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PREFACE

This Faculty publication is produced in parallel with the Braybrooke Press publication of the same name. Accordingly, references in the text to issues of *Manager Update* prior to April 1997 relate to the Braybrooke edition.
Manager Update helps the general manager keep abreast of the latest articles in specialist management journals. The most useful ideas in the fields of Strategy and Organisation, Marketing, Accounting and Finance and Human Resources Management are carefully selected from a wide range of publications with the busy general manager in mind. Experts in each field explain and discuss the relevance, practicality and usefulness of the key new concepts and ideas, thus enabling the senior executive to keep really up-to-date. The articles represent the personal views of the authors and not necessarily those of their organisations or of the Faculty. The nature of some subjects will preclude the articles from being definitive or mandatory. Being general in nature, the points made in *Manager Update* may or may not be relevant to specific circumstances. The Faculty committee intends that *Manager Update* will act as an aide-memoire for members, provide new ideas, and encourage good practice, but cannot accept responsibility for their accuracy or completeness. Responses from the membership will be a very important part of the successful development of the series. Comments please, to Chris Jackson on 0171 920 8486 or email CDJackson@icaew.co.uk.

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MARKETING

Interdepartmental Dynamics and Market Orientation

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Contemporary commentators have suggested that cross-functional working is a necessity for modern business and a panacea for solving a number of organisational problems. The marketing discipline is no exception. Multi-functional teams unfettered by the confines of the functional area are seen to be the answer to breaking down barriers with other departments and a means of sharing the responsibility for customers with others in the organisation. This emphasises marketing's role as an organisational philosophy in addition to providing technical skills through the marketing department. Research suggests that business performance levels including improved customer relationships, innovation, product development processes and quality, time to market and customer service are affected by closer departmental interactions. However, the direct link between interdepartmental interactions, cross-functional working and team work on the one hand, and business and market related outcomes on the other hand, has not been subject to rigorous investigation.

All the authors in the four articles selected indicate that the different aspects of interdepartmental dynamics they examine have, until now, lacked empirical support and foundation. Two of the articles have a common author, Bernard Jaworski, who worked extensively with Ajay Kohli in the early 1990s, on research which led to the development of a framework which enabled managers to understand and develop a market oriented organisation. The work they have published recently draws extensively on this earlier research, but concentrates on one core aspect, that of inter-departmental dynamics. The effect of interdepartmental conflict and connectedness on product quality is investigated by Menon, Jaworski and Kohli. (1) In the second article, Fisher, Maltz and Jaworski (2) are investigating the relative strength of managers' affiliation to the organisation, as opposed to their function or department, and the impact of affiliation on communication between departments. In this research, the focus is on the marketing and the engineering departments. Calabrese, (3) whose work is firmly based in the manufacturing sector, examines communication and co-operation between people in different departments, teams and functions in order to improve the quality of the research and development (R&D) process. 'Technological teaming' in an industrial marketing setting is the focus of the final article selected. Here, information technology is identified by Good and Shultz (4) as a means of linking individuals groups and organisations, improving co-ordination and enabling teams to develop close customer bonds.

Market orientation

In their original work on market orientation, Kohli and Jaworski (5) stated that the two primary consequences/outcomes of developing and implementing a market orientation were a combination of business performance and organisational outcomes, esprit de corps, employee commitment and team working. They took two of the key elements of market orientation, customer focus and co-ordinated marketing, and through their research proposed an organisational definition of market orientation which could be implemented by managers in practice. Market orientation is the 'organisation-wide generation, dissemination and responsiveness to market intelligence'. This definition emphasises the need for all departments to undertake activities which help them understand the customer, the need to share across all departments, and for the departments to focus on and work towards meeting customer needs.

Their research provided clear guidance on the actions that can be taken to cultivate or hinder the development of a market orientation. The three requirements they identified were senior management commitment, interdepartmental dynamics and organisational systems (such as reward systems) needed to support the implementation of a market orientation. Of these factors, interdepartmental dynamics has been singled out by Kohli and Jaworski and others for further investigation and, thus, it represents the central issue in this article.

Kohli and Jaworski define interdepartmental dynamics as the 'formal and informal interactions and relationships among an organisation's departments'. They state that conflict in those interactions is

damaging, since it obstructs communication and thus limits the spread of market intelligence needed to develop a market orientation. The second dimension they noted concentrated on interdepartmental connectedness. This is an important prerequisite to market orientation, as interaction between departments of a formal and/or informal nature facilitates the dissemination of market intelligence and all departments' responsiveness to it.

Organisational or departmental affiliation

The first step for marketers when managing interdepartmental dynamics is to understand the nature of an individual's affiliations inside the organisation. Social groupings are important, as Kelman (6) stated, since individuals in organisations gain 'strength and a sense of identity', from groups. Affiliations are considered by Fisher, Maltz and Jaworski to be significant because the source of the affiliation or identity whether it is a team, function, department or the organisation, has an impact on business performance. Internally, it can create competition and influence levels of co-operation, connectedness, conflict and communication. Externally, it is seen by the authors represented in this article to affect business performance, product quality, speed to market of new products, R&D and competitive advantage.

In their investigation of the role of information technology in guiding and influencing marketing teams, Good and Shultz start from the accepted position that 'teams are made up of individuals closely tied within organisational and functional boundaries who work collectively towards the same goal'. They stress that successful teams do not require close monitoring, as they consider them to be an effective use of a work force which is focused on a 'shared vision, goals and purpose of the organisation'.

Fisher Maltz and Jaworski illustrate a more complex pattern of affiliation which they refer to as Relative Functional Identification (RFI) in their investigation of the relationships between engineering and marketing departments. A marketing manager with a high RFI feels more affiliation/identification with the marketing department than the organisation. They would tend to concentrate on the health and success of the marketing department and, at its extreme, to the detriment of the organisation. On one hand, the success of the department tends to be felt collectively and, on the other hand, any attacks on the department can be taken personally.

