The company said, "As our company grew, we became slower to sense and respond to customer feedback, because of the layers employees needed to go through and get things done. Holacracy is a tool that allows every employee to quickly surface and act on customer feedback, so that we can continuously provide WOW service, regardless of the size of our company." Zappos Holacracy gives every employee the power to innovate, make changes, and have a voice, which is exactly the opposite of the traditional hierarchy

Source; ICFAI Research Center

12.7.2 Sources for External Stakeholders

The important external sources of power include resource dependence, involvement in implementation, expertise, and internal links.

Resource dependence

Almost all external stakeholders like banks, financial companies, and suppliers of raw materials derive power as the organization depends on them for resources. Usually, the short-term survival of an organization is mostly dependent on any one or more of these stakeholders.

Involvement in implementation

Under the present day circumstances, all over the world, the importance now has been shifted from manufacturing to the distribution. The distribution agencies have the power of knowledge about consumer's tastes and preferences. In fact, distribution agencies determine or influence the type of product to be produced. Thus, the distribution agencies derive power by involving in the implementation process.

Expertise

Organizations need the services of various specialized agencies such as advertising firms, investment banks, and consulting firms. Based on their expertise, such agencies can influence the organization.

Internal links

Internal links can provide a way for external stakeholders to influence the organization's strategy. A highly authoritarian organization normally does not provide sufficient internal links or opportunities for external stakeholders to influence the strategic management process.

Example

Jio, a leading telecom company in India, is popularly known for its free unlimited calling and data packages. In October 2019, Jio made the following announcement:

- Voice calls made by Jio users to Airtel/Vodafone Idea/BSNL and other telecom operators will be charged at 6 paise/minute.
- All Jio to Jio voice calls will, however, remain free.
- Jio users will get 1GB of data absolutely free for every additional 10-rupee paid.

This decision by Jio came out because of IUC charges. IUC or Interconnect Usage Charge is the price paid by one mobile telecom operator to another when its customers make outgoing mobile calls to the other operator's customers. These charges are fixed by the Telecom Regulatory Authority of India (TRAI) that are currently set at 6 paise/minute. All telecom operators pay IUC charges to other operators for outgoing calls and similarly, they receive the amount from other operators for incoming calls.

With effect from next Jio recharge, after October 10, 2019, Jio will charge these IUC charges (6 paise/minute) from its customers who make outgoing voice calls to other telecom operators. The company mentioned in its announcement that "Recovery of IUC will continue ONLY UNTIL the IUC charge is made zero by TRAI." The case depicts how TRAI has influenced the organizational strategy of Jio i.e. charging for outgoing voice calls to other telecom operators until the charge is made Zero by TRAI.

Source; ICFAI Research Center

12.7.3 Methods of Assessing Power

It is quite difficult to accurately assess the power of internal individuals or groups and external stakeholders. However, a good way of assessing power is to depend on indicators of power.

Assessing power within the organization

There are four basic indicators of power within organizations.

The status of the individual or groups: The position of an individual in the organizational hierarchy, the job, and the grade of work would indicate his/her power. Similarly, the reputation of an individual or group compared to others can also be used to assess its power.

The claim on resources: The claim of the individual or group for resources in terms of share in budget, number of employees, finances, etc., can be used to measure the power. Usually, resources of the least powerful group get eroded by more powerful group.

Representation in powerful positions: The power of the individuals and groups can be assessed by their representation in boards, committees, groups, teams, etc.

Symbols of power: Power of individuals and groups can also be assessed through various symbols like the size and location of offices; facilities like secretary, telephones, and meeting tables.

Example

In 2017, in P&G's board election, Nelson Peltz (an investor) was looking to put his own members on the board in an effort to improve the company. The other investors disagreed with Peltz's agenda for the company. In view of this, former P&G CEO John Pepper wrote a letter to the company's employees urging them to use their proxy votes to bar activist investor Nelson Peltz in his quest for board seats. Pepper offered his support for the then CEO David Taylor, adding that he has "great confidence" in Taylor's abilities and leadership. Pepper said the ongoing trajectory for the company is positive, and that Peltz's proxy fight with his Trian Fund (US-based Investment Company of which Peltz is a founding partner), even if it only won a single board seat, would greatly upset that upward trend. The case of Nelson Peltz shows the representation in powerful position methods of assessing power.

Source; ICFAI Research Center

Assessing power of external stakeholders

The indicators to assess the power of external stakeholders are:

The status: The status of the external stakeholders like suppliers of raw materials, distributors, and financial institutions can be assessed through the timeliness of response and the extent of demands that are met by the organization.

Resource dependence: Resource dependency can be measured by the proportion of the organization's business with a single distributor, proportion of the raw material supplied by a supplier to the total raw materials required by the organization, etc.

Negotiating arrangements: The power of the external stakeholder can be assessed through whether the stakeholder invited for negotiation is allowed to interact closely or treated at arm's length.

Symbols: Symbols are equally valuable clues. The symbols that are used to assess the power of external stakeholders include the level of the manager who deals with the stakeholder, the nature of expenses incurred on the stakeholders for relationship building and business entertainment, etc.

12.8 Culture and Change

Few environments are stable for a prolonged period of time. Thus, if an organization is to survive, managers must take actions that enable an organization to adapt to environmental changes. If they do not take such an action, they may find themselves faced with declining demand for their products.

Two distinct cultural settings, namely adaptive cultures and inert cultures, are observed in many organizations. Adaptive cultures are those that are innovative and encourage and reward initiative taking by middle and lower level managers. On the other hand, inert cultures are those that are cautious and conservative, that do not value middle and lower level managers taking such action, and may actively discourage such behavior.

Managers in organizations with adaptive cultures are able to introduce changes in the way the organization operates, including changes in its strategy and structure that allow the organization to adapt to changes occurring in the external environment. This phenomenon does not occur at organizations with inert cultures. As a result, organizations with adaptive cultures are more likely to survive in a changing environment and have higher performance than organizations with inert cultures.

In an organization, an inert culture may lead to the failure of strategic management. For instance, if top managers accept the same set of norms and values, the danger arises that they will be unable to steer the organization in a new strategic direction if the environment change occurs and new competitors or technology demand such a change. Moreover, having designed their structures, managers became used to the way they operate, and they rarely recognize the important effect structure has on cultural norms and values. Thus, organizational culture can promote inertia.

Another issue that distorts the decision-making process is cognitive bias. Over a period of time, the norms and values of an organization's culture can bias decision making and cause managers to misperceive the reality of the situation facing their organization. To prevent these strategic leadership problems, great care needs to be taken in composing the top management team.

Check Your Progress - 3

9. Which of the following is the leader's ability to influence others through personal magnetism, enthusiasm, and strongly held convictions?
   a. Charisma
   b. Expertise
   c. Internal integration
   d. Discretion
10. Which of the following cultures are innovative and encourage/reward initiative-taking by middle and lower level managers?
    a. Adaptive
    b. Inert
    c. Conservative
    d. Top-down

Activity 12.3

Insightful leaders in an organization nurture key themes or dominant values that reinforce the organization's mission and strategic objectives. Explain this link between strategy execution and organization culture with an example.

Answer:

12.9 Summary

- The purpose of organizational culture is to enable internal integration and external adaptation.
- Values are basic assumptions about which ideals are desirable or worth striving for.
- Values and beliefs have more personal meaning if an individual complies with the set of values as a guide to appropriate behavior in the organization. When these are shared across the organization, they constitute a meaningful value system of an organization.

- A combination of prior assumptions and new learning experiences determines the contents of a culture. For successful execution of strategy, leaders typically attempt to manage and create a distinct culture within their organizations through a variety of ways.
- Some common methods for this institutionalization are: emphasize key themes or dominant values; encourage dissemination of stories and legends about core values; institutionalize practices that systematically reinforce desired beliefs and values; and adopt very common themes in unique ways.
- Cultural diversity, both domestically and internationally, is something that most managers will experience due to differing backgrounds. Organizational culture must recognize cultural diversity – the reality of present global organizations.
- All forms of organization structures are not equally effective in the implementation of a strategy due to many cultural differences.
- Organizational growth and diversification necessitate simultaneous changes in structure and culture.
- Organizational culture is the product of the style of leadership/management. First, organizational culture is created by the strategic leadership provided by an organization’s founder and top managers. Second, the leadership style established by the founder is transmitted to the organization’s managers, and as the organization grows, it typically attracts new managers and employees who share the same values.
- The sources of power can be divided into two broad categories -- internal sources (hierarchy, influence/charisma, control of strategic resources, expertise/knowledge/skill, control over the environment, and exercise of discretion) and sources for external stakeholders (resource dependence, involvement in implementation, expertise, and internal links).
- It is quite difficult to accurately assess the power of internal individuals or groups and external stakeholders. However, a good way of assessing power is to depend on indicators of power.
- Two distinct cultural settings -- adaptive cultures and inert cultures, are observed in many organizations.
- Adaptive cultures are those that are innovative and encourage and reward initiative-taking by middle and lower level managers. Inert cultures are those that are cautious and conservative, that do not value middle and lower level managers taking such action, and may actively discourage such behavior. In an organization, an inert culture may lead to the failure of strategic management.

12.10 Glossary

McKinsey 7-S Framework: A framework that states that an organization's culture (shared values) should have a good fit with its strategy and other factors such as structure, systems, management style, and human resources (staff and their skills).

Shared Values: The values common to the members of the organization.

Power: An extent to which an individual or a group is able to persuade, induce, or coerce others into following certain courses of actions.

Values: Basic assumptions about which ideals are desirable or worth striving for.

12.11 Self-Assessment Test

1. Explain the significance of organizational culture to strategy execution. How can a desired culture be institutionalized in an organization?
2. Discuss the relationship of culture to strategy execution through structure, style of management, and power.
3. How are culture and change interrelated to one another?

12.12 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

12.13 Answers to Check Your Progress Questions

1. (b) Intangible, action

An organization's culture is equivalent to an individual's personality. It is an intangible, ever-present theme that provides meaning, direction, and the basis for action. Just as personality influences the behavior of an individual, the culture influences the opinions and actions within a firm.

2. (d) **Shared values, culture**

The McKinsey 7-S framework comprises structure, systems, style, staff, skills, shared values, and strategy where shared values form the nucleus of the framework. The framework highlights the importance of shared values leading to the culture of the organization as a whole. Shared values are the values which employees by and large believe in and they help in guiding action within the organization.

3. (c) **Both internal integration and external adaptation**

According to Richard L. Daft, the purpose of organizational culture is to enable internal integration and external adaptation.

Purpose	**Contribution Mechanism**
Internal integration	• Gives a collective identity to employees and clarifies how employees relate to each other • Contributes to effectiveness of performance by guiding working relationships, by ensuring communication among employees, and by allocating power and status • Determines what are the acceptable norms of behavior at the workplace • Guides decision making by employees if policies and procedures are not laid down clearly on how a particular situation should be addressed
External adaptation	• Helps the organization respond to customer needs • Helps the organization respond to competitors' strategies and tactics

4. (a) **Only i, ii, and iii**

There are three basic determinants of organizational culture. First, the influence of the business environment in general and the industry in particular. For instance, companies in industries characterized by rapid technological change, such as software, electronic, and computer companies normally have cultures that strongly value innovation. Second, founders, leaders, and managers bring a pattern of assumptions with them when they join the organization. These assumptions often depend on those individuals' own experiences in the culture of the national, regional, ethnic, religious, occupational, and professional communities to which they belong. Third, the actual experience people in the organization have had in working out solutions for coping with the basic problems the organization encounters molds shared assumptions. Taken together, these three principle sources suggest that the content of culture derives from a combination of prior assumptions and new learning experiences.

5. (c) Beliefs, values

An organizational member can simply be aware of the beliefs and values of the organization without sharing them personally. The beliefs and values have more personal meaning if the member views them as the guiding principles for appropriate behavior in the organization by complying with them.

6. (d) i, ii, iii, and iv

Some typical beliefs that shape organizational culture are: a belief in being the best, a belief in superior quality and service, a belief in the importance of people as individuals and a faith in their abilities to make a strong and effective contribution, and a belief in the importance of the details of execution – the nuts and bolts of doing the job well. For example, at Toyota, a world leader in automobiles, all these beliefs shape its organizational culture.

7. (a) Cultural diversity, differing

Cultural diversity, both domestically and internationally, is something that most managers will experience due to the differing backgrounds of the employees which is the result of global acquisitions and mergers.

