The Institute of Chartered Accountants in England & Wales

Faculty of Finance and Management

MANAGER UPDATE

ACCOUNTING AND FINANCE

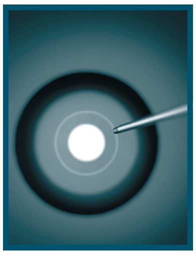
Valuing Internet businesses

Roger Mills, p 14

ISSN 1467-5765 ISSUE 13 MAY 2000

Customer satisfaction : guaranteed

Many firms undertake regular surveys of customer satisfaction. But are they asking the right questions ? What really prompts customer purchases ? Probably more than the price and features of the product itself. Emotions, life experiences, and the influence of friends and family can all be relevant. So is it 'satisfaction' that is really important ? Should companies be seeking instead to turn potential customer 'outrage' into 'delight' ?



Susan Foreman
Lead Tutor, Marketing Faculty, Henley Management College

Challenges and questions

One journal recently brought together for the millennium a collection of papers on the future of marketing. These articles delineated the current domain of marketing, its role, its contribution to society, and the development of marketing knowledge up to 2000.

In one of the contributions, Day and Montgomery[1] asked fundamental questions about the scope of marketing and the boundaries of theory and practice, and discussed some 'new directions for marketing'. They noted that marketing continues to change and evolve as new concepts emerge. One example of this evolution is the decline in the perceived relevance of the marketing mix, or the 'four Ps' (price, product, promotion, place) : '[given the] growing reservations about the validity or usefulness of the four Ps concept and its lack of recognition of marketing as an innovation or adaptive force, the four Ps are now regarded merely as a handy framework'. This once prominent model has now given way to other more useful ideas, such as market orientation and relationship marketing.

Marketers are obliged to rethink the theory, to consider practice and to move forward. Day and Montgomery urged marketers to consider the challenges to marketing presented by the knowledge economy, globalisation and consolidation, fragmented markets, the empowerment of customers and consumers, and adaptive organisations. In urging that a more integrative, multifunctional approach should be adopted, they posed a number of important questions for the future :

1. How do customers and consumers really behave ?
2. How do markets function and evolve ?
3. How do firms relate to their markets ?
4. What contributions does marketing make to organisational performance and societal welfare ?

Customers and consumers

From these broad questions, Day and Montgomery developed an extensive list of issues which required further work. This article focuses on the first of those topics, and it considers our understanding (or lack of understanding) of the customer.

Customer competence, satisfaction and loyalty all featured in a number of recently published articles. Prahalad and Ramaswamy[2] discussed the increasingly active role of the consumer in 'dialogue' with manufacturers. This is not altogether new. Proponents of a services or relationship marketing approach can chart many years of interaction, involvement and intimacy with customers. Interestingly, Prahalad and Ramaswamy encourage us to think about organisations as a collection of competencies rather than business units. In addition to the more obvious internal competencies, and those of suppliers and intermediaries, they suggested that the customer can bring new knowledge and competencies to the firm. The customer is, in essence, an untapped resource.

They stated that the following will occur in the future :

- Customers will emerge as creators of value.
- Customers will be collaborators, co-developers and competitors.
- Customers will be educators, and mould market acceptance of new products and services.
- Organisations will need to understand the customer in his or her social and cultural contexts.
- Organisations will need to encourage active dialogue and 'multilevel access and communication' with customers.

Bringing the active and fruitful involvement of customers inside the organisation is not straightforward. Prahalad and Ramaswamy proposed a number of steps which may be useful in capturing and incorporating customer competencies :

1. *Encourage active dialogue* : Customers' access to information, and their ability to learn and acquire knowledge, largely from the Internet, has increased their value to organisations.
2. *Mobilise customer communities* : The Internet has brought about the rise of close-knit and virtual communities which have a 'powerful influence in the market'[3]. These communities provide not only a common fund of shared knowledge, but also an effective and fast route for the dissemination of information, rumour and gossip. Recent price fluctuations of equities on world stock markets have been influenced by such groups. Smart organisations need to tap into this resource, to involve these communities, to capture their knowledge and to marshal their support.
3. *Manage diversity* : Prahalad and Ramaswamy warned that such close involvement with customers may not be wholly beneficial; it may make companies vulnerable. Their argument is similar to one used in the service sector, where customers' perceptions of the quality of the service are influenced to a great degree by the skill of the provider. Manufacturers have tended to avoid this problem, as they have traditionally been one step removed from the customer. However, the risk with virtual communities is that customers' views of the product (particularly in high-tech areas) may be dependent on the skills levels of the customers themselves. Customers may redirect their frustration with their inability to get the best out of virtual communities at the organisation. The frustration is then converted into a negative judgement on the product.
4. *Create personal experiences* : Customisation was a key issue for manufacturers in the 1990s. Prahalad and Ramaswamy believed that this will now be replaced by personalisation. They suggested that the product will play a less significant role in the purchase as the customer focuses on the experience which surrounds it. Here, the customer has a role in the development of the product. They have a voice and a say about the content or attributes of the product purchased. Customisation began with the manufacturer, but personalisation starts with the customer.

Customer satisfaction

Customer satisfaction and ownership of technological products have been explored by Fournier and Mick[4]. There are a number of definitions of satisfaction. At its simplest, it is seen as being based on 'conformation', where customers' expectations are met and the customer is thus satisfied. 'Disconformation', on the other hand, occurs when expectations developed prior to purchase are not met. Other factors, such as perceptions of quality, the performance of product attributes, and the role of customer beliefs and preconceptions, are also important. Indeed, we can ask in quite a fundamental way what satisfaction means. What are the components of satisfaction ?

To help answer these questions, Fournier and Mick discussed Oliver's work[5], which breaks satisfaction down into five elements :

- contentment;
- pleasure;
- relief;
- novelty;
- surprise.

Using this analysis, they then set out to 'develop a realistic account of satisfaction as it unfolds in the course of daily life'.