Inter-departmental conflict and connectedness

Calabrese believes that formal systems for managing communication are insufficient, and communication 'should be part of a common feeling of all individuals with formal and informal support mechanisms'. Similarly, conflict and connectedness are the focus of Menon, Jaworski and Kohli's investigation of interdepartmental interactions and product quality for two reasons. First, these informal aspects of organisational behaviour have, according to recent research, been seen to have an increasing influence on organisational performance; and, second, because they have been seen to be important aspects in market orientation.

The extensive primary and secondary research undertaken by Menon, Jaworski and Kohli illustrate the effect that positive group interactions and open communications have on product and overall quality. Their findings from a survey of marketing and non-marketing senior executives in 222 business units from 102 companies, support this earlier research. Interdepartmental connectedness, 'the level of formal or informal contact between employees of different departments' and conflict, 'the level of tension between departments caused by the incompatibility of actual or desired responses and goals', do both seem to affect levels of product quality.

They suggest that firms must appropriately manage interdepartmental connectedness and conflict as they move towards the use of more inter-functional teams. Their research sought to establish whether environmental conditions had an effect on connectedness and conflict between marketing and engineering. When market and technological turbulence exists in the environment, connectedness between departments seemed to be stronger. As customer demands change and increase the demands on the organisation, then connectedness between individuals and between departments is a fundamental prerequisite in the development of products that meet their needs. However, conflict has a negative effect on the level of product quality whether there is a high or low level of turbulence in the environment.

The research also tested to establish whether organisational factors influence the nature of connectedness and conflict. Their research concluded that inter-departmental dynamics between marketing and engineering can be improved by a range of management actions, which are similar to those highlighted in their earlier work on market orientation. To develop connectedness and manage conflict, organisations should consider:

empowerment of employees; decentralisation; reward systems based on common incentives; and creating a positive environment where management show that they are not afraid to accept new product development failure and are willing to take risks.

The dynamics of communication

The nature of communication has evolved as organisation structures have changed to meet market demands. Flatter structures provide the basis for the development of a market orientation, and communication is the key to fruitful integration between departments. It is common sense to think that new products are likely to have more chance of success if R&D and engineering have an awareness of what the customer wants and if marketing understands the demands of the design and development process.

Communication is seen to have a number of components. Three dimensions of communication are illustrated by the authors; frequency, bidirectionality and coerciveness in communication. According to Fisher, Maltz and Jaworski, the majority of research in this area concentrates on frequency as the key measure of the effectiveness of communication between departments. However, calculating the number of times information is passed from R&D to marketing to engineering is simplistic, and tells us little about the quality of the interaction between the departments.

Rather than an a series of independent information exchanges between departments, communication should be a two-way process. Calabrese takes our mind back to Cybernetics Theory, which placed importance on information exchange and the need to provide feedback. Fisher Maltz and Jaworski refer to this as bidirectionality, where two way flows of information help to reduce misunderstanding and add clarity for each department. This builds on information exchange to encourage departments to work together, rather than at worst blocking and at best working independently.

The third dimension highlighted is coercion in communication. They see this factor as a barrier to interdepartmental interaction. Where departments have different 'world views' and take different perspectives on organisational goals, as can often be seen between the marketing and the engineering departments, an attempt by one department to use coercion, power and influence to direct a project to suit their own perspectives will cause distance in the relationship between the departments. Good and Shultz suggest that in complex marketing activities teams and, in particular, technological teaming is a useful way of overcoming communication difficulties. Here, regular interaction improves co-ordination and minimises the chance of errors in communication. Fisher Maltz and Jaworski indicate that two key themes have emerged to enhance and develop communication between the departments, the frameworks and norms for sharing information and the development of integrated goals.

Integrated goals and information norms

Calabrese and Good and Shultz have stressed the need for groups, departments, project teams and technology teams to have mutually beneficial objectives and shared goals. Fisher Maltz and Jaworski stress that one way of promoting co-operation and communication between departments is to have integrated goals, that override those of individuals and departments and are designed to encourage dependence on others. The interests of the different groups are likely to be integrated when departmental performance is measured, and rewards made at an organisational level rather than at a departmental level. In response, communication exchange is likely to be frequent and bidirectional, because their mutual performance depends upon it. However, the research also found that where managers, in this case marketing managers, have a high RFI they are more likely to engage in coercive behaviour, as the attainment of integrated goals, performance and rewards depends on the activities of their engineering counterparts.

Norms for decision making, work attitudes and customer orientation are a part of everyday working life. The development of norms to determine attitudes and behaviour which will encourage unrestricted information sharing between departments can be encouraged by managers who aim to develop interdepartmental interactions. An emphasis on information sharing is developed by providing a good example, taking opportunities to interact with other departments and encouraging genuine two way (bidirectional) communication flows. Here, the acceptable patterns of behaviour are demonstrated to individuals and groups to encourage them to follow their lead and be rewarded for their actions.

Thus, where there is a high RFI in departments, the development of integrated goals that Good and Shultz seemed to take for granted is necessary to improve communication. Where there is low RFI and managers identify strongly with the organisation, it may be necessary to develop organisational frameworks and standards for people to follow that will encourage the open exchange of information between engineering and

marketing. Here, managers with a strong affiliation to the organisation, and thus a low RFI, will tend to use organisational frameworks to share information with their counterparts in engineering and/or marketing.

Marketing is discussed throughout these articles at an organisational level. The management implications and actions they stress do not conform to the traditional activities found in a separate department. Indeed, as marketing becomes part of everyone's job in the organisation, the use and success of interfunctional teams, the integration of departments, and the effective management of conflict, communication and connectedness have a profound effect on marketing management at a number of levels. In particular, the impact is felt at a cultural level, in the organisation-wide development of a market orientation and in marketing decision making at a strategic level. The challenge is develop the role of marketing and adopt new broad based practices, and the motive is to keep satisfied customers.

