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## Introduction

There are different study materials and modes for you to prepare for ACCA professional exams.

You can prepare the exam through self-study mode by reading textbooks and practicing revision tests from Approved Content Providers

Or you can go directly to the classes offered by ACCA Approved Learning Partners and stick into their notes.

However, no matter you are choosing which modes of study or which textbook, you need to know the technical articles published by ACCA for each paper is one of the best materials to prepare for your exams that you cannot miss.

In general, the articles are published by ACCA exam team and the contents are updated on a regular basis.

They highlight the core concepts or important areas that a lot of students cannot do well in the past exams.

The most important part is technical articles are generally the guidance to which question to be seen in upcoming exam.

Here are June 2018 examiners comments on ACCA Paper P7 (Advanced Audit & Assurance):

### Question Five

This was a reporting question and was in two sections. It was noted that this question was favoured by candidates who had obviously read the recently updated relevant article on the student website.

The second requirement was to critically appraise an extract from an auditor's report, which had been incorrectly prepared and needed amendment. As noted above it was clear that the candidates who selected this question had evidently read the relevant article and were able to identify that the sections were in the wrong order, contained inappropriate wording and that the key audit matters and emphasis of matters paragraphs had been incorrectly used. Good candidates were able to explain when an issue should be included as a key audit matter or if the issue would result in a qualification and hence needed to be part of the basis of opinion paragraph. Other candidates correctly commented that it would be inappropriate to include an emphasis of matter paragraph but that the report should include a section headed material uncertainty related to going concern.

Since it help thousands of students to prepare exam, I organized the articles published by ACCA and summarized them according to their topics and syllabus with relevant questions as Supplementary Notes for those who are interested to focus on the key or challenging areas.

Remember these articles are helping you to enhance your knowledge on particular subjects, and not a substitute of approved textbook.

## Chapter 1 Not-for-profit organisations – part 1

### Executive Summary

#### WHAT IS A NOT-FOR-PROFIT ORGANISATION?

- Do not have external shareholders providing risk capital for the business.
- Do not distribute dividends.
- Their objectives usually include some social, cultural, philanthropic, welfare or environmental dimension.

Types of not-for-profit organisation: 1) Public sector organisations; 2) Private sector organisations

Not-for-profit organisations are invariably set up with a purpose or set of purposes in mind

- If it is a company, it will have a Memorandum and Articles of Association, with the contents of the latter entrenched to ensure that the objectives cannot be altered easily in the future.
- Unlike profit maximisers, however, the broad strategic objectives of not-for-profit organisations will tend not to change over time.

Value for money:

- effectiveness
- economy
- efficiency

Several exams in the ACCA Qualification may feature questions on not-for-profit organisations. Although many of the principles of management and organisation apply to most business models, not-for-profit organisations have numerous features that distinguish them from the profit maximising organisations often assumed in conventional economic theory.

This article explains some of these features. The first part of the article broadly describes the generic characteristics of not-for-profit organisations.

The second part of the article takes a specific and deeper look at charities, which are one of the more important types of not-for-profit organisations.

## **WHAT IS A NOT-FOR-PROFIT ORGANISATION?**

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It would be simplistic to assume that any organisation that does not pursue profit as an objective is a not-for-profit organisation. This is an incorrect assumption, as many such organisations do make a profit every year and overtly include this in their formal plans. Quite often, they will describe their profit as a 'surplus' rather than a profit, but as either term can be defined as an excess of income over expenditure, the difference may be considered rather semantic.

Not-for-profit organisations are distinguished from profit maximising organisations by three characteristics. First, most not-for-profit organisations do not have external shareholders providing risk capital for the business. Second, and building on the first point, they do not distribute dividends, so any profit (or surplus) that is generated is retained by the business as a further source of capital. Third, their objectives usually include some social, cultural, philanthropic, welfare or environmental dimension, which in their absence, would not be readily provided efficiently through the workings of the market system.

## **TYPES OF NOT-FOR-PROFIT ORGANISATION**

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Not-for-profit organisations exist in both the public sector and the private sector. Most, but not all, public sector organisations do not have profit as their primary objective and were established in order to provide what economists refer to as public goods. These are mainly services that would not be available at the right price to those who need to use them (such as medical care, museums, art galleries and some forms of transportation), or could not be provided at all through the market (such as defence and regulation of markets and businesses). Private sector examples include most forms of charity and self-help organisations, such as housing associations that provide housing for low income and minority groups, sports associations (many football supporters' trusts are set up as industrial and provident societies), scientific research foundations and environmental groups.

## **CORPORATE FORM**

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Not-for-profit organisations can be established as incorporated or unincorporated bodies. The common business forms include the following:

- in the public sector, they may be departments or agents of government
- some public sector bodies are established as private companies limited by guarantee, including the Financial Services Authority (the UK financial services regulator)
- in the private sector they may be established as cooperatives, industrial or provident societies (a specific type of mutual organisation, owned by its members), by trust, as limited companies or simply as clubs or associations.

A cooperative is a body owned by its members, and usually governed on the basis of 'one member, one vote'. A trust is an entity specifically constituted to achieve certain objectives. The trustees are appointed by the founders to manage the funds and ensure compliance with the objectives of the trust. Many private foundations (charities that do not solicit funds from the general public) are set up as trusts.

## **FORMATION, CONSTITUTION, AND OBJECTIVES**

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Not-for-profit organisations are invariably set up with a purpose or set of purposes in mind, and the organisation will be expected to pursue such objectives beyond the lifetime of the founders. On establishment, the founders will decide on the type of organisation and put in place a constitution that will reflect their goals. The constitutional base of the organisation will be dictated by its legal form.

If it is a company, it will have a Memorandum and Articles of Association, with the contents of the latter entrenched to ensure that the objectives cannot be altered easily in the future. Not-for-profit organisations that are not companies most commonly have a set of Rules, which are broadly equivalent to Articles of Association.

As with any type of organisation, the objectives of not-for-profit organisations are laid down by the founders and their successors in management.

Unlike profit maximisers, however, the broad strategic objectives of not-for-profit organisations will tend not to change over time.

The purposes of the latter are most often dictated by the underlying founding principles. Within these broad objectives, however, the focus of activity may change quite markedly. For example, during the 1990s the British Know-How Fund, which was established by the UK government to provide development aid, switched its focus away from the emerging central European nations in favour of African nations.

It is important to recognise that although not-for-profit organisations do not maximise profit as a primary objective, many are expected to be self-financing and, therefore, generate profit in order to survive and grow. Even if their activities rely to some extent on external grants or subventions, the providers of this finance invariably expect the organisation to be as financially self-reliant as possible.

As the performance of not-for-profit organisations cannot be properly assessed by conventional accounting ratios, such as ROCE, ROI, etc, it often has to be assessed with reference to other measures. Most not-for-profit organisations rely on measures that estimate the performance of the organisation in relation to:

- effectiveness – the extent to which the organisation achieves its objectives
- economy – the ability of the organisation to optimise the use of its productive resources (often assessed in relation to cost containment)
- efficiency – the 'output' of the organisation per unit of resource consumed.

Many service-orientated organisations use 'value for money' indicators that can be used to assess performance against objectives. Where the organisation has public accountability, performance measures can also be published to demonstrate that funds have been used in the most cost-effective manner. It is important within an exam question to read the clues given by the examiner regarding what is important to the organisation and what are its guiding principles, and to use these when assessing the performance of the organisation.

The management structure of not-for-profit organisations resembles that of profit maximisers, though the terms used to describe certain bodies and officers may differ somewhat.

While limited companies have a board of directors comprising executive and non-executive directors, many not-for-profit organisations are managed by a Council or Board of Management whose role is to ensure adherence to the founding objectives. In recent times there has been some convergence between how companies and not-for-profit organisations are managed, including increasing reliance on non-executive officers (notably in respect of the scrutiny or oversight role) and the employment of 'career' executives to run the business on a daily basis.

**Questions**

Which of the following organisations would rely most heavily on value for money indicators and efficiency rather than information on performance and profitability?

- A A private accountancy college
- B A local authority
- C A small retailer
- D A pension fund

(2 marks)

The correct answer is B.

Value for money indicators and efficiency measures are commonly used in not-for-profit organisations such as local authorities.

While local authorities have become more exposed to commercial pressures in recent years, it is difficult to judge their performance by the use of conventional financial and non-financial performance measures. It is therefore necessary for these bodies to consider their results in relation to what they have delivered to the community against the resources consumed.

By contrast, the private accountancy college, the retailer and the pension fund rely heavily on performance and profitability measures.

## Chapter 2 Not-for-profit organisations – part 2

### Executive Summary

The term 'charity' refers to the practice of benevolent giving. Features:

- To benefit defined groups in society
- Favourable tax treatment, and for this reason have to be registered with a regulator
- Their activities are restricted or limited
- They rely on the financial support of the public or businesses (or both)
- They rely heavily on voluntary (unpaid) managers and workers.

Most charities are managed by a Council, made up entirely of volunteers. These are broadly equivalent to non-executive directors in limited companies. It is the responsibility of the Council to chart the medium to long-term strategy of the charity and to ensure that objectives are met.

Operational risk for charities arises from the high dependence on volunteer workers.



The term 'charity' refers to the practice of benevolent giving. Charities are established for general or specific philanthropic purposes.

They are one type of not-for-profit organisation, but with several additional distinguishing features:

- they exist entirely to benefit defined groups in society
- as their purposes are philanthropic, they can usually avail themselves of favourable tax treatment, and for this reason have to be registered with a regulator
- their activities are restricted or limited by a regulator
- they rely on the financial support of the public or businesses (or both) in order to achieve their objectives
- in order to be financially viable, they rely heavily on voluntary (unpaid) managers and workers.

## **CHARITABLE ACTIVITIES**

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In the UK, charities are regulated by the Charities Act 2006, which sets out in very broad terms what may be considered to be charitable activities, many of which would be considered as such in other jurisdictions within most other countries. These include:

- the prevention or relief of poverty
- the advancement of education
- the advancement of religion
- the advancement of health or the saving of lives
- the advancement of citizenship or community development
- the advancement of the arts, culture, heritage or science
- the advancement of amateur sport
- the advancement of human
- rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity
- the advancement of environmental protection or improvement
- the relief of those in need, by reason of youth, age, ill-health, disability, financial hardship or other disadvantage
- the advancement of animal welfare
- the promotion of the efficiency of the armed forces of the Crown or of the police, fire and rescue services or ambulance services
- other purposes currently recognised as charitable and any new charitable purposes which are similar to another charitable purpose.

The activities of charities in England and Wales are regulated by the Charity Commission, itself a not-for-profit organisation, located in Liverpool. The precise definition of what constitutes charitable activities differs, of course, from country to country. However, most of the activities listed above would be considered as charitable, as they would seldom be associated with commercial organisations.

## **CORPORATE FORM**

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Charities differ widely in respect of their size, objectives and activities. For example, Oxfam is a federal international organisation comprising 13 different bodies across all continents, while many

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thousands of charities are local organisations managed and staffed entirely by volunteers. Unsurprisingly, most of the constituent organisations within Oxfam operate as limited companies, while local charities would find this form inappropriate and prefer to be established as associations.

A charity is not forbidden from engaging in commercial activities provided that these activities fully serve the objectives of the charity. For example, charities such as the British Heart Foundation, the British Red Cross, and Age Concern all raise funds by operating chains of retail shops. These shops are profitable businesses, but if a company is formed to operate the shops, the company would be expected to formally covenant its entire annual profits to the charity.

Charities with high value non-current assets, such as real estate, usually vest the ownership of such assets to independent guardian trustees, whose role is to ensure that the assets are deployed in a manner that reflects the objectives of the charity.

The guardian trustees are empowered to lease land, subject to the provisions of the lease satisfying requirements laid down by the Charity Commission.

**FORMATION, CONSTITUTION AND OBJECTIVES**

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Charities are always formed with specific philanthropic purposes in mind. These purposes may be expanded or varied over time, provided the underlying purpose remains. For example, Oxfam was originally formed as the Oxford Committee for Famine Relief in 1942, and its original purpose was to relieve the famine in Greece brought about by the Allied blockade. Oxfam now provides famine relief on a worldwide basis.

The governing constitution of a charity is normally set down in its rules, which expand on the purposes of the business. Quite often, the constitution dictates what the organisation cannot do, as well as what it can do. Charities plan and control their activities with reference to measures of effectiveness, economy and efficiency. They often publish their performance outcomes in order to convince the giving public that the good causes that they support ultimately benefit from charitable activities.

**MANAGEMENT**

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Most charities are managed by a Council, made up entirely of volunteers. These are broadly equivalent to non-executive directors in limited companies. It is the responsibility of the Council to chart the medium to long-term strategy of the charity and to ensure that objectives are met.

Objectives may change over time due to changes in the external environment in which the charity operates. Barnardos is a childrens' charity that was originally founded as Doctor Barnardo's Homes, to provide for orphans who could not rely on family support. The development of welfare services after World War II and the increasing willingness of families to adopt and foster children resulted in less reliance on the provision of residential homes for children but greater reliance on other support services. As a result, the Barnardos charity had to change the way in which it looked at maximising the welfare of orphaned children.

Local charities are dependent on the support of a more limited population and therefore have to consider whether their supporters will continue to provide the finance necessary to operate continuously. For example, a local charity supporting disabled sports could be profoundly affected by the development of facilities funded by central or local government.

Every charity is confronted by distinctive strategic and operational risks, of which the Council must take account in developing and implementing its plans. International aid charities are vulnerable to country risk and currency risk, so plans have to take account of local conditions in countries whose populations they serve. Many such countries may, of course, be inherently unstable politically.

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Operational risk for charities arises from the high dependence on volunteer workers, including the extent to which they can rely on continued support, as well as problems of internal control.

For example, many charities staff their shops with the help of unpaid retired people, but there is some debate as to whether future generations of retired people will be as willing to do this for nothing. As many charities have to contain operating expenses in order to ensure that their objectives can be met, it is often difficult or impossible for them to employ full-time or part-time paid staff to replace volunteer workers. Risks also arise from the social environment, particularly in times of recession, when members of the public may be less disposed to give to benefit others as their discretionary household income is reduced. There is some evidence of 'charity fatigue' in the UK. This arises when the public feel pressurised by so many different competing charities that they feel ill disposed to give anything to anyone at all.

**Questions**

Different types of organisation have different characteristics. The following are types of organisation:

- A Charities
- B Co-operatives
- C Industrial companies
- D Non-governmental organisations

Indicate the organisation(s) which have each of the following characteristics, by selecting all that apply from A, B, C, D and E.

- (i) Aim is wealth maximisation
- (ii) Primary aim is not-for-profit
- (iii) May be not-for profit or profit-seeking
- (iv) Voluntary association

(2 marks)

The correct answers are –

- (i) C
- (ii) A and D
- (iii) B
- (iv) B and D

## Chapter 3 Introduction to microeconomics

### Executive Summary

**Microeconomics** is the branch of economics that considers the behaviour of decision takers within the economy, such as individuals, households and firms.

The platform on which microeconomic thought is built lies at the very heart of economic thinking – namely, how decision takers choose between scarce resources that have alternative uses.

Factors of production – **Land, labour, capital and entrepreneur**

**Law of diminishing returns** – This law states that if we keep on adding variable factors of production (such as labour) to fixed factors (such as land), we will get proportionally less output from each additional unit of factor added until, eventually, overall output will start to decrease with each additional unit of factor added.

Producers and consumers generate forces that we call supply and demand respectively, and it is their interaction within the market that creates the **price mechanism**.

The concept of **elasticity** is concerned with the responsiveness of quantity demanded or quantity supplied to a change in price.

Assuming all determinants of supply and demand are to be constant except price, a firm will produce where the supply curve intersects the demand curve. By definition, this is the point at which the quantity supplied equals the quantity demanded.

Some goods and services are 'public goods and services', which means that they can only be provided adequately by intervention.

### Theory of the firm

- Perfect competition
- Monopoly
- Oligopoly
- Monopolistic competition

**This article provides a broad overview of microeconomics. It is intended to introduce key topics to those who have not studied microeconomics, and to offer a revision to those who have done so**

## **WHAT IS MICROECONOMICS?**

Microeconomics is the branch of economics that considers the behaviour of decision takers within the economy, such as individuals, households and firms. The word 'firm' is used generically to refer to all types of business. Microeconomics contrasts with the study of macroeconomics, which considers the economy as a whole.

## **SCARCITY, CHOICE AND OPPORTUNITY COST**

The platform on which microeconomic thought is built lies at the very heart of economic thinking – namely, how decision takers choose between scarce resources that have alternative uses. Consumers demand goods and services and producers offer these for sale, but nobody can take everything they want from the economic system. Choices have to be made, and for every choice made something is forgone. An individual may choose to buy a car, but in doing so may have to give up a holiday which they might have used the money for, if they had not chosen to buy the car. In this example, the holiday is the opportunity cost of the car. Just as individuals and households make opportunity cost decisions about what they consume, so too do firms take decisions about what to produce, and in doing so preclude themselves from producing alternative goods and services.

Producers also have to decide how much to produce and for whom. A simple answer to the first question might be: 'As much as possible of course, using all the resources we can'. However, classical economists teach us that if we combine all of the factors of production – land, labour, capital and the entrepreneur – in different ways, we can get some surprising results. One of the most famous of these is confirmed by the law of diminishing returns. This law states that if we keep on adding variable factors of production (such as labour) to fixed factors (such as land), we will get proportionally less output from each additional unit of factor added until, eventually, overall output will start to decrease with each additional unit of factor added.

## **THE PRICE MECHANISM**

Much of the study of microeconomics is devoted to analysis of how prices are determined in markets. A market is any system through which producers and consumers come together. In early subsistence economies, markets were usually physical locations where people would come together to trade. In more complex economic systems, markets do not depend on humans actually meeting one another, so many markets today arise when producers and consumers come together less directly, such as by post and on the internet.

Producers and consumers generate forces that we call supply and demand respectively, and it is their interaction within the market that creates the price mechanism. This mechanism was once famously described as the 'invisible hand' that guides the actions of producers and consumers.

Markets are essential to produce the goods and services required for everyday life. Even if an individual can produce all the food needed to survive, that person will still need clothes, shelter and other necessities. Therefore, from very early times, communities learned that they would benefit from exchange. The crudest form of exchange was barter, but the evolution of money as a medium of exchange and unit of account accelerated the development of the process.

But how would people know what they could charge, or what they should pay, for goods and services? Before any formal thought was given to this, traders soon discovered that if they fixed

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their prices too low they would soon run out of inventory, while if they set their prices too high they would not sell what they had produced. In physical markets there would often be perfect knowledge, as traders would be able to check the prices of those who had similar goods and services to trade, simply by walking around the stalls. Once markets became more remote, less perfect knowledge of prices was inevitable and the process became less certain.

Alfred Marshall, whose *Principles of Economics* was published in 1890, drew heavily on the writings of Jevons and Mill. However, much of what you read today about supply and demand, elasticity, revenues and costs and marginal utility are based on Marshall's thoughts. Marshall provided a base upon which formal analysis of supply and demand, and consequently the determination of prices in markets, could be built.

**DEMAND**

Demand is created by the needs of consumers, and the nature of demand owes much to the underpinning worth that consumers perceive the good or service to have. We all need necessities, such as basic foodstuffs, but other products may be highly sought after by some and regarded as worthless by others.

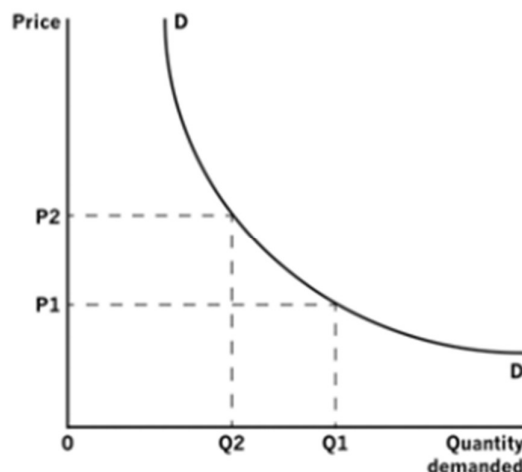
The level of demand for a good or service is determined by several factors, including:

- the price of the good or service
- prices of other goods and services, especially substitutes and complements
- income
- tastes and preferences
- expectations.

In orthodox economic analysis, these determinants are analysed by testing the quantity demanded against one of these variables, holding all others to be constant (or *ceteris paribus*).

The most common way of analysing demand is to consider the relationship between quantity demanded and price. Assuming that people behave rationally, and that other determinants of demand are constant, the quantity demanded has an inverse relationship with price. Therefore, if price increases, the quantity demanded falls, and vice versa. Figure 1 portrays the conventional demand curve.

**Figure 1: Demand curve**



For any change in price, there is an inverse change in quantity demanded. The price increase from  $OP_1$  to  $OP_2$  results in a reduction in quantity demanded from  $OQ_1$  to  $OQ_2$ .

A change in price will cause a movement along the curve. When the price increases, the quantity demanded will reduce. This happens with most types of goods, with some bizarre exceptions. Demand for what are known as 'Giffen goods' actually rises with an increase in the price for such goods. For example, when the price of rice increases in some regions of China, more rice will be purchased, as there is not enough income left over to some consumers to purchase higher value food items.

