Manager Update

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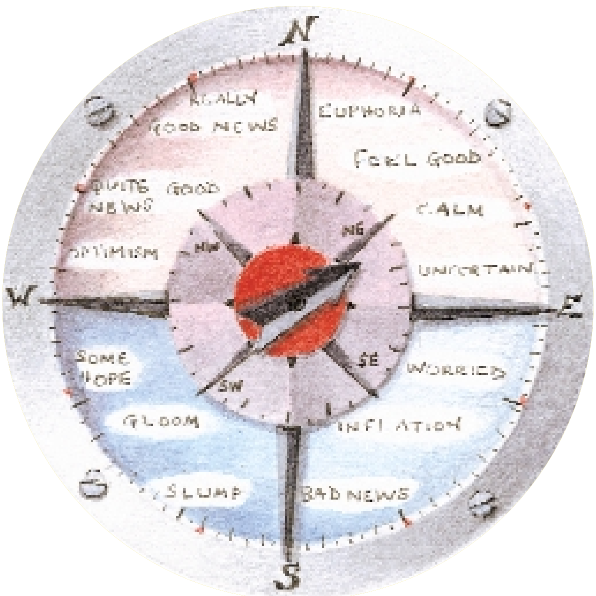

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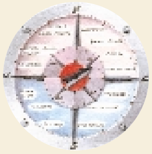

Manager Update

... is produced in parallel with the Braybrooke Press publication of the same name.

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 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.

Manager Update is compiled and edited by Kevin Money, director of the Centre for Organisational Reputation and Relationships at Henley Management College.

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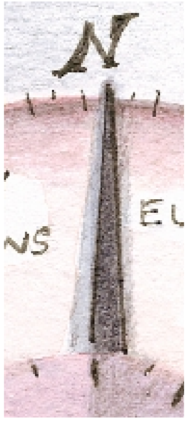
Accounting, finance and executive compensation



Is the misuse of stock options the cause of corporate failures such as those at Enron or WorldCom, or are stock options a major factor in the success of technology giants such as Microsoft? How can they be used properly and misuse prevented? In this article, **Roger Mills**, professor of accounting and finance at Henley Management College, answers these questions and sheds new light on the issue of executive compensation.

New accounting rules on expensing stock options

As shareholders across the globe lobby for increased transparency after accounting scandals at companies like Enron and WorldCom, pressure has been put on businesses to classify stock options as an expense. With the introduction of international accounting standards (IFRS2) from January of next year, businesses will have to do so. These new standards will be enforced nationally in the UK on the basis of generally accepted accounting principles (GAAP) and by financial reporting standard (FRS) 20 and in US GAAP by SFAS123.[1] IFRS2 will reveal new information about company option schemes that could have a potentially negative impact on company share prices.

The International Accounting Standards Board ruling will affect about 7,000 publicly traded companies in 90 countries, excluding the US. However, many analysts believe that, because foreign companies use options less than US-based ones, the effect of expensing those options will be smaller overseas. Some analysts, for example, have estimated that earnings for the Standard & Poor's (S&P) 500 would have been 30% lower last year if stock options had been expensed, while earnings at European companies would have fallen only 10%. What are these little understood options though, and how do they work?

Options are often part of a senior executive's remuneration package. These executives may be chief executive officers (CEOs), directors and senior managers whose package takes the form of salary, short-term bonus, long term incentive plans (LTIP), and ownership income (from equity share ownership). In total, this package is sometimes referred to as the 'director remuneration income portfolio', or DRIP for short. In research undertaken at Henley Management College, Ewers found that in the UK, options were not a substantial income source for many directors, but where they were, the gains were often considerable and in some cases exceeded their salary income many times over.[2]

Typically, an option plan gives employees the right to buy company stock at a certain price – the strike price – which is usually the market price on the date of the grant of the options. Under current US accounting rules, companies can choose whether to deduct option costs from expenses or disclose them in the footnotes. Proponents of expensing options argue that companies will go on showering top executives with extravagant option awards worth millions unless they are expensed. Opponents, though, point to options as an effective recruitment and retention tool and argue that, if they were expensed, this move would hurt employees more than senior executives, who would look at the bottom line and simply cut out broad-based stock option plans.

Typically, an option plan gives employees the right to buy company stock at the strike price

From an economic perspective, granting options to executives can be termed a reallocation of value from existing shareholders to the option holders (the impact is similar to that arising from a discounted share placing to new investors). Thus, it reduces the fair value of equity in the hands of existing shareholders, but has no impact on the underlying value of the business. One major problem, though, is that estimating this impact is difficult and depends in part on the company's strategy for hedging its exposure to the options. The simplest approach is to deduct the current option

Options are often part of a senior executive's remuneration package value from the value of the enterprise when determining the fair value of equity, eg

	£
enterprise value	2,000,000
less debt	(400,000)
less fair value of options in circulation	(30,000)
fair value of equity	1,570,000

IFRS2 attempts to address the problem of judging the fair value of options in circulation

The real problem is to judge the fair value of options in circulation, which IFRS2 attempts to address. It intends to provide investors with the means to estimate this figure and, as mentioned above, will result in the publication of information that has so far been unavailable to investors and analysts.

What, though, is likely to be the impact of such revelations on companies' share prices? Clearly, some will react negatively when IFRS2 is first adopted. US GAAP reconciliations, published by some companies that will adopt IFRS2, already disclose sufficient information to calculate a correct valuation. If this information has been overlooked in the past, share prices can be expected to correct before IFRS2 takes effect.

Whilst it is clear that options granted to executives should have a negative impact on the share price when they are exercised (since the company is required to issue shares at a discount to their market value and thus dilute existing holdings), estimating the share price impact at this point is difficult because the extent of the dilution is not known. Given that any value gained by the option holder at exercise must be matched by the value lost by existing shareholders through dilution of their holdings, Peter Elwood of Cazenove argues that the logical approach would be to deduct the present value of the expected option profit from the pre-grant value of equity.[3]

As an incentive to executives, options are often out-of-the-money when granted

However, as an incentive to executives, options are often out-of-the-money when granted and will obviously only be exercised if the share price increases beyond the strike price before the options expire.[4] Thus, any estimate of the options' impact must consider not only the various profitable outcomes for the holder but also that the options may lapse before they are exercised.

With traded options, this fact is priced into their market value and so this can be used as the best estimate of the impact of granting further options. More usually, options granted to executives are not traded and so the value must be derived from an option valuation model such as Black Scholes or the binomial model.

The start-up lobby against expensing options

The reception of IFRS2 has been very mixed with many groups, especially small, start-up companies and venture capital firms in the US, fighting it. Examining the case of US software giant Microsoft helps us to understand why. In 1985, the year before it went public, the company's fiscal year revenues were just $140 million, with a $24 million net profit. However, Microsoft's initial public offering (IPO) primed the pump for what became one of the world's largest wealth-creation machines. A share bought at the offering price of $21 is reckoned to be worth $7,776 today and was double that at its peak. At the time of the flotation it is estimated that Microsoft employees held 2.5 million stock options. Not surprisingly, as the company's performance improved and the share price soared, the granting of options attracted high calibre employees from companies like IBM and Digital Equipment Corporation while helping Microsoft retain its most valuable staff.