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HUMAN RESOURCES MANAGEMENT

Team Effectiveness, Team Learning and Learning in Organisations

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Team development has been seen as a means of improving organisational effectiveness in an increasingly competitive world, as well as a powerful way of promoting empowerment, innovation and learning. Indeed, the team has been seen as the principal learning unit in a 'learning organisation'.

Of course, many questions remain. For example, how can the effectiveness of teams be enhanced, and how can cultural barriers to team development be overcome? Also, what are the conditions and processes that best facilitate the development of team learning, and what are the implications for organisations? A number of recent studies have provided valuable insight into these questions.

Team effectiveness

Cohen and Bailey (1) have reviewed 54 studies on the effectiveness of teams in organisational settings published between January 1990 and April 1996, and provide a valuable model for understanding team effectiveness. A team is defined as 'a collection of individuals who are interdependent in their tasks, who share responsibility for outcomes, who see themselves and who are seen by others as an intact social entity embedded in one or more larger social systems . . . and who manage their relationships across organisational boundaries'. Four types of teams are identified:

1. **Work teams** Continuing work units responsible for producing goods or providing services, typically directed by supervisors.
2. **Parallel teams** Multi-functional groups existing alongside the normal organisational structure, typically for problem-solving and improvement oriented activities, and generally with limited authority.
3. **Project teams** Producing one-time outputs and frequently drawing members from different disciplines and functional units for the application of specialist expertise.
4. **Management teams** Co-ordinating and providing direction to the sub-units under their jurisdiction, with responsibility for the overall performance of the business unit, and composed of managers responsible for each sub-unit.

Team effectiveness has three major dimensions: (a) performance effectiveness in terms of the quantity and quality of outputs (such as productivity), (b) member attitudes (for example, job satisfaction), and (c) behavioural outcomes (including turnover). Outcomes may be at the individual, group, and organisational levels.

A number of key findings emerged from the review. Cohen and Bailey argue that in general 'recent studies indicate that substantive participation in the form of self-directed work teams has clear benefits. Worker autonomy enhances worker attitudes, behaviours, and performance (whether measured objectively or rated subjectively by team members). In contrast, the largely negative results for consultative participation suggest that it lacks such benefits'. In addition, teams with greater diversity evaluated their effectiveness more positively, and only two studies found any positive relationship between rewards and some form of effectiveness. While previous research has suggested that increasing team size has an inverted 'u-shaped' relation to effectiveness, more recent research suggests that this relationship does not always hold. Finally, 'relationship' conflict within teams is more destructive than 'task' conflict which, in some circumstances (especially for non-routine tasks), may be beneficial.

In contrast, for project teams, autonomy is not associated with higher performance. Also, the quality of

leadership in project teams is strongly correlated with member perceptions of team effectiveness, and functional diversity is associated with faster time-to-market and integration of development steps. In management teams, the level of social integration is positively related to effectiveness, and shared beliefs are important. In addition, larger teams were more likely to communicate formally and this was positively related to sales growth, and a direct relationship between team diversity and turnover is supported. Where significant relationships exist within the team the effects of 'cognitive' conflict were positive, while the effects of 'affective' conflict were negative. With regard to leadership styles, team members in 'high consideration' leadership situations showed greater commitment to decisions made, but leader consideration itself did not significantly affect decision quality. There was some evidence that where team members were able to influence the decision, both commitment and the quality of decision increased.

On a more general level, the key findings were that the type of team matters for the determinants of effectiveness, and the factors most associated with success vary, based on who is rating the team's performance: team members tended to stress internal processes, while managers stressed external factors. For all teams, group cohesiveness is positively related to performance, but the impact of autonomy, and diversity within teams, may differ in complex ways.

Commitment and team effectiveness

The notion of commitment as it relates to teams has been a significant theme in the literature and research on team development. According to Nevis, Lancourt, and Vasallo, (2) the involvement of everyone concerned with an issue not only leads to higher-quality decisions, but higher commitment to the end result, as well. There is, thus, a bottom-line reason for enhancing participation in organisations. Leaders need to be aware of this bottom-line perspective-in essence, participation goes beyond being 'nice to do'. We need participation from entire teams and individuals within teams for organisations to be maximally effective.

There is extensive evidence that effective teams must have a goal and that this goal must be clear to everyone on the team. One landmark study, conducted by Larson and LaFasto,(3) provided corroboration for this perspective. These researchers undertook a three-year study of teams, focusing on one key question: 'What are the secrets of successful teams?' They interviewed leaders and members of an extraordinarily wide range of teams, including the space shuttle Challenger investigation team, executive teams, management teams, cardio-vascular surgery teams, the McDonald's Chicken McNugget team, the team of the USS Kitty Hawk, mountain climbing teams, epidemiology teams, and teams from the Centers for Disease Control.

First and foremost, these researchers found that 'high performance teams have both a clear understanding of the goal to be achieved and a belief that the goal embodies a worthwhile or important result. Second, whenever an ineffectively functioning team was identified and described, the explanation for the team's ineffectiveness involved, in one sense or another, the goal'.

Interestingly, Larson and LaFasto found that while the team goal was always there in the effectively functioning teams, with almost as much consistency, it was missing in the ineffectively functioning teams. According to them, 'The team had raised - or had allowed to become raised - some other issue or focus above the team's performance objective . . . What got elevated above the goal? Personal success'.

Cultural values and resistance to team working

Kirkman and Shapiro (4) consider the impact of cultural values on employee resistance to teams and, in particular, self-managed work teams (SMWT). Cultural values are not explicitly identified in Cohen and Bailey's model of group effectiveness, but may be considered both as an environmental factor, and as a group psycho-social trait. A SMWT involves 'two dynamic components': the process of self-management and collaborative teamwork. SMWTs are increasingly seen as providing a number of positive benefits to organisations - in particular, greater productivity, customer satisfaction, safety, lower costs, and job satisfaction and organisational commitment for individual team members. No wonder, then, that SMWTs are increasingly being used, but Kirkman and Shapiro's work points to the importance of the cultural context.

