MANAGER UPDATE 5

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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.

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Marketing

Marketing on the Internet

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Speculation about electronic shopping began in earnest about 30 years ago. The vision of shopping, on computerised systems, was predicted in a range of diverse literature, from conventional business journals to science-fiction novels.1 However, it was only in the late 1980s and 1990s that the focus changed from electronic shopping to electronic markets. Indeed, marketing and the Internet has only been the subject of serious debate in the last few years and it would be fair to say that practice has far outstripped research and scholarship in this area. There are many examples which can illustrate the lag between practical developments and scholarship, from mass marketing to segmentation, from consumer markets to the different marketing requirements for services marketing, and now from the marketplace to the marketspace, where virtual commercial transactions are enabled by information technology.

The impact of the Internet can be seen across the marketing spectrum in consumer markets and business markets, and in its impact on the tools and techniques that marketers now have available to communicate and transact with their customers. A number of writers now consider that the impact of the Internet is so great that the dominant logic and theoretical foundations of marketing are changing, and we are on the verge of a paradigm shift. Brännback2 states that the traditional marketing mix is no longer useful in the marketspace where managers are concerned with a virtual value chain and the intermediaries in the distribution channel become redundant for some sellers. In many respects, the changes brought by the Internet are seen by Brännback to herald the return to direct customer relationships. She states that "everything is different: (i) content of the transaction is information based, (ii) the context in which the transaction occurs - electronic, (iii) and the infrastructure that enables the transaction to occur is different."

The Internet

The origins of the Internet are described by Peterson, Balasubramanian and Bronnenberg. They show that it was developed by the Department of Defence (USA) in the 1960s, as a means of linking incompatible computer systems and networks. The network developed over the decades until it became commercially available in the 1990s and easier access was provided by the World Wide Web (WWW).

As an alternative marketing channel Peterson, Balasubramanian and Bronnenberg show that the Internet has some features that are the same as in traditional channels, such as retailing, yet it also has some distinctive and unique features. They state that the Internet is a relatively inexpensive channel for sellers to develop, and that it can store large quantities of information in a number of virtual locations. Information can be located, organised and disseminated inexpensively on request by consumers wishing to learn about products and services, and some goods and services can even be distributed over the Internet.

Furthermore, exchanges and transactions can also take place after the consumer has been able to sample or trial the goods on the Internet. Whilst this may not be as satisfactory as personal inspection it is seen by Peterson, Balasubramanian and Bronnenberg as preferable to viewing printed material and catalogues.

Marketing, the Internet and consumer markets

Peterson, Balasubramanian and Bronnenberg have developed a framework which is based on a simple question. What will be the impact of the Internet on consumer markets? Their work is not an attempt to predict the size and the scope of this channel in the future, but to provide a framework which managers can use to compare the Internet with the existing marketing channels used in consumer markets. Underpinning this framework are a number of assumptions, each with the potential to be challenged in the fullness of time.

Nevertheless, the authors state that in the future there will be almost universal access to the Internet, that the Internet will not increase total consumer spending, since the existing spend will be spread across all the channels, that technical developments will mean that the Internet will not become over congested, and that solutions will be found to provide security and privacy in transactions. The framework for understanding the effects of the Internet on marketing for consumers is based on three dimensions; understanding channel management, classifying products and services, and an awareness of how consumers make decisions.

Channel management

In addressing the first dimension of the framework, the authors are asking two basic questions. In what way will the Internet complement existing channels in consumer markets, and in what circumstances will the Internet be a substitute for existing channels? The three broad categories of channel management are identified:

- Distribution channels incorporating logistics and inventory management. This channel they consider will be the least affected by the Internet except for "information goods . . .with digital assets".
- Transaction channels, typically wholesalers and retailers, who may have a role in the presentation and the price and take payment for the goods and services. Here, the impact of the Internet may be considerable because it enables consumers and sellers to interact, develop relationships and complete the sale efficiently without an intermediary.
- Communication channels, dominated by media and advertising agents, which facilitate interaction with consumers. This is the channel that is already the most affected by the development of the Internet in consumer markets and, as we shall see later, in business markets. The Internet can communicate information, which is targeted, appealing and cost effective on an international basis.

The characteristics of goods and services

Peterson et al argue that the Internet is sensitive to the nature of goods and services. In their framework they suggest that the cost and the frequency of the purchase is a key dimension which affects whether consumers will purchase products on the Internet. They also focus on the "value proposition", which could be tangible or physical goods and also intangible or service related, the latter being more suitable to marketing on the Internet. Finally, they also consider the degree of differentiation possible in the value proposition. They state that differentiation has a number of effects. If a proposition cannot be easily differentiated from the competition, marketing on the Internet may lead to a high degree of price competition, since searching for different prices is efficient and there is little other retail evidence for consumers to evaluate. On the other hand, where a proposition can be easily differentiated, the Internet provides the opportunity to develop one-to-one relationships with customers who are be able to view and even sample the product before they purchase. In a conventional retail setting this kind of extensive search would be both costly and time consuming.

Consumer decision process

The third and final dimension in the framework is based on understanding consumer decisions and choices. The starting point is to ask where does the consumer begin when searching for goods and services? Peterson et al state that a consumer is faced with a number of options when seeking information:

- Do the consumers focus on the product or service category or do they focus on the brand during the purchase process?
- Do consumers use the traditional retail channels when searching for information or do they use the Internet?
- Do consumers use the Internet or the retailer when they are making the final acquisition of the product service or the brand?

Inevitably, the consumer can use the channels interchangeably throughout the decision-making process. On the one hand, the framework shows that a consumer may intend to purchase a tangible good, for example wine, a low cost and frequent purchase product, with potential for high differentiation. The decision process is likely to include, brand choice after a visit to retail outlets, which includes a price search. Here, comparison of prices on the Internet is unlikely, and purchase is likely in retail channels. However, on the other hand, when considering a high price and infrequent purchase of an intangible or information product with the potential to be highly differentiated, the Internet becomes a more viable alternative. Here, brand choice and price information are readily available in both channels as is the final purchase. Peterson et al do not claim that this is the definitive work on consumer marketing and the Internet, and they state that in many respects the work raises more questions than it answers. The article concludes, perhaps appropriately, by looking to the future and providing an extensive list of questions for further research.