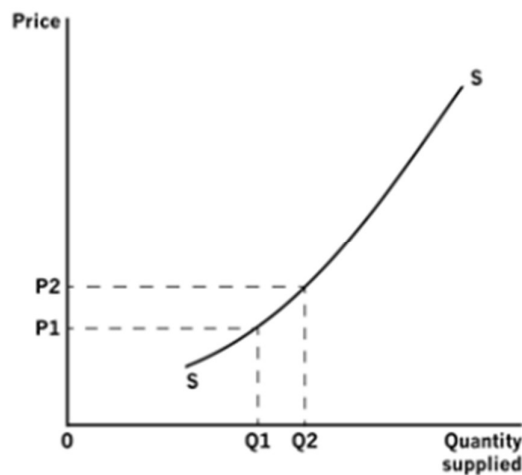
If we then relax the assumption that other variables (such as income and tax rates, etc) are constant, what happens then? An increase in income will often cause the demand for a good or service to increase, and this will shift the whole curve away from the origin. Likewise, a reduction in the price of a substitute good will move the demand curve towards the origin as the good in question will then be less attractive to the consumer.

While these generalisations are useful, it is important to remember that economic behaviour is based on human decisions, and so we can never predict fully how people will act. For example, some very basic foodstuffs will become less popular as incomes increase and when consumers find that they no longer have to subsist on basic diets.

## SUPPLY

Supply refers to the quantity of goods and services offered to the market by producers. Just as we can map the relationship between quantity demanded and price, we can also consider the relationship between quantity supplied and price. Generally, suppliers will be prepared to produce more goods and services the higher the price they can obtain. Therefore, the supply curve – when holding other influences constant – will slope upwards from left to right, as illustrated in Figure 2.

**Figure 2: Supply curve**



*There is a direct relationship between price and quantity supplied. An increase in price from OP1 to OP2 results in an increase in quantity supplied from OQ1 to OQ2.*

The determinants of supply are:

- price
- prices of other goods and services
- relative revenues and costs of making the good or service
- the objectives of producers and their future expectations
- technology.



Generally, a firm will maximise profit when its marginal revenue (the revenue arising from selling one extra unit of production) equals its marginal cost (the cost of producing that one extra unit of production). However, a firm may continue to produce as long as the marginal revenue exceeds its average variable costs, as in doing so it will be making a contribution towards covering its fixed costs.

Following the same rationale as applied earlier, a movement along the supply curve will be brought about by a change in price, but a movement of the whole curve will be caused by a determinant other than price.

## ELASTICITY

The concept of elasticity is concerned with the responsiveness of quantity demanded or quantity supplied to a change in price. If a small change in price brings about a massive change in quantity demanded, the price elasticity of demand is said to be highly elastic. Conversely, if a change in price has little or no effect on the quantity demanded, the demand is said to be highly inelastic. This concept is obviously very important to producers, who have to estimate the potential effects of their pricing strategies over time. It is also important to government finance departments, which have to model the implications of imposing sales taxes on goods and services in order to predict tax revenues.

Price elasticity of demand is measured by dividing the change in quantity demanded by the change in price and, conversely, price elasticity of supply is measured by dividing the change in quantity supplied by the change in price. Price elasticity of demand occurs when an increase in price leads to a reduction in total revenue ( $p \times q$ ) between those two points on the demand curve, and price inelasticity occurs when an increase in price leads to an increase in total revenue. Unitary elasticity occurs when the change in price causes no change in total revenue.

In addition to price elasticity, there are similar concepts of relevance to your study:

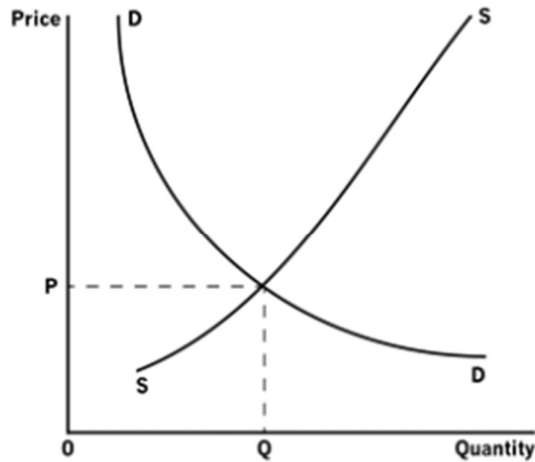
- Income elasticity is the responsiveness of quantity demanded or supplied to a change in income.
- Cross elasticity is the responsiveness of quantity demanded or supplied of good X to a change in price of good Y.

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### EQUILIBRIUM

## Supplementary Notes

Assuming all determinants of supply and demand are to be constant except price, a firm will produce where the supply curve intersects the demand curve. By definition, this is the point at which the quantity supplied equals the quantity demanded (Figure 3).



*Price is determined at the intersection of the supply and demand curves.*

If the price is set above the equilibrium price, this will result in the quantity supplied exceeding the quantity demanded. Therefore, in order to clear its inventory, the company will need to reduce its price.

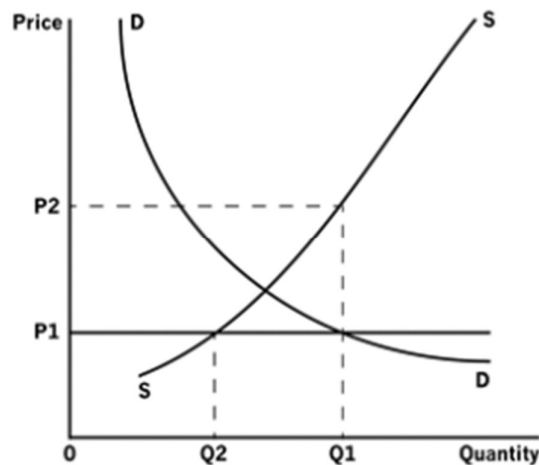
Conversely, if the price is set below the equilibrium price, this will result in an excess demand situation, and the only way to eliminate this is to increase the price.

### MARKET INTERVENTION

In capitalist systems, allowing markets to operate freely is considered to be desirable, but it is generally accepted that market forces cannot be permitted to operate for all the goods and services required by society. Some goods and services are 'public goods and services', which means that they can only be provided adequately by intervention. These include law and order and the military. For this reason, the government or supra-national organisations may choose to introduce and maintain systems that will ensure that such goods and services are produced, and may fix prices either above or below the equilibrium price.

A maximum price is sometimes imposed in order to protect consumers. This will result in a situation in which the quantity demanded will exceed the quantity supplied, provided the maximum price is struck below the equilibrium price (Figure 4). There are numerous examples of this in real life. During World War 2, the UK government intervened in this way in order to ensure that families could obtain adequate supplies of goods such as bread, butter and petrol. One consequence of this is that there was excess demand in the system, and this led to an illegal market developing.

Figure 4: Maximum price



Maximum price is  $OP_1$ . At this point, the quantity demanded ( $OQ_1$ ) exceeds quantity supplied ( $OQ_2$ ). The 'black market' price is  $OP_2$ .

A minimum price is sometimes imposed in order to protect producers. Here, the quantity supplied will exceed the quantity demanded, provided the minimum price is struck at a level above the equilibrium price. One of the goals of the European Union (EU) has been to protect the agricultural sector, and the common agricultural policy is a minimum price system. As a consequence of this, the agricultural sector of the EU has periodically generated surpluses.

The impact of intervention in the price system should not be seen as undesirable in all cases. However, one of the contributions that microeconomic analysis makes is that it teaches us that there will be consequences of such interventions, and society has to manage those consequences.

## THEORY OF THE FIRM

The theory of the firm is a branch of microeconomics that examines the different ways in which firms within an industry may be structured, and seeks to derive lessons from these alternative structures.

### *Perfect competition*

A perfectly competitive market is one in which:

- there are many firms producing homogeneous goods or services
- there are no barriers to entry to the market or exit from the market
- both producers and consumers have perfect knowledge of the market place.

Under such conditions, the price and level of output will always tend towards equilibrium as any producer that sets a price above equilibrium will not sell anything at all, and any producer that sets a price below equilibrium will obtain 100% market share. The demand 'curve' is perfectly elastic, which means that it will be horizontal.

As these conditions imply, there are few if any examples of perfectly competitive markets in real life. However, some financial markets approximate to this extreme model, and there is no doubt that in some fields of commerce the development of the internet as a trading platform has made the markets for some products, if not perfectly competitive, then certainly less imperfect.

### *Monopoly*

A monopoly arises when there is only one producer in the market. It should be noted the laws of many countries define a monopoly in less extreme terms, usually referring to firms that have more than a specified share of a market.

Unlike perfect competition, monopolies can and do arise in real life. This may be because the producer has a statutory right to be the only producer, or the producer may be a corporation owned by the government itself.

A monopoly enjoys a privilege in that it can strike its own price in the market place, which can give rise to what economists call 'super-normal profits'. For this reason, monopolies are usually subject to government control, or to regulation by non-governmental organisations.

#### *Oligopoly*

An oligopoly arises when there are few producers that exert considerable influence in a market. As there are few producers, they are likely to have a high level of knowledge about the actions of their competitors, and should be able to predict responses to changes in their strategies.

The minimum number of firms in an oligopoly is two, and this particular form of oligopoly is called a duopoly. There are several examples of duopolies, including the two major cola producers and, for several product lines, Unilever and Procter & Gamble. However, markets dominated by perhaps up to six producers could be regarded as oligopolistic in nature. Where a few large producers dominate a market, the industry is said to be highly concentrated.

Although it is difficult to make generalisations across all oligopolistic markets, it is frequently noted that their characteristics include complex use of product differentiation, significant barriers to entry and a high level of influence on prices in the market place.

#### *Monopolistic competition*

Monopolistic competition arises in markets where there are many producers, but they will tend to use product differentiation to distinguish themselves from other producers in the market. Therefore, although their products may be very similar, their ability to differentiate means that they can act as monopolies in the short-run, irrespective of the actions of their competitors.

For monopolistic competition to exist, consumers must know of – or perceive – differences in products sold by firms. There tend to be fewer barriers to entry or exit than in oligopolistic markets.

## **CONCLUSIONS**

Those embarking on their studies for Paper F1/FAB will quickly become aware that the syllabus is broad but shallow. It is essential to cover a wide range of topics, without necessarily having to study each component part in depth. The purpose of this article has therefore been to provide basic information on the most important areas of microeconomics without any intention of exploring any individual topic in detail. Awareness of key principles is important, but candidates should not assume that they have to be experts in order to deal with the objective test questions in the exam.

## Questions

(a) A national supermarket chain operates a “club card” scheme where the holder of the card is rewarded with points based on how much they spend and what they buy on each visit to one of the chain’s stores. The cumulative data collected on all of the supermarket’s customers is made available to government statisticians which is aggregated with similar data collected from other sources.

**Which form of economics does the above illustrate?**

- A Microeconomics
- B Business economics
- C Macroeconomics
- D Nano economics

(2 marks)

The correct answer is A

Microeconomics analyses the market behaviour of individual consumers and entities in an attempt to understand the decision-making process of those consumers (households) and entities.

**(b) An increase in the demand for ground coffee will most likely result when which of the following occurs?**

- A Price of tea declines
- B Consumers have a decline in disposable income
- C Advertising for ground coffee products increases
- D Price of coffee cream increases

(2 marks)

The correct answer is C

If advertising spending increases for ground coffee products, there will most likely be an increase in the demand for ground coffee (assuming all other factors are constant). A reduction in the price of a substitute product (tea), an increase in the price of complementary goods (coffee cream), and a reduction in consumer disposable income will most likely reduce the demand for ground coffee.

**(c) Which of the following differentiates a monopoly from an oligopoly market structure?**

- A Positive long-run economic profit
- B No product differentiation
- C Downward sloping inelastic demand curve
- D High barriers to entry

(2 marks)

The correct answer is B

A monopoly market structure would contain no product differentiation as there is zero competition, whereas an oligopoly market structure would include slightly differentiated products. The two market structures are similar in that each generates a positive economic profit over the long-term, have inelastic downward sloping demand curves, and have high barriers to enter the industry (with a monopoly having insurmountable barriers).

## Chapter 4 Mintzberg's theory on organisations

### Executive Summary

Mintzberg's model breaks down the organisation into five generic components in relation to coordinating its activities:

- Strategic apex – Directors and senior executives role is to interpret or define the mission of the organisation and ensure that its objectives are consistent with this mission.
- Middle line – The role is partially one of interpretation, as the work of the operating core has to be consistent with the expectations and plans of the strategic apex.
- Operating core – The operating core carries out the activities necessary to deliver outputs.
- Technostructure – Mintzberg states there are several roles here: Analysers and Planners.
- Support staff – Contribute to the efficiency and effectiveness of the strategic apex, middle line and operating core.

Based on his organisational model, Mintzberg described five categories of organisation structure:

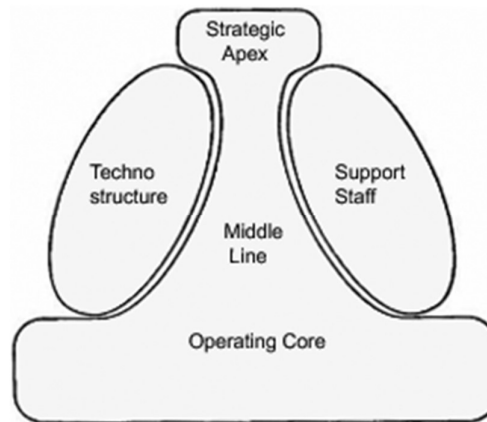
- Simple structure – Centralised and often autocratic, with power emanating from the strategic apex.
- Machine bureaucracy – Relies heavily on a robust technostructure. Strategic planners and financial controllers are influential, leading to the creation of multiple layers of management, formal procedures and standardised production processes.
- Professional bureaucracy – The professional bureaucracy is based on clear lines of authority and standard administrative practices. However, the practices may be built on standards set by law, regulations or independent external bodies, including professional bodies.
- Divisionalised – A small central core provides guidelines for business units that enjoy a high degree of autonomy.
- Adhocracy – The adhocracy is task or project-based and has to respond quickly and flexibly to changing demands. These demands may be driven by rapidly changing markets or by innovation.

Part B of the syllabus for Paper AB/FAB, *Accountant in Business* is concerned with the study of business organisation structure, functions and governance. In another article on this topic (see 'Related links'), various organisational models were described, including entrepreneurial, functional and matrix structures. These consider how organisations are structured primarily in terms of relationships.

By contrast, Mintzberg's model breaks down the organisation into five generic components, considering the role of each in relation to coordinating its activities. These are:

- strategic apex
- middle line
- operating core
- technostructure
- support staff.

Figure 1 shows these activities in diagrammatic form.



### STRATEGIC APEX

This element of the organisation is made up of directors and senior executives. Their role is to interpret or define the mission of the organisation and ensure that its objectives are consistent with this mission. The strategic apex is also responsible for managing the organisation's relationship with the macro-environment.

### OPERATING CORE

The operating core carries out the activities necessary to deliver outputs.

### MIDDLE LINE

This element provides the link between the strategic apex and the operating core. The role is partially one of interpretation, as the work of the operating core has to be consistent with the expectations and plans of the strategic apex. Simple, smaller organisations may not have a middle line at all.

**TECHNOSTRUCTURE**

The technostructure is made up of key individuals and teams working in functions such as human resources, training, finance and planning. Mintzberg states that there are several roles here. Analysts decide on the best ways to perform jobs and seek to standardise skills. Planners decide on outputs and define quality requirements.

**SUPPORT STAFF**

Support staff work in functions such as research and development, public relations and legal services. Their outputs do not contribute directly to the core purposes of the organisation, but their activities contribute to the efficiency and effectiveness of the strategic apex, middle line and operating core.

The relative influence of these elements to one another have a significant impact on the nature of the organisation. Mintzberg asserts that each element will have a preferred means of coordination. For example, the strategic apex will attempt to coordinate through direct supervision, and will be especially important in smaller organisations with simpler structures. The middle line seeks to standardise outputs, while the technostructure attempts to standardise work processes. The operating core will try to standardise skills.

**ORGANISATION STRUCTURES**

Based on his organisational model, Mintzberg described five categories of organisation structure, each of which would rely on one specific element of the model.

**SIMPLE STRUCTURE**

The simple structure is centralised and often autocratic, with power emanating from the strategic apex. Typically, control is exerted by the chief executive or small, influential executive team. Perhaps due to its simplicity, the structure can be flexible and sometimes informal, with a strongly defined sense of mission. However, Mintzberg warns that the simple structure is vulnerable, stating 'one heart attack can wipe out the organisation's prime coordinating mechanism'.

**MACHINE BUREAUCRACY**

This structure relies heavily on a robust technostructure. Strategic planners and financial controllers are influential, leading to the creation of multiple layers of management, formal procedures and standardised production processes. Due to the high degree of standardisation, the tasks performed by the operating core can be rigid, offering little discretion for the individual. For this reason, Mintzberg observed that motivation can be difficult and the organisation can be unreceptive to the need for change. The machine bureaucracy is typified by large-scale car manufacturing plants.

**PROFESSIONAL BUREAUCRACY**

Like the machinery bureaucracy, the professional bureaucracy is based on clear lines of authority and standard administrative practices. However, the practices may be built on standards set by law, regulations or independent external bodies, including professional bodies. Mintzberg cites schools, hospitals and professional practices as examples of this structure. He suggests that the professional bureaucracy is more democratic than the machine bureaucracy counterpart, and that it is easier to motivate people. The operating core is the major coordinating influence.



**DIVISIONALISED**

In a divisionalised structure, a small central core provides guidelines for business units that enjoy a high degree of autonomy. Mintzberg states that this is an extension of the machine bureaucracy, or may even comprise several machine bureaucracies within a single corporation. It is the middle line that forms a strong coordinating influence, as its key role is to translate the demands of the small central core into the objectives of the operating core. The divisionalised structure is typical of multinational companies.

**ADHOCRACY**

The adhocracy is task or project-based and has to respond quickly and flexibly to changing demands. These demands may be driven by rapidly changing markets or by innovation. There is little formality, so direct supervision and defined processes are less important than in other organisation structures. Research and development can be a primary driver of adhocracies, as typified by new technology industries.

**THE EVOLUTION OF ORGANISATION STRUCTURES**

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Mintzberg believes that structures are often a product of their time. He states that simple structures and machine bureaucracies were a feature of the past, when developed economies were highly reliant on large-scale production and manufacturing. By contrast, professional bureaucracies and the divisionalised form are more common today. Mintzberg predicts that the adhocracy will become more important in the future.

**Questions**

Which of the following is an advantage of centralisation in an organisation with a dispersed network of offices?

- A Decisions are easier to coordinate
- B Greater speed of decision making nearer the point of sale
- C Improved motivation of line managers
- D Reduced workload for senior management

(2 marks)

Answer: A

The centralised approach lends itself to greater consistency in decision-taking and should enable those in senior position to coordinate decisions more easily. The centralised decision-taking model concentrates decision taking at the strategic apex of the organisation. This means that in a dispersed organisation, those operating nearer the point of sale have less discretion, as they are usually required to follow policies and procedures determined at the core of the business.

(For example, in a credit institution, the centralised approach would normally mean that line managers have less authority to sanction loans to customers, while in the decentralised alternative; they would have mandates to sanction loans without consulting head office or a specialised decision taking unit.)

## Chapter 5 Organisations

### Executive Summary

#### Purposes of organisations

- An organisation is a group of people with a common purpose. The purpose is defined by the entity for which they work.

The **entrepreneurial structure** is adopted by smaller businesses. It is simple, informal and very fluid, in that it may change on a day-to-day basis.

The **functional structure** (by product / geographical region) is the most common organisational model. It is usually depicted as a triangle, with the chief executive officer at the top and reporting lines of others flowing vertically.

**Matrix structure** evolved in companies that sought to overcome some of the rigidities of the functional organisation structure. The most common application of the matrix structure is the creation of an extra layer of responsibilities across the traditional functional structure.

### Boundaryless organisations

Advances in information communications technology have resulted in new approaches that have redefined where, when and how people work.

#### 1. Virtual organisation

A virtual organisation is one which operates through electronic communications, taking advantage of the efficiencies made possible by information technology.

#### 2. Hollow organisation

A hollow organisation is one which relies heavily on outsourcing, enabling it to maintain low staffing levels while capitalising on the competences of partner organisations.

#### 3. Modular organisation

A modular organisation extends the hollow concept by breaking down production processes into modules.

### Shared services organisations

The shared services organisation is a medium through which defined services can be provided across the organisation by a dedicated unit.

The syllabus for Paper AB, *Accountant in Business* includes the theory of organisations and related topics. Candidates must be familiar with the different organisational structures that can be adopted, as well as related concepts such as departmentalisation, divisionalisation, centralisation and decentralisation, span of control, scalar chain and tall and flat organisations.

In addition to these topics, candidates should also study some of the more contemporary organisational models. These include 'boundaryless' organisations and shared services organisations.

This article provides an overview of some of these concepts.

