

Manager Update

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A quarterly summary of topical management ideas, focusing on four key issues.



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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.

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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.

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Reporting and financial economies draw closer

The introduction of international financial reporting standards (IFRS) represents a significant change to the ways in which companies will account and report on their value and performance. Here, **Roger Mills**, professor of accounting and finance at Henley Management College, reviews the standards with a focus on practice and gives companies guidelines on how to account for value. He concludes by offering both listed and non-listed companies practical advice on how to embrace the standards.



The introduction of international financial reporting standards across many countries from January 1 2005 represents a radical new approach to financial reporting. Some, indeed, have argued it will be a major stimulus to the harmonisation of financial reporting practices and it is certainly more significant than just a new set of accounting standards that need to be learned and applied.¹ IFRS represent a dramatic shift from the traditional basis of preparing accounts – the historical cost based method – to a more complicated and uncertain model of fair value accounting.

The international harmonisation process can, put simply, be described as the bringing together of national accounting standards in the attempt to create internationally accepted principles that will enhance the comparability of financial data. The rationale is that comparable, transparent and reliable financial information is fundamental for an efficient and integrated capital market and that a lack of such comparability will discourage cross-border investment.

The origins of the drive to such harmonisation can be found in the differences between two worlds: Anglo-American and Continental-European, and some have claimed that the movement to uniformity in accounting standards has to deal with the solving of conflicts resulting from the differing accounting philosophies of the two.²

The harmonisation process started in the 1960s and in 1973 the predecessor of the International Accounting Standards Board (IASB) was formed. This international body was assigned to develop accounting standards for international use. These accounting stan-

dards were called the international accounting standards (IAS) and most of them were developed between 1973 and 1987.

Between 1987 and 2000 the work efforts in the harmonisation process were mainly influenced by the agreement of the IASB and the International Organisation of Securities Commissions (IOSCO) to develop a list of IAS which would allow for cross-border listings of companies at international stock exchanges. The European Union's (EU's) announcement that all enterprises listed in the EU, ie around 7,000 companies, will have to prepare their consolidated accounts in accordance with international standards from January 1 2005 was also cited as a major step. Furthermore, the long existing outright rejection of IAS/IFRS by the US has changed.

The focus of financial reporting is now to provide information for the capital markets and the accounting standards are designed primarily for use in consolidated accounts. The price, though, of such a switch is that concepts often seen by accountants as fundamental to the whole basis of accounting – prudence, realisation, accruals/matching – are now being downgraded. The conventional view has emphasised being 'reliable' over being 'relevant', leading to criticism from some that accounts did not help management or investors enough.

That has now changed with the consequence that financial reporting is becoming less concerned with recording transactions and instead with emphasising the measurement of assets and liabilities. The focal point of the change concerns measurement in accounts and the question, 'How should assets and

Financial reporting emphasises measurement of assets and liabilities

liabilities be recognised and capitalised in the balance sheet?' Whilst many bases have long been recognised, the one that has been prevalent up to now is historical or actual cost.

The IASB has adopted the notion of 'fair value'

Now, though, in its place, the IASB has adopted the notion of 'fair value', defined as "the amount obtainable from the sale of an asset in a bargained transaction between knowledgeable, willing parties."³ This is broadly equivalent to the US definition adopted by the Federal Accounting Standards Board (FASB), ie "The amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."⁴

Objections to IFRS

Has, though, the move by the IASB towards fair value accounting really been properly thought through and understood by both the preparers of accounts and the users, including capital market regulators? One view is that the European banking industry certainly understood what fair values meant for them in terms of the financial instrument standard and as a result forced the European Union to adopt a 'carved out' standard.⁵ Yet there is widespread opposition to a fair value concept which leads to significant charges in the income statement for providing share options.

Some accounting experts believe the IASB is actually conducting an academic experiment in accounting on a grand scale. Such critics say fair values for items such as financial instruments do not really exist and can only be found by companies producing complex theoretical models. However, the IASB is convinced that it is right to produce accounting standards which, it says, more accurately portray economic reality, even if that means wild swings in reported numbers which simply expose the reality of the volatility that many businesses face.

IFRS verging on a push to achieve a 'monopoly'

While many have talked about IFRS in terms of 'harmonisation', some, like Professor David Myddleton, a well respected academic, actually regard the changes as verging on a push to achieve a 'monopoly'.⁶ He argues that there has been a conspicuous lack of disagreement with the standards. While the standard setters seem to agree on 'decision-usefulness to investors' as the essential basis of financial reporting he makes the case for the traditional 'stewardship' approach as being more important.

For him, accounts are not prospectuses – the fundamental analysis of accounts is not useful to investors in predicting future profits and the conceptual framework underlying these new standards is not generally accepted. Furthermore, he argues, the top UK accountancy firms were scathing in their criticism of the Accounting Standards Board's draft Statement of Principles.

Indeed, he argues, the new IFRS standards may not even be 'generally accepted' within the 14-person International Accounting Standards Board, since such changes require a simple majority and not unanimity among its members.

As indicated earlier, the IASB definition of fair value is "The amount obtainable from the sale of an asset in a bargained transaction between knowledgeable, willing parties." As Myddleton points out, though, even where there is an "active market" (which is often not the case), this is not a definite sum, but a range of values. So using 'fair values' will introduce an extra margin of error into accounts. Moreover, fair values will be far more volatile than historical cost – as people have already complained with respect to financial reporting standard 17 (FRS 17) on pensions and IAS 39 on derivatives.

Others have argued for 'economic value' as the basis of measurement, using the discounted cash flows related to an asset, but as is widely acknowledged it is extremely difficult to guess the amount and timing of cash flows in the uncertain future. Furthermore, there are significant problems in estimating an appropriate discount rate to use and again the margins of error are huge. In effect, fair value accounting would introduce wide scope for uncertainty and disputed judgment.

Myddleton argues that it is disappointing that we did not follow the Dearing Committee's view: "The purpose of accounting standards is to provide authoritative but not mandatory guidance on the interpretation of what constitutes a true and fair view."⁷ Although some claim that IFRS themselves are not compulsory, the European Union is requiring listed companies in EU member states to use them in group accounts from this year. What this means, Myddleton says, is that the European Union is prepared to interfere with international financial reporting standards much like the American and British governments did in the past (for example, with inflation accounting).

Accounting for combinations – how financial reporting and financial economics are moving closer

IFRS have introduced a new rule (IFRS 3) on accounting for business combinations that has far reaching effects on both published accounts and the valuation of equities. Indeed, some argue it is moving the worlds of financial reporting and financial economics closer together because the changes are much more than just another non-cash charge to the profit and loss account. The new standard, IFRS 3 'Business combinations', was issued by the International Accounting Standards Board in March 2004. IFRS 3 requires companies to estimate the fair value of all assets acquired – tangible and intangible – and liabilities assumed in transactions, a process referred to as a 'purchase price allocation'.