Industrial marketing on the Internet

The marketing of consumer goods, services and industrial products have evolved in different ways. In many respects, industrial or business-to-business markets focused on relationships and one-to-one communication. Deighton3 considers that the Internet is a "tool that solves the problem of consumer marketing's lack of customer intimacy as surely as it solves the business marketer's problem of field co-ordination". He also considers that one of the main consequences of the Internet is that it is likely to unite the theory and practice of consumer and business marketing.

Honeycutt, Flaherty and Benassi4 conducted three case studies in industrial companies which are all in the early stages of marketing their products on the Internet. Each of the companies are relative novices in this sphere, yet their approaches to the Internet range from global strategies to managing day-to-day operations.

The first company they investigated was a welding company which supplies gasses in cylinders and equipment to customers in a local area. The welding industry is a mature industry, with the company focusing on 20% of the market customers and leaving 80% of the market to fend for themselves. Despite the fact that this is a conventional market focusing on traditional distribution channels, the company identified initiatives taken in other industrial sectors and decided to launch a Web page on the Internet. Their initial objective was still focused on communicating with their more technically advanced customers. The first orders generated by the Internet and Web page came in the first four months, from new customers and overseas customers. In many respects the Internet and the industrial marketing channels were as interchangeable as the consumer channels. Here, the information search and evaluation of prices takes place on the Internet and purchase takes place in conventional channels, in this case through telephone orders. The company did not actually achieve its objective with existing customers, but it gained repeat business from customers outside its original catchment area and some overseas clients.

In contrast, the second company case presented by Honeycutt, Flaherty and Benassi, selling epoxy and marble floor products, had no Internet or email experience. Its objectives were more ambitious and were directly focused on the international exposure the Internet could provide. Using external Internet specialists, and after one poor experience, they launched their Web page. Within two weeks they reported that enquiries had increased and a number of international transactions had taken place.

The third case was not quite as positive. A metal products firm whose objective was to bring its products to the public's attention at low cost, stated that the Internet had minimal effect on sales. However, they noted that they felt they were serving existing customers better with improved information on the Internet, and that costs had declined due to the reduced demand for printed catalogues and subsequent reduction in postage costs.

This work encouraged Honeycutt, Flaherty and Benassi to consider that the Internet was leading to some "strategic shifts" and modifications in the use of the marketing mix in business markets. They make modest suggestions; the Internet had brought a new, alternative form of distribution, pricing needs to be competitive, Internet customers should be targeted with specific products which satisfy their needs, and promotion offered them the opportunity to inform and develop communications with customers. Brännback is bolder in support of the view that the paradigm is shifting. She states that two elements of the marketing mix have been influenced greatly by the Internet or marketspace, where the distribution and the customer's impression of the product have moved from the physical to the informational. Furthermore, the other elements of the marketing mix are also affected, as managers on the Internet need to reconsider their pricing strategies, with an emphasis based on the customer rather than cost. Finally, the promotion elements are heightened and new forms of advertising are emerging, more interactive, with customised material and focused on the transaction.

The work of Peterson, Balasubramanian and Bronnenberg on consumer marketing led them to stronger conclusions about the impact of the Internet on marketing. They stated that "[t]here is virtually no information on how, or to what extent, consumers will use the Internet in the context of marketing or what new marketing paradigms will prove viable". Nevertheless, the tremendous growth in the practice of marketing on the Internet has extensive implications for the marketing discipline. The practice needs to be supported by new robust frameworks for understanding, analysis and measurement in addition to support for the development of new, specific techniques to meet the needs of the Internet customer. As Deighton states, "seldom does the old intellectual capital do much to inform the use of the new tool".

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Human Resources Management

New Perspectives on Mentoring

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Mentoring has been the subject of increasing interest to organisations and researchers since the mid-1970s, alongside a greater focus on individual and organisational learning and change. Whilst recognising some potential problems typically in terms of implementation, the literature has been overwhelmingly positive about the benefits of mentoring for the mentee (or protégé) as well as for the mentor and the organisation.

Whether through formal programmes, or through the encouragement of informal relationships, mentoring has become increasingly popular in practice. At the same time, research into mentoring has often been characterised by a lack of agreement on the nature of mentoring and a lack of underpinning theory and rigour. This article considers some recent research into mentoring in an organisational context. In particular, it considers research into the potential for peer and group mentoring, the selection of the mentor and the development of the mentoring relationship, and the benefits of mentoring. It also raises the question of why some mentoring programmes are likely to fail.

Challenging the traditional view: peer and group mentoring

A mentor may fulfil a variety of roles, and three categories of functions have been identified: those of "psychosocial support", "career development" and "role modelling". It has also been recognised that formal and informal mentoring may have differing aims, and it is possible to identify two broad themes in literature and practice. The first, more associated with a US tradition, sees mentoring as principally focused on career advancement. Thus for Ragins,1 mentors are "individuals with advanced experience and knowledge who are committed to providing upward mobility to support their protégé's careers". The second theme sees mentoring as concerned with broader personal development and learning. This view, perhaps more commonly found in the UK tradition, is exemplified by a recent study2 which defines mentoring as "a process by which a manager, who is outside the normal line relationship, gives help and advice to a more junior member of staff".

