Performance Management Primer

2019-01-15

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INTRODUCTION

This Primer provides an introduction to performance management in a business context, and covers the following topics:

- governance and corporate social responsibility
- the development of a corporate mission, vision and values
- strategy formulation, implementation and evaluation, including environmental scanning and company and industry analysis
- the evaluation of strategic alternatives and measurement of their performance, including risk management
- tools used to monitor and evaluate ongoing organizational performance and ensure accountability in the decision-making process

PART 1

Governance

Governance is the system by which an organization is directed and controlled. Individuals and groups play different roles in an organization's governance, depending on the size and sophistication of the organization. The board of directors, management and owners all play key roles in governing an organization, and integrate with the external and internal auditors.

A typical public company's governance structure would include the following:

- Owners: Corporations are owned by shareholders. The owners of an organization are usually widely dispersed, resulting in an inability to make the daily decisions of the business.
- The board of directors: The board is appointed by the shareholders of the organization, and is responsible for overseeing and monitoring the strategic decisions. It is not expected to be involved in the day-to-day operational decisions; however, it is meant to represent the shareholders' interests in the decisions it makes. Boards usually consist of people with diverse backgrounds, such as those with legal, human resources and finance experience and industry experts.
- Committees of the board: Board committees are formed to address specific tasks or duties. They may include the audit committee, compensation committee or the executive committee.

- Other stakeholders: Other stakeholders are individuals and groups who have an interest in the organization or who may be affected by the organization's actions, such as customers and suppliers, employees, creditors and governments.
- Executive management and staff: Executive (or senior) management includes the senior employees responsible for the day-to-day operational activities of the organization. Senior management of the organization reports to the chief executive officer (CEO), who in turn reports to the board of directors.

Not-for-profit organizations have a similar structure, although the names of the governance structure vary slightly.

The role of governance in mitigating the principal-agency problem

Agency theory is concerned with managing the principal-agent problem. Under this theory, the agent has more information and control over the situation than the principal, and as a result may be motivated to act in the agent's own best interests rather than those of the principal.

This theory relies on two key assumptions:

- It assumes that people are rational and self-interested, meaning they will consistently choose actions that benefit themselves.
- It also assumes that people value money and will always make decisions that increase their wealth.

This theory can be applied to governance where the owners of an organization are the principals and management are the agents of the organization. The day-to-day decisions are left to management, which is supposed to allocate resources to promote the organization's interests. However, management may be motivated to act with self-interest to achieve promotions or certain metrics to achieve bonuses. Management may be more concerned with maximizing short-term results in order to receive better performance reviews and earn raises and bonuses, whereas the owners are interested in longer-term results.

In order to avoid these issues, principals (in this case, the owners) use incentives such as share options or bonuses to align management's behaviour with the best interests of the company, and monitor information to assess the current state of the organization against its plans.

External auditors' role in governance

The organization's external auditors perform another key form of external monitoring. The board of directors appoints the audit firm at the annual meeting on the recommendation of the audit committee (if such a committee exists).

Ethics and good governance

Strong organizational ethics are essential for good governance. The best action an organization can take to minimize unethical behaviour is to develop and maintain a strong ethical culture where all levels of the organization understand what is expected and a consistent set of principles and values applies equally to everyone. This culture is set by the board and the executives, and the management team must demonstrate their commitment to the culture they are setting, often referred to as “tone at the top.” Both corporate and professional codes of conduct (such as each province’s CPA code of professional conduct) provide guidance to individuals to assist with managing ethical dilemmas.

An organization’s established code of conduct can be used to measure the success in mitigating emerging ethical problems and challenges. The code should be updated periodically to incorporate mitigation advice for emerging issues and to keep the code current and relevant. The board of directors, management and employees of the organization should be reminded to review the code of conduct on an annual basis.

To minimize failures in corporate governance, board members need to be provided with resources and tools that allow them to carry out their significant responsibilities effectively. Board members should also complete an annual self-evaluation of both themselves and the board of directors overall. This will ensure the board continues to operate appropriately and identify areas of weakness that must be addressed. For example, it may be identified within the evaluation that a certain skill set is missing and therefore a new member of the board should be recruited with these skills.

Corporate social responsibility

Corporate social responsibility (CSR) can be defined as an approach undertaken by organizations to deliver social, environmental and economic benefits to all stakeholders. Organizations are expected to be good corporate citizens and are accountable for the impact of their actions on a number of stakeholders, such as employees, customers, the community, society and the natural environment.

Building a governance framework that considers a broad range of stakeholder interests is an essential component of CSR. Stakeholder theory suggests that it is in the best interests of a corporation to consider all the stakeholder groups affected by its activities. Proponents of stakeholder theory contend that appropriate acknowledgment of, interaction with and management of stakeholder groups will ultimately contribute to the company’s organizational wealth. This would presumably have positive effects on shareholder returns, although the focus is on longer-term benefits rather than short-term gains.

Measuring corporate social responsibility

CSR activities can be grouped into three categories: philanthropy, risk mitigation (to help ensure legal compliance and minimize reputational risk) and value creation (in terms of innovation, sustainability and brand leadership).[1]

Measuring CSR performance is more complex than measuring performance in economic or financial terms. The metrics used are specialized and frequently non-monetary in nature.

Many organizations would like to present the results of their social and environmental actions to the public; however, difficulties can arise when attempting to measure this performance because there is not a standard presentation. This makes it difficult to compare results across multiple organizations.

Environmental management and reporting

Monitoring and measuring environmental performance provides information that is useful to the board of directors and management when forming the corporate environmental policies of an organization. Environmental policies are typically developed to ensure compliance with legislation and regulatory requirements. This compliance is important to track; however, it can be challenging due to the changing environmental standards and differences in legislation in various locations. As a result, new models have been developed that also focus on other indicators such as processes, outcomes, systems and environmental impacts.

