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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.

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ARTICLE SUMMARIES

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MARKETING

Consumer Choice

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Increasingly, organisations are breaking markets down into smaller and smaller segments, targeting individual customers, and customising products and services to provide exactly what customers require. The current focus on customisation signals a trend away from thinking of customers as 'homogeneous' groups and a movement towards an approach that deliberately looks for the differences between customers. The organisation can thus meet customers' needs in a way that their competitors may struggle to achieve with a mass marketing approach.

Advertising has been at the heart of the mass marketing and mass production approach. Companies such as BT and Proctor & Gamble are reported to have spent around £100 million each in 1998 on promoting their brands[1] . Despite this level of investment, there is an ongoing debate about how advertising works and how to measure its success. What are the behavioural and the financial benefits of this investment ? Ambler and Vakratsas[2] state that 'with much advertising expenditure wasted on ineffective campaigns, advertising should be concerned with how advertising affects customers, how it works, in order to formulate more effective advertising strategies'. Indeed, a resolution to this debate would be useful as organisations facing increasingly fragmented markets look to other communication tools to provide tailored messages for specific customers.

Recent research by Huffman and Kahn[3] considers the impact of mass customisation on customer decision making. Whilst advertising campaigns continue to deliver their messages, inside the store the retail experience is becoming more complicated. Huffman and Kahn ask whether the wide variety of products offered by retailers, coupled with attempts to customise products, will 'backfire'. If customers feel confused and overloaded with information they may decide not to purchase at all. Do customers need help to guide them through the options available ? What strategies should the retailer pursue ? Retail strategies are also considered by Beatty and Ferrell[4] ; however, they focus on a different aspect of consumer behaviour, that of impulse buying. They aim to 'provide insights' for retailers into the factors that affect customers' urges to buy on impulse.

Choice and confusion

Retailing strategies have concentrated on providing variety and a wide range of products to the consumer, to accommodate every eventuality. There is a trend towards offering a wide variety 'under one roof' and 'one stop shopping' in, for example, grocery, toy and DIY stores. The aim is to provide huge assortments of products in all categories. Huffman and Kahn state that there can be difficulties with this approach as the wide variety can make it more difficult for customers to make a decision. The information can be overwhelming, and the customer can begin to feel confused, dissatisfied, and unable to select and buy a product.

Retailers are, therefore, not only offering the customer variety and choice, but are also pursuing customisation strategies. Their aim is to provide an exact match with customers' needs and preferences for a particular product. The authors question whether customers are equipped with the necessary skills when faced with the choice and customisation options available to them. They use the example of a sofa shop with a mass customisation approach offering the following choice. '… 500 styles, customers can choose from 3000 fabrics or from 350 leathers. The number of potential options are 150,000 different fabric sofas and 17,500 leather sofas.' The customer faces a major task to digest this information and select one sofa.

Bettman, Luce and Payne[5] also examine consumer choice, stating that prior research has 'assumed that the consumer is rational and makes sensible comparisons and trade-offs based on an assessment of value and utility and preferences'. However, they indicate that in reality consumers have limited capacity to process information. When making routine purchases, consumers have clear preferences, which they have learned and evaluated over time. However, in complex situations, customers do not have this resource to call on and they need to be guided by the retailer.

If the retailer does not help its customers they can become overwhelmed by the need to assess the options, compare them with preferences, consider the attributes, consider any priorities, and then reflect on their original needs. The danger, according to Huffman and Kahn, is that 'the customisation strategy can lead to dissatisfaction rather than competitive advantage'.

The authors suggest that, for consumers to get the most out of the shopping experience, retailers need to control the way information is presented to them. They need to help the customers learn about the attributes of the products and show them alternatives to ensure that they do not become overwhelmed and dissatisfied with the process. The sales assistant helps the customers to learn about their preferences. After this, the consumer is more able to consider the alternatives in the store. Indeed, this confirms the view of Gregory, Lichtenstein and Slovic[6] that 'consumer preference formation may be more like architecture, building some defensible set of values, rather than like archaeology, uncovering values that are already there'. The retailers' role does not end when they supply the 'sofas'; the retailers' job is to make the decisions manageable.

Advertising

At a time when mass marketing is giving way to mass customisation, one of the key components of the 'mass' approach, namely advertising, is analysed by Ambler and Vakratsas[7] . This paper represents a significant undertaking, as it discusses and 'synthesises' generations of research and publications in advertising. This work classifies every important and contemporary theory of advertising in order to establish 'what is and should be known about how advertising affects the consumer' and, thus, 'how it works'.

In the fast moving, dynamic world of advertising, some of the models underpinning the development of advertising strategies have been in place since the end of the 19th century. Mainstream research began with the 'hierarchy of effects models' which date back to 1898. The first model of this type, AIDA (attention, interest, desire, action), assumes that consumers go through a sequence of cognitive (awareness), affective (preference) and behavioural/experience (purchase) stages. Ambler and Vakratsas[8] suggest that these models are too simple as the brain does not work sequentially. Consumers' thinking, processing of information and development of preferences occur simultaneously. Indeed, they say that there is little in their research to support the models which have played such a large part in the development of advertising research.

How advertising affects the consumer

Whilst advertising has been dominated by AIDA and the hierarchy of effect approach, the authors classify the models into seven categories. Each model is a variant on three simple components : cognition, affect and experience (CAE). First, market-based models do not take into account the consumers' thoughts, attitudes and feelings towards a product; they focus on the direct effects of advertising on actual purchase behaviour. Thus the measurement of the effects of advertising can be related directly to outcomes such as sales and market share without the uncertainties caused by those cognitive and affective dimensions, which are more difficult to measure, being considered.

