Lesson 1: Strategy, Balanced Scorecard, and Strategic Profitability Analysis

Lesson Overview, Readings, and Objectives

Lesson 1 discusses corporate strategy and the three generic competitive strategies that organizations pursue: cost leadership, value leadership, and focus. You will learn how companies use performance measures to help them achieve their corporate strategy. In particular, this lesson provides in-depth coverage of the balanced scorecard (BSC). You will explore the development of effective performance measures in all four balanced scorecard perspectives.

Required Reading

- Chapter 1: *Strategy, Balanced Scorecard, and Strategic Profitability Analysis*, pages 1–36 in the eText

You may ignore any references to any chapters not assigned as readings for this course.

Learning Objectives

After completing this lesson, you should be able to

1. explain how the five competitive forces help identify strategic alternatives. (Chapter 1, pp. 2–4)

2. explain the differences between Porter’s strategies of value and cost leadership. (Chapter 1, p. 4; *Note 1*)

3. describe the key characteristics of cost leadership and value leadership strategies. (*Note 1*).

4. describe the strategic planning process. (*Note 2*)

5. explain how key success factors (KSFs) are necessary for the execution of strategy and how they are included in a strategy map. (Chapter 1, pp. 6–7)

6. explain how short-term measures evaluate the success of long-term strategies. (Chapter 1, p. 7)

7. identify the four perspectives of the balanced scorecard (BSC) and describe how they relate to each other and to corporate strategy. (Chapter 1, pp. 7–9; *Note 3*)

8. describe the key characteristics of measures on the BSC. (*Note 4*)

9. describe the concept of a triple bottom line. (Chapter 1, p. 10)

10. describe the features of a “good” BSC and identify the challenges of implementing a BSC. (Chapter 1, pp. 11–12)
11. evaluate effectiveness of strategy implementation through calculating growth, price recovery, and productivity components. (Chapter 1, pp. 12–18)

12. analyze specific productivity and capacity control strategies for achieving BSC expectations. (Chapter 1, pp. 18–22)

13. explain the importance of using the BSC in terms of measuring intangible resources within an organization. (Note 5)

**Note 1: Generic Competitive Strategy**

According to Michael Porter (1980) a company’s generic competitive strategy is a way to create a defendable position in the long run and outperform competitors in an industry. A competitive strategy is the way a company differentiates itself from its competitors. A strong competitive strategy can help a company create competitive advantage and excel in its given industry. Your textbook describes two of Porter’s generic strategies: cost leadership and differentiation. Your textbook does not describe focus, which is the third strategy.

- With a **cost leadership** strategy, firms seek to reduce costs through economies of scale, cost control, and operational efficiencies. For example, Walmart has mastered this strategy by creating economies of scale and efficiencies in all their business processes.

- With a **differentiation** strategy, firms seek to create a unique product or service offering though innovation, customer service, and marketing. Starbucks and eBay are examples of companies that use a differentiation strategy. Each of these companies delivers a unique product or service to a large marketplace.

- With a **focus** strategy, firms focus on a very specific market or segment of a product line. A company may also choose to be a low-cost provider or differentiator. The key difference between a focus strategy and the other two generic strategies is the singular focus on a particular target. Lululemon is an example of a company that focuses on a particular market, in this case, the fitness market. The company differentiates itself by providing high quality clothing to a growing fitness market.

Even though a focus strategy does not achieve low-cost or differentiation from the perspective of the market as a whole, it does achieve one of these positions vis-à-vis its narrow market target. Your textbook, therefore, excludes focus strategy because it is applied in the same manner as either cost leadership or differentiation.

A company must decide on the generic strategy it will follow before establishing the organization’s goals and objectives. If a company is going to pursue low costs, for example, this will impact the goals and objectives to be measured. For example, a low-cost company would need to focus on industry indices and other measures of cost to ensure they are competitive with other companies in the same marketplace. On the other hand, a differentiating company may still focus on cost but not at the expense of other key measures such as innovation and customer service. Table 1.1 summarizes the key
differences in the two main types of generic strategy.