### **PURPOSES OF ORGANISATIONS**

An organisation is a group of people with a common purpose. The purpose is defined by the entity for which they work. In smaller businesses, such as partnerships and small companies, it is common for those who work for the organisation to have created it, or to have had some part in creating it. By contrast, larger organisations have to employ or involve more people, the majority of which will have little or no connection with the founders or owners.

### **THE DEVELOPMENT OF ORGANISATIONS**

Organisations have been around for thousands of years. The mighty armies of Greece and Rome were organisations, and the Phoenician merchants who plied their trade across the oceans could not have run successful businesses without some organisational structure. Whenever two or more people come together to pursue the same outcomes, we have an organisation. Organisations exist because synergy can be achieved by combining human resources. Together, those in an organisation can produce more than the sum total output of individuals working alone.

The industrial revolution of the eighteenth and nineteenth centuries brought a need for more systematic and formal consideration of how organisations should be configured. Adam Smith used the example of the division of labour in a pin factory to describe the benefits of specialisation:

'One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head: to make the head requires two or three distinct operations: to put it on is a particular business, to whiten the pins is another ... and the important business of making a pin is, in this manner, divided into about eighteen distinct operations, which in some manufactories are all performed by distinct hands, though in others the same man will sometime perform two or three of them.' (The Wealth of Nations, 1776)

Generally, businesses start as small entities, and many remain so. Every country in the world has thousands of sole traders, many of which work alone and are able to make their living without involving others. However, if the activities of the business grow, it eventually becomes necessary to utilise the labour of others. In family concerns, the trader may involve a spouse, children or siblings, and this may not even require the creation of any contractual relationships. Yet it does require some degree of organisation. Who carries out which tasks? Does everybody do the same work or does each individual specialise? To what extent should everyone be able to carry out the tasks usually reserved for others? How do we ensure that all work is done, but there is no wasteful duplication of effort? These questions can be addressed in a relatively informal manner in a small business where all control is in the hands of a single person. However, the very same questions have to be asked in the largest and most complex businesses, and for these the answers are less straightforward.

**THE ENTREPRENEURIAL STRUCTURE**

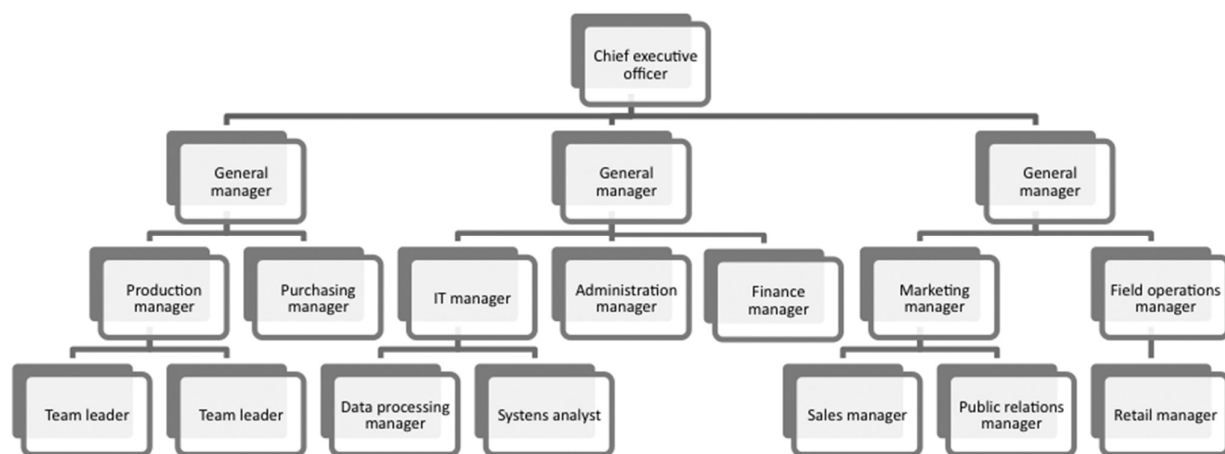
The entrepreneurial structure is adopted by smaller businesses. It is simple, informal and very fluid, in that it may change on a day-to-day basis.

This structure is adopted by sole traders who employ others, some small partnerships and some small companies. Those who own and control the business take decisions on the work to be done, how it will be done and by whom. It is quite common for employees to be expected to multitask and not to expect rigid job descriptions. Specialisation may be possible, such as a family member dealing with bookkeeping, but that individual may also be required to carry out additional tasks, perhaps if there is no bookkeeping work to be done at certain times.

The entrepreneurial structure is perfect for many small businesses, but is too informal and can even be chaotic once the level of business activity reaches a certain level. Eventually, the entrepreneur has to consider formalising the roles that employees play, and creating jobs with defined duties and responsibilities.

**THE FUNCTIONAL STRUCTURE**

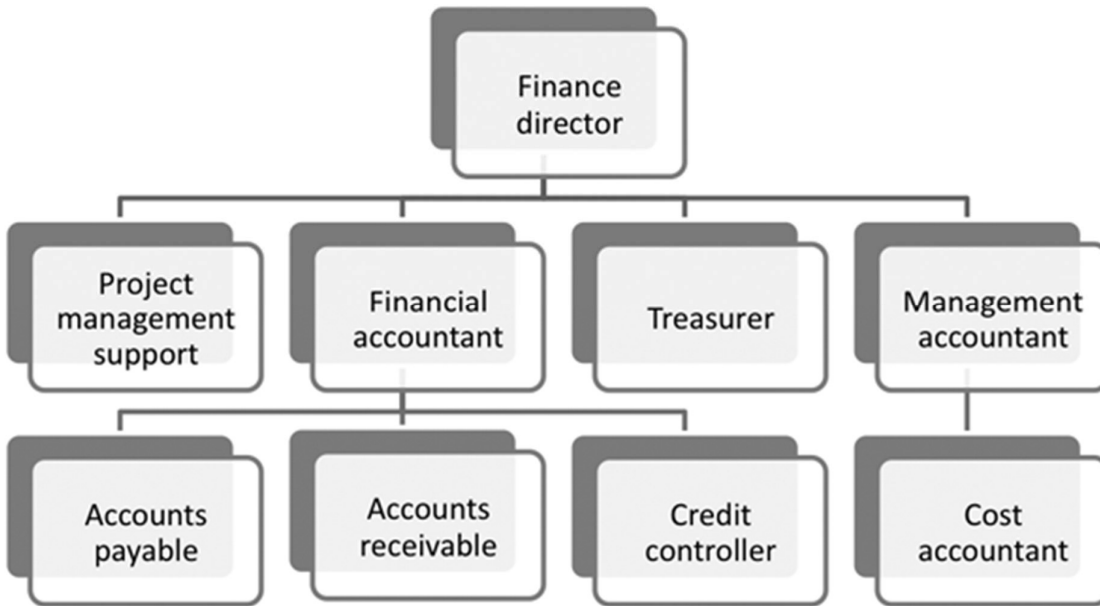
The functional structure is the most common organisational model. It is usually depicted as a triangle, with the chief executive officer at the top and reporting lines of others flowing vertically. The functional structure is formally depicted as an organisation chart. [Figure 1](#) shows a typical organisation chart.



The duties of individuals are allocated according to the functions they perform. For example, a small company may have a production manager, finance manager, sales manager and IT manager reporting to the chief executive officer. Each of the functional managers is responsible for a department.

Many larger companies have general managers or assistant general managers responsible for groups of functions. For example, the General Manager (Marketing) may be responsible for advertising, public relations, merchandising and direct sales, and there may be a departmental manager responsible for each of these activities.

For each function, employees are grouped together to perform similar or complementary tasks. Just as the organisation as a whole can be represented on an organisation chart, so too can each department. [Figure 2](#) shows how a finance department might be organised.



The functional structure has several advantages:

- it facilitates **specialisation**, by bringing together those with the knowledge and skills necessary to carry out each function, and therefore should create **economies of scale**
- it enables the organisation to operate through **clear lines of authority** and **well defined responsibilities**, with all employees knowing to whom they report and for whom they are responsible
- it **prevents duplication** of effort, thereby reducing inefficiencies
- it accommodates **specialists**.

The disadvantages of the functional structure are:

- it can be **inflexible**, particularly in a period of rapid change, and in economic systems where it is difficult or costly to recruit or dismiss employees
- it encourages **demarcation lines** to be created, which may make employees reluctant to carry out tasks that they consider not to be their responsibility
- as organisations become larger, there may be **coordination problems** as the number of functions increases
- as information tends to flow through formal organisational lines, larger organisations may encounter **communication problems**
- some argue that the functional model is too **inward looking**, focusing on processes instead of considering deliverables defined by customer needs.

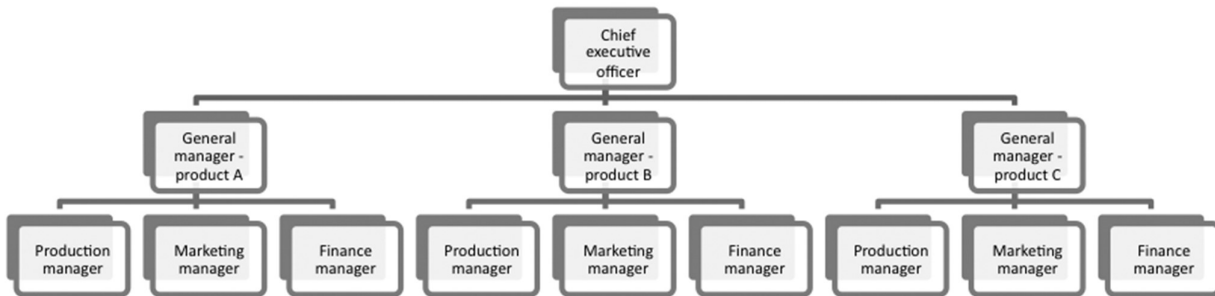
The functional structure is common to many organisations, but different concepts can be deployed within it. For example:

- the organisation can be **tall or flat**: tall organisations have many levels (a long **scalar chain**), while flat organisations have fewer levels
- the organisation may have many employees reporting to each manager, few employees reporting to each manager, or a combination of these: this so-called **span of control** will depend on many factors, including the nature of the work, variety of tasks performed, capabilities of employees and risk factors
- some organisations concentrate authority at the top of the management hierarchy, with key decisions taken by senior executives, while others empower subordinates, with greater

discretion permitted further down the management chain: this relates to the concept of **centralisation and decentralisation**.

### Functional organisation by product

The functional model can be adapted for organisations that offer a range of products. Just as managers responsible for different products can report to the product manager, it is also possible for each product manager to have his or her own functional structure. In this way, several functions are duplicated across the organisation, as the manager responsible for each product may have their own production, sales, marketing, finance and administration departments. This is shown in [Figure 3](#).



This organisation structure is sometimes appropriate if the design, production and marketing of each product is unique or significantly different to those for other products. This structure can also be suitable if products are distinctive brands. For example, some manufacturers of detergents offer both quality (or premium) products and discount products. Although they compete with one another to some extent, the products are usually targeted at different market segments.

### Functional organisation by geographical region

Many organisations operate across different regions, or across international frontiers, so they may consider it to be appropriate to maintain separate functional structures in each location. This approach is not appropriate to all geographically dispersed businesses, but is suitable for organisations whose geographical locations have distinctive but contrasting characteristics. For example, companies with a presence in the UK, Ireland and Germany would be able to identify major differences in the demographic profiles, personal and family values and tastes in the three locations, while companies operating in Belgium, Luxembourg and the Netherlands would identify differences that are less crucial in commercial terms.

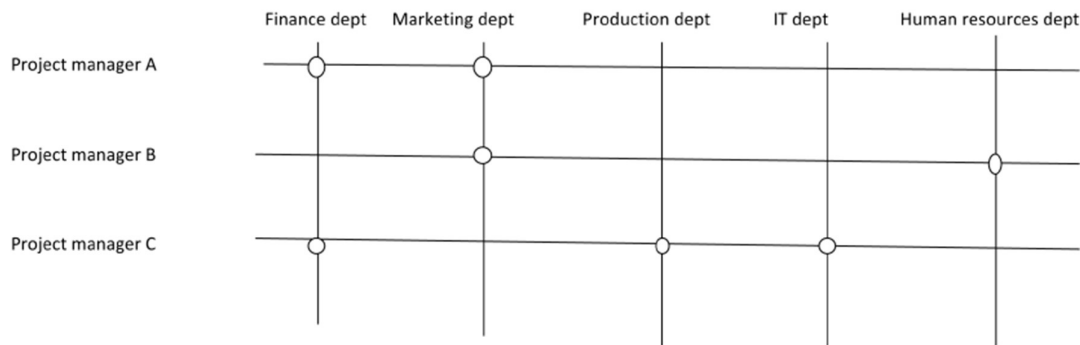
Functional organisation by geographical location is especially important for large companies that operate across several continents.

### MATRIX STRUCTURE

The matrix structure evolved in companies that sought to overcome some of the rigidities of the functional organisation structure. It was first deployed in the aerospace industry in the USA in the 1950s.

The most common application of the matrix structure is the creation of an extra layer of responsibilities across the traditional functional structure. As well as occupying a position in the organisational pyramid, which defines line relationships, employees have responsibilities to project managers. In this way, the employee may have two or even more managers. For example, an individual working in the finance department may report to the head of finance but may also have some duties in relation to IT/IS or marketing projects. The managers responsible for these projects will be able to call upon staff across organisational boundaries on a formal basis.

[Figure 4](#) shows the matrix organisation.



In this matrix structure, project manager A can call upon staff from the finance and marketing departments. Project manager B calls upon staff from the marketing and HR departments. Project manager C calls upon staff from the finance, production and IT departments.

Matrix organisations can be taken further in environments that are less dependent on rigid chains of command and lines of communication. For example, in some professional firms and consultancies, a position in a functional organisation chart is only important for the purpose of establishing accountabilities under employment law. As one individual working in such an organisation put it, when asked 'Who is your manager?', the reply was 'It depends what day it is.'

There are several advantages of adopting a matrix structure:

- by involving individuals formally in teams allocated to specific projects, the organisation can capitalise on the knowledge, skills and experience they can offer
- communication lines are shortened in that project managers can deal with staff assigned to them
- bureaucracy should be reduced
- employees' jobs are enriched, and this may improve motivation
- more ambitious individuals can exploit opportunities made available to them and more readily pursue advancement
- cooperation between departments can be increased, and the disadvantages of work being demarcated by 'silos' can be reduced
- the matrix approach may make employees more responsive to change and more willing to welcome change.

The disadvantages include the following:

- the matrix structure sacrifices the notion that every employee should be responsible to one manager, and this can result in conflicting demands on the employee, in terms of what work should be done, how time should be apportioned and how work should be carried out
- the different managers to whom the individual reports may have very different styles, which may create conflict, or even confusion as to the best or correct approach
- the matrix structure creates additional time management pressures, which may have an effect on costs
- if the matrix is not designed or implemented systematically, it can create organisational inefficiencies, such as slower decision taking.

### BOUNDARYLESS ORGANISATIONS

Traditionally, organisations bring people together in one or more physical locations in order to process inputs and create outputs, all within a formally defined structure. Advances in information communications technology have resulted in new approaches that have redefined where, when and how people work. The most obvious evidence of this is the reduction in reliance on the 9.00am to



5.00pm working day, the emergence of flexible working arrangements and increases in work sharing and home working. Organisations have also adopted new ways of configuring relationships.

### **Virtual organisation**

A virtual organisation is one which operates primarily through electronic communications, taking advantage of the efficiencies made possible by information technology. It removes many of the features of the working environment that were once taken for granted, such as bringing managers and staff together at a defined location. People work together remotely, with little or no dependence on physical premises. Instead, communications take place through media such as emails, e-conferencing, extranet and intranet. This virtual aspect of the operation sometimes extends to links with suppliers (upstream), and customers (downstream). By extending the virtual concept to customer relationships, the dependence on retail premises and customer-facing staff is eliminated. Amazon is often cited as the first major virtual business in this respect.

The virtual organisation model can be adopted wholly or in just certain parts of the business. For example, one major insurance company maintains a large head office which serves as a base for functional departments, but many of the staff working for certain departments work from home and rarely if ever need to visit the office.

Some service organisations can adopt the virtual approach in its entirety, with a token physical presence at a registered office to satisfy statutory registration requirements.

The advantages of virtual organisations are:

- Costs can be greatly reduced, as there is less dependence on premises. This can result in significant reductions in overheads, such as electricity, water, mortgage or rent, and service staff.
- The adoption of e-business solutions can create efficiencies, such as automated re-ordering and seamless transaction processing. In fact, while the virtual organisation is a relatively new business concept, many of the technologies deployed have been available for many years. For example, electronic data interchange (EDI) was first developed in the 1960s.
- Jobs with the organisation may be more attractive, as the need for daily commuting is removed. This can be particularly appealing to those with family commitments at certain times of day, and those who would be deterred from working due to the cost of transport and car parking.
- The virtual organisation has a modern image which may appeal to several stakeholder groups, including customers, suppliers and distributors. Increasingly, this approach to business aligns with the expectations of such groups.

The disadvantages of virtual organisations are:

- There is heavy reliance on information technology, so if things go wrong this can have a catastrophic effect. Problems can arise from lack of connectivity, hardware and software failures, malware and security breaches.
- Those who lack basic IT skills, or are unprepared to use information technology equipment, have no prospect of doing business with virtual organisations or working for them.
- In some cultures, there remains a preference for the 'personal touch', so virtual organisations may find it difficult to achieve a foothold.
- Some of those who work for virtual organisations feel isolated as direct human interaction on a face-to-face basis is minimal. Feeling personally connected to a work group can be motivational, and this effect is lost when members of teams do not meet on a regular basis.

### **Hollow organisation**

A hollow organisation is one which relies heavily on outsourcing, enabling it to maintain low staffing levels while capitalising on the competences of partner organisations.

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The most common application of this model is where an organisation identifies those competences that are core and must be retained. These are then kept in-house, while all non-core operations are contracted out.

The hollow organisation must forge strong strategic links with trusted partners. An example of this organisational form is Nike, a sports goods manufacturer, which sub-contracts production activities whilst maintaining total control over design and quality specifications.

**Modular organisation**

A modular organisation extends the hollow concept by breaking down production processes into modules. Production is outsourced, but each external organisation is responsible for only one element of the process. For example, in producing the Dreamliner aircraft, Boeing enters into contracts with many suppliers, each of which is responsible for one component or assembly. The outputs of these suppliers can then be integrated.

The modular organisation is a more efficient, contemporary version of the model previously used by many car manufacturers, who often owned the subsidiaries which produced components that make up the final product. The modular organisation removes the need for complex ownership structures through holding companies and subsidiaries, and also creates forced efficiencies, as those responsible for each module have to compete with organisations in the same marketplace for their services.

**SHARED SERVICES ORGANISATIONS**

The shared services organisation is a medium through which defined services can be provided across the organisation by a dedicated unit. This differs from outsourcing, in that the shared services provider is actually a part of the organisation.

Shared services organisations reduce the level of duplication of tasks. For example, instead of each part of the organisation employing human resources or information technology specialists, these services can be provided centrally, through a single team. In this way, they can reduce costs significantly and also standardise the policies and processes across the business. Management and operational support can be delivered through facilities such as hotlines or helpdesks.

An example of a very effective use of the shared services concept is the provision of professional training courses and support across large consultancy firms operating on a regional or multinational basis.

While the use of shared services organisations is increasing, the model is not suitable for all. For example, if the business units are very diverse, a centralised model may not be appropriate. It has also been suggested that potential cost reductions should not be over-estimated, as many organisations will still rely on local provision to meet the idiosyncratic needs of each business function or locality.

**Questions**

Greg Pye is the chief executive of a medium-sized company that has been organised hierarchically according to function. After attending a management seminar, he decided to encourage inter-functional departmental co-operation by implementing a matrix structure.

Greg agreed that a matrix organisation and cross-functional team working would provide flexibility and enhanced performance to the organisation. However, the company secretary drew Greg's attention to some potential drawbacks.

These include the possibility that "people won't know who they are meant to be reporting to, supervision will be difficult for their line manager who thinks they are working in their teams and team leaders will have no real authority over the team members".

After speaking to the company secretary, Greg began to have second thoughts about the matrix structure. Greg decides to ask for a more considered view of restructuring the company.

Required:

**(a) Which TWO of the following are specific features of the existing functional structure?**

- A Clear and logical division of tasks
- B Helps to develop broad experience in general managers
- C Suited to organisations which are growing rapidly through diversification
- D The scalar principle provides an unbroken vertical communication line

(2 marks)

**(b) Which TWO of the following are advantages of introducing a matrix structure?**

- A Emphasis on product and customer orientation
- B More direct contact between managers and employees
- C Role ambiguity due to lack of unity of command
- D Suited to industries with a less skilled workforce and many products and customers

(2 marks)

Answer:

(a) A, D The functional structure hinders the development of general managers and is not suited to rapidly-expanding organisations

(b) A, B Role ambiguity is a disadvantage. The matrix structure is suitable where there are few major customers in a highly-skilled industry with mature and professional employees

## Chapter 6 The role of marketing

### Executive Summary

Marketing is 'the management process responsible for identifying, anticipating and satisfying customer needs profitably'.

