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PREFACE

This Faculty publication is produced in parallel with the Braybrooke Press publication of the same name. Accordingly, references in the text to issues of *Manager Update* prior to April 1997 relate to the Braybrooke edition.

Manager Update helps the general manager keep abreast of the latest articles in specialist management journals. The most useful ideas in the fields of Strategy and Organisation, Marketing, Accounting and Finance and Human Resources Management are carefully selected from a wide range of publications with the busy general manager in mind. Experts in each field explain and discuss the relevance, practicality and usefulness of the key new concepts and ideas, thus enabling the senior executive to keep really up-to-date.

The articles represent the personal views of the authors and not necessarily those of their organisations or of the Faculty. The nature of some subjects will preclude the articles from being definitive or mandatory. Being general in nature, the points made in *Manager Update* may or may not be relevant to specific circumstances.

The Faculty committee intends that *Manager Update* will act as an aide-memoire for members, provide new ideas, and encourage good practice, but cannot accept responsibility for their accuracy or completeness. Responses from the membership will be a very important part of the successful development of the series. Comments please, to Chris Jackson on *0171-920 8486*. (or by e-mail to CDJackson@icaew.co.uk)

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ARTICLE SUMMARIES

Marketing *Consumer Behaviour and Emotions*

Traditionally, marketers have tended to assume that consumers behave rationally when making their purchases. But what are the implications if they often behave irrationally? Recent research is exploring the impact of emotions in consumer behaviour. Emotions may be influential before, during and after making a purchase; and a mix of both positive and negative emotions may be involved. This could demand that marketers rethink the implications for repeat purchases, lifetime values and the importance of word of mouth communications among consumers. **Page 2**

Human Resources Management *Pay, Performance, and Motivation*

What is the link between pay and performance? How effective is performance-related pay, and should it be part of the performance management process? Should incentives be targeted at the individual or the team? Are rewards based on individual attributes, such as competence, more effective than payment for aspects of the job? What is the most effective form of incentive scheme ? This Update considers some recent work on pay, performance and motivation, which helps to shed light on these questions. **Page 6**

Strategy and Organisation *Strategy and Meaning*

In this Update, the human element in strategy is made apparent. The credibility of strategic leadership may be dependent on the 'stories' they tell their followers; these stories having to be sufficiently novel to be inspiring, yet sufficiently grounded to be realistic. Warnings are also provided. Apparently, it is all too easy to underestimate competitors, with potentially disastrous results. This may especially apply in situations where one can get left behind by a dominant technology: the case of 'Technology Lockout'. **Page 11**

Accounting and Finance *Winners and Losers – Capital Allocation: Investment Decisions, Acquisitions and Restructuring*

While more evidence continues to demonstrate that most acquisitions are not very successful, a number of studies are reviewed in this Update which suggest explanations for those few acquisitions which actually achieve the expected benefits. Among the tips provided are: avoid hostile takeovers, do not pay cash, seek synergies with existing businesses (but do not rely too much on organisational restructuring) and pay great attention to timing and to managing the integration process. Also provided in this Update, are suggestions for allocating funds to R & D projects while maintaining current earnings targets. **Page 14**

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MARKETING

Consumer Behaviour and Emotions

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Consumer behaviour is a complex aspect of marketing. Understanding the processes, the choices that consumers make, the resources spent, the decisions made, and their feelings of satisfaction is continually evolving. Typically, our understanding of consumer behaviour has focused on the rational consumer. However, recently published research questions that underlying rationality, and highlights the debate on non-rational behaviour emphasising emotion in consumer behaviour.

The first article, by Marsden and Littler,[1] outlines some of these changes in consumer behaviour and explains a number of different perspectives. They divide the five key consumer behaviour theories into two broad categories: the traditional approaches of consumer behaviour, including the cognitive, behavioural and trait perspectives, and the new approaches which focus on the interpretive and post-modern perspectives.

As the notion of the rational consumer fades, Richins[2] attempts to refine the way we measure emotions in marketing by concentrating on the precise emotions exhibited before, during, and after customers make purchases. Meanwhile, Elliott,[3] still focusing on emotion, moves beyond the measurement and develops an alternative approach to understanding the consumer decision making process in society.

Whilst there is a tendency to focus on positive emotions, it is important to remember that in some instances consumers make purchases even when they feel negative emotions. Luce[4] considers how consumers handle the trade-off between personal goals and the attributes of products, for example the trade-off between style and safety when purchasing a car.

The traditional approach to consumer behaviour

According to Marsden and Littler, the traditional perspectives have influenced our understanding of consumers and their behaviour since the 1960s.

The cognitive perspective, which has dominated consumer behaviour, is based on a hierarchical model, with a buying process of a number of stages that consumers pass through on the route to purchase. The cognitive or thought process begins with affective involvement—or the emotions and feelings that we have towards a product or service—which then take us to our cognitive (action) stage of actual purchase behaviour.

The behavioural perspective, according to Marsden and Littler, is one of the most widely used models of consumer behaviour. This perspective has two dimensions: the ‘black box’ model which emphasises the external factors that cause behaviour and which is based on the behaviourist movement in psychology in the 1960s, and behavioural learning in the early 1980s which highlights the external or environmental factors that reinforce consumer buying behaviour.

The trait perspective groups consumers according to the inherent and abiding personality characteristics that affect their decision-making processes. In effect, the traits we are born with—for instance, introversion, extroversion, energy, calmness, innovativeness, coolness, quietness or adventurousness—affect our purchase decisions. Indeed, this is the basis for many lifestyle and psychographic methods of segmenting markets.