Some models maintain that consumers are rational and that advertisements exist to provide factual information. They assume that consumer preferences are not changed and advertising provides the information consumers need to reduce the time and costs of searching for products. However, others concentrate on the ‘familiarity and feelings that advertising evokes’. These models suggest that consumers are not necessarily rational and do not focus on information about product features. They develop interest or liking based on their response to the advertisement. Indeed, the research shows that advertising does not have to be informative to be effective. Certain advertisements are used to encourage trial of the product and then to build on the experience to reinforce the habit and thus develop loyalty.

These sequential models suggest that consumers always process advertisements in the same way. One alternative is an ‘integrative model’. This approach suggests that the way we think and feel about products is still hierarchical, but the sequence of thoughts, feelings, experiences and behaviours can change. The sequence depends on the consumer’s level of experience, involvement with the products and exposure to advertisements, and recommendations and word of mouth communication. Finally, the smallest group of models focus on the individual; they do not consider hierarchies or sequences. There are three key groups : anthropology, neuroscience and post-modern approaches. The latter is interesting to Ambler and Vakratsas as they suggest that as the brain processes information, thoughts and feelings operate ‘interactively and simultaneously’.

Advertising space

To overcome the flaws of the sequential models, which they believe cannot be supported empirically, Ambler and Vakratsas offer their own model called ‘CAE space’. Instead of ‘boxes’, ‘grids’ and hierarchies, they suggest that cognition, affect and experience should be thought of as continuous dimensions in ‘space’ and not as opposites or alternatives. They also state that customers cannot be separated from their environment, and that the advertiser should also bear in mind the advertising ‘context’. Valuable insights can be gained from advertising history, the level of competition, the product category, the marketing mix, the stage in the product life cycle, and the diverse target market.

Interestingly, Ambler and Vakratsas declare that the effect of advertising on sales has not been proven conclusively. They suggest that advertising has an effect on price, helps to refresh and keep images in the memory, and affects brand equity. Ambler[9] states that ‘good advertising affects brand equity, not necessarily sales’ and that ‘measuring advertising by the effect on sales is a myth whose time to depart has come’.

Impulse buying

There has recently been increased interest in compulsive shopping behaviour, compensatory shopping and impulsive buying habits in consumer markets. Certainly, impulsive decisions taken without regard for the consequences do not seem compatible with the hierarchies, sequences and rational models discussed by Ambler and Vakratsas.

Beatty and Ferrell investigate the nature and antecedents of impulse buying. This area has been researched on a regular basis over the last 30 years, but it has largely concentrated on impulse buying simply as ‘an unplanned purchase’. However, this research provides retailers with insights into the process of impulse buying, the urges and the actions of consumers, and the lack of thought by the consumer about the consequences of the purchase. Beatty and Ferrell define impulse buying as follows :

> *‘A sudden and immediate purchase with no pre-shopping intentions either to buy the specific product category or to fulfil a specific buying task. The behaviour occurs after experiencing an urge to buy and*

> *tends to be spontaneous and without a lot of reflection. It does not include the purchase of a simple reminder item, which is out of stock at home.'*

This extensive research examines the link between a number of variables and the urge to buy impulsively and the actual impulse purchase.

- **Shopping enjoyment** This is pleasure obtained from the shopping process. Does the shopper receive more pleasure from the process of shopping than the actual purchase ? Recreational shoppers are more likely to go on a pre-planned shopping trip without a pre-planned purchase in mind.
- **Impulse buying tendency** Does the consumer have the willpower to deflect the urge to buy, or is the consumer unable to resist the inclination or urge to make impulsive buying decisions on the spur of the moment without concern for the consequences ?
- **Time availability** Time pressures tend to reduce unplanned purchases, whilst consumers with more time to browse and search have more opportunities to purchase.
- **Money available** Does the availability of extra financial resources affect impulse purchases, or would the consumer buy regardless of the resources and the repercussions ?
- **In-store browsing** This is done for information or recreation. Browsing can lead to a number of positive feelings such as enthusiasm, concentration and engagement. It can also lead to negative feelings of distress, mood swings, guilt and fear. Thus an impulse purchase can be a means of enjoyment or an attempt to relieve depression.

If retailers wish to captivate the impulse buyer, they need to exploit the shopping environment and develop links between browsing, the 'urges' and the impulse purchases. In practical terms, retailers need to target the 'impulse shopper', to make the most out of the time available, and to provide incentives which encourage shoppers to spend time in the store. They need to pay constant attention to in-store displays, customer service, promotions, lighting and events.

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HUMAN RESOURCES MANAGEMENT

Managing Human, Social and Intellectual Capital for Competitive Advantage

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Human resource architecture

Modern human resources management (HRM) has tended to adopt a common approach to managing the human resource, an approach encouraged by the 'best practice' movement. Typically, this has centred on achieving high commitment and involvement from all employees. However, Lepak and Snell[1] argue that there is no single best practice and that there may be a justification for different human resource (HR) approaches within an organisation.

They focus on the 'make or buy' decision, that is, the decision as to whether a firm should develop and employ people from within (and gain the benefits of stability, co-ordination, control, and lower transaction costs), or whether development and employment should be externalised (to achieve reduced costs, flexibility, innovation, and a focus on core capabilities). This is not seen as an 'either/or' decision; there are various routes to competitive advantage based on first identifying the type of human resource involved, and then developing appropriate systems of staffing, training, appraisal and reward practices.

The key initial step for Lepak and Snell is that the organisation should identify both the value and the uniqueness of its human resource, or 'human capital' as they prefer to call it. Value is measured in terms of its potential contribution to competitive advantage or the core competence of the firm. Employees can add value if they can help firms to offer lower costs or provide increased benefits to customers. Uniqueness is the degree to which skills are specific to a firm. These two criteria form the foundation for developing an organisation's HR 'architecture', or framework.

