THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

From the Faculty of Finance and Management of The ICAEW

Manager Update

ISSUE 1 Spring 1997

PREFACE

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

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

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

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

Manager Update *is compiled and edited by* Professor Keith MacMillan, *Academic Dean and Deputy Principal of Henley Management College.*

Stephen Parkinson *is Professor of Business Strategy and Director of Ulster Business School at the University of Ulster.*

Ian Turner *is Director of Studies of the Distance Learning MBA and Diploma in Management at Henley Management College.*

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

The late Sheila Rothwell *was formerly Director, Centre for Employment Policy Studies at Henley Management College.*

ARTICLE SUMMARIES

Marketing *From Strategy to Service*

How is it possible to get the strategy of the whole business right, yet also focus on delivering the added value at the level of the individual customer? This review looks at recent articles covering strategic positioning; strategies which combine cost reduction and customer satisfaction; getting the whole company to face the customer; and managing individual customer service. **Page 1**

Human Resources Management *Flexible Firm Strategies*

Flexibility is the key aim of much organisational change in the 90s. It can be achieved in several forms: contracting-out, use of part-time and temporary staff, encouraging self-employment, teleworking, overtime, functional flexibility and pay flexibility. Each approach has its relative merits and drawbacks, as recent research has revealed. **Page 6**

Strategy and Organisation *Strategy & Unpredictable Environments*

To be successful, does strategic thinking today have to be revolutionary or evolutionary? Key recent articles argue both ways, but the edge is likely to go to businesses who are continuously transforming themselves. Amidst this debate comes Michael Porter's most recent contribution, which attempts, not altogether successfully, to provide a rational re-interpretation of competitive advantage. **Page 11**

Accounting and Finance *Evolving Rules of the Game*

As companies become more international in scope, differences between accounting standards must be mastered; hence the move to International Accounting Standards. These still await recognition by the world's leading stock markets, especially that of the US. Meanwhile, instruments such as American Depositary Receipts (ADRs) can prove useful to gain access to the US market. But funds, thus raised, have to be shown to have been put to good use. This *Update* therefore includes a review of the increasing use of Economic Value Added (EVA) approaches to shareholder value. **Page 15**

ISBN 1 85355 643 2

MARKETING

From Strategy to Service

Stephen Parkinson is Professor of Business Strategy and Director of Ulster University Business School

The management literature can be seen in terms of a continuum between strategic long term issues and short term operational decisions. At one extreme, authors discuss the relative merits of concepts such as empowerment, innovation, or re-engineering. At the other there are 'how to' articles on improving the performance of a salesperson, or using the Internet for company advertising. This split mirrors a debate that is frequently heard between two schools of thought, the pragmatists and the theorists.

Pragmatists concentrate on the here and now. They do not accept the value of long term strategic or conceptual thinking about business. Pragmatists suggest that the fluctuating nature of the business environment means that there is no value in having a long term strategy. Many of this group argue that business is a simple process that has been made over complex by consultants and business schools.

Theorists on the other hand argue that there is a value in taking a long term view of business problems. This group is responsible for a wide range of conceptual models addressing a variety of topics. Each model has its own fans and critics.

The four articles reviewed in this issue of *Manager Update* reflect both ends of this spectrum. Porter,[1] speculates on the nature of strategic planning. His article is focused on the apparent failure of management to distinguish between operational effectiveness and strategic planning. It represents the conceptual end of the spectrum. Edwards[2] concentrates on the issue of becoming customer driven and develops practical advice for companies seeking to pursue differentiation strategies.

Shaw's article[3] falls somewhere between the two ends of the spectrum. It begins with a practical discussion of the role of information technology in competitiveness. It then moves to a discussion of an extended case study of implementation of a business recovery plan. Van Vliet's article[4] is a pragmatic discussion of the importance of customer service in organizational performance. It shows how effective companies make customer service into a strategic weapon.

Delivering sustainable value

Michael Porter's latest article is reviewed here, as well as in the Strategy section of *Manager Update*, because his work over recent years has been of value to marketing as well as to strategic management. His particular contribution to marketing in this most recent paper lies in his discussion of strategic positioning.

The article distinguishes three distinctive approaches to strategic positioning, namely 'variety based positioning', 'needs based positioning', and 'access based positioning'. Variety based positioning means taking a subset of the total product or service and choosing to specialise on serving that segment better than anyone else. For example, a restaurant may choose to serve only a limited range of food, rather than offer a full menu. Its limited choice menu allows it to respond faster to customer needs, and operate more efficiently in terms of purchases of raw materials.

A company that defines its position in terms of needs has essentially segmented the market and defined a tailored set of activities to meet the needs of the segment. First Direct are a good example of this type of company. Having pioneered the direct banking approach, the company continues to dominate the market through innovation in its standards of customer service linked to effective database management.

Access based positioning means choosing to serve only carefully defined segments of the market which competitors have ignored. For example, in the UK until relatively recently all of the major grocery chains have ignored the Northern Ireland market. As a result, local chains have dominated the market. The recent entry of major chains, such as Sainsbury, threatens to revolutionise the market through higher levels of customer service, greater variety of products, and lower prices.

Activities must also fit together. For example, a flexible manufacturing system should be matched by an ordering system that can reflect the production capability, and a promotional campaign designed to tell customers about the variety of products on offer to meet specific customer needs. Each of these elements should be mutually re-inforcing, supporting the overall company position in the market. For example, product design improvements can eliminate the need for servicing later on in the life of the product. Companies, according to the author, do not compete in terms of one competence alone. Rather, they compete in terms of the degree of fit between all of their activities and the needs of the target market. The author summarises the argument as follows:

> 'It is harder for a rival to match an array of interlocked activities than it is merely to imitate a particular sales force approach, match a process technology, or replace a set of product features. Positions based on systems of activities are far more sustainable than those built on individual activities.'

The article presents a useful overview of how far Porter has moved in developing his thinking about strategy since the early 1980s. Being a little unkind, some of his arguments have now been overtaken by other management 'gurus' who have taken the view that strategy is ultimately implemented by managers. Such managers are subject to a wide range of different influences, making the rationalist approach presented by Porter less credible, at least to the practising manager.