As noted above, from this year, the European Union has made it mandatory for all listed companies to adopt IFRS by 2005 and the estimations are that almost 7,000 companies will be affected by this mandate. In terms of accounting for goodwill, it will no longer be acceptable to allocate the excess value over acquired net assets purely to goodwill. Instead, companies must identify and value the intangible assets acquired and amortise the fair value of these assets over their estimated useful life. Another departure from UK generally accepted accounting principles (GAAP) is that residual goodwill purchased in an acquisition will no longer be amortised over 20 years, but will remain on the balance sheet and be subjected to annual impairment tests.

Both changes are similar to those adopted by statement of financial accounting standards (SFAS) 141 and 142 under US GAAP in June 2001. Opponents of the changes argue that the valuation and amortisation of intangibles provides little additional information to investors, and instead make net reported earnings figures less reliable and more volatile.

Some have questioned what the impact of such a change will have on value. Ojala, for example, examined how goodwill amortisation numbers of the UK and the US relate to market determined equity values.⁸ He found that amortisation of goodwill seems to have incremental value relevance over earnings and equity values at 5% confidence level in the UK, but that the amortisation of goodwill was value relevant only if earnings were positive.

For loss-making firms, according to his research, the results were the opposite, possibly indicating that investors perceive amortisation of goodwill as an expense amortisation period. Finally – and consistent with prior research – his work did not support value relevance of amortisation of goodwill in the US in years 1996-2000 when both positive and negative earnings years were included in the analysis. He interprets these results as supporting the impairment approach to accounting for goodwill.

The valuation and amortisation of intangibles is not a purely scientific process and subjectivity is involved in both the interpretation and application of the standard. This will most likely result in varying applications of IFRS 3 and consequently, varying proportions of amortisation passing through the acquirer's profit and loss account. In addition, the initial adoption of IFRS 3 may lead to increased volatility in reported earnings when compared to periods prior to the adoption.

Crawford and Moore tested this theory by examining the volatility of reported earnings of companies in the S&P 500 index prior to and after the adoption of SFAS 141 and 142, which are comparable standards in the US.⁹ They analysed the annual reported earnings before interest, taxes, depreciation and amortisation (EBITDA) and earnings before interest and taxes (EBIT) for the 500 companies in the index between 1990 and 2003. The researchers removed companies that had insufficient detail or negative reported earnings throughout the sample period. A relative variance analysis was constructed to compare the variance in EBITDA to EBIT.

They made a simplifying assumption that depreciation was not materially different in relation to the reported earnings level of the companies since there was insufficient detail available on amortisation expense for the companies they had selected over the sample period. They constructed a coefficient of variation for the relative volatility in EBITDA and EBIT for pre- and post-SFAS 141 and 142 periods, and compared the statistics to determine whether reported earnings volatility increased after the adoption of the standards. The coefficient of variation is the standard deviation divided by the average.

Their simple test revealed that approximately 70% of the companies experienced more volatility in reported earnings caused by amortisation in the period following the

Subjectivity is involved in the interpretation and application of IFRS 3

Amortisation of goodwill is value relevant only if earnings are positive

Increased
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adoption of the standards in 2001 in the US. Assuming that the experience in the US is a reasonable approximation of the effects of IFRS 3, we might expect increases in volatility in reported earnings starting in 2005 and beyond. As they point out, all else equal, increased volatility introduces more risk to projected reported earnings and could have a negative effect on value.

The introduction of IFRS 3 also creates possible tax implications for companies and the valuation of shares. The overriding theme has usually been for tax treatment to follow the accounting treatment, at least for asset acquisitions. However, in contrast to UK GAAP, IFRS 3 may result in a large portion of intangible value being amortised over very short periods, and goodwill that may not be amortised at all. This would be a big departure from current policy under which all intangibles and goodwill can be amortised over 20 years.

What if IFRS may not really result in harmonisation across Europe at all? The changes imposed by IFRS 3 could have real cash flow impact if the rate of amortisation is allowed to follow accounting convention. Definite-lived intangible assets, such as technology and customer contracts, would be amortised over their useful life. Indefinite-lived intangible assets, such as trade names, and goodwill would not be amortised, but instead tested annually for impairment.

Amortisation
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widely
between
companies
and industries

Amortisation could vary widely between companies and industries since some acquisitions result in a much higher percentage of definite-lived intangibles relative to goodwill. Companies that allocate a large amount of the purchase price to definite-lived intangibles, rather than goodwill, will derive cash benefit from the shorter amortisation periods.

Conversely, companies that have purchased large balances of goodwill, which typically includes synergies and future growth opportunities under financial reporting standards, could be at a disadvantage in terms of tax amortisation. Companies with relatively high balances of goodwill and indefinite-lived intangible assets may elect to amortise such goodwill over 25 years. However, this choice does come with risks because the company could forfeit future tax deductions from impairments that may occur on the assets or associated goodwill.

This is more than just a technical issue. It is important because the change may also be

reflected in market multiples if we assume that the semi-strong or strong form of efficient market hypotheses operate. Proponents of such views would argue that, if the change is allowed by Her Majesty's Revenue and Customs, share prices would fully and immediately reflect the cash flow benefit of accelerated amortisation on future business combinations.

The result would be multiples that also reflect the tax advantages, or disadvantages, of comparable companies or companies acquired in specific transactions. Either commonly accepted method of valuation, the income or market approach, should result in changes in valuation due to potential tax amortisation changes brought on by IFRS 3 and the valuation of intangible assets.

In terms of what impact IFRS 3 will have, PricewaterhouseCoopers has provided a useful summary:¹⁰

- deal structures may change;
- the form of some deals will need to be reconsidered – in particular, the accounting for backdoor listings and combinations which result in the creation of a new company will change significantly. There must always be an identified acquirer, which must be the entity that gains control of the combined entity as a result of the transaction. In some circumstances, it may be difficult to ascertain which entity is the acquirer and which the target. Deals will have to be carefully structured to ensure that there are no unintended accounting consequences;
- results will be harder to predict;
- results of acquisitions will be more unpredictable due to more frequent, comprehensive and rigorous impairment testing of the acquired assets. Greater analysis of the target entity's business will be required to identify potential intangible assets, consider ongoing amortisation charges against those assets, and determine the risk of future impairment charges;
- value will be harder to demonstrate;
- the balance sheet and profit and loss account following an acquisition will look very different. New items will now be included, others will be measured on a different basis, and some existing items may need to be removed. While, and as discussed above, goodwill will no longer be subject to amortisation, the requirement to separately recognise and amortise short-lived intangible assets, along with tighter

rules for recognition of restructuring provisions, will mean that IFRS may make it more difficult to demonstrate earnings accretion after an acquisition;

- there will be greater transparency;
- significant new disclosures are required on matters such as the cost of the acquisition, the values of the main classes of assets and liabilities, and the justification for the amount allocated to goodwill. In general, IFRS 3 offers fewer opportunities for smoothing of results, as it requires some expenses and most changes in value to be recognised immediately;
- more work will be required; and
- the acquisition process, as noted above, will become more rigorous, from planning to execution. More rigorous evaluation of targets and structuring of deals will be required, to withstand greater market scrutiny. Expert valuation assistance may be needed to establish values for items such as new intangible assets and contingent liabilities. The impact of these changes on existing debt covenants and ratios will need to be considered. The structuring of cash generating units for reporting purposes is, the firm says, likely to be complex and time-consuming.