These imply a process through which the organisation must find out what customers want, or carry out research into what customers are likely to want in the future, and then fulfil these needs by deploying its resources in an appropriate manner.

The marketing mix is a model used when considering the range of activities necessary to construct and implement a comprehensive marketing strategy. It is most commonly expressed in terms of 'the four Ps':

- **Product** – This element of the marketing mix considers the technical features, benefits and limitations of the product or products offered by the business.
- **Price** – This refers not only to the price of the product, but to all costs related to the purchase.
- **Promotion** – Promotion refers to all activities that are intended to inform the customer and influence the purchasing decision.
- **Place** – This refers to all activities related to moving the product from the producer to the consumer. It is concerned with **distribution** through the producer's **channels to market**.

The extended marketing mix

- In addition to the four Ps, additional elements are people, processes and physical evidence.

The relationship of the marketing plan to the strategic plan

- Marketing objectives must be consistent with strategic objectives, and be drawn up alongside them.
- The marketing plan must also take account of the internal strengths and weaknesses of the organisation.

Section B2(e) of the Paper AB *Study Guide* states that candidates should be able to describe the roles and functions of the main departments in a business organisation: research and development, purchasing, production, direct service provision, marketing, administration and finance. The next section of the *Study Guide* amplifies the requirements in relation to marketing, setting out the following learning outcomes.

Explain the role of marketing in an organisation:

1. the definition of marketing
2. the marketing mix
3. the relationship of the marketing plan to the strategic plan.

This article provides an introduction to these important marketing concepts.

## WHAT IS MARKETING?

The definition of marketing published by the UK's Chartered Institute of Marketing is 'the management process responsible for identifying, anticipating and satisfying customer needs profitably'.

There is no doubt that marketing is a **management process**, as most successful organisations regard it as a crucial set of co-ordinated activities that must be driven from the strategic level of a business. Many organisations have an executive director with functional responsibility for marketing but, even if this is not the case, it is usually necessary for a strategic marketing plan to be put in place and implemented, consistent with the goals and objectives set out in the corporate plan. Despite a widely held perception that marketing is synonymous with selling, the definition confirms that the scope of marketing extends far beyond selling alone. Indeed, a business strategy built on selling and without due attention to other important marketing activities can have serious shortcomings: the customer's needs may be overlooked, the organisation may sell goods and services that the customer does not need, or the customer may have needs for the organisation's products and services but may purchase the wrong ones.

The essence of marketing is captured in the words '**identifying, anticipating and satisfying**'. These imply a process through which the organisation must find out what customers want, or carry out research into what customers are likely to want in the future, and then fulfil these needs by deploying its resources in an appropriate manner. The process has to be dynamic, as needs and preferences change over time, rendering some goods and services less suitable for their needs, or even obsolete. There are countless examples of products that have fulfilled genuine needs in the past, sometimes for long periods of time, but have eventually been superseded by alternative choices due to changes in needs, tastes and preferences, or have become totally unnecessary for consumers. Examples include audio cassettes, Super 8 cine films and projectors, 'twin tub' washing machines and cash registers.

Successful business organisations therefore regard marketing as a **continuous process**, through which actual and perceived customer needs are constantly analysed and monitored in order to fulfil these needs to the extent that the organisation's resources and capabilities allow.

## THE MARKETING MIX

The marketing mix is a model used when considering the range of activities necessary to construct and implement a comprehensive marketing strategy. It is most commonly expressed in terms of 'the four Ps' of product, price, promotion and place. 'Place' in this context refers to all activities associated with distribution.

### Product

This element of the marketing mix considers the technical features, benefits and limitations of the

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product or products offered by the business. Depending on the nature of the business, products can be physical goods or services.

The technical **features** of the product are important because they will determine whether it will meet the actual or anticipated needs of the customer. Features are expressed as technical specifications and capabilities, and sometimes the limits to which the product is subject.

**Benefits** are the utility to the customer and confirm what may be expected of the product. Benefits have an important role to play when devising promotional activities, and are therefore the crucial link between the product and promotion elements of the mix.

Some products are subject to a derived demand, so the features may be quite distinct from the benefits of the end product. For example, nobody actually wants a mortgage, as this represents a large, long-term financial commitment. The benefit lies in owning an apartment or house, and without the mortgage, of course, few people can realise this aspiration in the short term.

**Product planning** considers the position of the product within the portfolio of products offered by the organisation, and the potential contribution the product has to make to its future success. Nearly all products may be considered with reference to the **product life cycle**. This model suggests that products pass sequentially through various stages over time, with revenues increasing through the introduction and growth stages, then tailing off and eventually declining as shakeout, maturity and decline take place. The 'product' of professional firms is the services they offer, which are mainly intangible but may sometimes be delivered as reports and other outputs.

**Price**

This refers not only to the price of the product, but to all costs related to the purchase. It may be expressed in monetary terms, a rate of interest, costs, fees, or a combination of all these elements. The price may be a one-off payment, or a series of payments over time. It may be subject to time limits (such as a special deal for a limited period). It may also be conditional on purchasing other products, or a minimum 'lock in' period, such as a mobile telephone contract with a minimum duration.

In the context of professional services, price is expressed as fees or charges.

**Promotion**

Promotion refers to all activities that are intended to inform the customer and influence the purchasing decision. The range of promotional media deployed by an organisation is sometimes referred to as the promotional mix. This includes:

- advertising
- direct selling, such as face-to-face interactions and telephone or online sales
- public relations
- merchandising
- sponsorship.

Promotion may be highly specific to individual products or a range of products, or may enhance brand recognition in respect of the organisation's public image. In some cases, the name of the product may become synonymous with the organisation itself. For example, the ballpoint pen was once referred to routinely as a 'biro', which is both the inventor's surname (Laszlo Biro) and the name of his company. Likewise, a vacuum cleaner is still called a 'hoover' by many consumers, Hoover being the name of just one producer.

The promotional mix varies widely from organisation to organisation. Fast moving consumer goods producers rely extensively on advertising, while life assurance companies have traditionally used direct selling to a much greater extent.

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**Market segmentation** can be used for both research and planning purposes. It is highly relevant when considering the promotional mix, and is also important when considering the other elements of the marketing mix. Market segmentation involves analysis of the market with reference to homogeneous sub-sets that share like characteristics. Commonly used segments include:

- age
- gender
- geographical location
- socio-economic groups
- psychological factors, such as risk appetite, desire to conform or be different, and so on.

Segmentation provides insights into strategic opportunities and options. For example, some companies choose a highly focused approach by **targeted marketing** aimed at very specific market segments (Club 18-30 holidays, insurance for drivers with 'clean' licences), while others apply **differentiated marketing strategies** to address several segments deploying different marketing mixes (fast moving consumer goods companies often produce low price brands and premium priced brands within their product portfolios).

As legal constraints and universally accepted professional standards have changed over time, the promotional mix used by professional firms has changed radically in recent years. In many countries, accountants, lawyers and doctors were forbidden from advertising at all, and had to rely on testimonials and personal referrals, and even when such rules were relaxed, many professionals frowned upon promotion in the conventional sense. Such attitudes are rarely encountered today.

**Place**

This refers to all activities related to moving the product from the producer to the consumer. It is concerned with **distribution** through the producer's **channels to market**.

Distribution may involve physically moving the product to the consumer, or to intermediaries who take responsibility for different stages of distribution, such as agents and wholesalers. In retail industries, distribution was once only concerned with transferring goods from the point of production to the point of sale, but the logistics have now changed as more companies embrace online orders and home delivery alongside (and, in some cases, instead of) their stores.

Advancements in information and communications technology have changed the face of distribution in the last 20 years. In many countries, it has become apparent that retail shops are finding it increasingly difficult to compete with the more direct channels facilitated by e-commerce. While for the foreseeable future consumers will continue to rely on the traditional shopping experience for certain goods, such as fresh food and fashion, it is clear that certain businesses cannot expect their traditional business model to be sustainable. This has been borne out by the collapse of some long-established companies (such as Woolworth) and the difficulties encountered by others (such as various travel and holiday companies).

Professional firms now rely heavily on virtual channels to market, having previously been highly dependent on face-to-face interaction.

**THE EXTENDED MARKETING MIX**

In addition to the four Ps, some organisations incorporate additional elements into their marketing mix. The most common of these are people, processes and physical evidence.

**People**

This component of the marketing mix is especially important:

- when goods offered are considered to be homogeneous by customers
- for services, which are intangible and therefore have to be differentiated in an effective manner.

People are the most unpredictable resource employed by an organisation, as the contribution of any

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individual can vary from day to day, or even during any single day. People facilitate interactions between the business and the customer, so it is important that employees add value at the point of sale and in back office roles. Some writers refer to each interaction between the customer and an individual employee as a 'moment of truth'. Each moment of truth is an opportunity to delight the customer or merely satisfy the customer, but it is also a moment when inappropriate behaviour, attitudes, mood or language can drive the customer away, possibly never to return.

When considering this part of the marketing mix, the organisation has to consider matters such as:

- the duties that should be carried out by people, and how these duties should be allocated between them
- the extent to which tasks can be automated, making the service experience more effective and efficient, but without diminishing value to the customer
- the expectations of customers when dealing with people in the organisation
- the extent to which competitive advantage can be obtained by enhancing the contribution that employees may potentially make, which can be achieved through education, training, development, incentives and other motivational stimuli.

**Processes**

Processes are vitally important when they can impact on the effectiveness of delivering benefits to the customer. Automation and the linking of processes have parts to play here. Successful businesses capitalise on the use of technology to undertake tasks that are performed better by machines than people, while at the same time asking their people to fulfil roles that only people do well.

Many businesses have seen a revolution in the way that customer needs are addressed by focusing on process changes. These include the systems used by airlines for booking, ticketing and moving customers through airports and on to airplanes, and the systems used by financial institutions to provide remote banking services, including current accounts and card products.

Adding value through changes in processes may be achieved by adjusting and refining existing systems (process design and redesign), or by re-engineering processes completely.

**Physical evidence**

When considering the purchase of a good, the customer may respond to physical cues, such as whether the packaging is pleasing on the eye or whether the good itself is aesthetically attractive. In the context of the extended marketing mix, physical evidence is especially relevant to services. As stated earlier, services are intangible, so those responsible for marketing can design and implement physical cues to which the customer may respond positively.

There are many ways that this element of the mix can be used effectively, including attention to:

- the design of the building in which the service is delivered, and sometimes the environment in which the building is situated
- interior layout, decor, signage, as well as use of contemporary floor plans
- uniforms
- design of web pages and forms
- business cards
- loyalty cards.

**THE RELATIONSHIP OF THE MARKETING PLAN TO THE STRATEGIC PLAN**

The strategic plan of an organisation is formulated in order to achieve the organisation's long-term objectives. A typical planning horizon is five years, though this may depend on the nature of the business. For example, a 'dot com' company may choose a short timescale if technological



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developments in its field of operation are changing fast, while an oil or minerals extraction company might plan for a much longer period of time.

The strategic plan sets objectives that will be consistent with its values and mission as envisaged by the directors. In order to realise the objectives set down in the plan, it is necessary for each functional area of the business to create its own plan. Therefore, there will be a production plan, a human resources plan, a financial plan, and so on.

Marketing objectives must be consistent with strategic objectives, and be drawn up alongside them. Few organisations can operate without paying attention to the environmental (PEST) factors, so one of the first stages of planning is to analyse these factors and consider them in relation to the opportunities and threats presented by external forces. The marketing plan must also take account of the internal strengths and weaknesses of the organisation. Strengths are the platform upon which competitive advantage can be built, while weaknesses signal current limitations that the organisation may or may not be able to overcome.

At this stage, many organisations carry out a **marketing audit**, which addresses three questions:

- where are we now?
- where do we want to be?
- how do we get there?

The marketing plan can then be formulated, setting specific objectives and detailed plans on how marketing resources will be applied to achieve them. For many organisations, the detailed plans may be structured around the various elements of the marketing mix.

**Questions**

(a) “We need to ensure that, at the end of the day, our new computer is put “in front” of everyone, no matter who they are, what they do or where they go, they need to know about it so they can buy it.”

Which of the marketing “4Ps” is relevant to this situation?

- A Place
- B Promotion
- C Price
- D Product

(2 marks)

(b) In marketing, the “4Ps” relate to the marketing mix for products, with the “7Ps” relating to the marketing mix for service providers.

What are the additional Ps that relate to the marketing mix for service providers?

- A Process, Physical evidence, People
- B People, Physical evidence, Price
- C Physical evidence, Price, Place
- D Process, Promotion, People

(2 marks)

**Answer:**

(a) A

It is no good having promotion, price and a product if it is not widely available to buy (unless there is a deliberate policy to create uniqueness and exclusivity – which is not indicated in the scenario).

(b) A

Product, price, promotion, place PLUS people, processes, physical evidence.

**Chapter 7 Corporate governance : the board of directors and standing committees****Executive Summary**

Corporate governance is the system by which companies are directed and controlled.

The Organisation for Economic Co-operation and Development published its 'Principles of Corporate Governance' in 2004:

- *Rights of shareholders*
- *Equitable treatment of shareholders*
- *Stakeholders*
- *Disclosure and transparency*
- *Board of directors*

To whom is corporate governance relevant:

- Limited companies
- Not-for-profit organisations
- Public sector organisations

**Approaches to corporate governance**

- Most countries adopt a principles-based approach to corporate governance. This involves establishing a comprehensive set of best practices to which listed companies should adhere.
- Some countries prefer a rules-based approach through which the desired corporate governance standards are enshrined in law and are therefore mandatory.

**The role of the board of directors**

Nearly all companies are managed by a board of directors, appointed or elected by the shareholders to run the company on their behalf.

Structure of the board of directors: 1) Executive directors; 2) Non-executive directors

**Key Positions**

The **chairman** of the company is the leader of the board of directors. It is the chairman's responsibility to ensure that the board operates efficiently and effectively, get the best out of all of its members.

The **chief executive officer** (CEO) is the leader of the executive team and is responsible for the day-to-day management of the organisation.

The **secretary** is the chief administrative officer of the company. The secretary usually has responsibilities for liaison with shareholders and the government registration body.

**Standing Committees**

- Audit Committee
- Remuneration Committee

The syllabus for Paper AB/FAB, *Accountant in Business*, requires candidates to understand the meaning of corporate governance and the role of the board of directors in establishing and maintaining good standards of governance.

Specifically, the *Study Guide* refers to the separation of ownership and control, the role of non-executive directors and two of the standing committees commonly established by public companies. This article provides an introduction to corporate governance and some of the basic concepts that underpin it, and explains the roles of the board, the different types of company director and standing committees.

## WHAT IS CORPORATE GOVERNANCE?

The simplest and most concise definition of corporate governance was provided by the Cadbury Report in 1992, which stated: *Corporate governance is the system by which companies are directed and controlled.*

Though simplistic, this definition provides an understanding of the nature of corporate governance and the vital role that leaders of organisations have to play in establishing effective practices. For most companies, those leaders are the directors, who decide the long-term strategy of the company in order to serve the best interests of the owners (members or shareholders) and, more broadly, stakeholders, such as customers, suppliers, providers of long-term finance, the community and regulators.

It is important to recognise that effective corporate governance relies to some extent on compliance with laws, but being fully compliant does not necessarily mean that a company is adopting sound corporate governance practices. Significantly, the Cadbury Report was published in the UK shortly after the collapse of Maxwell Communications plc, a large publishing company. Many of the actions that brought about the collapse, such as the concentration of power in the hands of one individual and the company borrowing from its pension fund in order to achieve leveraged growth, were legal at the time.

The Organisation for Economic Co-operation and Development published its 'Principles of Corporate Governance' in 2004. These are:

- *Rights of shareholders*: The corporate governance framework should protect shareholders and facilitate their rights in the company. Companies should generate investment returns for the risk capital put up by the shareholders.
- *Equitable treatment of shareholders*: All shareholders should be treated equitably (fairly), including those who constitute a minority, individuals and foreign shareholders. Shareholders should have redress when their rights are contravened or where an individual shareholder or group of shareholders is oppressed by the majority.
- *Stakeholders*: The corporate governance framework should recognise the legal rights of stakeholders and facilitate cooperation with them in order to create wealth, employment and sustainable enterprises.
- *Disclosure and transparency*: Companies should make relevant, timely disclosures on matters affecting financial performance, management and ownership of the business.
- *Board of directors*: The board of directors should set the direction of the company and monitor management in order that the company will achieve its objectives. The corporate governance framework should underpin the board's accountability to the company and its members.

## TO WHOM IS CORPORATE GOVERNANCE RELEVANT?

Corporate governance is important in all but the smallest organisations. Limited companies have a primary duty to their shareholders, but also to other stakeholders as described above. Not-for-profit

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organisations must also be directed and controlled appropriately, as the decisions and actions of a few individuals can affect many individuals, groups and organisations that have little or no influence over them. Public sector organisations have a duty to serve the State but must act in a manner that treats stakeholders fairly.

Most of the attention given to corporate governance is directed towards public limited companies whose securities are traded in recognised capital markets. The reason for this is that such organisations have hundreds or even thousands of shareholders whose wealth and income can be enhanced or compromised by the decisions of senior management. This is often referred to as the **agency problem**. Potential and existing shareholders take investment decisions based on information that is historical and subjective, usually with little knowledge of the direction that the company will take in the future. They therefore place trust in those who take decisions to achieve the right balance between return and risk, to put appropriate systems of control in place, to provide timely and accurate information, to manage risk wisely, and to act ethically at all times.

The agency problem becomes most evident when companies fail. In order to make profits, it is necessary to take risks, and sometimes risks that are taken with the best intentions – and are supported by the most robust business plans – result in loss or even the demise of the company. Sometimes corporate failure is brought about by inappropriate behaviours of directors and other senior managers.

As already mentioned, in the UK, corporate governance first came into the spotlight with the publication of the Cadbury Report, shortly after two large companies (Maxwell Communications plc and Polly Peck International plc) collapsed. Ten years later, in the US, the Sarbanes-Oxley Act was passed as a response to the collapse of Enron Corporation and WorldCom. All of these cases involved companies that had been highly successful and run by a few very powerful individuals, and all involved some degree of criminal activity on their part.

The recent credit crisis has brought about renewed concern about corporate governance, specifically in the financial sector. Although the roots of the crisis were mainly financial and originated with adverse conditions in the wholesale money markets, subsequent investigations and reports have called into question the policies, processes and prevailing cultures in many banking and finance-related organisations.

**APPROACHES TO CORPORATE GOVERNANCE**

Most countries adopt a principles-based approach to corporate governance. This involves establishing a comprehensive set of best practices to which listed companies should adhere. If it is considered to be in the best interests of the company not to follow one or more of these standards, the company should disclose this to its shareholders, along with the reasons for not doing so. This does not necessarily mean that a principles-based approach is a soft option, however, as it may be a condition of membership of the stock exchange that companies strictly follow this 'comply or explain' requirement.

Some countries prefer a rules-based approach through which the desired corporate governance standards are enshrined in law and are therefore mandatory. The best example of this is the US, where the Sarbanes-Oxley Act lays down detailed legal requirements.

**THE ROLE OF THE BOARD OF DIRECTORS**

Nearly all companies are managed by a board of directors, appointed or elected by the shareholders to run the company on their behalf. In most countries, the directors are subject to periodic (often annual) re-election by the shareholders. This would appear to give the shareholders ultimate power, but in most sectors it is recognised that performance can only be judged over the medium to long-term. Shareholders therefore have to place trust in those who act on their behalf. It

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is rare but not unknown for shareholders to lose patience with the board and remove its members *en masse*.

The role of the board of directors was summarised by the King Report (a South African report on corporate governance) as:

- to define the purpose of the company
- to define the values by which the company will perform its daily duties
- to identify the stakeholders relevant to the company
- to develop a strategy combining these factors
- to ensure implementation of this strategy.

The purpose and values of a company are often set down in its constitutional documents, reflecting the objectives of its founders. However, it is sometimes appropriate for the board to consider whether it is in the best interests of those served by the company to modify this or even change it completely. For example, NCR Corporation is a US producer of automated teller machines and point-of-sale systems, but its origins lay in mechanical accounting machines (NCR represents National Cash Register). As cash registers would quickly become obsolete with the emergence of microchip technology, the company had to adapt very rapidly. Whitbread plc originated as a brewer in the 18th century in the UK, but in the 1990s redefined its mission and objectives completely. It is now a hospitality and leisure provider (its brands include Premier Inn and Costa coffee) and has abandoned brewing completely.

The directors must take a long-term perspective of the road that the company must travel. Management writer William Ouchi attributes the enduring success of many Japanese companies to their ability to avoid short-term 'knee-jerk' reactions to immediate issues in favour of consensus over the best direction to take in the long-term.

## **STRUCTURE OF THE BOARD OF DIRECTORS**

There is no convenient formula for defining how many directors a company should have, though in some jurisdictions company law specifies a minimum and/or maximum number of directors for different types of company. Tesco plc, a large multinational supermarket company, has 13 directors. Swire Pacific Limited, a large Hong Kong conglomerate, has 18 directors. Smaller listed companies generally have fewer directors, typically six to eight persons.

The board of directors is made up of **executive directors** and **non-executive directors**.