Winning Ways

Edwards' article starts from Porter's original propositions, namely that a winning enterprise is able to provide higher levels of service leading to greater customer satisfaction, at competitive cost levels. He distinguishes between four different types of company. These four types are differentiated by the extent to which they can achieve low costs or satisfy customers. 'Laggards' are companies with high relative cost and low levels of customer satisfaction. Such laggards may survive in some sectors, principally public utilities, according to the author, but their days are ultimately numbered. 'Cost driven enterprises' are relatively efficient but do not provide high levels of customer satisfaction. Such businesses survive in industries or markets which are predictable in terms of technology or demand. However, the long run prognosis for such companies is poor. The third category, the 'benevolent enterprise,' continues to give high levels of customer satisfaction, even when its costs are relatively high. Such companies may continue to provide high levels of value to customers, even if they are relatively inefficient in delivering the product or service. They frequently survive through innovation in products or services but are not likely to grow rapidly. The final category, the 'winning enterprise' has high levels of customer satisfaction and high levels of cost efficiencies. Cost reduction programmes and customer satisfaction are both goals in such an organisation, and a deliberate attempt is made to balance the emphasis which is given to both.

The author identifies several characteristic behaviours of the winning organisation. It can react more rapidly to meet changing market conditions. Organisations in this category are likely to have designed their structures and processes so that they can react rapidly to new opportunities and exploit new emerging market segments. They will also attempt to mobilise a network of organisations to meet new opportunities. They are likely to play a catalytic role in mobilising such networks. This includes co-ordinating and leading distribution channels as well as suppliers.

Such systems will evolve according to need, but a key role for marketing in such organisations will be to play a lead role in defining and building strategic alliances to deliver competencies beyond the company. Understanding customer needs is central to this process. Edwards argues against conventional market segmentation which identifies clusters of customers. True innovation, according to the author depends on developing detailed insight into the behaviour of *individual* customers. This should be coupled with direct marketing programmes which allow the company to respond flexibly to individual customer requirements. In Edward's view, companies will move inevitably to a form of segmentation, at the individual customer level. This will facilitate direct and continuous dialogue, which will be essential to customer retention in the future.

Getting the whole company to face the customer

Shaw's article draws out this theme. It begins with a discussion of the potential of information systems to manage customer relationships effectively. It then moves on to consider how to develop an integrated customer focused approach across the whole organization.

Viking Direct, a distributor of office supplies, is used as an example of a company that has created a complementary set of activities. The secret of the company's success is allegedly its computer system. The system tracks every purchase made by a customer, and uses this information to continue a dialogue following first contact. Customers who do not buy frequently receive a letter asking if anything is wrong. Customers receive a letter on the 'anniversary' of their first purchase enclosing special offers. Customers receive personalised communication attached to delivery notes and catalogues. A customer may receive a suggestion to change from manufacturer brand to own label computer disks, following an order for the manufacturer brand.

This technology can be used to build customer relationships. For example, once supermarkets have set up databases to track individual customer purchases, a customer would simply need to use a smart card at a terminal in the store to 'check in'. The store could immediately print out the customer's last shopping list, generated by the scanning system at the check-out. It could also identify special offers and issue coupons for redemption on products on promotion. The system is then being used in an integrated way to create a sustainable competitive position.

Shaw maintains that most companies do not use databases in this way. Databases can all too frequently be 'dustbins' or 'warehouses', rather than real sources of competitive advantage or 'goldmines'. Interdepartmental conflict is frequently the main problem. Managers do not agree on the best way to integrate systems to respond to the market place. This echoes Porter's views about achieving a consistent fit between organizational capabilities and market opportunities. However, unlike Porter, Shaw extends the argument to include the problems of building a management consensus around the implementation of strategy.

Shaw argues for a 'ring of commitment' around the company, binding together different interests. This commitment must be based on accurate measures of customer relationships. Since the whole business is involved in creating and sustaining relationships with customers, measures must be taken across the whole company. Interdepartmental barriers can restrict or stop the flow of useful information. The tendency to locate the responsibility for computing or IT in accounting also reinforces the accountancy role of computers rather than the strategic one.

The article contains a detailed description of how commitment was obtained in one large organization facing severe problems in meeting business targets. The company, a large utility had set ambitious profit targets but was not achieving its goals. Conflicts between Marketing and Operations had led to major disagreements about strategy. Front office staff had not accepted the rationale for changes put forward in the company's development plans. A series of excuses had been put forward to explain problems in the implementation of specific customer care initiatives.

The problem was addressed by looking at the reasons why commitment was necessary, followed by a discussion of what to change, and how to implement the necessary changes. A series of workshops was initiated with senior management to identify the scope of the problem facing the company. The problem was disaggregated into a series of issues. This list included poor customer communication, missed development opportunities, wrong customer acquisition, lost pricing opportunities and weak relationships with business partners. A value was attached to each of these issues that indicated the impact on profit of each element. The group was then asked to address the potential benefits from solving the problem. By the end of the process the overall extent of the problem had been determined and there was no longer any question that action was required.

A second workshop followed to address the issue of 'what' should be changed. The author describes how this workshop led to a series of jointly agreed actions for improvement. For example, problems of customer communication were addressed by developing easy quick routing of customer contacts. Easier customer quotation processes were developed. Flexible billing systems were introduced.

Finally the question of how to make the necessary changes was addressed. There were still considerable barriers between departments to overcome. The existing organization was one of 'divide and rule', with each department setting different standards for customer commitment. The process is still ongoing. However there has been sufficient success to date to make it worth continuing. The article shows in a practical way how Porter's strategic direction can be implemented.

Managing customer service

The article by van de Vliet looks at one element of implementation in depth. Customer service is widely recognised as an area where improvements can make a major impact on profitability and customer satisfaction. Just as many Japanese companies were able to outstrip their competition in the 1970s and early 1980s by improving manufacturing and delivery systems, so many organizations today are discovering that improving levels of customer service can lead to competitive success.