Practice questions

1. Multiple-choice questions:

   i. Which individual or group of individuals would be best suited to appoint the external auditors on an annual basis?

      a) The chief financial officer (CFO)
      b) The board of directors
      c) The controller
      d) The CEO

      Solution

      Option b) is correct. The board of directors is considered to be the group responsible for the overall governance of the organization. While the CFO and the controller will be the first point of contact for the auditors for all financial matters, there can be a perceived lack of independence should an employee of the organization have the sole responsibility to appoint the external auditors. And although the CEO may provide guidance to the board of directors when

[1] Barry Reiter, *Directors' Duties in Canada*, 5th edition (Toronto: CCH, 2012), p. 785.

making decisions relating to auditor appointment, there can also be a perceived lack of independence, as the CEO's compensation is often based on the organization's financial results.

ii. Which of the following would be implemented by an organization that is considering CSR?

a) Change the employee policy to ensure all employees start and finish work at the same time

b) Start a composting and recycling program for waste at the workplace

c) Hold monthly, in-person, mandatory management meetings, and require all managers to travel to the meeting location

d) Expand a charity's program that offers a breakfast program to a number of schools located in underprivileged areas

Solution

Option b) is **correct**. This change in policy is looking at the societal aspects of waste on the environment.

Option a) is incorrect. This would make the work environment stricter and goes against what would be a social benefit.

Option c) is incorrect. This does not consider other options that may have a lower environmental and work-life balance impact (such as using video conferencing to reduce the environmental impact of driving to each meeting and the time that employees are away from their families).

Option d) is incorrect. Although this promotes social good, it is not an example of CSR, as the charity is expanding an existing program that helps to fulfil its mandate.

2. What is stakeholder theory? What are the impacts of considering the various stakeholder groups to an organization's success?

Solution

Stakeholder theory suggests that it is in the best interests of a corporation to consider all the stakeholder interests affected by its activities. Ignoring the interests of any one group that may appear contrary to the shareholders' profit-maximization objective is expected to have negative, long-term profitability implications. Failing to consider the interests of stakeholders such as community and environmental groups, labour organizations and government regulators can easily lead to adverse public opinion, loss of customers or even legal action.

PART 2

Strategic planning

The strategic planning process includes the following:

- setting the mission, vision, values and objectives
- environmental scanning and industry analysis
- strategy formation
- strategy implementation
- strategic evaluation and performance measurement

Setting the mission, vision, values and objectives

Setting a strategy is critical to the development of the mission, vision, values and objectives of an organization. Each of the elements below represents a different part of the strategic process:

Element	What it expresses	What it looks like
Mission	Why the organization exists	A written statement of purpose or reason for existence
Vision	Where the organization is going, or what ultimate success will look like	A written statement defining the future desired goals
Values	Non-negotiable beliefs or ethical/cultural priorities that define the organization and attract stakeholders	A written statement of priorities and core beliefs
Goals / objectives	How the organization will achieve its vision and how progress will be measured along the way	A stated set of measurable milestones that move the organization toward its vision

Each of these items must be clearly documented and communicated to employees to ensure that the organization remains focused on activities relevant to achieving its goals. To ensure that there is a sense of ownership in the mission and vision of the organization, employees and the organization's key stakeholders should be involved in the development. Once the mission and vision are established, a statement of values is developed. Each of these items should be reviewed periodically to ensure that they remain relevant to the organization.

An organization will then set its goals and objectives. Goals, which are broader than objectives, define an organization's direction of development. Objectives are milestones that support the company's goals and align with its mission and vision. Each objective should be stated in a way that is specific, measurable, appropriate, realistic and time-bound (SMART).

Goals and objectives can be financial or non-financial. Financial goals tend to be easier to measure and report upon. However, relying solely on financial goals and objectives can result in decision-making that has a short-term focus where the bottom line of an organization is improved in current periods with little focus on the future. Goals or objectives can be tangible (easy to measure) or intangible (not able to be measured precisely).

Environmental scanning

Environmental scanning is the next step in the strategic planning process where an organization gathers information about its competitive environment. Environmental scanning focuses on both current and future impacts to the organization. A solid understanding of the industry in which the entity is operating is critical to ensuring that an appropriate environmental scan is done. Information is obtained from both internal and external sources when completing the analysis. As part of the internal analysis, organizations assess their systems and processes, culture, financial, human and intellectual capital. In the external analysis, an organization must monitor trends occurring within its industry, including the outlook of the market, changes in regulation and the competitive environment. Organizations need to understand what forces are in effect within the industry and identify the forces impacting their operations.

Organizations use a number of tools and models in completing their environmental assessment, which are detailed below.

PESTEL

PESTEL is a tool that is used to consider the political, economic, social, technological, environmental and legal factors within the operating environment. A comprehensive analysis of the external environment is essential to environmental scanning and strategy formulation, as multiple external forces and influences may impact organizations in complex and interrelated ways.

Value chain analysis

Value chain analysis enables an organization to understand how value is created along the supply chain. It can be performed at an organizational level as part of internal analysis and/or at a larger industry-wide level. To complete a value chain analysis, an organization must have a good understanding of its supply chain. Throughout this analysis, an organization divides the value chain into primary and secondary activities. Primary activities are those directly involved in the creation of a product or service, its sale and distribution and after-sales service. Secondary activities are those that provide the support necessary for the primary activities to occur.

Profit pool analysis

Profit pool analysis looks at where value is added at each point on the value chain to see where profit can be enhanced.

Porter's Five Forces

Porter's Five Forces is a framework used to analyze the competitive characteristics of an industry at the business-line level. The five forces are:

- threat of new entrants — an assessment of an organization's ability (or lack thereof) to enter a market
- threat of substitutes — the availability of substitute products or services available to customers
- bargaining power of customers — the customer's ability to buy the product at a lower price while maintaining a certain level of service or quality
- bargaining power of suppliers — the ability of the supplier to sell its goods or services at the highest price possible (which conflicts with the organization's desire to purchase at the lowest price possible)
- rivalry among existing competitors — an assessment of the intensity of competition within the industry

SWOT analysis

A SWOT (strengths, weaknesses, opportunities and threats) analysis is a tool used to evaluate the internal (strengths and weaknesses) and external (opportunities and threats) position of a business or a project, and is usually presented in a matrix format.

Industry and product life cycles

Each industry and product has a life cycle that goes through four major stages — introduction, growth, maturity and decline. Where the product or industry is in its life cycle determines the strategic approach the company will take.