There are many criticisms of these models. They are seen to be deterministic, since they assume that consumers' behaviour is out of their control because it is determined by the traits they either inherit or develop as children. These models suggest that consumers are static, passive and, as Marsden and Littler state, 'change is not something that is which consumers do for themselves, rather it is a result of something that is done to them by some internal (traits) or external (environmental) force over which they have no control'. Finally, the enduring criticism of these approaches, and in particular the cognitive standpoint, is that consumers are inherently rational decision-makers!

The new approaches to consumer behaviour

The new approaches to understanding consumer behaviour offer a more positive perspective on consumers, who are seen as proactive rather than passive decision-makers.

The post-modern view is that consumers do not have predetermined traits or characteristics that affect their behaviour. According to Marsden and Littler, consumers are constantly changing, and their behaviour is fluid. Decisions depend on their values, social contacts, relationships and communication, their needs, the environment and the moment.

Thus, they vary from purchase to purchase as consumers 'frequently change their self-concepts, characters, values and often subscribe to multiple and often highly contradictory value systems, lifestyles etc, with out feeling inconsistent or improper'.

The new approaches, as with the traditional, are not without their critics. Marsden and Littler highlight the idealism in the post-modern perspective, and they consider it necessary to explore the boundaries to consumer decisions and the extent to which socialisation, culture, history and physiological needs confine consumer behaviour.

Emotional aspects of consumer behaviour

Contrary to the rational approach, which shows consumers thinking about purchases before emotions come into play, here the emotions drive the consumer decision making process. Indeed, Elliott suggests that consumer purchases can be full of emotion, with feelings of enjoyment, excitement and impulse! However, research into the role and measurement of emotions is limited.

Measuring emotions

Richins emphasises the need to understand and measure emotional states, from the anticipation felt before and during consumption, to the post-purchase feelings of consumers.

In this research, she assesses the usefulness of existing measures, which are based either on psychological or biological perspectives. Whilst previous research has shown that emotions are an important component of consumer behaviour, she suggests that it is time to develop a measure of emotion which is focused specifically on consumer purchasing behaviour rather than the broad spectrum of all human emotion. As Richins states, 'emotions are context specific and the emotions that arise in the context of intimate personal relationships are likely to differ in intensity and quality from the emotions experienced when buying a pair of shoes'!

In research that spanned six studies, she attempts to develop a reliable measure to encompass the breadth of emotions most frequently experienced in a range of purchases. The Consumption Emotion Set (CES) she developed is extensive, despite the objective to identify a narrow range of consumption specific emotions. The CES can be broken down into broad measures of anger, discontent, worry, sadness, fear, shame, envy, loneliness, romantic love, love, peacefulness, contentment, optimism, joy, excitement, surprise, guilt, pride and eagerness.

Emotional driven choice

In an attempt to understand the role emotions play in our decisions processes, Elliott develops a model of 'Emotional Driven Choice'. This model does not focus on the individual, isolated and rational consumer but on the consumer interacting and making choices in the social and cultural environment. Whilst Richins states that emotions are specific to particular purchases, Elliott highlights a slightly different perspective. His view is that emotions are not solely internal events but should be seen as social and relational. There are three broad dimensions to this model—motivation, preference formation and justification.

Motivation

The first stage in this model is to understand consumers' motivation to buy. Elliott suggests that the foundations can be found in consumers' search for meaning about who they are and what they think of themselves as 'What I have and what I consume'.[5] Therefore, the image that consumers portray to others is a strong motivation in consumer decision-making, and that reason can often be substituted by emotions.

Emotion and preference formation

At the next stage, he suggests that there are a number of complex issues that impact on how consumers develop preferences. He outlines five factors that lead consumers to form *non-rational* preferences.

Rather than decision-making being rational, *self illusion* can take over. He suggests that consumers enjoy and relish the buying process so much that rationality is postponed and hedonism prevails.

The traditional approaches to consumer behaviour assume that the consumer is rationally assessing the attributes of the product prior to purchase. Elliott introduces the notion of *self-focus*, which suggests that consumers often focus on themselves when they are buying a product rather than on the product itself. He suggests that 'when evaluating an item of clothing the consumer is likely to be imagining how they would look in the clothing rather than the features of the clothing itself'.

Furthermore, a rational model of consumption shows consumers assessing the attributes of the product, identifying the components when making decisions. By contrast, where consumers' preferences are non-rational, there is what Elliott refers to as *holistic perception*. Here, feelings rather than attributes dominate, and consumers make an overall assessment and find it difficult to explain and evaluate their purchases.

This process suggested by Elliott, emphasises the *non-verbal images* in communication. Consumers are bombarded with advertising images which, when combined with personal experiences and history, can conspire to create meanings which can have a significant effect on consumer behaviour.

Finally, the decision to buy a product may in fact be a negative action. Consumers may *refuse other tastes*, and select the 'best out of a bad bunch' or the least worst alternative.

Justification

The third key element of the model of emotion driven choice is that of justification. Elliott discusses three elements of justification for purchases. First, *post-hoc rationalisation*, where emotional and non-rational decisions influence consumer purchases and these are followed by the application of reason to justify the purchase after the event. This behaviour often exists to minimise the feelings of 'guilt anxiety and regret'. Alternatively, he discusses research by Zajonc and Markus,[6] which states that because consumers believe that they should act rationally, they often tell researchers they have acted rationally when in reality they did not.

Our understanding of *guilt anxiety and regret* in the consumer decision making process is in the early stages of research. The most relevant studies used by Elliott to illustrate this dimension are studies of impulse purchasers, who on one hand expressed feelings of anxiety and guilt and yet, on the other hand, pleasure and excitement.

Finally, to what extent do consumers use *hindsight bias and bias based information searches* to justify choices and purchase that they have made? Consumers will expend considerable energy to search out information that will support the decisions made and avoid or forget evidence to the contrary.