**Executive directors** are full-time employees of the company and, therefore, have two relationships and sets of duties. They work for the company in a senior capacity, usually concerned with policy matters or functional business areas of major strategic importance. Large companies tend to have executive directors responsible for finance, IT/IS, marketing and so on.

Executive directors are usually recruited by the board of directors. They are the highest earners in the company, with remuneration packages made up partly of basic pay and fringe benefits and partly performance-related pay. Most large companies now engage their executive directors under fixed term contracts, often rolling over every 12 months.

The chief executive officer (CEO) and the finance director (in the US, chief financial officer) are nearly always executive directors.

**Non-executive directors** (NEDs) are not employees of the company and are not involved in its day-to-day running. They usually have full-time jobs elsewhere, or may sometimes be prominent individuals from public life. The non-executive directors usually receive a flat fee for their services, and are engaged under a contract for service (civil contract, similar to that used to hire a consultant).

NEDs should provide a balancing influence and help to minimise conflicts of interest. The Higgs Report, published in 2003, summarised their role as:

- to contribute to the strategic plan

- to scrutinise the performance of the executive directors
- to provide an external perspective on risk management
- to deal with people issues, such as the future shape of the board and resolution of conflicts.

The majority of non-executive directors should be independent. Factors to be considered in assessing their independence include their business, financial and other commitments, other shareholdings and directorships and involvement in businesses connected to the company. However, holding shares in the company does not necessarily compromise independence.

Non-executive directors should have high ethical standards and act with integrity and probity. They should support the executive team and monitor its conduct, demonstrating a willingness to listen, question, debate and challenge.

**It is now recognised as best practice that a public company should have more non-executive directors than executive directors.** In Tesco plc, there are five executive directors and eight independent non-executive directors. Swire Pacific Ltd has eight executive directors and 10 non-executive directors, of which six are independent non-executive directors.

An individual may be accountable in law as a **shadow director**. A shadow director is a person who controls the activities of a company, or of one or more of its actual directors, indirectly. For example, if a person who is unconnected with a company gives instructions to a person who is a director of the company, then the second person is an actual director while the first person is a shadow director. In some jurisdictions, shadow directors are recognised as being as accountable in law as actual directors.

## UNITARY V TWO-TIER BOARDS

The unitary board model is adopted by, *inter alia*, companies in the UK, US, Australia and South Africa. The company's directors serve together on one board comprising both executive and non-executive directors.

In many countries in continental Europe, companies adopt a two-tier structure. This separates those responsible for supervision from those responsible for operations. The supervisory board generally oversees the operating board.

Paper FAB, *Accountant in Business*, focuses mainly on the unitary board system, though knowledge of both models is required for subsequent studies for Paper P1, *Governance, Risk and Ethics*.

## KEY POSITIONS

The **chairman** of the company is the leader of the board of directors. It is the chairman's responsibility to ensure that the board operates efficiently and effectively, get the best out of all of its members. The chairman should, for example, promote regular attendance and full involvement in discussions. The chairman decides the scope of each meeting and is responsible for time management of board meetings, ensuring all matters are discussed fully, but without spending limitless time on individual agenda items. In most companies the chairman is a non-executive director.

The **chief executive officer** (CEO) is the leader of the executive team and is responsible for the day-to-day management of the organisation. As such, this individual is nearly always an executive director. As well as attending board meetings in his or her capacity as a director, the CEO will usually chair the management committee or executive committee. While most companies have monthly board meetings, it is common for management/executive committee meetings to be weekly.

The **secretary** is the chief administrative officer of the company. The secretary provides the agenda and supporting papers for board meetings, and often for executive committee meetings also. He or she takes minutes of meetings and provides advice on procedural matters, such as terms of reference. The secretary usually has responsibilities for liaison with shareholders and the

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government registration body. As such, the notice of general meetings will be signed by the secretary on behalf of the board of directors. The secretary may be a member of the board of directors, though some smaller companies use this position as a means of involving a high potential individual at board level prior to being appointed as a director.

**SEGREGATION OF RESPONSIBILITIES**

It is generally recognised that the CEO should not hold the position of chairman, as the activities of each role are quite distinctive from one another. In larger companies, there would be too much work for one individual, though in Marks & Spencer, a large listed UK retail organisation, one person did occupy both positions for several years.

The secretary should not also be the chairman of the company. As the secretary has a key role in liaising with the government registration body, having the same person occupying both roles could compromise the flow of information between this body and the board of directors.

**STANDING COMMITTEES**

The term 'standing committee' refers to any committee that is a permanent feature within the management structure of an organisation. In the context of corporate governance, it refers to committees made up of members of the board with specified sets of duties. The four committees most often appointed by public companies are the audit committee, the remuneration committee, the nominations committee and the risk committee.

The *Syllabus* and *Study Guide* for Paper F1/FAB require students to study only two committees. These are the audit committee and the remuneration committee.

**AUDIT COMMITTEE**

This committee should be made up of independent non-executive directors, with at least one individual having expertise in financial management. It is responsible for:

- oversight of internal controls; approval of financial statements and other significant documents prior to agreement by the full board
- liaison with external auditors
- high level compliance matters
- reporting to the shareholders.

Sometimes the committee may carry out investigations and may deal with matters reported by whistleblowers.

**REMUNERATION COMMITTEE**

This committee decides on the remuneration of executive directors, and sometimes other senior executives. It is responsible for formulating a written remuneration policy that should have the aim of attracting and retaining appropriate talent, and for deciding the forms that remuneration should take. This committee should also be made up entirely of independent non-executive directors, consistent with the principle that executives should not be in a position to decide their own remuneration.

It is generally recognised that executive remuneration packages should be structured in a manner that will motivate them to achieve the long-term objectives of the company. Therefore, the remuneration committee has to offer a competitive basic salary and fringe benefits (these attract and retain people of the right calibre), combined with performance-related rewards such as bonuses linked to medium and long-term targets, shares, share options and eventual pension benefits (often subject to minimum length of service requirements).



**PUBLIC OVERSIGHT**

Public oversight is concerned with ensuring that the confidence of investors and the general public in professional accountancy bodies is maintained. This can be achieved by direct regulation, the imposition of licensing requirements (including, where appropriate, exercising powers of enforcement) or by self-regulation. As the US operates a rules-based system of governance, these responsibilities are discharged by the Public Company Accounting Oversight Board, which has the power to enforce mandatory standards and rules laid down by the Sarbanes-Oxley Act. In the UK, regulation is the responsibility of the Professional Oversight team of the Financial Reporting Council.

## Questions

*Sample question 1:*

**LLL Company is listed on its country's stock exchange. The following individuals serve on the board of directors:**

**Asif** is a non-executive director and is the chairman of the company.

**Bertrand** is the CEO and is responsible for the day-to-day running of the company.

**Chan** is a professional accountant and serves as a non-executive director.

**Donna** is the finance director and is an employee of the company.

**Esther** is a legal advocate and serves as a non-executive director.

**Frederik** is the marketing director of a manufacturing company and serves as a non-executive director.

**Which of the following is the most appropriate composition of directors for LLL Company's audit committee?**

- A Chan, Donna and Esther**
- B Asif, Bertrand and Frederik**
- C Asif, Esther and Frederik**
- D Chan, Esther and Frederik**

The correct answer is D. Executive directors should not serve on the audit committee. This eliminates options A and B. Option D is the best choice, as the audit committee should have at least one director with expertise in finance.

*Sample question 2:*

**Which of the following is a duty of the secretary of a listed public company?**

- A Maintaining order at board meetings**
- B Clarifying the terms of reference of the board meeting**
- C Ensuring that all directors contribute fully to discussions at board meetings**
- D Reporting to the board on operational performance for the last quarter**

The correct answer is B. Options A and C are responsibilities of the chairman, while option D is the responsibility of the CEO.

*Sample question 3:*

**The board of directors of JJJ Company has decided to increase the basic salary of its chief executive officer by 20% in order to bring her pay into line with those occupying similar positions in the industry.**

**This action will achieve which of the following purposes?**

- A Improve the prospect of retaining the chief executive officer**
- B Increase the productivity of the chief executive officer by at least 20%**
- C Motivate the chief executive officer to achieve long-term targets**
- D Create greater job satisfaction for the chief executive officer**

The correct answer is A.

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The basic pay offered by a company serves as a beacon to attract applicants, and can also deter the present incumbent of a position from seeking opportunities elsewhere, especially if they perceive themselves to be underpaid at present.

A substantial pay increase is unlikely to achieve a significant increase in productivity or increase long-term motivation (though pay increases can have a short-term impact on motivation). Job satisfaction is derived from factors other than remuneration, such as challenges inherent in the work and the nature of the tasks performed.

## Chapter 8 Internal controls

### Executive Summary

Internal Control: The policies, processes, tasks, behaviours and other aspects of an organisation that taken together.

#### Objectives of internal control

- Efficient conduct of business
- Safeguarding assets
- Preventing and detecting fraud and other unlawful acts
- Completeness and accuracy of financial records
- Timely preparation of financial statements

#### Responsibilities for internal control

- In many smaller, unincorporated businesses such as sole traders and unlimited partnerships, the responsibility for internal controls often lies with the owners themselves.
- In a limited company, the **board of directors** is responsible for ensuring that appropriate internal controls are in place.

#### Common Control Procedures

- Physical controls
- Authorisation and approval limits
- Segregation of duties
- Management controls
- Arithmetic and accounting controls
- Human resources controls

### Internal Audit

Internal audit may be defined as an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation.

Internal audit is an **internal but independent assurance function**.

The head of internal audit should report to the board of directors, or to the audit committee.

**Internal audit testing** is the internal assessment of internal controls and as such is a management control to ensure compliance and conformity of internal controls to pre-determined standards.

#### Types of Audit

- Operational audits
- Systems audits
- Transactions or probity audit



The purpose of this article is to provide an overview of internal control, with particular emphasis on topics relevant to Part C of the F1/FAB syllabus. The article will focus on the following learning objectives, as set out in section C6 of the study guide:

- a) Explain internal control and internal check
- b) Explain the importance of internal financial controls in an organisation
- c) Describe the responsibilities of management for internal financial control.

The article will also describe the roles of internal audit and internal audit testing, relevant to section C2(e) and (f) of the study guide.

## DEFINITION AND PURPOSES OF INTERNAL CONTROL

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The Turnbull Report, first published in 1999, defined internal control and its scope as follows:

‘The policies, processes, tasks, behaviours and other aspects of an organisation that taken together:

Facilitate effective operation by enabling it to respond in an appropriate manner to significant business, operational, financial, compliance and other risks to achieve its objectives. This includes safeguarding of assets and ensuring that liabilities are identified and managed.

Ensure the quality of internal and external reporting, which in turn requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from both internal and external sources.

Ensure compliance with applicable laws and regulations and also with internal policies.’

Turnbull’s explanation focuses on the positive role that internal control has to play in an organisation. Facilitating efficient operations implies improvement, and, properly applied, internal control processes add value to an organisation by considering outcomes against original plans and then proposing ways in which they might be addressed.

At the same time, Turnbull also conceded that there is no such thing as a perfect internal control system, as all organisations operate in a dynamic environment: just as some risks recede into insignificance, new risks will emerge, some of which will be difficult or impossible to anticipate. The purpose of any control system should therefore be to provide **reasonable assurance** that the organisation can meet its objectives.

## OBJECTIVES OF INTERNAL CONTROL

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Internal control should have the following objectives:

### **Efficient conduct of business:**

Controls should be in place to ensure that processes flow smoothly and operations are free from disruptions. This mitigates against the risk of inefficiencies and threats to the creation of value in the organisation.

### **Safeguarding assets:**

Controls should be in place to ensure that assets are deployed for their proper purposes, and are not vulnerable to misuse or theft. A comprehensive approach to this objective should consider all assets, including both tangible and intangible assets.

**Preventing and detecting fraud and other unlawful acts:**

Even small businesses with simple organisation structures may fall victim to these violations, but as organisations increase in size and complexity, the nature of fraudulent practices becomes more diverse, and controls must be capable of addressing these.

**Completeness and accuracy of financial records:**

An organisation cannot produce accurate financial statements if its financial records are unreliable. Systems should be capable of recording transactions so that the nature of business transacted is properly reflected in the financial accounts.

**Timely preparation of financial statements:**

Organisations should be able to fulfil their legal obligations to submit their account, accurately and on time. They also have a duty to their shareholders to produce meaningful statements. Internal controls may also be applied to management accounting processes, which are necessary for effective strategic planning, decision taking and monitoring of organisational performance.

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**RESPONSIBILITIES FOR INTERNAL CONTROL**

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In many smaller, unincorporated businesses such as sole traders and unlimited partnerships, the responsibility for internal controls often lies with the owners themselves. In most cases, the owners are fully engaged in the business itself, and if employees are engaged, it is usually within the capability of the owners to remain fully aware of transactions and the overall state of the business.

As organisations grow, the need for internal controls increases, as the degree of specialisation increases and it becomes impossible to remain fully aware of what is going on in every part of the business.

In a limited company, the **board of directors** is responsible for ensuring that appropriate internal controls are in place. Their accountability is to the shareholders, as the directors act as their agents. In turn, the directors may consider it prudent to establish a dedicated internal control function. The point at which this decision is taken will depend on the extent to which the benefits of function will outweigh the costs.

The directors must pay due attention to the **control environment**. If internal controls are to be effective, it is necessary to create an appropriate culture and embed a commitment to robust controls throughout the organisation.

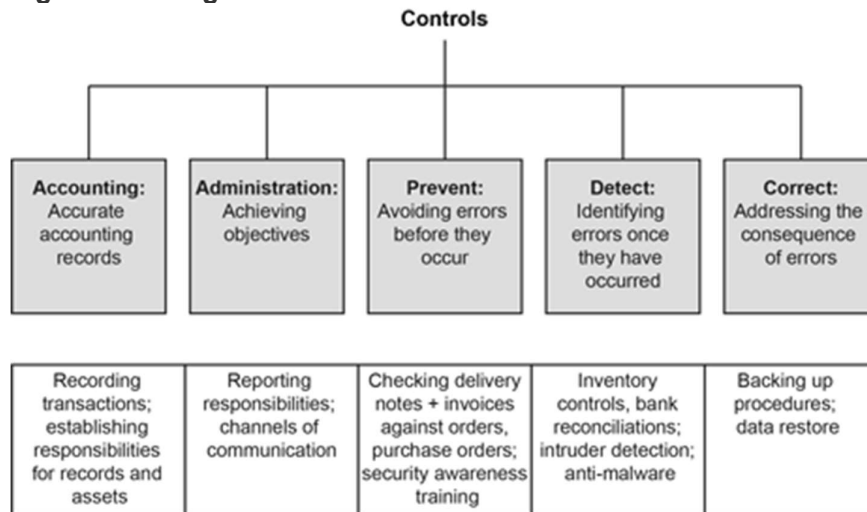
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**GENERIC CONTROL CATEGORIES**

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Controls can be categorised in many different ways. Figure 1 described five categories that are often used.

Figure 1: Categories of controls



Internal controls can be:

#### **Mandatory or voluntary:**

Mandatory controls are those which **must** be applied, irrespective of circumstances. These are widely used to prevent breached of laws or policy, as well as to minimise risks relating to health and safety. Voluntary controls are applied according to the judgement of the organisation and its managers.

#### **Discretionary or non-discretionary:**

Managers may be permitted discretion according to their interpretation or judgement of risks in given circumstances. Non-discretionary controls must be applied.

#### **Manual or automated:**

Manual controls are applied by the individual employee whereas automated controls are programmed into the systems of the organisation. Some systems combine the two: for example, when deciding on whether a customer should be permitted days on hand for payment, there could be automated 'accept' above a specified credit rating or 'decline' or below a specified credit rating, and an intermediate range in which a manager may be able to override the automated system.

#### **General controls or application controls:**

This classification of controls applies specifically to information systems. General controls help to ensure the reliability of data generated by systems, helping to ascertain whether systems operate as intended and output is reliable. Application controls are automated and designed to ensure the complete and accurate recording of data from input to output.

## **COMMON CONTROL PROCEDURES**

#### **Physical controls:**

These controls include restrictions on access to buildings, specified office or factory areas or equipment, such as turnstiles at the entrance to the premises, swipe cards and passwords. They also include physical restraints, such as fixing non-current assets to prevent removal.

#### **Authorisation and approval limits:**

Many employees must adhere to authorisation limits, and these will usually be specified in the terms of employment. For example, a junior manager may be permitted to book business flights up to the value of \$500, but for tickets costing more than this, the purchase may have to be approved by someone more senior.



**Segregation of duties:**

To minimise the risk of errors and fraud, duties associated with cash handling are often segregated. For example, in the post room of a company that received cash by post, the employee recording the cash will be a different person to the one who opens the post. Segregation is also relevant to other functions. At executive level, it is now best practice to segregate the roles of chairman and chief executive officer, and as an independent assurance function, internal audit should be totally segregated from the finance department, with a reporting line direct to the board of directors or the audit committee.

**Management controls:**

These controls are operated by managers themselves. An example is variance analysis, through which a manager may be required as part of their job to consider differences between planned outcomes and actual performance. Performance management of subordinates is also an integral part of many managerial positions. Further down the chain of command, **supervision controls** are exercised in respect of day-to-day transactions. **Organisation controls** operate according to the configuration of the organisation chart and line/staff responsibilities.

**Arithmetic and accounting controls:**

These controls are in place to ensure accurate recording and processing of transactions. Procedures here include reconciliations and trial balances.

**Human resources controls:**

Controls are implemented for all aspects of human resources management. Examples include qualifications verification, references and criminal record checks on recruits, checks on staff who have to be attested for competence and training effectiveness.

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**INTERNAL CHECK**

Internal check is a system through which the accounting procedures of an organisation are so laid out that the accounts procedures are not under the absolute and independent control of any person. The work of one employee is complementary of that of another, enabling a continuous audit of the business to be made.

The essential elements of an internal check are:

- checks are implemented on day-to-day transactions
- checks operate continuously as a part of the system
- the work of each person is complementary to the work of another.

By allocating duties in this way, no one person has exclusive control over any transaction.

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**INTERNAL AUDIT****Definition and purposes of internal audit:**

Internal audit may be defined as an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. Internal audit supports management in the effective discharge of their responsibilities. To this end, internal audit furnishes management with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed.

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**OBJECTIVES OF INTERNAL AUDIT**

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The formal objectives of internal audit may include some or all of the following:

- review of accounting and internal control systems
- examination of financial and operating information
- review of the 'three E's (economy, efficiency and effectiveness)
- review of compliance with laws and regulations
- review of arrangements for the safeguarding of assets
- review of implementation of corporate goals and objectives
- identification of significant risks to the organisation, and monitoring risk management policy and risk management strategies
- special investigations as required.

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**WHY IS INTERNAL AUDIT NECESSARY?**

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The importance of internal audit was highlighted by the Turnbull Report. It states that listed public companies that do not have an internal audit function should review the need to have such a function at least annually. Turnbull goes on to state that listed public companies that do have an internal audit function should review the scope, authority and resources of this function at least annually.

Turnbull suggests that the need for the internal audit function will depend on several factors. These include:

- the scale, diversity and complexity of the organisation's activities
- the number of employees – the need for an internal audit function increases as the number of employees increases, or if employee interrelationships become more complex
- where the benefits of such a function will outweigh the costs of implementation and operation
- when changes occur over time in the organisation's structures, reporting processes or underlying information systems
- the nature of risks, changes to risks and emerging risks
- problems and issues arising with internal control systems, both actual and perceived
- the occurrence of an increasing number of unexplained or unacceptable events.

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**INTERNAL AUDIT AND INTERNAL CONTROL**

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Internal audit is an **internal but independent assurance function**. While internal auditors are usually employees of the organisation, they should operate independently of management so that their analyses, judgements and reports are free from bias or undue influence. The head of internal audit should report to the board of directors, or to the audit committee. Some organisations reinforce independence by outsourcing the internal audit function to professional external firms.

**Internal audit testing** is the internal assessment of internal controls and as such is a management control to ensure compliance and conformity of internal controls to pre-determined standards.

**Key risks:**

Internal audit reviews and reports on internal controls in relation to key risks affecting the organisation. The objective here should be to test the extent to which the controls will control the risk if it crystallises. The conclusions of these reports should enable management to reconsider the controls and modify or redesign them if appropriate.

**Financial and operating information:**

Internal audit may examine this information in order to ensure it is accurate, fit for purpose and timely. Tests may be applied to determine whether information is correctly measured and therefore suitable as a basis for informing management and external stakeholders.

**Compliance:**

Increasingly, organisations have to implement performance standards in relation to compliance. This may be to satisfy the demands of external regulators, or to operate to pre-determined internal standards. Internal audit should review operations for compliance with such standards. In this respect, the work of internal auditors in broadening, as organisations increasingly pursue compliance not only with industry standards for products and service provision, but also with criteria relevant to environmental standards.

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**TYPES OF AUDIT**

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In the course of their duties, internal auditors may carry out various types of audit. These include the following:

**Operational audits** may be concerned with the efficiency of the organisation's activities. They consider performance relative to pre-determined criteria.