The authors developed a fascinating qualitative approach to their research that was based on long and detailed interviews over time. Their aim was to discover insights into satisfaction from the customer's perspective. They developed rich case studies 'based on histories, current life contexts and product interactions experiences'. Key elements of their findings enhance our understanding of customer satisfaction :

- *Consumer product satisfaction is an active, dynamic process* : Conventional models of satisfaction tend to be sequential and 'logical'. Fournier and Mick found (not surprisingly) that consumer behaviour is neither stable nor logical. In reality, expectations are variable. Expectations held prior to purchase may change. Satisfaction can be gained from different features discovered through use.
- *The satisfaction process often has strong social dimensions* : Existing models of customer satisfaction often concentrate on the individual. This research highlighted how the actions of family and friends can influence levels of satisfaction.
- *Meaning and emotion are integral components of satisfaction* : Fournier and Mick suggested that research to date had neglected the role of emotions in feelings of satisfaction. Rather than taking a clinical approach to evaluating expectations and perceptions of performance, managers should consider the 'usage experience', that is, the effect of everyday life and personal feelings on judgements about satisfaction.
- *Product satisfaction is intertwined with life satisfaction and the quality of life itself* : Two consumers may purchase the same item, for example a telephone answering machine, with similar expectations. When used, the machine performs the functions required. One might assume that the level of satisfaction would be the same for both people. This research, however, highlighted the differences in the nature of the satisfaction experienced. For the first person, satisfaction might be gained because family harmony had been promoted, while the second customer might feel satisfaction because he or she had been able to exercise parental dominance, for example by screening unwanted calls. In the latter case, there might be satisfaction for some members of the family and dissatisfaction for others.

Fournier and Mick essentially suggested that it is not possible to develop one all-encompassing model (as some have suggested) to measure customer satisfaction. This is a complex issue, and there are a number of routes to satisfaction which are influenced by a mixture of emotions, motivations and expectations, all of which affected by social setting and cultural backgrounds. Furthermore, satisfaction can vary as personal circumstances change over time.

Customer delight or outrage ?

Schneider and Bowen[6] have suggested that customers tend to be either moderately satisfied or moderately dissatisfied with products and services.

When considering customer satisfaction, one also needs to consider the range of emotions that customers feel. At one end of the spectrum, customers may be delighted with the service, act as advocates, and recommend the product or the company to others. At the other, when the customer is highly dissatisfied, the resultant feelings of outrage may lead to defections and negative comments to others.

Like Fournier and Mick, Schneider and Bowen thus questioned the conformation/disconformation model.

Focusing on the service sector, they suggested that feelings of delight and outrage 'originate with the handling of three basic customer needs – security, justice and self esteem'. Their work was based on two simple assumptions : 'customers are people first', and 'people strive to satisfy core needs in life'. A failure to satisfy their expectations as a customer may lead to dissatisfaction, but a failure to satisfy their personal needs may lead to outrage. Schneider and Bowen explained the nature of these needs in detail.

People are often unaware of their security needs until they are at risk. There are many service sector examples where security is a key determinant of satisfaction. According to Schneider and Bowen, in the financial service sector, for example when a pension or a mortgage is purchased, the customer's first intention is to protect his or her stability. If the customer's security needs are violated, for example if he or she is given inappropriate advice and hence purchases the wrong pension scheme, or when an endowment mortgage does not achieve its expected investment return, this leads not to dissatisfaction but to outrage.

Justice, fair play and the psychological contract between the customer and the organisation are also key issues in managing delight and outrage. We accept the investment that organisations make in delivering a service, but we do not often consider the investment made by the customer. This will become increasingly important if we 'co-opt customer competencies', as suggested by Prahalad and Ramaswamy, and encourage customers to invest more and more time in the development of the products and services that they consume.

If the level of investment is significant, and the customer thinks that the firm has acted unjustly, this can lead to lack of trust and an adverse impact on loyalty and continued business. This effect is difficult to reverse; moving from outrage to satisfaction is a big step. Schneider and Bowen made some suggestions which are consistent with well known service recovery strategies :

- A recovery strategy must be put in place and the customer must be involved.
- The recovery should lead to resolution. Otherwise, the level of outrage may be increased.
- There must be compensation. As Schneider and Bowen stated, 'leave the customer better off than before the error'.

The discussion in their article did not just focus on preventing customer outrage. Self-esteem is a key element in creating customer delight. A company can build delight into its product or service by, for example, developing an exclusive image. The service delivery process can also be used to build and develop customer esteem through the way in which customers are treated and given some control over the service. Customers also respond to information. The suppression of information can result in anxiety, but the sharing of information, at a doctor's surgery for example, can give the impression of equality.

Schneider and Bowen suggested some practical strategies in three areas to help organisations to manage needs and satisfy customers :

- Human resources management can help by recruiting the right people and designing training programmes and performance management systems which create customer delight.
- Market research into customer needs and employees' perceptions of customer delight is also required. Internal focus groups can be used, combined with customer feedback mechanisms that monitor strategies targeted at customer delight.
- Technology should be reinforced to provide for the delivery of security needs. Internet-based technologies can be introduced to give customers some control over the development of the service as they consume it. This can help customers to build their self-esteem and sense of justice.

References

1 **'Charting new directions for marketing'**
Day, G S and Montgomery, D B, *Journal of Marketing* Vol 63 (1999) pp 3–13 (special issue).

2 **'Co-opting customer competence'**
Prahalad, C K and Ramaswamy, V, *Harvard Business Review* (January/February 2000) pp 79–87.

3 **'Marketing organisation and virtual communities'**
Foreman, S, *Manager Update* Issue 11 (1999) p 2.

4 **'Rediscovering satisfaction'**

Fournier, S and Mick, D G, *Journal of Marketing* (October 1999).

5 **'Processing of the satisfaction response in consumption : a suggested framework and research propositions'**

Oliver, R, *Journal of Consumer Satisfaction, Dissatisfaction and Complaining Behavior* Vol 2 pp 1–16.

6 **'Understanding customer delight and outrage'**

Schneider, B and Bowen, D E, *Sloan Management Review* (Fall 1999) pp 35–45.

How do leaders make a difference ?

Is there a link between a chief executive's leadership style and company performance ? Is there a particular leadership style which produces superior results ? If so, can existing leaders learn to change their styles ? If not, how can the next generation of effective leaders be identified ? Do you look inside the organisation or outside ? What does the latest research reveal about whether insiders or outsiders are more likely to be successful ?

Richard McBain
Director of Studies of the Consortium MBA Programme, Henley Management College

The nature of leadership and the role of the leader have always been central themes of management research.