8. (a) All forms of organization structures are equally effective in the implementation of a strategy due to many cultural diversifications.

Due to many cultural diversifications, all forms of organization structures are not equally effective in the implementation of a strategy.

9. (a) Charisma

Influence, an important source of power, arises from personal qualities like charisma of the leader. Charisma is the leader's ability to influence others through personal magnetism, enthusiasm, and strongly held convictions. Leaders communicate these convictions and their vision for the future through a dramatic, persuasive manner of speaking. Charismatic leaders create an image of competence and success. Their personal magnetism makes them role models for their employees, thus influencing the overall organizational culture. The more the followers admire their leaders, the more likely they are to accept their leader's values and beliefs.

10. (a) Adaptive

Two distinct cultural settings, namely, adaptive cultures and inert cultures, are observed in many organizations. Adaptive cultures are those that are innovative and encourage and reward initiative-taking by middle and lower level managers. On the other hand, inert cultures are those that are cautious and conservative, that do not value middle and lower level managers taking such action and may actively discourage such behavior.

Unit 13

Strategic and Operational Control

Structure

"There's no magic formula for great company culture. The key is just to treat your staff how you would like to be treated."

- Richard Branson, (Founder, Virgin Group)

13.1 Introduction

Richard is actually saying leaders should treat employees in a way how he/she himself/herself wants to get treated. This approach would give fair control over strategic and operational activities between leaders and subordinates.

In the previous unit, we have discussed strategy execution and organization culture. In this unit, we shall discuss strategic and operational control.

In management, control systems are broadly concerned with the attainment of goals and implementation of strategies. Management control has been defined as "a process whereby management and other groups are able to initiate and regulate the conduct of activities so that their results accord with the goals and expectations held by those groups." The control system should induce effectiveness and efficiency in the different functions and responsibility centers. At the same time, it should allow employees the freedom to be creative, innovative, and responsive to the external environment of the business.

This unit shall first discuss the concept of control systems in management. We shall then move on to discuss the specifics of strategic control and operational control. Finally, we shall discuss the important management tools like balanced scorecard, benchmarking, and re-engineering.

13.2 Objectives

By the end of this unit, you should be able to:

- Discuss the concept of control systems in management.
- Explain the specifics of strategic control and operational control.
- Discuss three important management tools – Balanced Scorecard, benchmarking, and re-engineering – that are relevant for strategy execution.

13.3 Control Systems – An Overview

A management control system (MCS) is "a set of interrelated communication structures that facilitates the processing of information for the purpose of assisting managers in coordinating the parts and attaining the purpose of an organization on a continuous basis." It may also be viewed as a collection of controls that are used to address one or all of the following situations:

- Managers and employees do not have a clear idea of what is expected of them;
- They have a fair idea of what is expected but do not feel motivated, that is, conditions in the organization (for example, reward system) fail to provide an impetus for performance; and
- In spite of knowing about the expectations and having sufficient motivation for performance, managers and/or employees are not able to perform.

An MCS assists the management in formulating strategies, coordinating the activities of the organization, and in steering those activities toward the achievement of the overall goals and objectives. Certain established performance measures are used to assess whether organizational activities are in keeping with the goals and objectives.

Designing an optimal MCS is important for the effectiveness and long-term sustainability of an organization: a very low degree of control can result in confusion and chaos; on the other hand, too great a degree of control can result in eroding creativity and entrepreneurship. The effectiveness of a control system is evaluated by comparing the probability of achieving organizational objectives where a control system does not exist with the increased probability or assurance of achievement when the control system is implemented. This increased assurance, which is referred to as the 'degree of certainty' derived from the system, is the benefit derived from the control system.

The 'degree of certainty' is described in terms of its 'control tightness' or 'control looseness'. Tighter control aims for a higher 'degree of certainty' and is often (but not always) accompanied by a higher cost of control. In designing an MCS, it must be seen that each of the controls used has a good 'fit' with others and that the controls are used in the right balance to promote efficacy and learning. It is essential that there exists a fit between the MCS and the internal environment. The system should also fit in with the organization's external environment to a considerable extent.

13.3.1 Levers of Control

Managers have to strike the right balance between empowerment and control. Managers must find ways to encourage employees to be creative and to initiate process improvements, but must still retain enough control to ensure that employee creativity benefits the organization. To address this issue, the concept of 'levers of control' was proposed by Robert Simons in 1995. According to him, diagnostic control systems, beliefs systems, boundary systems, and interactive control systems are the four levers of control used in management. Refer to Table 1 for an overview of the four levers of control.

Table 1: Levers of Control

Organizational problem	Managerial solution	Lever of control
Lack of focus or resources to accomplish objectives	Communicate clear targets; provide the necessary support and feedback	Diagnostic control systems
Ambiguity of purpose	Convey core values and mission	Beliefs systems
Pressure or temptation to act illegally or unethically	Indicate and enforce rules	Boundary systems
Suppressed creativity due to lack of prospects or fear of risk	Open communication between functions to encourage organizational learning	Interactive control systems

Adapted from Simons, Robert. "Control in the Age of Empowerment." Harvard Business Review. Vol. 73 Issue 2, Mar/Apr 1995, p83.

All the four levers of control are linked. Having just the diagnostic control system or the beliefs system in place will not help in bringing about better performance. The four levers of control can help managers not only in motivating people to be creative but also in enforcing the control systems of the organization effectively.

Interactive control systems

Interactive control systems like performance management, budgeting, and brand management are futuristic and involve frequent communication between top managers. These help organizations position themselves strategically in the rapidly changing market. The top management chooses which of them are to be focused on to bring about the necessary control in the organization.

There are four characteristics of interactive control systems. First, they focus on dynamic information like technologies, government policies, competitor activities, and customer preferences. Second, this information is important to all the managers at all organizational levels. Third, the information or data generated by the interactive control systems has to be discussed at open meetings between all organizational levels. Fourth, these systems help in healthy discussions about the assumptions of the top management and action plans intended. Interactive control systems help trigger better action at the management level as they provide information about future challenges that the organizations may face. They may also help in building trust between the top management and the other levels in the organization.

13.3.2 Control Alternatives

Experts have proposed different schemes for classifying management controls, of which three have been discussed here. They are: based on the object of control (action controls, results controls, and personnel/cultural controls); based on the extent of formalization of control (formal control and informal control); and based on the time of implementation of controls (open loop control and closed loop control).

Action controls are aimed directly at the actions which take place at different levels of an organization. Results controls are focused on the consequences of actions taken rather than on the actions themselves. Personnel/cultural controls influence the people and the organizational culture, with the expectation that the right people in the right culture will perform the right actions that will ultimately yield the desired results.

Action controls

This class of controls tries to ensure that all actions being taken by the personnel in an organization are aimed at achieving the organization's objectives. At the same time, it attempts to ensure that all activities which are either non-beneficial or counter-productive to the attainment of objectives are avoided. Hence, it may be said that these controls encourage the right actions and detect/prevent wrong actions.

This class of control may be implemented in one or more of the following three forms: behavioral restrictions, pre-action appraisal, and action accountability. Behavioral restrictions are limitations placed on the behavior of organizational personnel and are a form of negative discipline. Pre-action appraisal involves a supervisor reviewing a subordinate's plans of action before the action is taken. Action accountability entails making employees responsible for their actions and in essence is applicable after an action has been carried out.

Results controls

Unlike action control, where actions are restricted to avoid undesirable actions from taking place, results controls do not place any such restriction. They empower individuals and groups to use their discretion in doing what they feel are best for the organization. The emphasis in this type of control is not on the action itself but on its repercussions on the organization as a whole. The outcome or output of action is the focus of control based on which a reward system is put in place. Individual rewards often accompany results controls to motivate individuals to perform well in the hope of earning rewards.

Personnel/Cultural controls

Personnel/cultural controls aim at encouraging employees to monitor themselves and others with whom they work. These controls co-exist with action and results controls or are used in organizations to control aspects in which action and results controls are not effective or sufficient. Employees are empowered to direct themselves and their peers within and outside their own groups.

These controls are established in a manner that certain culture, values, beliefs, and norms of behavior become intrinsic to the organization as a whole. It is to be ensured that the right people are placed in the right positions, and provided with the right resources. It is also to be ensured that the job is designed keeping in mind the person to whom it is being allotted. Establishing a reward system which commends group achievement is suitable for personnel/cultural controls, rather than rewards based on individual performance. Group-reward systems enable the focus to shift to a group effort which motivates members of a group to monitor themselves and the others in the group.

Designing a control system

Depending on the situation, various combinations of controls may be used in an MCS. The type of controls that is required in an organization will be dependent on the purpose for which the management controls are being used. As a single type of control cannot usually address all problem areas in management, it is appropriate that various types of control coexist in an organization.

Designing an MCS involves an understanding of the expectations from the organizational units and employees in terms of either the key actions (what activities the unit must perform in order to have the greatest possibility of success), or the key results (the outcome the unit must achieve for the organization to succeed), or both. It is also important to anticipate the likely actions and results in the absence of the control system.

Depending on the degree of variance between the ‘desired’ and the ‘likely’, and the resources available to meet the costs of control, the management has to make decisions regarding the control alternatives which will constitute a control system and the extent of tightness or looseness with which they are to be implemented. After deciding on the set of control alternatives, the organization’s policies and practices should be framed and implemented to fit the control alternatives.

The modern MCS seeks to reasonably answer contextual issues that impact an organization's short-term success and long-term survival by integrating the diverse activities of the organization. It deals with detecting environmental variables that can significantly affect organizations, ensuring effective resource utilization, sustaining competitive advantage, translating corporate goals into business unit objectives, maintaining transparency and clarity of financial reporting, and preserving conformity with the relevant regulatory framework. It is also concerned with operational efficiency issues. An adaptive MCS facilitates organizational learning and the adoption of new strategies (where required) with the external environment in focus, and making innovations which lead to improved processes and better responsiveness to the market conditions.

Example

Google Moderator is a management tool that allows Google employees to get involved in meetings by asking questions, voting up questions and generally being involved in new ideas. Google also allows engineers to spend 20% of their working week on projects that interest them personally. This is a great way of encouraging employees to explore their own ideas and bring new services and products to the company.

Google employees set goals for themselves and their performance is rated on a five-point scale that ranges from 'Need Improvement' to 'Superb'. Google employees are reviewed by peers and also by junior employees. The top management finally reviews the performance based on how the employee could improve and contribute better to the company. Google's people policy believes in employee empowerment to encourage innovation culture. The conducive environment and the team spirit drive employees towards self-improvement. Thus, this control scheme has created appropriate culture and team spirit as its primary objective.

Source; ICFAI Research Center

Activity 13.1

What type of controls would you recommend to design a control system for the creative team in a company that creates multimedia/animation films in the entertainment industry?

Answer:

13.4 Strategic Control

The control mechanisms that increase the organization's probability of achieving its strategic objectives are collectively referred to as strategic control. Strategic control can be discussed under the following topics: critical success factors and controls, performance measurement for strategic control, and establishing strategic controls.

13.4.1 Critical Success Factors and Controls

According to John F. Rockart, critical success factors (CSFs) are the limited number of areas in which results, if they are satisfactory, will ensure successful competitive performance for the organization. They are the few key areas where things must go right for the business to flourish. These are the areas of activity that should receive constant and careful attention from management. CSFs, if ignored, will lead to eventual failure of the organization. The organization has to control its performance to address the needs placed on it by these factors.

Each industry, and in turn, each organization has a different set of CSFs. CSFs differ depending on the mission and strategic goals of an organization. Strategic controls ensure that the mission is properly aligned with the strategic goals. All the CSFs are interrelated to each other and should be attended to by the organization in order to have a competitive advantage in the marketplace. For example, for a grocery retail chain, 'the ability to source farm fresh vegetables at low prices' and 'store location' could be two of the CSFs. And in the case of a consumer electronics manufacturer, 'sustainable customer relationships with distributors' and 'cutting edge research and development' could be CSFs.

CSFs, as a control function, indicate to the management the need to take timely action. Organizations should identify about five or six CSFs that would help them achieve their strategy, goals, and objectives. Once identified, the organization can depend on them to monitor business activities and be ready to face the changes in the business environment that could drastically affect the attainment of management goals. After deciding on the CSFs, the organization should track the activities that would help in achieving them and monitor their performance. Performance measures help in: finding out whether the approach taken to address the CSFs is appropriate or not; achieving a more stable performance; and defining the employees' accountability.