Once an emotional decision has been made, Elliott suggests that it makes any rational investigation less likely. However, he emphasises that this may not be harmful—in fact it could be helpful, as 'there is evidence that actually thinking about the reasons for preferences may have disruptive effects leading to less optimal choices and to people being less satisfied with their choices'.

Negative emotions

Decisions to buy products are not always accompanied by positive emotions. Luce's article discusses how consumers feel when they have difficult choices to make between products or services. She focuses particularly on the effect of negative emotion on the decisions made by consumers. Her experimental research, involving 235 people in Experiment 1 and 123 in Experiment 2, is based on two key elements.

First, consumers make a *primary appraisal* of the choices they face. Consumers who assess the attributes of a number of products automatically compares them with their personal goals. If many of the consumers' goals are likely to be affected by the purchase decisions, or if the goals affected by a potential purchase are important to them there is more potential for emotion to come into play. Indeed, if these goals are threatened then the emotions will tend to be negative. The example used in this article shows a consumer assessing the attributes of a car they intend to purchase and the 'trade-off' made between price, safety and style. The consumer may have to sacrifice one goal at the expense of the other, which may lead to purchase despite their negative feelings and emotions.

Secondary appraisal is also thought to have an impact on negative emotions. Here, the consumer may adopt coping strategies to lessen the impact of the difficulties they experience when making the trade-off between product attributes. Consumers have different coping strategies to deal with their decisions, such as increased efforts to collect information and advice to support the accuracy of the decision—a more rational and problem focused coping strategy. Here, the decision-making process is longer, as the consumer tries to avoid making a 'sub-optimal choice leading to negative outcomes regret and blame'.

Alternatively, the consumer may adopt emotional coping strategies and try to minimise the level of emotion they feel. They can use a number of avoidance strategies, such as leaving the decision to someone else—commonly referred to as 'passing the buck'. When they do this they protect themselves and feel more secure. Other avoidance strategies include choosing an alternative product which is less emotionally demanding—a compromise solution. Consumers sometimes choose to retain the 'status quo': by following the same path and not deviating from the norm, their decisions are less likely to come under that scrutiny which may lead to the regret and blame mentioned earlier.

Ultimately, this research shows how consumers reconcile the conflicting demands facing them, and it illustrates the lengths consumers will go to avoid negative feelings. Interestingly, consumers who are naturally more emotional do not completely opt out of the process, but seem to select the status quo and thereby avoid the more serious decisions.

Whilst there are still many unanswered questions, the implications of this research for marketing managers are wide ranging. Its effects have already been seen in advertising and branding with the increasing use of emotional messages. If consumers are, as we suspect, not wholly rational then the potential impact stretches beyond communication with customers. Marketers will need to understand the role of emotions in the satisfaction levels felt by the customer, whether these emotions and feelings are constant or whether they change over time. This leads to still more implications for marketing to existing and new customers. If the emotional attachment changes—what are the implications for repeat purchases, lifetime values and word of mouth communication with potential customers?

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HUMAN RESOURCES MANAGEMENT

Pay, Performance, and Motivation

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A key challenge for contemporary human resource management is the need to enhance organisational performance by maximising the competence and the performance of the individual employee and the team. In meeting this challenge a number of important questions are raised. What is the link between pay and performance? How effective is performance-related pay, and should it be part of the performance management process? Should incentives be targeted at the individual or the team? Are rewards based on individual attributes, such as competence, more effective than payment for job attributes? Finally, what is the most effective form of incentive scheme? This Manager Update considers some recent work on pay, performance and motivation which helps to shed light on these questions.

Some myths about pay

A useful route into the issues is provided by Pfeffer,[1] who identifies the following persistent and 'dangerous myths' about pay:

- Labour rates and labour costs are the same thing.
- Labour costs can be reduced by cutting labour rates.
- Labour costs constitute a significant proportion of total costs.
- Low labour costs are a potent and sustainable competitive weapon.
- Individual incentive pay improves performance.
- People work for money.

He argues that it is productivity that matters, not rate of pay, and he disputes the claim that competing on labour costs will create sustainable competitive advantage. Instead, organisations should compete on quality, customer service, product, process and service innovation, or technological leadership.

As for individual incentives, he argues that despite 'the evident popularity of this practice, the problems with individual merit pay are numerous and well documented. It has been shown to undermine teamwork, encourage employees to focus on the short term, and lead people to link compensation to political skills and ingratiating performance.' Other problems noted include the difficulty in measuring individual performance, perceived unfairness, the potential for fraud and customer alienation, and the absorption of management time. Furthermore, he argues that people want more out of their jobs than just money, and that extrinsic rewards not only diminish intrinsic motivation but large extrinsic rewards can actually reduce creativity and innovation.

So why do organisations persist with these practices? Underlying some of the myths is an ingrained and self-reinforcing economic model of human behaviour, emphasising rationality and the maximisation of self-interest, and a view that people require reward to overcome a natural aversion to work. It is easier to do what everybody else is doing, and easier for organisations to 'tinker with the compensation system' than to change their culture, the way work is organised, the level of trust and respect in the system, and to make work more fun and meaningful.

What should organisations do? Pfeffer argues that organisations paying on a more collective basis (such as profit-sharing) perform better than those who do not. Moreover, the more aggregated the unit used to measure performance, the more reliably can performance be assessed. Managers should de-emphasise pay, make pay practices more public, and recognise that pay has both substantive and symbolic components. Pay is only one means of building, or reducing, commitment, teamwork, and performance, and leaders must ensure congruence between pay and other management practices. Finally, he argues that 'companies that have successfully transcended the myths about pay know that pay cannot substitute for a working environment high on trust, fun, and meaningful work'.