The leader who is able to build a shared vision for the organisation, secure the commitment of all employees to that vision, and create the conditions for the achievement of organisational objectives is a much sought after figure.

The picture of leadership that is emerging from management research is one in which the leader can indeed have a significant impact upon individual, team and organisational performance. This picture is complex, and it must take account of the characteristics of both leader and follower, the nature of their relationship, and the context of leadership.

This article reviews some recent research on a number of leadership-related topics, including

- leadership styles;
- choosing between internal and external successors;
- leader effectiveness;
- leadership and employee creativity;
- emotional intelligence.

Leadership style and performance improvement

The modern organisation must be flexible and customer focused if it is to survive in a complex, competitive and uncertain environment. In this environment, what is the impact of the various leadership styles ?

Shea[1] compared the impacts of three distinct leadership styles on the performance of a complex manufacturing task. The leadership styles were the following :

- *Charismatic leadership* : This is characterised by clear visions of the future, high expectations in relation to performance, and confidence in the follower's ability to accomplish challenging tasks.
- *Structuring leadership* : This is focused on the task, and it emphasises such behaviours as maintaining standards and meeting deadlines.
- *Considerate leadership* : This is concerned with the welfare of the members of the group. The leader puts people at their ease, appreciates good work, recognises job satisfaction, and strengthens the self-esteem of subordinates by treating them as equals.

Unsurprisingly, perhaps, given the complexity of the manufacturing task in question, individuals exposed to structuring leaders performed consistently less well than those exposed to considerate or charismatic leaders. It was found that considerate leadership resulted in both a higher quantity and quality of output than did charismatic leadership. However, the differences in quality decreased from trial to trial. The performance of those in charismatic leadership improved at a faster rate than that of participants in other leadership conditions.

Thus leadership style does make a difference. Considerate leaders seem to be able to reduce the uncertainty and stress associated with complex and unfamiliar tasks, and allow people to perform better. A considerate style has an immediate impact; a charismatic style seems to take longer to have an effect, but then brings about a greater improvement in quality.

Predicting leader emergence

Shea's research could imply that leaders need to learn to adapt their behaviours. This raises the question of the extent to which learning is possible.

Atwater *et al.*[2], in a four year longitudinal study of cadets in a US military academy, considered the extent to which leader emergence and leader effectiveness could be predicted by earlier life experience. Physical fitness and previous experience of positions of influence were found to predict leader effectiveness, as assessed by peer rankings. Cognitive ability, physical fitness, prior influence experiences and self-esteem predicted leader emergence, but not leader effectiveness. On the other hand, conscientiousness, hardiness, moral reasoning, and the ability to go beyond self-interest for the common good did not seem to affect leader emergence or effectiveness.

These kinds of studies must be interpreted with care, as they are often conducted in very specific situations. If they are carried out elsewhere, the findings may not be the same. The results often depend on who is rating the characteristics or performance of the leaders. The nature of the relationship between the leaders and the followers being studied can also be important. Such studies nevertheless prompt greater awareness of factors to bear in mind when appointing people to leadership positions.

Appoint from within or without ?

At very senior levels, other issues may be particularly important. For example, when a chief executive departs, the board of directors must make a decision about whether to appoint from within the organisation or to seek an external candidate. Lauterbach, Vu and Weisberg[3] noted the perceived advantages of internal successions :

- There will be organisational continuity and stability, because the new chief executive will have participated in the development of the current corporate strategy, for example.
- There will be increased employee loyalty and commitment, because the staff will be able to see that upward mobility to the very top position is possible.
- The new chief executive will have a greater knowledge of the firm and be a member of more established social networks than an executive from outside.

External successions are typically seen as being appropriate for a firm in difficulties. An external manager is not bound by old policies and implicit contracts, and can bring new perspectives and fresh ideas, and take decisive actions.

Lauterbach, Vu and Weisberg examined the actual succession choices of 165 US companies to identify the factors influencing internal/external succession decisions, and to discover whether these succession practices proved effective. Their key findings were as follows :

- The poorer the firm's performance is, the more likely it is that the succession will be external.
- The larger the company is, the more likely it is that the succession will be internal.
- The greater the amount of power and discretion offered to the new manager is, the more likely it is that the succession will be external.
- External successions are associated with better post-succession performance.
- Larger firms performed relatively better before the succession.
- Top performers tend to appoint from within.

They argued that 'external successions transform poor performing firms into normal firms, while internal successions lead on average to performance losses'. For them, the post-succession performance results were consistent with the conjecture that an 'agency problem' exists. That is, members of the board of directors allow their personal acquaintances and relations to distort their succession choice.

The key message for a board faced with this decision is to be clear about the objectives of the succession, and to understand the need to be objective about the circumstances facing the organisation and the competence of the internal and external candidates. Executive search consultants may have a role to play here.

Leaders : a key to empowered teams

'Empowerment' is a practice that goes beyond the mere delegation of authority. It implies that subordinates are also given scope for greater flexibility and freedom in how they go about their work. Teams, as well as individuals, can be empowered.

In the case of empowered teams, what type of leadership is appropriate, if any ? Kirkman and Rosen[4] studied 111 teams in four USA-based organisations. They found that more empowered teams were more productive and proactive than less empowered teams. They displayed higher levels of customer service quality, job satisfaction, and organisational and team commitment.

An external team leader may empower a team in various ways. The most obvious is through the delegation of responsibility, but the leader can also ask for and use employee input in decision making, and enhance the team members' sense of personal control over their work tasks. Team leaders can also foster the team members' collective belief in their abilities, to boost their confidence in their own effectiveness.

Interesting questions remain with respect to the relationship between individual and team empowerment. For example, will an empowered team restrict individual freedom ? Also, in what situations is an empowered team the best response ? Kirkman and Rosen stressed the importance of the organisational context in creating team empowerment experiences. They also emphasised the need for appropriate training in team leadership skills that, for example, encourages teams to solve their own problems and sets high team expectations. In addition, there is a need to design other human resource policies to support a team focus, rather than an individual one.

Leadership and creativity

In an era of increasing complexity, global competition and connectivity, it is potentially critical that employees' levels of creativity and innovation be improved.