Only relevant to listed companies?

Unlisted companies have not been directly affected with the introduction of IFRS and will still be able to use their national GAAP.¹¹ However, they should not be complacent. Many EU countries are already planning to align their national GAAP with IFRS, and it is likely that all large unlisted companies in the EU will be required to adopt a version of IFRS within the next few years. Such companies, in fact, actually have compelling reasons to consider adopting IFRS sooner rather than later as many private companies are subsidiaries of larger listed ones.

So, from that perspective, adoption of IFRS allows consistency of reporting across groups, helping to align internal information with external statutory information. Similarly, the adoption of IFRS should facilitate mergers and acquisitions because potential acquirers can view financial information in a standard format rather than on the basis of numerous different GAAP.

Pressure to adopt IFRS may well come from external sources too, including suppliers, financial backers and banks. For example,

financial reporting information on the basis of IFRS enables the banks – as the principal funders of many of these unlisted companies – a greater degree of insight into their financial reporting affairs. It also enables them to have only one set of criteria for countries across the whole of Europe.

What, though, are the challenges for unlisted companies of converting to IFRS? To a large extent, they are the same as for listed companies. The impact will vary both from country to country – the transition from UK GAAP to IFRS is more straightforward than that from German GAAP to IFRS, for example – and from company to company. Earlier, we provided just one illustration of the impact in terms of IFRS 3 and accounting for business combinations. For unlisted companies, though, the big areas are probably around hedging, currency conversion, revenue recognition and pension schemes.

The real impact depends on whether the company has these within its accounting records, and even if that is the case areas of apparent commonality between standards may also turn out to contain subtle but material differences and it is important that those differences are recognised. Many of the changes will be costly and time-consuming – in particular, those affecting IT systems and databases. There may be substantial implications for systems, especially if much more information needs to be collected to meet the disclosure requirements. Finance staff will need to be trained both in the new standard and in the use of new IT systems. Clearly, for larger companies, with perhaps 50 staff or more in the finance function, that will require a substantial investment.

For unlisted companies, the decision of whether to adopt IFRS early or to wait and see is a difficult one. They will need to assess whether the benefits of early adoption outweigh the costs – but the choice needs to be informed by a clear understanding of the potential impact of each option. *Accountancy Age* offered the following advice to companies:¹²

FTSE 350 companies

Consider what other companies in your sector are doing, looking at, for example, press releases, analysts' presentations and releases on web sites.

Consider whether you can improve on their presentation – especially companies with a

Challenges of IFRS for unlisted companies include hedging

Finance staff need to be trained in IFRS and the use of new IT systems

March year end, who can draw on published results of December companies. Review press and analyst comment to see what the market considers to be important. And review IFRS accounts or press releases from competitors overseas – especially in the EU or in other territories that already use IFRS.

Other listed companies

On the assumption that companies below the FTSE 350 will not be making an early voluntary release of IFRS information, they should monitor and study the releases of information by larger listed companies, preferably in the same industry:

- to see what accounting policies they are adopting. If different from the accounting policies chosen for their own company, consider whether to stick with those or

change to what market leaders are using;

- to see how they are presenting the information (eg separate disclosure of exceptional items, or non-GAAP measures such as earnings adjusted to remove volatility); and
- to consider whether the impact on their own company will be similar or different – eg is their own company's share scheme similar/different, larger/smaller than that of the comparator company?

There is little doubt that the new reporting regime will have a profound effect on companies and professional service providers. The division between auditors and those providing valuation services will have to close rapidly. In principle, the potential prospects for drawing the worlds of financial reporting and financial economics closer together could be good, but only time will tell. **MU**

The new reporting regime will have a profound effect

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Innovation – the engine of growth

This issue of *Manager Update* looks at corporate growth in two parts. On page 18, we look at how companies can develop a sustainable growth strategy. Here, **Susan Foreman**, professor of marketing at Henley Management College, focuses on what the marketer can do to sustain growth, arguing that a focus on understanding customers and on the role of marketing in acquisitions holds the key.

Innovation is often referred to as the engine of growth and is growing in importance for companies who feel the impact of intensive competition, global markets, technological change and turbulent markets. There is certainly no room for complacency for companies or even, in today's globalised world, nations. For example, in looking at emerging markets, Asia is often considered as the factory of the world – providing low cost labour and raw materials, yet in a short space of time we have seen rapid growth in innovation and entrepreneurship there. The factory of the world is, in turn, becoming the catalyst for product and process innovations that are exchanged on a global scale.¹ Companies, in such an environment, need to strive to discover new opportunities that can create value for the customer.

Whilst innovation stretches throughout the whole organisation – and needs a multi-functional approach – it has always been closely linked with marketing. Even the earliest definitions of marketing highlight the connection between the two and that still remains today. In 2000, authors Kohli and Jaworski reminded us that to be market oriented, companies need to create an atmosphere that values the customer and their role as a key 'driver of innovation'.² In examining a range of issues in innovation through a marketing lens, it is clear from recent research that customer-related knowledge management pervades all aspects of this organisation-wide strategy.

The role of customer knowledge in new product success

For decades, researchers and practitioners have bemoaned the difficulties involved in managing innovation and successfully launching new products and services in the marketplace. The

high failure rates among many companies can, for example, be attributed to poor products or positioning, lack of market readiness, or customer ambivalence. Many researchers, though, have stressed that involving customers in the development process is the best way to avoid such failures. Despite this, and the importance of developing a match between customer needs and product features, Joshi and Sharma have highlighted some poor practices that are widespread; and they also offer advice to managers to help them to improve performance and increase the success rate of product launches.³

Joshi and Sharma highlight the need to understand customers' needs and choices on a continuous basis. Customers' preferences, they say, are not fixed in time and continue to evolve as products are being developed. They stress that customer contact is not a 'one-off event' and that customer companies need to be flexible, the project teams need to be properly funded and employees need to be motivated through the process for the company to remain 'close' to the customer. The key points are:

- strategic flexibility is crucial to successful product development. A customer-oriented approach in which the new product evolves in line with customer feedback requires suppleness in the organisation;
- project teams need to have resources ie a budget, which extend beyond the early investments in market research. Teams need access to funds they can use to 'research' customer needs throughout the development process from initial screening of ideas through to the concept testing and development of product prototypes;
- project teams need to be motivated through the development process. As customers express their preferences and become involved in the development of the product



It is necessary to understand customers' needs and choices on a continuous basis

Teams should 'research' customer needs throughout the development process

Management support and project 'champions' are crucial

through a 'trial and error' process, setbacks and failure may occur. At this point, project teams may become disheartened and motivation can be an issue as they repeat tests on their route to the finished product. In these situations, the research also emphasises the need for a climate of "constructive conflict resolution" in teams;

- management support and project 'champions' are crucial. It is important to clearly communicate their encouragement and inject enthusiasm into the project team and develop a focus on customer learning and knowledge acquisition;
- the management of the product development process is also important. Here, Joshi and Sharma support previous research advocating the use of multi-functional teams using personnel from across the company. The authors also encourage using incentive schemes to reward initiatives, to help maintain motivation and momentum; and
- managing new product development is a key feature of strategic and marketing decision-making and a key driver of growth. It is, however, also important to take into account the broader issue of the management of innovation and to look beyond key drivers like technology and products to consider also the developments in processes, operations service delivery and logistics in creating superior value for the customer.