Based upon a review of the literature on SMWTs and cultural values they propose a model of globalised self-managing team effectiveness. They identify a number of cultural values and perceptions which may influence resistance to either self-management or to teams, and they argue that the greater the resistance to the SMWT, the lower will be its effectiveness. Resistance can be in terms of behaviours such as sabotage or protest, or attitudes such as withdrawal, or reduced commitment.

This work has a number of practical implications, not least because of the increasing internationalisation of business. On a general level, it should sensitise managers to the importance of considering the cultural context of team working. In particular, they outline a number of specific recommendations. Organisations should implement selection systems that choose the members of SMWTs on the basis of compatibility of values. They should also adapt the form of the SMWT and the implementation strategy to the cultural values of the country, paying particular attention to the choice of change agent. Finally, they should 'pay special attention to resistance on teams that are small, have high task interdependence, are composed of homogeneous members, or have resisters with high group status'.

Team learning

Teams have been seen as critical to the development of the learning organisation, but there is no accepted definition or clear description of team learning. Kasl, Marsick and Dechant (5) provide a research-based model of team learning which identifies a number of team learning modes, processes and conditions.

'Team learning' is defined as 'a process through which a group creates knowledge for its members, for itself as a system, and for others'. They identify five interrelated processes, cognitive and behavioural, in team-based learning. These are: Ôframing' (the initial perception of an issue or problem); 'reframing' (the transformation of that perception into a new understanding); 'experimenting' (taking action to test hypotheses); 'crossing boundaries' (seeking or providing information through interaction with other individuals or units); and 'integrating perspectives' (synthesising divergent views and resolving conflicts through dialectical thinking and not compromise).

In addition, they argue that there are three enabling conditions for effective team learning. The first is an appreciation of teamwork, which involves openness to hearing and considering others' ideas, and the value placed on playing a team role. The second is individual expression, or the extent to which individuals are willing and able to provide individual input. Finally, the team must have operating principles which establish commonly held beliefs, values, purpose and structure, and it must strike a balance between work on task and building relationships, respectively.

The third and final aspect of the model is a description of four modes of team learning. It is recognised that a team may go back and forth between these stages. In the 'fragmented' mode, individuals learn separately, and may not be committed to working as a group. In the 'pooled' mode, individuals begin to share information and perspectives, but the group as a unit does not learn. In the 'synergistic' mode, members create knowledge mutually and holistically, integrating divergent perspectives to create shared meaning systems. In the 'continuous' mode, synergistic learning becomes habitual.

Teams and the learning organisation

Both Romme (6) and Dovey (7) explore some radical implications for organisational structures. Romme considers the structure of 'learning organisations' from the position that teams are the key learning units in organisations. Hierarchical structures have been seen as an impediment to team learning and the development of the 'learning organisation', because teams can be defined as a set of decision-makers without a chain of command but with an equal voice in the final decision, or at least with a culture of equality and colleagueship, and hierarchical systems tend to become inert, bureaucratic and centralised. However, Romme makes the points that teams are vulnerable to personnel turnover, and that whilst the direct and informal linkages among team members may create a 'community of commitment' stimulating innovation, without a hierarchy these outcomes may not be stored, co-ordinated or accumulated.

Thus, for Romme, both hierarchy and teams are essential for large organisations as learning systems. The question is how can teams and a hierarchy be combined. Following Endenburg, (8) Romme offers the 'sociocratic organisation' as a solution since it superimposes a hierarchy of teams on the existing administrative hierarchy. It operates on two principles. The first is the 'consent' principle (defined as the absence of argued objection, and thus distinct from consensus). The second is the principle of 'double linking', which is intended to promote both downward and upward communication between teams by ensuring that each team is represented in the next higher team by its supervisor or manager, and at least one additional representative chosen from the team by consent.

For Dovey, a learning organisation may have a profound impact on reward systems and involve 'deep probing into . . . the culture, power relations, hidden learning and work practices of the organisation'. Such organisations require a culture of shared power and transformational learning. The task of leadership now is to transform a hierarchical bureaucratic culture, characterised by the values of individualism, personal

ambition and instrumental learning, into a culture that 'flattens power structures and encourages relationships characterised by dialogue amongst its members'. The inability of many organisations to become learning organisations is due to their inability to transform their power relations. While a team culture is seen as the ultimate goal of a learning organisation, Dovey argues that a culture of 'guided participation' of novice members by more experienced members in the work of the organisation, through a system of 'cognitive apprenticeships', is a means of facilitating explicit and tacit learning and the progression towards a team culture.

Towards a theory and practice of organisational learning?

For Easterby-Smith (9) it is neither possible nor desirable to create a comprehensive theory of organisational learning since the different disciplines (such as psychology, sociology and strategy) each provide a different perspective and research agenda. He provides both a useful review of these perspectives, and also a plea that we should 'conceptualise organisational learning not as another managerial lever that can be pulled by senior executives at their behest, but as a normal, if problematic, process in every organisation involving reciprocal exchanges between individuals, groups, and other organisational entities'.

The facilitation of learning within organisations requires appropriate mental models and theories, as well as practical methods. One such method is the 'Learning History', described by Kliner and Roth, (10) which allows organisations to reflect collectively on past experiences, and translate them into more effective future actions. In the form they describe, a learning history comprises written narratives by people who took part in a relevant event, 'woven into an emotionally rich, cogent story'. It also includes commentaries and analysis of the events and narratives provided by 'learning historians' comprising both trained outsiders and knowledgeable insiders, the role of which is to question, raise issues, and to identify themes. Learning histories may then be used as a basis for group discussion, transferring learning to others, and encouraging openness.