Tierney, Farmer and Graen[5], in a study of 191 R&D employees, examined the role of the leader in the creativity process by looking at characteristics of both leaders and employees. Two employee characteristics were considered

- level of self-motivation;
- cognitive style, that is, the preferred means of problem solving, which can range from the innovative (a preference for generating new ideas) to the adaptive (a preference for generating ideas that are consistent with convention).

Employees with a high level of self-motivation in relation to creativity-related tasks not surprisingly produced a high degree of creative output. When they worked with supervisors who also had a high level of self-motivation, their creative performance was enhanced further. On the other hand, employees with a low level of self-motivation produced a lower creative output when they worked with supervisors with a high level of self-motivation.

The position with respect to cognitive style was more complex. The relationship between the leader and follower was important for cognitive 'adapters', but not for cognitive 'innovators'. The creativity of adapters was found to be significantly higher when the relationship between the leader and the employees was supportive. This was also the case when the leader allowed greater job latitude, was concerned to eliminate constraints on employee performance, and provided opportunities for engaging in challenging and relevant tasks. One possibility is that innovators are 'loners', and not interested in relationship building.

One implication of this research is that a person's cognitive style, which is relatively stable, can be identified and used in the selection of both employees and leaders. The provision of leadership training for relationship building may enhance the ability and willingness of leaders to facilitate creativity.

Another inference is that there is a need to match leaders with employees, for example by placing supervisors with a true appreciation of creative work among employees with a similar motivation.

Leaders and emotional intelligence

Emotional intelligence (EQ) was one of the big ideas of the 1990s. This coincided with writers and researchers in the fields of strategy and organisational behaviour becoming increasingly aware of the limitations of rational thinking and rational processes.

Sosik and Megerian[6] defined EQ as a set of factors for 'monitoring one's own and others' feelings, beliefs and internal states in order to provide useful information to guide one's and others' thinking and action'. The factors were as follows :

- self-awareness;
- emotional management (or self-monitoring);
- self-motivation;
- empathy;
- relationship management (or a predisposition toward handling interpersonal relationships effectively).

They also argued that aspects of EQ, and in particular self-awareness, may underlie 'transformational leadership', which is characterised by

- charisma;
- inspirational motivation;
- intellectual stimulation;
- development of others through individualised consideration.

Self-awareness seems to be the foundation on which all other aspects of EQ are based.

Sosik and Megerian studied 63 managers and 192 subordinates in a business unit of a large US-based IT firm. EQ was examined to see if it was a predictor of transformational leadership.

They found that managers who were self-aware possessed more aspects of EQ, and were rated as more effective than those who were not self-aware by both superiors and subordinates.

Sosik and Megerian therefore argued that features of self-aware leadership (for example a purpose in life, personal efficacy, interpersonal control, and social self-confidence) may be important selection criteria for managers.

Organisations could promote training programmes relating to aspects of EQ (especially self-awareness). They could also seek to improve self-learning, develop leaders as mentors, and assess and develop emotional competencies of organisation members.

It seems clear from this research that the self-awareness of managers and leaders is an important factor in their actual and perceived effectiveness. Tools such as 360° appraisals could play an important role in developing this awareness.

References

1 **'The effect of leadership style on performance improvement on a manufacturing task'**
Shea, C M, *Journal of Business* Vol 72 No 3 (1999) pp 407–422.

2 **'A longitudinal study of the leadership development process : individual differences predicting leader effectiveness'**
Atwater, L E, Dionne, S D, Avolio, B, Camobreco, J F and Lau, A W, *Human Relations* Vol 52 No 12 (1999) pp 1543–1562.

3 **'Internal vs. external successions and their effect on firm performance'**
Lauterbach, B, Vu, J and Weisberg, J, *Human Relations* Vol 52 No 12 (1999) pp 1485–1504.

4 **'Beyond self-management : antecedents and consequences of team management'**
Kirkman, B L and Rosen, B, *Academy of Management Journal* Vol 42 No 1 (1999) pp 58–74.

5 **'An examination of leadership and employee creativity : the relevance of traits and relationships'**
Tierney, P, Farmer, S M and Graen, G B, *Personnel Psychology* Vol 52 No 3 (1999) pp 591–620.

6 **'Understanding leader emotional intelligence and performance : the role of self–other agreement on transformational leadership perceptions'**
Sosik, J J, and Megerian, L E, *Group and Organisation Management* Vol 24 No 3 (1999) pp 367–390.

New ideas for competitive advantage

There are rival ideas about how a company can compete most successfully. Can one pick the best elements from each and weave them into a composite approach ? One such framework is outlined in this article. Research is reviewed which asked whether corporate social responsibility pays off. Another study explored whether it is possible to be too responsive to customers. Can this narrow the focus of a business so much that it misses out on key innovative ideas ?

Ian Turner
Professor of Management Studies and Director of Graduate Business Studies, Henley Management College

Over the years, we have examined many contributions on the theme of competitive advantage in MU. These have included the work of Porter and his followers, who concentrate very much on market structures as a determinant of company success, and more recent writings on the resource-based nature of competitive advantage, which stress the internal aspects of a company, and in particular its skills and assets. We have also discussed contributions which treat strategy less as the outcome of material resources and more as the product of human interpretations. Thus terms such as 'dominant logic', 'organisational identity' and 'strategy as narrative' have all described different aspects of the 'social construction' of strategy.

Model of competitive advantage

Now we report on an ambitious attempt to combine the material aspects of competitive advantage with its interpretational aspects to create a new model of competitive advantage.

Rindova and Fombrun's model of competitive advantage (see reference 1, pp 691–710) is based on four factors :

1. *Markets* : The source of competitive advantage in markets depends on the industry structure, barriers to entry and product differentiation.
2. *Resource-based advantages* : In Rindova and Fombrun's analysis, these largely relate to the physical and financial assets of the firm.
3. *Macroculture* : This is a combination of the firm's reputation within its environment, the groupings or categories within which it is placed by its stakeholders, and the success measures or rankings which position it in its chosen organisational field.
4. *Microculture* : This consists of the knowledge and skills which the company has acquired, together with its values and beliefs and the identity which it projects.

Within this model, firms seek to build distinctive strategic positions through three so-called generic processes :

- making strategic investments;
- developing strategic projections;
- developing a strategic plot.