**Systems audits** are used to test and evaluate controls as described in the last section. They test whether the controls can be relied upon to ensure that resources are allocated and managed effectively. They also test whether the information provided by the organisation's systems is accurate. **Compliance tests** verify whether internal controls are being applied in a proper manner. **Substantive tests** verify the accuracy of figures, and can be used to identify errors and omissions.

A **transactions** or **probity audit** is concerned with detecting fraud and other types of criminal or unlawful behaviour. However, it can also be extended to matters relating to fairness of dealings, impartiality, accountability and transparency, sometimes considered to be within the scope of **social audit**. Generally, social audit may be concerned with any matters relating to governance.

## Questions

**(a) Who should maintain a sound system of internal control?**

- A The shareholders
- B The audit committee
- C The risk committee
- D The board of directors

(2 marks)

The correct answer is D

The board of directors is ultimately responsible for overseeing the running the business.

**(b) In the context of internal control, which of the following best describes the control environment?**

- A The application of risk assessment procedures
- B The cascading, communication and enforcement of integrity and ethical values
- C The attitude, awareness and actions of management
- D The implementation of appropriate information systems and controls

(2 marks)

The correct answer is C

Sets the tone of an organisation, influencing the control consciousness of its management and employees. It is the foundation for effective internal control, providing discipline and structure. Strongly relates to how management (and governance) has created a culture of honesty and ethical behaviour, supported by appropriate controls to prevent and detect fraud and error.

(c) A listed company fully complies with the requirements of the stock exchange and the corporate governance code of its jurisdiction.

**What component of internal control does the company's actions best represent?**

- A Risk assessment
- B Control monitoring
- C Control activities
- D Control environment

(2 marks)

The correct answer is D

The attitude, awareness and actions of the board of directors and management.

## Chapter 9 Theories of leadership style

### Executive Summary

The main leadership theories present two basic approaches - **task-centred** and **employee-centred**.

John Adair suggests that there are three basic needs that result in differing leadership styles: the needs of the task, the needs of the group, and the needs of the individual.

Tannenbaum and Schmidt's continuum-based theory suggests a range of styles ranging from autocratic to democratic.

- Dictatorial style
- Autocratic style
- Democratic approach
- The laissez-faire approach

Feidler, suggests a relationship between leadership styles and departmental effectiveness and success. He distinguishes between two types of leader –

- Psychologically close
- Psychologically distant.

Fundamental to the management of people is an understanding of the importance of leadership. Managers must lead, and as such must accept responsibility for the activities and successes of their departments. All leaders must exercise authority, but leadership style will vary. It is generally accepted that a leader's style will affect the motivation, efficiency, and effectiveness of their employees.

The main leadership theories present two basic approaches - **task-centred** and **employee-centred**. Tannenbaum and Schmidt suggest that **leadership style is a continuum**, and that the appropriate style depends on the characteristics of the leader, the subordinates, and of the situation.

In a more contemporary approach, known as '**action-centred leadership**', John Adair suggests that there are three basic needs that result in differing leadership styles: the needs of the task, the needs of the group, and the needs of the individual. Feidler, on the other hand, takes a more psychological approach to defining leadership.

As these approaches to leadership vary, it is interesting to explore the differences. Tannenbaum and Schmidt's continuum-based theory suggests a range of styles ranging from autocratic to democratic, although not suggesting that any one style within the continuum is right or wrong.

At one end of the continuum is the **dictatorial style** - the manager makes decisions and enforces them (the so-called tells approach) or, in a slightly gentler way, 'sells' their decision (the tells and sells approach).

Further along the continuum, is the **autocratic style**, where the manager suggests ideas and asks for comments (the tells and talks approach), or the manager presents outline ideas, seeks comments and amends the ideas accordingly (the consults approach).

The next step in the continuum is the **democratic approach**. Here the manager presents a problem, again seeks ideas and makes a decision (the involves approach), or allows employees to discuss the issue and make a decision (the delegates approach).

Finally, the continuum ends with **the laissez-faire approach**. Here the manager allows employees to act in whichever way they wish, within specified limits (the abdicates approach).

However, Tannenbaum and Schmidt's continuum is not a static model. It recognises that appropriate style depends on both the leader's personality, values and natural style, and the employees' knowledge, experience and attitude.

Furthermore, the range of situations which present themselves to a leader depend on factors such as the culture of the organisation, time pressure, the amount of authority and the amount of responsibility the leader has. This last factor is dependent - as is so often the case - upon the organisation's general environment.

A more contemporary approach is to regard leadership as comprising a number of different skills (action-centred leadership), a theory associated with the writer John Adair.

This idea recognises that leadership style is determined by three interrelated variables: the needs of the task, the needs of the group, and the needs of the individual.

The leader needs to balance the relative importance of all three, with emphasis given to identifying and acting upon the immediate priority.

'Task needs' refer to the setting of objectives for the department, planning and initiating the task, allocating responsibilities, setting and verifying performance standards, and establishing a control system.

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'Group needs' require team building so that mutual support and understanding is achieved, standards established, training provided and most importantly, communication and information channels opened.

'Individual needs' recognise the development and nurturing of individual achievement, of motivation, the encouragement of creativity, delegation of authority to encourage group support, and attention to any problems or issues.

In contrast, a different, more psychological approach to leadership, described by the writer Feidler, suggests a relationship between leadership styles and departmental effectiveness and success. He distinguishes between two types of leader - those who are psychologically close and those who are psychologically distant.

Psychologically close managers prefer informal relationships, are sometimes over concerned with human relations, and favour informal rather than formal contacts. This is sometimes called 'relationship oriented'.

Psychologically distant managers prefer formal relationships. They tend to be reserved in their personal relationships even though they often have good interpersonal skills. This approach is sometimes called 'task oriented'.

It is, of course, vital to recognise that no leadership style is correct, and that style is always dependent upon the particular situation, and the nature and culture of the organisation.

## Questions

(a) Fiedler studied the relationship between leadership style and the effectiveness of the work group, identifying psychologically distant managers (PDMs) and psychologically close managers (PCMs).

The following are characteristics associated with these styles of leadership:

- (1) They are primarily task-oriented
- (2) Judge subordinates on the basis of performance
- (3) Tend to be people-oriented
- (4) Prefer informal over formal meetings

**Which TWO of the above are characteristics of PCMs?**

- A 1 and 2
- B 1 and 3
- C 2 and 4
- D 3 and 4

(2 marks)

The correct answer is D

Fiedler's research noted that a PCM leadership style usually involves managers that are people-oriented with a preference of having informal meetings with subordinates. In contrast, a PDM leadership style involves managers that are task-oriented and primarily judge subordinates on the basis of performance.



## Chapter 10 Equal opportunities

### Executive Summary

**Equal opportunities** is a universally used and understood term which describes the idea that everyone in an organisation should have an equal chance to apply and be selected for posts, to be trained or promoted and to have employment terminated fairly.

Three main categories of sex discrimination: direct discrimination, indirect discrimination and victimisation.

Different policies adopted by organisations:

- Sex discrimination policy
- Race relations policy
- Equal pay policy
- Disability discrimination policy

Managing diversity on the other hand expands the horizons beyond equality issues and builds on recognised approaches to equal opportunities.

Organisations and businesses are made up of many individuals working together to achieve organisational success. These individuals bring different attitudes, perceptions and learning experiences to the workplace, as well as ethnic, gender and personality differences.

These can be a source for developing creativity within an organisation. However they can also be the cause of problems. Over the past 30 years or so employment has changed beyond all recognition. This change has led to a fundamental re-thinking of the way employees are managed. Managers have had to recognise the need (or in many countries the legal requirement) to develop and enforce company policies aimed at reducing and eliminating discrimination. In addition, the increasing globalisation of business has meant that managers must be aware of cultural and race issues.

**Equal opportunities** is a universally used and understood term which describes the idea that everyone in an organisation should have an equal chance to apply and be selected for posts, to be trained or promoted and to have employment terminated fairly. Employers can discriminate only on the basis of ability, experience or potential. All employment decisions are based solely on an individual's ability to do a particular job. No consideration should be taken of a person's sex, age, racial origin, disability or marital status.

In addition, many organisations have adopted a **sex discrimination policy** that requires gender equality in all areas of employment including the selection process, opportunities for training, promotion, benefit provision, facilities and dismissal. Such a policy deems it wrong to make any form of discrimination within employment matters because of marital status or sex and covers three main categories of sex discrimination: direct discrimination, indirect discrimination and victimisation.

Direct discrimination involves treating a person less favourably than others on sexual, racial or marital grounds. For example, a dismissal from employment upon marriage. One act of discrimination is sufficient and must be directed against an individual. Indirect discrimination describes a term or condition applicable to both sexes, but where one sex has a considerably lesser ability to comply with it than the other. For example, a condition that a candidate must be of a particular height. Finally, victimisation is discrimination against an individual who has brought proceedings or given evidence in another case involving discrimination or disciplinary matters.

A **race relations policy** adopts the same approach as the sex discrimination policy. However, this policy looks at racial grounds and racial groups, phrases which refer to colour, race, nationality or other ethnic or national origins. The same three categories of direct and indirect discrimination and victimisation can be applied.

An equal pay policy requires that both women and men receive identical pay in respect of what is described as 'like work', 'work that is rated as equivalent' or 'equal value'.

'Like work' defines work of a broadly similar role where differences are not of a practical nature. 'Work equivalent' is where work has been evaluated and graded to be equivalent to other work in relation to effort, skill and decision-making. Work of 'equal value' is that of a woman's to that of a man's in the same organisation.

As well as issues affecting gender and race discrimination issues, employers are paying more attention to the rights of the disabled in the workplace. Many organisations have therefore adopted a disability discrimination policy.

A disabled person is defined as someone who has a physical or mental impairment that has substantial and long-term (more than 12 months) adverse effect on his or her ability to carry out normal day-to-day activities. Severe disfigurement is included, as are progressive conditions such as HIV, even though the current effects may not be substantial.

Factors affecting ability include mobility, manual dexterity, physical coordination, lack of ability to lift or speak, hear, see, remember, concentrate, learn or understand, or to perceive the risk of physical

danger. In addition, the employer has the duty to make reasonable adjustments to the physical features of the workplace where they constitute a hazard to the disabled person.

The disability discrimination policy must also make it clear that it is wrong to discriminate against disabled people in the interviewing and selection process, for promotion, transfer or training and dismissal.

In some cases, managers can be confused between the ideas and requirements of equal opportunities and the more up-to-date idea of managing diversity. In many ways laying down policies and procedures to ensure that discrimination is eliminated from the workplace is admirable, desirable and indeed good for business.

The new generation of managers regard the quality of their employees as the distinguishing feature of a successful organisation. People are the single sustainable source of competitive advantage – high performance through the development of people is essential if organisations are to remain viable and competitive.

The promotion of equal opportunities makes good business sense. Equal opportunities are promoted as a key component of good management as well as being a legal requirement. It is also socially desirable and morally right.

Managing diversity on the other hand expands the horizons beyond equality issues and builds on recognised approaches to equal opportunities. It adds new impetus to the development of equal opportunities and creates an environment in which enhanced contributions from all employees works to the advantage of the business, employees themselves and society generally.

It offers an opportunity for organisations to develop a workforce to meet business goals and to improve approaches to customer care. Managing diversity is about having the right person for the job regardless of sex, race or religion.

Essentially the management of diversity is a quality assurance approach. It helps identify hidden organisational barriers, which make it more difficult for people who are perceived as being different from the majority of their colleagues to succeed and develop careers.

It also helps to effect cultural change and to create an environment in which people from all backgrounds can work together harmoniously. The management of diversity combats prejudice, stereotyping, harassment and undignified behaviour.

## Questions

(a) Gemstone Co boasts that it provides equal opportunities for all of its employees with its claim supported by published documents in its employee manual. The reality is that the company actually does very little to support this claim for all its employees with the exception of promoting equal opportunities for its middle level management.

**The organisation is most likely practicing which of the following?**

- A Direct discrimination
- B Circumvention
- C Victimisation
- D Discriminatory selection

(2 marks)

The correct answer is B

Gemstone is most likely practicing circumvention, where the company appears to be providing equal opportunities for all its employees, but is only selectively providing actual equal opportunities to its middle level management.

## **Chapter 11 The importance of teams**

### Executive Summary

Tuckman identifies five distinct stages of development through which teams should pass:

1. Forming stage
2. Storming stage
3. Norming stage
4. Performing stage
5. Dorming stage

Dr Meredith suggested that all teams are a matter of balance and that the team members fulfil two roles.

- The primary role is the skill or function for which the individual was appointed to the team in the first place.
- The secondary role is the team role based on the individual's preferred behaviour pattern.

We are often told that teams are the way forward, especially in business. But of course the problem is that if the team is not working, perhaps because the members cannot get on, or the skills are out of balance or indeed the team has not come together, then serious, often negative, problems can arise. And that's bad for business. Teams are everywhere. They have to develop, mature and often eventually terminate.

According to the writer Tuckman, it is possible to identify five distinct stages of development through which teams should pass. The first stage is the so-called forming stage, when the members meet and decide on the purpose of the team and how it will operate.

At this stage the team is no more than a collection of individuals, finding out about one another and discussing the task - which may be unclear. Although wasteful and time consuming, this stage is essential to ensure that the team members become comfortable with each other.

The second stage is referred to as storming. The phrase is a deliberate reference to conflict, ideas, ideals and behaviour that are challenged and sometimes rejected. There is competition and argument about who should fill the roles in the team. Although characterised by conflict, this is constructive with trust developing and if the individuals are successful with this stage then a stronger team will result.

The third stage is norming, when the routines under which the team will operate become established. The team is now settling down, investigating ideas, testing the reactions of the team's members and consequently norms are established. In addition, patterns of behaviour are established, trust will develop and the methods by which decisions will be taken will be decided on. By the time the performing stage is reached, the team is complete and is able to perform effectively.

Problems with team roles, conflict and issues of adjustment have been resolved. In practice, many teams reach the dorming stage, which is the final stage. The team becomes complacent, loses interest in the task and self-preservation becomes the dominant issue.

All teams, it is suggested, go through these five stages. However, if for some reason the team loses or gains members, or the external environment imposes fundamental changes on it, the team very often may revert to earlier stages of development.

Team development is however only one dimension in understanding the importance of the ways in which teams work. Dr Meredith Belbin has studied team membership (as opposed to team development). He has suggested that all teams are a matter of balance and that the team members fulfil two roles. The primary role is the skill or function for which the individual was appointed to the team in the first place. This is usually the individual's professional role.

The secondary role is the team role based on the individual's preferred behaviour pattern. All the team roles are needed for a team to be successful, the team role being in addition to the members bringing their own disciplines and skills. It is also possible that members have more than one team role skill, although one will usually dominate. The team role may change, depending on the task and the number of team members to avoid the problem of team imbalance. Belbin describes eight team roles:

- the coordinator provides the leadership, presides and coordinates the activities - he or she is a balanced and disciplined person, good at working with others
- the company worker is the administrator and organiser who turns the team's ideas into jobs and tasks - this person is efficient, trustworthy and unexcitable
- the shaper is highly-strung and a dominant, extrovert personality - task-driven to the point of passion, he or she is a force for action
- the plant is the introvert, invariably intellectually bright, and imaginative who acts as a source of ideas

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- the resource investigator is the popular, social member of the team - an extrovert, this person is relaxed and a useful source of new contacts but not ideas
- the monitor-evaluator is not creative but is analytically gifted - often tactless and aloof, the role is to examine ideas and spot errors and flaws
- the team worker is the silent member - concerned with the maintenance of the team, he or she is supportive, understanding and popular with the team but only noticed when absent
- the completer-finisher enjoys the details, pushes the team to meet targets and sees urgency and follow-through as important.

Later research has identified a further team role - the specialist. This person joins the team only when expert or specific advice is required on matters outside the competence of the team. This additional role has come about because of the greater use of teams for project work.

## Questions

**(a) According to Tuckman's theory of team development, which of the following is a characteristic of a team in the "storming" stage?**

- A Team members test reactions to others and establish normal behaviour
- B Time-wasting within the team may occur
- C Members form cliques or sub-group into alliances

(1 mark)

The correct answer is C

During the "storming" stage, members form cliques or begin sub-grouping into alliances. In the "forming" stage, time wasting may occur and the establishment of normal behaviour occurs during the "norming" stage.

(b) A team has been successfully operating for some time, when two of its members are promoted to be the manager of their own teams. They are replaced by two new employees recruited externally specifically to join the team.

**At what stage within Tuckman's theory of team development would the team most likely find itself?**

- A Forming
- B Storming
- C Norming
- D Performing

(2 marks)

The correct answer is B

As the team members who left appear to be reasonably senior (as they have been promoted to managers) other team members may now start to jostle for the positions. As two new external employees have joined the team, they may naturally feel that the vacant positions are theirs.



## Chapter 12 Understanding Herzberg's motivation theory

### Executive Summary

**Herzberg's motivation theory** is one of the content theories of motivation.

This theory of motivation is known as a **two factor content theory**.

It is based upon the deceptively simple idea that motivation can be dichotomised into:

- Hygiene factors; and
- Motivation factors.

The most important part of this theory of motivation is that the main motivating factors are not in the environment but in the intrinsic value and satisfaction gained from the job itself.

Motivators lead to satisfaction because of the need for growth and a sense of self-achievement.

Hygiene factors are also often referred to as 'dissatisfiers'. They are concerned with factors associated with the job itself but are not directly a part of it.

Understanding what motivates people in all walks of life is basic to all who aspire to management. One of the best known of all the writers on motivation is Herzberg.

He is noted for – among other things – his ideas on job enrichment, enlargement and rotation. However, his ideas on motivation in the hygiene-motivation theory are particularly useful to our understanding of what motivates people.

This is particularly relevant as the original research was undertaken not in the factory, but in the offices of engineers and accountants.

## CONTENT THEORIES OF MOTIVATION

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Herzberg's motivation theory is one of the content theories of motivation. These attempt to explain the factors that motivate individuals through identifying and satisfying their individual needs, desires and the aims pursued to satisfy these desires.

This theory of motivation is known as a two factor content theory. It is based upon the deceptively simple idea that motivation can be dichotomised into hygiene factors and motivation factors and is often referred to as a 'two need system'.

These two separate 'needs' are the need to avoid unpleasantness and discomfort and, at the other end of the motivational scale, the need for personal development. A shortage of the factors that positively encourage employees (the motivating factors) will cause employees to focus on other, non-job related 'hygiene' factors.

The most important part of this theory of motivation is that the main motivating factors are not in the environment but in the intrinsic value and satisfaction gained from the job itself. It follows therefore that to motivate an individual, a job itself must be challenging, have scope for enrichment and be of interest to the jobholder. Motivators (sometimes called 'satisfiers') are those factors directly concerned with the satisfaction gained from a job, such as:

- the sense of achievement and the intrinsic value obtained from the job itself
- the level of recognition by both colleagues and management
- the level of responsibility
- opportunities for advancement and
- the status provided

Motivators lead to satisfaction because of the need for growth and a sense of self-achievement.

A lack of motivators leads to over-concentration on hygiene factors, which are those negative factors which can be seen and therefore form the basis of complaint and concern. Hygiene factors (often referred to as maintenance factors) lead to dissatisfaction with a job because of the need to avoid unpleasantness.

They are referred to as hygiene factors because they can be avoided or prevented by the use of 'hygienic' methods. The important fact to remember is that attention to these hygiene factors prevents dissatisfaction but does not necessarily provide positive motivation.

Hygiene factors are also often referred to as 'dissatisfiers'. They are concerned with factors associated with the job itself but are not directly a part of it. Typically, this is salary, although other factors which will often act as dissatisfiers include:

- perceived differences with others
- job security
- working conditions

- the quality of management
- organisational policy
- administration
- interpersonal relations

Understanding Herzberg's theory recognises the intrinsic satisfaction that can be obtained from the work itself. It draws attention to job design and makes managers aware that problems of motivation may not necessarily be directly associated with the work. Problems can often be external to the job.

## **IMPROVED MOTIVATION**

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Managers' understanding that factors which demotivate can often be related to matters other than the work itself, can lead to improved motivation, greater job satisfaction and improved organisational performance by the entire workforce.

Understanding individual goals, coupled with wider skills and abilities, can lead to greater opportunities. Individuals are seen as valuable to organisations and can acquire new skills useful in the future.

Improving skills, opportunities and increasing employee knowledge will, in the longer term, increase the value of an organisation's human assets. Most importantly, it can lead to greater staff commitment, understanding and loyalty.

## Questions

(a) Herzberg's two-factor theory is based on the premise that man has \_\_\_\_\_ and \_\_\_\_\_.

**Which of the following completes the sentence above?**

- (1) Maintenance needs
- (2) Physiological needs
- (3) Motivation needs
- (4) Security needs

- A 1 and 2
- B 1 and 3
- C 2 and 4
- D 3 and 4

(2 marks)

The correct answer is B

Herzberg's two-factor motivational theory is based on the premise that man has maintenance needs and motivation needs. In contrast, Maslow's hierarchy of needs contain physiological needs and security needs, which are both classified as primary needs.