In both of these traditions mentoring is seen as a one-to-one relationship. This view has been challenged in a number of ways. Based upon a study of a mentoring programme at Motorola, Caruso3 distinguished between mentoring as an "open" and as a "closed" system. In the latter, or "traditional" view, the mentoring relationship is seen as unaffected by the context in which it occurs. In contrast, Caruso sees mentoring as a dispersed activity in which an individual may gain mentoring "from a variety of individuals or other sources", and which is open to the context in which it takes place. Another assumption of the traditional view, that mentoring is a hierarchical relationship, may also be challenged. A key reason for exploring alternatives to the traditional view of mentoring lies in the changes that have occurred in organisations, including downsizing, de-layering, flatter structures, and increasing diversity in the workforce, which have combined to reduce the potential pool of "traditional" mentors.

McDougal and Beattie4 consider the nature and outcomes of peer mentoring relationships, which they define as "a process where there is mutual involvement in encouraging and enhancing learning and development between two peers, where peers are people of similar hierarchical status or who perceive themselves as equals". This definition raises interesting and important questions about the extent to which the mentor needs to have greater experience or knowledge than the mentee, and seems to emphasise the function of providing support. Their research, based on a qualitative study of post-graduate management students, identifies two types of peer mentoring relationships, the "utilitarian" and the "holistic". The former has a high work focus, while the latter has an emphasis on both work and personal aspects of learning. Both types require trust and provide support, but only in the holistic relationship is there an interest in the whole person and personal challenge stretching the individual. McDougal and Beattie found that peer mentoring relationships are less directive and less inhibited than hierarchical relationships, as well as being more reciprocal and open. The principal benefits identified for peer mentoring are broadly similar to those found in traditional mentoring relationships, and include support, confidence building, mutual learning, different perspectives, friendship, motivation, networking, having a confidante and stress management. Only minor problems were identified, the key issue being time and availability.

For McDougal and Beattie, peer mentoring offers organisations and individuals many advantages, including access to "the power of informal learning" and "a valuable alternative source of support for individuals during periods of significant change, including restructuring and mergers". They also suggest that peer mentoring relationships may be more attractive to women, given their "collaborative management styles".

Organisations need to be aware that the promotion of peer mentoring relationships requires a supportive organisational climate, and that whilst they may help to create the conditions in which holistic mentoring relationships may flourish naturally, their principal focus should be on encouraging utilitarian peer relationships which may then develop into holistic ones.

Another challenge to the "traditional" view is provided by Dansky,5 who considers whether mentoring can be interpreted as a group phenomenon. Dansky proposes that group dynamics may take on mentoring qualities, and allow individuals to gain career and psychosocial benefits. She defines "group mentoring" as a "group influence that emerges from the social norms and roles that are characteristic of a specific group and results in the career enhancement of an individual member". In particular, Dansky found that membership of a professional association has a positive influence on career progress as measured by salary and job title. She identified four distinct types of group mentoring behaviours: "role modelling", "inclusion/belonging", "networking", and "psychosocial support". Psychosocial support and inclusion meet emotional needs, while networking and role modelling meet instrumental needs, such as skill development. She found that feelings of inclusion were positively related to job title, and that role modelling was a significant predictor of salary. Professional organisations "offer opportunities for members to observe and model the behaviours exhibited by other, higher status, members".

Selecting a mentor - willingness, ability, "ways of knowing", and power

The selection of suitable mentors is important for the success of the mentoring relationship. Pullins, Fine and Warren6 identified a number of factors that influenced a person’s willingness and ability to mentor. Not surprisingly perhaps, they found that key factors were high levels of job experience, job satisfaction and inter-personal competence, and that inter-personal competence was important for the ability to mentor. Of more interest was the finding that high levels of role ambiguity, or being unsure how to perform a job, was negatively related to both willingness and ability, whilst role conflict, defined as having multiple role partners, was positively related to both. Other recent studies have shown the need also to consider a mentor and mentee’s "ways of knowing", and also power differences within and outside the mentoring relationship.

Egan7 considers the influence of the ways in which women learn, or their epistemologies, on their perceptions of work, on themselves and on mentoring. She defines three "ways of knowing": the "constructivist", "proceduralist" and "subjectivist". The constructivist is a "creator of knowledge" with a high perception of self-efficacy and with defined goals. The proceduralist likes to "follow the rules" and to "think within the system". The subjectivist perceives knowledge as personal and intuitive and, typically, has the lowest perception of self-efficacy. She found that the three categories differed significantly in their perceptions of the workplace and their opportunities for success, their perceptions of their self, relationships and work, and also in the effectiveness of particular mentoring roles for enhancing their growth and advancement.

Constructivists are most likely to have had a mentor, and they particularly value the roles of encouraging, educating and role modelling. They are the least likely to want their mentor to take a protecting role. The constructivist has clearly defined goals and is most likely to find her own mentor, similar to herself in terms of ambition and intelligence , and therefore an informal mentoring relationship is likely to work best. The proceduralist, less self-assured than the constructivist, is least likely to have a mentor as a role model, because she is least likely to seek one, feeling that she should be the model. Proceduralists prefer a consulting relationship, and are unlikely to benefit from a formal mentoring programme, although they can benefit from mentoring. Subjectivists, with the lowest perception of their own self-efficacy, and therefore the most likely to doubt that they can succeed, rely on intuition and are the least likely to seek role models. As a result, Egan argues that they are the most likely to gain from a formal mentoring programme. Thus, successful mentoring requires that the mentor functions in roles compatible with the protégé's world-view and way of learning.

Ragins8 shows the importance of considering power relations within mentoring, particularly in respect of minority groups (defined by ethnicity, gender, class, disability, etc). She argues that organisations should promote informal mentoring programmes, since existing research suggests that formally assigned relationships may be less effective than informally developed relationships, and that one way of achieving this is by recognising mentoring relationships in performance appraisals and salary decisions. In the short term, minority protégés who may have restricted access to mentors, should be encouraged to obtain more than one mentor in order to obtain role modelling in homogeneous relationships and career development functions in diversified relationships. In the long term, the solution for Ragins is to equalise power relationships among groups in organisations, and expanding the future pool of minority mentors by increasing the current minority employees access to minority and majority mentors can help in this process.