Practice questions

1. Multiple-choice questions:

   i. If General Motors were doing a SWOT analysis during the 2008 global economic crisis, how would the company have considered the offer of the U.S. government to bail out the auto industry?

   a) Opportunity
   b) Strength
   c) Weakness
   d) Threat

   Solution

   Option a) is **correct**. As the offer is from a third party, this would be an external rather than internal source. Opportunities are external factors that impact an organization and can arise from competition, the market or the economy. Opportunities also include any chance the organization has to survive, increase market share or gain new sales (for example, following the collapse of a competitor).

   Options b) and c) are incorrect. These are internal factors.

   Option d) is incorrect. The bailout gave GM the opportunity to stay in business, and would not be considered a threat.

   ii. ABC Co. set an objective to decrease its central administrative expenditures activities by 5% within the next year. How would this objective be categorized?

   a) An intangible non-financial objective
   b) A tangible non-financial objective
   c) An intangible financial objective
   d) A tangible financial objective

   Solution

   Option d) is **correct**. The objective is financial, and it is measured by comparing both years' expenditures to determine if they decreased 5% from one year to the next. This is a tangible measure that can be assessed by using financial reports of the organization.

   Options a), b) and c) are incorrect. The objective is financial and is tangible, as it is easy to measure this objective reliably with the use of company financial reports.

2. Given the nature of the industry, both financial and non-financial objectives are critical to the success of airlines such as Air Canada. In fact, given the changing needs of customers and the increased use of social media to share experiences on the airline, some may argue that non-financial objectives are as important as the financial objectives in this industry

   Required:

   Provide examples of at least three financial and three non-financial objectives that may be applicable to an airline such as Air Canada.

   Solution

Financial objectives	Non-financial objectives
• Improving the operating margin by 4% for the upcoming fiscal year	• On-time arrival of flights (defined as arrival within 15 minutes of the posted arrival time) on 75% of all flights
• Increasing the passenger load factor percentage to 81% overall	• Delivery of luggage to the baggage carrousel within 15 minutes of a domestic flight and 30 minutes of an international flight
• Increasing the return on invested capital to 14% overall in the upcoming fiscal year	• Reduce carbon dioxide emissions by 50% by 2025 (relative to 2005 levels)
• Achieving a reduction in net debt of $500 million within the next three fiscal years	• Maintain the 7/7 star safety record through the Australian-based rating system of airlineratings.com
• Achieving an improvement in diluted earnings per share of $0.50/share	• Increase the number of women and visible minorities in management positions to 45% by 2020

PART 3

Strategic management

Strategy formulation, implementation and evaluation are collectively referred to as strategic management. The strategic management process encompasses the complete set of commitments and decisions made and actions taken by an organization to achieve and sustain the desired benefit of strategic competitiveness and above-average performance. Using the tools and analysis discussed in Part 2, an organization formulates its unique strategy. Strategy is looked at from three different levels:

- corporate — focus on determining how an organization can obtain a competitive advantage
- business — focus on how each division or program in the organization will use its resources to succeed in its market and meet the goals and objectives set for it by the corporate-level strategy
- functional — focus on using the resources and competencies of each functional area, such as departments within an organization, to create value that supports corporate- and business-level strategies

These levels are applicable to both for-profit and not-for-profit organizations.

Customer value proposition

A customer value proposition is a concise statement of reasons why a customer should buy a product; it distinguishes a product or service from competitors' products. To develop this, an organization must know what is valued. There are several common strategies to support the customer value proposition:

- cost leadership — adding value by finding efficient ways to reduce cost
- price leadership — attracting customers by offering the lowest price
- differentiation — finding ways to be cheaper than competitors based on reputation, service, quality or other features valued by the customer
- focused/niche — offering a small number of products or services focused on a subset of customers, but at the level of quality required to gain their loyalty and justify a premium price
- best value — finding the optimal tradeoff between price and quality or price and performance to provide the greatest benefit to customers
- blue ocean — creating a market where there is no competition, based on the idea that low cost and high differentiation can be achieved simultaneously

Strategic vehicles

Strategic vehicles support an organization's chosen strategy, and may form part of the organization's corporate- or business-level strategy. There are a number of vehicles an organization can use:

- diversification —expanding products and services into different areas, either within the existing industry or outside of it
- defensive — changing the direction of the company, which can include divesting all or part of a business, or retrenchment
- integration — focus on how much of an industry's value chain the organization owns (forward, backward and horizontal integration)
- intensive — focus on growth through concentration (as opposed to diversification) in an attempt to do more with less, achieving superior results
- unbundling/outsourcing — dissecting a company's value chain into its component parts in order to determine which functions or activities add value to the organization. If they don't add value, they are outsourced (pay another entity with expertise to do the tasks).

An organization may also choose to grow its business by other means, such as engaging in:

- joint ventures — a business agreement in which two or more parties agree to combine resources for a specified period of time to develop a new entity with new assets
- strategic alliances — any cooperative effort between two or more independent organizations to develop, manufacture or sell products or services
- mergers — when two firms are combined on a relatively equal basis
- acquisitions — the purchase of one firm by another

An organization may also choose to grow internationally, which will require an assessment of the risks found in the international markets. Part 2 discussed a number of tools and models that can be used in this type of assessment.

Strategic implementation

Once a strategy is determined, it is time for the organization to implement its strategy. Poor implementation of the strategy can result in a failure of even the greatest strategies. Strategy implementation is arguably the most important element of strategic management, and strategy should never be formulated without a plan for its implementation. One type of strategy implementation an organization may use is the three Cs: clarify, communicate and cascade.[2]

Implementing an organization's strategy may require changes to the organization's structure. The goal is to have the strategy and the organizational structure align as

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[2] Scott Edinger, *Three Cs of Implementing Strategy* (forbes.com/sites/scottedinger/2012/08/07/three-cs-of-implementing-strategy/, 2012).

much as possible. The most common organizational structures are functional, divisional or matrix structures.