**Chapter 13 Let's get motivated**

## Executive Summary

Maslow's hierarchy of needs: Each need is important until it is satisfied and then the next need becomes important, i.e., once one has obtained shelter and food that no longer becomes a priority and one aspires to a need for security and so on.

Food → Shelter → Security → Social / Love → Esteem → Self-actualisation

This article looks at ways in which staff motivation can be improved and also shows how some of the management theories that you may have come across in your study texts can be applied to a workplace situation.

With regards to management theories and motivation I guess that almost all students will have come across Maslow's hierarchy of needs and Herzberg's two-factor theory. However very few students actually ever understand how Maslow and Herzberg can be applied to the workplace and simply learn the examples given in the examination textbook.

To enlighten those of you who are not familiar with either Maslow or Herzberg they are ideas on what motivates people as a result of observation of workers' behaviour. Maslow talked about people having a hierarchy of needs. Each need is important until it is satisfied and then the next need becomes important, i.e., once one has obtained shelter and food that no longer becomes a priority and one aspires to a need for security and so on.

How then, can these needs be translated into the workplace? Maslow never really intended his theory to be directly applied but gave it as an example of how people may behave in ideal conditions. However, for the purpose of exams it's a worthy theory to apply.

In the modern developed world most of us are fortunate to have no real problem with lack of physiological needs or safety needs. We can normally buy food and drink and provide shelter as a result of earning a regular salary.

Security is provided through contracts of employment and pension and medical insurance provision. However, it is attention to the rest of the needs in the hierarchy, which distinguishes an organisation that has a highly motivated workforce, from one that is less so.

In order to fulfil social/love needs companies with motivated workforces will encourage teamworking which leads to better relationships for both managers and subordinates which often translates into higher work output. Together with company parties and outings, staff social clubs and sports societies are also likely to be heavily subsidised to encourage good relationships outside the workplace.

Esteem needs are fulfilled through satisfying the individual. The military were probably one of the initial exponents of this idea through the awarding of medals for bravery.

A modern day equivalent can be seen in McDonalds where hard work and high levels of customer service result in the employee being awarded stars which they can proudly wear on their uniform. A very simple way of esteem being fulfilled is to simply recognise good work through saying thank you.

Many companies now take this a stage further by giving regular feedback through performance appraisals.

Richard Branson of the Virgin group is a master at getting the most from his entire workforce. Despite the number of employees being in the thousands they are all regularly invited to barbecue's or drinks parties at his house (not all at the same time of course) and he will be there to welcome them and thank them for all the hard work they do for the company.

This leads to many staff having a much higher level of commitment to the organisation than is present in other similar organisations. Financial recognition in forms of bonuses are another way of recognising performance although provision of only financial incentives can often create more problems than they solve and hence successful organisations use more innovative ways of motivating.

Self-actualisation is achieved when an employee is able to fulfil their maximum potential. Companies satisfy this desire by providing no ceiling on promotion and enabling employees to

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improve themselves through education and training. More senior roles may give employees discretion in how they interpret their job roles thus enabling the individual to put their own stamp on a job.

Hopefully now you are able to see a little bit beyond the textbooks theoretical view and I would encourage you to think of the ways in which your employer improves your motivation together with colleagues in other organisations.

## Questions

**(a) Which of the following is correct regarding Maslow's hierarchy of needs theory?**

- A Need interactions for most people are complex
- B Satisfaction of needs is not order dependent
- C There are more varied ways to satisfy primary needs than secondary needs
- D A satisfied need provides motivation

(2 marks)

The correct answer is A

According to Maslow's hierarchy of needs theory, need interactions for most people are complex with various needs impacting a person at the same time. The primary basis of Maslow's hierarchy of needs theory is that primary needs must be satisfied before secondary needs (are order dependent). Additionally, there are more varied ways to satisfy secondary needs than primary needs, with satisfaction of a particular need not resulting in motivation.



## Chapter 14 Understanding the importance of appraisals

### Executive Summary

Appraisal systems exist to improve organisational efficiency by ensuring that individuals perform to the best of their ability, develop their potential, and earn appropriate reward.

Appraisals have three main purposes.

The first is to measure the extent to which an individual may be awarded a salary increase compared with his or her peers. This is the **reward review component**.

The second purpose of an appraisal is to identify any training needs and, if appropriate, to provide training and development to enable an individual to help the organisation to achieve its objectives. This is the **performance review component**.

Finally, appraisals are also important to aid an individual's career development by attempting to predict work that the individual may be capable of in the future. This is the **potential review component**.

Basic to the successful application of appraisal systems is the appraisal interview. A formal appraisal interview is an integral part of appraisal and performance management. The interview must be organised properly and carefully.

Three appraisal methods:

- Tell and sell method
- Tell and listen method
- Problem solving method

Appraisal systems are often misunderstood and mismanaged. Appraisals are central both to human resource management and performance management. Understanding their role, objectives, benefits and purpose is important to all employers. Careful preparation and understanding is required if the appraisal process is to be successful, worthwhile and relevant.

Appraisal systems exist to improve organisational efficiency by ensuring that individuals perform to the best of their ability, develop their potential, and earn appropriate reward. This in turn leads to improved organisational performance.

Appraisals have three main purposes. These are often misunderstood. The first is to measure the extent to which an individual may be awarded a salary increase compared with his or her peers. This is the reward review component.

The second purpose of an appraisal is to identify any training needs and, if appropriate, to provide training and development to enable an individual to help the organisation to achieve its objectives. This is the performance review component. Finally, appraisals are also important to aid an individual's career development by attempting to predict work that the individual may be capable of in the future. This is the potential review component.

Employees often question the value and usefulness of the time and effort taken up by an appraisal. However, it establishes key results that an individual needs to achieve within a time period while also comparing the individual's performance against a set and established standard.

The employee is not the only beneficiary - the organisation benefits through identifying employees for promotion, noting areas for individual improvement, and by using the system as a basis for human resource planning.

## **CONDUCTING THE APPRAISAL INTERVIEW**

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There is often misunderstanding as to how an appraisal should be conducted. Appraisees sometimes perceive their annual appraisal as a threat. However, this can be overcome if the appraisal system is well-constructed, and seen to be fair to the individual and consistent across the organisation. A typical negative response to appraisals is that they are confrontational.

This is often due to a lack of agreement on performance or poor explanation by management. Additionally, it is sometimes seen as a judgement - a one-sided process based entirely on the manager's perspective. At the other extreme it is simply regarded as a chat.

Perhaps the greatest problem with appraisals is that they are often regarded as a nuisance. At best, appraisals may be considered an annual event, the results of which quickly become out-of-date. Moreover, some may view the whole process as bureaucratic - a form-filling exercise devised to satisfy the organisation. Consequently, the main purpose of an appraisal - that of identifying individual and organisational performance and improvement - is forgotten.

Basic to the successful application of appraisal systems is the appraisal interview. A formal appraisal interview is an integral part of appraisal and performance management. The interview must be organised properly and carefully. Prior to the interview, the appraiser, who should be the immediate supervisor, must prepare the correct and relevant documentation.

This comprises the job description, a statement of performance or appraisal form, and a record highlighting the employee's performance. Other relevant documentation used at an appraisal can include peer assessments, if appropriate, comments from clients and customers, and any self-

assessment forms issued to the employee prior to the interview. Finally, the individual's employment file should be referred to.

This should contain notes on the employee's general personal attitude and any disciplinary issues.

## **APPRAISAL METHODS**

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Many writers and practitioners in people management take one of three basic approaches to the appraisal interview. The so-called tell and sell method involves the appraiser explaining how the assessment is to be undertaken, gaining acceptance for the evaluation and improvement plan. Interpersonal skills are important with this approach to motivate the appraisee.

An alternative approach is the tell and listen method, where the appraisee is invited to respond to the way that the interview is to be conducted. This requires counselling skills and careful encouragement to allow the appraisee to participate fully.

Finally, there is the problem solving method, where a more helpful approach is taken which concentrates on the work problems of the appraisee, who in turn is encouraged to think through any problems. After the interview, both parties should agree on any actions to be taken, an agreed action plan on improvement, and methods of monitoring progress and appropriate feedback.

## Questions

**Which appraisal method has a tendency to rank employees as “average” and may include management’s subjective interpretation?**

- A Peer comparison
- B Rating scales
- C Critical incident rating

(1 mark)

The correct answer is B

Rating scales (grading) tend to rank employees as “average”. Additionally, the individual grades are subject to management’s interpretation.

**For which form of appraisal does a manager use recorded observations to grade an employee’s behaviour?**

- A Rating scales
- B Open assessment
- C Critical incident rating
- D Peer ranking

(2 marks)

The correct answer is C

When a manager uses a critical incident rating form of appraisal they are observing an employee’s behaviour and recording both their successful and unsuccessful behaviour. The employee is then graded on critical behaviour and actual incidents.

## Chapter 15 Communicating core values and mission

### Executive Summary

A mission statement formalises the organisation's mission by writing it down.

Johnson, Scholes and Whittington define a mission statement as 'a statement of the overriding direction and purpose of an organisation'.

### WHY COMMUNICATION OF MISSION AND CORE VALUES TO STAKEHOLDERS IS IMPORTANT

- Investors need to know how the organisation intends to make;
- Directors and other employees need to know the organisation's purpose;
- Customers may wish to know what the organisation promises;
- All stakeholders should want to know how the organisation intends to conduct its operations.

Communicating objectives to stakeholders is likely to require different messages to each stakeholder group.

Mission and core values are long-term public commitments and promises, and it is vital that they are consistent otherwise they are quickly undermined.

Shannon-Weaver Model, when communicating core values and mission, the five elements would typically be:

- information source
- transmitter
- the communication channel
- the receiver
- destination

Noise can interfere with the message at any stage and this can be termed a barrier to communication

**This article focuses on the syllabus area relating to an organisation's core values and mission to the public, shareholders and employees. This is an objective which can easily get overlooked in the rush to master environmental analyses, strategic choice and outsourcing decisions**

This article will:

- briefly describe what the terms 'mission', 'mission statement' and 'core values' mean
- suggest why their communication to stakeholders is important
- describe a commonly used model of communication
- briefly describe communication methods that are available
- describe and give examples of how organisations might undertake the communication process.

## TERMINOLOGY

An organisation's mission is its basic purpose: What is it for? Why does it exist? What is its 'raison d'être'?

A mission statement formalises the organisation's mission by writing it down. Johnson, Scholes and Whittington define a mission statement as 'a statement of the overriding direction and purpose of an organisation'. Some companies refer to 'vision statements' instead of mission statements; some writers and textbooks wring their hands attempting to distinguish between the terms 'vision' and 'mission'. However, the distinction does not achieve much and the Paper SBL exam will treat the terms as meaning the same.

Many other writers attempt to expand the definition of a mission statement by adding detail to it. In summary, mission statements are usually assumed to address:

- what business is the company in?
- whom does the organisation serve?
- what benefits are to be delivered?
- what are the organisation's values and ethics?

The final line above introduces the concept of values or core values. Johnson, Scholes and Whittington define core values as 'principles that guide an organisation's actions'.

Remember, there is no standard format or list of contents for mission statements, and organisations are completely free to write their own. However, for most purposes, it is worth distinguishing between a mission statement and a slogan. Nike's 'Just do it' is a powerful advertising slogan, but under most definitions does not qualify as a mission statement.

Here are several examples of mission statements and core values:

## TESCO (A UK SUPERMARKET CHAIN):

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### Our vision

To be the most highly valued by:

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**The customers we serve**

Our core purpose is to create value for customers to earn their lifetime loyalty. This objective sits right at the heart of our business as one part of our Values – ‘No one tries harder for customers’.

**The communities in which we operate**

For Tesco to be considered a force for good, we must be a good neighbour and a responsible member of society.

**Our loyal and committed staff**

We know that if we look after our staff, they will look after our customers. Work can be a large part of our lives so our people deserve an employer who cares. That’s why one of our values is ‘Treat people how we like to be treated’. We are committed to providing opportunities for our people to get on and turn their jobs into careers, and across all of our markets we offer a wide range of competitive benefits.

**Our shareholders**

As the owners of the business, it’s crucial that our shareholders value Tesco highly. Shareholders want a good return on their investment and that’s what we will continue to deliver for them. ... We offer sustainable, profitable growth from a combination of a strong core UK business and exposure to rapidly growing emerging markets.

**INTEL (A MANUFACTURER OF COMPUTER CHIPS):**

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**Our mission**

This decade we will create and extend computing technology to connect and enrich the lives of every person on earth.

**Our values**

Customer orientation  
Results orientation  
Great place to work  
Quality  
Discipline  
Risk taking

**ACCA**

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ACCA's mission is to:

- provide opportunity and access to people of ability around the world and support our members throughout their careers in accounting, business and finance
- achieve and promote the highest professional, ethical and governance standards
- advance the public interest
- be a global leader in the profession.

ACCA's core values are:

- **Opportunity:** we provide opportunity, free from artificial barriers, to people around the world – whether students, members or employees and we support them in their careers.
- **Diversity:** we respect and value difference, embracing diversity in our people and in our output.

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- **Innovation:** we create new and unexpected possibilities, providing innovative solutions for the future.
- **Accountability:** we accept individual and corporate responsibility for our actions, working together to deliver a quality service and to promote the best interests of our stakeholders.
- **Integrity:** we act ethically and work in the public interest, treating people fairly and honestly; we encourage the same from others.

**WHY COMMUNICATION OF MISSION AND CORE VALUES TO STAKEHOLDERS IS IMPORTANT**

- Investors need to know how the organisation intends to make profits or fulfil some other ambition.
- Directors and other employees need to know the organisation's purpose, and how it intends to add value and to compete.
- Customers may wish to know what the organisation promises.
- All stakeholders should want to know how the organisation intends to conduct its operations; the principles that guide its actions; its moral and ethical 'compass'.

For example, it is clear from Tesco's mission statement that it places the highest emphasis on its long-term relationship with customers. This should guide management and staff as they make day-to-day strategic, tactical and operational decisions. To a large extent the other three parts of their vision statement flow from the first: customers, their families and friends will be part of the community, so it is important to deal fairly with that; staff are the company's interface with its customers; if customers are well looked after and are loyal, good financial results should follow.

If Tesco had not placed such emphasis on its customer relationships it is likely that the goods it stocks, sales promotions, customer facilities, prices and quality would all subtly change. Tesco is saying to all that it lives or dies by the strength of its customer relations.

Of course, a strong and focussed mission does not guarantee success and in January 2012 Tesco suffered a 16% fall in share price after it announced its results. In response to this, the chief executive said that the company needed to reconnect with its customers and that Tesco needed to sharpen up its act in the quality and availability of its goods and the service it offered customers. The company planned to invest cash to put more people into the right stores, in the right areas, and to train them to be even better so they can look after the product and customers.

Intel places its sphere of business in the technology sector and has an international outlook. Nothing surprising there, but interesting detail is added in its core values. Perhaps the juxtaposition of discipline' and 'risk' is most noteworthy. Stakeholders are made aware that a high tech company will only survive by taking risks (not all research and development will pay off), but this must be counter-balanced by a disciplined approach to market research, forecasting, expenditure and deadlines.

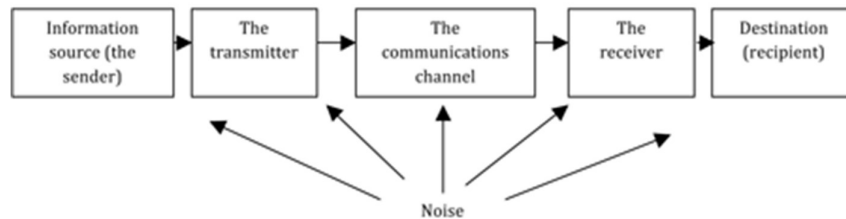
ACCA states very plainly that at its heart is the provision of opportunities to all nationalities and a diverse population. This will influence management, employees, students and members. Without the strong international reference, presumably ACCA would be much more likely to concentrate on a narrow, local market. Additionally, there is great emphasis on ethics and accountability.

Communicating objectives to stakeholders is likely to require different messages to each stakeholder group (for example, customers do not need to know about detailed cost objectives given to employees). However, mission and core values are long-term public commitments and promises, and it is vital that they are consistent otherwise they are quickly undermined. There is no point preaching to customers that the company aims to have a low carbon footprint while at the same time telling employees not to bother with recycling. Inconsistencies and half-heartedness will quickly be exposed and are likely to cause the organisation reputational damage – at the very least.



## A COMMUNICATION MODEL

A commonly-used model of communication is the Shannon-Weaver model. This depicts the communication process as:



For communication to be successful the message has to get from the sender to the recipient and be *understood and acted upon*. When communicating core values and mission, the five elements would typically be:

- information source: the board
- transmitter: encoding the message – deciding what needs to be said or what needs to be shown and designing the message
- the communication channel – eg internet, letters, meetings. These are listed more fully in the next section
- the receiver: decodes the message – eg a web-browser displaying a page
- destination – employees, customers, shareholders.

Noise can interfere with the message at any stage and this can be termed a barrier to communication. Noise can prevent or distort communication. Typical sources of noise are:

- language difficulties – ensuring that the message is properly translated into foreign languages and that any terminology used can be understood
- information overload – too much information so that recipients are overwhelmed and fail to see the most important information
- failure to receive – wrong email addresses, trying to display Flash animations on iPhones
- reluctance to receive the message – eg employees might be reluctant to change their behaviour and might ignore the communication
- status differences – eg management stays remote from employees and is reluctant to hear bad news about the organisation's performance
- inappropriate communications channels – eg expecting employees to read and digest a long text on the organisation's core values when a training course, video presentation or discussion might be much more effective.

Communications can break down very easily and the organisation's management might not even be aware of this. A survey carried out by the Boston Consulting Group (1) found that although around 27% of bosses believe their employees are guided by a 'set of core principles and values that inspire everyone to align around a company's mission' only 4% of employees agree. Similarly, 41% of bosses say their firm rewards performance based on values rather than merely on financial results. Only 14% of employees believe this. So, quite obviously there are serious communications failures relating to the core values of the organisations in the survey.

## COMMUNICATION METHODS (CHANNELS)

Mission and core values cannot guide behaviour or support performance and create a common understanding among the various stakeholders if they are not effectively communicated. There is no

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point in shareholders believing that they are investing in an innovative company if perceptions of customers and employees are quite different. Although messages and sentiments must be consistent, there is a wide choice as to which types of communication are likely to work best for each stakeholder group.

Methods of communication include:

- conversations and discussions
- advertising
- publications, such as journals, newsletters and mail shots
- financial statements
- meetings, such as the AGM
- company stationery
- company merchandise
- presentations
- training courses
- press releases and other public relations activities
- collaboration
- video
- SMS (texting)
- internet (organisation's web site) and intranet
- email
- social media, such as Facebook, Twitter and LinkedIn

This list is set out, very approximately, in the order in which the techniques became available over time: talking to one's employees face-to-face came long before Tweeting to one's valued employees. Generally, any communications campaign will use a mix of techniques and the methods chosen will depend on which audience is being targeted, the nature of the message and expense, both in terms of money, time and environmental impact. For example, instead of sending printed financial statements to every shareholder, many companies now email a web link to shareholders showing where the financial statements can be viewed online and downloaded if required.

Similarly, sending newsletters by email is faster, cheaper and causes less environmental impact than producing and despatching printed copies. This shift in communication methods is an example of a common organisational core value in action – the wish to minimise environmental impact and to promote sustainability.

**EXAMPLES OF ORGANISATIONS COMMUNICATING MISSION AND CORE VALUES**

Good communications requires a plan and typically this would have the following steps:

- Listing your communications stakeholder groups (here, shareholders, employees and customers)
- Defining what has to be communicated to each stakeholders group (here mission and core values)
- Identifying suitable communications methods and events
- Allocating resources
- Developing a communications event schedule
- Monitoring the effectiveness of the communications events

**FACEBOOK – TESCO**

Let's say that a company wanted to communicate some of its core values to its customers. Mission and core values are fundamental, serious and relatively permanent features of organisations and it would be difficult to communicate these as statements appropriately via Facebook or Twitter where information tends to be more ephemeral, if not trivial. However, social media can be used successfully to communicate examples of mission or core values in action.

Amongst Tesco's many recipes and competitions posted by them on their Facebook wall (and therefore appearing in the Facebook pages of Tesco's 'friends') are postings such as the following:

*TESCO'S GREAT SCHOOL RUN is looking for five to 11 year olds to slip on the trainers for a 2 km fun run. Ask your school to sign up <[http://....>](#)*

*Exercise can be a fun part of everyday life and we hope to get one million children on the move. To be one in a million, find out more here <[http://....>](#) and*

*Hi, ...I work at Tesco Express in Eastbourne. I'm doing a parachute jump to support Tesco's current Charity of the Year, the Alzheimer's Society, as part of their 'Leap Year Challenge'! Follow my nervous build up to the big day [HERE!](#) <[http://....>](#)*

*YOU can take a giant leap for people with dementia and sign up for a parachute jump or abseil!*

*Find more details [HERE](#) <[http://....>](#)*

Both of these are illustrative of Tesco's wish to be valued within the communities in which they operate and the messages will automatically appear on the Facebook pages of anyone who 'Liked' Tesco. This will be an effective, almost subliminal way of communicating a core value of Tesco to its customers.