From these elements Lepak and Snell develop a four-quadrant model, which allows an organisation to decide whether to internalise or externalise development and employment decisions, according to the type of people it employs.

- **Developing human capital** High value and high uniqueness employees are 'core' employees who are a source of competitive advantage. Accordingly, they should be developed internally. The employment relationship should emphasise the significant mutual long-term investment in developing critical firm skills and participation in decision making. The HR configuration is based on securing commitment through involvement, career development, and pay systems based on learning and teamwork.
- **Acquiring human capital** High value and low uniqueness employees are widely available throughout the market and, therefore, organisations may buy human capital that does not require further investment. These employees are less committed to the firm and more focused on their career. Accordingly the HR configuration is market based, emphasising recruitment and the immediate deployment of skills. Hence little training or development is offered and it is vital to pay a market wage which reflects the value of transferable human capital.
- **Contracting human capital** Low value and low uniqueness labour is a commodity. Employment costs may be decreased by contracting externally where jobs contribute little to competitive advantage. In addition to a 'contracting' employment mode, the employment relationship will be transactional, focusing on short-term economic exchanges, with limited organisational

involvement. The HR configuration focuses on compliance, and conformity to standards, with limited training or development, and job-based rewards.

- **Creating human capital alliances** Low value and high uniqueness human capital is not essential in creating customer value. Therefore, this employment mode is a hybrid which blends internalisation and externalisation. The employment relationship is a partnership, requiring information sharing and trust between both parties to the alliance. The HR configuration is collaborative, rewarding co-operation and information sharing, and there is a tendency to invest in the relationship itself rather than the partner, for example through training in process facilitation skills and team building.

A number of implications arise for the organisation :

- It must be clear about the contribution of its (different) employees to its competitive advantage.
- It needs to manage the entire HR architecture as well as its components.
- It must recognise that it needs to manage both current and future forms of human capital.

The organisation will face issues of complexity and dynamism. Competitive advantage may demand a complex HR architecture, and if the competitive environment is dynamic the value and uniqueness of human capital will change and evolve. How does an organisation manage these issues ? Part of the answer to this question lies in the management of its social and intellectual capital, and also in its ability to learn, from both its own experience and that of other organisations.

HRM processes as a source of competitive advantage ?

The development of tacit knowledge is one route to developing competitive advantage, since it is difficult to replicate. This argument is developed by Amit and Belcourt[2] with regard to human resource management processes. 'Rooted in a firm's culture and social norms, yet strategically oriented, HRM processes are deeply-embedded, firm specific, dynamic mechanisms by which a firm attracts, socialises, trains, motivates, evaluates, and compensates its human resources.'

They contrast their process view, which focuses on the 'how' and not the 'what', with the two existing theories which consider the contribution of HRM to a firm's performance. They argue that the 'human capital view' is 'static', and also that human capital itself is extremely difficult to value. Furthermore, the 'best practices' perspective suffers from a focus on activities, and there is no universal set of best practices that can be recommended to a particular firm. They state that HRM processes can be firm-specific 'transformational mechanisms' that allow information exchange and decision making. They are dynamic, path-dependent, and largely tacit processes which can lead to a productive, flexible and creative workforce.

This approach recognises the potential strategic role of HRM processes in gaining competitive advantage, and also the need to make HRM decisions that balance the internal and external perspectives. In this view, the HR practitioner needs to consider the HR processes as an integral part of the social and intellectual capital of an organisation. However, questions remain regarding the selection of particular HR processes, that is, by what criteria should an organisation choose one HR process over another ?

Developing learning capability

Another approach to managing current and future human capital needs for competitive advantage is to focus on organisational learning. Fulmer, Gibbs and Keys[3] argue that the challenge is to use existing learning tools for new purposes, and also to develop other learning tools to increase corporate competitive advantage. They report on a study which identified four categories of learning tools, and on examples of particular tools which can be used for each type :

- **Maintenance tools** are predominantly used for 'creating agreement' strategies. Examples are employee suggestion schemes, internal management development, statistical process control, and benchmarking.
- **Anticipatory tools** are mainly used for 'creating the future' strategies. Examples are decentralised strategic planning, scenario analysis, joint ventures and strategic alliances, external management development, and the Delphi method.
- **Crossover tools** are used equally for creating agreement or creating the future. Examples are group software, internal management development, and taskforces.
- **Utility tools** are applied across all strategies. They include customer surveys, external advisory groups, and content analysis, which identifies and tracks current issues.

They also identify five 'new' tools associated with organisational learning :

1. dialogue (leading to shared meanings and common thinking processes);
2. the Merlin exercise (visualising a future state and working backwards to identify the route to it);
3. action learning;
4. practice fields (to promote experimentation and risk taking);
5. knowledge management (including the use of database technologies and learning histories).

Whilst these issues are important it is necessary to ask 'are these tools really 'new' and is there something 'deeper' that an organisation needs to address to promote learning capability ?'.

Overcoming organisation learning disorders

Snyder and Cummings[4] develop a framework for identifying and overcoming barriers to learning in an organisation. They argue that organisational learning comprises four interrelated processes :

1. discovery;
2. intervention;
3. production;
4. generalisation.

For Snyder and Cummings, specific problems tend to occur in each process.

1. *Discovery*

Discovery is the process of defining and setting organisational objectives and performance standards, and then comparing them with current outcomes. The problems are 'blindness' (failing to see opportunities or problems) and 'projection' (distorting what is seen). They affect the development of the organisation's learning agenda and all other learning processes, leading to insufficient organisational knowledge and competence.

Discovery disorders should be addressed by clarification of visions of what is possible, facilitation of the ability to discover opportunities, and alignment of personal and organisational goals. Specific interventions may include promoting dialogue through team building, exposing members to environmental influences such as the demands of customers and suppliers, and using events to uncover and assess mental models.