Successful strategy implementation

An organization's culture is of critical importance when forming and implementing strategies. All organizations have cultures of one type or another, but having the right organizational culture is key to achieving strategic goals. A strong culture helps to ensure focus on the strategy and commitment from employees and translates into strong support for implementing a strategy that reinforces the beliefs, systems and corporate values.

Employee recruitment, training and retention also play a critical role in strategy implementation. A company needs to have the right people in the right places doing the right things at the right time to ensure success.

Implementing a new strategy is not a linear process. Change management techniques such as communication, managing resistance to change and involving stakeholders to understand the change help to ensure that everyone involved understands the organization's strategy, including the mission and vision as well as the specific divisional- and functional-level changes that impact them. Without effective change management, employees may resist the change or act in ways that are out of alignment with the new strategic direction. Fair, open and regular communication is one of the best tools for overcoming resistance to change and facilitating strategy implementation.

Many areas in an organization have a role to play with strategy implementation, most notably the operations, human resources, finance, accounting, marketing and information technology groups. The leaders of each of these groups are responsible for implementing the strategy. This will involve each of the groups working together and gathering information to assist with the evaluation of the strategy.

Strategy evaluation

An organization must evaluate and monitor performance to determine if the strategy is being properly implemented and if it remains relevant and appropriate. If it is determined that there are changes in the factors or circumstances on which the strategy was originally developed, a corrective action will be required.

The assessment should include both internal and external changes that may impact the organization's ability to achieve its objectives. Many of the tools and frameworks addressed in Part 2 would be utilized during this assessment phase. Comparing the actual performance against targets will show where performance is meeting expectations and where it is not. The assessment should allow management to determine if the strategy is not being properly implemented or if the strategy itself is flawed. Throughout the assessment, the organization's stakeholders should be considered.

The competitive environment should also form part of this assessment as organizations are often inclined to make changes to their operations in response to changes from their competitors. Evaluating the competitive environment can help the organization ascertain why competitors are making strategic changes and why some competitors' strategies are more successful than others.

If it is determined that the strategy is flawed or not properly implemented, corrective action is required. Corrective action may involve steps such as resource reallocation, further training or revising estimates and plans. Strategy formulation, implementation and evaluation is an iterative process, and organizations will go through these three steps as they grow and change.

Practice questions

1. Multiple-choice questions

   i. A corporate-level strategy addresses which one of the following issues?

      a) Selecting the industries where the firm will compete
      b) Selecting specific product markets to compete within
      c) Identifying the primary value chain activities the firm will use to design, produce and deliver the product or service
      d) Determining particular geographic locations where the firm will operate

      Solution

      Option a) is **correct**. An organization's strategy describes how it will match its own capabilities with the opportunities available in the marketplace to accomplish its overall objectives. The determination of the industry to do business in is a critical corporate strategic decision relating to being in the right mix of businesses.

      Options b), c) and d) are incorrect. These decisions relate to the business-level strategic decisions. The focus at the business level is to ensure that the organization is using its resources to succeed in its market and meet the goals and objectives set for it.

   ii. Mountain Gear Outfitters is a manufacturer of gear required for indoor and outdoor wall/mountain climbing. It has recently determined that it will start to offer clothing that climbers can wear for both indoor and outdoor climbing. What type of strategic vehicle does this best represent?

      a) Unbundling/outsourcing
      b) Defensive
      c) Integration
      d) Diversification

Solution

Option d) is **correct**. This is an example of a diversification strategy. Mountain Gear Outfitters is developing new products that are closely related to its core business of mountain climbing gear.

Option a) is incorrect. Unbundling/outsourcing strategies involve dissecting a company's value chain into its component parts in order to determine which functions or activities add value to the organization.

Option b) is incorrect. Defensive strategies involve divesting of a part or all of a business or retrenchment to change the direction of the company.

Option c) is incorrect. Integration focuses on how much of an industry's value chain the organization owns.

2. An organization may use the cost leadership strategy or the price leadership strategy to pursue its mission and vision.

Required:

a) Explain the concept of the cost leadership strategy and provide one real-world example of a company applying this strategy.
b) Explain the concept of the price leadership strategy and provide one real-world example of a company applying this strategy.

Solution

a) Under a cost leadership strategy, value is created by keeping costs lower than those of competitors. Under this strategy, organizations need to find ways to reduce costs. One way a company can achieve this is by producing in higher volumes as a means of reducing the average costs per unit. The McDonald's restaurant chain is an example of the cost leadership strategy. McDonald's has been able to keep its costs low as a result of ordering high volumes of food, due to the thousands of locations it owns. As a result of the low costs, McDonald's is able to offer lower prices to its customers.

b) Under a price leadership strategy, customers are attracted to the organization by offering them the lowest price. The price leadership strategy differs from the cost leadership strategy as price leaders generate their profits by selling high volumes. Under this strategy there is still a focus on cost reduction, but the main focus is maximizing sales volume. An example would be a grocery store offering multi-discounts on items (buy one jar of pasta sauce for $4, or buy three jars for $10).

PART 4

Strategic control

Strategic control is the process used to control strategy formulation and implementation and to gauge whether the organization is making the right strategic choices on an ongoing basis during these stages. Contemporary strategic control is a dynamic approach to strategic control that looks at the relationships between strategic control, strategic formulation and strategic implementation, and it can be divided into two distinct parts:

1. **Informational control** attempts to determine whether the company is doing the right things.
2. **Behavioural control** attempts to determine whether the company is doing things right.

Performance measurement systems

Performance measurement systems monitor detailed results over the long term, using precise metrics to support an organization's internal evaluation of progress toward achieving its objectives. Organizations determine the relevant key success factors and which metrics to track — often referred to as key performance indicators.

Timely reporting on the organization's performance assists with determining whether adjustments are required to keep the organization on track to meet its strategic objectives, and it provides management with early warnings of emerging problems. This reporting forms part of the dynamic approach noted above, and changes can be made where needed to get the organization back on track to achieve its strategic goals.

Rewarding performance

Organizations will develop a performance measurement system to assess performance against established metrics or targets. This assessment assists in determining whether the organization's strategic objectives are being met. Individual employees' performance is assessed against subsets of these metrics, and this is typically tied to their compensation.