Would Microsoft have done quite so well if stock options had been treated as expenses at the time? The answer, at least from some authors, is a clear no. 'Microsoft's history is proof that early-stage companies need broad-based stock options', Blasi et al argue.[5] The company, they say 'could not have afforded to offer that kind of employee ownership if stock options were expensed.' Blasi et al examined the effects of stock options in leading corporations, focusing not only on the effects on incomes and compensation, but also on how options affect corporate culture. Their frame of reference was the 'High Tech 100', an index of 100 publicly-traded information technology firms which use options extensively and which includes household names like Cisco, Sun, America Online, and Intel. These companies share some common characteristics as they:

- provide options to all employees;
- derive 50% of sales from internet-related business; and
- all rode the ups and downs of the dotcom era, with eight of them declaring bankruptcy at one point, but with nearly all still in business.

Blasi et al's review of the High Tech 100 as well as employee ownership among the top 1,500 US companies yields some interesting findings:

- *some executives misused options* – for example, the authors examined compensation for the top five executives at the 1,500 leading firms. They found that this small cadre of senior managers gained $18 billion in options profits in 2001 – a fivefold increase from the early 1990s. This small executive group still controls nearly 11% of all outstanding public shares. Moreover, these more traditional firms reserved most options for those at the top. About 30% of all options are held by senior management, while rank and file employees controlled only 2% of total equity. Overall, only 6% of large corporations provide options to all employees;
- *the firms in the High Tech 100, by contrast, were much more democratic in their use of options* – managers in these firms did not make major pay sacrifices, as the top five executives group still controlled 14% of total equity. Yet, rank and file employees in these firms did better. They controlled 19% of total equity, compared to only 2% in the larger 1,500 firm sample;
- *intriguingly, the authors found employees can gain from options even in bad times* – employees in the High Tech 100 paid dearly after the 2000 technology downturn as their options lost $171 billion in paper value (an 83% decline) between March 2000 and July 2002. Yet, even in these doldrums, the average value of remaining options was $25,000 per worker. While that total will not create new millionaires, it is still reckoned to be a sizeable compensation component; and
- *widespread use of options seems to have a positive effect on company performance* – the authors conclude that broadly distributed ownership boosts a company's productivity by about 4% and raises total shareholder return by about 2%. At the same time, they found that concentrated ownership has no beneficial effect on corporate performance.

So, what does this all mean? One clear conclusion is that fat options packages are often an ineffective way to motivate and reward senior managers. However, at the same time, it seems clear that widespread distribution of options to all employees can have a positive impact on both employee morale and company performance. Shareholder value is built through wide equity sharing, not just by rewarding those at the top. The authors argue that the US should embrace this form of 'partnership capitalism' as an effective means to turn all employees into economic partners in the enterprise.

Options probably helped to build the technology industry in the 1980s, helping fuel America's productivity engine during the '90s. Mandatory expensing of options, though, could make it harder to get that machine humming again, with a negative impact on both competitiveness and productivity. Large companies can probably afford to expense options, but start-ups could find it harder to bring new innovations to market. Expensing would make it more difficult for start-ups to recruit, since they use the potential of a huge options payday to lure top talent. It could suppress earnings at a time when start-ups need credibility with potential customers. *Analyst's Accounting Observer* estimates that expensing would have suppressed the earnings of the S&P 500 by 23% in 2002[6] (see box below 'Big Tech, big problems'[7] for examples).

Mandatory expensing of options would make it harder for start-ups to bring new innovations to market

The impact on options-heavy start-ups could be considerably higher. Expensing could also delay their IPOs since post-boom, investors want to see a strong earnings track record. Some, therefore, advocate giving pre-IPO companies a break on stock options.

A further concern is regulatory oversight. The chairman of the Small Business Survival Committee, a US advocacy organisation, for example, criticised the Federal Accounting Standards Board (FASB) for refusing to conduct field testing on proposed options-valuation

Big tech, big problems

Expensing options will hit earnings at these brand-name tech firms.

Company name (ticker)	*2002 earnings/share* As reported	With options expensed	*2003 earnings/share* As reported	With options expensed
Adobe Systems (ADBE)	$0.79	$0.03	$1.10	$0.33
Apple Computer (AAPL)	$0.18	-$0.46	$0.19	-$0.27
Applied Materials (AMAT)	$0.16	-$0.03	-$0.09	-$0.32
EMC (EMC)	-$0.05	-$0.22	$0.12*	$0.00
Network Appliance (NTAP)	$0.01	-$0.78	$0.22	-$0.28
Siebel Systems (SEBL)	$0.08	-$2.27	-$0.09*	-$0.93
Yahoo (YHOO)	$0.18	-$0.63	$0.26*	-$0.10

** Full-year earnings not yet available.*
Source: SEC filings; Analyst's Accounting Observer

methods. Furthermore, the assessment of the case for expensing options based on the analysis of 18 companies about the costs of implementing an expensing standard is argued as being a very unsatisfactory way to secure input on valuation and undertake a cost-benefit analysis.

Expensing options to help prevent accounting scandals

The counter argument is that there should be one standard whether a company is public or private. Many have also argued that introducing a whole package of changes to the accounting framework, like expensing options, will help avoid large corporate scandals like that at Enron. Sahlman, though, disagrees.[8] The proposals, he says, can do no more than placate public outrage and we instead need to take a deeper look at the recent scandals and examine the real issues behind their cause.

The current accounting proposals for stock options actually serve as a model for disclosure

Enron, he argues, was liberal with stock option grants, but not as liberal as many others. From his perspective, expensing options in Enron's accounts would have changed reported profits by only about 10%. Compare that with Microsoft, where the change would more likely be around 30%, yet the software company has received almost no criticism for its options programmes. For him, the accounting scandal at Enron related to the failure to disclose other items on the income statement and balance sheet, and not on the failure to expense options.

Enron took advantage of some liberal accounting rules that allowed it to transfer assets and liabilities to SPEs

The company, he says, was able to take advantage of some very liberal (and widely perceived as economically nonsensical) accounting rules that allowed the company to transfer assets and liabilities to certain so-called special purpose entities (SPEs). According to the Powers report, which was published by a special committee of Enron's board after the company entered bankruptcy protection proceedings, Enron's management used the SPEs simultaneously to overstate income and understate debt. For example, Enron would sell certain assets to new SPEs, booking a gain on the sale.

Then, in quite a few of the transactions, Enron would repurchase the very same assets within months at a slightly higher price. These were not legitimate sales; they were instead short-term, unrecorded loans to Enron and, furthermore, several of Enron's officers were partners in some of the SPEs. These officers had more to gain from their SPE ownership than from their ownership of Enron (an obvious conflict of interest): a situation that offered more temptation to structure transactions that were favourable to the SPE, rather than to Enron.

Were some of these issues disclosed in Enron's financial statements and related footnotes? Yes, but even the special committee of the Enron board of directors later described the disclosures as 'obtuse' and woefully inadequate. A careful and skilled analyst probably could not have figured out all of the possible problems at Enron from its reported financial statements.