The starting point in improving customer service levels is to measure existing perceptions. The author claims that many companies do not have effective systems to measure customer satisfaction levels. An effective system would contain data on performance features that the customers felt were important rather than those chosen by the company and its distributors. These measures would be collected systematically and regularly. There would be a system to translate such measures into improvement actions that relate directly to customer requirements.

The author identifies several factors that make measurement more likely to succeed. It is important to put the questions in the language of the customer. Qualitative survey work helps with this, by identifying the agenda which customers believe to be important. BT uses the information from its telephone interviewing to produce case studies for training. One building society telephones every customer who fills in its customer satisfaction questionnaire (some 36,000 people a year), to thank them for completing the survey, and to deal with any complaints that have been made.

One of the current issues is whether to link measures of customer satisfaction to employee remuneration. The problem has been to identify an unambiguous measure that can be used systematically. BAA survey 250,000 customers annually as they arrive or depart from its airports. Customer satisfaction is now linked directly with salary bonuses, not only for front line staff, but also for middle and senior management.

Internal measures of performance are less useful than measures that compare the company's performance with the competition and other best-in-class competitors. The author suggests that companies follow the example of BA which benchmarks its performance against Ford, BT and Thomas Cook: and 3M which benchmarks its performance against Hewlett Packard, Shell and BP. Clearly, it is important to identify the right partners for comparison. However, it is frequently difficult to identify a partner with similar markets and customers with whom the company is not in competition.

The article contains many useful examples of how to use customer service to improve business success.

Readers will find the discussion of implementation of strategies for customer service of immediate relevance in their own organization.

REFERENCES

1 **'What is Strategy?'**
Porter, M *Harvard Business Review* November-December 1996, pp 61–78

2 **'Delivering differentiation: Building winning enterprises'**
Edwards, J *European Management Journal* Vol 15, No 1, February 1997, pp 79–91

3 **'Creating a Ring of Commitment to Customers'**
Shaw, R *Journal of Marketing Practice, Applied Marketing Science* Vol 2, No 3, 1996, pp 71–92

4 **'Are they being served?'**
van de Vliet, A *Management Today* February 1997, pp 66–69

HUMAN RESOURCES MANAGEMENT

Flexible Firm Strategies

The late Sheila Rothwell was formerly Director, Centre for Employment Policy Studies at Henley Management College

Flexibility is the key aim of much organisational change in the 1990s. Definitions of it are also infinitely varied and flexible, ranging all the way from general organisation change processes to very specific 'family friendly' policies. Interpretations of its meaning also vary, according to organisational and national culture contexts. While the drivers of it appear to be global—changing patterns of world trade, increasing competition, the advances of information technology,—the strength of these forces has differential impact according to time, place and shape of development. This *Update* reviews recent trends.

Flexible organisation structures

Much of the delayering of organisation hierarchies and restructuring around processes and customers of the past decade has been aimed at achieving greater flexibility, and this has been well illustrated by a study of restructuring among the largest international oil companies during the period 1980-92. Cibin and Grant showed how the drive to achieve greater efficiency and flexibility were the unifying themes of their search for greater profitability.[1] Reductions in capacity and in employment, (at least in headquarters) involved leasing and contracting-out as part of the drive for operational flexibility by the oil companies. (It has been reflected in similar practices in a large number of other private-sector companies.)

This form of 'employment' flexibility has also been forced on much of the public sector by government policies in the UK and elsewhere in the EEC. A study of compulsory competitive tendering in Southburgh Cleaning Services was a case study of some of the effects of the UK 1988 legislation, requiring the contracting out of a wide range of local authority services through a process of competitive tendering.[2]

Many of the typical 'flexible employment' policies were performed in SCS—the full time manual workforce was reduced by 23%, with intensification and restructuring of work and a wider mix of tasks required. There was a significant increase in the use of temporary, seasonal and agency workers, employed on inferior terms and conditions, but sometimes unable to keep up with the increased physical demands of the work. Much of this change was made possible by the local labour market context, which exhibited 9% unemployment.

Self employment in the flexible labour market

The growth in self-employment, notable in the UK (13% of the workforce in 1994; 3.27 million) and to a lesser extent elsewhere in Europe and in the US (13.5 million) is often cited as a sign of the new 'flexible' labour market or 'contingency' work, even though it is hardly a new phenomenon in itself. This is partly because the 'downsizing', which often precedes or accompanies the development of flexi-firm strategies, results in redundant individuals setting themselves up in their own businesses and then becoming suppliers or subcontractors of their products or services to larger firms.

In the US, in a symposium of papers on flexible employment, Kirchof demonstrates that the self-employed are primarily small business owners who make up the core of the US economy and create a disproportionate share of net new jobs, even if they do not employ many people themselves.[3] The evidence reported by him suggests that most self-employment is chosen as an occupational decision, and that unemployment is not the major reason for it, although he acknowledges its significant role in providing an 'upward' mechanism for the poor and unemployed in all parts of the world. Similar findings were made by Dennis who concluded from a study of a range of sources that people largely enter self-employment, often seeing it as preferable to alternative work arrangements.

A rather different focus was taken in a UK study of the culture of the (new) self-employed.[4] This explored the experiences of working class people in Tyneside who attempted to 'become their own boss'. It followed the progress of 'young entrepreneurs' from 1989 into the mid-1990s and complemented this with an investigation of 52 self-employed adults. Survival rates were low and the majority in both groups had returned to unemployment. Macdonald concluded that there was little sign of 'enterprise culture' but rather that people had become 'forced entrepreneurs'. 'Survival self-employment' was part of a growing culture of new, informal and risky ways of making a living at the margins of depressed local economies.

Numerical flexibility

Labour market changes in the forms of increases in contractual and numerical flexibility through fixed-term, temporary and part-time employment have continued, following marked increases in the 1980s, particularly in Britain but also in Germany, France, Netherlands and other European countries. Rajan's study of future trends in Britain's Flexible Labour Market (and their implications for training policy) begins with an overview of its current extent, showing that at present:

> 'one in two employers use very flexible forms of work. This figure is expected to increase over the rest of this decade, albeit moderately, owing to recent restrictive rulings from the European Court of Justice and the House of Lords . . . Past and future growth is both demand and supply driven: for employers it brings cost and efficiency gains; for employees, the choice of different life styles.'[5]

So far, women, and to a lessening extent, ethnic minorities have gained most jobs as a result of the increasing flexibility.