Linking pay to skills

Skill-based pay programmes link remuneration to the attributes of individuals (in terms of knowledge, skills and abilities), rather than to the attributes of jobs. The advantages of such programmes to organisations have been identified as:

- Increased workforce skill base.
- Increased flexibility.
- Decreased labour and supervision costs.
- Increased product quality.
- Increased productivity.

For the individual employee the benefits may include:

- Jobs with greater skill variety and significance.
- More task identity.
- Greater autonomy.
- Increased involvement in quality through greater involvement in the production process.
- Rewards for increasing skill.

Murray and Gerhart[2] studied the introduction of a skill-based pay programme over 37 months in a component assembly site of a large corporation manufacturing vehicle safety systems. The plant, employing about 500 people, developed a skill-based pay system with the following objectives: to support job rotation; to allow employees to have knowledge of the full production process; to motivate increased skills; to promote more interest in the work; and to support more attention to quality and teamwork.

The plant defined the required skills and identified a process for determining person-based pay based on skill competency. The skill-based pay plan was based on five sequential skill blocks of increasing complexity and requiring increasing knowledge. The skill blocks represented a complete production process. Employee progress was facilitated by on-the-job training, and some classroom training, and was regulated by certification exams to ensure skill mastery. Progress through the skill blocks was largely at the discretion of the employee, and the plant had designed the work to allow movement among jobs to take advantage of available work-assignment flexibility.

The key results from the study were that:

- Labour costs (wage expenses divided by number of good parts produced) were reduced by 16 per cent.
- Quality (percentage of scrap in total units) showed an 82 per cent reduction when compared with another of the corporation's plants.
- Productivity (labour hours per part) showed a 58 per cent increase.
- The increase in wages at the plant was more than offset by the increase in productivity.

On the basis of their study, Murray and Gerhart offer the following guidance regarding skill-based schemes:

- Such a programme is only part of a comprehensive human resource programme requiring adequate resources for training and certification, timely and unbiased appraisal, and complementary job design and production scheduling.
- It needs to fit with an organisation's overall strategy and culture, and may be best suited to a high involvement environment.
- It involves challenges and some additional administrative burdens.

Social cognitive theory and self-efficacy

Stajkovic and Luthans[3] argue that social cognitive theory (SCT), originally developed by Bandura,[4] is a means of better understanding the complexities of human resources in the modern workplace and more effective management of human performance. SCT explains organisational behaviour in terms of the 'reciprocal causation among the employee (unique personality characteristics such as need for achievement), the environment (perceived consequences from the organisational environment, such as pay for performance), and the behaviour itself (previous successful or unsuccessful performances)'. Employees are at the same time both products and producers of their personality, their behaviours, and their environments.

Individuals have five basic capabilities to self-influence themselves and to initiate, regulate, and sustain their own behaviour—symbolising, forethought, vicarious learning, self-regulation, and self-reflection. These capabilities lead to beliefs about self-efficacy, or 'an individual's convictions (or confidence) about his or her abilities to mobilise the motivation, cognitive resources, and courses of action needed to successfully execute a specific task within a given context'. Employees who perceive themselves as having high self-efficacy will activate sufficient effort that, if well executed, will produce successful outcomes. On the other hand, employees who perceive low self-efficacy are likely to cease their efforts prematurely and fail at their task.

In contrast to the concept of self-esteem, which is seen as a global construct, self-efficacy is task and context specific. A range of factors may determine self-efficacy beliefs. These include the extent to which an individual has previously succeeded in a challenging task, or has been able to observe and learn from competent others, persuasion from a trusted other, and the state of psychological or emotional arousal.

What does this mean for performance and rewards? One consequence is that employee behaviour cannot be predicted only on the basis of contingent consequences (such as rewards). It also requires an understanding of beliefs about personal self-efficacy. Given that research shows a clear link between high self-efficacy and high performance, the challenge for human resource management is to 'select and/or develop high self-efficacy in today's and tomorrow's human resources'.

Designing an incentive system

Lee, Locke and Phan[5] studied the extent to which personal goals and self-efficacy beliefs influenced the relationship between goal difficulty and a pay system on the one hand and task performance on the other. Participants in this experimental study were assigned goals (identified as hard, medium or easy) and a payment system (hourly rate, piece rate or bonus payment incentive system). They had to complete two 10-minute trials in which the task consisted of arithmetical problems, and it was possible for a learning effect to take place between the first and second trials. The participants were also asked to set personal goals for their tasks, and a measure of self-efficacy was taken prior to the trials. The results were congruent with SCT.

Those participants who had been assigned easy goals performed better under a piece rate system than under a bonus system on both trials—perhaps because the latter participants were holding down production when they had attained their bonus. Hourly paid subjects also performed better than bonus subjects on both trials, and better than piece-rate subjects on the second trial. Bonus subjects set lower personal goals and had lower self-efficacy than piece-rate subjects under easier goals. Medium goal subjects under a bonus system performed better than piece-rate subjects on both trials, but only better than hourly paid subjects on the second trial. When hard goals were attempted, bonus subjects performed worse than bonus subjects with medium difficulty goals on both trials. There was also a noticeable drop in both personal goals and in self-efficacy in these subjects between the first and second trials—in contrast to the hard goal hourly or piece-rate subjects. The highest level of performance on the second trial was achieved by hourly rate subjects, followed closely by piece-rate subjects, both of these groups achieving higher performance than those in the same category with medium difficulty goals.

Recognising the potential limitations in generalising from an experimental study, the authors conclude that a bonus pay system has the most potential pitfalls. When goals are set at a low level, performance is low because the bonus is easy to attain. When the goals are set at a very high level, performance is low because people do not believe that they can attain the bonus and hence lower their effort. Only when the bonus is paid for moderate goals is performance high. However, it is not always possible in practice to keep goals at a moderate level. A piece-rate system does not suffer for the same problems, because pay is tied to actual performance rather than goal attainment. If goals are too easy or too hard, subjects are free to adjust them and still attain the full benefit of high effort and performance. Even hourly pay was found to be effective with goals.