In this regard, the current accounting proposals for stock options actually serve as a model for disclosure. Investors are given lots of information about stock option plans, including some that can help them assign a value to the options granted. In sharp contrast, investors in Enron could not judge the value – on the basis of the information they were given – of the contingent liabilities that Enron had incurred either for itself or for its complex SPEs. But even much fuller disclosure would not have saved Enron or, for that matter, WorldCom. The failures at those companies were more likely caused by a combination of fraud committed by individuals, inadequate control and governance systems that tolerated clear conflicts of interest. A frothy market, where analysts apparently failed to do even the simplest reality checks on reported cash flows, facilitated the deception.

Arguably, those analysts who took WorldCom's reported income as proof that it was doing well would have come closer to the truth if they had simply calculated free cash flows. Then they would have seen the capital expenditures that the company was reporting falsely in order to conceal the true level of its operating expenses.

Even if the proposed rules for stock option accounting end up discouraging the use of stock options, the potential for fraud, and grotesquely excessive gains, will not be reduced. Any compensation system that is based on performance has the potential to encourage cheating. Only ethical management, sensible governance, adequate internal control systems, and comprehensive disclosure will protect the investor against disaster. The current focus of attention on options expensing could be regarded as a distraction from deeper flaws in accounting standards and there is a risk that if the advocates of expensing win there will be a greater problem. Quite simply if it causes the spotlight on corporate America to fade away, nothing at all may have been done to prevent unscrupulous executives from yet again stealing their investors' money.

When beliefs in the benefits of a high growth market economy reached their peak, stock options as a motivator were appropriate. On the downside, when the supposed causes of scandals were associated with allegations of market supported greed and the expansive power of boards to allocate fat-cat rewards, then the risk of misleading investors and the goal of constraining rewards started to take priority. In this new context, it may be that the positive effects of stock options for company growth are for a certain period of time side-lined or suffer diminished credibility.

EVA and executive compensation

Many companies attach performance criteria relating to value creation in the granting of options and one commonly acknowledged in this regard is economic value added (EVA®).[9] Stern Stewart says we can distinguish those companies that take value creation seriously from those that have good investor relations by looking at executive remuneration. 'If management commits their pay to shareholder value, we know they are serious.'[10]

In 1999 Stern Stewart reviewed the remuneration practices of the FT30 to see whether UK executive incentives really align with owners and found, in effect, no correlation between performance and pay. Since then, it seems, surprisingly little research seems to have been undertaken on the link between EVA® as a measure of firm performance and the form of executive compensation. One exception was an examination by Evans and Evans of the compensation structure and EVA® of 209 companies in 1995 – 1998 where EVA® was found to be positively and significantly related to incentive based compensation.[11]

Despite its enormous apparent popularity, some have expressed concern about the claimed superiority of EVA®, in comparison with earnings. Stern Stewart & Company have long argued the case for abandoning traditional measures.[12] However, as reported previously, Chen and Dodd examined the EVA® performance of 566 US companies and compared the information usefulness of EVA® with accounting earnings and residual income, concluding that although improving EVA® performance is associated with a higher stock return, the association is not as perfect as claimed by EVA® advocates.[13]

Furthermore, Biddle, Bowen and Wallace researched the issue of whether EVA® beats earnings and looked at the evidence on associations with stock returns and firm values.[14] They tested the assertion that EVA® is more highly associated with stock returns and firm values than accrual earnings. They produced results that do not support claims that EVA® dominates earnings in relative information content and, in fact, the results suggest quite the contrary, ie that earnings generally outperform EVA®.

> Biddle et al produced results that do not support claims that EVA® dominates earnings in relative information content

Recent research by Feltham et al examined updated EVA® data to determine whether the results of Biddle et al continue to hold.[15] To ensure integrity of analysis, Feltham et al used the same statistical and econometric methods as Biddle et al, but they examined different sets of companies, for different time periods and different markets. The results of their replications were not, in general, consistent with the findings of Biddle et al insofar as EVA® was found to have significantly greater value relevance than accounting earnings. They recommend that the EVA® debate should be reopened, and few doubt that it will. **MU**

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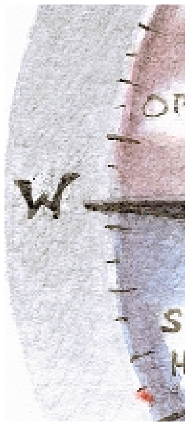
Managing customers – and information



Customer relationship management (CRM) is a fashionable concept in marketing. Each year more and more is spent on software-based systems for managing customer relationships. Yet there is growing evidence that many of these systems do not add value and that many may in fact harm customer relationships. **Susan Foreman**, professor of marketing at Henley Management College, reviews this evidence as well as providing useful pointers to how CRM can be implemented successfully in organisations.

Learning about customers

Most firms face a competitive climate where a deep knowledge of the customer is essential. To facilitate support for marketing and strategic decision-making, firms need to have effective processes and appropriate technologies that can help them to generate, disseminate and respond to market intelligence. Using customer knowledge and intelligence to meet existing and future customers' needs requires a dual perspective as the organisation builds an internal 'engine' which can drive an external customer focus.

Building organisational competence in customer relationship management

The desire to build customer loyalty has led to huge investment in technologies that help marketers try to understand their potential and actual clients. Indeed, such investments, focused mainly on customer relationship management (CRM) systems, have often been a priority. Yet, as Coyles and Gokey note, many firms still aren't benefiting from CRM as loyalty 'is increasingly elusive' and the implementation of CRM projects has been fraught with difficulties.[1]

Many firms have expressed dissatisfaction with CRM systems, despite the multi-million pound investments. Rogers states that 55% of all CRM projects are deemed to be failures and, even more worryingly, that 20% may even have damaged customer relationships.[2] The reasons for this failure are often attributed to poor decision-making, organisational problems and technological limitations. To make CRM work for the firm and the customer, Rogers says, companies need to address a number of factors including: the customer experience, customer lifetime value and satisfaction, internal quality issues and the need to manage CRM projects to a strict budget and time plan.

However, among these issues, internal and organisational concerns appear to present significant barriers. For example, the firm needs to manage change (and minimise resistance) where there are multiple stakeholders and project teams with distinct responsibilities and variable levels of employee commitment. Argarwal, Harding and Schumacher condense these concerns into two key issues; fuzzy accountability and resistance to change.[3]

Internal and organisational concerns present significant barriers to implementing CRM

Fuzzy accountability

CRM projects tend to have a large number of stakeholders with different responsibilities, which can lead to the danger of what the authors call 'fuzzy accountability'. For example, IT people, who are responsible for the technical solutions, often focus mostly on the practical aspects of implementation while those with more commercial roles concentrate specifically on the business solutions.

'Fuzzy accountability' is a problem which can affect CRM projects

That can lead to a lack of overall ownership and accountability between the two with problems continuously passed over. Neither group is focused on the customer nor are they thinking of the enhanced experience which the CRM system ultimately may offer.