**Table 1.1: Characteristics of Low-cost vs. Value Strategies**

<table>
<thead>
<tr>
<th>Low Cost</th>
<th>Value Leadership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focus on cost control</td>
<td>Focus on innovation and quality</td>
</tr>
<tr>
<td>Need for highly structured and controlled organization</td>
<td>More fluid and decentralized organizational structure</td>
</tr>
<tr>
<td>Highly efficient operations</td>
<td>Concentrate on marketing and research</td>
</tr>
<tr>
<td>Attract less skilled workforce</td>
<td>Attract highly skilled, creative workforce</td>
</tr>
<tr>
<td>Highly standardized products/services</td>
<td>Less standardization; products/services are often customized to customer needs</td>
</tr>
</tbody>
</table>

**Note 2: Strategic Planning**

A company's strategy sets the stage for competing in the marketplace and communicates how the firm will compete. For a strategy to be successful, an organization must establish strategic plans that work toward achieving the overall strategy. Figure 1.1 depicts the strategic planning process.

**Figure 1.1: Strategic Planning Process**
Mission and objectives outline, in a broad sense, what the company wants to achieve and their overall vision. For example, Starbucks’ mission is “to inspire and nurture the human spirit – one person, one cup and one neighborhood at a time.” (Starbucks, n.d.). This mission tells us that the company is differentiating itself through personal service and creating a sense of community.

Environmental scanning includes assessing a company’s internal and external environments. This assessment uses tools such as value chain analysis, which involves looking at the activities within a company and the value of each activity in terms of meeting customer needs. It also includes an external assessment of the industry using tools such as STEEP analysis (social, technological, economic, environmental, and political factors that may impact the industry) and five forces analysis, whereby a company assesses the power of buyers, suppliers, and substitutes, as well as the industry’s competitive rivalry and entry barriers.

Strategy formulation is the next step where an organization defines their strategy based on their mission and the environment. This strategy will be derived from the mission and will be influenced by the macroenvironment in which the company operates.

Strategy implementation involves outlining the specific steps necessary to achieve the desired strategy. At this point, all company divisions and employees are guided by specific objectives which are set to help achieve the overall strategy.

Evaluation and control involves measuring how successful a company has been in achieving its strategy.

In this course, we will primarily focus on three areas of the strategic planning process: environmental scanning, strategy implementation, and evaluation and control. The balanced scorecard (BSC), which is introduced in this lesson, is an important part of both the strategy implementation and the evaluation and control processes. A balanced scorecard ties together the various metrics that help a company to achieve its overall
strategic plans. Throughout this course we will discuss the balanced scorecard as a means to provide control and manage the many complex factors that contribute to strategic success.

**Note 3: Balanced Scorecard**

After studying Chapter 1 in your textbook, you should have a good understanding of the purpose and components of a balanced scorecard (BSC). The BSC ties specific measures to a company’s strategic plans. If a BSC is designed well, collective achievement of BSC measures should help a company meet and potentially exceed its plans. The balanced scorecard is discussed repeatedly throughout this course as a very useful tool for pulling together key components to achieve corporate strategy. Figure 1.2 illustrates the BSC process and how it related to corporate strategy.

**Figure 1.2: BSC and Corporate Strategy**
Note 4: Balanced Scorecard Measures

The following YouTube video on the balanced scorecard by IntrafocusUK provides a good overview of the purpose of the BSC and the types of measures that should be monitored for a company to achieve its overall strategy.

**Balanced Scorecard** (3:59)

When you are developing measures for a BSC, you need to keep in mind some very important things:

1. A BSC should include measures that are both **leading** and **lagging**. Lagging indicators
are typically related to outputs, such as financial results, quantities of materials used, or production completed. Lagging measures are generally easy to measure but hard to change. Leading indicators, on the other hand, are usually input oriented (e.g., training hours, direct labour hours, number of meetings held). They are sometimes difficult to measure but are easy to change. Leading measures are activities that should be monitored as they may predict the performance for lagging measures.

2. Measures should link to an organization’s strategy. If you have a goal of cost leadership, for instance, measures should be related to this strategy. Balanced scorecards will vary from company to company depending on their goals and strategies.

3. Measure should be quantifiable, specific, and relevant. “Improve efficiency” would not be a good measure. A measure needs to be expressed in a way that answers the question “what specific quantitative measure can we use to track whether we are achieving this goal?” For instance, a company might monitor the number of labour hours per unit produced to see if they are being efficient.

**Note 5: Intangible Assets**

The BSC is unique in that it recognizes the importance of intangible assets (those assets that cannot be measured using precise financial measures) including reputation, customer loyalty, ability to innovate, commitment to quality, employee knowledge, employee dedication, and many others. The BSC provides a way to measure these intangibles and make them an important part of the overall planning and control process. Traditionally, managers looked at the bottom line for results.

