CHAPTER 11

evaluation and Control

STRATEGIC MANAGEMENT & BUSINESS POLICY

13TH EDITION

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11.1 Evaluation and Control in Strategic Management

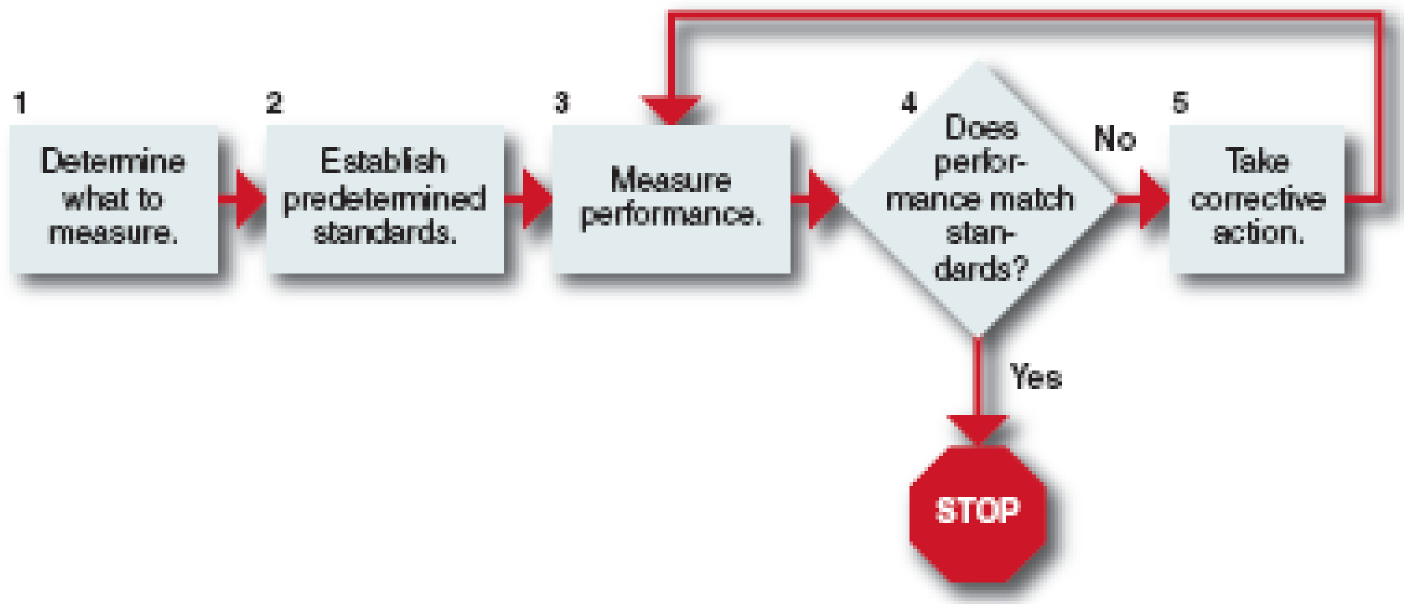
Evaluation and Control ensures that a company is achieving what it set out to accomplish by comparing performance with desired results and taking corrective action as needed

11.1 Evaluation and Control in Strategic Management

1. Determine what to measure
2. Establish standards of performance
3. Measure actual performance
4. Compare actual performance with the standard
5. Take corrective action