2. *Intervention*

Intervention is the process of analysing performance gaps and developing solutions to address them. The problems are ‘simple-mindedness’ (deficiencies in the perceptual maps that organisation members use to guide analysis and to generate solutions) and ‘multiple personality disorder’ (a lack of co-ordination between multiple, competing perspectives). These disorders may result in deficiencies in organisation knowledge, ineffective plans, unimaginative or ineffective solutions to persistent problems, or infrequent or unsuccessful innovation.

Intervention disorders may be overcome by helping members to ‘complicate themselves’ and understand the ‘complexity of their competitive environment’. Interventions may include dialectical decision-making processes, cross-functional teams, decentralised or parallel structures, conceptual and experiential training to develop reasoning and enquiry skills, groupware technologies, and community-building.

3. *Production*

Production is the process of taking action to implement solutions which address performance gaps. Potential problems are ‘paralysis’ (the inability to act) and ‘alien hand syndrome’ (a disconnection between intentions and expectations, and uncoordinated or unintended actions). These may be manifested as an inability to act on ideas, risk aversion, or lack of experimentation.

Production disorders may be tackled through experiential learning, the encouragement of innovation, experimentation and risk-taking by avoidance of rigid controls, a search for modest change projects, and the creation of micro-worlds where members can learn the consequences of their actions within simulated yet realistic environments.

4. *Generalisation*

Generalisation is the process through which organisations evaluate their experience, document the results, and encode them through organisation routines, conceptual maps, and social norms. The potential problems are ‘amnesia’ (inability of the organisation to monitor, document, encode, or disseminate its experiences and results) and ‘superstition’ (inaccurate interpretation of the meaning of experience). These disorders affect what is learned and the extent to which organisational knowledge is disseminated.

Generalisation disorders require interventions to help members to remember what works and to forget knowledge that does not work. Examples are ‘groupware’ or database technologies, interpersonal networks, the sharing of lessons, training in reasoning skills, and communities of practice.

The significance of social relationships

Perhaps the most profound response to the issues of managing the human resource to meet current and future organisational needs, and of promoting organisational learning, lies in a new understanding of the importance of relationships. Nahapiet and Ghoshal[5] and Tsai and Ghoshal[6] consider the importance of relationships to the development of social and intellectual capital, and the link between these and competitive advantage.

Nahapiet and Ghoshal argue that ‘increasingly, the special capabilities of organisations for creating and transferring knowledge are being identified as a central element of organisational advantage’. Their view of organisational advantage is a fundamentally social one. In it, organisations are institutions which are conducive to the development of social capital. Moreover, the development of intellectual capital, which underpins organisational advantage, goes 'hand in hand' with the development of social capital.

They define social capital as follows. '[It is] the sum of the actual and potential resources embedded within, available through, and derived from the network of relationships possessed by an individual or social unit. Social capital thus comprises both the network and the assets that may be mobilised through the network.' It has three dimensions :

- **structural** : the overall patterns of connections between people;
- **relational** : those assets created and leveraged through relationships, and especially through trust, norms, expectations, and identification;
- **cognitive** : those resources providing shared representations, interpretations, and systems of meaning among parties.

Unlike with other forms of capital, no one has exclusive rights to social capital. It increases the efficiency of action, by improving information dispersion, and it facilitates creativity and learning through encouraging co-operation. It also facilitates the development of intellectual capital (the 'knowledge and knowing capability of a social collectivity') by providing the conditions necessary for any resource creation – those of exchange and combination.

Nahapiet and Ghoshal argue as follows. 'Differences between firms, including differences in performance, may represent differences in their ability to create and exploit social capital. Moreover, at least regarding the development of intellectual capital, those firms developing particular configurations of social capital are more likely to be successful.'

Social capital and product innovation

Tsai and Ghoshal examined the relationships between dimensions of social capital and product innovation within a large multinational electronics company, and found support for the argument that social capital facilitates value creation. They considered levels of 'social interaction', 'trustworthiness' and 'shared vision' as dimensions of social capital, and found that these had significant effects on resource exchange and combination. In particular, they found that trustworthiness was significantly associated with both social interaction and shared vision, and that social interaction and shared vision had positive effects on trustworthiness, but, surprisingly, that there was no significant relationship between social interaction and shared vision. They highlight the importance of intra-firm networks in relation to organisational performance. They demonstrate that social capital influences the number of product innovations per year at business unit level.

Tsai and Ghoshal argue that their analysis does the following. '[It] suggests that investing in the creation of social capital inside a firm eventually creates value. Informal social relations and tacit social arrangements encourage productive resource exchange and thereby promote product innovations.' They also argue that their findings are consistent with recent developments in strategy literature that assert that organisational advantage can be achieved through resource sharing among different organisational units. The question now is 'how can social capital be created ?'. The answer is both simple and challenging. To develop one form of social capital is to reinforce the other forms. At the same time, the creation of social capital is not a 'quick fix'. Nahapiet and Ghoshal recognise that the development of social capital requires a very significant investment, in terms of both cost and time.

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STRATEGY AND ORGANISATION

Corporate Restructuring

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This issue of *Manager Update* reviews recent work on corporate restructuring. Over the last decade or so, there has been frenetic activity within the corporate sector in the area of corporate restructuring. The impact of industry consolidation, deregulation of markets, globalisation of brands and convergent technologies across industry boundaries has caused companies not only to change their strategies but also to make major, and in some cases repeated, changes in their organisational structure. This preoccupation with restructuring, fuelled no doubt by the large consultancies, reached new heights in the mid-1990s with the re-engineering wave, propelled in many cases by the adoption of computer-based enterprise resource planning systems such as SAP.

When does restructuring improve performance ?