A focus on teams and learning does raise potentially critical, and uncomfortable issues for organisations. These include, as we have seen, issues of hierarchy, rewards, power relations and leadership. As Senge (11) argues: 'Poised at the millennium, we confront two critical challenges: how to address deep problems for which hierarchical leadership alone is insufficient and how to harness the intelligence and spirit of people at all levels of an organisation to continually build and share knowledge'.

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STRATEGY AND ORGANISATION

Competitor Intelligence

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In this issue of *Manager Update* we cast an eye over the burgeoning field of competitor intelligence. Experienced readers will quickly recognise that there is nothing particularly new in competitor intelligence and also that the principles and techniques of the field, like many things in business strategy, originally derived from the military. In this sense, competitive intelligence is as old as recorded history. However, two major changes have occurred in recent years to promote the field of competitor intelligence to increasing prominence:

1. **The ending of the Cold War** The East-West political conflict, pursued relentlessly for over 40 years by both sides, clearly gave rise to intense interest in new techniques for gathering and processing information about actual or potential hostile forces. With the end of the Cold War, much of the intensive effort which went into gathering military intelligence has been redirected towards industrial competition. Many of the individuals who earned their spurs in the services of various intelligence agencies have since chosen, particularly in the United States, to swell the ranks of the 'competitive intelligence professionals'.
2. **The growth in available information** This has become a cliché, that we now live in an information age. Provision of data on competitors and industry trends via on-line services or CD-ROM databases is now a fact of life. Increasingly, too, large companies operating in the information rich industries are using groupware systems like Lotus Notes to capture and disseminate information about competitors.

Of course, at one end of the spectrum competitive intelligence is virtually indistinguishable from industrial espionage, and it is in an attempt to distance itself from that perception that the industry has formed together as a 'Society of Competitive Intelligence Professionals' (SCIP), a US association which now has an offshoot in Europe. (1) Using open sources for competitive intelligence, the SCIP publishes a quarterly journal. The focus of this journal seems to be principally, but not exclusively, North American, fairly practitioner orientated and with an emphasis on the legal and ethical aspects of competitive intelligence.

Open source intelligence

This is not to say that there are not some interesting articles from a strategy perspective. Take, for example, Melissa Pery Call's article on 'Open Sources for Competitive Intelligence': (2) Call is at pains to dispel some of the myths surrounding what she calls 'open source intelligence' (ie, gathering information from secondary sources or from the firm's own internally generated information). Yes, there is a tremendous amount of information out there accessible to analysts. The Dialog on-line system, for example, claims to have more than 330 million records in 1996 spread across 500 different databases. (3) This is, however, not the same as saying that the answer to virtually any question an analyst likes to pose is capable of being addressed either by a commercial or by free data source. Nor is it the case that, even with the information that is out there, it is easy to extract in the format which is needed for a managerial decision. Data services are not identical and, just as we have traditionally used different books and directories to extract different pieces of information, so it makes sense, according to Call, to learn how to use different systems and be familiar enough with their strengths and weaknesses to know which system is likely to deliver the information we require.

The other key insight from Call's article is that information - as we all expected - is not free. In fact, the total US market for electronic data bases in 1995 was in the region of $15 billion and some analysts' reports available from on-line services retail for over $10,000 a time. For some companies in some situations, eg, contemplating a major acquisition, this sort of money may be relatively trivial. However, on an on-going basis, this is likely to exceed the budgets of all but the largest corporate entities and this probably explains the

popularity of so-called 'information wholesalers' like MAID, (4) which allow analysts to extract particular pieces of information, eg, a table on market shares, from the core of an industry report for a fee which is a fraction of the full cost.

So, with time and enough money, you should be able to find out all the information you require about your competitors? Well, not quite. As Call points out, there are some industries which are very information rich and others where information is sparse. As a general rule of thumb, one can assume that the more established an industry is and the more wealth that is generated by that industry, the greater the likelihood of systematic generation and analysis of information. Thus, around mature industries like the automotive and pharmaceutical sectors, whole industries have grown up in their own right, supplying the major players with industry and competitor information. No such luck if your industry is insufficiently large or attractive. There may be information available locally as a result of legal requirements for recording business performance but as Call puts it 'these systems are rarely automated. Even worse they are not interconnected so you have to spend time digging for the data as well as tracking down the target's customers, suppliers, competitors for first hand information'. (5)

The New Competitor Intelligence

The bible of the competitive intelligence professionals is clearly Leonard Fuld's *The New Competitor Intelligence.* (6) This is not the only work on competitor intelligence, nor even the first. (7) Fuld starts from the premise that most information is already out there in the public domain if you can only find it. The cardinal rule of intelligence, he claims, is that where money is exchanged, so is information. So, wherever competitors interact with suppliers, with buyers, with service providers and with government authorities, information flows through official filings of information, news reports, community gossip and internal industry grapevines. Probably, only about 5 per cent of the total information on competitors can be classified as trade secrets and, Fuld claims, this is generally the least important part of describing a competitor's make-up. Fuld's book provides the aspiring analyst with enough checklists and 'do's' and 'don'ts' to get started. It also supplies a comprehensive list of information sources. Fuld has an interesting section on international sources. Surprisingly, perhaps, he regards the best sources of information about international competitors as being those that are internal to your own organisation. Much of the approach adopted seems, however, to be predicated on the sort of industrial transparency which is common in the United States where disclosure of information about commercial activity is much greater.