Part-time employment is the most widespread form of flexible employment in the UK, covering about one quarter of all those in employment (and 28% of jobs in Western Germany but only 17.5% in the USA).

Over the period 1983-93 more than a quarter of US employment overall was involved in contingency work. It has also accounted for most of the overall growth in employment since June 1995, with the rate of growth being proportionately faster among men than among women.[6] Nevertheless, only 9% of all male workers are part-time compared to 44.7% of women. A study by the Institute of Management and the TUC found nearly half of all organisations expected to increase their usage of part-time workers, and to do so at all occupational levels, not just in low level ones.[7]

> 'Part time workers are integral to roles such as information processing, computing, sales and marketing and customer relations.'

They are increasingly employed as part of a strategic approach to competitiveness and to obtaining specialists in skills in the numbers and at the times required. Nearly two-thirds of the employees surveyed thought that legislation to equalise the employment rights of full and part-time employees should be introduced, while three-quarters recognised the need for training. Individuals surveyed, regarded as part-time by employers, might in fact be working for three or four organisations throughout a month or year and regarding themselves as full-time.

Some saw part-time work as a way of balancing work and home life, while others regarded it as a stepping stone. The same was true of *temporary* work. A recent survey by the Institute of Employment Studies found that 68% of those who employed temporary staff had appointed at least one to a permanent position in the past three years and a fifth said they deliberately used some of their temporary jobs as 'trials for permanent positions'.[8] The reasons for using temporary staff were, according to employers, partly the traditional uses of short term cover for absence or sick leave but mainly the more strategic reason of 'matching staff levels to peaks in demand' which was particularly marked in telesales and in financial services. Very few cited the advantages of reduced wages, or the lower cost of benefits or training and many who recruited through private agencies criticised their high cost. Unreliability, and high turnover of temporary staff were cited as the main disadvantage, although 17% said they had not experienced any problems with using temporary labour, although as with other factors the extent varied according to industrial sector. While over a half of all employers surveyed used temporary labour, small firms were least likely to do so, and in general the scale of temporary working is small—less than 10% of the workforce in nearly two-thirds of firms surveyed.

Temporary workers were more likely to be found among the oldest and youngest in the workforce, to be relatively well qualified and to be female; but the proportion of male employees in temporary work is increasing. Overall, more are doing it involuntarily because they could not find permanent work. Employers were generally no more ready to recruit from a disadvantaged or underqualified group for a temporary than for a permanent vacancy; with the exception of a greater willingness to consider the short-term unemployed for such work.

The conclusion of the 'flexibility' symposium was that while there was recognition that temporary workers have lower wages, fewer benefits, and less training than permanent employees, they do get access to employment and a chance to move up the ladder. For their part, employers who exploit their use for long periods tend to suffer higher costs in the form of turnover, legal claims and low morale.[3]

Location flexibility

Teleworking is one aspect of the flexible labour market which is often said to have been more widely researched than practised, but the variety of forms it can take make it difficult to categorise and it may represent full-time, part-time, or temporary employment or self-employment. The location of it—at home, away from the employer's premises or at a local centre, plus its use of information technology is what makes it part of the new 'flexibility'. An overview of the research for government undertaken by Huws, defined it as 'individualised' or 'collective' teleworking, examining its impacts on transport, the environment, business development and employment.[9] The particular needs for communication, objective-setting and training in the management of teleworkers are only just beginning to be realised.

Functional flexibility

'Functional' flexibility—whereby employees widen their skills and competencies to undertake either a wider range of tasks, a more demanding level of work or new types of work has long been considered a major form of 'flexible' working, and one which may or may not involve a typical contractual relationship. Research by Rajan, particularly in the financial service sector, has shown the growth in importance of knowledge workers. While his recent report focuses on the learning and training implications of the flexible firm in general, there is considerable emphasis on this category of staff and their future development needs. Overall, he sees the increasing importance of 'soft skills' in the delayered, downsized, decentralised 'open network' organisation structures, in which team working and face-to-face contacts are increasingly dominating changing working methods.

Job insecurity is a major current concern for staff and employers are trying to re-motivate them to perceive themselves as internally 'self-employed' persons with a commitment to retain their customers' (ie, employers') business. Alternatively, staff are encouraged to acquire transferable skills to improve their employability inside and outside their current organisation. Either way, motivation is becoming driven by 'market discipline' rather than paternalistic personnel policies. So far, however, Rajan acknowledges that employers' attitudes on training remain lax on intentions and short on 'deliverables'.

The basic gap lies in the perceived inability of the workforce to handle state-of-the-art technologies and working methods. It arises from low self-learning, problem-solving, reliability and drive. Rajan acknowledges the difficulty of discovering whether growing flexibility in the labour market is contributing to market failure in employer-based training, especially for part time contract workers and in small firms. Flexibility requires continuous learning and the use of new learning methods, such as mentored learning, experiential learning and distance learning. More of this—or other forms of 'training' (as in Rothwell's work on training in the supply chain)[10]—may well be taking place than is implied by regular surveys. The evidence, however, suggests that the development of core skills and appropriate personal attitudes may be weakening, especially the skills and attributes needed to cope with insecurity in emotional terms. This seems to be the 'Achilles heel' of the new flexibility.

Policies emphasising education, development and training were found in a comparative study of Brazilian, Korean and Japanese telecommunication firms at the leading edge of technology. Qualitative research, carried out in 11 companies, revealed considerable innovation in various HRM practices, even though these were specific to each country, as were the market competitiveness conditions. All sought to change the employees' profile—in some Japanese and Korean companies towards developing individual creativeness and performance: while in Brazil, the commitment and stabilisation of employees was also seen as important. Intensive training programmes and self-development opportunities were adopted for all levels of the workforce.[11]

Pay flexibility

'Employability' was seen by Rajan as one major approach to replacing the traditional drivers of employee motivation, such as security and career progression, but he also commented on the increasing prevalence of performance related pay as a substitution for the old motivator of automatic pay rises. Widening pay differentials showed that those who had the skills and attributes to cope with market insecurity were thriving at the expense of those who did not. From the employer's point of view, financial flexibility is one of the major aims of the new flexibility strategy. Reducing the numbers of full-time employees and replacing fixed by variable costs, standardised by contingent pay systems are all measures which can contribute to greater financial control.