Another major issue, the authors say, can be that of resistance to change.

Resistance to change

Despite Rogers' comments about technological constraints, some analysts believe that technological problems don't decide the ultimate success or failure of CRM projects. For Argarwal, Harding and Schumacher, for example, the majority of the systems devised have the functionality and benefits specified at the start of the project. The bottom line, for them, is that implementing a CRM system involves significant organisational change. Thus, to encourage employees from all parts of the organisation to accept and use it, the implementation plan needs to communicate the business value and personal benefits of the system to everyone.

A number of firms have seen the benefits from CRM in increased customer retention and higher revenues

The authors propose an interesting market-based approach to the introduction of CRM systems, which, they say, should replace a standard project 'roll-out'. They advocate segmenting the internal market and targeting different groups of employees with similar needs. In this way, the company can send a focused message about the product features, benefits, value and price and any after-sales service that may be available to employees who are, after all, the internal customers. They suggest a number of practical organisational initiatives to facilitate the success of the CRM system:

Shared responsibility for the project
Here, the technical and business teams are jointly responsible for the success of all aspects of the project, including technical capability, business development and change management.

Communications infrastructure
This requires a clear definition of the information requirements for each team. Argarwal, Harding and Schumacher suggest a 'sending and receiving' framework, in which two-way communication between teams is structured so that specifications, costs, timescales, solutions and implementation issues are shared.

Clear two-way interactions help avoid people defining their part in the project too narrowly

They state that these clear two-way interactions will help to avoid people defining their part in the project too narrowly, and will also provide accountability, helping avoid 'budget overruns, slipping delivery dates, scope creep and ultimately disappointment'.

Senior management support
From the start of the project the business objectives should be clearly communicated. The benefits to customer satisfaction, retention, competitor analysis, market share and the impact on revenue, must be at the forefront. However, as the project progresses the management role changes to one of support and motivation and, of course, accountability.

A number of firms have seen the potential benefits from CRM in increased customer retention and higher revenues. Many, though, still need to tackle issues of responsibility and accountability in the early stages of the project and gain employee commitment to implementation and adoption in the longer term before the impact on the bottom line is felt.

Managing information for competitive advantage

Organisations, of course, vary in their ability to use information and knowledge about customers when they develop relationships and partnerships. If businesses build their competences in managing information, if they distribute it throughout the organisation and use it to develop deeper relationships, they can, according to Zahay and Griffin build capabilities that are difficult for competitors to copy.[4] Ultimately, this could become a strategically important competitive asset.

At the core of this process, though, is not the information system but the ability of the organisation to learn a process which Zahay and Griffin believe may be a company's 'only true source of competitive advantage' in the future.

In this wide-ranging research, Zahay and Griffin draw on work from a number of disciplines to help them explore the different aspects of learning and information systems. They suggest that a sophisticated information system is an indicator of the company's ability to learn about customers and capacity to develop and sustain a competitive advantage.

To support a learning orientation, they state that organisational learning needs to be a priority and this in turn needs a team approach, an open culture and strong, supportive leadership. Indeed if these 'intangible learning assets' can be developed, they can help build a competitive position that is difficult to replicate, they argue.

Their research examines three key issues: what specific types of customer information may help to create competitive advantage? What is the relationship between learning and performance? And lastly, they examine the connections between customer information systems and strategic marketing decision-making.

Customer information systems
In addressing these questions, they state that a sophisticated customer information system will:

- generate and collect customer information;
- process and store that information for use in the firm at an appropriate time and place;
- disseminate that information so that it is available in a timely fashion; and
- include the processes needed to ensure that there is a shared understanding about what the information means and that the information is used wisely.

Customer performance levels
According to Zahay and Griffin, the development of a sophisticated customer information system should bring with it improved customer performance, such as customer retention, an increased share of customer spending and improved customer value over a lifetime.

Customer information systems and strategic marketing decisions
Here their work concentrates on the low cost/differentiation strategies developed by Michael Porter, rather than on more specific marketing based measures. Their view is that learning will differ, depending on strategic positioning. For example, in the first instance, a firm that adopts a differentiated strategy will need to have a sophisticated customer information system and therefore deeper learning about customers will prevail. On the other hand, a company pursuing a low cost strategy will have a more general approach and doesn't need to customise or personalise their offering.

From their research they conclude that the learning benefits achieved with customer information systems are centred on the knowledge management capability that firms develop. Interestingly, Zahay and Griffin do not show that information systems actually improve performance as they originally thought, but do say that the real benefits of a customer information system lie in its capacity to help firms measure customer-based performance, to identify high spending customers, assess their loyalty and measure their value to the company.

Ultimately, understanding the role of customer information as a competitive weapon remains in the early stages of its development. It is clear from this research, though, that customer information systems cannot stand alone and need to be linked with strategic decision-making and performance measures if they are to bring real competitive advantages.

Customer information systems need to be linked with strategic decision-making and performance measures

Maximising customer value

Relationship management and customer information systems can, if implemented effectively, enable firms to pinpoint customers for individual and personalised attention, helping ensure their loyalty and a potentially lucrative relationship for the company. The specific application of information technology to direct marketing, for example, enables a firm to move beyond understanding customers to specific targeting and focused communication.

Thomas, Reinartz and Kumar provide a number of success stories showing, for example, that Otto Verstand (the owners of Crate and Barel) can predict with 80% accuracy how a customer will respond to a direct mail-shot.[5] However, the success stories are matched by other examples of less successful firms who are not maximising their returns from their investment in direct marketing and information systems in general. Thomas, Reinartz and Kumar suggest some reasons for these difficulties:

- an emphasis on the short-term costs, instead of long-term investment;
- too much emphasis on current customers;
- too much emphasis on 'cheap' and accessible customers in preference to potentially profitable ones; and
- focusing on either customer acquisition or retention when, in fact, both strategies are needed.

Difficulties with information systems can arise from an emphasis on short-term costs rather than long-term investment

Managing customer acquisition and retention
One of the fundamental challenges in maximising value from customers is, of course, simultaneously generating new business

while retaining existing profitable customers. According to Thomas, Reinartz and Kumar, measuring performance in this way is challenging because:

- managers may have a short-term perspective which concentrates on costs, whilst ignoring revenue;
- ultimately, the cost of acquisition or retention outweighs the returns and thus managers need to compare profitability with cost effectiveness; and
- customers are not equally profitable.

It is, therefore, a concern if firms concentrate their efforts on customers who are cheap and easy to acquire and retain at the expense of trying to attract those who, while in the first instance may be difficult to hook, are profitable and loyal in the long term. Indeed, in a study of customers at a mail order firm, Thomas, Reinartz and Kumar found the most significant contribution to profit came from the smallest groups who needed more investment and support in the early stages but who were more cost effective to retain in the long term.

In one example, the most significant contribution to profit came from the smallest groups

The next challenge is deciding how to allocate resources. How much, for example should be spent on customer acquisition? How much on retention and how do you allocate resources between different segments of customers?