Strategic investments

The strategic investments process is not difficult to understand. We can all grasp the value of investing in a particular set of assets, for example building a new plant or developing a new technical process. Rindova and Fombrun maintained that strategic investments deliver value when they focus not on competitors' actions, but on customer needs :

> *'[Companies should] concentrate resources on investments that have the highest impact on customer evaluations. They should do so by eliminating product features that the industry takes for granted or adding features that the industry has ignored … (so-called) value innovators do not set out to build advantages over the competition but they end up achieving the greatest advantages.'* (reference 1, p 696)

Strategic projections

Strategic projections are how a company communicates and signals to its environment the characteristics of its competitive advantage that it wishes to emphasise. Strategic projections can be anything from factual reporting in the press to symbolic images such as a company logo. Clearly, the more consistent the picture that is projected is, the more likely the company is to be successful. Thus, in enduringly successful companies such as BMW, painstaking attention is paid to the image that the company wishes to project, even down to a uniform layout for cars on the forecourts of showrooms worldwide.

Strategic plot

The strategic plot is the link between the company's strategic investments and its projections. Strategic plots are based very much on the company's dominant logic, its belief system, and in particular the assumptions it makes about how its particular world operates. This, in turn, is likely to have a powerful impact upon the decisions, sometimes implicit, that the company makes in implementing its strategy.

Rindova and Fombrun pointed to the mismatch between IBM's strategic investment and its strategic plot in the early 1980s. On the one hand, IBM was successful in entering a completely new market with the development of the IBM PC. However, instead of continually investing in the product to ensure that it was 'leading edge', IBM relied upon its existing strategic plot : the emphasis on standardisation of products, the IBM reputation and an active sales force. This, in turn, undermined the effectiveness of its strategic investments and, ultimately, its strategic projection.

Actors and stakeholders

Of course, other actors (or stakeholders) can also affect a firm's competitive advantage through the way in which they allocate resources. Thus investors who invest in the company, suppliers that gear up their processes to supply the firm, and buyers who make choices about buying into the company's standard or format are all making resource allocations that contribute to the company's competitive advantage.

Similarly, the company's stakeholders can define how successful the company has been, for example by commenting on it or by placing firms of different levels in reputational rankings, and this can affect the company's long-term success.

Just as the strategic plot builds the link between strategic investments and strategic projections on the part of the firm, so the firm's stakeholders provide the shared understanding within an industry about what constitutes an appropriate allocation of resources, and about which products are likely to be winners (and, by implication, which are likely to be losers) :

> *'As they interpret industry conditions, investors, bankers and analysts for instance, confirm an industry paradigm by authorising flows of financial capital to perceived winners and denying funds to perceived losers.'*
> (reference 1, p 701)

Rindova and Fombrun illustrated this process with a case study based on the decline of IBM in the 1980s and early 1990s. (Unfortunately, they were not able to continue their analysis into the late 1990s to track IBM's recent renaissance.) What is interesting is how the perceptual side (what Rindova and Fombrun refer to as human interpretations) mediates the direct aspects of material resources. Thus, for example, the peak of IBM's share price in the mid1980s was reached long after it had become clear that IBM's strategy (its strategic projection and its strategic investments) was seriously wanting and out of alignment with the demands of the industry and its key customers. However, as with a brick attached to an elastic band, when a crash comes, the impact is likely to be swift, brutal and, in some cases, enduring :

> *'A firm may be able to continue to attract resources for a period of time even when its strategy is no longer viable, as the case of IBM shows. Such a firm may be misled into believing that it enjoys actual advantage when it is using up accumulated goodwill.'*

Does stakeholder orientation matter ?

It is clear that in Rindova and Fombrun's model of competitive advantage, the perception of a company's stakeholders is quite critical to the establishment and also the dissipation of competitive advantage. Does that mean that addressing the interests of stakeholders is likely to improve a company's performance ? This assumption has certainly underpinned the stakeholder management literature that has evolved out of the work of Freeman[2] in the 1980s. Perhaps surprisingly, in the 15 years since Freeman's first work on stakeholder theory was published, relatively little empirical work has been done to demonstrate that a stakeholder orientation does actually improve a firm's financial performance.

A recent article[3] by Berman *et al*. sought to address this deficit. The authors were able to use two databases. One contained information about the so-called corporate social performance of companies, and the other was derived from financial performance data for firms. Berman *et al*. used the data to test whether the two approaches to stakeholder management that they had identified resulted in enhanced performance.

They called the first approach the 'instrumental approach'. This was derived directly from Freeman's original work. The assumption underpinning this approach is that companies should be responsive to stakeholder needs because this will lead to superior performance in the long run. Stakeholder management is therefore seen as a means to an end, the end being enhanced profitability of the organisation. Under this view, it is necessary to manage stakeholders effectively not because of their intrinsic merit, or because it is ethically important, but because not doing so would run counter to the company's own best interests.

The second approach was what the authors called the 'normative approach'. This holds that stakeholder claims are not subsidiary to, but rather the main drivers for, a company's strategy. Some claims from stakeholders are based on fundamental moral principles which may be completely unrelated to whether or not the stakeholder is important to the company. A firm therefore cannot choose to ignore these stakeholder interests simply because its management perceives that taking them into consideration will not serve the firm's strategic interests. According to this argument, a company which espouses an explicitly ethical strategy which places concern for the environment, the community and its employees ahead of profit maximisation will have a competitive advantage. This is because it will be better placed to create and sustain relationships with key stakeholders based upon trust.

The empirical work done by Berman *et al*. provided little support for the second position, alas. However, there was clear support for the first position, that is, that an explicit stakeholder orientation which set out to meet the needs of key stakeholders would result in improved financial performance. Interestingly, though, this holds only in some areas. They found, for example, that meeting the needs of employees and addressing product safety and quality issues (that is, customer orientation) directly affected financial performance. On the other hand, being responsive to the needs of the community, employing a diverse workforce, and addressing the needs of the natural environment had no statistically significant impact on the company's performance.

The latter result, the authors speculated, might be a function of their sample, which was cross-industry. Concern for the environment may be more industry-specific.

To serve or to create ?

It is possible for companies to become too responsive to stakeholders. This applies in particular to customers, as Berthon, Hulbert and Pitt pointed out[4]. The literature in this area seems to be divided between that which claims that the primary purpose of a company is to serve its customers, and that which maintains that the role of a firm is to create new products and new markets.