Customer oriented innovation in logistics

Despite the broad scope of early work in innovation (noted by Schumpeter in 1934)⁴, which argues that innovation can exist in products, services, processes or a social system, much recent work in marketing has focused on product-related innovations. Flint, Larsson, Gamelgaard and Mentzer, though, refer to a largely ignored area of new developments in the logistics sector, where customers drive innovation.⁵ They consider a comprehensive range of issues in the area and cover the salient issues. Their work discusses a market-oriented approach and emphasises the value of customer knowledge, which, they say, must be managed strategically. They highlight the value of an organisational learning approach, which must be implemented more effectively and efficiently than by their competitors.

Flint, Larsson, Gamelgaard and Mentzer conducted wide-ranging research in four countries and found that interest in innovation encompassed minor/small scale changes in logistics as well as more dramatic 'new-to-the-world' innovations.

Being innovative, they said, did not always lead to spectacular outcomes but innovative outcomes could be derived from four basic building blocks!

Setting the stage for innovation is the first step. This is predominantly an internal activity aimed at creating a culture that supports innovation. Some key elements include:

- developing a clear mission and statement of values and disseminating those values throughout the organisation;
- recruiting employees who can and want to work in an innovative environment and supporting them with training;
- creating an organisational structure that supports innovation, such as cross-functional teams;
- encouraging employees to meet and visit customers; and
- creating a work environment conducive to innovation.

The second, 'customer clue gathering', tended to be at the forefront of innovation in the logistics sector and the authors' research noted the need to keep abreast of changes and trends in the macro environment, which may lead to changes in future customer needs. At a micro level, a number of practical customer clue-gathering activities were identified.

They balanced secondary research with primary investigations that included in-depth customer interviews, focus groups, joint strategy groups and 'away-days' or retreats. Some companies preferred to conduct this research themselves, allowing the development of a feeling of ownership of the data and deeper learning, whilst others preferred the objectivity provided by an external person like a consultant or academic.

The third, negotiating, clarifying and reflecting activities, helps to facilitate the change in the organisation needed to meet the needs of the customer. In essence, this is a process of the translation of the customers' expressed needs into solutions. This clarification process also encourages employees who perhaps do not relish change to see the shape of customers' future needs and enables them to see their role in effecting that change.

Finally, inter-organisational learning is a natural outcome of the customer clue gathering process. The research found that by learning together in this way new opportunities emerged, including new ways of working which benefited both parties. A continuous learning

An organisational learning approach is valuable

perspective helped to create an innovative atmosphere of reflection, improvement and innovation.

In the world of logistics Flint, Larsson, Gamelgaard and Mentzer think that managers should raise the awareness of innovation inside the organisation. In this way, a wide range of employees in the workforce could be involved in the innovation process. As employees get involved in clarifying consumer needs and shaping and delivering the new logistics service, innovation becomes a more integrated, iterative and continuous process of improvement.

Continuous innovation

Many large organisations clearly find it challenging to maintain and develop a culture of innovation. Välikangas and Gibbert assert that managers get so absorbed in their current roles and responsibilities that they fail to see new opportunities.⁶ The authors identify a number of traps that can ensnare managers:

- in the performance trap successful organisations focus on their current work and fail to notice new opportunities. In the same way, companies in difficulty can also be myopic as they focus on the 'core business' and become blinkered in their focus on survival which, paradoxically, could flourish from a more flexible and open outlook;
- managers who fall into the commitment trap are either bold or hesitant about proceeding with new products. The former can lead to a 'gung ho' mentality while the latter can lead to a lengthy development process and missed opportunities. This is a fine line to tread, since managers have to be bold and sometimes audacious, yet also scientific in their assessments of the innovation and market readiness. The cautious approach is expensive and may lead to failure. The gung ho approach is equally dangerous, especially if it also leads to a market failure; and
- sometimes the business model is a trap for managers, such as when an individual sees an opportunity but is unable to move the organisation to support innovation. In many respects, changing direction in some companies may be like changing the direction of an oil tanker, in that the objective may have moved in the time it takes to undertake the manoeuvre. Välikangas and Gibbert consider this to be the most difficult trap to escape from, as a transformation like this often needs new strategies, new competencies and, in some cases, a new business model.

These traps, it seems, can be avoided by closer management of the innovation process. Välikangas and Gibbert state that managers should put boundaries around their innovation projects to provide a focus, a context, and a structure through which potentially successful innovations can get organisational recognition and funding. Performance traps, they argue, can be avoided by building a sense of urgency.

Where performance is poor, Välikangas and Gibbert suggest managers should try to make better use of current capabilities to build on an organisation's strengths and provide space for new opportunities to flourish. Where there is a problem of commitment, the innovation processes should be clearly explained and mapped out to help managers identify innovations that are strategically important and provide signposts to those projects which match with the business imperatives.

Innovation by acquisition

To complement their own innovation strategy, many companies try to buy innovations through acquisitions – an established way to bring new perspectives and knowledge to the organisation. It can allow a company to build competences in complementary and new fields of enquiry and help it avoid the commercial traps highlighted by Välikangas and Gibbert.

Technical knowledge or 'know how' can come from within the organisation or from external sources. In their work on innovation and acquisitions, Prabhu, Chandy and Ellis state that a narrow focus on investing in internal knowledge generation can be too restrictive and "dangerous".⁷ Thus, acquisitions can provide new energy as well as valuable insights. The authors' work provides an alternative to other research work which states that innovation through acquisition simply does not work because it is expensive, and deflects managers' attention away from other work in innovation.

Prabhu, Chandy and Ellis consider this research to be pessimistic and suggest a different approach – they claim that companies with a high-quality knowledge base might be in a good position to benefit from innovation generated through acquisitions. They break knowledge down into three parts – depth, breadth and similarity:

- *depth* – this is the quantity of 'technical know how' within a particular technical specialism. Early research in this area suggests that depth

Acquisition can build competences in new and complementary fields

makes companies narrow in their viewpoint and fixed in their perspective, stifling innovation. More recent work, though, highlights the importance of building expertise through incremental growth in knowledge, which can provide a firm foundation that will help facilitate innovation.

- *breadth* – this is the range and number of the specialist areas in which the company has expertise. Again, early research suggests that this provides a surface approach, which is detrimental to innovation. However, where a company has breadth of knowledge it can work creatively, can draw together work from different areas, manage complexity and is less likely to be blinkered in its approach to innovation; and
- *similarity* – this is the degree of overlap between the knowledge of different firms. To maximise the benefits of the acquisition it is necessary to learn and transfer knowledge to the parent company. Prabhu, Chandy and Ellis state that companies with complementary knowledge will help increase innovation levels more than companies with knowledge that is hard to assimilate or so similar that it is redundant.