Example

When Vistara Airlines, a joint venture between Tata Sons and Singapore Airlines, was launched, it was struggling to fill its seats. However, with reconfigured airline space, aggressive pricing policy, new marketing campaigns, the performance scenario of the airline has changed for the better.

Contd....

Vistara, which was launched as premium airlines, reduced its cabin size, premium economy seats and increased economy class seats. Ever since all these changes have been made, Vistara has been able to fill up 80% of its seats, in spite of increasing its weekly flights by 90% (from 176 flights to 334 flights). Customer feedback has also been very positive for Vistara. In the case of an airlines like Vistara, better utilization of aircraft space, right pricing, suitable marketing campaign etc. are CSFs. By getting them right, a company can improve its performance drastically.

Source; ICFAI Research Center

13.4.2 Performance Measurement for Strategic Control

Performance measures can be of three types – performance indicators (PIs), key performance indicators, and key result indicators. PIs reveal the organization's or the business unit's performance. There might be a variety of PIs in different areas. For instance, production PIs could be plant efficiency rates and machine downtime rates.

PIs act as control tools by describing what is to be done, where to achieve the desired results or outcomes, and by identifying the specific areas that need control intervention to enhance organizational performance. PIs can be either lead indicators (performance drivers) or lag indicators (outcome indicators). PIs can be recognized by identifying the variable that is being measured and by understanding whether it is a single variable's performance that is being measured or the performance of collective variables in a single indicator.

The middle management may be interested in a PI that reflects a single variable's performance (e.g., machine downtime). However, the top management may be interested in a PI that indicates the collective performance of a number of variables in a single indicator (e.g., plant efficiency). Good PIs are SMART, that is, Specific, Measurable, Attainable (Achievable), Realistic, and have a Time perspective. The frequency of monitoring PIs has shifted from periodic intervals (weekly or monthly) to a continuous or daily basis with the emergence of concepts like TQM and continuous improvement, and improvements in information systems and technology.

Key Performance Indicators (KPIs)

KPIs deal with aspects which when enhanced would result in radical performance improvements and would lead to a cascading improvement in most of the other PIs. They have an impact on all the key result areas of the organization. Better results from KPIs would result in better organizational performance. The top management uses KPIs as yardsticks or measures to monitor and control the organization's performance.

KPIs are identified from the PIs based on the strategic nature of the indicator considering the industry to which the organization belongs. Here, strategic nature refers to the indicator's ability to include performance measurement of multiple factors, both internal and external to the organization. Thus, KPIs for organizations will vary from industry to industry.

KPIs also vary from organization to organization within an industry depending on the strategic positioning of the organization in terms of the need fulfillment of customers (and other stakeholders), that is, what is being satisfied, and how it is being satisfied. A KPI can be identified from a set of PIs based on how it reflects the performance parameters of several CSFs and based on how it reflects in totality the effect of other PIs.

Characteristics of key performance indicators

- KPIs are generally non-financial in nature. For example, in a dine-in restaurant, the occupancy level may be a KPI.
- These are usually measured at short intervals of time like 24/7, daily, or weekly.
- Top executives should devise KPIs in such a way that they are understood and effectively utilized by employees at all levels in the organization. Both teams and individuals are held responsible for the KPIs.
- KPIs have a major effect on most of the CSFs and they have a positive impact on most of the PIs.

Key Result Indicators (KRIs)

KRIs emerge from the organization's activities. They indicate whether the approach toward achieving performance is appropriate but do not indicate a means or method to achieve better performance or outcomes. KRIs are indicators of the quality of the results achieved by the organization and are predominantly used for enforcing action accountability (after the action has been completed). These are measures that are useful for the governance aspect of the organization and are generally reported to the top management or the board and are monitored on a monthly or quarterly basis. Return on capital employed and profitability are examples of KRIs used by many organizations.

13.4.3 Establishing Strategic Controls

Strategic control focuses on monitoring and evaluating the strategic management process to ensure that it moves in the right direction. In other words, strategic control is concerned with tracking the strategy when it is implemented, detecting problems or changes in underlying premises, and making necessary adjustments.

Strategic control answers questions such as -- Are the organization's internal strengths still holding good? Are its internal weaknesses still present? Has the organization added other internal strengths? Does it have other weaknesses?

Are there new opportunities? Do the threats to the organization still exist, and are there any new threats? Are the decisions consistent with the organizational policy? Are there sufficient resources to achieve the objectives? Are goals and targets being met? and Are the organizational vision, mission, and objectives appropriate to the changing environment?

Thus, strategic control provides feedback about the various steps of strategic management. It enables the management to find out whether the strategic management process is appropriate and compatible with organizational goals and whether it is functioning in the desired direction. Sometimes, strategic controls may initiate changes in objectives as well. Strategic controls can be established in the form of premise control, implementation control, strategic surveillance, and special alert control.

Premise control

Premise control involves checking whether the assumptions on the basis of which a strategy was formulated are still valid or not. The assumptions are the premises, and in premise control, premises are checked systematically to check if they are still valid. Premise control is concerned with two types of factors – environmental factors and industry factors.

Environmental factors: Environmental factors are those over which a firm has little or no control. However, these factors have an impact on the firm's operations. These can be classified as Economic, Social, Political, and Technological factors. Examples are inflation, technology, interest rates, government policy, demographic/social changes.

Industry factors: Industry factors are the competitors, the suppliers, the customers, the substitutes, and the barriers to entry into the industry. Every industry will have a different set of interplay among these factors and will differ from industry to industry. These factors have a bearing on the performance of the firms operating in the industry.

Based on environmental factors and industry factors, various premises are made and referred to as bases for strategy formulation. Some of these premises are static in nature while others are dynamic. For premise control, the dynamic premises which are likely to have a major impact on the firm and its strategy need to be considered. Managers have to keep track of the premises and they need to respond in case of any change in them. For instance, in the highly volatile consumer durables industry, if a firm's competitor reduces the prices by 10%, then the firm's managers must be able to counter that quickly, even though at the time of strategizing, the premise was that the competitor will not reduce prices.

Implementation control

Implementation control deals with putting into action the devised strategy over a period of time. It ensures that appropriate resources -- human or otherwise -- are mobilized and allocated. In general, goal setting is done for specific units and individuals, and control is exercised by periodically reviewing progress against these goals. There are two special types of implementation control: monitoring strategic thrusts, and milestone reviews.

Monitoring strategic thrusts: The overall strategy for which a firm strives is broken down into smaller components for implementation; these smaller components are referred to as strategic thrusts. By monitoring these strategic thrusts, the strategic performance of the firm can be controlled.

Milestone reviews: Milestone reviews are timeline-based reviews related to either the occurrence of critical events or resource allocations. In milestone reviews, a review is done at certain specified points of time to control the performance of the firm. It is seen whether the critical events which were supposed to be completed have been completed or not.

Strategic surveillance

Strategic surveillance is designed to monitor a broad range of events inside and outside the company that are likely to threaten the course of firm's strategy. It is a form of general monitoring through multiple information sources. The specific intent of strategic surveillance is to uncover important, yet unanticipated, information. Surveillance must be kept unfocussed as much as possible and should be designed as a loose 'environmental scanning' activity. Trade magazines, trade conferences, as well as intended and unintended observations are common sources for strategic surveillance.

Special alert control

Sudden events in the environment can make a firm change its strategy. For a firm to be able to cope with such changes, special alert controls or triggers should be in place. The environmental factor could be the launch of a technologically superior product by a competitor. When Apple, Inc. launched the iPhone with a touch-screen and other distinguishing features, it immediately had an impact on all the players in the industry. The special alert control reflects the need to reconsider the firm's basic strategy. Special alert controls are considered to be most effective when they are able to detect the event before it actually occurs and so minimize the crisis.

Example

Walmart year-over-year sales growth from e-commerce was 40% at Walmart US. Walmart's E-commerce division has benefited from the expansion of its grocery pickup and delivery efforts as well as a broader online assortment. Ever since Amazon's grocery sales increased, eating into Walmart's market share and sales, Walmart has been aggressively pursuing an 'online-forward strategy', laying down ambitious e-commerce growth targets.

Contd….

The company was quick to be alerted by Amazon's inroads into its territory and it also made acquisitions to push its e-commerce strategy. Encouraged by the 40% e-commerce growth rate, industry experts say that the high growth rate signals that Walmart may have the competitive strength to compete with Amazon. The control system in Walmart sent out the message that it was losing business to E-Commerce giant Amazon. Hence, Walmart was quick to pursue 'an online-forward' strategy.

Source; ICFAI Research Center

Check Your Progress - 1

1. Critical success factors are those factors which the organization cannot ignore and it has to control its performance to address the needs placed on it by these factors. Which of the following statements is **not** true regarding critical success factors?
   a. They are the areas of activity that need constant and careful attention from management.
   b. They are the few key areas where things must go right for the business to flourish.
   c. All industries have a common set of critical success factors irrespective of their mission and strategic goals.
   d. The number of critical success factors selected should not be more than five or six.
2. Performance measures are required for the organization to know whether the approach it has taken to address its critical success factors is appropriate. Match the following factors in the BPO industry with the type of strategic performance control devise that they refer to.
   i. Ability of the BPO to sustain a customer base
   ii. First call resolution and response time
   iii. Return on capital employed
   p. Key performance indicators
   q. Key result indicators
   r. Critical success factors
   a. i/p, ii/q, iii/r
   b. i/q, ii/r, iii/p
   c. i/r, ii/p, iii/q
   d. i/q, ii/p, iii/r

3. Match the following types of management controls (based on the object of control) with their respective descriptions.

   Type of control

   i. Action controls

   ii. Results controls

   iii. Personnel/cultural controls

   Description

   p. These controls empower individuals and groups to use their discretion in doing what they feel are best for the organization.

   q. These controls aim at encouraging employees to monitor themselves and others with whom they work.

   r. They may be implemented in the form of limitations placed on the behavior of organizational personnel and are a form of negative discipline.

   a. i/r, ii/p, iii/q

   b. i/q, ii/r, iii/p

   c. i/q, ii/p, iii/r

   d. i/r, ii/q, iii/p

13.5 The Balanced Scorecard

Organizations should combine both financial as well as non-financial measures to gain a complete picture of their overall performance. The BSC, proposed by Robert Kaplan and David Norton in 1992, helps organizations in strategic performance control by considering financial and non-financial measures; short-term and long-term goals; the organization's market performance and internal improvements; past outputs and ongoing requirements; etc. It also helps the organization in strategic learning.

The BSC framework considers four perspectives – customer, internal business, innovation/learning and growth, and financial – which are observed and evaluated in a combined manner. For instance, apart from the net profit margin, factors like new products, quality of product and/or service, and quality of customer service provided, give a clear picture of the organization's performance.

13.5.1 Customer Perspective

The customer perspective in BSC is concerned with the business objectives of attracting, satisfying, and retaining profitable customers/consumers in the chosen target segments. Attaining these objectives would enable the organization gain the targeted market share in terms of volume and/or value. Here the underlying question would be ‘To achieve our vision, how should we appear to our customers?’. Quality, time, performance and service, and cost are the four factors influence the customers’ perception of the value delivered by an organization’s product or service.

- *Quality*: Enhanced quality would reduce the defects that the products have, which in turn, creates a better image of the organization in the minds of the customers.
- *Time*: Taking less time to respond to customers’ requirements consistently is considered critical in acquiring and retaining customers’ loyalty.
- *Performance and service*: This aspect helps in determining the value addition that a customer gets on using the product/service.
- *Cost*: This factor deals with reducing the costs of orders, delivery, etc.

Example

Amazon is a multibillion-dollar e-commerce retail brand. Amazon has created, tested and perfected its customer service model ‘Amazon Prime’. Amazon Prime is a subscription service that gives members access to highly valued benefits like access to ‘Amazon prime video’, free 2-day shipping on purchase of Amazon products, access to exclusive Prime deals, etc. Jeff Bezos, CEO of Amazon, in his letter to shareholders said, “We want Amazon Prime to be of such value that a customer should feel irresponsible if he weren’t a member. Loyal customers are exactly what you want. They buy more, tell others about you, and they cost less to service and maintain. It's a win all around”. In the Amazon case, through ‘Amazon Prime’, the company is providing a high value service to attract and satisfy customers and build customer loyalty (Customer perspective).