Common sense suggests that serving existing customer needs, while necessary, will certainly not guarantee long-term survival. This approach will result in incremental adaptation, which, in turn, may generate diminishing returns. The firm will run the risk of being sidelined by the more radical innovation of competitors. Listening to existing customers, however systematically this is conducted, will not necessarily generate winning concepts or products for the future. Motor manufacturers, amongst others, know this to their cost. Great companies are capable of generating new concepts which create new markets and new customer needs. The Disney Corporation is one such organisation.

Of course, as Berthon, Hulbert and Pitt recognised, it may be that companies can change their approach to this issue over time. They can move from a production orientation to a sales orientation to a marketing orientation to an innovation orientation and back again as a result of changes in their environment. Companies can adopt a low or high customer orientation and a low or high innovation orientation and can, depending upon the combination of these, pursue one of four strategic 'orientation modes' :

1. *Isolate* : This mode combines a low customer orientation and a low innovation orientation. It implies that the organisation is inwardly focused and may be in either a monopolistic or a regulated environment where the full impact of market forces is not felt.
2. *Follow* : This mode is based on a combination of high customer orientation and low innovation orientation. Innovation is driven by customers, and products are put together on the basis of precise feedback from customers. Followers often perfect or develop concepts which have been pioneered by innovative competitors.
3. *Shape* : This mode is characterised by low customer orientation and high innovation orientation, and it implies that innovative technology is used to influence customer needs. In the shaping mode, strategies can both define or redefine the rules of the game for competing, as with the Renault Espace, or influencing the expectations that customers have about particular products, for example Apple Macintosh computers.
4. *Interact* : In this mode there is a dialogue between the company and its customers about the design or delivery of a particular product or service.

Implicitly, there seems to be a normative aspect to this. One doubts whether too many companies would explicitly wish to pursue an 'isolation mode'. The examples of this provided by the authors, which include Microsoft and its pre-Netscape approach to the Internet, are not terribly auspicious. On the other hand, as we know from research previously discussed in MU[5], follow modes can be quite viable strategies. In particular, the so-called 'fast follower strategy' seems to avoid some of the risk inherent in pioneering, which is of course the major problem with the shape mode. Berthon, Hulbert and Pitt made the following clear :

> *'Successful shaping requires the placing of two large bets, one on technology and the other on the market, but failure to establish a new technology in the market as well as ceding an early position to a fast follower through under-investing in marketing and distribution seem to be all too common failings of companies in shape mode.'*

Even interact modes, which, as the authors recognised, would probably get the popular vote at the moment, have their drawbacks. They appear to be less likely to produce either a breakthrough product or service or the devotion to true customer satisfaction that shapers and followers seem to be able to deliver by adopting their 'purer' modes of operation. Berthon, Hulbert and Pitt believed that this is ultimately a matter of 'horses for courses'. Depending on factors such as the stability of the environment, the power of customers, the nature of the competition, and the regulatory environment, companies are likely to move from one mode to another.

References

1 **'Constructing competitive advantage : the role of firm–constituent interactions'**

Rindova, V P and Fombrun, C J, *Strategic Management Journal* Vol 20 (1999).

2 ***Strategic Management* : *A Stakeholder Approach***

Freeman, R E (1984) Prentice Hall.

3 **'Does stakeholder orientation matter ? The relationship between stakeholder management models and firm financial performance'**

Berman, S L, Wicks, A C, Kotha, S and Jones, T M, *Academy of Management Journal* Vol 2 No 5 (1999) pp 488–506.

4 **'To serve or create ? Strategic orientations toward customers and innovation'**

Berthon, P, Hulbert, J M and Pitt, L F, *California Management Review* Vol 42 No 1 (1999) pp 37–58.

5 **'Making a difference'**

Turner, I, *Manager Update* Issue 11 (1999) pp 12–16.

Valuing Internet businesses

Many commentators view Internet shares valuations as excessive, and believe the bubble will burst. But investors continue to pour money into share purchases. Do they know something others don't ? Does some rationality underpin their actions, or is it merely speculation ? Is there a way of judging the true worth of a company, that is, its intrinsic value ? What is the intrinsic worth of Internet stocks, and how does this compare with current share prices ?

Roger Mills
Professor of Accounting and Finance, Henley Management College

What is the intrinsic value of a share ?

In 1999, US equity markets surged onwards and upwards. A number of observers have expressed concerns about the values of these markets and about whether they are correctly valued[1], particularly in relation to Internet shares.

Market efficiency

These concerns have prompted the question 'to what extent is market capitalisation the best indication of the true and fair value of a company ?'. The answer can be thought to hinge largely upon issues associated with the efficient market hypothesis (EMH), which asserts that share prices reflect all relevant information. What is 'relevant' in this context depends largely on one of three forms of market efficiency that were originally proposed by Fama[2] :

- *Weak-form efficiency* : Share prices contain all past information, and no investor can earn excess returns by developing trading rules based on historical price or return information.
- *Semistrong-form efficiency* : Shares prices contain all information in the public domain, and no investor can earn excess returns from trading rules based on publicly available information.
- *Strong-form efficiency* : Share prices contain all currently available information, and no investor can earn excess returns using any information, whether it is publicly or privately available.

The debate about market efficiency has continued throughout the 1970s, 1980s and 1990s, and a large amount of research has been undertaken on the issue.

Research results have provided some support for both the weak and semistrong forms of market efficiency. However, research has also highlighted some interesting anomalies in all forms of market efficiency. Megginson and Megginson aptly summed up the literature[3] :

> *'While empirical tests of capital market efficiency do not provide completely unqualified support for the most extreme versions of efficiency, there remains little doubt that modern capital markets are immensely fast, accurate, and impartial processors of information.'*

The definition of market efficiency is a disputed issue. A useful interpretation has recently been provided by Damodaran[4], a renowned authority on valuation issues, who defined an efficient market as 'one in which the market price is an unbiased estimate of the true value of the investment'.

According to Damodaran, three key issues relating to market efficiency are the following :

1. The market price of a share is not necessarily right at any point in time; it is only unbiased (it is randomly higher or lower than the true value).
2. Deviations from true value are not correlated with any other variable (for example the price/ earnings ratio).
3. No group of investors can consistently beat the market.