The development of the mentoring relationship

The mentoring relationship has typically been thought of as developing through a number of stages, usually three or four, with different psychosocial and career development functions dominant in each stage. Pollock9 examined the development of informal mentor protégé relationships (MPRs) and looked for empirical support for a three-stage model of mentoring relationships. The overall results suggest that mentors fulfil the full range of functions within the first year or so of the MPR, and continue to do so as the MPR progresses. Although all functions were displayed early, the functions of challenge and psychosocial support were found to predominate. Challenging and respecting the subordinate forms the foundation of MPRs, and both functions are performed more frequently as the relationship progresses, and are consistently performed more frequently than are coaching and political behaviour.

Evaluating mentoring programmes: why do they fail?

There can be little doubt that mentoring is becoming increasingly popular, particularly in those organisations which consider themselves innovators in human resource practice. Thus, Mirvis,10 reporting on the results of a survey of more than 400 American-based organisations, argues that innovative firms have "a cultural mindset" in which investing in people is seen as essential to their success. In addition to being more likely to improve the workplace and promote team work, to develop employee involvement programmes, to invest more in training, and promote workplace flexibility, human resource innovators are more likely to value diversity and have mentoring programmes.

At the same time, mentoring programmes seem to have been particularly difficult to evaluate. The principal reasons for this difficulty include the confidential and elusive nature of the relationship, its focus on long-term development, the challenge of isolating the effects of mentoring, the changing individual and organisational objectives involved, and the lack of "hard" measures. A recent IDS Study11 provides a useful survey of current practice in six UK organisations, and notes that "the evaluation of mentoring programmes tends to look at participant's satisfaction rates and whether the practical details of the scheme are correct".

Arnold and Johnson12 investigated the career-related and psychosocial benefits for graduate protégés in their early careers in formal mentoring programmes in two UK companies. They found that contact time in particular, and also the perceived influence of the mentor were the most important variables affecting the perceived benefits of the mentoring relationship. They also found, perhaps surprisingly, that the reported level of benefits were low, both in absolute terms and in comparison to the level of benefit reported by previous studies. Further differences with previous research included the absence of significant correlations between the duration of the mentoring relationship and reported benefits. One possible reason that was advanced by the authors for the low level of reported benefit was that most protégés reported that their meetings with their mentors were not sufficiently frequent. In one of the organisations, some protégés reported that their mentors were too senior and therefore too remote (whether geographically, organisationally or interpersonally) but that, overall, the seniority of the mentor was found to be "positively associated, albeit weakly, with benefits derived by the protégé,". One finding that was consistent with earlier work was that psychosocial benefits may be more easily provided than career benefits in formal mentoring programmes, particularly where the latter provides more risk to the mentor. In addition to drawing attention to the need for regular contact time, this research also points to the need for clear objectives, the provision of benefits which cannot easily be obtained from other sources, consistency with organisational culture, the reward and recognition of mentors, the selection of mentors with influence, and training for both mentor and protégé.

A key theme in much of the research is the central role of organisational culture in determining, or mediating, the success of mentoring programmes, and the quality of the mentoring relationships which lie at its core.

Trust is the key issue for the success of all mentoring, whether involving "traditional" or peer mentors, and this trust requires a supportive organisational climate. Without a supportive culture, mentoring is unlikely to thrive and to achieve the benefits of which it is capable.

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Strategy and Organisation

Strategy Under Uncertainty

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In this issue of Manager Update we look at some new ideas on managing strategy in organisations under uncertainty. As anyone who has been involved in strategy will by now know, one of the greatest challenges posed to strategy as a discipline is resolving the question: "how can we formulate and deploy something as concrete as a strategy, when the future is inherently unpredictable and unknowable?" Courtney, Kirkland and Viguerie have developed an approach to answering this question.1 They point out that it is a mistake to view the business environment as either stable and controllable, on the one hand, or totally unpredictable and turbulent on the other hand. This so-called "binary mode of thinking", they believe, can encourage managers either to build detailed complex plans on flimsy assumptions or to be paralysed into inaction by the complexity of the situation.

Four levels of uncertainty

They hold that uncertainty should be viewed as a continuum (and in this they should perhaps acknowledge a debt to the work of Igor Ansoff).2 On the first level, when the future is "clear enough", it is possible to develop a reasonably precise forecast of the future upon which strategy can be based. This assumes, of course, that companies are in possession of all the facts which are at least knowable, even though they may not be currently known (in the real world information also has a time and a cost which have to be considered). The point about level 1 situations is that the "residual uncertainty", ie the amount of uncertainty which is left once strenuous efforts have been made to find out what is knowable, is relatively low.

At level 2, the future is less certain but a few alternative scenarios can at least be mapped out and probabilities assigned. For example, scenarios can be built around the outcome of deregulation or of competitive behaviour in oligopolistic situations.

At level 3, the company is faced not with a set of well-defined scenarios but with a range of possible futures. An example of this would be a company seeking to invest in new, untried technology or in an emerging market.

The final level, level 4, is defined as "true ambiguity": because, here, the causes of uncertainty are likely to be multiple and the causal relationships are non-linear, small changes in apparently unrelated events can provoke major changes which are impossible to predict. This is the "chaotic" situation which we have discussed in a previous issue of Manager Update.3

The point that Courtney et al make is not just that we need to tailor the analytical approach to the level of uncertainty in the environment, important as that might be. It is rather that companies need to think about their approach, what the authors call the "strategic posture" to managing uncertainty at these different levels. There are three strategic postures which they identify:

- Shaping the future This is where either powerful incumbents or revolutionary new entrants seek to re-write the rules of the game within any particular industry, for example, by establishing a dominant format.
- Adapting to the future This is where companies respond to any given set of market conditions. Speed

and flexibility are the keynotes to competitive success for adapters.