The authors' work, which concentrates on the pharmaceutical industry, shows that there are two routes to increased levels of innovation and that in each case, knowledge is the key. Companies can develop internal knowledge or they can acquire it. In turning first to the acquirer, Prabhu, Chandy and Ellis demonstrate that companies can be smart in the way they develop their own knowledge.

It is not merely the volume but also the type of knowledge they generate that is important, the authors say. The research shows that organisations that combine breadth and depth of knowledge are likely to be more successful. Moreover, they show that breadth of knowledge is more important than depth, as it enables an organisation to be flexible and adaptive as it copes with a diversity of opinions.

Crucially, the researchers found that organisations that understood the importance of building their own breadth and depth of knowledge, and matched this with an acquisition strategy, were more likely to be successful. The knowledge base that they develop helps them to identify and choose the organisations they should acquire, and the skills in managing knowledge help them to maximise their learning and assimilate and apply their knowledge.

The selection of the company to acquire is crucial. Managers are not just looking for companies with a lot of knowledge – they must assess the nature of the knowledge they possess and look for companies that have complementary knowledge that can enhance their own competitive position.

Innovation, as has been argued above, is a constant and unending process. When it is part of the culture and embedded into a company, it enables constant reinvention and maintains closeness to the customer. It can provide a defence against a changing and turbulent marketplace and be the engine of growth for the company. **MU**

The selection of the company to acquire is crucial

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The effectiveness of teamworking

The importance of positive team working to organisational success has been long established. But how can organisations gain the most from existing teams and how can they build the best new teams? In this article, **Richard McBain**, director of distance learning programmes at Henley Management College, reviews the latest literature to suggest that the answer lies both in the psychological and the organisational factors that managers can influence.

Working in a team has become a common experience for many people and, indeed, is often a stated requirement for particular jobs. Some teams are permanent features with a relatively stable membership, as in the case of 'self-managing teams'. Others, such as project teams, are more temporary, brought together – often at short notice with members from various functions – to achieve specific tasks by a certain deadline. Much of the recent research into teams has been criticised for over-reliance on a psychological focus while paying scant attention to organisational and work design issues.¹ A team may be defined as 'two or more people working interdependently toward the achievement of a common goal'.²

This article will consider research that examines the factors that can have an impact upon team effectiveness. The research identifies some of the boundary conditions for teamworking, as well as such issues as the integration of new team members, the importance of the team formation phase in project team development and the value of a collaborative style, particularly in teams with a culturally diverse membership. What emerges is that teams should not be regarded as a panacea. The introduction of teams requires careful consideration. It includes the adjustment of organisational support systems as well as structures to achieve both interdependence in operation and as much autonomy for the team as possible.

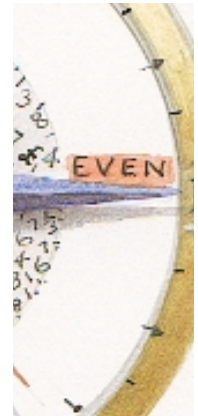
'The romance of teams'

A recent review of laboratory and field research into the effectiveness of teams reaches some provocative conclusions. Allen and

Hecht argue that laboratory-based studies into team effectiveness provide "only minimal evidence that group activity offers performance advantages compared with combining the performance of the same number of individuals working alone or, even, by a single talented individual" (p442).³ Their view of field research is similar: "Considering all the empirical evidence from field studies together, it does not appear that teams alone either consistently, or robustly, produce the gains in productivity that are reported anecdotally" (p444). On the other hand, they argue that there is a "puzzling faith in the effectiveness of teams."

They use the phrase 'the romance of teams' for what they see as the mismatch between the modest evidence suggesting teams are effective and continued enthusiasm for teams within companies and offer a psychological account of its development and maintenance. Teams or groups – since, interestingly, Allen and Hecht do not distinguish between the two – provide their members with two kinds of psychological benefit, which promote the assumption that teams perform very well in a similar way to the perceived link between happiness and performance:

- social-emotional benefits of teamwork: working in teams may fulfil universal social needs, promote enjoyment, job satisfaction and well being, facilitate human adjustment and reduce uncertainty in work situations; and
- competence-related benefits of teamwork: working in teams can give individuals the opportunity to deflect their own failures, gain a positive or even enhanced view of their own performance and contribution to



There is a "puzzling faith in the effectiveness of teams"

the group so that belonging to groups and teams helps to develop feelings of efficacy and confidence.

The authors do not dispute that there are situations where a team may be the most appropriate structure: for example when the work has reciprocal interdependence and when the skill sets of various people are required. Nor, in fact, do they dispute that teamwork can lead to significant gains in productivity. Their view, though, is that the romance of teams often results in their overuse. The danger, they say, is that an organisation may fail to adequately consider whether teams are, in fact, appropriate for the work to be done. For the individual, this 'romance' may lead to pressure to toe the team line and the danger of being a scapegoat.

Organisations may fail to consider whether teams are appropriate for the work to be done

Leading teams and management by objectives

It is important to recognise that teams are not always the answer to an organisational problem and also to try to understand the factors that lead to the effective operation of teams. Many organisations have introduced self-regulated teams to promote faster adjustment to changing internal and external demands. Alongside this development has arisen a renewed interest in management by objectives (MBO) as a means for leading and motivating such teams.

Self-regulating, or semi-autonomous, teams fulfil tasks such as quality control and production planning and organise themselves on issues like work assignment, job rotation, working time and vacation planning. The supervisors or leaders of these teams support the groups but typically do not interfere in the group processes. MBO systems set goals for the organisation, which are then cascaded down to team level, thereby integrating the efforts of teams and aligning them with the needs of the organisation. But how do MBO systems work and how effective are they?

MBO systems set goals for the organisation

Antoni used goal-setting theory to develop a model of MBO which was then tested in a study of 21 groups in a construction supply company, which had implemented MBO at team level five years previously.⁴ The model sees group goals and goal commitment as influencing group effectiveness in terms of productivity and satisfaction, through the group processes of collective planning and group effort. The key findings and conclusions of this research are that:

- MBO systems can improve group effectiveness in respect of both group productivity and job satisfaction and can be an effective tool for motivating and leading self-regulating teams. However, whether it can be used successfully depends on contextual factors, including the degree to which teams can influence goal achievement, which in turn depends on team characteristics such as team competencies and decision latitude, as well as on external influences such as market developments;
- group goals were key to predicting group productivity while goal commitment was key to explaining job satisfaction. If group members are committed to their goals, both group productivity and job satisfaction of team members can be improved; and
- group processes, such as effort and planning, can influence levels of job satisfaction but not productivity.

The practical implications for managers mean that they need to recognise that team competencies must be developed to meet task and goal requirements, which would enable teams to solve potential group conflicts constructively. Team leaders play a crucial role and should be trained to coach teams. Furthermore, any external factors that could influence goal attainment must be considered carefully in setting goals, otherwise team members may attribute goal attainment to external factors and no longer strive for these goals.

Collaborative conflict management style and virtual team performance

Another increasingly common feature of contemporary organisations is the 'virtual' team: a group of geographically or organisationally dispersed members who are connected with the help of telecommunication and information technology to accomplish organisational tasks. Such teams, clearly, may be more complex than traditional teams because they cut across barriers of time, distance, and organisation. They may also involve increased diversity in team composition.