Thomas, Reinartz and Kumar use a complex regression analysis procedure called 'allocating recourses for profits' (ARPRO) to address this, and found that obtaining the best possible balance between investments is more important than finding the optimal level of investment overall. Indeed, manipulating spend on acquisition and retention is more effective than wholesale reductions in the overall budget, they argue.

Spending and marketing can be an emotive subject as marketers are often accused of lack of accountability for expenditure. Nevertheless, Thomas, Reinartz and Kumar state that, 'spending too little – especially on customer retention – is nearly always worse!'

Deep customer focus

A deep customer focus must be embedded in the culture of an organisation

Developing CRM systems, managing customer information systems and creating tailored offerings are all important aspects of building a dialogue with customers.

However, Vandermerwe states that tracking customers and implementing systems are not sufficient on their own.[6] Organisations, she says, need a strong customer focus that goes beyond processes and reaches into the heart of the organisation – it must be embedded in the culture. The achievement of that cultural transformation has, according to Vandermerwe, been neglected.

Nevertheless she manages to identify 10 steps that firms could follow to implement a deep level of customer focus:

- *strategic excitement* should be created and emanate from senior management. They should provide direction and acceptance of that risk and should concentrate on customer needs rather than products;
- *enlist a group of employees* who are keen to embrace change to lead the way. Customer focus is not about consensus, it is about moving forward in a creative manner. Enthusiastic employees will, according to Vandermerwe, create energy and momentum;
- *articulating a new market space* for the company based on aspirations and some research into the future;
- *identify the value and the opportunity* for the customer and the company by examining true customer behaviour, uncovering gaps and identifying opportunities. Ask what can the firm do that will be indispensable to the customer?
- *build a compelling case* and present it inside the company in 'story' format. It should describe what makes the firm indispensable to the customer. This will provide a more convincing picture of the future to employees than a business plan;
- *size the prize* means that the management team need to demonstrate the value of the new proposition, with the aim of stimulating confidence and boosting investment in the new direction;
- *model the concept* with customers who can help in two ways; by testing the ideas and, ultimately, acting as advocates and innovators. They will influence others and add credibility;
- *get people working together* in the organisation. A functional/departmental approach will not provide the energy and motivation for the new 'deep' customer focus so partnerships and team-working need to be developed;
- *critical mass* and acceptance from the customer will help to build momentum internally, so that the value concept becomes

accepted. The key is to build enthusiasm so that the interest in the concept is contagious; and

- *momentum* is important, and this will develop as customer demand increases and there are outward signs of success. Once this happens, customers aren't just customers any more, they need to be treated like assets.

Ultimately, this approach creates more cohesion in the organisation and fosters an entrepreneurial spirit. Clearly, however, being customer-focused is not something that can happen overnight as it takes more than information, processes and new technology, but also time to implement. Nevertheless, if true customer focus transformation takes place, Vandermerwe states that it is possible to create sustainable competitor advantages and is, she says 'the only way to outpace others.' **MU**

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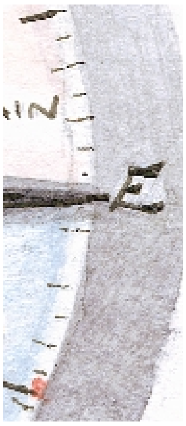

The link between HRM and performance

Human resources management (HRM) systems are costly investments, but how can they add the most value and how can managers know they have invested in the correct solutions? Here **Richard McBain**, director of distance learning programmes at Henley Management College, explains how HRM systems can affect performance.

Evidence of the link between an organisation's HR practices and its performance is growing. Current research focuses on two main areas: first, the impact of the HR system itself and second, on the 'fit' between an organisation's HR practices, its competitive strategy and its context. Both areas of the research have raised questions that have yet to be answered.

One is whether there's a relatively stable set of practices that should make up the HR system, as in the case of a 'bundle' of 'high performance' or 'high commitment' work practices? Another relates to the debate between 'universalist' and 'contingency' approaches. According to the former, there is a combination of 'best' practices that, regardless of the context, will result in superior performance. By contrast, the contingency approach argues that there may be different combinations of practices that are most effective under different circumstances.

HRM can provide competitive advantage through the development of unique resources

This approach is typically underpinned by a 'resource-based' view of strategic HRM, which argues that human resources can provide competitive advantage through the development of unique and difficult to imitate resources. Finally, straddling both research strands is the question of how HR practices actually produce outcomes at the organisational level. This article considers some recent research that addresses these key questions.

Searching for components of a 'bundle' of HR practices

Both conceptual and measurement difficulties have contributed to the lack of clarity concerning what specifically the 'bundle' of HR practices should contain. Guest, Conway and Dewe, who have analysed data gathered as part of a separate study of 1,308 senior personnel managers, provide a useful contribution to the debate.[1] They have, for example, identified 14 HR practices that can help contribute to work-force competence as well as employee motivation, participation and commitment, which together make up the high-performance and high-commitment models of HRM. Their analysis identifies how the HR practices are related to four key organisational outcomes: management ratings of employee performance, employee innovation, employee relations and intention to leave:

- *employee performance* – team-working, and then training and development, are the only practices that discriminate between high and low performance;
- *innovation* – performance appraisal is most important, followed by job design and team-working;
- *employee relations* – performance appraisal (contrary to expectations but possibly linked to perceptions of fairness), keeping employees well-informed and job design are the key practices; and
- *labour turnover* – job design plus employee involvement are the most important HR practices.

Interestingly, only half of the HR practices studied showed a significant effect on organisational outcomes. Team working, performance appraisal and job design emerged as the most significant in explaining the outcomes investigated, with employee involvement, training and development, provision of information and equal opportunities being less important. The value of this research is that it suggests key areas where managers should focus their efforts and attention.

Modelling the linkage between HR practices and organisational outcomes

An important issue for researchers and practitioners is, clearly, to understand how HR practices contribute to business performance. The first example of research that addresses this question is provided by Park et al in their study of 52 Japanese multinational corporation subsidiaries operating in the US and Russia.[2] They suggest that HR practices themselves don't have a direct impact upon the performance of an organisation. Rather, the impact is achieved more indirectly and less tangibly through the development of employee skills, job satisfaction and commitment, and employee motivation. That means changes in these attitudes will probably precede changes in a company's performance. By measuring changes in these factors, managers can thus try to assess likely changes in firm performance.

Paul and Anantharaman also say the impact of HR practices is largely achieved through employee competence and attitudes, but have a more ambitious approach.[3] They test a causal model of the impact of an HR system on organisational performance using data derived from 370 employees in 34 Indian software companies. In their model, HR practices such as selection and performance appraisal impact upon operating and financial performance outcomes through their effect on four key intervening variables: employee competence, teamwork, organisational commitment, and customer orientation. Their key findings were that:

- no single HRM practice has a direct causal connection with organisational financial performance, but each and every HRM practice has an indirect influence on the operational and financial performance of the organisation;
- alone among HRM practices, employee ownership-based incentives have a direct causal relationship on all the operational performance parameters and influence financial performance indirectly, especially through increasing competence levels;
- training, rather surprisingly, does not impact upon employee competence but does seem to enhance productivity, probably because training is typically task-focused;
- team-based job-design impacts indirectly on financial performance, by enhancing speed of delivery of service or product;
- a well-designed compensation system can reduce operating costs through enhanced commitment and overall productivity;
- selection improves product quality and induction practices may promote teamwork and customer orientation;
- the work environment does not directly influence financial performance or any single operational performance parameter, but it does contribute to all four intervening employee-relation variables, and it is the only HR practice to do so;
- performance appraisals have an impact on the competence, organisational commitment and customer orientation of employees; and
- career development has a direct impact on employee commitment which in turn affects employee retention, as well as productivity and the company's financial performance.