Lee, Locke and Phan suggest a way of integrating the bonus and piece rate systems with several levels of performance goals (minimum, ideal, and stretch) with incremental rewards for incremental achievement.

Is performance related pay necessary for effective performance management?

Performance related pay (PRP) is usually seen as an integral aspect of performance management. Lewis,[6] in a study of managers in three UK financial services organisations, sought to identify the performance management processes which are fundamental to the successful implementation of PRP, and to establish how effectively these processes were conducted in the three organisations considered.

He considers the performance management process as an interactive, iterative, cycle of four stages with communication at the centre and flowing around the complete process:

1. Setting objectives.
2. Measuring performance.
3. Giving performance feedback.
4. Translating performance into award.

Lewis found that there was more evidence of ineffective than effective implementation of stage 1 of the PRP process cycle. In particular, he found objectives that were narrowly focused on short-term financial targets, and were often imposed upon the managers. 'This had the effect of disenfranchising the recipient managers, of creating the impression that the PRP process cycle was something "done to them" rather than something in which they played an active part.'

In terms of measuring performance, issues identified in two of the organisations included subjectivity, perceived unfairness in assessment and 'favouritism', as well as the selection of 'safe ratings', possibly because of a limited 'pot' of funds for PRP. In the third organisation, 'Premierco', feedback was gained from a wide range of other parties which led to a perception of a more complete feedback process, and a more accurate award. Intrinsic motivation was also ensured in this organisation because PRP depended on improved performance and managers were given new projects and fresh challenges. Finally, in this organisation implementing managers met on a quarterly basis to review ratings and to achieve greater conformity across divisions thereby improving credibility.

Issues raised regarding the third stage in two of the organisations included irregular and inadequate feedback, a lack of focus on learning or a clear picture of what was needed to improve performance. Lack of time, and the number of direct reports, were factors in the willingness and ability of line managers to provide regular feedback. In contrast, in 'Premierco', the process was more continuous with weekly, monthly, and quarterly review meetings as well as the annual appraisal, the aim of which was to achieve consensus on future objectives and on training and development needs.

In all of the organisations there existed a lack of financial resources to drive the performance management system, which in some cases exacerbated the dissatisfaction. In these circumstances it is argued that it is particularly important to communicate and manage expectations, especially regarding the organisation's performance, and the size of pot available for distribution. In none of the organisations was the distribution of ratings communicated to managers.

Lewis argues that if the four stages of the PRP process cycle 'are conducted effectively and information flows around the cycle, then PRP is more likely to be accepted by individuals and the objectives of the organisation in its introduction are more likely to be achieved'. He also argues that the general agreement of employees with the principle and practice of PRP will lead to motivation for better job performance and to beneficial organisational outcomes. Without this agreement, 'rather than improved job performance, employees will feel at best apathetic, leading to PRP being largely ignored or alienated from both the PRP process and those responsible for its implementation'.

For Lewis, it is employee acceptance that determines the level of success of PRP. On this basis, only in Premierco could PRP be said to be successful, and key reasons for this were the skilful giving of performance feedback, coaching to improve performance, the gathering of performance data from a wide variety of sources, negotiation of objectives, and management of expectations about final award.

His study suggests that it is the 'softer' processes (those involving employees in the cycle) which are more likely to be associated with acceptance. The effective implementation of the softer processes turns on the skills and attitudes of the line manger, who need a longer term investment perspective on their management of employees to promote the involvement of individuals in the process cycle, rather than their exclusion from it. The study also suggests that even if the pay element of the cycle is not accepted, the processes which concern the determination of the award, if conducted effectively, may mitigate the unacceptable impact of the pay element. Indeed, he argues that the first three stages of the process cycle could be part of a performance management process without the presence of pay.

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STRATEGY AND ORGANISATION

Strategy and Meaning

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In the last issue of *Manager Update*, I looked at some contributions about the state of strategy and examined in particular Gary Hamel's recent article lamenting the lack of a true theory of strategy formulation.[1] In this issue I shall look at some contributions from alternative schools of strategy which focus on how strategies are presented and interpreted by protagonists in organisations.

Strategy as narrative

As mentioned in the last issue of *Manager Update*, there is an emerging school of thought in strategy which is reinterpreting strategy as a form of storytelling, where protagonists in an organisation seek to impose sense on a particular interpretation of reality. In the narrative perspective, what matters in strategy is not the rigour of the analysis per se, but the way that the story is put together and whether or not the story is accepted and gains currency within the organisation. As Gardiner, quoted by Barry and Elmes in their recent article, makes clear:

> '. . . the formidable challenge confronting the visionary leader is to offer a story and an embodiment that builds on the most credible of past syntheses, revisits them in the light of present concerns, leaves open the space for future events and allows individual contributions by the persons in the group.'[2]

How far does this approach to strategy get us? The answer, I believe, is further than we might at first think. Barry and Elmes argue that the two criteria which successful strategic stories must exhibit are credibility and defamiliarisation (or novelty). In other words, the author of a successful strategy must convince its audience that the narrative which is unfolding is at least plausible, and therefore based on their experience and understanding of the world, but at the same time is new and distinct and offering a unique perspective on the future. As the authors remark, these two criteria are in constant tension: thus in seeking to be credible, strategists run the risk that the stories might become mundane and familiar, whereas stories which emphasise the novel and revolutionary run the risk of lack of plausibility. The authors then go on to identify the characteristics of strategic credibility and defamiliarisation.