This in turn, however, has also given rise to some interesting and quite sophisticated techniques. For example, competitor analysis of relative cost positions seems to be highly developed in US competitor intelligence organisations. Fuld cites the case of a glue manufacturer anxious to determine whether a competitor was really operating at a lower cost position than itself. In order to establish how the competitor was able to undercut on price, a side by side profit and loss statement was constructed. By using information derived from internal sources within the organisation, eg, by talking to people in functions like R & D, purchasing and manufacturing and from interviewing suppliers, scanning local newspaper articles for information about output and local wage rates, contacting suppliers of machinery and equipment and accessing information from local authorities about submissions for planning permission and environmental compliance, they were able to get together a comparative P & L with sufficient precision to generate the conclusions that the competitor not only had a significantly different manufacturing process which was difficult to duplicate, but also had lower labour costs and that their strategy was likely to be sustainable. Thus, the level of detail which competitor intelligence can provide would appear, on this reading at least, to be much more highly developed in North America than elsewhere.

Business intelligence on the Internet

One source which Fuld does not include is the Internet. Indeed, according to the blurb on the back of his book, readers are urged to 'forget the Internet'. Pawar and Sharda ignore this advice and focus on this new information resource for business intelligence analysts. (8) They conclude that the Internet, and in particular the World Wide Web, is a valuable source for business intelligence, albeit the value of the information content is likely to vary according to what information is being sought. For example, the Internet is much better for identifying information about general environmental trends than it is for looking at the specific task environment of the company, eg, competitors, suppliers, consumers and distributors. Even within the task environment, however, there are some things which the Internet can deliver much better than others. For example, the Internet does not seem to be particularly good at providing information which would lead us to predict the intentions or the opinions of competitors, but it is good at recording outcomes. (9)

The Internet, of course, does have some immediate and powerful appeal to business intelligence analysts. In

the first place it is comparatively cheap, at least if you focus on the direct costs of Internet subscription. The downside of that, of course, is, as Pawar and Sharda point out, the information seeker can at times get drawn into a search process that could extend unreasonably.

One noted advantage of the Internet which is not covered in the article however, is timeliness. Time lags in information availability have traditionally beset analysts of conventional information sources like directories and even annual financial reports. Increasingly, however, information from, for example published accounts, is available quicker and sooner on the Internet than it is on published sources of information either printed or electronic. The initial decision of the trial judge in the Louise Woodward case to issue a statement on the Internet in order to disseminate the judgement more quickly to news organisations around the world indicative of the benefits of the Internet which business analysts enjoy.

Making sense of information

Of course, as Call and others have pointed out, gathering information is one thing - putting it to good use is another. One of the main problems besetting competitor intelligence analysts is actually getting managers who take the decisions to take them seriously. This is borne out by one of the few pieces of empirical research done on the practice of competitive intelligence in large organisations, that by Ghoshal and Westney. (10) Competitor intelligence gathering in large organisations often suffers from low prestige and is frequently dismissed by decision makers as being too soft and insufficiently predictive. Conversely, the producers of competitive intelligence complain of a lack of direction and of information which is wasted or ignored, and they are loathe to make predictions for which they could subsequently be called to account.

Moreover, as Wagner and Gooding (11) point out, managers typically interpret information about their own organisation and competitor organisations in ways which are self-serving. Thus, an organisation's own successes are usually attributed to its organisational strengths, whereas organisational failures are often blamed on environmental forces beyond the company's control. Conversely, when looking at competitors in the industry, managers seem to be inclined to attribute business success to the environment and organisational failure to internal weaknesses! This can lead, as the authors point out, to a form of systemic over-confidence whereby the organisation's own performance is constantly over-rated and competitive behaviour is under-rated. The authors find evidence of this systematic bias in sense-making in the recent histories of famous companies like IBM, Kodak, General Motors and American Express.

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ACCOUNTING AND FINANCE

Modern Financial Theory - How Useful?

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Modern Financial Theory (MFT) is the collective term that has been adopted to capture theoretical developments which have occurred in finance over the last three decades or so. Opinion is divided about the breadth of such theoretical developments. For example, one view is that there have been just seven such developments: (1)

1. Capital budgeting, project appraisal and discounted cash flow analysis - net present value rule.
2. Portfolio analysis and selection.
3. Capital structure (the choice between debt and equity).
4. Capital Asset Pricing Model (CAPM).
5. Efficient Markets Hypothesis (EMH).
6. Options pricing models.
7. Arbitrage Pricing Theory.

Frankfurter and McGoun assert that:

> '. . . forty years of effort (generating over 50,000 articles) have not greatly enhanced the arsenal of the financial decision maker'.

So, what value is MFT? This has been the subject of recent review in the journal The Treasurer, in which the following question was posed:

> 'If such people (managers) did update themselves on the ideas coming out of the business schools, would their companies' performance improve?' (2)

In response to this, Alan Clements, Chairman of David S. Smith Holdings and former finance director of ICI, argues that the theory is at times inadequate, or over-complex, or impractical; and the practice is often at variance with the theory. (3) This is argued as being particularly so in the case of the first issue for consideration in this issue of *Manager Update*, capital structure. This relates to the decision about how much debt to employ in a company's capital structure, and what proportion of earnings to pay out as dividends. These are among the most basic policy choices confronting corporate financial specialists and, as some in the academic finance community have recognised, the insights from theory have been less helpful in offering guidance on these matters than they might have been. (4)

MFT and capital structure

Finance scholars over the past several decades have engaged in extensive theorising about factors that might be important in determining a firm's gearing (leverage) and dividend policies. The trigger for the theoretical debate was a pair of papers published in 1958 and 1961 by Nobel laureates Merton Miller and Franco Modigliani (M & M), who provided proofs for their now famous 'irrelevance' propositions. Under a restrictive set of conditions,* they asserted that neither a company's financing policy nor its dividend policy should be expected to affect its current market value. That value is determined solely by managerial decisions affecting the assets side of the balance sheet - that is, by the entire range of corporate strategic planning and operating decisions, often referred to under the heading of 'investment decisions'.

* Eg, no corporate or personal taxes, no contracting costs, corporate investment policy is fixed, and no information costs.