**FACEBOOK – ACCA**

ACCA uses Facebook to post many routine messages about exam results, studying and membership fees. However, amongst those it also has, for example, information about recording practical experience requirements (PER), which is an integral part of the ACCA Qualification. The huge variety of people who 'write on ACCA's wall' is evidence of ACCA's success at being a global organisation and of welcoming diversity. This, of itself promotes ACCA's mission and core values and will encourage people from a very wide range of backgrounds to participate.

Of course, not every organisation uses social media. HSBC, one of the world's largest banks and financial services organisations, makes practically no use of Facebook or Twitter. There is, however, a lot of material on their website about sustainability, working with stakeholders, protecting the environment and investing in communities (see <http://www.hsbc.com/citizenship/sustainability>).

**TELEVISION/VIDEO – THE COOPERATIVE GROUP**

Television advertising is often used to promote values and mission. A 60-second advert will never contain a vast quantity of detailed information but a well-shot short film can be very effective indeed at getting across an organisation's ethos, particularly to external stakeholders.

The Cooperative Group is a diverse UK organisation that includes supermarkets, a bank, insurance, travel, legal services and funeral care. It is a mutual organisation, owned by its customers and has been very successful in differentiating itself by promoting a very ethical approach to business. The ad is quite long, but shows the care and expense that the organisation went to try to communicate its values ([www.youtube.com/watch?v=YHzBItFKHaw](http://www.youtube.com/watch?v=YHzBItFKHaw)).

**TELEVISION/VIDEO – ETIHAD**

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This video example is too long for a television advert but was used for staff recruitment and training. No doubt it would be effective if viewed by customers also

([www.youtube.com/watch?v=BTl0qM6swYc](http://www.youtube.com/watch?v=BTl0qM6swYc)).

Listen to the words relating to mission and values that the film packs in: challenging the status quo, change, a belief that nothing is impossible, continual striving, embrace optimism and creativity, vision is to be a driving force of change in the industry, see things differently, hospitality, multinational crew, vision of a more elegant flight experience, innovative design, attempt to meet diverse needs, investment in customers, continual growth, challenge and creativity.

**TELEVISION/VIDEO – ESB**

The final ad to look at is by ESB, the Irish Electricity Supply Board. It is communicating the company's ecological values: [www.youtube.com/watch?v=aAYFS-3hY\\_Y](http://www.youtube.com/watch?v=aAYFS-3hY_Y)

**PUBLIC RELATIONS/PRESS RELEASES – ACCA**

Public relations (PR), as the term suggests, can play a very important role in communicating to external stakeholders: the public. PR is often promoted via press releases which are sent to newspapers and broadcasting organisations (who are always on the look-out for features and news items) in the hope that mention will be made of the organisations. For example, here are some press releases recently made by ACCA:

- **28 November 2011: Accountants have key role to play in fight against climate change, says ACCA.** The profession [accountancy] has extensive experience of measuring, reporting, and validation mechanisms, all of which will be vital for any credible action on climate change. The profession must use its expertise to make a positive contribution to the formulation of credible policy frameworks and agreements.
- **17 November 2011: The challenge of diversity in the workplace: experts to offer solutions for the future.** For ACCA and the ESRC [Economic and Social Research Council], we want to explore the link between diversity and innovation and in particular the benefits to organisations in encouraging diversity to achieve business benefits.

The ACCA and the ESRC are collaborating on this project and collaboration is likely to extend ACCA's reach beyond its normal audience. More can be found at [www.esrc.ac.uk/acca/](http://www.esrc.ac.uk/acca/).

**PUBLIC RELATIONS/PRESS RELEASES – GLAXOSMITHKLINE**

This is a multinational pharmaceutical company. Its mission is to: 'Improve the quality of human life by enabling people to do more, feel better and live longer.'

**30 January 2012: GSK joins new global partnership to help defeat 10 neglected tropical diseases by 2020:** ...We are committed to playing our part in helping to achieve universal coverage of intervention programmes for diseases that can be controlled or eliminated by existing treatments, and to spur R&D into new treatments for diseases where none currently exist.

The company also emphasises its work with communities:

- **22 March 2011: GSK launches London 2012 initiative with King's College London to inspire young people into science careers:** ...The programme comprises a series of free events running between now and the Olympic and Paralympic Games in 2012. These events offer local school children the opportunity to experience a day at a university and through a series of sports based lectures and interactive workshops aims to encourage 11–14 year old students to take their science studies further and consider a career in science.

**CONCLUSION**

Communicating an organisation's mission and core values to shareholders, employees and customers is very important. However, as the communications model shows sending messages is

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not the same as successful receipt of those messages (in terms of changing or sustaining behaviour) by the intended audience. Just because large amounts of money are spent on communicating mission and core values does not mean that the messages are understood or acted upon.

Consider News Corporation. Their standards of business conduct (which includes the company's core values) can be downloaded from the [News Corporation website](#)

It contains sections on commitment to the public, stockholders, employees and the global community. However, in the UK, the activities of News Corporation's newspapers has caused public outrage and provoked a public enquiry into the behaviour of the press in hacking into mobile phone voice mails. Substantial damages have already been agreed with 37 victims (the 15 settlements made public total around \$1m). Additionally, there is reputational damage to the organisation which will affect its relationship with shareholders, employees and customers for years to come.

## Questions

(a) Jupiter Co has experienced declining sales and management has decided to implement a company-wide 10 percent staff reduction at the start of the new fiscal year.

**Which of the following is the most suitable method for communicating this information to its employees?**

- A E-mail to all employees
- B Monthly newsletter
- C Employee meeting
- D Notice board

(2 marks)

The correct answer is C

Given the magnitude of the announcement, an employee meeting would be the most appropriate form of communication. This method will allow employees to ask questions regarding the details of the staff reduction and allow management to provide the necessary feedback.

## Chapter 16 A question of ethics

### Executive Summary

Ethics is concerned with what society considers to be right or wrong. It therefore relates to standards of behaviour.

Ethical principles may be adopted that discourage behaviour that is undesirable but legal.

### Approaches to ethics

Ethical behaviour may be defined in terms of duties:

- 1) Absolutists;
- 2) Relativists

Ethical behaviour may also be defined in terms of consequences:

- 1) Utilitarians;
- 2) Pluralists;
- 3) Egoists

Ethical Principles (International Federation of Accountants) IFAC / ACCA

- integrity
- objectivity
- professional competence and due care
- confidentiality
- professional behaviour.

IFAC is a global representative body for accountants, with 164 members and associates from 125 countries. It develops international standards on ethics, auditing and assurance, education and public sector accounting standards.

The ACCA Code provides clear guidance on conflicts of interest. It states that members should not accept engagements in which such conflicts arise, or even where there is a possibility of such conflicts arising.

This article gives an overview of ethics and provides a platform for further study on this vitally important aspect of the work of the professional accountant.

The AB/FAB Syllabus states that, on completion the student should 'recognise that all aspects of business and finance should be conducted in a manner which complies with and is in the spirit of accepted professional ethics and professional values'. The *Study Guide* sets out four sets of learning outcomes (Sections F1–4):

- fundamental principles of ethical behaviour
- the role of regulatory and professional bodies in promoting ethical and professional standards in the accountancy profession
- corporate codes of ethics
- ethical conflicts and dilemmas.

These are considered in turn in this article. It must be stressed that this is intended to be an introduction, and further detailed study will be necessary to acquire the required level of knowledge and understanding.

## FUNDAMENTAL PRINCIPLES OF ETHICAL BEHAVIOUR

### What is ethics?

Ethics is concerned with what society considers to be right or wrong. It therefore relates to standards of behaviour. At first this may appear to overlap with one purpose of law, in that law seeks to address behaviour of which society disapproves. However, ethical principles may be adopted that discourage behaviour that is undesirable but legal. For example, during the expenses scandal that arose in the UK in 2009 regarding claims for reimbursement by politicians, one politician responded to criticism by stating that she had done nothing illegal. This rather missed the point, as the general public may still regard legitimate expenses claims as inappropriate, and therefore unethical.

Ethics lacks the certainty usually provided by the law, as individuals may consider some things that are legal to be unethical. In turn, views on morality differ, so even when ethical principles are codified by professional bodies or commercial organisations, they may be regarded differently according to the moral principles of each individual.

All professions rely on their practitioners adopting not only legal but ethical standards. If accountants behave unethically, their clients will lose confidence in their services, and society in general will no longer trust them or feel that they act in the public interest. The potential effects of this would be devastating, not only to accountants themselves, but the profession and its stakeholders, including individuals, organisations and others affected directly or indirectly by their work.

### Approaches to ethics

Ethical behaviour may be defined in terms of duties. Many philosophers have argued that certain core duties are imperatives, and as such will always apply, regardless of circumstances. Absolutists (or dogmatists) admit no exceptions, as these duties are believed to be sacrosanct. They often have their foundations in religion or deeply embedded values, universally accepted by society. The most common examples are the duties not to kill and to always tell the truth. This approach to ethics is sometimes called the deontological approach (from the Greek word 'deon', meaning 'duty').

Relativists (or pragmatists) accept that duties are important but are prepared to admit exceptions. For example, they may argue that it is right to kill if the cause is just, or to tell a lie if the purpose is noble. So if a frail and terminally ill loved one asks 'Am I dying?', it may sometimes be right to lie.



Codes of conduct issued by professional bodies, and corporate codes issued by business organisations, define responsibilities in terms of duties, and may provide guidance on the more common exceptions that apply. As it is impossible to define the appropriate response to every single human interaction, these codes can only serve as sets of minimum standards and have to rely on the inherent willingness of practitioners to deduce what is right or wrong.

Ethical behaviour may also be defined in terms of consequences. This is sometimes referred to as the teleological approach (from the Greek word 'telos', meaning 'the end'). Here, the right course of action is that which will result in the most acceptable outcome. Most acceptable to whom? This is dependent on the ethical stance of those who determine what is an acceptable outcome.

Utilitarians regard the right course of action as that which will benefit the majority, or serve the 'greater good'. In doing so, the ethical decision may disregard any impact on the minority, believing that they should defer to the greater needs and influence of the majority. On the other hand, pluralists pursue consensus in order to accommodate the needs of both the majority and the minority. Finally, egoists favour courses of action that are right for them. This last, seemingly selfish approach to right and wrong was supported by Adam Smith, the 18th century UK economist, who suggested that pursuit of self-interest is often a catalyst for the creation of prosperity through entrepreneurial innovation and risk taking.

A practical application of these concepts may be considered in relation to the conflicting views on the use of mobile telephones on commuter trains. Should railway users be denied the right to use their mobile telephones while travelling on trains? If one assumes that the majority will tolerate constantly ringing telephones and loud conversations during a railway journey:

- the utilitarian will propose that mobile telephones are acceptable to most commuters, so the minority will have to put up with them
- the pluralist accommodates both groups by setting aside a limited number of 'quiet' carriages in which mobile telephones cannot be used
- the egoist decides on the course of action that is most desirable for him, which may in turn be based on profit motive or personal belief.

Using the duty-based and consequentialist-based approaches to ethical decisions may result in different potential outcomes. Consider the case of a highly successful and dynamic chief executive officer who has been caught up in a scandal relating to his personal life, reported widely in the national newspapers and on television, with resultant embarrassment to his organisation. Should he resign? The duty-based approach may suggest that, as a senior executive, he should adopt high moral standards in and out of work, and because he has failed to meet those standards, he should resign. The consequentialist may agree, stating that by not resigning it will result in damage to the reputation of the organisation as long as he remains in office. However, the consequentialist may also disagree, arguing that by resigning the chief executive officer deprives the organisation of his knowledge, skill and experience, which will result in a lack of leadership and direction, at least in the short term. This argument may be reinforced by the view that, in future, other organisations may choose to accept resignations on the same basis, even though the individual's personal life should have nothing to do with his work.

### **Ethical principles**

Led by international bodies such as the International Federation of Accountants (IFAC) and its many member associations and institutes, several principles have been identified as being of crucial importance to the profession:

- integrity
- objectivity
- professional competence and due care

- confidentiality
- professional behaviour.

These are discussed in more detail later in the article, as they form the fundamental principles of the ACCA Code on Ethics and Conduct.

It is not adequate to simply identify and articulate the above principles. In order to put them into practice, organisations must adopt values that will promote adherence to the principles, thereby maintaining the confidence of stakeholders. Accountants have to recognise that their duties are not limited to what clients expect of them, and must accept that they have a fiduciary duty, or duty of absolute trust, to a wide range of stakeholders. Table 1 sets out additional values that should be adopted.

**TABLE 1: ORGANISATIONAL VALUES**

Value	
Openness	Being full and complete in the provision and disclosure of information and reasoning behind decisions
Trust	Relying on the judgments and information provided by other professionals, and embracing values that encourage others to rely on our judgments
Honesty	Not only telling the truth, but being prepared to give complete information on which others can fully depend
Respect	Treating others with dignity and adopting a professional manner
Empowerment	Ensuring that those who are entrusted with responsibilities have the authority to carry out the tasks necessary to fulfil their duties
Accountability	Taking full responsibility for the outcomes of our work, including work carried out on our behalf by others

**CORPORATE CODES OF ETHICS**

Corporate codes of ethics are published by private sector organisations in order to communicate their values and beliefs to stakeholders. These include:

- customers, whose buying decisions may be influenced by ethical considerations
- shareholders, whose investment decisions may be influenced by ethical factors
- employees, who have to know the standards expected of them
- suppliers, who need to understand the expectations of their customers and also that they will be treated ethically during the course of the commercial relationship
- lobby groups, who may have specific interests in certain practices of the organisation
- the community in which the organisation is situated, which may seek reassurance that the organisation will act in its interest as an employer and as a good 'corporate citizen'.

The contents of a typical code of ethics are set out in Table 2.

**TABLE 2: CONTENTS OF A CODE OF ETHICS**

Commitment	
Core principles	These should refer not only to its commercial objectives but the manner in which they will be pursued. For example, they may state social and environmental commitments as well as best practices that will be adopted
Financing	How share and loan capital will be raised. This must also allude to how the organisation will deal with providers of share and loan capital, confirming that its published statements will be honest
Customers	Customers may refer to the statement in order to confirm the minimum standards that can be expected from their purchases, especially in terms of benefits to be derived from the products and services. They may also be interested in matters such as customer service and distribution channels, supply chain policies (such as 'Fairtrade' commitments, organic ingredients, and so on) and animal testing
Suppliers	The code may refer to how suppliers will be chosen and the standards to which they must adhere. It may also set down the terms of business on which suppliers are engaged

## Commitment

**Employees** The code should confirm employment practices in relation to engagement of workers, including equal opportunities and diversity, working conditions and how employees will be developed

**Community** Organisations bring value to the community by providing employment and generating income, but may also have adverse effects through traffic congestion, emissions and even unemployment if the company decides to downsize or relocate. The code may provide assurances in respect of such factors

**Lobby groups** Lobby groups express specific concerns relating to factors such as raw materials, working conditions and environmental impact. The code may address such issues by stating broad policies

## THE ROLE OF REGULATORY AND PROFESSIONAL BODIES

Ethical behaviour can be promoted, or even enforced, in several ways.

If specific unethical practices are considered to be widespread and detrimental to the public at large, a national government or supra-national authority may take action to curtail such practices by making them illegal. The most obvious examples are discrimination in the workplace and selling high interest consumer loans to vulnerable people. Many governments have outlawed various forms of discrimination by passing national legislation and have introduced disclosure requirements at pre-application stage when personal borrowers are considering taking out loans that may not be in their best interests.

It is not possible to legislate on every matter of concern, however, so professional bodies have a vital role to play in controlling unethical behaviour. Professions are characterised by offering specialist services that are underpinned by certain minimum educational standards. Unfortunately, although it is possible to teach ethics, this does not ensure that those who learn about it will necessarily become ethical as a result. For this reason, most professional bodies set ethical standards to which all their members are expected to adhere. Failure to do so may result in censure or even removal from membership.

The accountancy profession has to consider ethical issues not only nationally but also in a global context. It is in this regard that IFAC has a role to play. IFAC is a global representative body for accountants, with 164 members and associates from 125 countries. It develops international standards on ethics, auditing and assurance, education and public sector accounting standards. Under the auspices of IFAC, the International Ethics Standards Board for Accountants (IESBA) develops ethical standards and guidelines. In turn, the work of IESBA is overseen by the Public Interest Oversight Board.

The IFAC Code of Ethics is available free of charge from the IFAC website (see 'Related links'). It sets out internationally agreed standards, starting with a definition of fundamental principles and going on to elaborate on specific matters relevant to accountants in public practice and accountants in business. When preparing for Paper FAB, it is useful to refer to this Code. It is also relevant to Papers AA, SBL and AAA.

In common with other major accountancy bodies, ACCA publishes a Code of Ethics and Conduct, as well as a non-examined, online Ethics and Professional Skills module. Both are available on its website. All ACCA members are bound by the provisions of this code, so it is not only desirable but essential reading. The ACCA Code also defines fundamental principles. It elaborates on the principles discussed earlier in the article as follows:

- Integrity – 'Members should be straightforward and honest in all professional and business relationships.' The ACCA Rulebook (and the IFAC Code of Ethics) goes on to state that integrity implies not merely honesty, but fair dealing and truthfulness.
- Objectivity – 'Members should not allow bias, conflicts of interest or undue influence of others to override professional or business judgments.'
- Professional competence and due care – 'Members have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards when providing professional services.'
- Confidentiality – 'Members should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority, or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.'
- Professional behaviour – 'Members should comply with relevant laws and regulations and should avoid any action that discredits the profession.' The ACCA Rulebook goes further, and states that members should behave with courtesy and consideration towards all with whom they come into contact in a professional capacity.

The Code then goes on to elaborate on specific responsibilities in relation to many aspects of practice, including money laundering, whistleblowing responsibilities, advertising and publicity, the descriptions of members and firms, changes in professional appointments, legal ownership and access to books and other documents, professional liabilities and clients' monies.

## **ETHICAL CONFLICTS AND DILEMMAS**

As the number of human interactions in business is infinite, it follows that professional accountants will be faced with conflicts of interest and ethical dilemmas that they have to address.

Conflicts of interest arise from various sources. The accountant may be asked to:

- take a decision on a matter in which the individual has a personal involvement, such as where the accountant has a family or personal relationship with the client
- advise a company that is in direct competition with an existing client
- support two clients who are in competition with one another.

The ACCA Code provides clear guidance on conflicts of interest. It states that members should not accept engagements in which such conflicts arise, or even where there is a possibility of such conflicts arising. Members should evaluate the threats arising from conflicts and apply relevant safeguards against the threats materialising. If in doubt, the accountant should disclose the conflict

to relevant parties.

Ethical dilemmas arise when the accountant has to consider two or more seemingly incompatible ethical obligations. For example:

- he may be asked by a manager to remain silent about certain matters that would have an adverse impact on the financial accounts of an organisation, thereby testing the accountant's loyalty to his manager on the one hand, and his responsibilities as a professional accountant on the other
- he may consider that the policies of his employer are unethical and may find it difficult to reconcile personal values with those of the organisation
- he may be advising a longstanding client who is also a personal friend, only to discover that one of the client's family is behaving dishonestly, thereby playing the bond of friendship against the professional duty to give objective, truthful advice.

The IFAC Code offers a framework through which ethical dilemmas may be addressed. When faced with ethical conflicts, the decision taker should consider:

- the facts of the situation
- the ethical principles involved
- related fundamental principles
- relevant internal procedures
- the alternative courses of action
- consequences of each alternative course of action.

## **CONCLUSIONS**

Ethics is not an easy subject but one that has become critically important in a business environment in which failure to adhere to proper standards can have a devastating effect on organisations, investors, suppliers, employees and, of course, customers. Looking back over the past 25 years, there have been several high-profile corporate scandals that have all involved the human ethical failings to some degree. They include Enron and WorldCom in the US, Parmalat in Italy and Maxwell Communications, Polly Peck and Barings Bank in the UK.

Arguably, the revolution in information communications technology has meant that more people know about these issues, and more quickly than ever before, and that such events are nothing new. Perhaps this is one of the very reasons why professions must constantly reaffirm their commitment to ethical values and high standards of moral behaviour.

## Questions

(a) An investment firm allocates “hot” new shares of an initial public offering to its largest fee-paying clients first.

**Which IFAC code of ethics fundamentals appears to be violated?**

- A Confidentiality
  - B Integrity
  - C Objectivity
- (1 mark)

The correct answer is C

The objectivity principle is violated as the investment firm gave preferential treatment to its largest fee-paying customers and did not have a fair procedure in place to allocate the IPO shares to its clients.

(b) During an audit engagement, an auditor accepts from the client a pair of front row tickets to a sold out concert. The auditor keeps this matter private until after the engagement is completed.

**Which of the following principles of IFAC’s Code of Ethics has most likely been violated?**

- A Objectivity
  - B Integrity
  - C Independence
  - D Confidentiality
- (2 marks)

The correct answer is C

The scenario facts indicate that the gift accepted by the staff auditor is more than an insignificant gift. Although there is no indication that the auditor provided any favourable treatment to the client in return for receipt of the gift, accepting the gift is clearly a threat to the auditor’s independence.