Career development has a direct impact on employee commitment

This research sheds more light on the way HR practices can impact a company's performance and suggests managers need an integrated, holistic approach to HRM that recognises the complex interrelationships between HR practices and their linkages to organisational performance.

The third example of recent research in this area is a study by Collins and Clark of 73 high-technology companies in the US mid-Atlantic region.[4] They have examined whether top management team (TMT) social networks mediate this relationship. TMT social networks are the relationships top managers have with employees and others outside their own organisation who hold information of potential value to the organisation.

A number of HR practices may develop and sustain such networks, including peer mentoring, incentives and performance appraisal to encourage the development of business relationships with key external and internal actors, training in relationship-building skills, and providing time and resources for networking.

Peer mentoring, incentives and performance appraisal may develop and sustain TMT social networks

The key findings from the study are that:

- the diversity and strength of ties within external networks, but not their size, are significantly related to sales growth and stock returns;
- the size and diversity of internal networks, but not strength of ties, were related to sales growth and stock returns;
- network-building HR practices were significantly related to the size and strength

of ties in TMT external networks, and to all three measures of internal networks.

HR practices may lead to higher company performance

Their research suggests that HR practices may lead to higher company performance through the development of valuable employee-based resources, in this case internal and external TMT social networks. They also provide further evidence of an indirect link between HR practices and firm performance. Unsurprisingly, once again, employee skills are seen as important in developing the resources that build this performance. The research is also noteworthy in its focus on targeted HR practices to achieve specific employee-based resources.

HR orientation and firm performance

This article has considered how specific or 'bundles' of HR practices may promote organisational outcomes. There are, however, other aspects of an organisation's approach to HR which may have an impact on organisational performance. For example, Panayotopoulou et al have studied the relationship between the orientation of the HR function, firm performance, competitive strategy, the external environment and organisational size.[5]

Their model of HRM orientations is based on the 'competing values framework' and its application to HRM (Cameron and Quinn).[6] This framework assumes that an organisation's effectiveness depends upon its ability to balance the competing values of flexibility-versus-control and internal-versus-external focus. Four HRM orientations are identified:

- *human relations model* – combining flexibility and internal focus. The HR task is to develop employees and their motivation, commitment, involvement and participation. The HR role is, therefore, that of 'employee champion'.
- *open system model* – combining flexibility and external focus. The HR task is to enable an organisation to deal with environmental change through the acquisition of new resources and adoption of new processes and methods. Here, the HR role is that of change agent.
- *internal process model* – combining control and internal focus. The HR task is the development of appropriate rules, regulation and process improvement and the HR role is that of administrative specialist; and
- *rational goal model* – combining control and external focus. The HR task is concerned mainly with goal-setting, enabling the organisation to achieve these goals and aligning HR policies with business strategy. The HR role is that of a strategic business partner.

Key findings from the research of a sample of 104 firms in Greece are as follows:

- when the HRM orientation is consistent with the competitive strategy it has significant effects on financial performance, thus providing support for a contingency approach;
- HRM flexibility seems related to a differentiation strategy, while HRM control is related to cost leadership strategy;
- the most frequently adopted HRM model is the internal process model;
- a combination of HRM control and a differentiation strategy seems to lead to poorer financial performance;
- HRM control seems to have a role in managing complexity and in a complex environment it is positively related to growth. However, HRM control is less appropriate for environmental dynamism, and in these circumstances the human relations and internal-process models seem most appropriate; and
- market performance is positively influenced by HRM flexibility and negatively influenced by HRM control, unless the external environment is complex, when the most successful combination is the control-internal orientation (the internal process model).

This research helps managers not only with the development of a typology of HR orientations, but also gives a greater understanding of the relationship between these orientations on the one hand and competitive strategy and environmental influences on the other. The competing values framework is also used to describe an organisation's cultural orientation, rather than the orientation of the HR function in the research considered next.

Den Hartog and Verburg considered the relationship between HPWPs and firm performance

High performance work systems, organisational culture and firm effectiveness

Den Hartog and Verburg considered the relationship between high performance work practices (HPWPs) and firm performance in a study of 175 Dutch firms and also developed the understanding of the linkages by relating HPWPs to organisational culture.[7] HRM may contribute to the emergence and maintenance of shared patterns of norms, values, and informal rules within organisations underpinning behaviour, which taken together make up an organisation's culture. Four cultural orientations are identified:

- *support orientation* – combining flexibility and internal focus and emphasising co-operation, mutual support, commitment and trust;
- *innovation orientation* – combining flexibility and external focus and characterised by creativity, openness to change, and experimentation;
- *rules orientation* – combining control and internal focus and emphasising authority, compliance, hierarchy, rationality of procedure and division of work; and
- *goal orientation* – combining control and external focus and characterised by rational objectives, productivity and functionality.

Fourteen specific HPWPs were included in the study: strict selection, incentive pay for performance, profit-sharing, the use of job redesign/evaluation and task analysis, information sharing, employee autonomy, performance appraisal, teamwork, training, an emphasis on keeping skills up-to-date, opportunities for internal promotion and management development, as well as an overarching philosophy in terms of a mission statement and an HRM strategy.

These HPWPs were related to several measures of organisational output, including CEO perceptions of organisational performance, turnover, absenteeism and managers' assessments of employees' willingness to 'go beyond contract'. The key results of the study are that:

- the core HPWPs are strict selection/assessment centres, training, obligation to update skills, possibilities for internal promotion, management development, mission and HRM strategy;
- positive relationships were found between this set of practices and employees' willingness to go beyond contract, as well as perceived economic performance. In addition, HPWPs seem to reduce absenteeism. Turnover was not strongly related to the core HPWPs, but it was negatively correlated with performance evaluation and information-sharing; and
- a rules orientation is least often correlated with HPWPs, while the goal and innovation orientations (and to a lesser extent the support orientation) are positively related to the combined set of such practices.

While this study produces somewhat different results to those of Guest et al in terms of key HR practices, it provides further evidence of the link between high-performance work systems and firm performance, in a Dutch context, and relates these to organisational culture.

Understanding HRM-firm performance linkages: the role of the strength of the HRM system

The final study to be considered does not report the results of empirical research, but instead develops an interesting theoretical framework for future testing. Bowen and Ostroff argue that climate is a mediating variable between HR practices and organisational performance.[8] Their focus is not on HRM content, or a set of HRM practices, but rather on HRM process.

This is defined as 'the features of an HRM system that send signals to employees that allow them to understand the desired and appropriate responses and form a collective sense of what is expected'. An HRM system thus has a symbolic function within an organisation.