Thus, credibility depends on:

- **Materiality** To be credible a strategic story needs to have substance. The key insight here is that written strategies need a different form of presentation and level of detail than spoken narrative.
- **Voice and perspective** To gain credibility written strategies are often written in language which is objectivised. Stories are written in the third person, individuals are referred to by title rather than by first name. The aim here is to depict the strategies as neutral and objective rather than partial and political.
- **Plots** Many strategies revolve around variations of long standing themes. Thus, many strategies are depicted as a form of 'hero's journey', where the company as hero finds itself confronting a number of obstacles, and needs to overcome them successfully in order to emerge at the end victorious and renewed.
- **Readership** Credibility assumes familiarity with an acceptable style of discourse. Thus stories which make references to certain vocabulary, eg strategic planning terminology, are afforded a level of legitimacy not given to other texts.

Equally, acceptance of a strategy is also contingent on it being perceived as something new and creative. This need for periodic 'defamiliarisation' accounts for the need to conduct strategy 'away days', the need to redefine periodically the company's competitive threats and even to look for new ways and technologies for delivering the strategy (eg Powerpoint presentations). The need to be perceived as novel also accounts, in Barry and Elmes's view, for the change in fashions in strategic theories:

> 'We suggest that various strategic or theoretical frameworks succeed one another because organisational readers have shifting preferences and attention spans, and not because of some Darwinian progression towards an ultrafit theory. In other words the currency of today's strategic models may have less to do with the accuracy of their predictability than with their appeal to current tastes and interests.'[3]

Clearly, the 'strategy as narrative' school is still at an early stage of its development. We do not know, for example, which strategy narratives prove to be the most effective or even if some narratives are appropriate for certain organisations in certain situations. It does, however, provide an intriguing perspective on strategy and a reminder to us that strategies are essentially works of fiction and not tablets of stone.

How managers perceive competition

Another new and equally intriguing perspective on strategy is the emerging 'organisational identity' school. Regular readers of *Manager Update* will recall that in an earlier issue I reported on some research which revealed that managers have an asymmetric perception of the causes of success and failure. Thus success is generally attributed to internal organisational strengths, whereas failure tends to be assigned to environmental problems.[4] The 'organisational identity' school looks at how managers in organisations perceive, and in some cases fail to perceive, their competitors. Krzysztof Obloj[5] has recently published some work testing the work of Porac and his colleagues into rivalry perception amongst Scottish knitwear producers. Essentially, Porac's research showed that many companies have only a partial perception of their competitors and that they filter out information which does not conform to their dominant logic. Specifically, the size of competitors turned out to be highly significant. Thus, big companies typically perceived other large companies as their competitors. Small companies likewise only perceived large companies to be rivals and no-one perceived small companies to be competitors!

In a similar vein, work has recently been carried out by Ellsbach and Kramer.[6] This work, which focused on the response of US business schools to the Business Week ranking surveys, revealed that those business schools which did poorly out of the rankings typically responded by either emphasising other criteria, not ostensibly addressed by the rankings, or by redefining their reference group (eg private business schools, small business schools etc).

Obloj tested these hypotheses by investigating the perceptions of radio stations in Warsaw. He selected the market because it was intensely competitive and transparent—objectively there was no reason why managers in the target companies should not be capable of making sound rational assessments of their rivals and their competitive positions. The conclusions of the research were that, despite the presence of multiple competitors in a closely knit and well defined market, very few firms considered any other company as a prime competitor and hardly any had formal scanning mechanisms for monitoring the behaviour of competitors. The managers concerned responded partly by deprecating the formats and approaches adopted by other radio stations and partly by claiming that they addressed a different audience (usually of lower intelligence or social class). The smaller the radio station, typically the greater was the tendency to define the station's output as in some way unique and therefore operating in a market of one. Ignoring competitors entirely was particularly a feature of those radio stations that were not dependent upon the market for their existence. 'If market success and/or professional development of a winning strategy is not part of the identity of a firm, it used the marketplace only as a mirror to stress its uniqueness (even where this is false).'[7]

Obloj believes that these perceptions of managers, which govern the dominant logic of companies, are important to our understanding of company strategy and survival. He believes that the way that managers make choices at the beginning of an organisational life cycle and, thereafter, manipulate symbols that become part of the organisation's identity are critical. This shapes the organisation's perception of the marketplace and of its competitors, and can lock the company either into a virtuous or a vicious cycle depending on whether the organisation is in a marginal or dominant market position. These perceptions, he believes, help to explain the abiding organisational inertia which locks organisations into particular strategic positions.

Technology lockout

If perceptions succeed in locking companies in, technologies can often lock companies out of a particular competitive arena. This is particularly the case with the so called 'fast-cycle' industries studied in Shilling's recent article,[8] where life cycles of products may be less than two years. Technology lockout is defined here as a situation where a company finds itself unable to sell its products because a particular technology has become the dominant standard within that marketplace or because it has simply fallen behind in the technology race. Technology lockout can, as Shilling makes clear, be disastrous for a particular company. She gives the example of Micropro, whose word processing programme Wordstar was the dominant word processing programme in the late 1970s and early 1980s, but was subsequently locked out of the market when the IBM PC became the dominant standard and it failed to come up with a product which worked well with this technology. By contrast, dominant designs (Microsoft Word, for example, in this case) enjoy increasing returns to adoption, generating revenue flows that can then be used in the future to refine the product. These become ever more widely adopted and in turn generate other complementary assets, for example compatibility with other computer packages. Dominant designs benefit from experience curve advantages, but also in certain circumstances, from so called 'network externalities', where the more people that buy a particular product, the more each individual consumer benefits: telephone networks are a good example of this, as are word processing packages.

According to Shilling, the major factors influencing the probability of technological lockout are:

- A failure to invest in the capacity to learn and develop core capabilities.
- Lack of complementary goods.
- An insufficient installed base of customers.
- The timing of entry.