Some of the changes undertaken in the name of corporate restructuring have in fact proved to be very painful, not least to the employees most closely involved, who ended up as the prime casualties of restructuring. Thus the question is 'has it all been worthwhile ?'. Edward Bowman and his co-authors have recently reviewed a number of studies which have tried to correlate restructuring with economic performance. Overall, their investigation covers some 52 studies reporting data from 5,000 firms[1] .

In seeking to address the question of whether restructuring improves economic performance, the authors distinguish three different types of restructuring :

- **Portfolio restructuring** This consists of making additions to or disposals from companies' businesses, for example through acquisitions or spin-offs.
- **Financial restructuring** This changes the capital structure, for example through leveraged buyouts.
- **Organisational restructuring** This involves, for example, a change from a functional design to a business-unit design.

For each of these types of restructuring, the authors have attempted to investigate the impact on market performance (that is, whether there is any abnormal movement in the firm's stock price after the announcement of such a restructuring event) and on accounting performance (measuring changes in earnings before and after the restructuring over a period of years).

The conclusions of the study make for interesting reading. The type of restructuring which is most likely to result in an improvement in performance, and by the greatest margin, is financial restructuring. Much of the evidence for this contention is based on studies of leveraged buyouts of companies, particularly management buyouts. The authors believe that the evidence from these studies supports the argument that leveraged buyouts result in increases in free cash flow, improved operational efficiency, and a greater focus on the company's core business. The causes of the improvement following financial restructuring are reportedly benign and cannot be attributed to lay-offs of employees; rather, the increased efficiency of operations coupled with improved control of capital expenditure seems to account for much of the difference.

Interestingly, leveraged buyouts which involve divisions of companies seem to display larger improvement gains than corporate leveraged buyouts. On the other hand, the authors do enter a caveat, as the risk of bankruptcy and financial disaster with leveraged buyouts seems to be greater. Moreover, leveraged buyouts appear to under-invest in long-term assets where the risk is greater.

Portfolio restructuring also has a high probability of improving performance, although the performance gain is likely to be much more modest than with financial restructuring. According to the authors, by far the greatest improvement comes from spinning off parts of the business, followed by trade sales, whilst acquisitions and divestments generate no improvement in performance on average. It seems that selling off parts of the business can improve financial performance, but this is particularly the case if, as a result, the company gains in focus and the disposed-of asset is acquired by a company with a similar industry background.

The spinning-off of divisions can also improve performance, particularly if the spun-off division is subsequently acquired by another company, and if the proceeds of these sales are used to reduce debt in the parent company or to distribute dividends to the shareholders. Significantly, the authors believe that aggressive buying and selling of companies, at least in the period covered (which from observation seemed to be skewed towards the 1980s), yielded returns slightly below the returns realised from no transactions.

The real surprise is the poor performance of organisational restructuring. Overall, positive improvement was generated by organisational restructuring in only half the cases, and the mean impact on performance was actually negative. Organisational restructurings generally have a favourable impact on shareholder value, although stock market performance depends to some degree on the credibility of the company, the way in which organisational restructuring is presented, and the view of the markets as to whether the changes are part of a broader well conceived strategy or an indication of financial distress. Similarly, the impact on earnings performance following restructurings is not generally favourable, mainly because of the increased costs associated with the process of organisational restructuring.

There are limitations to this survey. There is hardly any mention, for example, of studies specifically related to re-engineering. The studies on financial restructuring seem to be rather narrowly focused on leveraged buyouts, and it would be good to delve more closely into the data on mergers and acquisitions. That notwithstanding, it is impossible not to be impressed by the relatively meagre performance of portfolio and organisational restructuring. However, of course, as the authors point out, we do not know what would have happened to the companies had they not restructured. In any case, faced with the major changes in their business environment alluded to at the start of this article, it is difficult to argue that companies could simply remain the same.

Breaking up is good to do

McKinsey and Company also argue that restructuring can create shareholder value. Coincidentally, Patricia Anslinger and her co-authors[2] , in common with Bowman *et al.*, cite the case of AT&T to prove their point. They argue that through spinning off Lucent Technologies and NCR, AT&T more than doubled the combined market capitalisation of the companies within little more than a year. These authors looked at three forms of financial restructuring :

- **Tracking stocks** A parent company issues shares which track the earnings of a divisional subsidiary (for example General Motors and EDS).
- **Equity carve-outs** A public offering is made of shares in the subsidiary, but the parent retains majority ownership.
- **Spin-offs or demergers** The entire ownership of the subsidiary is divested.

All such restructuring is likely to involve costs (both transaction and overhead costs). Thus, McKinsey estimates that the average transaction cost for a spin-off or tracking stock is likely to be around 2%. In addition to these transaction costs, there are also the ongoing costs of retaining multiple governance structures and subscribing to additional reporting requirements. Despite these costs, McKinsey believes that the risk involved in such restructuring is generally exaggerated, whilst the performance of these vehicles has generally out-performed the stock market as a whole. Most of the benefit, they believe, comes from increased transparency and greater accountability, which in turn leads to improved operating performance and better coverage by financial analysts. Such restructuring can also attract new investors with different risk/return profiles, who may find the shares in the new entity more to their taste than those of the parent company as a whole.

When to restructure

Anslinger *et al*. produce a number of test questions for management to pose when considering whether to 'desegregate' or not. They include the following :

- Are the parent and its subsidiary operating in separate industries ?
- Are the growth rates between the parent and subsidiary divergent ?
- Do financial analysts make separate mention of the subsidiary's future prospects ?
- Is there any evidence of key employees being lost to smaller competitors as a result of the subsidiary being subsumed within a larger, more amorphous whole ?