In a laboratory-based study of 22 groupware-supported virtual teams, Paul and colleagues examined the impact of the individualism or collectivism of team members on the development of a collaborative conflict management style and whether this in turn has an impact on group performance.⁵ Furthermore,

the research sought to find out whether the homogeneity or heterogeneity of the group affects the relationship between a collaborative management style and group performance.

The participants in the study were MBA students from one Indian and one US university who were randomly assigned to their groups – some were culturally homogeneous in that they were drawn from one university, whilst others were mixed groups. All participants were trained in the use of the group decision support software employed in the study and their task was to select a computer use fee for students enrolled in an on-line university. The key findings of the research were that:

- the higher the individualistic orientation of the members of a virtual team, ie the preference to act as individuals rather than as members of a team, the lower the level of its collaborative conflict management style, which involves a high concern for others as well as a high concern for self and seeks to integrate the views of all participants;
- a collaborative conflict management style tends to lead to improved satisfaction with the decision process, perceived decision quality and the degree of group agreement;
- group type impacts on the relationship between collaborative conflict management style and perceived decision quality and group agreement. At low levels of collaborative conflict management style the culturally homogeneous virtual teams outperformed the heterogeneous teams, but where heterogeneous teams have high levels of collaborative conflict management style, they tend to perform better than their heterogeneous counterparts; and
- there was no significant effect of a collaborative conflict management style on perceived participation.

What then, are the practical implications of such research for managers? Clearly, it seems that effective collaboration is critical to improving the performance of culturally diverse virtual teams. Cultural heterogeneity itself may not be detrimental to the performance of teams, providing the members are willing to communicate and collaborate with other members. Indeed, heterogeneity may enhance the perceived decision quality when team members are willing to collaborate.

The main implication for managers involved with global virtual teams is the need to con-

sider the cultural orientation and the degree of diversity among team members.

It may be important to motivate individualistic members differently from collectivistic members – through, for example, personal versus group incentives – and different mixes of cultural orientation and degree of diversity may be more appropriate to different types of task. Furthermore, it is important to train team members in the use of group decision software. Managers may need facilitation techniques to address the deficiencies in coordination and human communication cues that are usually associated with the work of groupware-supported global virtual teams.

Team members must be trained in use of group decision software

The importance of early team events

This article will now consider project team development and performance. Previous research has shown that the mobilisation period of a project (its initiation phase prior to the project launch meeting) may exert a considerable influence on the subsequent project team development and performance. A qualitative study by Ericksen and Dyer compared three high-performing and three low-performing teams from five major US corporations to see whether they differed with respect to how they were launched and mobilised and whether these differences had an impact upon subsequent team progress and performance.⁶ The six teams of between five to nine members were studied from the time their projects were initiated until the time their work was completed.

A number of key differences were noted between the high-performing and low-performing teams in the mobilisation phase. Leaders of high-performing teams mobilised and launched relatively quickly, typically taking around a third of the total project time on this phase.

High-performing teams mobilised and launched quickly

They focused on content-related issues, such as elucidating project scope and requirements, gathering supportive background information, and creating working documents. They engaged in extensive outreach activities, involving participants other than project champions and team leaders in the mobilisation process, both to gather essential information about the substance of the projects and to locate potential team members.

Participants were selected for team membership on a competence-based approach. Team

leaders conducted participatory launch meetings in which the team members engaged in discussions of project-related issues, including potential products and solutions, and ultimately collectively prepared work plans and timetables. Activities relating to process formation were deferred until the launch meeting.

Low-performing teams mobilised more slowly

In contrast, and unsurprisingly, the leaders of low-performing teams mobilised more slowly, typically taking around 50% of the total allocated time for the project on this phase. They focused on process-formation activities relating to work planning and scheduling, while deferring content clarification for the team to do later, with limited outreach activities and a stakeholder or politically-based approach to staffing that relied mostly on personal contacts to identify potential team members. They typically ran information-poor launch sessions in which they focused on 'telling and selling' their preconceived work plans and timetables.

This research identifies three conclusions from the mobilisation and launch phase, relating to time, talent and tasks that systematically differed between the high- and low-performing teams. These outputs served as inner resources for teams in the subsequent achievement of their tasks:

- high-performing teams emerged from the formative phase with at least two thirds of their total time remaining and a perception of urgency, higher levels of task-relevant competencies and team members who had sufficient time commitments to allocate to the project. They also had agreed tasks and complete performance strategies comprising problem definitions, solution frameworks, and individual and sub-team assignments. Low-performing teams emerged with only half their total time remaining and a low perception of urgency, lower levels of task-related competencies and team members with insufficient time to allocate to the project, inadequate task definitions and agreement and only partial performance strategies; and
- differences in the mobilisation and launch experiences between the high-performing and low-performing teams did not, however, appear to influence their subsequent overall development. All the teams followed the following three phases: a post-launch to midpoint transition, post-midpoint transition to 'showdown', and post-showdown to completion.

Mobilisation and launch experiences did not influence subsequent development

However, the inner resources gained by the high-performing teams fuelled a 'virtuous path' while the deficiency in some or all of the key inner resources of the low-performing teams fostered inactivity and led ultimately to failure.

High-performing teams were able to use their midpoint transitions to confront and correct any deficiencies in key resources (ie time, task, and talent) and thus emerge with rejuvenated resources, successfully traverse their showdowns and ultimately deliver high quality products or solutions by their deadlines.

In contrast, project teams that enter the post-launch period deficient in or devoid of one or more of these key inner resources are unlikely to correct these deficiencies during this period or during their midpoint transitions. Indeed, Ericksen and Dyer argue that such teams would better serve their causes if they quickly and appropriately remobilised and relaunched or, failing this, disbanded rather than continuing to press on.

Integrating new team members

Finally, this article considers research into the integration of new team members, the lessons of which may apply both to project teams and to more permanent teams. However, the issue of newcomer adaptation is perhaps more acute in high technology industries, in which knowledge workers frequently move across project teams and organisations, given the costs of integrating new employees into project teams, and the costs of losing them.

The research of Chen, involving 390 knowledge workers in 104 project teams from three high tech firms in the US shows how managers can best integrate newcomers into teams and demonstrates that effective management of newcomer performance can have important consequences for the work team and for the organisation.⁷ This research shows that:

- the initial socialisation period is typically about two months and during these early stages newcomer performance is malleable;
- the level of initial newcomer empowerment is a key motivation factor early in the socialisation period, and together with the shared expectations of the team, about how effectively a newcomer would

perform for example, it predicted the initial performance of the newcomer but not his or her performance improvement;

- initial team performance, in terms of levels of productivity and access to personnel and resources, predicted performance improvement but not initial performance – thus the benefits of joining more effective teams may not be realised early in socialisation; and
- empowering newcomers not only boosts their performance but it also improves newcomer retention: for example, as early as 42 days following entry employees who did not feel empowered performed worse and later indicated greater willingness to quit their jobs.