Source; ICFAI Research Center

13.5.2 Financial Perspective

The financial perspective looks at the financial health of the organization. It is concerned with increase in revenue, productivity, and profitability; reduction in costs; and better utilization of the organization’s assets in monetary terms. Here the underlying question would be ‘To succeed financially, how should we appear to our shareholders?’. Shareholders get the necessary information about the health of the organization when they look at the measures under the financial perspective. Sales turnover, earnings per share, and net profits are some of the financial indicators of the organization’s performance. As financial results at a point of time are the outcomes of performance on the other perspectives at an earlier point of time, measures of financial performance are termed as ‘lagging indicators’.

13.5.3 Internal Business Process Perspective

The internal business process perspective deals with the processes, decisions, and actions that influence customer satisfaction, and are internal to the organization. Here the underlying question would be 'To satisfy our customers and shareholders, at what business processes must we excel?'. Cycle time, quality, and employee skills are some of the internal factors, which are broken down to the individual employee level.

Every employee is given a specified target in terms of quality, cost, time, and service, which when reached, leads to the achievement of the corporate objective. This helps in creating a greater sense of accountability among the employees. Besides, it ensures that the employee targets or goals are aligned with the broad corporate objectives of bringing out improved products, improving the internal and external processes, and after-sales service for the customers.

13.5.4 Innovation/Learning and Growth Perspective

Organizations should regularly improve their existing products and processes and should also come out with new products. This strategy helps the organization to manage business in a changing environment. Here the underlying question would be 'To achieve our vision, how will we sustain our ability to change and improve?'. The ability to come out with new products, enhance and upgrade the existing processes, and enhance employee capabilities depends on the organization's value systems. The shareholder value increases only when the organization grows by capturing newer markets, developing new products, improving operations, and enhancing the customer value proposition.

13.5.5 Implementing the BSC

An organization that lays stress only on short-term or financial goals cannot successfully carry out its strategies and excel in business. BSC serves as a tool for strategic performance control. It clarifies the organization's vision and strategy, and expresses the expectations of the top management through clearly defined strategic objectives and related performance measures. These strategic objectives and measures are communicated throughout the organization in order to align the objectives of the organization with those of the individuals. They are also expressed in terms of more detailed, operational objectives at the department level, group level, or individual level.

Once the individual and organizational objectives have been aligned, a business plan is devised. This plan helps the organization create a link between the short-term goals, long-term objectives, and the financials. The top management continuously monitors performance to assess whether the planned strategies are being successfully executed and to learn whether there should be a change in the strategy itself.

Activity 13.2

The Balanced Scorecard (BSC) is a measure of the key elements of a company's strategy, ranging from continuous improvement and partnerships to teamwork and global spread. Explain, with the help of an example, how the deployment of the Balanced Scorecard would benefit a company.

Answer:

13.6 Operational Control

Operational control systems help operating managers to implement strategy at their level. These systems help to guide, monitor, and evaluate progress in meeting the annual objectives of the company. They provide post-action evaluation and control over short time periods (usually one month to one year). For operational control systems to be effective, the following four steps are usually taken -- set standards of performance, measure actual performance, identify deviations from standards, and initiate corrective action or adjustment.

Example

Myntra is a Bangalore-based Indian fashion e-commerce company. The Walmart owned e-commerce company, Myntra, faced a huge problem on account of return of purchased products by customers. Since Myntra offered free-return, its customers too made use of the facility to return and this was creating operational problems. In a bid to reduce the high level of returns, Myntra offered customers additional discounts on purchases if they choose not to return the products that they ordered. Customers could thus benefit by availing extra discounts by making good purchase decisions. Myntra changed the purchase return policy by incentivizing customers (with a higher discount) who opted for not returning products that they ordered. Since customers still had a choice, there was no reason for them to be unhappy. Myntra's new policy of discouraging purchase returns is an operational control tool that would enable them to save costs incurred on reverse logistics.

Source; ICFAI Research Center

13.6.1 Corporate Resource Planning

Corporate resource planning relates to the allocation of resources between various parts of the organization together with corporate investment decisions concerning the acquisition of additional resources. If investment funds are limited, their allocation will be based on the strategic importance of the various spending opportunities.

Also, the financial evaluation of the viability of each project has to be considered. If funds are not available, they need to be borrowed to finance the projects. In such a case, the return on investment should exceed the cost of capital. Companies should seek the best possible returns from investments because they may be seen as undesirable but necessary freezing of corporate funds. Sometimes, managers see investments as a reflection of status, especially if they are invested in new plant and technologically advanced equipment. In this case, there would be a sub-optional allocation of corporate resources.

The organization structure forms a basis for allocating corporate resources. For a multidivisional organization, the extent of decentralization will determine the freedom that is given to general managers to allocate resources amongst their functional managers and departments. If the power to change strategies is delegated, authority is required to change resource allocations. Sometimes, additional resources need to be acquired from outside the organization. In such cases, the resources must be allocated to those areas that are most significant in the creation of competitive advantage.

If strategic resources are located centrally, but are used by various divisions, then their effectiveness needs to be carefully monitored. The resources should be allocated to the areas in which they can yield the greatest benefit for the organization.

Corporate resource planning and organizational growth

Resource allocation at the corporate level is closely tied to the planning system. The corporate resources may be allocated in different ways, in line with the degree of stability in the environment and the speed of growth in the organization. The various factors to be considered are:

Rapid growth: Where the business is growing rapidly, the resource allocation process must be able to accommodate the continual demand for additional resources. The resource allocation process could be centralized, decentralized, or both. In any case, the decisions should balance the potential financial gains with the strategic logic implied.

Limited change and stability: Where businesses are growing more steadily and in a relatively stable environment, resource allocation for continuing programs could be a straightforward extrapolation of previous budgets.

Decline situations: When business units are in the decline stage, the strategic leader must search for new opportunities for re-deploying resources such as by transferring resources to activities with better growth and profit potential.

Once resources are allocated to divisions, they would be further allocated to individual managers within each area. This allocation will be delegated to the general manager or functional manager in charge of each division or function.

13.6.2 Budgets

Resource allocation requires planning and controlling. Most organizations do this by using the budgeting method. Budgeting is an instrument for putting plans and policies into effect for the achievement of objectives, thereby acting as a major means for implementing organizational strategy. The budgeting function generates formal written statements called budgets. Budgets are financial statements of the resources required to achieve a set of finite, short-term objectives, or put into action a formulated strategy. They represent the organization's objectives in monetary terms. They indicate how much should be spent, by which department/ program/ project/ product/ division, when, and for what purpose.

Budgets involve the allocation of resources to individual managers who are responsible for the completion of particular tasks. Budgets are assigned to individual products and business units. Unless the future prospects and viability of products and business units are evaluated objectively, budgeting may become more financially-oriented than strategic. Budgets help managers coordinate operations, and facilitate managerial control of performance. They also provide a basis for negotiating short-term resource requirements to implement strategy at the operating level. Most firms use the budgeting system to control strategy implementation.

Organizations have several types of budgets that are combined into an overall master budget. The most common types of budgets that translate company objectives are revenue budgets, capital budgets, and expenditure budgets.

Revenue budgets

A revenue budget provides for the daily management of financial resources. It also provides key feedback as to whether the strategy is working or not. A sales budget is one such revenue budget; it gives a formal and detailed expression of the sales forecast. This sales forecast is the cornerstone of planning and also acts as the foundation for budgetary control. Sales revenue budgets give feedback on the effectiveness of a firm's approach. If the deviation is more than expected, managers can re-evaluate the strategy or operations and make necessary adjustments.

Capital budgets

Capital budgets outline specific expenditure for plants, equipment, machinery, inventories, and other capital items needed during the budget period. These budgets need to be prepared with great care, as they give a definite form to the spending plans of an enterprise. Cash budgets and balance sheet budgets are often developed along with the capital budget to control the use of capital resources.

Expenditure budgets

An expenditure budget presents the financial plan for each department during the budget period. The expenditure budget for each functional unit and for sub-functional activities guides and controls the strategy execution for each function.

Depending on how budgets are used, they can have either positive or negative effects on managerial effectiveness in organizations. On the positive side, budgets keep managers informed about organizational activities and enhance coordination across various units. Negative effects arise if the budgets are used in a rigid manner.

The budgeting process

A budgeting process begins with the development of detailed economic, revenue, and profit forecasts, which are designed to meet organization goals and produce guidelines that can be used in budget preparation. Most organizations use a top-down approach, that is, they develop budgets at the top management level and allocate them throughout the hierarchy.

But the 'bottom-up' approach to budget development also has many advantages such as: personnel in each department are likely to be familiar with their own needs; the supervisors and personnel are more likely to be motivated to accept and meet a budget if they have participated in its development; and the members of a department are less likely to overlook a factor from their own departments that might prove to be a crucial element in budget development.

Once the preliminary budget proposals are developed by the various departments, they are submitted to a budget committee. This committee reviews the proposals and attempts to reconcile the various budgets to construct a final budget. Thus, budgets represent agreed targets that relate closely to the organization's objectives. Also, individual budgets will be a part of master budget because the objectives of individual managers contribute towards the objectives of the departments, business units, divisions, and ultimately the organization as a whole.

Budgets and objectives are clearly related and resources are allocated to those areas in the organization that are seen as priorities. Where resources are available and new developments are being considered, the previous record and contribution of managers is likely to have an influence on the allocation of resources. Also, the ability of certain managers to exercise power and influence within an organization has an impact on the resource allocation process.

Building flexibility in a budget

Most budgets are rigid in the face of changing conditions. The budgeting process normally takes place on an annual basis, but as the targets are utilized for regular performance reviews, there should be scope to adjust budgets either upwards or downwards. The allocation of resources to managers is dependent upon the strategies that the organization has decided to continue, but adaptive changes require flexibility that must be accounted for. Thus, budgets should provide a means of adjustment because they are forward looking and changes affect the forecasts upon which they are based.

In order to avoid the problem of inflexibility, organizations often develop variable or flexible budgets. A variable budget is a series of different budgets based on different levels of output. Since expenses and allowances are computed for different levels of activities, department budgets can be adjusted easily by a predetermined formula to reflect more realistically the actual costs related to actual output.

Most organizations have shifted their focus away from traditional budgets to 'rolling budgets' or 'rolling forecasts'. Rolling budgets/forecasts are developed at regular intervals, say after every three months, and forecast performance for a specified time period, say the next twelve or eighteen months. These forecasts are made frequently and continuously updated with the expected impact of the latest changes that occur in the environment. This helps the organization in adapting its strategies to the changing business environment. Rolling budgets/forecasts help organizations to control inaccuracies regarding projections, and in turn, minimize the discrepancies between the standards and the actuals.

Zero-base budgeting (ZBB)

ZBB is a forced periodic justification of any expenditure program in which each department calculates its resource needs based on next year's priorities rather than on last year's budget or expenditure patterns. With ZBB, no previous experience is assumed, and every proposed activity must be justified afresh.

ZBB requires that objectives and priorities be reviewed in every budgeting cycle. In the first step of ZBB, managers justify each item in their budget, as if they were proposing a completely new project. The second step requires the evaluation and ranking of all activities to benefit the organization, followed by the actual allocation of resources based on the final ranking.

ZBB is conceptually very attractive, as it distinguishes between high and low priority areas and contains the pursuit of personal objectives by managers. However, the implementation of ZBB presents a number of difficulties, which often results in a preference for traditional budgeting. Thus, it can be concluded that a ZBB process provides greater justification for the continuation or termination of activities and allows greater participation in planning. However, the process is costlier and requires more time to complete.

13.6.3 Policies and Procedures

A policy is a general guide that specifies the broad parameters within which organizational members are expected to operate in pursuit of organizational goals. Policies provide general boundaries for action, but they do not dictate exactly the actions that should be taken. Policies frequently spell out important constraints.

Policies guide either thoughts or actions, or both, by indicating what is expected by the managers in certain decision areas. Over time, policies place constraints upon the decision-making freedom that managers have by establishing the way that certain tasks should normally be carried out.

The process of strategy formulation is a planned activity, but managers at times wish to pursue objectives that are personally important to them. Therefore, policies should be related to stated strategies but, at the same time, they should not restrict managers to the extent that they are unable to make adaptive changes, when such changes are appropriate or necessary. Policies need to be written down and formulated.