- Reserving the right to play This is, in effect, taking out an option on a particular strategy so that when the smoke clears and the direction which the industry is taking becomes recognisable, the company is in a position to pursue a particular strategy (setting up pilot plants or doing joint venture research into promising but largely uncharted areas would fall into this category).

A portfolio of actions

Courtney et al also distinguish a portfolio of actions or moves that companies can adopt under conditions of uncertainty. These are:

- Big bets This means making a large commitment, eg through capital investment, with the intention of shaping the industry.
- Options These are moves which reserve the company's right to play (see above).
- No regrets moves These are moves which are likely to be beneficial under virtually any eventualityÑeg increasing levels of flexibility or reducing costs.

The authors also identify strategies for managing uncertainty at the different levels. Thus at level 2, shapers will seek to send clear signals to competitors in the marketplace in order to reduce uncertainty and prevent ruinous competition developing, eg through overcapacity. At level 3, shapers will be mainly interested in defining what the coming rules of the game in the industry are likely to be, eg what the dominant technologies, formats and standards are likely to be, whilst adapters proceed incrementally with small bets and rely heavily on organisational flexibility and responsiveness. Strategies for level 4 include leveraging the organisation's credibility, eg its reputation for innovation, to articulate a vision of the way that the industry may be heading and, as a result, reduce the level of uncertainty in the environment. Adapters in this situation are more likely to take out options, eg setting up small joint ventures in emerging markets or investing in no regrets moves, eg building up capability to deliver electronically.

Older readers might recognize in this echoes of the work of Miles and Snow who distinguished between prospectors, defenders and analysers.4 Courtney et al's approach to uncertainty does have the great merit that it does not assume that every company has the capability or the desire to revolutionise the industry. Some companies, even in inherently risk-averse business systems, can nevertheless manage quite high degrees of environmental uncertainty.

The real power of real options

One approach to managing uncertainty is to apply the concept of real options derived from financial markets to looking at strategy. Many managers schooled in the now fashionable theory of shareholder value analysis* have been trained to assess strategic options on the basis of the net present value of the cash flows flowing from a particular investment. Shareholder value analysis has become a highly developed and at times somewhat arcane analytical tool which, because it is based essentially on measurement of cash flows, would appear to offer a more rigorous method of evaluating options than traditional approaches based on the accounting notion of profits. However, shareholder value has now come under fire for offering too static an approach to strategic analysis. In particular, shareholder value has been criticised for ignoring the so-called "flexibility value". SVA assumes that the present value of cash inflows and outflows are fixed and cannot be affected by learning more about a particular investment before a full commitment is made. As a result, shareholder value analysis has been accused of creating a risk averse approach to investment which results in over conservative approaches to long-term investments.

The real options school, by contrast, encourages us not to abhor uncertainty but to embrace and exploit it.

Keeping your options open

The point about a stockmarket option is that a buyer acquires the right to purchase the shares of a company at any time over a specified period for a particular price. If the price of the shares rises above the option exercise price then the buyer stands to make a profit. If the stock falls then the investor is not under any obligation to exercise his option. It is the perfect win-win situation (except of course that there is the cost of purchasing the option in the first place). Lesley and Michaels of McKinsey5 have applied options theory to strategy in capital intensive industries such as oil and gas. These industries are particularly suitable for the option theory approach as exploring new strategies, eg gas or oil fields, often develops incrementally through a series of stages, each one requiring a greater level of commitment to the ultimate strategy. When investing in an oil field an oil company exercises an option in the same way as an investor in the options market does. The oil company purchases a licence to exploit a particular field and this gives the company the right to invest in the field (or not as the case may be) once uncertainty over the value of the potential reserves has been resolved.

A straightforward NPV type analysis would make assumptions about the price of oil and about the expected yield from the field. A real options evaluation, however, would assign a value to the flexibility of not having to make a decision based on the information currently available but instead waiting to get a better idea of the price of oil, the cost of extraction and the size of the field. Like shareholder value analysis, real options takes account of the present value of investment costs and the present value of expected cash flows. But it also takes account of other "levers" such as the period over which the option can be exercised, ie the length of time during which the investment opportunity is valid (eg a product's life cycle or the duration of a licence), the uncertainty in relation to the cash flows associated with the asset which is being invested in, the values lost over the duration of the option, for example by foregoing immediate investment and the cash flows that might flow from it, and the risk free interest rate which a riskless security with the same duration as the option would yield.

Managing real options proactively

As Lesley and Michaels point out however, using this framework to assess an investment opportunity is simply to take account of the reactive flexibility of a real option. But options theory as applied to strategy draws our attention to the possibility of proactively increasing the value of an option, once acquired, by focusing on each of the "levers", mentioned above, which determine the value of the option. For example, companies can focus on reducing the present value of fixed costs by exploiting economies of scale or scope. In this way management are in a position to improve the value of the option before they actually exercise it.

Managers can also seek to increase the uncertainty of expected cash flows, for example by product innovation or product bundling. This is where real options theory produces an apparent paradoxÑthe greater the level of uncertainty, the higher the value of the option. This is because, in purchasing the option, the company is only exposed to the upside, not the downside risk. The option holder, i.e. the company making a decision whether to invest or not, has an incentive to increase the uncertainty of the expected returns and then either exercise the option when it has the highest perceived value or back out without investing further.

This can be taken one stage further. Not every company will have the same capability to influence proactively the value of a particular option. For example, one competitor may have developed a proprietary process which would permit it uniquely to reduce the present value of fixed costs. In such a situation it might be advantageous for the other players simply to sell their options to the player which is able to generate the most value.