Is there evidence that an investor or group of investors can consistently outperform the market ? The answer appears to be no, although there are a number of studies that identify asset-pricing anomalies, including the

- small firm effect[5,6];
- January effect[7];
- day of the week effect[8].

However, while these studies may indicate market inefficiency, there is no evidence that this information can be utilised in a profitable trading strategy.

Intrinsic value estimation

Increasingly, companies such as Internet businesses where the apparent intrinsic value of the shares is not reflected in the market capitalisation are being brought to our attention. This raises the all-important question 'how can intrinsic value be estimated ?'.

The issues associated with estimating intrinsic value have been reviewed recently by Lee, Myers and Swaminathan (see reference 9, pp 1693–1743). They pointed out the following :

> *'Most financial economists agree that a stock's intrinsic value is the present value of its expected future dividends (or cash flows) to common shareholders, based on currently available information.'* (reference 9, p 1693)

They went on to make the following statement :

> *'However, few academic studies have focused on the practical problem of measuring intrinsic value. Perhaps the scant attention paid to this topic reflects the standard academic view that a security's price in the market is the best available estimate of intrinsic value.'* (reference 9, p 1693)

They argued that the rationale for the equality of price and value is based on the assumption that the costs of switching between shares are insignificant. If information and trading costs are unimportant, it is argued that share prices should be bid and offered to the point where they fully reflect intrinsic values. However, this will not necessarily be the case when intrinsic values are difficult to measure and/or when trading costs are significant.

Price can deviate from intrinsic value because of 'noise trading'[10–12]. In this case, price diverges from value because some traders follow what are referred to as 'pseudo-signals' or 'noise', that is, signals that give an impression, but not the substance, of value-relevant news. Examples of pseudo-signals provided by Wang[12] include the advice of Wall Street 'gurus', and technical and momentum-based strategies that do not consider intrinsic values. The result is that, to the extent that uninformed traders make systematic estimation errors based on such 'noise', price can deviate from value.

In the long run, switching, or 'arbitrage', causes price to converge to value. However, in the short run, the costs of arbitrage may be sufficiently large to prevent this convergence from occurring instantaneously. This being the case, a more realistic view of the relationship between price and value is one of continuous convergence rather than static equality. This means that valuation based at a point in time may well give a misleading picture. The very real possibility that price may diverge from value makes the measurement of intrinsic value of paramount importance.

Lee, Myers and Swaminathan[13] evaluated several alternative measures of the intrinsic value of the 30 shares in the Dow Jones Industrial Average (DJIA). As a departure from much conventional practice, they did not require price to equal intrinsic value at all times. Rather, they estimated that price and value would eventually converge over time. They compared estimates of intrinsic value using two criteria :

- the relative ability to track price variation in the DJIA over time;
- the ability to predict market returns.

They showed that, under reasonable assumptions, superior estimates of intrinsic value can be provided on either, or even both, dimensions.

Last, but not least, the findings by Lee, Myers and Swaminathan suggest a framework for reconciling different approaches in accounting and in finance to this problem. Traditionally, value measures that track contemporaneous returns (and prices) have been the primary emphasis in accounting, while the finance literature has emphasised the ability of these fundamental measures to predict future returns. The authors suggested that 'when price is a noisy proxy for intrinsic value, it is reasonable to expect better value measures to perform better on both dimensions'[13].

The tentative conclusion at this stage is that, as markets are not perfect, there is no support for the viewpoint that the quoted price of a publicly traded share at a certain point in time reflects its intrinsic value. The study by Lee, Myers and Swaminathan supports the existence of a significant discrepancy between price and intrinsic value, at least in the short run. However, the finding that market price and intrinsic value are convergent in the long term indicates that traditional financial methods of estimating long-term share values are still valid, despite aberrations in the short term.

Valuing Internet businesses

Anyone who follows Internet share prices would probably agree with the tentative view that there may well be a significant discrepancy between the price of a share at a point in time and its intrinsic value. In recent times, we have seen many Internet shares come to the market at values that even the gurus find difficult to explain. In fact, some of them fully recognise the problems of valuing such shares. According to one source, Warren Buffett is reported as having said that if he were a business school professor, he would quiz his students on how to value Internet companies and fail everyone who did not leave the answer sheet blank !

Internet companies are an interesting illustration of the difficulty of measuring intrinsic or fundamental value. Advocates of such businesses would argue that the bricks and mortar approach used in traditional valuation methods is inappropriate in any case. To them, the value of an Internet business is reflected in other traits, such as the speed of adaptation and responsiveness of the organisation. In reality, these attributes are very difficult to convert to asset values. Internet businesses are also often of the type in which one opportunity leads to another, and this thereby makes the projection of revenues and costs difficult. As a result, qualitative analysis may be as important as quantitative analysis in assessing the value of Internet businesses, simply because investors in such businesses may be regarded as placing bets rather than making investments.

This raises the question of what investors look for in Internet companies. If we look at venture capitalists, which are one of the primary sources of funding for such businesses, some apparently compare the valuation of Internet firms to the valuation of real estate[14]. In the evaluation of real estate, key considerations are location and the prices of similar houses for sale in that area, that is, what in financial terms are called 'market comparables'.

By all accounts, venture capitalists will often look at a number of key issues when valuing an Internet company. These include the following :

1. What is the quality of the existing management ? Are they capable of taking the business forward, or will key staff need to be recruited ?
2. Does the company have a new market niche, or is it entering an existing market ?
3. Does the company have a tried and tested business model ?
4. What is the structure of the competition, and are there any partnership/alliance opportunities ?
5. How important is technology to the future success of the business ?

Methods used to justify the high value of Internet shares have tended to be creative. While using multiples of revenue, particularly in cases in which earnings are negative, some venture capitalists have adopted metrics based on the customer, such as 'eyeball' counts, total customer usage, and marketing monies spent. Some have adopted methods that seem to complement the belief about the source of future success. For example, one portfolio manager believes that websites with the highest traffic and the companies with the most cash backing will prove to be the long-term winners. To this end, he adopts a valuation approach based upon various measures of the website traffic, including subscribers, sales, page views and growth rates[15].