A policy can be advisory, leaving the decision-makers with some flexibility. Or it can be mandatory, whereby managers have no discretion. Mandatory policies tend to stop the efficient and effective thinking of managers and employees, and these are unlikely to motivate managers. Therefore, advisory policies should be preferred because it is essential to allow managers some flexibility in order to adapt to organizational changes and environment. Thus, policies should guide rather than remove discretion.

The creation and use of policies

Policies can be created consciously and unconsciously. The main stated policies are drawn by managers based on their areas of discretionary responsibility. The key policies are created by the strategic leader and then filtered down the organization. There should be consistency between the policies created by the general manager and those created by the divisional or functional managers. Sometimes, external stakeholders force certain policies on the company.

The major functional areas of the business should be covered by explicit policies. All employees who will be affected by them should know such policies. Explicit policies provide a clear framework in which decisions can be made. They also allow people to understand the behavior patterns that are expected of them in particular circumstances. Lastly, changes in strategies may require changes in policies to be implemented successfully.

Characteristics of good policies

The potential effectiveness of policies in relation to strategy implementation is determined by the following principles.

- Policies should reflect objectives and be reviewed/controlled periodically.
- An organization’s policies should be consistent and conflicting policies should be avoided.
- Policies should be flexible.
- Policies should be communicated, taught, and understood.

Procedures

A procedure is a prescribed series of detailed, related, step-by-step instructions as to what should be done under certain recurring circumstances. It is a type of plan designed to establish the steps that employees should follow when carrying out certain routine tasks. Well-established and formalized procedures are called Standard Operating Procedures (SOPs). A well-conceived and straightforward procedure ensures that the necessary action in certain circumstances is clear to everyone, and they provide a useful control mechanism.

13.7 Benchmarking

The business environment is changing at a rapid pace and it is a mixed blessing: on one hand, it provides opportunities for growth and innovation, and on the other, it represents threat, disorientation, and upheaval. To survive into the future, organizations have to reappraise their structures, products, processes, and markets. They have to ensure that they are quicker to reach the market, innovative, flexible, customer-focused, and capable of handling rapid change. This is possible if they benchmark their performance with the world's best, adapt the new best practices, and innovate in order to be world-class. Adapting and learning from other's best practices increases the probability of success for an organization.

Benchmarking is based on the premise that in all processes including supply, production, sales, and services, one or other organizations have achieved world-class competitiveness.

Example

JD Power, a US-based global information services company, conducts annual customer surveys and provides information relating to how well various features and benefits of an automobile satisfies customers. Further, JD Power ranks automobile producers on various quality aspects like initial quality, dependability, overall performance and appeal and sales and service. The valuable information published by JD Power is used by automobile manufacturers to understand their present position and identify areas for improvement. The report of the annual customer survey information published by JD Power provides valuable information for benchmarking for automobile companies.

Source; ICFAI Research Center

13.7.1 Definition of Benchmarking

Benchmarking is a process for improving performance by constantly identifying, understanding, and adapting best practices and processes followed inside and outside the company, and implementing these adapted practices. It emphasizes improving a given business operation or a process by exploiting 'best practices', not on 'best performance'. Best practice is the continuous process of learning, feedback, reflection, and analysis of what works (or does not work) and why. In simple words, Companies can adopt one or more of the types of benchmarking given in Table 2.

Table 2: Types of Benchmarking

Type	Description
Strategic benchmarking	Aimed at improving a company's overall performance by studying the long-term strategies and approaches that helped the 'best practice' companies to succeed. It involves examining the core competencies, product/service development, and innovation strategies of such companies.
Competitive/Performance benchmarking	Used by companies from the same sector to compare their positions with respect to the performance characteristics of their key products and services.
Process benchmarking	Used by companies performing similar work or offering similar services to improve specific key processes and operations with the help of best practice organizations.
Functional or generic benchmarking	Used by companies to improve their processes or activities by benchmarking with other companies from different business sectors or areas of activity but involved in similar functions or work processes.
Internal benchmarking	Involves benchmarking against its own units or branches like business units of a company at different locations. This allows easy access to information, even sensitive data, and also takes less time and resources than other types of benchmarking.
External benchmarking	Used by companies to seek the help of organizations that succeeded on account of their practices. This kind of benchmarking provides an opportunity to learn from high-end performers.
International benchmarking	Involves benchmarking against companies outside the country, as there are very few suitable benchmarking partners within the country.

A typical benchmarking exercise is a four-stage sequential process comprising planning, data collection, data analysis and reporting, and adaptation.

The planning stage includes identifying, establishing, and documenting specific study focus areas, key events, and definitions. The best-practice companies are identified and appropriate data collection tools are selected and updated for use. The purpose of the data collection stage is to accumulate qualitative data and learn from the best practices of different organizations. Information is collected mainly through questionnaires administered to all best practice companies. This stage also includes site visits to organizations that follow best practices.

Data analysis and reporting involves the critical evaluation of practices followed at high performing companies, and the identification of practices that help and deter superior performance. A detailed final report with the key findings is presented. When these findings are discussed, best practice companies also take part through systematic networking activities and presentations. The adaptation stage includes developing an initial action plan to adapt and implement the practices followed by high performance companies.

13.7.2 Approaches to Benchmarking

Benchmarking is a learning process aimed at ensuring best performance. It also focuses on improving any given business process by exploiting 'best practices' by discovering the specific practices that result in high performance, analyzing and understanding the way these practices work, and adapting and applying them in the organization. Benchmarking skills can be gained by reading articles, books, and other publications on benchmarking, or watching videos on benchmarking; through informal liaison with benchmarking experts; attending benchmarking training events; and attending benchmarking conferences.

13.7.3 Benchmarking Practices Worldwide

According to a worldwide survey, benchmarking was a widespread practice used in organizations worldwide despite their location, size, or industry. Benchmarking, when successfully implemented, led to major benefits in process improvement, setting internal standards, and quality improvement, but was of little benefit to organizations which tried to change their leadership style. Benchmarking was found to be clearly useful in influencing the strategic decision-making process, allowing effective deployment of resources, and process improvement. A company can achieve success in benchmarking by understanding benchmarking, and following its methodology correctly.

13.7.4 Complementing Strategy

Benchmarking helps in bringing about operational efficiency that can lead to productivity gains, and in turn, to increase in profits. But benchmarking cannot be used as a strategic decision-making tool. Laggard companies sometimes benchmark their performance against the best practitioners and move nearer to them to improve their earnings. However, in most cases, this strategy destroys value as the profits of the industry leader are redistributed among the companies who are imitating it. When competitors benchmark around a single strategy, they may derive sub-normal returns.

Best practices need not equal best strategy. Managers should be careful not to transform benchmarking from a purely process-related technique into an overriding goal of strategic decision making.

Activity 13.3

Benchmarking has transformed the way businesses are organized, managed, and run. The practice of benchmarking is likely to become even more widespread in the future. Explain, with the help of an example, the benefits to an organization adopting benchmarking.

Answer:

13.8 Re-engineering

Business process reengineering (BPR) is an improvement philosophy that achieves performance improvements by redesigning operational processes, maximizing the value-added content, and minimizing all production-related costs. BPR aims at large scale improvements and focuses on process execution rather than departmental boundaries. It questions, and if necessary, discards, the basic assumptions and beliefs concerned with the organization’s design. It leverages Information Technology (IT) to implement new and effective ways of carrying out tasks and streamlining business processes. Moreover, it focuses on measuring outcomes such as customer satisfaction, process performance, and throughput efficiency. This is a fundamental shift from the traditional perspective of measuring individual activities.

BPR has wider implications than redesigning an operating process and implementing new technology. A firm should rewrite its job descriptions, make multi-functional skills and team working ability a priority, review reward systems that support individuality and internal competitiveness in favor of more cooperative working, design and test new information systems, and install new measures of performance. This task demands a total cultural change within the organization.

Example

Mahindra & Mahindra (M&M) is the flagship company of Mahindra Group. In the mid-1990s, India's largest MUV (Multi-Utility-Vehicle) manufacturer and tractor manufacturer faced major problems at its Igatpuri and Kandivali plants in Maharashtra. The plants were suffering from manufacturing inefficiencies, poor productivity, long production cycle, and sub-optimal output, due to a highly unionized, under productive and bloated workforce. M&M took action against unruly workforce by introducing stringent rules and voluntary retirement scheme to get rid of the excess manpower.

The company's business was divided into six clusters of related businesses, each headed by a president. The objective was to make people accountable and fix responsibility. Major restructuring was done and the revamping exercise yielded dividends. The various measures (Reengineering) initiated by M&M include workforce reduction, disciplining of workforce and restructuring of operations (by way of reduction of activities into 6 clusters for fixing accountability and responsibility) etc. These initiatives enabled cost reduction, operational efficiency, value addition and improvement in profitability.

Source; ICFAI Research Center

Activity 13.3

Re-engineering is a fundamental rethinking and radical redesign of business processes to achieve improvements in cost, quantity, and service. In re-engineering, the strategic managers make business processes the focus of attention. Describe a re-engineering effort at any Indian company.

Answer:

13.8.1 Types of Processes

The processes followed in different organizations can be classified into three categories: strategic processes, operational processes, and enabling processes.

Strategic processes

Strategic processes like strategic planning, product/service development, new process development processes, and developing and communicating the marketing message prepare the organization for the future and set a direction for the organization.

Operational processes

Operational processes help an organization to oversee its regular day-to-day functions through interactions with customers and suppliers for winning, satisfying, and supporting the customer. While (strategic) marketing processes make ‘promises’ in the marketplace, operational processes actually deliver on those promises.

Enabling processes

Enabling processes enable the smooth flow of strategic and operational processes. Management of human resources, accounting and finances, and the management of information systems come under this category.

The organizational processes mentioned above can be further classified into sets of sub-processes, which in turn, can be classified at further levels of detail and so on, until the level of the individual task. When reengineering, a firm should redesign activities only when the redesign is expected to benefit the organization.

After identifying the processes to be redesigned, an organization has to decide on a new design. A process is usually redesigned to make it better (deliver better service and ensure higher satisfaction levels to stakeholders), cheaper (to perform different activities of the organization at highest efficiency levels), and/or faster (to increase the rapidity of response). Redesigning a process involves eliminating non-value-adding activities, and streamlining core-value-adding activities. The rules followed can be represented by an acronym ESIA (Eliminate all non-value-adding activities, Simplify aspects of work where possible, Integrate elements of the process, and Automate where appropriate).

13.8.2 Approaches to Re-designing

There are two broad approaches to redesigning: the systematic approach, and the clean sheet approach.

Systematic approach

A firm following this approach maps out and attempts to understand an existing process, and then works through it systematically to create a new process to deliver the desired result. While doing so, some aspects of the existing process may be retained in the proposed process.

Clean sheet approach

A clean sheet approach seeks a fundamental re-think of the way the product or service is delivered, and designs new processes from scratch by discarding the existing processes. It is based on the premise that significant performance improvements can be achieved only by doing work in a different way. It basically involves working back from the target to a design that will make it happen. Firms adopt a ‘clean sheet’ approach when they reach breakpoint, or when they fail to redesign the existing processes through a systematic strategy.

This approach allows new ways of thinking to enter an organization and allows the exploitation of the latest technological innovations. It is easier to create the desired culture with a new workforce than an old one, so a separate business unit may be created. The risk associated with this approach is considerably higher compared to the systematic approach. New processes may also be fundamentally different and workers may face lot of difficulty in relating to them. Workers may get disoriented in switching to new methods of working.

Most firms use both approaches together. The choice of approach depends on the organization's level of comfort with respect to a particular approach. It should be ensured that the existing process is not over-analyzed; the danger of this is higher in the systematic redesign approach. A firm must always remember that the objective is to obtain a significant improvement in performance.

Redesigning any process is a creative activity and there are many techniques to help those involved in the redesign to engage in 'creative thinking'. There are software packages to help in process mapping available in the market.