A number of theories, including expectancy theory, have been developed to predict how employees will behave when a performance evaluation system is put in place. Expectancy theory states that individuals are motivated to pursue results if they believe there is a predictable relationship between their decisions and measured performance and between measured performance and rewards, and that a favoured performance will result in a valued reward.

The sophistication of compensation plans is based on the type of organization and the resources available. Management and employees are typically paid a wage as well as a year-end bonus, which may include share-based compensation such as share options and share awards. These types of plans are designed to directly align management, employee and shareholder interests.

Risk management

A key part of an organization's governance and strategic planning processes relates to identifying and managing risks. Risk is the probability that an outcome will vary from expectations; the greater the likelihood of the outcome is, the riskier the proposition will be. Risk management responsibilities are shared by management and those charged with governance. A typical process includes the following steps:

1. Determine risk tolerance/appetite and verify it matches the mission, vision and values of the organization.
2. Ensure the business model is aligned with the level of risk tolerance/appetite.
3. Identify and evaluate risks.
4. Compare identified risks against the level of risk tolerance/appetite.
5. Determine and implement risk responses.
6. Monitor the effectiveness of the risk responses and adjust as required.

Strategic planning requires an organization to determine its risk tolerance and risk appetite in order to make an informed decision.

Enterprise risk

Enterprise risks are the risks faced by an organization in the course of working toward its strategic objectives. Types of enterprise risk include the following:

- **Strategic risk** arises as a result of errors or miscalculations made in planning, implementing and executing strategies.
- **Operational risk** is a risk of loss resulting from inadequate or failed resources, systems, personnel or processes.
- **Compliance risk** is a risk to the financial results of an organization arising from violations or non-conformance with laws, regulations, practices or policies.
- **Reporting risk** is a risk resulting from misreporting of information (financial or other).

Risk assessment and evaluation

Once the risks related to an organization or their strategies have been identified, the next step is risk assessment and evaluation, which includes determining the probability the risk will occur and the impact of the risk if it does occur.

There are five methods of responding to risk:

- **Accepting** a risk means acknowledging that if the risk event does occur, the organization will have to absorb the consequences involved with responding to that event at the time it happens.
- **Sharing** minimizes risk by spreading it out among two or more organizations, particularly in situations involving large projects and transactions.
- **Transferring** risk occurs when an organization arranges for a third party to accept the risk on its behalf.
- **Reducing or mitigating** risk involves taking precautions that reduce the probability of events occurring and minimizing the associated costs if they do occur.
- **Avoiding** risk involves staying away from risky activities.

The chosen risk response should correspond with the evaluation of the probability and impact of the risk.

Contingency planning

When completing a risk assessment, it is important to consider contingency plans for critical risks that exist. It is not necessary to develop a contingency or backup plan for all risks identified in the organization's risk assessment, but plans should be made for the key risks identified. Depending on the nature of the risk, an organization may create a disaster recovery or business continuity plan. The major objectives of contingency planning are to minimize the loss of or injury to personnel, to contain damage to property and to ensure continuity of the company's key functions and operations.

Management reporting needs and systems

Reliable and relevant information is critical for management and those charged with governance to monitor results and make decisions relating to strategy. Data to make these decisions are extracted from an organization's information systems, which rely upon proper controls, such as appropriate access, processing and data entry controls and adequate backup procedures.

Information systems are a powerful tool for organizations to use as part of their business strategy. Management is responsible for developing and implementing information system strategies that integrate and support the organizational objectives. The board's role is to approve and oversee these strategies and to ensure that they deliver the expected results.

An organization may decide to acquire a system or develop the system internally. There are four steps to this process:

1. Establish system requirements, including detailed technical requirements.
2. Obtain proposals from vendors.
3. Analyze vendor submissions and rank proposals.
4. Award contract.

Regardless of whether the system is acquired or developed internally, when implementing a new information system, management can follow the systems development life cycle, which involves five steps:

1. Planning
2. Analysis
3. Design and development
4. Implementation (parallel, phased or direct cut over conversions)
5. Maintenance

Project management principles should be applied when a system is in the process of being developed or implemented, as this helps to ensure the project deliverables are achieved.

Practice questions

1. Multiple-choice questions:

    i. Vacation Adventures Ltd. (VAL) is a travel company offering extreme vacation experiences worldwide. VAL will arrange all details in the vacation including air travel, accommodations and extreme local experiences relying heavily on the expertise of the local residents to provide guidance. VAL has recently partnered with an insurance company to offer travel insurance to vacationers.

    The purchase of travel insurance is an example of what type of risk response?

    a) Mitigating risk
    b) Transferring risk
    c) Avoiding risk
    d) Accepting risk

Solution

Option b) is **correct**. The purchase of travel insurance transfers the risk from the vacationer to a third party who accepts the risk on the traveller's behalf.

Option a) is incorrect. Risk mitigation would involve the traveller taking precautions to reduce the probability of risks or events occurring, which is not possible in this scenario.

Option c) is incorrect. Avoiding risk would involve staying away from risky activities (that is, choosing not to travel).

Option d) is incorrect. Accepting the risk would mean the traveller would not purchase any insurance; if a risk event occurred, they would absorb the financial consequences of dealing with the event.

ii. Rocky Mountain Gold Corp. holds mining interests throughout Canada. It has recently purchased a new property in the Yukon that has been abandoned by the predecessor mining company for a number of years. Upon further due diligence, it was identified that the new property was in violation of a number of recently announced environmental regulations.

What type of enterprise risk does this best represent?

a) Compliance
b) Reporting
c) Strategic
d) Operational

Solution

Option a) is **correct**. Compliance risk is the risk to a company's earnings or assets arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, internal policies and procedures or ethical standards. The violation of the environmental standards will require Rocky Mountain Gold Corp. to complete work to ensure compliance with the regulations.

Option b) is incorrect. Reporting risk is the misreporting of information, either financial or relating to company practices.

Option c) is incorrect. Strategic risk arises from mistakes or miscalculations made in planning, implementing and executing strategies.

Option d) is incorrect. Operational risk is loss resulting from inadequate or failed resources, systems, personnel or processes.