One major recent study of why firms adopt profit-sharing and employee ownership plans, among 500 US companies in the 1975-91 period, found that apart from productivity related motivations, flexibility related motivations were high.[12] Prior to the adoption of such schemes, variations in company profit levels had been much greater, thus actual or expected improvements in performance seemed most likely to have triggered their adoption. Firms wanted employees to benefit, but not through permanently higher wages. In other cases where there had been a fall in profits, employers did not want to impose wage or benefit cuts, but tried to shift some income risk to workers. 'Productivity-related' reasons for the adoption of profit-sharing plans tended to be associated with the presence of job enrichment programmes, such plans being seen as a complement to other ways of motivating worker efforts. They also tended to be found where employee involvement programmes and self-managed teams had been introduced.

A strategic approach to flexibility?

The search for the ingredients of Japanese success and the extent to which Japanese companies provide models for Western ones has been a frequent focus of academic and management research since the 1970s. Management strategy on labour flexibility in Japanese manufacturing enterprises has recently been explored by Benson.[13]

He found that emphasis on skill development and sophisticated functional flexibility was a key aspect of Japanese strategy for 'core' workers, particularly in large firms. Numerical flexibility was achieved in large firms by varying the use of subcontractors and the extent of overtime; while in small firms it was done largely through the use of temporary workers and by varying working hours. Nevertheless, a "core of employees remained protected, even if it was a smaller proportion than in the larger ones where the strategy was to maintain a highly skilled workforce that is adaptable rather than dispensable".

Benson concluded that Japanese employment practices had a strategic component and that their use of contract and casual employees is similar to the Western notion of 'core' and 'peripheral' employment strategies. Small firms tend to 'adopt short-term or defensive forms of flexibility' and large firms achieve improved productivity by more efficient capital equipment and organisational change.

As this review of the recent literature has indicated, 'flexible working' takes many forms. Researchers, trying to make sense of what they observe, have produced several theories. Practical managers may not be aware of these theories as they experiment with their staff in gaining greater flexibility; they are simply responding to the imperatives of a rapidly changing business environment.

REFERENCES

1 **'Restructuring Among the World's Leading Oil Companies, 1980-92'**
Cibin, R, Grant, R M *British Journal of Management* Vol 7, No 4, Dec 1996

2 **'Neither One Thing Nor the Other: Compulsory Competitive Tendering and Southburgh Cleaning Services'**
McIntosh, I, Broderick, J *Work Employment and Society* Vol 10, No 3, Sept 1996

3 **'Symposium: Flexible Employment and Alternative Work Arrangements'**
Dennis, Donald A (ed) *Journal of Labor Research* Vol XVII: No 4, Fall 1996

4 **'Welfare Dependency, the Enterprise Culture and Self-employed Survival'**
Mcdonald, R *Work Employment and Society* Vol 10, No 3, Sept 1996

5 ***Britain's Flexible Labour Market: What Next?***
Rajan, A, Jaspers, A, van Eupen, P, DfEE/CREATE, Nov 1996

6 **'Temporary Work and the Labour Market'**
Atkinson, J, Rick, H, Morris, S, Williams, M *Institute of Employment Studies* Report No 311, 1996

7 ***Flexibility and Fairness***
Hastings, M O W *Institute of Management Research Report* London, 1996

8 **'Employers' Use of Temporary Workers'**
Heather P, et al *Labour Market Trends* Vol 104, No 9, September 1996

9 ***Teleworking: an Overview of the Research, Communications and Information Industries Directorate***
Huws, U *DTI*, London, 1996

10 **'Polishing up the Supply Chain'**
Rothwell, S *Personnel Management* September 1992

11 **'Managing Human Resources for Learning and Innovation: a comparative study of Brazilian, Japanese and Korean firms?'**
Fleury, M T L *International Journal of Human Resource Management* Vol 7, No 4, Dec 1996

12 **'Why Do Firms Adopt Profit Sharing and Employee Ownership Plans?'**
Kruse, D *British Journal of Industrial Relations* Vol 34, No 4, Dec 1996

13 **'Management Strategy and Labour Flexibility in Japanese Manufacturing Enterprises'**
Benson, J *Human Resource Management Journal* Vol 6, No 3, 1996

STRATEGY AND ORGANISATION

Strategy & Unpredictable Environments

Ian Turner is Director of Studies of the Distance Learning MBA and Diploma in Management at Henley Management College

To judge from recent journal articles, strategy is reaching another of its crossroads. The traditional theory of strategy and strategic planning as originally developed by Kenneth Andrews, Igor Ansoff and others depicted strategy as a rational process which proceeded in a linear fashion from defining the mission and objectives, through analysing the company situation, to evaluating the options faced by the business and implementing strategies. This approach of course gave rise to the doctrine of corporate planning and saw the introduction of large corporate planning departments in companies and formal strategic planning processes.