There are several important practical implications of this research. Firstly, managers must recognise that they need to integrate newcomers more quickly than most previous models of newcomer socialisation have suggested. Second, managers should quickly empower newcomers by, for example, involving them in key decisions, by giving them challenging work and boosting team expectations of them, such as by informing team members of their competence and potential, in order to facilitate early newcomer performance. Thirdly, managers could facilitate newcomer performance improvement by establishing high productivity norms in their teams, eg by setting challenging goals and by providing newcomers with sufficient social support and material resources. **MU**

Managers
should
empower
newcomers

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Sustaining growth in a competitive market

Sustaining growth is critical to the long term success of a business. But how can a business do this in increasingly commoditised and competitive markets? Should it follow the route of acquisitions, innovation or customer focus? Or should it look to new and emerging markets? **Ian Turner**, professor of management studies and director of graduate business studies at Henley Management College, reviews the latest research.

The pursuit of growth

According to the *Economist*, the boards of US and European companies have recently been boosted by a new breed of so-called CXOs: a generic class of top corporate executives which includes chief executive officers, chief operating officers, chief financial officers, chief information officers and even chief learning officers. A new addition is the so-called chief growth officer, which exists in Heinz and Honeywell, to name just two companies.¹ Is this just another empty corporate fad?

After all, the job of a chief growth officer would seem little different from that of sales, marketing and new product development. On the other hand, we should recognise the inertia and structural obstacles which sometimes defeat efforts to achieve better growth in large organisations. Perhaps a senior level champion tasked with cross-functional initiatives to improve growth isn't, then, such a bad idea after all?²

Strategies for growth

Traditional approaches to growth in the strategy literature were influenced by two (now legendary) frameworks. In the 1960s, Igor Ansoff mapped the growth options facing companies on a matrix. The four quadrants captured the available alternatives for growing in existing or new markets or with familiar or novel products and technology. His work was complemented by the Boston Consulting Group (BCG), which helped diversified firms to strategically manage growth.

The BCG matrix, which mapped relative market share against industry growth rates, was

designed to aid companies in making decisions about where to invest their funds. It showed that within their portfolio, companies should invest the cash generated by mature businesses into promising, high-growth new businesses and into established champions in growth markets.

This approach of managing growth by balancing a focus on established positions in mature markets, exploiting well-defined opportunities in markets which are growing quickly and laying down the seedcorn for future success in embryonic markets with potential, characterises much strategy writing, even to this date.³ McKinsey, for example, has an approach based on balancing the three so-called business horizons: extending and defending core businesses, building emerging businesses and creating viable options.

Still, many companies are apparently struggling to achieve growth.⁴ According to Richard Wise, research on mergers and acquisitions reveals clearly that such moves often produce no value and sometimes lead to disaster. Similarly, international growth, especially that in emerging markets, can be notoriously difficult, as many businesses attracted by the huge but complex Chinese market have discovered to their cost: competition, for example, can be more intense than anticipated and purchasing power significantly lower than in more developed markets. It is also becoming much more difficult to grow the business through price increases, as deregulation and greater price transparency through the internet help remove many traditional switching costs.

According to Marakon, by mid 2004, organic growth had risen to the top of the corporate

The chief growth officer is a new addition to the breed of CXOs

agenda in the majority of US, European and Asian companies. Their research showed organic growth is a significant driver of value and that companies relying on growth through organic development tend to generate higher shareholder returns than their acquisitive counterparts. Clearly, though, the prospect of increasing market share and size through acquiring or merging with another organisation can be very attractive in mature markets when organic growth rates are relatively low.

For example, Marakon state that major consumer product companies were able to grow by only 6% between 1996 and 2000. Interestingly, though, while the difference between the top performers and the average companies in their sample was only four percentage points, it was enough to generate very significant differences in shareholder returns – with the superior organic growers having returns of more than double their lower-performing rivals.

According to Meer, the main determinant of organic growth is to understand clearly what drives customer value.⁵ Even when companies are able to do this, however, internal organisational barriers can prevent them from realising their potential. Companies demonstrating superior organic growth tend, according to this research, to have a more disciplined approach, better capabilities for driving growth and manage to engender a more supportive culture in the organisation.

Thus, companies with sustained organic growth tend not to reduce critical areas of investment like training, marketing or research and development in the face of short-run pressures to satisfy shareholder demands. Similarly, companies with good organic growth records have a better understanding of customer behaviour, can react more rapidly to changes in their markets and are successful in attracting and retaining the most creative and inventive people. Finally, such companies create a culture that supports growth and will tolerate failures as learning opportunities.

The relative value of growth

Nathanial Mass also makes a persuasive case for the value of growth as opposed to margin improvement.⁶ Most business people, even those that are financially literate, often assume that margin increases have a bigger impact on shareholder value than increases

in growth, he argues. Even those who factor in the compounding effect of growth over time still routinely underestimate the value of growth. He estimates that for many companies, the value of an additional percentage point of growth per annum can, in fact, be worth between six and 10 times as much as an extra percentage point of margin. Moreover, he's unsure that there must be a trade off between profitability and growth.

Mass and his associates have developed a financial metric, the so-called Relative Value of Growth (RVG) – which expresses the value an extra percent of growth will generate in terms of shareholder value as a multiple of the value of a percentage point increase in operating profit. He then calculates, based on publicly quoted data, a list of RVG values for well known companies, which range from 0.7 to 14.5 and then correlates this with their stated or inferred strategy.

This reveals some interesting disjunctures: for example, companies like Merrill Lynch whose RVG is a high 10.5, espousing a strategy which emphasises margin improvement rather than growth. At the other end of the spectrum are companies like Hewlett Packard, which with a low multiple of 1.2, is apparently stressing growth at the expense of margin.

Clearly, not all companies benefit equally from growth. Some companies, like EDS, have to 'earn the right to grow' because their current operating margins are too low and they operate on relatively high costs of capital. Procter & Gamble, by contrast, has a much higher RVG by virtue of its higher operating margin, lower asset intensity and a lower discount rate.

If the shareholder value impact of growth strategies is so measurable, why do companies not pursue such strategies more aggressively? The answer, Mass says, is partly that modern corporations fail to reward growth adequately and often lack management capabilities to produce growth. Companies which regard cost reduction as an almost routine management discipline often fail to develop similar growth expertise. "Growth programmes are not being pursued purposely and diligently under the eye of top level management, confidence in the programme erodes, the organisation doesn't build a solid experience base. As a result growth projects fail to deliver on their promises, reinforcing the perception that profitable growth is too difficult to achieve."⁷

RVG expresses the value a percentage point of growth will generate in shareholder value

Not all companies benefit equally from growth

Taking command of growth

Michael Treacy, known for hailing the importance of customer intimacy and operational efficiency, has also studied companies and their growth paths between 1997 and 2002.⁸ He believes that great companies should be capable of consistently achieving double digit growth. Such continuous growth triggers three virtuous cycles: an economic cycle, leading to greater capital for investment in the organisation, a customer surge cycle and an innovation cycle.⁹

Like Mass, Treacy believes that part of the problem is that managers do not have the right tools to analyse sources of growth and to break them down into intelligent categories. To address this issue, Treacy and Sims have developed a tool called the sources of revenue statement (SRS). This breaks down growth into five separate sources, distinguished not, for example, by market segments or national categories or other organisational dimensions, but by the range of strategies open to the company.¹⁰

These include:

- base retention, ie continuing sales to existing customers;
- share gain, ie sales won from competitors;
- market positioning, ie new sales in expanding markets;
- adjacent markets (where companies core capabilities can be leveraged); and
- new lines of business unrelated to the core.