2. Waterloo Theatre Centre (WTC) is a regional, non-profit, professional theatre company offering six mainstage productions every season as well as comedy, music, drama and family programming. Recently, WTC began offering ticketing services to third parties that host the shows and allow patrons to purchase tickets using the WTC platform. This new line of business is cumbersome within the existing system. As a result, WTC is looking to implement a new integrated ticketing and reporting system to facilitate the reporting to its board of directors, funding agencies and third parties.

   Required:

   When purchasing or developing a new ticketing and reporting system, what should WTC consider?

   Solution

   WTC will first need to determine whether it will develop the system internally or purchase one from a third party. While the staff and volunteers at WTC are aware of the requirements of the system, it is unlikely that there are appropriate internal resources to develop a stand-alone system given that the organization is a regional, non-profit theatre. In addition, the cost to develop a system internally would likely exceed the benefits. Therefore, the purchase of a third-party system would be most appropriate. WTC would follow the four steps for system purchases:

   1. Establish system requirements, including detailed technical requirements.
      - This step will involve input from all users of the system to ensure their requirements and specifications are considered within the request for proposal (RFP) submitted to vendors. The specifications will include user criteria against which the various vendors can be compared.

   2. Obtain proposals from vendors.
      - Vendors will submit proposals to WTC which are assessed against the RFP issued.

   3. Analyze vendor submissions and rank proposals.
      - Upon receipt of the proposals from the vendors, WTC staff will analyze and rank the proposals. The ranking will be in accordance with the criteria set out in the first stage and other considerations, such as vendor experience and cost.

   4. Award contract.
      - Based on the ranking and cost of the proposals, WTC will award a contract for the purchase of the system and develop the plan for the implementation of the system.

PART 5

Strategic cost, capacity and quality management

Part 5 focuses on management tools and models that help organizations strategically manage costs or increase quality to provide higher value to customers, and ultimately generate improved profitability.
There are a number of common practices or approaches used in planning and managing an organization's costs and capacity.

Target costing

The target cost is set by determining what price the market will bear, rather than determining the costs to manufacture and then marking the product up. This tool determines the product's design and thereby the process that will be used to manufacture the product. The target costing cycle is as follows:

1. Estimate the price the market will set for a proposed product with specific attributes.
2. Estimate the cost of developing and producing the proposed product. This actual expected cost is called the as-if cost.
3. Determine the required investment level in the product, based on the product and process design.
4. Compare the product's as-if cost to the target cost. If the as-if cost is greater than the target cost, the product and process are redesigned or reformulated to reduce the product's as-if cost.

Capacity resource planning

An organization will make decisions regarding how much output to produce in conjunction with anticipated demand and will incorporate this quantity into the annual capital and master budgets. There are two types of capacity: design capacity, which is the maximum output based on ideal operating conditions; and effective capacity, which is the output considering certain factors such as maintenance, scheduling considerations and rest periods. Capacity can be increased by hiring additional personnel or making changes to the flow of work. It can be decreased by reassigning employees to other tasks. Organizations work to manage overall capacity by using three basic strategies:

- Capacity lead strategy is an aggressive strategy where capacity is increased in anticipation of increased demand.
- Capacity lag strategy is a conservative strategy where capacity is increased only after demand increases.
- Average capacity strategy is a moderate strategy where capacity is increased to meet average expected demand.

Outsourcing

Outsourcing is done to free up resources and increase overall capacity, after determining what activities can be outsourced. Outsourcing is often used as a means of cost management.

Offshoring involves using overseas service providers for certain outsourced activities, such as the finance and accounting functions. Offshoring allows an organization to take advantage of different time zones around the world to increase productivity but has the disadvantage of loss of control of the process. Offshoring can also result in ethical challenges, such as compensation of employees significantly differing from the onshore environment.

Core competencies should not be outsourced or offshored, as these situations remove activities from the organization’s control and greatly reduce internal team members’ knowledge and competence in that particular area.

Improving efficiency and effectiveness

There are a number of models organizations can use to improve efficiency and effectiveness:

- Business process management (BPM) works to optimize business processes in order to improve efficiency and flexibility. An organization will document its critical activities to break them down so that it will have a better understanding of the processes to improve efficiency and effectiveness.
- Business process re-engineering goes further than BPM; it involves completely rethinking and redesigning the business processes to achieve significant improvements in performance. It is often used to help achieve an organization’s revised strategy. This can be a time-consuming process and often relies on effective change management techniques, given the significant changes to an organization.
- Just-in-time (JIT) production maintains minimal inventories in an attempt to eliminate disruptions and use resources effectively to reduce product defects, inventory and wait time. This approach requires commitment from management and suppliers as well as an appropriate communication strategy with employees and customers.
- Lean management focuses on maintaining what the customer values while reducing the work performed by the organization.
- Customer relationship management (CRM) manages an organization’s relationship with current and future customers. Integrating sales, marketing and customer supports/service allows an organization to improve and enhance communications with customers.
- Enterprise resource planning is software that integrates all departments and functions into a single information technology (IT) system for all business processes to allow employees access to organizational information in order to make the best decisions for the organization.

Quality management

Managing an organization's quality is critical to the long-term success of the organization. Quality management encompasses both quality control (focus on finding problems and defects after the fact) and quality assurance (a proactive approach that attempts to integrate quality into processes and production to avoid issues after the fact).

Total quality management (TQM) focuses on efficiencies and standardization within processes in order to support product quality and reduce costs. Some commonly used TQM tools are process flowcharts, scatter diagrams, control charts, Pareto charts and cause-and-effect diagrams (Ishikawa diagrams).

Cost of quality

Cost of quality is a methodology that looks at the costs of failing to produce a defect-free product. There are four components to the cost of quality:

- **Prevention costs:** costs of activities designed to prevent defects (such as training employees responsible for production).
- **Appraisal costs:** costs of inspections used to identify defects (such as inspecting raw materials upon delivery from suppliers).
- **Internal failure costs:** costs of repairing or replacing defective products during production (can include normal scrap costs).
- **External failure costs:** costs of repairing or replacing defective products after they have been delivered to the customer (such as warranty claims).