Anslinger *et al*. also give some tips on which of the vehicles is likely to be the most appropriate in specific cases. Thus spin-offs make sense if the subsidiary is a supplier to the parent and this prevents the subsidiary from developing a market with the parent's key competitors. Selling a stake in a company, on the other hand, may be the most suitable choice if the company requires better access to capital. Alternatively, tracking stocks may be appropriate if a subsidiary can take advantage of its parent's lower cost of borrowing to finance its operations, or if one or other of the entities can offset taxable profits against operating losses.

Unbundling the corporation

Hagel and Singer take an altogether broader look at restructuring[3] . These authors (who are also from McKinsey) believe that once one looks beneath the surface of most companies, it is possible to detect three different types of business :

- **Customer relationship management** In this type of business, the main objectives are to identify and attract potential customers, maintain and build relationships with them, and sell them as many different services and products as possible. The economic principle governing this type of business is that of economies of scope. The culture of the organisation is likely to be highly geared to satisfying customer needs, and because of the needs for economies of scope it is possible that in the future only a few large players will dominate in each field.
- **Product innovation** This type of business is dedicated to thinking up new ideas for products and bringing them to the market. The economic principle governing such organisations is likely to be speed to market, as first movers will enjoy price premiums and be able to establish themselves in the marketplace. Such organisations will be focused more on retaining employees than customers, particularly the talented employees who come up with the creative new ideas, and it is likely that because small organisations are inherently more creative, many small entities of this nature will be able to survive.
- **Infrastructure management** This type of business is engaged in setting up the facilities and processes needed for high volume, repetitive operations. Because of the high, up-front costs of

capital investment and the high overhead cost of running such operations, economies of scale will be important. The culture will tend to emphasise cost efficiencies and standardisation, and because of the needs for scale, only a few large players will ultimately survive.

Hagel and Singer believe that in large organisations these three different types of business sit uneasily together. Their need for scope, speed and scale, respectively, makes it difficult for them to be optimised simultaneously. As a result, trade-offs have to be made which mean that one or other of the businesses is operating sub-optimally. They believe that, in the future, large companies will increasingly unbundle along these 'fault lines'. Thus, in a typical newspaper operation, the product innovation will increasingly be outsourced to specialised news services, whilst the production of print will be carried out by specialised printers. This will leave the newspaper to concentrate on customer relationships, targeting particular types of consumer and enabling advertisers to target specific market segments.

Because of the low transaction or interaction costs, Hagel and Singer believe that the Internet provides us with a working model of how industry will develop in the future, with companies such as Yahoo! acting as a so-called info-mediary, acquiring, storing and selling information about customers, whilst other smaller innovative companies provide new products, for example software and search engines, and a few large players such as America On-Line provide the infrastructure management.

Hagel and Singer predict that in future we shall witness an unbundling of large organisations which will dwarf previous reorganisation attempts. 'The secret to success in fractured industries is not just to unbundle, but to unbundle and rebundle, creating a new organisation with the capabilities and size required to win', and in the process no doubt providing rich pickings for consultancy companies such as McKinsey !

Conditioned emergence

If organisations are going to be compelled to engage in this radical unbundling, then more work will need to be done on the process of business transformation. Mackintosh and MacLean[4] have developed a new approach to major organisational change based on a variant of complexity theory. Over the last couple of years, we have discussed the implications of complexity theory on strategy many times (see, for example, references 5–8). Mackintosh and MacLean have adopted a specific variant of complexity theory which they refer to as 'conditioned emergence'. This approach, which they contrast with the 'edge of chaos' variant of complexity theory, focuses on so-called 'dissipated structures'.

Mackintosh and MacLean say that whilst the process of change is difficult to control, it does exhibit certain common patterns or characteristics, and is subject to managerial intervention. Organisations undergoing transformation, they maintain, experience a common sequence of events. In stage 1, the organisation is moved out of its existing equilibrium state. In this stage, the organisation has to identify a so-called 'deep structure' which the authors define as 'a quasi-permanent invisible substructure which remains largely intact whilst manifest observable structures break down'[9].

This concept of the deep structure, which can be operationalised in the form of a set of simple rules about desirable or undesirable behaviour, seems to be close to Bettis and Prahalad's concept of dominant logic[10]. In order to effect substantial change during stage 1, these rules are surfaced and a new deep structure is then constructed which may or may not consist of some of the older rules. In stage 2, so-called 'far from equilibrium' conditions are created, conceivably by a major restructuring exercise, although to judge from the evidence which the authors present in their article, companies should be cautious about putting too much reliance upon such devices as Business Process Re-engineering and Total Quality Management. As a result of this process of moving away from the equilibrium, organisations should become more open and adaptable to change. In stage 3, the organisation must manage the feedback processes, as in this stage there is a danger that the organisation could revert to the old equilibrium. It is therefore important that, through management action and the use of symbols in communications, positive reinforcement is given to signs of the emergence of new rules developed in the previous stages. The authors propose the three-stage model of business transformation as a way forward for strategy which reconciles conflicting schools of thought which emphasise, respectively, strategy process or strategy content.

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ACCOUNTING AND FINANCE

Is Shareholder Value Dead ?

Roger Mills is Professor of Accounting and Finance at Henley Management College, and Consultant Professor to PriceWaterhouseCoopers on Shareholder Value.

In a recent issue of *Manager Update*, my colleague Ian Turner observed that 'if the current glut of articles on options theory is to be believed, shareholder value is out and options theory is in'[1] . There is little doubt that options theory has come of age but, as I will illustrate, the issue of shareholder value is alive and kicking.

Shareholder value trends

Reference to the popular press provides many illustrations of the pursuit of strategies focusing upon shareholder interests[2] . In February, a number of UK banks announced buyback programmes. These were surpassed on 23 February by the £5 billion ($8 billion) special dividend from Unilever, which was in effect a sum equal to over 10% of the company's market value. This was the biggest one-off handout by any company anywhere.