An HRM system has a symbolic function within an organisation

They argue that HRM content and process must be integrated effectively in order for strategic HRM to produce results in terms of organisational performance.

They introduce the notion of the 'strength' of the HRM system. Individuals, they say, give psychological meanings to situations. These meanings influence their potential behaviours. A strong situation is one that promotes conformity of meaning while a weak situation is ambiguous. A strong HRM system can lead to a strong climate, in which employees share a common interpretation of what is important and what behaviours are expected and rewarded.

Bowen and Ostroff introduce the notion of the 'strength' of the HR system

Thus, strength of the HRM system can bridge the individual's psychological climate (what people 'see' as they make sense of the environment) and the organisational climate (a shared perception of what is important in the organisation and what behaviours are rewarded).

Bowen and Ostroff identified three features of an HRM system that can create a strong situation, and each has a number of components:

- *distinctiveness (standing out in the environment)* – including visibility, legitimacy of authority, and relevance to important goals;
- *consistency 'instrumentality'* – in terms of producing defined outcomes, validity, and consistent HRM messages; and
- *consensus (agreement among employees in their view of the event effect relationship)* – agreement among principal HRM decision makers, and fairness.

A strong HRM system will enhance organisational performance

Clearly, a strong HRM system will enhance organisational performance by facilitating shared meanings and 'cognitive maps', which in turn promote behaviours and collective responses that are consistent with organisational strategic goals.

In contrast, in a weak situation, individual attitudes and behaviours could be inconsistent with organisational strategic goals.

Concluding comments

This article gives further evidence of the link between HR practices and organisational performance. It has suggested that there are certain core HR practices to be included within the bundle of high-performance or high-commitment work practices. However, it is also clear that the research findings suggest the relationship between the HR system and organisational outcomes is largely indirect – and also complex. Various factors mediate the relationship. In addition to employee skills and attitudes, such factors as the climate promoted by an organisation's approach to HRM and top management team networks have an influence. Moreover, the relationship is affected by an organisation's culture, the orientation of HR within the organisation, the competitive strategy and an organisation's external environment. Future research will shed more light on these relationships. **MU**

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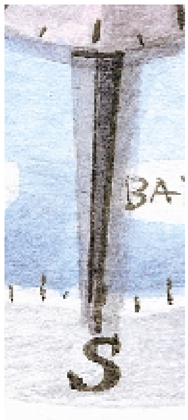
Do leaders make a difference?



Do leaders impact upon the performance of organisations? Should managers invest in developing leaders internally or recruit from the outside? And what is the value of charisma in a leader? **Ian Turner**, professor of management studies and director of graduate business studies at Henley Management College, draws on the latest research to explore these issues and offer practical tips for managers.

Ten years ago, James Collins and Jerry Porras' best selling book 'Built to Last', tried to identify the characteristics of companies that have been successful over a long period. The authors' research approach made the book particularly interesting and important as they identified a group of so called 'visionary' companies that had out-performed their industry and then matched them against companies that had performed in-line with the average for that industry. So, for example, General Electric (GE) was matched against Westinghouse, Procter and Gamble against Colgate and Hewlett Packard against Texas Instruments.[1] Thus, the empirical basis for Collins and Porras' analysis was particularly strong compared to similar books.

That methodology also adds to the value of their statements on leadership in top companies. 'In 1700 years of combined life-spans across the visionary companies', the authors said, 'we found only four individual incidents of going outside for a chief executive officer (CEO) – and those were only two companies. Home-grown management was always at the visionary companies to a far greater degree than the comparison companies (by a factor of six). Time and again they have dashed to bits the conventional wisdom that significant change and fresh ideas cannot come from insiders'.[2]

They demonstrate persuasively how visionary companies make provision for management development and leadership succession. Less successful companies who invest less in such processes are, however, often forced to look outside the company for new leaders, disrupting the performance of the organisation. This was perhaps most famously epitomised by Collins and Porras' comments about 3M, a company frequently praised for its innovative capacity. Who, the authors wondered, was the charismatic visionary leader behind 3M's success? In fact, the research revealed that 3M was distinguished not by a series of charismatic chief executives but by an enduring institutional culture that was helped by a commitment to internal advancement.

The risky business of hiring stars

In most fields, those who excel are in scarce supply and can thus demand significant premiums

Groysberg, Nanda and Nohria have also examined the danger of bringing new blood into a well-established corporate culture.[3] They acknowledge that in recent years it has been common to talk about the 'war for talent' in recruiting talented employees. In most fields, those who excel are now in scarce supply and can demand significant premiums compared with their peer group.

Clearly, this applies to top business people as well as, for example, equity analysts in investment banks. Groysberg et al argue conclusively that top performers recruited from outside companies more often turn out to be comets than stars, with their shine fading once they're removed from the context where they achieved their original success. In addition, the arrival of such stars can lead to resentment over pay and other perks at the company they are joining, as employees there learn what's been paid to prise the executive from their former post. Employees at the company may then isolate the new executive and refuse to co-operate. Meanwhile, the new 'star' must adapt to fresh working practices, new processes and new people whose skills and loyalties will be unfamiliar.

Visionary companies make provision for management development and succession

The work of Groysberg et al is consistent with the philosophy of the so-called resource-based school of strategy, which has been previously discussed in *Manager Update*. This states that organisational success is generally attributed less to a specific asset which can be readily transferred from one organisation to another, than to complex social relationships within and outside the organisation such as networks of individuals which are built up over time, teams of support staff to ensure that even stars can perform at their best and an atmosphere and culture which prizes trust and commitment to organisational goals rather than egomania. 'The only viable strategy is to recruit good people, develop them and retain as many of the stars as possible,' is their conclusion.[4]

The impact of charismatic leadership

Collins and Porras are also dismissive about companies who rely upon outsiders to make significant organisational change. Look at General Electric's Jack Welch, whom the authors call the 'leading master of corporate change in our time'. He spent his entire career within GE before becoming CEO. They even question the wisdom of IBM appointing Lou Gerstner from Nabisco to head up IBM in the mid 1990s, even though he helped turn the company around. Clearly, insiders can and do effect transformational change in organisations, but some companies also get trapped in their own 'dominant logic', or culture and ways of operating. Clearly, it sometimes takes an outsider to challenge a recipe that's worked well in the past but which is now no longer appropriate.

Does charismatic leadership produce superior performance, or is it the other way around?

Charismatic leadership has also fallen into disrepute after recent corporate scandals. Today, we question the cult of leadership and more often associate charisma with the web of spin and deception which helped cloak massive fraud at companies like WorldCom and Enron.

Investors were more likely to invest in a company with a charismatic leader

Flynn and Staw have conducted research into the influence of charismatic leadership styles on the external perception and support for an organisation.[5] These authors wanted to test some propositions about the impact of charisma on investor support for a company. Specifically, they proposed that investors as prime stakeholders in companies would be more attracted to invest in a company headed by charismatic leaders and that the influence of charismatic leadership is likely to be disproportionately greater when the company is facing a difficult economic situation. Furthermore, they hypothesize that the appeal of charismatic leaders will be greater for investors who already hold shares in a particular company, since this is likely to emphasize the shared bond between them. Finally, and controversially, they believed that being exposed to the persuasive messages of charismatic leaders would have a profound and sustained impact upon the acceptance of risk in any investments which investors are prepared to undertake.