While this was certainly the dominant strategy paradigm well into the 1980s, it then came under fire from a new school of thought associated with writers like Henry Mintzberg and Quinn who argued that, in reality, strategies were much more likely to emerge over time, rather than being the outcome of cognitive planning processes. However, as John Camillus points out,[1] neither the traditional approach —what he calls the 'predictive paradigm'—nor the incremental approach or 'learning paradigm' offer much help to companies competing in industries and markets which are characterised by massive discontinuous change both inside and outside of the company. The reason for this is that both of the competing paradigms make an implicit assumption of stability and continuity. The predictive paradigm assumes that it is possible to foretell, with some degree of precision, what the market is going to be like in five years or even, in some industries, twenty years time. The learning paradigm assumes that change in the business environment will be incremental and organisations will be able to cope best with this change by learning to adapt incrementally to it. One of the problems encountered by companies currently, however, is that change in their business environment is often discontinuous. This problem of coping with what has been termed variously: industry breakpoints, strategic inflection points, waves of creative destruction or punctuated equilibria has been discussed in previous issues of Braybrooke's *Manager Update*.[2]

The origins and implications of discontinuity

Camillus discusses intelligently the reasons why business environments have become susceptible to radical change. He identifies three main developments. The first two are the impact of information technology and the globalisation of products, markets and personnel. Camillus' third driver is perhaps more interesting. This is the increased professionalisation and knowledge orientation within businesses. This is the idea that knowledge critical to the competitive advantage of a company is now located at all levels within the organisational hierarchy. According to Camillus these internal drivers of radical change in organisations give rise to the need for what he calls 'high involvement organisations'. Traditional organisations, he believes, tended to emphasise hierarchical control on the one hand and horizontal differentiation between management functions on the other. The characteristics of these new high involvement organisations, like the network or virtual organisation, or the project based 'superteam' type organisation, is that they typically score low on either functional differentiation or levels of hierarchy.

The new transformational model of strategic management about which Camillus writes has two characteristics which distinguish it from the previous models. The first difference is that neither the structure nor the strategy is a given. In transformational organisations these factors are variables. The second difference is that transformational organisations are not about trying to predict change or respond to developments as they happen. Rather they are about the process of producing and exploiting change. One of the implications of the transformational model, Camillus believes, is that it requires a different managerial mindset, a mindset which is governed as much by the opportunities for collaboration with other organisations and actors possessing different capabilities and resources as it is with competing.

Coping with turbulence

Bala Chakravarthy,[3] by contrast, sees competition as being one of the defining characteristics of turbulent industries. Chakravarthy has developed a new framework for managing turbulence based on his study of what he calls 'Infocom', which is the newly converging computer, telecommunications and broadcasting industries. In these industries, turbulence, defined as a combination of the unpredictability of change and the speed of change, is caused by falling barriers to entry and mobility between industries, increasing returns to scale and short product life cycles. Chakravarthy differentiates his approach from previous frameworks developed by Porter, Hamel and Prahalad and D'Aveni. The three elements of his framework are:

- *Repeat first mover* Turbulent industries like Infocom, Chakravarthy believes, are different from traditional manufacturing industries where first mover advantages, experience curves and economies of scale will often guarantee companies which make the decisive first investments an unassailable competitive position. In Infocom, dominant players are confronted continually head to head by challenges. Maintaining a company's position in the face of such challenges requires a readiness to destroy the firm's existing sources of competitive advantage and move quickly to dominate the new ground. 'The failure of Apple, IBM and more recently Compaq to hold onto their leads in the PC industry is due in part to their inability to make their strategies obsolete quickly enough before being attacked by a competitor'.[4] In this sense there are clear linkages between Chakravarthy's concept of repeat first mover advantages and Camillus' transformational model.

- *Managing network effects* This refers to the importance of collecting enough customers early on in the life cycle to guarantee lock-in to a particular product or technology and to withstand the subsequent contest over dominant standards.
- *Going with the flow* Chakravarthy quotes Arthur on the importance of adaptability. 'The essence of surviving in a positive feedback environment is to be highly adaptive. If the flow is in your direction go with it; if it isn't don't resist—retreat.'[5] The challenge for companies in turbulent environments is to retain the flexibility which Arthur talks about to respond and indeed, if necessary, withdraw or relinquish a particular strategy, whilst maintaining commitment. Strategies, Chakravarthy believes, should be thought more of as financial 'call options' which may or may not be realised in the future.

Chakravarthy rightly points out that if the key to operating in turbulent environments is flexibility and speed of movement, then a new approach to 'missions' and the definition of 'what business the organisation is in' is needed. Holding on to one particular mission can easily trap a firm in a market in which it is no longer competitive. Chakravarthy prefers the admittedly vaguer concept of a guiding philosophy which doesn't identify the business scope or even the main competitive target but tells employees where they should be looking for opportunities. In such situations, the strategy becomes not the responsibility of the top management so much as the preoccupation of employees throughout the organisation. The opportunities identified by employees are reconciled with the 'vision' of the top management because the chief executives should have enough knowledge and experience of the business to be able to discern whether the proposed innovations are likely to be 'in the flow'.

Chakravarthy also has something interesting to say about competitive advantage and capabilities. Competencies are important, he believes, to an organisation's competitive advantage in three ways: they leverage competitive advantage through linkages with external organisations; they strengthen competitive advantage through combining individual skills and competencies to form 'metacompetencies' (eg, miniaturisation at Sony) and they diversify competencies either by acquiring new skills or by building them from scratch and retiring the old competencies.

As Chakravarthy says, these three activities may not be always mutually compatible and part of the role of top management is to find the appropriate balance between them.

The case for evolutionary change

Of course, all this talk about radical discontinuities and transformational change may have swung the emphasis in strategy too far towards strategy as a form of revolution. The examples quoted in such articles tend to be very much the same companies, often focusing disproportionately on the behaviour of companies in the IT industry. Not all industries are like information technology and not all change can be characterised as revolutionary. To this extent Tom Duening has performed a useful function in his attack against what he calls the 'catastrophist school of management'.[6] Prescriptions for organisational management, he believes, which are drawn from chaos theory and the study of complex systems, are likely to cause more trouble than they are worth: 'All these prescriptions are based on the assumption that change is inherently unpredictable, usually harmful and has broad organisational effects'.[7]

Duening believes that most change in most organisations most of the time is actually evolutionary and that each generation has always maintained that it lives in uniquely turbulent times. Companies which pursue a policy of evolutionary change and pursue a core ideology religiously over decades are much more likely to be successful, he maintains. In this instance he cites the cases of 3M, IBM, Walt Disney and Kodak. Of these, probably Walt Disney most clearly exemplifies evolutionary change, although even in the case of Disney the ability to create radical new departures in strategy, eg, the move from films into theme parks and the ability to respond and to exploit emerging new technologies, eg, the convergence of IT and traditional film animation, must be seen as part of their competitive advantage.