Buybacks, special dividends and the like are typically the result of an increased awareness of the potential benefits of restructuring the balance sheet to take on proportionately more debt. As Modigliani and Miller demonstrated many years ago, enormous potential value can be gained from using cheaper debt funding as opposed to equity. In simple terms, if we consider the value of a firm to be represented by its prospective future cash flows discounted at the cost of capital, anything that reduces this cost of capital will increase value. Shareholder value models are powerful in demonstrating the impact of changing the capital structure upon business value.

Of course, one might ask 'why change the capital structure by giving money back to the shareholder ?'. Why not invest it in business opportunities or acquisitions ? The simple answer is that many such opportunities may just be far too expensive, and, in the case of many companies, particularly those from continental Europe, the need to consider restructuring their balance sheets by taking on more debt is seen as an imperative, irrespective of alternative prospects. The one problem with taking on more debt is that it is fine when times are good, but what about when times are bad ? Some companies might find themselves with significantly higher interest rates on their increased debts, and some might have to cancel capital investments.

In the USA, the application of shareholder value analysis and value-based approaches has attracted attention in some very controversial areas, such as the valuation of Internet stocks. For example, Amazon.com, the online bookseller, is currently valued at $20 billion, even though it has never made a profit; the Internet portal Yahoo! owns almost no assets and yet commands a value larger than the aircraft manufacturer Boeing, and the auctioneer eBay is valued at 2,000 times prospective earnings estimates[3] . Internet stocks are among those often cited as being appropriate for options-type valuation modelling, but there are those who are making a fairly powerful case for assessing their value using shareholder-value type frameworks[4] . Mauboussin and Hiler illustrate how the free cash flow framework associated with shareholder value can be used to understand the value of Internet stocks. In effect, they demonstrate that such companies have cash economics that are superior to those of their so-called 'Old Economy' counterparts, although they generate cash in a totally different way. They cite the example of Amazon.com, which incurred a cash outflow from earnings of $58 million in 1998. However, it generated a positive cash inflow of $54 million from investments, thereby coming close to generating a positive free cash flow. Such analysis is argued to demonstrate the importance of looking at both profit and loss account and balance sheet effects, as it is free cash flow (the sum of a firm's earnings and investments) that drives shareholder value creation. If analysts follow conventional practice by focusing upon the cash earnings of a business, this may well understate its real free cash flow potential.

Shareholder value in continental Europe

Much attention is being directed towards the issue of shareholder value within the context of continental Europe, where in many countries there has been a tradition of greater concern with a broader stakeholder perspective. *Fortune* commented as follows :

> *'The Euro isn't the only change rocking European business. Two decades after the US, the Old World's blue chips are finally getting the shareholder-value religion.'* [5]

According to *Fortune*, the combined forces of deregulation, globalisation and the recession of the 1990s had demonstrated Europe's productivity shortcomings. With the liberalisation of financial markets, privatisations of $200 billion, the demand for capital and the introduction of the Euro, CEOs in Europe are having to justify their strategies to the providers of funds, an increasing number of which hail from the USA. In fact, since 1990, the number of European companies listed on the New York Stock Exchange has quadrupled to 137, and many are very big players.

Nokia is quoted as a good example of one company that has adopted the shareholder value ethos after a long period of having previously put it on the shelf. Nokia's refocusing did not come until it had suffered through huge losses, haemorrhaging sales, a capital famine, a management takeover, and exposure to the demands of Wall Street. Arguably, the same revolution will occur in other companies which will doubtless face the sort of crises Nokia suffered in the early 1990s.

Whilst the shareholder value movement in continental Europe gains momentum generally, there are some markets where the pace of change is noteworthy. Germany, in particular, has been identified as one important European market in which shareholder value is truly coming of age[6]. By all accounts, the Deutsche Telekom privatisation inspired a lively investor culture in a country where it had hardly existed before. Corporates are responding by pursuing strategies, in mergers and acquisitions, portfolio management, balance sheet restructuring, capital raising and investor relations, that focus on pleasing their shareholder base.

In fact, changes to German share buyback legislation in 1998 were a major contributor to some of the value creating initiatives that have been adopted. After extensive lobbying by some of the larger companies, the government sanctioned in May the buyback by companies of up to 10% of their registered share capital over an 18 month period. There followed a six month period of uncertainty with respect to the tax position of shareholders in such circumstances, but, having resolved that issue, the pharmaceuticals group Schering undertook a buyback and BASF followed suit.

In such environments, the role of the CFO is going through a transformation. Traditionally, the CFO was the conduit for control work and was heavily involved in treasury matters. Today, the CFO in Germany is more likely to be involved with the CEO in restructuring and planning, cost of capital analysis, investor relations, funding techniques and portfolio matters.

Shareholder value emerging metrics : cash flow return on investment

New metrics continue to attract much attention, as evidenced by the publication of a number of books and articles on cash flow return on investment (CFROI)[7].

CFROI has attracted considerable interest in recent times and has a well established track record in the

USA. For example, the large US chemical company Monsanto has been using the approach for some time[8]:

> *'Our objective was to put in place a system of economic based metrics that correctly measures shareowner value and that drives decisions so that shareowner wealth is continually enhanced over time. We selected Economic Value Added (EVA) as Monsanto's overall metric. The EVA financial management system will be supported by Total Business Return/Cash flow Return on Investment (TBR/CFROI) at the planning level.'*

Cash flow return on investment compares the cash flow to all of the firm's owners with the total assets employed to generate those cash flows[9]. CFROI is an inflation-adjusted measure of corporate performance, calculated in the same manner as an internal rate of return. It entails comparing real returns with the real cost of capital, in contrast to the other approaches, which are expressed in nominal terms.

The essence of CFROI is to look at cash-in versus cash-out, much as in a capital project appraisal. CFROI is intended to measure the performance of a business from the investor's point of view because it looks at what the cash investors have put in versus the amount they are getting out. It can be used to give a cross-sectional measure of returns and as a valuation method.