Options thinking

Lesley and Michaels believe that the greatest benefit from options theory is in the approach which it brings to managing strategy under conditions of uncertainty. They highlight four aspects in particular:

- Options theory emphasises opportunities and corrects an inherent bias in management thinking in favour of incremental investment in established products rather than exploiting new opportunities.
- It focuses management attention on managing uncertainty through incremental investments as opposed to traditional diversification strategies which reduce the upside as well as the downside.
- It focuses on the value of rights. The cost of a particular investment, eg developing an oil field, is relatively stable but the value of the likely returns from the investment can vary greatly, for example, due to prevailing price levels. Managers are therefore able to make the most of the value of the option (the acquired rights) by deferring the investment opportunity without increasing the cost of exercising the option.
- It minimises obligations. Applying the concept of real options implies deferring commitment until a point in time when uncertainty has diminished.

As the authors themselves put it:

"the application of real options steers management towards maximising opportunity while minimising obligation, encouraging it to think of every situation as an initial investment against future possibility."6

Game On

Another fascinating approach to strategy which has recently gained prominence is the application of game theory. Game theory, like complexity and chaos theory, is enjoying something of a vogue currently, although as a branch of theory it is already well established in mathematics and has been applied over many years to politics and the study of international relations. According to Brandenburger and Nalebuff,7 too often we draw on analogies from war or sports when discussing business. However, this may not be a particularly useful comparison since business is not always about win/lose situations. Essentially, game theory focuses our attention upon the reaction of other players in any particular situation. This is perhaps epitomised most famously in the prisoner’s dilemma, where the sentence likely to be meted out to a suspect is dependent not just on his own admissions, but upon those of an accomplice whose behaviour has to be assessed.

Brandenburger and Nalebuff believe that, too often, companies become locked in self defeating competitive situations. Take dry cleaning for example. In order to attract customers and smooth out troughs in demand, dry cleaning companies traditionally discount their services heavily to customers. Over the years, these discounts have become a fixture. Customers have factored them into their calculations and become dissatisfied on the rare occasions when no discount is available. The price level across the industry has settled at a new lower level. This competitive situation is what game theorists would term a negative sum gain, ie one where all the competitors have lost. Negative sum gains are a common outcome of price-based competitive strategies.

Now consider, by contrast, the credit card schemes launched by General Motors in the early 1990s. This allowed card holders to accumulate points which they could use for purchasing a new General Motors car.

Apart from the income generated by the card scheme itself, it has allowed General Motors to increase its market share at the expense of other players in the market, notably Ford. But, as Brandenburger and Nalebuff point out, it has had a beneficial effect on the market as a whole. First, it has replaced traditional price-based incentives which proved as corrosive in the automotive sector as they do in the dry cleaning example mentioned above. Second, the scheme has effectively raised the price to anyone who is not involved in the card scheme of acquiring a General Motors car. This allows Ford and the other competitors breathing space to raise their prices, which in turn helps General Motors to follow suit without fear of losing market share. In fact, the strategy remains beneficial even when the other players imitate it. When other players in the automobile market responded by launching their own credit card schemes, this increased the level of loyalty within the customer base and reduced the incentive to compete on price.

Competition and co-operation

Game theory is particularly useful at focusing our attention on the need for companies to deploy strategies which are both competitive and co-operative. One of the key concepts in Brandenburger and Nalebuff’s article is the importance of complementors. Perhaps the most obvious examples of complementors are hardware and software producers in the IT industry. It is well known, for example, that the success of Intel and Microsoft feeds off one another. Thus, Intel’s investments in the next generation of microprocessors and memory chips depend upon Microsoft developing ever more powerful software programmes. Meanwhile Microsoft’s continued success depends upon making its existing software obsolete and replacing it with ever more memory- and processor-hungry programmes. Similarly, in the mobile phone market there is a natural complement between the manufacturers of the hardwareÑcompanies like Nokia, Motorola and PhilipsÑand the service providers. Thus, the latter companies subsidise the cost of mobile telephones in part or full in order to stimulate demand for their services.

Changing the rules of the game

Another important insight from game theory is the importance of playing in the right game and, if necessary, changing the rules of the game. One example cited by Brandenburger and Nalebuff is the use of the so-called "meet the competition clause" (MCC) in contracts between suppliers and customers. This is a provision standardised in some industries, which allows the incumbent supplier the right to make the last bid when a contract comes up for renewal. This rule in effect deters a competitor from trying to wrest a contract from an incumbent by submitting a lower price, since he knows that ultimately the incumbent would be in a position to match with a lower price. The challenger therefore knows that the price could be bid down to a level at which none of the players could make a profit. He also knows that the incumbent could launch a tit-for-tat response. Furthermore, by aggressively bidding the price of the supplied material down, the challenger runs the risk of giving the incumbent's client a major price advantage in the marketplace over the challengers" clients. In fact, the more widespread the adoption of the MCC is, the less prospect there is of the suppliers starting an aggressive share war amongst themselves. Clearly, therefore, the rule can be beneficial to the suppliers. But do their clients gain as well? Brandenburger and Nalebuff suggest that the full implications of MCCs may not always be recognised by clients but conceivably, even when they are recognised, the advantage to the client of a longer-term relationship which in turn could reduce costs or increase quality might outweigh the momentary advantages of lower price supply.

Game theory, then, can produce some interesting and occasionally surprising insights. One conclusion, for example, is that in certain situations it can be beneficial for a player to encourage competition. This is so particularly at the start of the life cycle of an industry, when the availability of credible suppliers can be critical in stimulating demand for products and in reassuring customers that they will not be dependent on one source. But, equally, game theory shows that in some situations, participating in the game itselfÑnot winning itÑ has an economic value. This is particularly the case in any bidding situation. For example, in a takeover bid for a company, where a firm is in play, it is obviously to their advantage that there is more than one bidder since this will ultimately increase the value of their shares. In this situation, it can pay the target company to guarantee to a potential bidder that they will compensate them in the event of the bid failing and cover the costs of embarking on the bid.