Check Your Progress - 2

4. In the implementation of Balanced ScoreCard as a tool for strategic performance control and strategic learning, identify the activity to be performed after clarifying and translating the vision and strategies of the organization.
   a. Communicating and linking strategic objectives and measures
   b. Planning, setting targets, and aligning strategic initiatives
   c. Measuring, monitoring, and reporting
   d. Taking corrective actions for strategic performance control
5. Which of the following analyses is based on the premise that in all processes including supply, production, sales and services, one or other organizations have already achieved world-class competitiveness?
   a. BCG Analysis
   b. Strategic analysis
   c. Benchmarking
   d. Gap Analysis
6. Arrange the following steps into the correct sequence of a benchmarking exercise:
   i. Critically evaluate the practices followed by high performing companies, and identify the practice that helps and deters superior performance.
   ii. Identify, establish, and do documentation of specific focus areas, key events, and definitions.

iii. Develop an initial action plan to adapt and implement the practices followed by high performance companies.

iv. Identify best practice companies and use appropriate data collection tools to collect qualitative data and learn from the best practices of different organizations.

a. i, ii, iii, and then iv

b. ii, iv, i, and then iii

c. iii, ii, i, and then iv

d. i, iv, iii, and then ii

7. Which of the following statements about re-engineering is **false**?

   a. It seeks redesign of current process configurations and not just optimization.

   b. The focus of organizational processes is the execution of tasks.

   c. It focuses on new measures of performance.

   d. It stresses customer satisfaction, performance of processes, and throughput efficiency, and not the individual activities that are part of the process.

8. Which of the following processes make promise in the marketplace and actually deliver on those promises?

   a. Enabling, strategic

   b. Operational, strategic

   c. Strategic, operational

   d. Operational, enabling

9. Which of the following processes are involved in redesigning a process with respect to non-value-adding activities, and core-value-adding activities respectively?

   a. Eliminating, eclipse

   b. Adding, simplifying

   c. Eliminating, streamlining

   d. Accumulating, streamlining

10. Which of the following redesign approaches is followed by a firm that maps out and attempts to understand an existing process, and then work through it systematically to create a new process to deliver the desired result?

   a. Clean sheet

   b. Systematic

   c. Gap

   d. Product

Activity 13.4

Re-engineering aims at achieving performance improvements by redesigning operational processes, maximizing value-added content, and minimizing all production-related costs. Q&S, a leading supermarket chain in the country, wants to re-engineer its operations. How can Q&S go about it?

Answer:

13.9 Summary

- In management, control systems are broadly concerned with the attainment of goals and implementation of strategies.
- According to Robert Simons, diagnostic control systems, beliefs systems, boundary systems, and interactive control systems are the four levers of control used in management.
- Based on the object of control, management controls are classified into action controls – behavioral restrictions, pre-action appraisals, and action accountability; results controls; and personnel/cultural controls.
- The control mechanisms that increase the organization's probability of achieving its strategic objectives are collectively referred to as strategic control.
- Critical success factors (CSFs) are "the limited number of areas in which results, if they are satisfactory, will ensure successful competitive performance for the organization. They are the few key areas where things must go right for the business to flourish."
- Performance measures are of three types: performance indicators (lead or lag indicators), key performance indicators, and key result indicators.
- 'The Balanced Scorecard (BSC)' is a concept that combines financial and non-financial measures; short-term and long-term goals; the organization's market performance and internal improvements; past outputs and ongoing requirements; etc. It helps the organization in strategic learning.
- The BSC framework considers the customer perspective; internal business process perspective; and the innovation/learning and growth perspective; in addition to the financial perspective.
- Operational control systems help operating managers to implement strategy at their level. These systems help to guide, monitor, and evaluate progress in meeting the annual objectives of the company.

- Benchmarking is the process of improving performance by continuously identifying, understanding (studying and analyzing), and adapting outstanding practices and processes found inside and outside the organization, and implementing them in the organization.
- Business process reengineering (BPR) is an improvement philosophy that achieves performance improvements by redesigning operational processes, maximizing the value-added content, and minimizing all production-related costs. BPR aims at large scale improvements and focuses on process execution rather than departmental boundaries.

13.10 Glossary

Balanced Scorecard: The Balanced Scorecard (BSC), proposed by Robert Kaplan and David Norton in 1992, helps the organization in strategic performance control and strategic learning. The BSC framework considers the customer perspective, internal business perspective, and the innovation/learning and growth perspective, in addition to the financial perspective.

Benchmarking: A process for improving performance by constantly identifying, understanding, and adapting best practices and processes followed inside and outside the company, and implementing these adapted practices. The main emphasis of benchmarking is on improving a given business operation or a process by exploiting ‘best practices’, not on ‘best performance’. Best practice is the continuous process of learning, feedback, reflection, and analysis of what works (or does not work) and why.

Re-engineering: Re-engineering or business process re-engineering is an improvement philosophy that can be applied at the level of the individual process or at the level of the organization. Re-engineering achieves performance improvements by redesigning operational processes and maximizing value-added content.

13.11 Self-Assessment Test

1. Discuss the concept of control systems in management in detail.
2. Explain the specifics of strategic control and operational control.
3. Explain the management tools of Balanced Scorecard, benchmarking, and re-engineering. Discuss their importance in strategy execution.

13.12 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019

3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

13.13 Answers to Check Your Progress Questions

1. (c) All industries have a common set of critical success factors irrespective of their mission and strategic goals.

John F. Rockart defined critical success factors (CSFs) as *the limited number of areas in which results, if they are satisfactory, will ensure successful competitive performance for the organization. They are the few key areas where things must go right for the business to flourish.* He also concluded that CSFs are *areas of activity that should receive constant and careful attention from management.* For each firm, the critical success factors would be different dependent upon its mission and strategic goals. A firm should identify a few critical factors that are crucial to the attainment of strategy, goals, and objectives of an organization. The number of critical success factors chosen should not be more than five to six.

2. (c) i/r, ii/p, iii/q

For the BPO sector, the ability to sustain the customer base is a critical success factor. The key performance indicators are day-to-day operations like first call resolution, call quality, service level, response time, average handle time, and cost per call. Return on capital employed is a key result indicator.

3. (a) i/r, ii/p, iii/q

Based on the object of control, management controls can be classified into action controls, results controls, and personnel/cultural controls. Action controls are aimed directly at the actions which take place at different levels of an organization. These controls may be implemented in the form of behavioral restrictions which are limitations placed on the behavior of organizational personnel and are a form of negative discipline. Results controls are focused on the consequences of actions taken rather than on the actions themselves. These controls empower individuals and groups to use their discretion in doing what they feel are best for the organization. Personnel/cultural controls influence the people and the organizational culture, with the expectation that the right people in the right culture will perform the right actions that will ultimately yield the desired results. These controls aim at encouraging employees to monitor themselves and others with whom they work for the organization.

4. (a) Communicating and linking strategic objectives and measures

Given the vision, mission, and strategy as inputs, the Balanced ScoreCard serves as a tool for strategic performance control by clarifying the vision and strategy of the organization and articulating the top management's expectations in terms of clearly defined strategic objectives and associated measures of performance. To align the organization's objectives with individual objectives, these strategic objectives and measures are communicated throughout the organization, and also expressed in terms of more detailed, operational objectives at the departmental level, group level, or individual level. Once the individual and organizational objectives have been aligned, a business plan is devised. This helps the organization in creating a link between the short-term goals, long-term objectives, and the financials. The top management continuously monitors the performance.

5. (c) Benchmarking

Benchmarking is aimed at identifying one or more firms who have achieved world class competitiveness in managing supply, production, and sales and services. The idea is to incorporate the same practices in one's own business to reach the same level of competitiveness. It is possible that one competitor might have achieved the world class quality in production, while another might have achieved world class quality in customer service. The aim is to learn from the best practices of both the firms and incorporate them in one's own firm to emerge as the leader in the industry. For instance, Pizza Hut aims more at serving Pizzas in a Dine-in mode while Domino's is known for world class delivery standards. In benchmarking, a firm learns from the best practices of both the firms and incorporates them in their own business processes to emerge as a leader.

6. (b) ii, iv, i, and then iii

A typical benchmarking exercise is a four-stage process involving: Planning stage: identify, establish, and do documentation of specific focus areas, key events, and definitions; Data collection: identify best practice companies and using appropriate data collection tools, collect qualitative data and learn from the best practices of different organizations; Data analysis & reporting: this stage involves the critical evaluation of practices followed at high performing companies, and the identification of practices that help and deter superior performance; and Adaptation: develop an initial action plan to adapt and implement the practices followed by high performance companies.

7. (b) The focus of organizational processes is the execution of tasks.

Re-engineering seeks redesign of current process configurations and not just optimization. It focuses on new measures of performance and stresses customer satisfaction, performance of processes, and throughput efficiency, and not the individual activities that are part of the process. Reengineering is concerned with the fundamental business processes that underlie the operations of an organization. In reengineering, attempts are made to change the focus of organizational process from execution of tasks to the outcome of tasks. For example, manual complaint booking process may be replaced by an integrated automated voice response system with a view to improve consumer response rates. This will change the focus of the process from booking complaints to speedy rectification of consumer complaints.

8. (c) Strategic, operational

Strategic processes indicate and promise to the markets what value will be delivered by their products and services. This is done via press releases and interviews by top executives of the firm in the electronic media or with the print media. They are broad in their nature and indicate whether the products and services will deliver economical products and services or they will be niche products or services. They also indicate to a certain extent how their offerings would be similar to or different from the competitors. Operational processes help an organization to oversee its regular day-to-day functions like winning the customer, satisfying the customer, and supporting the customer. They are geared towards delivering on the strategic promises made to the market.

9. (c) Eliminating, streamlining

Redesigning a process involves eliminating non-value-adding activities, and streamlining core-value-adding activities. The rules followed can be represented by an acronym ESIA: Eliminate all non-value-adding activities, simplify aspects of work where possible, Integrate elements of the process, and Automate where appropriate.

10. (b) Systematic

A firm following a systematic redesign approach maps out and attempts to understand, an existing process, and then works through it systematically to create a new process to deliver the desired result. This may allow some aspects of the existing process to be retained in the new proposed process. A clean sheet approach seeks a fundamental re-think of the way the product or service is delivered, and designs new processes from scratch.

Unit 14

Organizational Roles in Strategic Management

Structure

"Ultimately, it's on the company leaders to set the tone, not only the CEO, but the leaders across the company. If you select them so carefully that they then hire the right people, it's a nice self-fulfilling prophecy."

\- Tim Cook (CEO, Apple)

14.1 Introduction

Tim Cook is showcasing the benefits of selecting the right leaders across the organization who could in turn bring the right people in organization.

In the previous unit, we have discussed strategic and operational control. In this unit, we shall discuss organizational roles in strategic management.

In an organization, many employees contribute to the various elements of the strategic management process: environmental scanning, strategy formulation, strategy implementation, and evaluation and control. However, the responsibility of formulating and executing the organization's strategy primarily vests with the key leaders in the organization, along with the Board of Directors. This set of individuals can be collectively referred to as the strategy team.

The strategy team visualizes the future of the organization and translates it into a vision and a mission statement for the employees so that they can strive toward it. It is the responsibility of this team to clarify the mission and objectives of the organization, to define the corporate strategy, and establish and manage the organization's structure and control systems. The strategy team also influences the organization's culture and values, which are key determinants of the ways in which strategies are formulated and implemented.

This unit shall first discuss the roles and responsibilities of the strategy team. We shall then move on to discuss the specific contributions made by the general managers and the board of directors toward strategic management in a corporate context.

14.2 Objectives

By the end of this unit, you should be able to:

- Discuss the roles and responsibilities of the strategy team.
- Explain the specific contributions of general managers and the board of directors toward strategic management in a corporate context.

14.3 The Role of the Strategy Team

The primary role of the strategy team is to ensure that long-term strategies have been determined, understood, and supported by managers within the organization who will be responsible for implementing them. The more feasible the strategies, the more likely they are to be supported. In a corporate context, the responsibilities of the strategist are:

- To provide direction in the form of a mission or purpose.
- To provide policies and guidelines for managers to facilitate the management of operations and changes in competitive/functional strategies.
- To monitor and control operations, with special reference to financial results, productivity, quality, innovation, customer service, and staff development.
- To formulate and implement changes to corporate strategies.
- To manage the business on behalf of all the stakeholders.

The strategy team has to build a system of communications within the organization. This system should enable the managers to be strategically aware. Moreover, it should ensure that the strategic leader stays informed of any changes that are taking place. As an analogy, the strategy team provides a survival kit. There is a map (mission), but managers need emergency provisions and ways of summoning assistance when the map proves inadequate. The policies and communication networks provide this flexibility.