To many, the M & M irrelevance propositions appear to present a paradox. Finance specialists are paid small fortunes to make gearing and dividend decisions that purportedly 'do not matter'! However, seen more positively, the M & M propositions have had considerable practical value in directing research towards

understanding those factors likely to be important in setting corporate gearing and dividend policies. In effect, researchers have stood the propositions on their heads by arguing that if corporate financing and dividend decisions affect the values of companies in fairly predictable ways, it is for the following reasons:

- They affect taxes paid by issuers or investors.
- They affect the probability - and associated costs - of getting into financial difficulty (or bankruptcy).
- They affect management's incentives to follow the value-maximising rule of investing in all positive-NPV projects and, perhaps just as important, rejecting all others.
- They provide a credible 'signal' to investors of management's confidence (or lack thereof) about the firm's future earnings.

Against this background, various views about the determinants of capital structure have emerged. Some have argued, for example, that corporate and personal income taxes are the only factors that systematically affect capital structure and dividend decisions - and that even this effect may be small. Another school of thought holds that corporate financing choices reflect an attempt by managers to balance the tax shields of greater leverage against the increased probability and costs of financial distress (known as bankruptcy costs). In cases where such costs are low, some go on to argue, high leverage and dividends can even have important benefits in controlling a natural corporate tendency to over-invest (called the 'free cash flow' problem).

Signalling

Still others argue that corporate managers making financing and dividend decisions are concerned primarily with the 'signalling' effects of such decisions - for example, the tendency of share prices to fall significantly in response to dividend cuts and new share offerings. Extending this signalling argument, some have suggested that actual corporate capital structures are simply the cumulative result of a series of individual financing decisions in which managers follow a financial 'pecking order', where retained earnings are preferred to outside capital, and debt is preferred to equity, if outside funds are necessary. According to this argument, companies finance new investments with the 'cheapest available' source of funds. Specifically, they prefer internally generated funds (retained earnings) to outside capital; and, if internal funds are insufficient, they prefer debt to equity because of debt's lower flotation and information costs. Under this model, companies issue equity only as a last resort, when their debt capacity is fully exhausted. The pecking order theory would thus suggest that companies with few investment opportunities and substantial free cash flow will have low debt ratios - and that high-growth firms with lower operating cash flows will have high debt ratios.

Although each of these theories describes at least some important aspect of corporate financial decision-making, there is the important question - 'Which does the best job of explaining observed capital structure and payout policies?' The scientific method for deciding among competing theories is to subject them to a controlled experiment - or, in the case of research in finance, empirical testing. In the matter of gearing and dividend policy, however, designing broad-based tests of actual corporate decision-making that enables a distinction to be made among these theories has proved to be quite difficult. The dearth of reliable empirical evidence on this topic has forced proponents of each theory to rely largely on anecdotes to buttress their arguments.

There have been attempts to analyse the gearing and dividend choices of companies, much of which has been undertaken in the US. Barclay et al reviewed more than 6,700 industrial corporations over a 30-year period with a view to assessing the relative importance of the various factors -taxes, contracting costs (particularly, the financial distress costs and the 'free cash flow' benefits of debt), and signalling effects - in explaining corporate financial behaviour. (5) They calculated gearing ratios and dividend yields for these 6,700 companies from 1963 to 1993, and they found considerable differences in gearing ratios and dividend yields. This was both among companies in any given year ('cross-sectional' variation), and in the financing and dividend choices made by the same firm over time ('time-series' variation). Their next step was to devise quantitative measures (or 'proxies') for each of the three factors noted above-taxes, investment opportunities, and signalling effects. Having devised these proxy measures, they used regression analysis to assess the strength of the correlations between the various proxies and corporate gearing ratios and dividend yields.

Investment opportunities

Their main finding was that the most important systematic determinant of a company's gearing ratio and dividend yield appears to be the extent of its investment opportunities. Companies whose value consisted largely of intangible growth options (as measured by high market-to-book and research and

development-to-value ratios) had significantly lower gearing ratios and dividend yields, on average, than companies whose value was represented primarily by tangible assets (as indicated by low market-to-book and high depreciation-to-value ratios). This pattern of financing and dividend choices they explained as follows: for high-growth firms, the need to invest associated with heavy debt financing and the costs of high dividends make both policies potentially very costly. But, for mature firms with limited growth opportunities, high leverage and dividends can have substantial benefits in controlling the 'free cash flow' problem - the temptation of managers to over-invest in mature businesses or make diversifying acquisitions. (Taxes, too, may play a role in this pattern since low-growth companies are likely to be generating more taxable income and thus have greater use for interest tax shields.)

The researchers also found:

- Inconsistency with the prediction of pecking order theory.
- No support for the proposition that managers choose the level of firms' dividends to signal their superior information.
- No support for the proposition that taxes have an important impact on corporate gearing policies.

However, just to provide a counter-balance to these results, Opler and Titman pursued a different piece of empirical research and compared US firms which issued equity between 1976 and 1993 with those which issued debt, with an emphasis on determining the relative importance of each. (6) For example, their results suggested that pecking order explanations of capital structure choice theories are useful in explaining corporate behaviour. They found that firms which have less debt than that anticipated by a cross-sectional predictive model of the debt ratio were the most likely to issue debt. Moreover, profitable firms which can enjoy significant gains from gearing are the most likely to issue debt. At the same time, they confirmed previous studies which show that firms are much more likely to issue equity after experiencing a rise in their share price.

So, attempts to test MFT have not resulted in any clear consensus, as these two illustrations serve to show. A fairly common view expressed by practitioners is captured well in Alan Clements' summing up:

> 'The somewhat disappointing conclusion to all of this is that, as far as two of the major problem areas of finance are concerned - gearing and dividends - modern financial theory is inadequate. In fact, in some ways - for example its encouragement of gearing at the expense of sound, conservative, pragmatic principles - it has even been counter-productive.'