An organization's cost of quality is often reported in a form that examines each type of cost and identifies it as a percentage of the total sales to determine the actual costs of ensuring a quality product.

Quality measurement systems

Quality measurement systems are statistical tools used to measure quality initiatives. These systems can use various tools, such as descriptive statistics, statistical processes, control and acceptance sampling. A common example of a quality measurement system is the Six Sigma quality management initiative.

Practice questions

1. Multiple-choice questions:

   i. Nifty Sneakers Co. is a designer of high-quality, customized running shoes used by all types of runners (beginners to competitive marathon runners). Recently, given the success of the running shoes, Nifty Sneakers has expanded into a line of customized runners' clothing. In anticipation of the demand for the products, Nifty Sneakers has arranged production with a subcontractor, who will manufacture the clothing. It is now March, and to ensure the clothing is available for customization in time for the outdoor training season, Nifty Sneakers has instructed the subcontractor to produce a significant quantity of the base products to allow the customization to occur quickly, as its customer base tends to request customized products immediately.

   This is an example of which strategy for managing overall capacity?

   a) Capacity lag strategy
   b) Capacity lead strategy
   c) Average capacity strategy
   d) Capacity resource planning

   Solution

   Option b) is **correct**. Capacity has been increased in anticipation of demand, given that the customer base may be impatient and may request its customized products immediately. This is an aggressive strategy, as there can be issues if the demand does not materialize.

   Option a) is incorrect. Capacity lag strategies will increase capacity only once demand for the products increases. In this example, Nifty Sneakers would wait for the demand from customers to increase before producing the base products.

   Option c) is incorrect. Capacity is increased to meet the average expected demand. With Nifty Sneakers, there was a planned significant quantity increase of the base products, which is riskier.

   Option d) is incorrect. Capacity resource planning describes different strategies used to manage overall capacity.

ii. MC Car Company has completed an assessment of the production process where it has mapped out the process, provided training to employees on the process completed and determined the areas of the production process where there is waiting time, scrap produced within the process and inventory onsite that is not required at the current time. Based on this exercise, MC has contacted its key suppliers to obtain commitment on the on-time delivery of critical components of the production process.

This is an example of which management tool?

a) Lean management
b) CRM
c) Enterprise resource planning (ERP)
d) Just-in-time production (JIT)

Solution

Option d) is **correct**. JIT attempts to eliminate disruptions and use resources in the best possible way. Anything that does not contribute to the value of the product is considered waste. A successful JIT implementation requires careful planning and buy-in across the organization and from suppliers.

Option a) is incorrect. Lean management looks at reducing waste and increasing efficiency in order to improve value to the customer — that is, the focus is on the customer first.

Option b) is incorrect. A CRM model looks to manage relationships with current and future customers.

Option c) is incorrect. ERP is software that integrates all departments and functions into a single IT system.

2. Outsourcing can be an effective way to increase an organization's capacity and reduce its costs. Provide at least two examples of the advantages and disadvantages associated with outsourcing.

Solution

Advantages	Disadvantages
Outsourcing of activities can free up time to allow employees to focus on the critical or core areas of the business and not be responsible for routine, non-value-added tasks.	Control of the outsourced activity is transferred to another company. This may be one activity or the activities of an entire department. This situation may create conflict if the outsourcing company does not have the same standards.
Outsourcing can be a means of significant cost reduction for a company.	Ethical issues can arise if the working conditions and labour practices of the company the activities have been outsourced to are not consistent.
The outsourcing company will specialize in the area being outsourced, resulting in more efficient and perhaps higher-quality outputs.	Proprietary company information can be shared if the same privacy regulations are not consistent or enforced.
Depending on the location of the outsourced company, there may be advantages in the distribution network to end customers.	Outsourcing can create strain on the existing staff if the communication of the logic for outsourcing is not properly communicated.
There can be increased productivity depending on the location/time zone of the outsourcing company (may act as an additional shift).	There may be quality issues with the products, given the lack of oversight by the company (depending on the location of the manufacturing facilities).

PART 6

Performance monitoring and evaluation

Organizations use a number of tools or methods to monitor and evaluate their performance. Part 6 focuses first on monitoring tools and then on responsibility accounting, identifying the differences between profit-oriented and not-for-profit organizations.

Monitoring tools

Management by objectives

The manager and employee develop objectives, goals and measures that align with the overall vision and mission statement, along with the time frame in which these will be achieved. This approach can foster greater employee commitment to the organization, given that employees are personally vested in achieving the goals and objectives they helped develop. For the approach to be successful, management must be open to the ideas put forth by employees, and all employees must be aware of how their role integrates with the larger organization.

Activity-based management

Activity-based costing (ABC)[3] is the first step in the activity-based management (ABM) process. Once an organization has implemented the ABC system, ABM uses the cost driver and activity information to establish the appropriate costs and activities to be used within an employee's performance evaluation. Using ABM in an organization improves costing information, giving management improved information for analysis and decision-making purposes. However, the implementation of such a system can be costly, and tying an employee's performance to individual activities may result in a lack of strategic focus.

Balanced scorecard

The balanced scorecard (BSC) is a strategic performance measurement tool that utilizes four distinct yet interrelated perspectives (both financial and non-financial) to provide a more balanced view of organizational performance:

1. The financial perspective includes traditional measures such as profit margins, return on equity or return on assets. It is necessary, as adequate financial returns need to be provided to shareholders.
2. The customer perspective focuses on measures such as customer satisfaction and growth in market share. These measures tie into the financial perspective, as repeat

[3] If you require additional information on this topic, please refer to the discussion of ABC included in the Management Accounting Primer.

customers and an increase in market share will increase the bottom line, thus generating higher profits.

3. The internal business process perspective focuses inside the organization by measuring such items as variances to standard costs and the number of product returns due to quality issues. By focusing on this measure, the organization can see where it needs to tighten up processes or where there are gaps to fill to improve profitability.
4. The learning and growth perspective focuses on the ability to change and improve an organization and can include measures such as number of new products or services developed, or training hours. By focusing on employees, an organization can improve employee engagement and loyalty, thus decreasing training and hiring costs. In addition, employees can help move the organization forward with their in-depth knowledge of the organization.