With respect to the role of the strategy team, let us now discuss the following: leadership qualities and leadership style for strategic management; ambitions and values of the strategic leader; risk profile and strategy team; strategy team and change; and the role of the CEO in strategic management.

Activity 14.1

A strategist is primarily responsible for creating and implementing strategic change. Anyone in the organization who controls key or precedent-setting actions can be called a strategist. Discuss, with the help of an example, the role the strategist plays in leading an organization.

Answer:

14.3.1 Leadership Qualities

Successful organizations are those that are well led rather than those that are well managed. The emphasis is on a clear vision. An organization may be very efficient even without a vision, but it is less likely to be as effective as those organizations which have a clear and shared direction. Also, market forces can determine short-term success, but long-term success requires a clear vision of where the organization is going. The qualities and skills for effective strategic leadership are:

- The ability to build and control an effective team of managers.
- The ability to recognize and synthesize important developments, both inside and outside the organization; this requires strategic awareness, the ability to judge the significance of an observed event, and conceptualization skills.
- Credibility and competence
- The ability to exercise power and influence, and to create change.
- Implementation skills, that is, the ability to get things done. This requires drive, decisiveness, and dynamism.
- Perseverance and persistence in pursuing the mission or vision
- Mental and physical stamina.

Example

Jamie Dimon has been heading JPMorgan Chase, the American investment bank for more than 12 years (2006-18). Over the years, Dimon has evolved as a skillful leader most notably since his recovery from throat cancer some years ago. He has been very outspoken on political and social issues and is able to exercise influence in the financial sector. Yet, New York Times once referred to him as “America’s least-hated banker.” When his reputation took a hit due to derivative transactions made by a trader that resulted in $6.2 billion in losses, Jamie took personal responsibility and apologized by writing a letter to shareholders, hence reclaiming his credibility. In Jamie Dimon’s case, he is known for his unique leadership qualities - taking personal responsibility for his actions, speaking his mind without offending others and fiercely guarding his credibility.

Source; ICFAI Research Center

14.3.2 Leadership Style

The success of an organization is strongly influenced by the style adopted. Some strategic leaders are entrepreneurial, that is, they seek out opportunities for change and are willing to take the necessary risks. Some leaders are more conservative, that is, they will not take or will be less likely to take major risks. In relatively stable environments, both types of leaders can be appropriate and successful.

The strategic leader can adopt an autocratic or a democratic style. Generally, small organizations are run autocratically. Where a big organization is divisionalized, much depends on the amount of freedom and encouragement that the strategic leaders of each division are given.

Leadership style also relates to the role of planning and the importance of incremental change in strategic management. For example, some leaders rely heavily on forecasts and plans for determining strategic change and this could be linked to a strict adherence to financial targets.

Example

Known for his carefree demeanor and democratic style, Siddhartha Lal, the managing director of Eicher Motors has been successfully able to combine his passion with the business. Under his watch, Eicher's Royal Enfield has had a dream run with sales surging from under 50,000 units to 7.53 lakh. Lal attributes his success mainly to a combination of Delegative, Participative, Authoritative and Disruptive styles of running the business. In case of Siddhartha Lal, he attributes his success to his participative leadership style of working and a general informal approach in formal situations as demonstrated in the bike launch.

Source; ICFAI Research Center

14.3.3 Ambitions and Values of the Strategic Leader

The strategic leader may be very ambitious about creating a certain type of organization. Some strategic leaders are appointed to rescue a company in difficulties and they have a clear remit. On the other hand, others may have considerable freedom to choose their own terms of reference.

When a new strategic leader is appointed, the results could be either positive or negative. The result depends on various factors such as the need to change, the directions for change that are chosen, and how well they match existing skills. Similarly, companies might face difficulties when a strong and charismatic leader departs. Due to this, there can be temporary or even permanent decline. Thus, organizations can change markedly when the strategic leader changes.

The strategic leader may have certain values and this in turn influences his/her style and culture in the organization. For example, a strategic leader with a marketing background is more likely to focus on consumers and competition. If a new strategic leader is appointed (from another organization), it is inevitable that he/she will bring values which have been learned elsewhere. This may involve change.

Strategic leaders are generally appointed because of their successful record in previous companies, and as a newcomer, they may be determined to establish their presence by introducing changes. However, these perceptions are generalizations and may not always prove to be true.

Example

Online retailer Flipkart's valuation has increased from $11.6 billion to $21 billion under the leadership of CEO Kalyan Krishnamurthy. Experts attribute the turnaround to Kalyan's focus and expertise in day-to-day operations of the e-commerce business. Known to be a leader who sets high targets, Kalyan was the Managing Director at Tiger Global before joining Flipkart. Tiger Global is an investment firm known for its bold bets and aspiring target-driven approach in the start-up space.

Kalyan's deep e-commerce knowledge also helped in Flipkart's transformation, knowledge that he had gained from eBay, the e-commerce pioneer. Kalyan had worked with eBay for over six years before joining Tiger Global. In Kalyan's case, his values and general management approach have been heavily influenced by the companies that he was part of previously - namely Tiger Global and eBay.

Source; ICFAI Research Center

Check Your Progress - 1

1. The responsibilities of the strategy team include:
   i. Providing direction in the form of a mission or purpose.
   ii. Formulating and implementing changes to corporate strategies.
   iii. Managing the business on behalf of all the stakeholders.
   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii, and iii
2. The strategy team monitors and controls operations, with special reference to:
   i. Financial results.
   ii. Quality and productivity.
   iii. Innovation.
   iv. Staff development and customer service.

a. Only i, ii, and iii
b. Only i, ii, and iv
c. Only i, iii, and iv
d. i, ii, iii, and iv

3. Which of the following qualities and skills should an effective strategic leader possess?
   i. The ability to build and control an effective team of managers
   ii. The ability to exercise power and influence, and to create change
   iii. Implementation skills
   iv. Perseverance and persistence in pursuing the mission or vision, plus mental and physical stamina
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only i, iii, and iv
   d. i, ii, iii, and iv
4. Which of the following statements about entrepreneurial strategic leaders are **true**?
   i. They seek out opportunities for change.
   ii. They do not take or are less likely to take major risks
   iii. In relatively unstable environments, they are successful.
   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii and iii

Activity 14.2

The strategist should clarify the mission and objectives of the organization, define the corporate strategy, and establish and manage the organization's structure. He also influences the organization's culture and values, which are key determinants of the ways in which strategies are created and implemented. With the help of an example, explain the role played by a strategist.

Answer:

14.3.4 Risk Profile of the Strategy Team

Certain business environments involve higher risks than others. For example, a high technology industry where there is constant innovation and technological change involves high levels of risk. Here the question arises as to what is risk? Risk occurs whenever anyone must make a choice and the potential outcome involves uncertainty. For example, if a person has to make a decision and the alternative choices involve potential gains and losses that are not certain, the situation involves risk. In general management, the outcome of a typical decision will depend on factors such as customer reaction, levels of demand, and competitor reactions.

There should be compatibility between the strategic leader's attitude toward risk and demands of the industry. For example, a risk-averse strategic leader in a high-risk industry may miss valuable opportunities. Also, the willingness to take risk is affected by the investment amount and by its relative importance to the decision taker. The criteria that are to be considered while taking decisions regarding risk are:

- The attractiveness of each option to the decision maker
- The estimated probabilities of success and failure
- The extent to which the decision-maker is prepared to accept the potential loss in each alternative.
- The degree to which the decision-maker is likely to affect the success or failure.

In considering risk and strategic leadership in an organization, a number of factors have to be investigated. The culture and values of the organization with regard to reward for success and sanction for failure have to be considered in taking risks. Moreover, attitudes toward risk also affect the way managers make decisions. Generally, high-risk takers tend to make more rapid decisions than low risk takers.

Another factor that influences risk taking is environment. Examples of environmental factors could be the availability and cost of finance, forecasts of market opportunities and market buoyancy, and suitability of internal resources. Factors in the internal environment of the organization such as styles of leadership and reward systems also influence risk taking.

14.3.5 Strategy Team and Change

Change results from decisions taken and implemented in response to perceived opportunities or threats. It therefore requires strategic awareness and strategic planning. Managing change implies interpreting signals from the environment. Environmental signals come in numerous ways and it is essential that they are monitored and filtered in such a way that the important information reaches decision-makers.

For example, if strategic change is dependent on marketing managers, they must feel that they have the authority to make changes. In this context, strategic leadership is required to direct activity. The major decisions fall to the strategy team and therefore it must decide upon the most appropriate planning system and manage it.

Managers should be constantly aware of and alert to changes in the environment. Also, they should be constantly alert to new ways of producing/marketing their products in order to improve or strengthen their competitive advantage. If this is to happen effectively, the strategic leader must ensure that the managers are encouraged, motivated, and rewarded for acting accordingly. The strategy team must design and manage an appropriate organization structure to ensure this.

Example

French automaker Renault's top management, in its Indian unit, saw a decline in sales by 17-20 per cent, attributed mainly to a slowdown in the automobile sector. The management realized that it was time for a significant change in the product mix. Research showed that there was space in the market for a large vehicle at an affordable cost. The strategy team decided to develop a vehicle and a year later, Renault launched the Triber, a 7-seater compact Multi-Purpose Vehicle (MPV), a crossover between a car and an SUV for ₹ 4.95 lakh, the average price of a hatchback car. The Renault India team understood the need for change, studied the environment and quickly went about developing a unique product in terms of space and pricing.

Source; ICFAI Research Center

14.3.6 Role of the CEO in Strategic Management

The chief executive officer (CEO) or the Managing Director is the person responsible for the functioning of the entire organization. The CEO has to play crucial and multiple roles in formulating and implementing the organization's mission, objectives, policies, and strategies. Among all the members of the strategy team, the CEO is the key person in the organization.

Being at the topmost executive position, he/she has an integrated perspective of not only the various functions and divisions but also of the external environment and its impact on business. The CEO guides the senior managers in formulating, implementing, evaluating, and reformulating strategies. Further, he/she provides inputs and recommendations to the board of directors regarding the organization's strategic options and their implications.

Example

Sundar Pichai joined Google as a product manager overseeing the building of Chrome, Google's web browser. Eleven years later, he became the company's CEO.

Contd….

In the role of CEO, Sundar was able to manage relationships with tough partners like Samsung Electronics with his ability to understand the expectations of external stakeholders and balance it with the company's internal needs. He revived revenue growth at Google with share prices of parent Alphabet Inc. rising more than 50% since he took over. The Board of Directors granted him restricted stock worth $550 million and offered him another big grant for his efforts. Sundar's case clearly reflects his integrative perspective.

Source; ICFAI Research Center

14.4 General Managers and Strategic Management

There are various functions in an organization such as marketing, finance, and human resource. These functions act as subsystems of the organization system. The responsibility for the successful performance of this system rests with the general management. The general management consists of the board of directors, the chief executive officer, and the divisional/functional heads. The general managers of an organization are executives at the apex of the enterprise, its strategic business units, or functions, and they are responsible for the survival and effective functioning of the organization.

The general manager is an entrepreneur, strategist, leader, and implementer. General managers integrate various activities, roles, and functions for achieving organizational objectives. In strategy implementation, the nature of the general manager's role is both symbolic and substantive. The actions of each general manager and the perceived seriousness of his/her commitment to a chosen strategy, particularly if the strategy represents a major change, exert a significant influence on the intensity of commitment to implementation from subordinate managers and employees. Further, during the implementation of strategy, the general manager represents an important source for clarification, guidance, and mid-course corrections.

The strategic management responsibilities of a general manager are:

1. *Establishing the mission*: Deciding on the business or businesses that the company or division should engage in and other fundamentals that will guide and characterize the business, such as continuous growth. A mission is usually enduring and timeless.
2. *Formulating a company philosophy*: Establishing the beliefs, values, attitudes, and unwritten guidelines that add up to, "the way we do things around here".
3. *Establishing policies*: Deciding on plans of action to guide the performance of all major activities in carrying out strategy in accordance with company philosophy.