Interestingly, Shilling reviews evidence on entry timing and first mover advantages and concludes that while some companies have been able to enjoy the advantages of being the innovator, in many other cases it pays to delay entry until after a particular technology has been mastered or achieved customer acceptance. Timing of entry, she believes, is critical and entering very early or very late will increase the likelihood of technological lock-out.

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ACCOUNTING AND FINANCE

Winners and Losers—Capital Allocation: Investment Decisions, Acquisitions and Restructuring

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An important factor that distinguishes winners from losers in creating shareholder value is the quality of investment decisions which can be seen to depend substantially upon the soundness of a firm's capital budgeting system. The first section in this *Manager Update* looks at how it is possible to win in the capital allocation game.[1] However, winning and losing is not just restricted to the internal investment decision, it is an issue of relevance within the context of mergers and acquisitions. Given the evidence reviewed in earlier *Manager Updates* indicating that all too often take-overs are unsuccessful, the results of recent research about the factors that constitute success will be considered.[2] This will be viewed alongside research that adds an interesting and potentially contradictory slant on such findings with reference to financial engineering practices.[3] Last, but by no means least, one of the most important issues revealed from the research on success with take-overs is the integration process. Insights into the integration process are considered by reference to the work of GE Capital.[4]

Capital budgeting and the capital allocation game

Boquist et al[5] identify a number of common drawbacks of capital budgeting systems that include:

- Misalignment between strategy and capital budgeting.
- Lack of dynamic structure.
- No connection between compensation and financial measures.
- Deficiencies in analytical techniques associated with poor base case identification, competition and cannibalisation issues, inadequate treatment of risk, and non-uniform assumptions.
- Finance function not being a strategic partner.
- Lack of integration.
- Confusing financial measures.
- Poorly trained financial analysts.
- Inadequate post-audits.

They propose a framework for senior managers to use in allocating capital, which has the objective of maximising shareholder wealth. This framework has six key features and recognises that capital budgeting cannot be the exclusive domain of financial analysts and accountants but is a multifunctional task that must be integrated with a firm's overall strategy. The six features of the capital budgeting framework are:

1. Dynamic not static.
2. Integral to strategy.
3. Recognition of options potential.
4. Cross functional.
5. Compensation system as a centrepiece.
6. The importance of performance-based training.

The framework is presented as forming part of a system with three simultaneous steps:

1. Map out the strategy of the firm. The capital budgeting system is seen as being a plan to execute the strategy.
2. Develop an evaluation system for project proposals, the goal being to separate winners from losers.
3. Develop a culture within the firm that is consistent with the strategy and the evaluation system.

Boquist et al emphasise the importance of qualitative as well as quantitative issues, a point brought out by Sharpe and Keelin with respect to the resource allocation decisions at Smithkline Beecham.[6] They identify how, in 1993, Smithkline Beecham was spending more than half a billion dollars per year on research and development. Senior management faced a problem in the form of needing to meet current earnings targets while supporting research and development to create future revenue streams. This was at a time when many projects were reaching the final stages of development with heavy funding demands. There was an acute need to rationalise and prioritise projects—the big question was how to do it. All were agreed about the ultimate goal—to increase shareholder value. The difficult issue was how to devise a process that would be credible to all, particularly in view of the earlier disappointments with quantitative approaches. The result of their endeavours was a three phase process emphasising the role of both management and product teams.

The starting point in Phase 1 is the generation of options to provide alternatives about which the management teams would give guidance. Phase 2 focuses upon the valuation of alternatives, with an evaluation of the surviving alternatives from Phase 1 by the project teams, and their calibration by the management teams. Phase 3 focuses upon the allocation of resources, with the project teams refining the evaluations and the management teams acting upon their input to make decisions.

By all accounts the new process has been a success, not least because the company has tackled the difficult soft issues, like information quality, credibility and trust, that impact significantly upon resource allocation.

Take-over profitability

The issue of capital allocation to create shareholder wealth is not confined to the internal investment decision, but also to take-overs. As reported in earlier *Manager Updates*, previous empirical studies have not provided consistent evidence that acquisitions are profitable for acquiring firms. Many studies have shown that acquirers achieve significantly poorer returns after the take-over of another companys—although the evidence is not entirely conclusive. Agrawal et al showed that the shareholders of an acquiring company 'suffer a statistically significant wealth loss of about 10 per cent over the five years following the merger completion'.[7] Consistent with this, Higson and Elliot found negative returns to UK bidders of around 10 per cent over the two years post-take-over, that bidder shareholders suffer negative returns in the announcement period unless they are hostile bidders, and target shareholders gain in the announcement period.[8] However, many corporate managers are sceptical of these findings, arguing that the stock market cannot fully understand the consequences of transactions immediately.[9] Studies using long-term share price data show some evidence of a downward drift in share returns for acquiring companies after the take-over, suggesting the possibility of poor performance after the announcement.[10] These results run contrary to the efficient market hypothesis, which would suggest that shares are correctly valued by the market and will give normal returns.

The evidence is pretty damning, insofar as it does suggest that acquirers pay too much for the companies they are purchasing, a view supported by a Coopers and Lybrand study.[11] It surveyed 199 companies drawn from the largest companies in Belgium, France, Germany, Italy, Spain, Sweden, Switzerland, UK and USA. The research found that companies in all countries by their own assessment, with the notable exception of the USA, overpaid for their acquisitions in over 20 per cent of the cases.

More recently, Healy et al examined acquiring companies' cash flow performance after a merger in the 50 largest take-overs from 1979 to mid-1984. This study built on their earlier work which showed that mergers in the same sample created new value for the shareholders of the target company and the acquiring company combined.[12] Their results in the most recent study showed that *on average* acquirers did not generate any additional cash flows beyond those required to recover the premium paid. However, the profitability of individual transactions varied widely.