MFT and emerging markets

Whilst MFT has limitations in so-called mature markets, these are noticeably greater in emerging markets, ie,

> '. . . places where financial institutions and multinational companies see profitable opportunities for investment or speculation in what used to be called the Third World.' (7)

Despite the recent turmoil in financial markets, emerging geographic markets are important and cannot be ignored for many reasons, not least because they:

- Cover more than three-quarters of the world's land area.
- Represent more than three-quarters of the world's population.
- Account for only about one quarter of the world's GDP.
- Make up less than one tenth of global stock-market capitalisation.
- Have a recent track record of high growth rates.

In fact, the World Bank recently reported that private capital flows into emerging markets increased by $60 billion in 1996 to achieve a new record level.

Of the emerging markets, some are particularly attractive because of the potentially large opportunities they offer. This is particularly so for the so-called 'Big Emerging Markets', like China, India, Brazil, Mexico and Indonesia. (8) However, there are many smaller markets, like those in Eastern Europe, where the potential opportunities cannot be ignored.

The theory is that emerging markets offer higher returns than those in mature markets of the industrialised world. Because these economies are expected to enjoy higher rates of economic growth the value of their stock markets tends to grow faster. Of course, there are higher risks associated with each market but the higher risks should be rewarded by higher returns. The theory is that by diversifying a portfolio with investments across a range of markets, risk can be lowered whilst at the same time enjoying better returns.

The changing profile of capital markets is placing new demands on advisers to assist clients looking to invest

in emerging nations or governments selling off businesses previously owned and operated by the state. Whilst the same basic MFT techniques should be applicable in principle, the practice is typically very different. For example, Matyszczyk and McCreanor make the case for using a framework which recognises both the context or situational circumstances surrounding a valuation and company-specific factors. (9) Some of the important issues to be faced in applying MFT in emerging markets include:

- Differences in accounting practices.
- Limited and sometimes questionable data.
- Treatment of risk and uncertainty.
- Estimating the cost of capital.
- Dealing with inflation pressures and currency.

As indicated in previous *Updates*, accounting practices differ substantially despite international standardisation. Currently, 'standardisation' goes under the banner of compliance with US GAAP set by the Federal Accounting Standards Board (FASB), or International Accounting Standards (IAS) set by the International Accounting Standards Committee (IASC). The requirements of US GAAP transparency in financial reporting are not always appealing, but have been an essential prerequisite until recently for gaining access to equity capital in the US. A recent change in attitudes in the US has been influential in the IASC striving to put in place a set of core standards for acceptance by the world's leading stock markets. (10)

Whilst the moves towards increased international standardisation are to be welcomed, major limitations of accounting data will not be removed. The basic challenges to valuation in economies that are in transition, such as those of the former Soviet bloc countries, derive from the use of socialist styled accounting data, historic under-investment and neglect, and the absence of capital markets. (11) In Russia, an important emerging market, few companies even produce Western style accounts; preferring to use cash based accounts rather than the accruals method used in the West. (12)

Types of risk

Transparency in financial reporting may not be an accepted or acceptable practice, which means that in addition to the problems created by accounting differences, emerging markets are often characterised by a lack of relevant data. The implications of this are that time spent upon developing and refining elegant mathematical models may well be more productively spent in focusing upon improving the input data set. To this end, scenario analysis can be used very powerfully to force thinking around the limitations imposed by having imperfect data. (13) The assumption underpinning this approach is that:

Total risk = Market risk + Specific risk (14)

Market risk, sometimes referred to as systematic risk, is non-diversifiable and unavoidable, whereas specific (or unsystematic) risk is assumed to be diversifiable or avoidable. Market risks, like changes in the economy, tax reform, or a change in the world energy situation cannot be diversified away, such that even the investor who holds a well-diversified portfolio will be exposed to this type of risk. This is not so for specific risks which are often unique to a particular company and are independent of economic, political, and other factors which affect securities in a systematic manner. Examples are technological breakthroughs threatening product obsolescence, a new competitor producing essentially the same product, or the potential expropriation of assets by a foreign government.

Whilst the distinction between these two types of risk is very often difficult to make in respect of some issues, it forces appropriate questions to be asked about key issues which might otherwise not be questioned. It also helps to prevent the loading of the discount rate as being the simple and only solution to higher perceived risk. Whilst such action may be appropriate in the case of market-related risk, it is a far less convincing argument for risks which may impact at a specific point in time. Associated with this is the advantage that not all cash flows are penalised, as would be the case if risk was built into the cost of capital by raising the percentage required. The implication of this risk separation is that alternative cash flow scenarios can be constructed to take account of specific risks.

Specific risks can be factored into analysis by means of alternative cash flow scenarios, whilst market-related risks are built into the discount rate via the cost of capital. Estimating the cost of capital is a problem because financial markets in emerging market countries are often thin or non-existent. What is more, long-term government bonds may not be quoted, such that substitutes are required. Even if there is a quoted yield, it may not be default-free, as would usually be expected for developed economies. In such circumstances, what is known as the arbitrage principle can be used as the starting point for estimating the cost of capital in emerging markets. (15)

Last, but by no means least, there are many currency related problems associated with undertaking valuations in emerging markets, not least of which is the availability of spot and forward rate data. What is more, care has to be taken to ensure that any conversion rate used is appropriate. Unfortunately, it is not uncommon to find that the relevant conversion rate is not that which is officially quoted, but the black market rate!

Applying MFT in emerging markets is a real challenge. It is really as much an art as a science and whilst to many investors, the potential growth opportunities offered by such markets make the challenges worthy of considerable attention, there is no complete and perfect analytical framework or tool-kit that can be used to provide 'the answer' where problems of data availability or integrity often exist. Attempts to use very sophisticated analytical frameworks may often be wasted, but there are some approaches that may be useful for forcing key issues surrounding the business decision.

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