Clearly, this categorisation owes much to Ansoff's original conceptualisation. Nevertheless, there are novel elements. By breaking down revenue in this way and estimating the impact of market growth rates and customer 'churn' rates, it is possible to analyse growth much more closely. For example, a company which has grown by 17% may on the face of it look successful and management may be pleased if a large portion of it is generated in adjacent markets. If, though, the overall figure conceals only a marginal increase in market share, combined with high customer churn rates – that is to say the weighted average rate at which customers defect to competitors – it may be that the underlying trend is actually a cause for concern.

The framework is a useful tool to analyse past performance, but it can also be used for planning a company's future growth strategy, by breaking down the sources of future growth

into their respective categories. One insight that this exercise is almost certain to reveal is the importance of reducing customer churn and retaining customers, particularly if growth rates falter.

How to achieve higher growth

In an era where many products and services have become commoditised, the best way to achieve superior organic growth is to address higher order economic issues that affect customers, Wise argues. "Customers want to save time, reduce hassle or feel more secure. Business customers want help with things such as improving their operating efficiency or reducing their risk. Companies that address these higher order needs stand to create sustainable new growth."¹¹

This theme is pursued by McGrath and MacMillan of Columbia, in their article on market busting strategies for exceptional business growth.¹² These authors identified five so-called 'market busting strategies', which include:

- transforming the customer's experience;
- transforming the nature of products and services;
- redefining the businesses' profit drivers and key metrics;
- anticipating and exploiting industry changes; and
- exploiting the opportunity of so-called tectonic opportunities in industries to create a radical new offering.

McGrath and MacMillan's article emphasises building a better model and using metrics more attuned to customer needs. Thus, in the example of a ready-mix concrete supplier, traditionally the company had priced the concrete it sold by the cubic yard. The company discovered, though, that its clients were not particularly interested in cubic yards of a product they considered a commodity and that much of the value was created through delivering the product in a timely fashion.

By investigating how other companies in the delivery business in other industries operated (such as pizza delivery companies and Federal Express), they were able to restructure their business – and its logistics – by using communication systems and digital control systems. This enabled them to adjust in real time the destination of their trucks, many of whom would be stuck in traffic, to meet and exceed customer expectations.

Managers do not have the tools to analyse sources of growth

The authors conclude that it is often possible to grow a business organically by changing the unit of business, ie the metrics used to sell products and services, to something which more closely reflects the value created by customers; or to change the performance against these key metrics in ways which dramatically enhance the offering. They maintain that it can commonly take quite a long time for such strategic moves to be registered by the competition and even longer for them to replicate it. This is because such moves often require the acquisition of new capabilities.

Other moves to improve the value to customers include:

- improving the cash flow velocity of the company and if possible of the client, eg through electronic systems for recycling funds;
- dramatically improving asset utilisation, eg by allowing clients to pay for a service rather than investing in expensive hardware;
- improving the customers' performance, eg UPS now employs technicians to do repair work on Toshiba laptops; this extension of their existing shipping service for personal computers enables UPS to reduce its maintenance staff and by integrating the repair and shipping activity, reduces the time taken to return broken equipment to its owners;
- improving customers' personal productivity; this, in effect, does the same thing for individual customers as the previous point did for corporate clients; and
- reducing customers' asset intensity, by allowing them to remove fixed assets from their balance sheets and substitute them with variable costs.

Blue ocean strategy

Kim and Mauborgne are also worried about growth potential for companies in mature industries.¹³ The authors argue that you can divide business opportunities into two distinct types, which they characterise as 'red' and 'blue oceans'. Red oceans describe existing markets, where boundaries are accepted, rules of the game understood and competitors familiar.

In such situations, they say, trade-offs around cost and differentiation are usually unavoidable. Blue oceans represent uncharted parts of the market. Here, demand has to be created,

there are ample opportunities for growth and profitability – particularly for successful first movers – and companies often succeed through an offer that is both low cost and which differentiates it from the competition.

Unsurprisingly, it is in these blue ocean areas that the authors see the most attractive opportunities for companies to achieve future growth as traditional industries become more commoditised. Yet, they say, most companies seem to be calmly drifting on red oceans, with the majority of growth strategies being line extensions rather than attempts to develop new markets and industries, even though the latter delivered startling rates of return.

According to these authors the strategic logic of blue oceans is characterised by the following:

- they are rarely about technology, per se, but they are often about changes in processes or products which create step changes in value for customers, eg the launch of the model T Ford, which through mass production created a whole new market for mass transportation for ordinary people;
- blue oceans are created as often as not by incumbents and often from within their core businesses. This challenges two beliefs: one that incumbents are unable to innovate and that true innovation comes from industry challengers and also that the new markets need to be created far away from the company's core business; and
- the concepts of a company in an industry are not helpful as analytical concepts: "There is no consistently excellent company ... Every company rises and falls over time. Likewise, there is no perpetually excellent industry. Relative attractiveness is driven largely by the creation of blue oceans from within."¹⁴

The authors argue that so-called blue ocean strategies are not only more profitable – they also generate greater growth and are more difficult to imitate than traditional strategies, since they require other companies to change their entire systems and structures to compete effectively. While this may be true, it contradicts other research on the topic.

Consider, for example, the personal computer as a typical blue ocean strategy. While this product created a whole new multi billion dollar industry, the process of innovation, in historical retrospect, did not, in fact, favour

Blue ocean areas represent opportunities for future growth

Blue ocean strategies are more difficult to imitate than traditional strategies

the pioneers. The concept was originally developed by Xerox, exploited by Apple and leveraged by IBM, which in turn lost much of the value created to its suppliers Microsoft and Intel and to innovative competitors like Dell, whose built to order system ultimately proved unstoppable.

This perspective on growth is fascinating but not entirely novel. We have discussed before research on 'first mover' advantages versus the 'fast followers' as well as the pioneering work on innovation by Clayton Christensen, who coined the term 'disruptive innovation' to characterise new offerings which changed the rules of the game and the way customers viewed the product market.

This review reveals that many companies in mature industries are facing a crisis as both their traditional sources of top line growth –

as well as more recent hopes such as e-commerce or emerging markets – have proven not to be sustainable sources of growth. As competition intensifies and industries become more commoditised, achieving growth becomes more difficult. Top line growth is still a valuable commodity: it is no longer possible to create sustainable strategies solely on the basis of increased prices or reducing costs.

Even companies which grow successfully through acquisition will eventually need to focus on top line growth. This will inevitably place the emphasis on sources of innovation and processes for ensuring that companies can continue to innovate both in technology and products, as well as in novel product service bundles and/or processes which deliver significant step changes in value for customers. **MU**

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