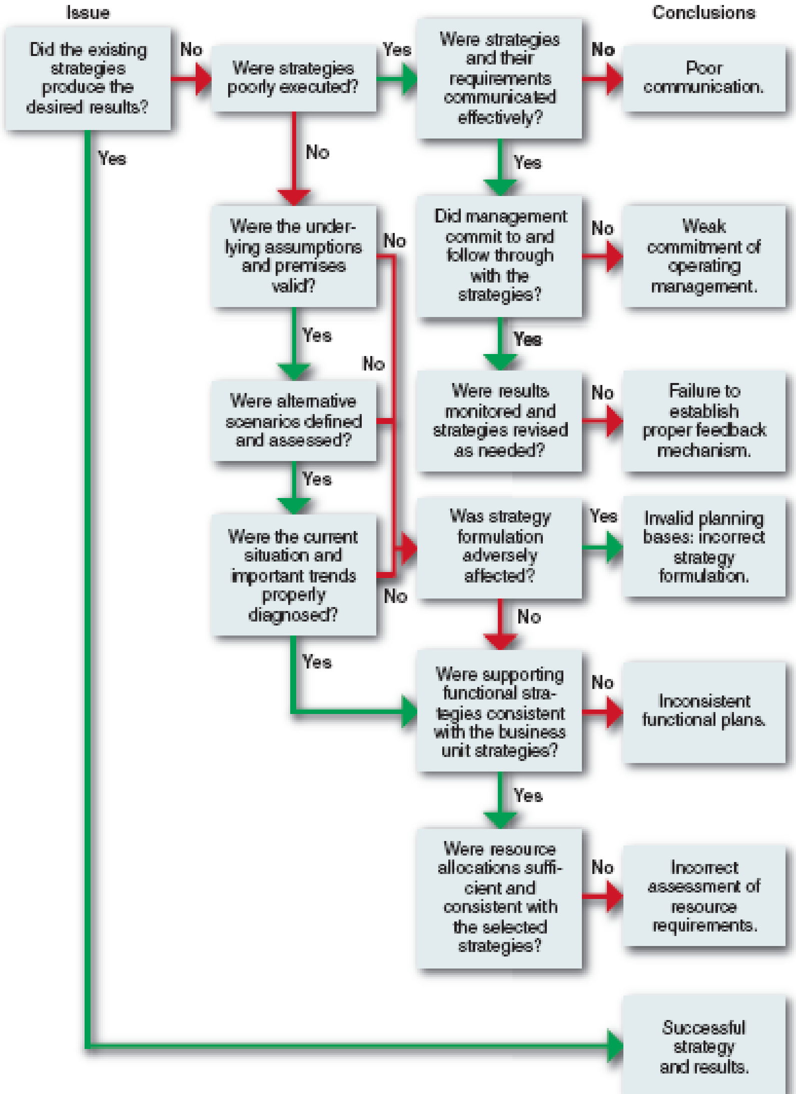
11.1 Evaluation and Control in Strategic Management

FIGURE 11–1
Evaluation and Control Process



11.1 Evaluation and Control in Strategic Management

FIGURE 11–2
Evaluating an Implemented Strategy



Appropriate Measures

Performance is the end result of activity

Steering controls measure variables that influence future profitability

- Cost per passenger mile (airlines)
- Inventory turnover ratio (retail)
- Customer satisfaction

Types of Controls

- Output controls- specify what is to be accomplished by focusing on the end result
- Behavior controls specify how something is done through policies, rules, standard operating procedures and orders from supervisors
- Input controls emphasize resources

Activity Based Costing

- Activity based costing- allocates indirect and direct costs to individual product lines based on value-added activities going into that product
  - Allows accountants to charge costs more accurately since it allocates overhead more precisely

Enterprise Risk Management a corporate-wide, integrated process for managing uncertainties that could negatively or positively influence the achievement of objectives

1. Identify the risks using scenario analysis, brainstorming, or performing risk assessments
2. Rank the risks, using some scale of impact and likelihood
3. Measure the risks using some agreed-upon standard

Primary Measures of Corporate Performance

- Return on Investment (ROI)
- Earnings per share (EPS)
- Return on equity (ROE)
- Operating cash flow
  - Free cash flow

11.2 Measuring Performance

TABLE 11–1

Advantages and Limitations of Using ROI as a Measure of Corporate Performance

Before using Return on Investment (ROI) as a measure of corporate performance, consider its advantages and limitations.

Advantages

- ROI is a single, comprehensive number that includes all revenues, costs, and expenses.
- It can be used to evaluate the performance of a general manager of a division or SBU.
- It can be compared across companies to see which firms are performing better.
- It provides an incentive to use current assets efficiently and to acquire new assets only when they would increase profits significantly.

Limitations

- ROI is very sensitive to depreciation policy. ROI can be increased by writing down the value of assets through accelerated depreciation.
- It can discourage investment in new facilities or the upgrading of old ones. Older plants with depreciated assets have an advantage over newer plants in earning a higher ROI.
- It provides an incentive for division managers to set transfer prices for goods sold to other divisions as high as possible and to lobby for corporate policy favoring in-house transfers over purchases from other firms.
- Managers tend to focus more on ROI in the short-run over its use in the long-run. This provides an incentive for goal displacement and other dysfunctional consequences.
- ROI is not comparable across industries which operate under different conditions of favorability.
- It is influenced by the overall economy and will tend to be higher in prosperity and lower in a recession.
- It is affected by inventory practices (LIFO or FIFO) and inflation.