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Accounting and Finance

Developments in International Accounting

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Financial reporting differences in the European Union (EU)

"JBA hit by world according to GAAP" was the heading in a recent article in the Financial Times.1 JBA Holdings, a business applications software vendor, reported interim pre-tax losses as a result of having adopted US accounting standards over its maintenance revenue. In fact, the result of restating 1996 results was the conversion of pre-tax profits of £0.4m to a loss of £0.42m. Such situations are by no means new.

For example, in 1993 Daimler-Benz became the first German company to list its shares in New York. Under German rules, it reported a $372m profit; under tougher US ones, its loss was $1.1 billion!2

Such differences have also been well illustrated in studies of the European Union (EU) reported in previous issues of Manager Update where, unlike many other parts of the world, a "harmonisation" of accounting and financial reporting practices has been under way. Harmonisation is a term that is frequently misunderstood. It is all too easy to view it as implying the adoption of identical practices rather than its typical consequenceÑcompromise. In fact, the limited effect of harmonisation of accountancy practices in the EU was brought out many years ago in a study of seven EU states.3 The preparers of accounts were asked to draft accounts (in ECU) for the same hypothetical group of companies to provide statements, which should be directly comparable as between different jurisdictions. For the profit and loss account, participants were asked to use the maximum flexibility of local rules to provide three alternative figures:

1. That at which a real company would be most likely to arrive,

2. The highest profit possible, and

3. The lowest profit possible.

The results of the study illustrated the potential for significant differences in reported net profits between EU member states. Also, the range over which the profit may be measured could be different. To take an extreme case, the British profit could have been at best 191m ECU and, at worst, 171m ECU while the German profit could have been at best 140m ECU. A major reason for the difference between the net profit figures concerned the treatment of goodwill. In an acquisition, an acquiring company's financial reports include the target's assets and liabilities adjusted to fair value to reflect the total consideration paid. In the typical acquisition situation where the amounts paid exceed the fair value of net assets acquired, the difference is classified as goodwill. Combined net income includes the target company's operating results only from the purchase date forward. Goodwill amortisation, applied as standard practice in EU countries other than the UK, reduces such combined net income. However, recent developments in the UK (reported later in this issue of Manager Update) should remove some of these differences in the future.

This study is now some eight years old and it is not unreasonable to believe that there has been greater progress towards harmonisation in financial reporting practices. In the next section, we consider more recent research which sought to investigate whether there are still such differences and what progress has been made towards removing international differences from a broader perspective than just the EU.

International comparability

As indicated in an earlier issue of Manager Update, the International Accounting Standards Committee (IASC) is striving to put in place a set of core standards for acceptance by the world's leading stock markets. The question of the extent to which EU practices were in agreement with the IASC and the current situation as regards comparability between each member state, were the subject of a recent study by Roberts et al.4 The researchers analysed completed questionnaires provided by respondents from 55 IASC countries, of which approximately one quarter was from nine of the EU countries. The initial analysis consisted of computing mean compliance rates for each country across 27 identifiable accounting issues. Within this initial analysis, a comparison of individual EU countries revealed the greatest differences with the IASC as being in Belgium, Germany and the Netherlands. Eight of the 27 issues were found to be significantly different in these countries by comparison with the UK, which was considered as being most like the IASC. However, when a statistical technique known as cluster analysis was applied, it was found that in no single EU country was there sufficient agreement with the IASC standards for there to be an IASC clone group from the EU. The following six clusters were found from the analysis:

1. The IASC.

2. The UK.

3. Germany.

4. Portugal and Spain.

5. Belgium and France.

6. Italy, Denmark and the Netherlands.

In terms of general comparisons between EU financial reporting practices and the rest of the world, few differences were evident. As the researchers recognise, this is hardly surprising because the EU contains the UK, France, and Spain, the ancestors for most of the accounting systems found internationally.5, 6

They also considered differences within EU countries, as distinct from the level of agreement between the IASC and EU. This confirmed the five EU groups identified above. The results obtained suggested some important differences across the EU and with specific issues (eg recognition of revenue on construction contracts, treatment of gains or losses on long-term monetary items, and the treatment of development costs).

The impression provided by the study is that the IASC has managed to reduce the number of options available to corporations. However, while the overall compliance rate with the IASC recommendations was found to be relatively high, considerable diversity still exists within the EU. What is more, harmonisation attempts by the EU appear to have had no influence on the extent to which EU practices are congruent with the IASC standards.

The researchers recognised that, as with any such study, the results obtained may be limited by the research method adopted. In this case, the questionnaire approach was used which is heavily dependent upon the quality of responses provided. One clear area for further work is specific case study analysis with a view to unravelling the nature and source of such differences more fully.

US Generally Accepted Accounting Principles (GAAP)Ñstill pre-eminent?

There has been a tendency to portray the US as being pre-eminent in setting accounting standards. For example, in a recent article in the Financial Times it was reported that:

"The Financial Accounting Standards Board (FASB)Ñthe US accounting watchdogÑhas attracted attention lately, both in the US business community and around the world".7

In simple terms, its endeavours on some fronts have been received very positively, and far more favourably than the perceived lax approach believed to be pursued in the UK. However, there are some concerns about FASB practices. For example, the former head of the US watchdog, Dennis Beresford, recently commented:

"I believe the US board has an opportunity to improve the accounting for combinations by following the lead of the Accounting Standards Board (ASB), the UK’s financial reporting regulator, which today (December 4th 1997) published its standard on accounting for goodwill and intangible assets."8

The ASB now requires purchase, or goodwill, accounting to be applied in all but the rarest situations. By comparison, US practice, with a few notable exceptions, is largely a "flow-through" method of accounting which uses a system of bookkeeping that forces all transactions to flow through both the profit and loss account and the balance sheet.9 As regards accounting for mergers and acquisitions, merger accounting is still common practice in the US. For example, when companies exchange only capital stock as consideration, and many other detailed criteria are met, merger (pooling of interests) accounting must be followed. Resulting financial statements are, then, simply the combination of the two companies" previous historical reportsÑas if they had always been together. Furthermore, the net income of the combined entity is the sum of the amounts previously reported by the two separate entities. However, if cash is exchanged or more of the detailed pooling criteria is not met, purchase accounting is mandatory.