Readers will not be surprised to know that Duening is in favour of: learning organisations, TQM, continuous improvement and other techniques of adaptive change and fairly sceptical of tools like re-engineering which call for radical discontinuous change. Duening concludes that evolutionary change results in a process of market selection whereby the environment is continually weeding out organisational forms that are not competitive and reinforcing effective and successful examples of business practice. He also believes, sensibly, that no single organisational form or management prescription is likely to fit every organisation. In emphasising the role of natural selection in industry evolution, Duening is probably closer to the complexity theorists than he acknowledges. Where he departs from them, and where I find his arguments less convincing, is in his assurance to managers that evolutionary change should be a source of comfort and that even new entrants into an industry must adopt the tried and tested procedures of the incumbents. This seems to me to be flying in the face of developments in so many of our industries where recently new entrants coming into the marketplace without the burden of legacy systems are transforming systems, not least in distribution channels.

What is strategy?

A new article from Michael Porter, the doyen of competitive strategy, is always eagerly awaited. Porter's most recent contribution[8] must in part be seen as a response to the dominance latterly of the 'Resource-based School of Strategy' and particularly the work of Hamel and Prahalad. Porter, in his recent article, takes some well-aimed side-swipes at core competencies, strategies for revolution and hypercompetition and in the process sets up some pretty egregious straw men. His table comparing 'the implicit strategy model of the past decade' ('What can he mean?') with his own approach, which he characterises as 'sustainable competitive advantage', seems to me to be particularly disingenuous.[9]

Porter seems to be saying, or rather repeating, two things in his article:

- The first is that strategy is about making choices and trade-offs and organisations typically cannot compete on multiple dimensions simultaneously.
- The second is that strategy is not about identifying or developing specific core competencies. It is about how the organisation's different functions fit together to produce a sustainable competitive position.

Porter's remarks on the trade-off issue will be scrutinised closely by those who are interested in the celebrated controversy about whether it is possible to be both a cost-leader and a differentiator or whether such behaviour would inevitably result in a firm becoming stuck in the middle and under-performing. In a separate box, Porter concludes that 'the generic strategies remain useful to characterise strategic positions at the simplest and broadest level'[10] and in the same box he goes on to characterise Ikea and South Western Airlines as being cost based focusers.

Porter must be the only person still left in the world who thinks that Ikea is competing on the basis of focus cost leadership, but to be fair, Porter does have something interesting to say about the possibility of combining both competitive strategies. It is possible to make improvements simultaneously, he believes, in cost and quality but only when 'a company begins far behind the productivity frontier or when the frontier shifts outward. At the frontier where companies have achieved current best practice, the trade off between cost and differentiation is very real indeed'.[11] Thus, he believes it was possible for companies like Toyota and Honda, through their manufacturing skills, to pursue cost leadership and differentiation but only up to the point at which other competitors successfully emulated their production prowess. Once Honda and Toyota successfully exploited the cost advantages of lean production, any further reductions in the cost of the product had to be achieved by sacrificing the features which would damage the differentiation.

Porter's second main argument—that sustainable advantage comes from the way activities in a company interlink with one another rather than from a single set of skills - is also well made but certainly not new. The emphasis within the resource-based school on 'architecture'[12] is a good example of competitive advantage relying on linkages—what Porter calls 'fit'—which may be socially complex and difficult to disentangle from organisational legacies or history.

REFERENCES

1 **'Shifting the Strategic Management Paradigm'**
Camillus, John *European Management Journal* Vol 15, No 1, pp 1-7, 1997

2 See *Manager Updates* Vol 6, No 4, Summer 1995 and Vol 7, No 1, Autumn 1996, Braybrooke Press

3 **'A New Strategy Framework for Coping with Turbulence'**
Chakravarthy, Bala *Sloan Management Review* Winter 1997, pp 69–82

4 Chakravarthy, Bala *op cit* p 78

5 **'Increasing Returns and the New World of Business'**
Arthur, W P *Harvard Business Review* Vol 74, July-August 1996 (Quoted in Chakravarthy *op cit*)

6 **'Our Turbulent Times? The Case for Evolutionary Organisational Change'**
Duening, Tom *Business Horizons* Vol 40, No 1, Jan-Feb 1997, pp 2–8

7 Duening, *op cit* pp 3

8 **'What is Strategy'**
Porter, M E *Harvard Business Review* Nov-Dec 1996, pp 61–78

9 Porter, *op cit* p 74

10 Porter, *op cit* p 67

11 Porter, *op cit* p 69

12 ***Foundations of Corporate Success***
Kay, John (Oxford), 1993

ACCOUNTING AND FINANCE

Evolving Rules of the Game

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

'The acceptance of international accounting standards is gathering pace' was the introductory sentence by David Cairns, former Secretary-General of the International Accounting Standards, who goes on to argue, in a short review, that the different ways accounting standards can be applied can lead to confusion.[1,2] He cites illustrations of differences in interpretation by the US regulator and some based on his own surveys of the financial statements of Asian and European companies compiled under international standards. It is Cairn's contention that the uncertainty caused by different interpretations and the significantly different results which follow could undermine the push towards global harmonisation.

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 by early 1998 and is in the process of developing a procedure to issue interpretations of its standards. There are some possible alternative approaches for dealing with such interpretations. One would involve the establishment of a taskforce similar to those set up in the UK, Australia, Canada and the US. Included within the taskforce would be accounting firms and companies familiar with both national accounting requirements and the underlying transactions which gave rise to disputes. The potential problem with this approach is that such a body could be dominated by people from English speaking countries and cultures, at the same time excluding those with experience of interpreting standards in different countries. Alternatively, there is the approach used in the European Union where a group of experts from the member states deals with interpreting directives. By contrast, Cairns advocates a more flexible procedure involving the representatives of companies, audit firms, accountancy institutes, the standard-setting body and business groups in the country concerned.