- What is our return on investment (ROI)?
- How much has our net income increased over the last year?
- What are the earnings per share on our common stock?

Although these are all important questions, the importance of intangible assets has become a key concern to many companies. During the early 20th century, most companies achieved competitive advantage through effectively managing tangible assets such as property, plant, and equipment (Kaplan & Norton, 2007). Today, however, intangible assets are a key resource and source of competitive advantage for most organizations. Kaplan and Norton (2007) looked at the book values (i.e., the total value of the company’s assets recorded on its balance sheet) and market values (i.e., the current value of the company if it was sold) of industrial companies in 1982 and compared this to the book values and market values at the end of the 20th century. They determined that book values equaled 62% of market values, on average, in 1982—by the end of the 20th century, these book values were less than 20% of companies’ market values. This demonstrates that the value of a company is no longer determined by its physical assets—instead, a large portion of a company’s value is determined by intangible assets that are not recorded as assets on the financial statements, including things like employee skills, reputation, technology, and customer service.

While managers will continue to ask questions about profitability, the increasing importance of intangible assets means that other questions are also important.

- How innovative are we?
• How knowledgeable is our workforce?
• Do we have a good reputation in our marketplace?
• Are our employees happy?
• Have we improved our quality?

The BSC provides a way to answer these less definable questions and include them in the strategic measurement process. It creates an environment where the importance of intangible assets becomes visible and measurable.

Because of the non-financial, intangible focus of not-for-profit organizations, the BSC is also a very useful tool in creating a performance evaluation system in such organizations.

Practice with Feedback

Practice Activity: BSC Application

Billy Sands Office Solutions manufactures workstations for offices. They have three models of workstation: WS1, WS2, and WSD. The WS1 and WS2 are lower-cost models with the WS1 as the company’s top seller. In 2015, in response to customer demand for a higher quality product, Amy Chung (president of Billy Sands) developed a deluxe workstation, the WSD. In the past, Billy Sands has been focused on sourcing low cost materials and has implemented many production process innovations that have sped up production times and increased overall efficiency.

The firm plans to market the WSD extensively in 2016 and 2017. To be successful with launching this new product, Ms. Chung feels they need to bring more quality into all their products, and she would like to change the image of Billy Sands to a company that carries a higher quality product. Billy Sands has been struggling with declining profits due to increased international competition. Key competitors tend to have a higher degree of quality in their workstations, and Billy Sands realizes they need to improve quality if they want to compete in the global marketplace.

Billy Sands’ employees work in a manufacturing environment that uses a typical assembly line production process. They source their key materials from numerous suppliers and usually purchase materials from the lowest cost bidder. They realize that this may not be the best option and have now implemented a new bidding process where quality is a factor equal to cost.

During 2016, Billy Sands established the following goals and objectives.

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<tr>
<th><strong>Goals</strong></th>
<th><strong>Objectives</strong></th>
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| **Cost Control** | • Maintain a profit margin of 35% on all sales  
• Lower warranty and repair costs by 10%  
• Develop stronger relationships with suppliers and implement just-in-time ordering where possible |
| **Sales** | • Increase sales of both WS1 and WS2 by 10% over 2015  
• Increase sales of WSD by 25% over 2015  
• Improve reputation as a high quality product |
| **Quality** | • Reduce quality costs by 25% from 2015  
• Lower warranty and repair costs by 50% in 2016  
• Improve manufacturing quality of WS1 and WS2 |
Required:

Develop a BSC for Billy Sands that will help them achieve their plans for 2016.

Compare your BSC to the multimedia Suggested Solution.

Practice with Feedback Exercises

Complete the Problem for Self-Study on pages 22 and 23 of the textbook (solution is on pp. 23–25).

Then complete the following activities from your textbook and check your answers with the Suggested Solutions (PDF file below).

- Exercise 1-16, page 27
- Exercise 1-18, page 28
- Exercise 1-20, page 28
- Exercise 1-22, page 29
- Exercise 1-24, page 30
- Exercise 1-26, page 30
- Exercise 1-28, page 31
- Problem 1-30, page 31
- Problem 1-32, page 32
- Problem 1-34, pages 32 and 33
- Problem 1-36, page 33 and 34
- Problem 1-37, page 34
- Problem 1-38, page 34 and 35
- Collaborative Learning Case 1-40, pages 35 and 36