The proponents of this approach argue that it is preferable to other approaches because it does not focus upon the measurement of the difference between a calculated return on capital, which is reliant upon accounting principles and practice, and an estimated cost of capital. The suggestion by its supporters is that even when other measures have been adjusted to convert them from accounting to cash flow numbers they are still not comparable. This is because, as they are based upon historical cost accounting, such measures suffer from the effect of non-zero past inflation rates on accounting statements, and these effects vary widely across companies and countries.

It would be fair to say that CFROI is not without its critics, both with respect to some of the premises of the approach and the extent to which it can be implemented to facilitate the management of the business. Nevertheless, there is little doubt that is being taken very seriously by a number of companies, analysts, fund managers and advisors.

Shareholder value and cost management

One very important extension of shareholder value is the linkage that has been established between one of the popular shareholder value approaches and activity based costing (ABC).

The notion that one should try to account for value is not new, but the attempt to link the principles of shareholder value with cost management issues is. To this end, one significant development has been the recognition that ABC analysis can be improved by incorporating it with the concept of Economic Value Added (EVA). So what are ABC and EVA ?

Activity based costing

One of the most prominent developments in management accounting in recent times has been activity based costing, popularly known as ABC. According to traditional cost accounting practices, costs are allocated by applying judgement, for example the allocation of rent and rates on the basis of floor space occupied. Once all such overheads have been allocated, they are apportioned to products or services on the basis of, say, labour hours. Such traditional practices have long been viewed as being of little use today, where often the relationship between costs and the activities that drive them is much more difficult to see. As a consequence, an approach which attempts to relate costs and activities, activity based costing, emerged in the 1980s as an alternative to traditional approaches.

ABC assumes that activities cause costs to be incurred and that products (or other selected cost objects, such as customers) consume activities in varying amounts. A link is made between activities and products by assigning the cost of activities to products on the basis of an individual product's demand for each activity.

Economic Value Added

The theory of Economic Value Added is very simple, and it is that, to be economically justifiable, an investment must earn at least its cost of capital. EVA (which is a Stern Stewart registered trademark) is computed by multiplying the difference between the return on capital and the cost of capital by the invested capital. It is the residual income that remains after operating profit covers a full return on capital employed, that is, profit in excess of the cost of capital. According to EVA thinking, the objective is to ensure that the business generates a return in excess of the cost of capital; otherwise value is destroyed. This can equate with operating the business to achieve a greater efficiency on existing capital, and better cost and capital management to give higher profits, divesting parts of the business that will not return their cost of capital in the long term, and growing the business when the return on new investment exceeds the cost of capital.

Linking EVA and ABC

An explicit link between ABC and EVA has now been provided[10] . The ABC-based EVA of a product can be estimated using the following formula :

ABC-EVA = revenue – [ABC cost + (capital employed × cost of capital)].

The EVA extension to ABC looks very simple and requires that the capital employed for each product (or other cost object) be determined, and that a risk-adjusted rate for that capital be identified. The practicalities are more difficult, but there is little doubt that there are benefits to be obtained in linking EVA with ABC, as has been demonstrated with reference to a two-product situation. Consider the following example. Product 1 sells for £100, and has an ABC cost of £30, but requires capital employed of £100. Product 2 also sells for £100, and has an ABC cost of £30, but it requires capital employed of £1,000. If the cost of capital is 10%, then the first product has a positive EVA of £60 (100 – (30 + [100 × 10%])), whereas the second has a negative EVA of £30 (100 – (30 + [1000 × 10%])). While product 1 creates wealth, product 2 destroys it, but both have the same £70 ABC profit.

The integration of ABC and EVA focuses attention upon the economic return of products, customers, and channels, as well as rewarding the more efficient use of capital. That is not to say that there are no practical problems. As anyone who has worked with EVA and other valuation tools will know only too well, the allocation of capital is fraught with all sorts of problems, as is the estimation of the cost of capital at business unit level, let alone product level.

How can the approach be applied ?

One way in which the linked approach could be applied is in deciding how to use or allocate capital employed. At the product and customer level, there are three ways in which capital can be employed more efficiently.

1. First, the assets can be used to support a different product or customer mix. For example, if a machine is used to produce an equal volume of the two products described above, it will generate an EVA of £30 (£60 – £30) for every pair of products that it produces. If the mix can be changed to 100% of product 1, then the EVA for a pair of products climbs to £120 (£60 × 2).

2. Second, dedicated assets that are no longer required can be sold and the capital used for new investment purposes that have a higher EVA.
3. Third, additional assets that are required to support the new product or customer mix can be acquired.

Linking shareholder value with management accounting : future prospects

The link between management accounting and the currently popular valuation approaches will doubtless attract much more attention. Research currently under way seems to confirm this view. For example, a well respected UK academic, Michael Bromwich, has provided a research-oriented appraisal of value-based financial management systems. As he argues, management accounting in the last two decades has been faced with increasing challenges to adopt new approaches designed to correct perceived inefficiencies in existing management accounting systems. The essence of value-based approaches is their seeming simplicity and, what is more, value-added approaches, with the objective of maximising market value, can be taken down the organisation[11].

Stakeholder revival in UK

Last, but not least, it is worth noting that the issue of the stakeholder has been revived. A wide sweeping review of company law in the UK is set to re-open the debate about the relationship between business, shareholders and the wider community[12]. The 200-page consultation paper compiled by a high-level steering group puts greater emphasis on the needs of stakeholders alongside those of shareholders. At the heart of the committee's analysis was a recognition that companies should have a proper inclusive relationship with stakeholders that could include employees, customers, suppliers and local residents, as well as shareholders. It will be interesting to see how the proposals progress.

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