What were the characteristics of the more profitable take-overs? Three transaction characteristics under the control of management accounted for greater profitability:

- Friendly take-overs outperformed hostile take-overs.
- Take-overs with payment of stock and debt outperformed cash transactions.
- Take-overs involving highly overlapping acquirers and targets performed better than those in unrelated businesses.

In each of these three comparisons, superior performance was found to arise because of both higher take-over synergies and lower premiums paid to target shareholders.

They identified two distinct types of take-overs in their sample:

- Friendly transactions that typically involved equity payment for firms in overlapping businesses, which they refer to as strategic take-overs; and
- Hostile transactions that generally involved cash payments for firms in unrelated businesses, which they refer to as financial take-overs.

Their analysis revealed that strategic take-overs generated substantial gains for acquirers, while financial transactions broke even at best. Strategic acquirers seemed to be able to pay less and obtain more, as indicated by lower premiums and higher synergies, thus indicating that transaction characteristics under management's control substantially influenced the ultimate take-over payoff.

As they indicate, their results raise more questions than answers. For example:

- How do strategic acquirers negotiate lower take-over premiums and integrate target firms more effectively to realise larger synergies?
- Why do financial acquirers pay such large premiums for target companies, given few immediate operating cash flow improvements?

The results of the research are interesting, but also raise many questions. As will be illustrated in the last section of this *Manager Update*, there are many groups that could be seen as financial acquirers and who would claim to be able to derive benefit from the financial characteristics of the transaction, as much as from operating sources. Perhaps, as the last article to be reviewed indicates, it is their attention to the integration process that is so important.[13]

This research emphasises the importance of operating synergies and seems to direct attention away from the fact that benefits may be derived in restructuring situations, like take-overs, from financial synergies. This view is balanced in the findings of research by Bowman et al.[14] Their study collected several thousand cases of restructuring in the US over a decade, and grouped them into three classes:

- **Organisational restructuring—**downsizing, realignment of business units, etc.
- **Portfolio restructuring—**changes in the asset base through take-overs and divestitures, asset sales, or spin-offs.
- **Financial restructuring—**big changes in the capital structure through leveraged buy-outs or debt-equity swaps.

The study looked at immediate share price reactions and profit performance over the following few years. In the case of organisational restructuring, the average performance worked out slightly negative; for portfolio restructuring it was slightly positive; for financial restructuring it was very positive indeed.

A number of reasons can be offered to explain the results, but one particularly worthy of consideration on the basis of personal experience is that for too long companies have devoted much effort to becoming more operationally efficient. Many companies are now turning their attention to the efficient use of capital.

Take-over integration

One other view expressed by Ashkenas et al on poor take-over performance is that all too often the acquiring company's management focuses upon how to get acquisitions over with rather than how to do them better. In fact, a study undertaken in 1997 found that companies tend to regard their merger and acquisition transactions as being successful, even though more than half were found to have no formal post-transaction review policy.[15]

Ashkenas et al illustrate with reference to 'The Wheel of Fortune' how GE Capital has developed 'The Pathfinder Model' for acquisition integration.[16] The Pathfinder Model developed from the lessons GE Capital learned from its experiences. These lessons Ashkenas et al describe as follows:

- **Lesson 1** Acquisition integration is not a discrete phase of a deal and does not begin when the documents are signed. Rather, it is a process that begins with due diligence and runs through the ongoing management of the new enterprise.
- **Lesson 2** Integration management is a full-time job and needs to be recognised as a distinct business function, just like operations, marketing, or finance. As such, integration managers are viewed as being those individuals who manage the integration process, not the business.
- **Lesson 3** Decisions about management structure, key roles, reporting relationships, layoffs, restructuring, and other career affecting aspects of the integration should be made, announced, and implemented as soon as possible after the deal is signed—within days, if possible. Creeping changes, uncertainty and anxiety that last for months are debilitating and immediately start to drain value from an acquisition.
- **Lesson 4** A successful integration melds not only the various technical aspects of the businesses but also different cultures. The best way to do so is to get people working together quickly to solve problems and accomplish results that could not have been achieved before.

Drawing upon these lessons, the Model divides the process into four 'action stages':

1. Pre-acquisition work in the form of due diligence, negotiation and announcement before the deal closes. This focuses upon:

   – assessing the target's culture;
   – identifying business/cultural barriers to integration success;
   – selecting an integration manager;
   – assessing the strengths and weaknesses of business and function leaders;
   – developing a communication strategy.

2. Foundation building via the launch, the acquisition integration workout and strategy formulation. Attention is directed at:

   – the formal introduction of an integration manager;
   – orientation of new executives to GE Capital business rhythms and non-negotiables;
   – joint formulation of an integration plan, including 100-day and communication plans;
   – providing sufficient resources and assigning accountability.

3. Rapid integration, consisting of implementation, course assessment and adjustment. This focuses on:

   – using process mapping, CAP, and Workout to accelerate integration;
   – use of audit staff for process audits;
   – using feedback and learning to continually adapt the integration plan;
   – initiation of short-term management exchange.

4. Assimilation, in the form of long-term plan evaluation and adjustment, and capitalising on success. At this stage the emphasis is on:

   – continued development of common tools, practices, processes, and language;
   – continued longer-term management exchanges;
   – use of the corporate education centre;
   – use of audit staff for an integration audit.

Within these four 'action stages', great emphasis is placed upon integration management and the appointment of an integration manager. This is identified as being a key contributor to success. However, Ashkenas et al. do indicate that the framework outlined should not be seen as a straightjacket. Every situation is different, and the learning process is ongoing. This is certainly borne out by my experience with acquirers and principal finance/transactions groups similar to GE Capital.

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16 As they indicate, GE Capital is itself the product of dozens of acquisitions that have blended to form one of the world's largest financial service organisations.

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