4. *Setting objectives*: Deciding on achievement targets within a defined time range. Objectives are narrower in scope than the mission and are designed to aid in making operational plans for carrying out strategy.
5. *Developing strategy*: Developing concepts, ideas, and plans for achieving objectives successfully, and meeting and beating the competition. Strategic planning is part of the total planning process that includes management and operation planning.
6. *Designing the organization structure*: Developing the plan of organization and the activities that help people work together to perform activities in accordance with strategy, philosophy, and policies.
7. *Providing personnel*: Recruiting, selecting, and developing people to fill the positions in the organization plan.
8. *Establishing procedures*: Determining and prescribing how all important and recurrent activities will be carried out.
9. *Providing facilities*: Providing the plant, equipment, and other physical facilities required to carry on the business.
10. *Providing capital*: Making sure the business has the money and credit needed for working capital and physical facilities.
11. *Setting standards*: Establishing measures of performance that will enable the business to best achieve its long-term objectives successfully.
12. *Establishing management programs and operational plans*: Developing programs and plans governing activities and the use of resources which, when carried out in accordance with established strategy, policies, procedures, and standards, will enable people to achieve particular objectives. These are phases of total planning process, which include strategic planning.
13. *Providing control information*: Supplying facts and figures to help people follow the strategy, policies, procedures, and programs; to be alert to forces at work inside and outside the business; to measure overall company performance against established plans and standards.
14. *Activating people*: Commanding and motivating people to act in accordance with philosophy, policies, procedures, and standards in carrying out the plans of the company.

Activity 14.3

At functional level, managers develop short range objectives and strategies in areas such as production and operations, research and development, finance and accounting, marketing, and human resources. These managers have the primary responsibility of implementing and executing the firm's strategic

plans. In the context of production and operations, describe the conceptualization and implementation of functional strategy in an organization, with an example. **Answer:**

14.5 The Board of Directors and Strategic Management

The board of directors represents the shareholders of the company and it evaluates the management's performance. The CEO reports the performance of the company to the board on a periodic basis. The board of directors also performs certain legal functions as per the law of the land.

The Board acts as one collective entity and contributes to the strategy team. In the context of strategic management, the specific responsibilities of the board of directors are:

14.5.1 Formulation of Mission, Objectives, and Policies

The board formulates and reformulates the mission, objectives, and policies of the company with a long-run perspective, and thus provides the basis for strategy formulation.

14.5.2 Selection of Top Executives

The board screens and selects top executives who can formulate and implement strategies.

Example

When Infosys, the IT services company, announced that its Board of Directors has appointed Salil S. Parekh as Chief Executive Officer of the company, the Board members felt that he was the right person to lead Infosys as he had a strong track record of executing business turnarounds. The company was going through a difficult phase. The Infosys board handed Salil an employment contract with strict terms including clauses preventing him from joining a rival company for six months after leaving the firm and waiving off his rights to civil court action. One of the conditions of the termination of employment was refusal to follow "reasonable and lawful instructions of the board". In this case, Salil Parekh was brought in to lead the company through uncertain times. Parek was given clear instructions with respect to the terms of his employment including detailed termination clauses.

Source; ICFAI Research Center

14.5.3 Organization Design

The board designs/approves the organization structure based on the objectives, policies, environmental factors, expectations of employees, etc.

Example
Hewlett-Packard (HP), US-based multinational information technology company, announced its new global operating model and organizational structure to better serve its global customers and partners. The company said, "The tech giant is moving from its current structure which is built around three large regions to a single commercial organization. Reducing the number of management layers in its go-to-market process will make us more agile and efficient, drive faster decision making, and increase flexibility and authority at the local level where it counts the most." HP initiated the OD exercise to strengthen its business.

Source; ICFAI Research Center

15.5.4 Feedforward and Feedback Loops

The board obtains critical information from the external environment and forwards it to the company. The board formally reviews major executive decisions and provides guidance to the management. Further, it provides feedback to the management regarding their failure(s), so that there is no repetition of mistakes.

15.5.5 Link between the Company and its External Environment

The board of directors acts as a link between the company and the external environment like government, customers, local public, and social institutions. It often supports new strategies, mobilizes resources, protects the organization from outside threats, and links the company with powerful outsiders.

15.5.6 Formulation of Strategy and Evaluation of Execution

One major function of the board of directors is to engage itself in strategic management. Also, it is the duty of the board to evaluate corporate strategy and performance.

15.5.7 Strategic Change

It is the duty of the board of directors to actively involve itself in formulating vital strategies like takeovers, mergers, diversification, vertical and horizontal integration, and so on. The board of directors plays a crucial role in strategy formulation and execution, and in managing strategic change. The variation in the degree of involvement of the board of directors in strategic management is indicated in Table 1.

Table 1: Degree of Involvement of Board of Directors in Strategic Management

Type of Involvement	Description	Degree of Involvement
Phantom	Does not know what to do and/or does not get involved.	Low and passive
Rubber stamp	Permits officers to make all decisions. On key action issues, it votes as per the recommendations of officers.	
Minimal review	Formally reviews selected issues that officers bring to its attention.	Moderate
Normal participation	Involved to a limited degree in the performance or review of selected key decisions, indicators, or programs of management.	
Active participation	Questions, approves, and makes final decisions on mission, strategy, policies, and objectives. Has active board committees. Performs fiscal and management audits.	High and active
Catalyst	Takes the leading role in establishing and modifying the mission, objectives, strategy, and policies. It has a very active strategy committee.	

Adapted from Wheelen, Thomas L. and J. David Hunger. Strategic Management and Business Policy. Pearson, 13th Edition, 2011.

Check Your Progress - 2

5. Which of the following criteria should be considered before taking decisions relating to choice of course of action?

   i. The attractiveness of each option

   ii. The estimated probabilities of success and failure

   iii. The extent to which the decision maker is prepared to accept the potential loss associated with each alternative

   iv. The degree to which the decision maker is likely to affect the success or failure of a course of action

   a. Only i, ii, and iii

   b. Only i, ii, and iv

   c. Only ii, iii, and iv

   d. i, ii, iii, and iv

6. Which of the following is **not** a responsibility of the board of directors of a company?
   a. Evaluates the management's performance and contributes to the strategy team
   b. Formulating the vision and mission
   c. Screening and selecting people to fill all positions in the organization
   d. Perform certain legal functions
7. Which of the following boards can be referred to, when there is no degree of involvement of the board of directors in the strategic management?
   a. A phantom board
   b. A rubber stamp board
   c. Minimal review by the board
   d. Normal participation by the board
8. Which of the following is true, when the board of directors acts as a rubber stamp?
   a. Formally reviews select issues that officers bring to its attention
   b. Does not know what to do
   c. Makes final decisions on mission, strategy, policies, and objectives
   d. Permits officers to make all decisions
9. The board of directors questions, approves, and makes final decisions on mission, corporate strategy, and policy. Which of the following results in the above mentioned statement?
   a. Phantom involvement
   b. Rubber stamp involvement
   c. Active participation
   d. Normal participation

Activity 14.4

Independent, non-executive directors are expected to contribute a lot to the functioning of the Board of Directors. In your opinion, is this expectation realistic?

Answer:

14.6 Summary

- The responsibility of formulating and executing the organization's strategy primarily vests with the key leaders in the organization, along with the Board of Directors. This set of individuals can be collectively referred to as the strategy team.
- The strategy team's responsibility is to clarify the mission and objectives of the organization, to define the corporate strategy, and to establish and manage the organization's structure and control systems.
- With respect to the role of the strategy team, the following issues are important: leadership qualities and leadership style for strategic management; ambitions and values of the strategic leader; risk profile and strategy team; strategy team and change; the role of the CEO in strategic management; and the role of general managers in strategic management.
- The responsibilities of the directors on a company's Board include formulation of mission, objectives, and policies; selection of top executives; organization design; feedforward and feedback loops; link between the company and its external environment; formulation of strategy and evaluation of execution; and managing strategic change.
- Based on the variation in the degree of involvement of the board of directors in strategic management, boards can be classified into: phantom boards, rubber stamp boards, minimal review boards, normal participation boards, active participation boards, and catalyst boards.

14.7 Glossary

Active participation (degree of involvement of board of directors in strategic management): Questions, approves, and makes final decisions on mission, strategy, policies, and objectives. Has active board committees. Performs fiscal and management audits.

Catalyst (degree of involvement of board of directors in strategic management): Takes the leading role in establishing and modifying the mission, objectives, strategy, and policies. It has a very active strategy committee.

Minimal review (degree of involvement of board of directors in strategic management): Formally reviews selected issues that officers bring to its attention. Normal participation (degree of involvement of board of directors in strategic management): Involved to a limited degree in the performance or review of selected key decisions, indicators, or programs of management.

Phantom (degree of involvement of board of directors in strategic management): Does not know what to do and/or does not get involved.

Rubber stamp (degree of involvement of board of directors in strategic management): Permits officers to make all decisions. On key action issues, it votes as per the recommendations of officers.

14.8 Self-Assessment Test

1. Discuss the roles and responsibilities of the strategy team.
2. Explain the specific contributions of general managers and the board of directors toward strategic management in a corporate context.

14.9 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

14.10 Answers to Check Your Progress Questions

1. (d) i, ii, and iii

The responsibilities of the strategy team include:

- To provide direction in the form of a mission or purpose.
- To provide policies and guidelines for managers to facilitate the management of operations and changes in competitive/functional strategies.
- To monitor and control operations, with special reference to financial results, productivity, quality, innovation, customer service, and staff development.
- To formulate and implement changes to corporate strategies.
- To manage the business on behalf of all the stakeholders.

2. (d) i, ii, iii, and iv

The strategy team monitors and control operations, with special reference to financial results, productivity, quality, innovation, staff development, and customer service. Financial results and productivity provide the strategist with a benchmark to evaluate the adopted operations. Quality and innovation help the strategist to monitor and control operations with respect to differentiation. Staff development aims at evaluating human resource assets, and the type of customer service provided helps in monitoring and controlling operations relating to customer satisfaction.

3. (d) i, ii, iii, and iv

The qualities and skills that an effective strategic leader should possess are: the ability to build and control an effective team of managers; the ability to exercise power and influence and to create change; implementation skills, i.e., how to get things done, which requires drive, decisiveness, and dynamism; and perseverance and persistence in pursuing the mission or vision, plus mental and physical stamina.

4. (b) Only i and iii

Strategic leaders who are entrepreneurial will seek out opportunities for change and are willing to take the necessary risks. They are willing to invest in new ideas and products and are willing to enter unexplored areas of business. Hence, they assume and undertake **major risks** as compared to conservative leaders. Entrepreneurial strategic leaders, if successful, create new avenues for investment for conservative strategic leaders. For example, Sabeer Bhatia created the immensely successful Hotmail which led other firms to launch internet-based mail services. Due to their greater ability to assume risk, entrepreneurial strategic leaders are more successful in unstable environments as they find and implement new methods of executing the business in a changing environment.

5. (d) i, ii, iii, and iv

Taking decisions regarding risk involves all the criteria mentioned in the options.

6. (c) Screening and selecting people to fill all positions in the organization

The board of directors evaluates the performance of the management, and contributes to the strategy team. It authorizes the corporate strategies chosen by the CEO. The board of directors formulates and reformulates the mission, objectives, and policies of the organization with a long-run perspective, thus providing the basis for strategy formulation. The board screens and selects **only the top executives** who can formulate and implement strategies. The board of directors also performs certain legal functions as per the law of the land.

7. (a) A phantom board

If the board of directors is not at all involved in the strategic management process, it is referred to as a phantom board. The board's existence is only on paper and it plays no role in the management of the company. For all practical purposes, the board is non-existent. A phantom board of directors is created by a CEO who is autocratic in his/her style of functioning and does not want any interference by the board. The creation of such a board is done to meet the legal requirements. Phantom boards are primarily witnessed in closely held companies.

8. (d) Permits officers to make all decisions

As a rubber stamp, the degree of involvement of the board of directors in strategic management is less, and it permits officers to make all decisions. As the term rubber stamp implies, the relevance of the board is only in terms of its ratification of important strategic issues in order to comply with the provision of law. The board permits officers to make all decisions and agrees with their decisions without engaging in any independent analysis. Such a board is normally comprised of members who are either not interested in the firm's business or do not possess any knowledge about the dynamics of the business, and are on the board for purposes of prestige and social standing.

9. (c) Active participation

The board of directors questions, approves, and makes final decisions on mission, strategy, corporate policy, and objectives when it actively participates in strategic management. The board plays a proactive role in defining the mission, and formulating strategies for achieving growth in the light of the firm's environment. It also has active board-level committees. In successful firms, normally there is active participation of the board of directors in strategic management.

Business Policy & Strategy

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