SOURCE: Adapted from "Advantages and Limitations of ROI as a measure of Corporate Performance" from *Organizational Policy and Strategic Management: Text and Cases*, and ed. by James M. Higgins, copyright © 1983. By permission of South-Western College Publishing, a division of Thomson Learning.

11.2 Measuring Performance

TABLE 11–2 A Sample Scorecard for "Keeping Score" with Stakeholders

Stakeholder Category	Possible Near-Term Measures	Possible Long-Term Measures
Customers	Sales ($ and volume) New customers Number of new customer needs met ("tries")	Growth in sales Turnover of customer base Ability to control price
Suppliers	Cost of raw material Delivery time Inventory Availability of raw material	Growth rates of: Raw material costs Delivery time Inventory New ideas from suppliers
Financial community	EPS Stock price Number of "buy" lists ROE	Ability to convince Wall Street of strategy Growth in ROE
Employees	Number of suggestions Productivity Number of grievances	Number of internal promotions Turnover
Congress	Number of new pieces of legislation that affect the firm Access to key members and staff	Number of new regulations that affect industry Ratio of "cooperative" vs. "competitive" encounters
Consumer advocate (CA)	Number of meetings Number of "hostile" encounters Number of times coalitions formed Number of legal actions	Number of changes in policy due to CA Number of CA-initiated "calls for help"
Environmentalists	Number of meetings Number of hostile encounters Number of times coalitions formed Number of EPA complaints Number of legal actions	Number of changes in policy due to environmentalists Number of environmentalist "calls for help"

SOURCE: R. E. Freeman, *Strategic Management: A Stakeholder Approach* (Boston: Ballinger Publishing Company, 1984), p. 179. Copyright © 1984 by R. E. Freeman. Reprinted by permission of R. Edward Freeman.

11.2 Measuring Performance

Shareholder Value- the present value of the anticipated future streams of cash flows from the business plus the value of the company if liquidated

Economic Value Added (EVA)- measures the difference between the pre-strategy and post-strategy values for the business

EVA=After tax income-total annual cost of capital

11.2 Measuring Performance

<u>Market Value Added (MVA)-</u> measures the difference between the market value of a corporation and the capital contributed by shareholders and lenders

- Measures the stock market's estimate of the net present value of a firm's past and expected capital investment projects

11.2 Measuring Performance

Balanced score card– combines financial measures that tell results of actions already taken with operational measures on customer satisfaction, internal processes and the corporation's innovation and improvement activities

- Financial
- Customer
- Internal business perspective
- Innovation and learning

Evaluating Top Management and the Board of Directors

- Chairman-CEO Feedback Instrument
- Management Audit
- Strategic Audit

Primary Measures of Divisional and Functional Performance

<u>Responsibility centers-</u> used to isolate a unit so it can be evaluated separately from the rest of the corporation

- Standard cost centers
- Revenue centers
- Expense centers
- Profit centers
- Investment centers

11.2 Measuring Performance

Benchmarking- the continual process of measuring products, services and practices against the toughest competitors or those companies recognized as industry leaders

11.2 Measuring Performance

1. Indentify the area or process to be examined
2. Find behavioral and output measures
3. Select an accessible set of competitors of best practices
4. Calculate the differences among the company's performance measurements and those of the competitors and determine why the differences exist
5. Develop tactical programs for closing performance gaps
6. Implement the programs and compare the results

11.4 Problems in Measuring Performance

Short term orientation- managers only consider current tactical or operational issues and ignore long-term strategic issues

- Lack of time
- Do not recognize importance of long-term issues
- Are not evaluated on a long-term basis

11.6 Strategic Incentive Management

FIGURE 11–3
Weighted-Factor Approach to Strategic Incentive Management

Business Strength/Competitive Position

Industry Attractiveness	High	Low
High	**Star** ROI (25%) Cash Flow (25%) Strategic Funds (25%) Market Share (25%)	**Question Mark** ROI (0%) Cash Flow (0%) Strategic Funds (50%) Market Share Growth (50%)
Low	**Cash Cow** ROI (20%) Cash Flow (60%) Strategic Funds (0%) Market Share (20%)	**DOG** ROI (50%) Cash Flow (50%) Strategic Funds (0%) Market Share (0%)

SOURCE: Based on Paul J. Stonich, "The Performance Measurement and Reward System: Critical to Strategic Management," *Organizational Dynamics*, (Winter 1984), pp. 45–57.