These are intriguing questions and raise some fundamental research issues, eg how do we define charismatic leadership, and who exactly fits the bill? These authors adopted a two-pronged approach. They identified chief executives in the US who had been described in publications as 'charismatic' and looked at the performance of some 46 different companies over a 10 year period. The results of the study showed companies led by charismatic chief executives performed significantly better than the industry average. This difference was more pronounced when economic conditions or industry structure were particularly adverse.

Such research, of course, raises questions of the direction of causation, or more simply, did charismatic leadership produce superior performance or did superior performance help generate the attributes of charismatic leadership? To control for this, the authors conducted an experiment using undergraduate business school students. The group were invited to analyse the attractiveness of investing in Apple computers. Half were asked to make their investment decision before viewing a video of Apple CEO Steve Jobs, whilst the other half made their investment decision following the video.

The results of the experiment reveal that the investors were, on average, more likely to invest in a company with a charismatic leader, even when they were exposed to negative information about the company's strategic position, than if they were in possession of positive information about the company but were not exposed to the charismatic leadership appeal.

The research revealed support for these authors' hypotheses which they believe could have significant implications for organisations. Thus, if charismatic leadership encourages investors to take greater risks, it may be more appropriate as a style for firms that are innovating, introducing new products or technology, and entering new markets. Conversely, such leadership styles would be less appropriate for organisations in more stable environments requiring high levels of reliability and risk averse stakeholder behaviour.

When chief executives believe their own press

Flynn and Staw recognise that there can be a dark side to charismatic leadership, in that charismatic leaders can succeed too well in securing support for strategies that are fundamentally unsound and it is important to recall in this context that this research is based on experiences in large US companies. In other countries, such as Germany, there is an innate suspicion of charismatic leadership that stems from the country's unique historical experience.[6]

As the authors also make clear, charismatic leadership styles may of course also be a function of over-attribution: ie that we attribute the success of a company to great leadership when it is, in fact, more a combination of luck, timing, organisational support or broader industry factors.

Hayward, Rindova and Pollock have examined this issue in their article on the causes and consequences of CEO celebrity.[7] They argue that CEO celebrity is typically created by journalists who are able to set the agenda and shape the public consciousness of issues and personalities. Journalists, they say, are particularly susceptible to the so-called 'fundamental attribution error' of exaggerating the influence of leadership on actions and outcomes, at the expense of more complex situational factors. That's because journalists are typically generalists who can lack specialist knowledge and because time pressure can lead them to look for short cuts. They are particularly prone to attribute responsibility for a firm's performance to its chief executive when the company's actions seem to differ from those of its peers or when the CEO's actions seem consistent with what they've done in other companies and industries.

Thus, for example, if a chief executive or a corporate leader like Virgin's Richard Branson exhibits risk-seeking behaviour in some aspects of their personal life, then the risk-seeking strategic decisions taken by the company are more likely to be attributed to the chief executive. Indeed, according to the authors, the more idiosyncratic the chief executive's own behaviour, the greater the probability that journalists will attribute the firm's strategic actions to its chief executive.

While this explanation seems plausible, does it really matter? According to Haward et al, the consequences of this celebrity can be quite profound. This is because the description of leaders and their actions provided by the media is central to the way we, including chief executives themselves, make sense of the business world. Thus, the more that success is attributed to leadership, in their own organisation and others, the more chief executives come to believe this themselves, potentially leading to an exaggerated perception of their control over the company's present and future performance.

Once celebrity has been achieved moreover, it is in the chief executive's interest to develop and nurture it, and to emphasise the relationship between their leadership style and the firm's performance. For example, this may increase the perception in the mind of stakeholders of the extent to which the chief executive can influence company performance, making it easier for the chief executive to get their way and further reinforcing the perception that firm performance is tied closely to CEO decision making.

Charismatic leadership styles may be a function of over-attribution

Thus, CEO celebrity is likely to produce over-confidence in the leader's own abilities and an over-commitment to strategies which produced that celebrity in the first place. As Hayward et al point out, there is enough evidence to suggest that over-confident leaders end up over-paying for acquisitions, develop riskier products, take a greater risk in entering new markets and over-estimate the likely success of new projects. A quotation from Daniel Vasella, CEO of Novartis, is telling in this respect "there is a pattern of celebration leading to belief, leading to distortion ... you are idealised by the outside world, and there is a natural tendency to believe that what is written is true. It isn't though. No CEO is as good (or as bad) as the media makes him or her out to be. Nevertheless many come to believe their own press. But it becomes difficult, if not impossible, to change the course you and your company are on … you must make the targets – you must keep delivering record results at whatever cost to continue the celebration".[8]

Over-confidence can be a trap for the CEO celebrity

Over-confidence, described in the article as 'perhaps the most robust finding in the psychology of judgement' may not be entirely negative, however, as it can lead people to achieve things that they might not otherwise have done and can produce remarkable successes.[9] In the business world over-confidence can also produce some spectacular misjudgements. It can be exacerbated by so-called 'escalation of commitment'; a phenomenon which seems to be akin to the losing punter in a gambling casino, increasing the bet to try to recover ever larger losses.

Corporate leaders and corporate strategy

Why do top management teams make the strategic decisions they do? Clearly, there are objective economic factors such as a company's previous performance, its capabilities, firm size, personnel and financial resources, which have a major impact on all strategic decisions. Top management teams, though, are also conditioned in their decision-making by their backgrounds and their governance positions.

There are two distinct schools of thought: the 'upper echelons theorists' emphasize the influence of demographic characteristics and background experiences on the way corporate elites think, whilst the 'agency theorists' believe top management team actions are primarily conditioned by their governance role, ie: whether they are a chief executive, an executive director or a non-executive director. Jensen and Zajac have recently sought to combine these two perspectives to answer the question 'how corporate elites make strategic decisions'.[10]

Combining two schools of thought can yield interesting new insights

Apparently, there's strong empirical support for the theory that top management with predominantly financial backgrounds prefer high levels of diversification and acquisition. Why so? Partly, the authors say, because such individuals often look at companies as 'portfolios' of multiple businesses rather than as organic organisations. Conversely, leaders who come from a production or operational background usually stick closer to their knitting and are less prone to acquisitions. This, itself, is an interesting insight into how organisations make strategic decisions. It suggests, for example, that by examining the functional backgrounds of top leaders in competitor companies, inferences can be drawn about their propensity to prefer one strategy over another. Jensen and Zajac, however, take this a step further, distinguishing between the functional backgrounds of chief executives and other directors, both external and internal. Having a CEO with a finance background thus increases the level of diversification and acquisition.

Having both internal and external directors with a finance background has a negative effect on the propensity for acquisition and diversification. This is clearly a case where combining two schools of thought can yield interesting new insights into strategy and leadership. **MU**

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