This tool helps an organization have a balanced focus and includes past, current and long-term measures. It can be costly to implement and requires information beyond financial information in order to assess the success against the various metrics.

Responsibility accounting

Responsibility accounting is the accounting system used to measure the plans and outcomes of the responsibility centres within an organization. It assists in the performance management process by holding managers accountable for the activities, decisions and results they are responsible for or the ones they can control. Responsibility centres are a means to delegate decision-making responsibilities within an organization, with managers being assessed on the activities they have control over. An organization must choose the type of responsibility centre used in performance reporting. The following are the four major types:

1. **Revenue centres** assume the responsible manager has control only over the revenues generated by the centre, not over the costs associated with the centre. Managers may be assessed based on metrics such as revenue growth or customer satisfaction.
2. **Cost centres** assume the responsible manager has control over the costs incurred but not the revenue generated. Managers may be assessed based on how well they control cost in comparison to the budgeted cost information.
3. **Profit centres** assume the responsible manager is accountable for the profit their unit contributes to the organization — that is, both the revenue generated *and* the costs incurred. Managers may be assessed based on a comparison of the organization’s actual profit to the budgeted profit as well as an increase from prior years’ profits.

4. **Investment centres** assume the responsible manager has control over both the profit and the level of investment in the centre. The manager is responsible for revenue generated, costs incurred and the assets and resources allocated to the centre. Common performance measures are return on investment and residual income.

Responsibility accounting and performance for not-for-profit and government organizations

Measuring success in a profit-oriented organization versus a not-for-profit organization (NFPO) is very different. A profit-oriented organization focuses on maximizing sustainable shareholder value, which leads to a focus on maximizing profits. NFPOs focus on efficient and effective service delivery by following their charters. They also need to be mindful of any donor or funder stipulations that may impact the use of funds. These organizations must still manage their costs to ensure they are operating within their approved budgets; however, the focus is not on increasing profits because profits do not exist in an NFPO.

There are four basic steps in management control in NFPOs:

1. **Programming and program analysis** involves measuring the output the organization wishes to accomplish through the delivery of the programs. An NFPO will set objectives with its program delivery to ensure its goals are being met. For example, a program to deliver hot breakfast to underprivileged children may measure the number of meals served.
2. **Budgeting and control of operations** involves comparing the actual results to the budgeted results. Given the focus on the programs offered by the NFPO, program managers should be responsible for the development of their budget. Performance of the program managers should be based on the achievement of the program budget (for example, serving the target number of families at or below budgeted cost).
3. **Output measurement** is used to measure efficiency and effectiveness. NFPOs focus on measuring social indicators (the organization's impact on society), process measures (measures relating to the organization's activities) and results measures (results measuring the organization's effectiveness). For example, the budget as given was supposed to feed 500 underprivileged children, but efficiencies were found, and we were able to feed 600 underprivileged children without additional cost.
4. **Reporting performance** is concerned with reporting the results of the NFPO. Reporting should be based on comparing the actual performance to the best available standard (which is typically one of the budgeted, historical or external standards). For example, in each of the past three years, we have increased the number of underprivileged children receiving breakfast by 15%.

Practice questions

1. Multiple-choice questions:

   i. Fred is the production manager for Loggerhead Manufacturing Company, a manufacturer of prefabricated log homes in British Columbia. Fred negotiates contracts for raw materials based on the most economic means of minimizing ordering and storage costs without running out of materials. He also schedules staff to maximize the number of log cabins made with the resources available. Fred's department should most likely be what type of responsibility centre?

      a) Revenue
      b) Cost
      c) Profit
      d) Investment

      Solution

      Option b) is **correct**. Fred can control costs, but he has no control over revenues and therefore no control over profits. There is also no indication that he has any control over the long-term assets used in his department.

      Option a) is incorrect. Fred appears to have no control over revenues, so he should not be held responsible for them.

      Option c) is incorrect. Fred appears to have no control over revenues and therefore no control over profits, so he should not be held responsible for profits.

      Option d) is incorrect. There is no indication that Fred has any control over the long-term assets used in his department, so his department should not be evaluated as an investment centre.

   ii. Which of the following is true when comparing profit-oriented entities and NFPOs?

      a) NFPOs and profit-oriented enterprises both evaluate success on the basis of performance metrics.
      b) NFPOs' activities are often constrained by the requirements of funders, whereas profit-oriented enterprises are not.
      c) Profit-oriented enterprises consider tax implications in the decisions they make, whereas NFPOs never need to consider tax implications.
      d) Diversity and expertise on the board are more important in NFPOs than in profit-oriented enterprises.

Solution

Option a) is **correct**. Both NFPOs and profit-oriented enterprises evaluate success on the basis of performance metrics. The two will have very different metrics, though, based on how they define success.

Option b) is incorrect. Profit-oriented enterprises are also constrained by funding requirements, such as major shareholder demands or bank covenants.

Option c) is incorrect. This is not always true. NFPOs generally do not need to consider income taxes when making decisions, but they do need to ensure that they are onside with Canada Revenue Agency guidelines on an ongoing basis for items such as GST returns and employee remittances.

Option d) is incorrect. Diversity and expertise on the board are essential for both types of organizations. The difference is that profit-oriented boards may have an easier time attracting board members because they have better access to financial resources and are less dependent on volunteers.

2. Little Tykes Day Care offers full-time, half-day and before- and after-school day care services to children aged one year to 12 years of age. Its mission is to provide high-quality, personalized childcare in a safe and nurturing environment to stimulate cognitive, emotional and social growth. The executive director of the day care is looking to implement a balanced scorecard as a performance measurement tool to ensure all organizational activities are aligned with the mission.

Required:

Provide an example of a measure for each perspective under the balanced scorecard model for the day care.

Solution

Perspective	Example
Financial	Financial results for the year ending March 31 compared to the budget
Customer	Length of wait list by age level for the current and prior fiscal years
Internal business process	Successful completion of the most recent licensing assessment for the day care
Learning and growth	Length of time to implement the new provincial child care curriculum (from release to implementation)