While many have sought to value Internet companies using new methods, there are those who consider that tried and tested traditional approaches are still valid. Mauboussin and Hiler of Credit Suisse First Boston have illustrated how cash flow analysis can be used with much the same metrics as those applied to offline businesses[16]. In simple terms, Mauboussin and Hiler contended that the discrepancies in valuations between Internet businesses and more conventional businesses are caused by the radically different cash economics of Internet businesses, not the valuation methods. Essentially, cash flow is king for Internet businesses, just as it is for other types of business. By analysing the free cash flows of various businesses, they argued that a basis for understanding different valuations can be found.

Free cash flow is calculated by deducting investment to support current and prospective operations from cash earnings. Typically, traditional businesses have a cash inflow from earnings and a cash outflow for investments. Mauboussin and Hiler used the example of Barnes and Noble, the traditional US bookstore, to illustrate how the company generated \$150 million in cash flow earnings for the 12 months ending 31 October 1998. In the same period, the company invested over \$240 million, resulting in a negative cash flow of \$95 million. This meant that capital expenditure requirements, additional working capital and the like more than exhausted the supply of cash. By comparison, Internet companies have a different cash flow model because they generate cash in a completely different way from traditional firms. Mauboussin and Hiler cited the example of Amazon.com, which incurred a cash outflow from earnings of \$58 million in 1998. However, it generated a cash inflow of \$54 million from investors. Essentially, the company came very close to generating a positive free cash flow for the year.

The traditional concentration upon the profit and loss account may well misdirect attention away from the most important feature of an Internet business. Mauboussin and Hiler considered that it is more important to look at the balance sheet to assess the free cash flow status. In essence, the argument is that, because Internet companies require significantly less investment than traditional bricks and mortar companies in similar lines of business, their free cash flow is higher, which thereby makes higher stock market valuations more comprehensible.

It is fair to say that Mauboussin and Hiler recognised the importance of understanding the business case for an Internet company in assessing value. For example, they referred to an irreversible shift toward a knowledge-based, rather than a manufacturing-based, economy. In simple terms, people, ideas and networks are the sources of competitive advantage for firms in the new economy. With such intangible assets becoming more important than conventional tangible assets, it is considered that it is more important for investors to understand the different cash economics that underpin Internet businesses.

What is very evident is that there are many differing views on how to value Internet businesses. Is it just like placing a bet, or is there more to it ? Time will tell !

References

1 **'A smaller share'**
Coggan, P, *Financial Times* (22 December 1999) p 14.

2 **'Efficient capital markets : a review of theory and empirical work'**
Fama, E F, *Journal of Finance* Vol 35 (1970) pp 383–417.

3 ***Corporate Finance Theory***
Megginson, W L and Megginson, D (1997) Addison–Wesley, p 150.

4 ***Corporate Finance* : *Theory and Practice***
Damodaran, A (1996) John Wiley, p 420.

5 **'The relationship between return and market value of common stocks'**
Banz, R W, *Journal of Financial Economics* Vol 9 (1981) pp 3–18.

6 **'The smaller companies puzzle'**
Dimson, E and Marsh, P R, *The Investment Analyst* No 91 (1989) pp 16–24.

7 **'Size-related anomalies and stock return seasonality : further empirical evidence'**
Keim, D B, *Journal of Financial Economics* Vol 12 (1983) pp 13–32.

8 **'Stock returns and the weekend effect'**
French, K R, *Journal of Financial Economics* Vol 8 (1980) pp 55–69.

9 **'What is the intrinsic value of the Dow ?'**
Lee, C M C, Myers, J and Swaminathan, B, *Journal of Finance* Vol 54 No 5 (1999).

10 **'Stock prices and social dynamics'**
Shiller, R J, *The Brooking Papers on Economic Activity* 2 (1984) pp 457–510.

11 **'Noise trader risk in financial markets'**
DeLong, J B, Shleifer, A, Summers, L H and Waldmann, R J, *Journal of Political Economy* Vol 98 (1990) pp 703–738.

12 **'A model of intertemporal asset prices under asymmetric information'**
Wang, J, *Review of Economic Studies* Vol 60 (1993) pp 249–282.

13 Lee, C M C, Myers, J and Swaminathan, B, *Review of Economic Studies* Vol 60 (1993) p 1694.

14 **'Determining whether a startup is showplace or fixer-upper'**
Fong, K, *Network World* Vol 2 (August 1999).

15 **'Internet firm valuations prove a challenge'**
Lucchetti, A, *Wall Street Journal* (30 November 1998).

16 **'Cash Flow.com : cash economics in the new economy'**
Mauboussin, M J and Hiler, R, *Frontiers of Finance* Credit Suisse First Boston, Vol 9 (26 February 1999).

MANAGER UPDATE

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 020 7920 8486 (or by e-mail to CDJackson@icaew.co.uk).

Manager Update is compiled and edited by Professor Keith MacMillan, Academic Dean and Deputy Principal of Henley Management College.

Feedback

Comments and suggestions should be addressed to Chris Jackson BA FCA, Head of Faculty, telephone 020 7920 8486, e-mail CDJackson@icaew.co.uk, or write to the Faculty at the address below.

This issue of *Manager Update* is produced by Letterfit Publishing Services, Godalming, and printed by Silverdart Limited, London SE1 0LH, on behalf of the Faculty of Finance and Management of the Institute of Chartered Accountants in England & Wales.

Faculty members

Each member of the Faculty in the year of publication will receive one copy of every *Manager Update* published by the Faculty free of charge. Copies are not available to non-Faculty members.

Issues of *Manager Update* published to date are :

Issue 1 :	April 1997	Issue 8 :	February 1999
Issue 2 :	July 1997	Issue 9 :	May 1999
Issue 3 :	October 1997	Issue 10 :	August 1999
Issue 4 :	February 1998	Issue 11 :	November 1999
Issue 5 :	May 1998	Issue 12 :	February 2000
Issue 6 :	September 1998	Issue 13 :	May 2000
Issue 7 :	November 1998		

Any members who have not received the above should contact Chris Jackson at the Faculty using the contact details set out below.

The Faculty of Finance and Management
The Institute of Chartered Accountants
in England & Wales
Chartered Accountants' Hall
PO Box 433, Moorgate Place, London EC2P 2BJ
Telephone: 020 7920 8486
Fax: 020 7920 8784

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

The Faculty's website address is – www.icaewmembers.co.uk