By all accounts, the existence of the two approaches in the US has problems because companies strive to use the pooling treatment to avoid high expenses from goodwill amortisation in future income statements. Some companies that are unwilling targets of acquisition initiatives have been known to take certain corporate actions to try to defeat the acquirer's opportunity to use the pooling treatment. In addition to such potential gamesmanship, the rules for poolings versus purchases in the US are very complex.

New rules on goodwill accounting in the UK

The new mandatory rules imposed by the ASB now require goodwill to be shown alongside a company's assets.10 Instead of writing-off goodwill (the difference between the price of a company and the sum of its assets) immediately against reserves, companies will now be required to show goodwill as an asset and amortise it against future years" profits. This will bring the UK in line with the practices adopted in most other countries including the US's flow through accounting approach, and should remove some of the differences outlined in the earlier EU study.11 However, there will still be some rare cases where the ASB will allow companies not to amortise goodwill when they can demonstrate that its value has not been impaired, eg goodwill that effectively represents brands like Scotch whiskies that have retained their value perhaps longer than the US has existed!

A new era of value reporting?

One other plea made by Beresford is for the provision of more relevant information to those who use financial statements in making decisions about companies.12 Along similar lines, Wright and Keegan have argued that the financial reporting model is an anachronism that, despite increasingly tight regulation and extensive disclosure requirements, does not meet the needs of those who run businesses and invest in them.13 They propose an approach called "Value Reporting" which has seven core components:14

1. Perform a preliminary evaluation of the financial drivers of the companyÑthe levers of shareholder value.

2. Determine how these drivers are embodied in the corporation's objectives and how the drivers are shaping business operations.

3. Understand how management has developed the strategies currently in place to achieve these objectives.

4. Determine whether the objectives and strategies are supported by performance measurements, and assess the quality of measurement data provided to management.

5. Assess whether management processes foster value creation.

6. Draw up the "big picture" from all of the foregoing activities and select the most relevant points to communicate with the investing public about value-creating strategies, processes, goals, and results.

7. Review, on a rotating basis, how effectively the major processes of the company (such as capital planning and acquisitions, budgeting, strategic planning, product/service planning, management forums, and executive compensation) are functioning, and fix what needs to be fixed.

The value report

Value reporting is illustrated in a set of accounts for Blueprint Inc, a fictitious company. The futuristic document they provide includes a Statement of Shareholder Value Achieved, based on estimated future cash flows. It analyses financial and non-financial "value drivers", which are the key variables that lead to the creation of shareholder value. The examples of the kind of financial variables represented by these value drivers are those which have been discussed in earlier issues of Manager Update on shareholder value and include:

- Sales growth rate.
- operating profit margin.
- Cost of capital.
- Non-financial drivers include:
- Market share.

- Customer satisfaction.
- Product defects.
- "Intellect index", to gauge employees" skills.
- Research and development.
- Brands.
- Indicators of administrative efficiency, such as process cost per sales transaction or office space utilisation.

All financial and non-financial variables are explained in Blueprint Inc.'s financial statements, and performance quantified and commented upon. Within the report there is a disclosure that the company's market value was not out of line with its own assessment of its implicit value, calculated as the present value of its projected free cash flows discounted to a net present value at the cost of capital, less company debt.

Link with operational and financial performance

The process of producing the report in this way will require a detailed review of the variables which lead to the creation of shareholder value. It is reckoned that this will go hand in hand with an assessment of the measures used to monitor operational and financial performance. The result will be a "value scorecard" of performance measures which will have a common focus on long-term, sustainable shareholder value. These are intended to be readily understood by employees and to be used as the basis for performance-related remuneration. In fact, some corporations already have initiatives in place to report to their various stakeholders along similar lines. As part of their move to be more investor friendly, Royal Dutch/Shell, the Anglo-Dutch oil group, will publicly disclose how it is doing against internal performance targets.15

The pressure for value reporting

Gaved quotes that institutional investors (UK and overseas) now account for over 75% of the value of the London stock exchange, whilst the ten largest investors alone account for a quarter of total market capitalisation.16 This highlights the move towards a concentration of ownership. During the 1990s we have seen another trend gather momentum; the rise of shareholder activism to which one response has been the corporate governance debate. The lesson from the Cadbury Report and the Greenbury Committee was the need for much greater emphasis on the meaning and significance of information provided to shareholders. In addition, Gaved argues that there is a need to close the communications gap with investors through greater disclosure. He proposes that in addition to being well informed about a company's business strategy and the key factors and risks involved, fund managers will also want to update their understanding and knowledge of the company's plans in progress and those planned for the future. This would include proposed research and development expenditure, product/service launches, major contracts, etc.

Wright and Keegan contend that value reporting takes financial reporting much further than even the most progressive of forward-looking companies. Its focus upon the future as well as the past is a welcome development and, if adopted, will lead to a hitherto unknown level of transparency. Certainly the concept is being heavily promoted, not least to the professional investor.17 Phillips argues that without the type of development proposed by value reporting, the information gap between companies and the investment community could increase. Anticipating the future has traditionally been the domain of a certain part of the market rather than the responsibility of management. What he and others believe is that more companies will take greater ownership of providing information about their future prospects. Evidence that companies have started to respond is provided by a recent survey that showed that Europe's top companies are giving their shareholders much more information in their annual reports as privatisation and the need to raise capital in international markets drive them to disclose more financial data.18 In the US a similar trend has been underway, where some companies have made a number of forward looking statements in their recent annual reports, which they say are subject to a number of cautionary factors, i.e. certain risks, uncertainties and assumptions.19 There can be little doubt that this trend towards greater disclosure will continue, and that the pressure for value reporting by companies will be significant.

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