There is, however, a real need to resolve this issue because the US Securities and Exchange Commission (SEC) has indicated that by the end of the decade it will allow the use of reformed International Accounting Standards (IAS) for full SEC recognition.[3] In view of this, acceptance of IAS is seen as being a vital step in persuading companies from jurisdictions whose accounting standards are far removed from US Generally Accepted Accounting Principles (GAAP), such as Switzerland and Germany, to list in New York. However, as indicated, the key issue to be resolved is who will interpret the reformed IAS. If there is not quick action then the SEC has implied that it is willing to do the job itself.

Raising funds in the United States

A major result of the acceptance of reformed IAS is that many companies will look to the US for funding. At present, foreign companies wishing to broaden their investor base look to the American Depositary Receipt (ADR) market. ADRs are instruments that effectively allow non-US corporates to sell equity to US investors, by virtue of corporate shares being held by a depositary bank which issues a receipt. Such receipts are marketed and sold by co-ordinating banks like The Bank of New York, Citibank, JP Morgan and Bankers Trust.

A company wishing to issue ADRs has traditionally had four choices: registration under level-1, level-2, or level-3, or under rule 144A:

- **Level-1** is the most popular form of ADR. It is a non-capital raising option for corporates that do not seek a full stock exchange listing. In common with SEC registered stock, level-1 receipts can be bought by any investor, but trading must be done via a registered broker or dealer using 'Pink Sheets'.
- **Level-2** is also for companies not wishing to issue new shares but involves listing on a stock exchange. The price paid for such a listing is that reporting requirements are significant, involving both SEC registration and US GAAP reporting.
- **Level-3** is for companies wishing to raise new shares and involves obtaining a full stock exchange listing on the New York Stock Exchange, Nasdaq or Amex. To do this it must comply with the Security Exchange Act of 1934, and make a full registration with the SEC. Part of the current demands of the SEC is that all companies subscribe to US Generally Accepted Accounting Principles (US GAAP). However, as indicated there are moves afoot to relax this to include reformed IAS.
- **Rule 144A** An alternative to a full listing is rule 144A (RADR) which does not require full SEC registration and therefore reduces disclosure requirements substantially. Three thousand qualified institutional buyers (QIBs) are allowed to trade RADR stock on Portal (private offerings, resales and trading through automated linkages). QIBs are institutions that manage at least $100 million in securities, or broker-dealers that trade more than $10 million in securities of non-affiliates.

During 1996, corporates from the emerging markets have been raising dollars under rule 144A.[4] For example, East European corporates, like the Croatian pharmaceutical company Pliva, have been prime candidates for rule 144A offerings. However, whilst Rule 144A makes issuing ADRs simple it is no guarantee of success. Companies using this rule have to fight for the attention of investors because there are some well known players in the market, like Adidas and Gucci.

Other companies have entered the level-1 ADR market with the objective of being able to build a core group of American investors with minimum regulation and reporting. In other words, the approach is seen as being a stepping stone to a full listing, as was the case for Astra, the Swedish pharmaceutical company, which entered the ADR market in 1994 with a level-1 programme.

However, there is a problem with the level-1 route because up to 80% are reckoned to be very thinly traded and it may well be the case that, with the progress in the accounting standards debate, more companies will be stimulated to abandon this and the 144A route in favour of a full stock exchange listing.

EVA® - Economic Value Added*

In previous Braybrooke Press*Updates*, I have reviewed various shareholder value approaches including Economic Value Added (EVA).[5] EVA is attracting considerable attention all over the world. For example, its use has been the subject of recent attention in Canada and Brazil.[6,7] The Canadian study provides a useful review of EVA, its use by Canadian corporations and an illustration of its adoption by one Canadian company - Husky Injection Molding Systems Ltd. The Brazilian article reviews the findings of a study of leading Brazilian corporations and illustrates how many apparently profitable companies have negative EVAs. To understand the implication of a negative EVA it is necessary to consider the fundamental underpinnings of the approach. A simple explanation of EVA has been provided by Tully.[8,9] With reference to two US companies Anheuser-Busch and Spiegel, Tully has demonstrated how EVA equals after tax operating profit minus the cost of capital. In the case of Anheuser-Busch this produced a positive EVA of $235m but for Spiegel the cost of capital exceeded the operating profit and produced a negative EVA—the same situation as for many Brazilian corporations. The implications are that companies generating positive EVA, like Anheuser-Busch, are creating economic value whilst those like Spiegel are destroying it.

How is EVA calculated? According to Stewart, EVA is 'computed by taking the spread between the rate of return on capital, r, and the cost of capital, c, and then multiplying by the economic book value of the capital committed to the business.'[10] At first sight, this approach appears to mix accounting based measures with economic measures but this is not so. It is not as simple as just taking numbers from a company's financial statements. Many adjustments are required to convert accounting profit to the economic measure of profit used in EVA. To give some indication of the potential complexity, there are up to 162 possible profit and loss account and balance sheet adjustments to be made. EVA is in fact a cash flow approach which can be shown to produce exactly the same results as other shareholder value analysis approaches.[11]

One argument against EVA is that the basis for calculating the measure annually using historical data means that it fails to look forward. This apparent limitation can be addressed using a related performance measure called 'market value added' (MVA). MVA 'is the difference between a company's fair market value, as reflected primarily in its stock price, and the economic book value of capital employed.'[12]

The MVA equation is:

$$\begin{aligned}\text{MVA} &= \text{Market Value} - \text{Capital}\\ &= \text{Number of Shares x (Price} - \text{Economic Book)}\end{aligned}$$

In theory, MVA is the market's assessment of the net present value of all past and projected capital investment projects of a company. If the market anticipates that a company will continue to earn profits

* EVA is a registered trademark of Stern Stewart & Co.

above its cost of capital, the company will have a positive MVA. If the market anticipates that profits will not exceed the cost of capital, the company's MVA is negative.

MVA and EVA are both closely related. EVA is an internal measure which leads to the market building a premium or discount to the market value of a company. It is possible for EVA and MVA to move in opposite directions. For example, organisations implementing aggressive expansion strategies or making costly acquisitions may simultaneously have a negative EVA and a positive MVA if the market anticipates that their earnings will soon exceed their capital costs.

The emphasis in EVA upon economic rather than accounting principles is important. Numerous studies have shown a far better correlation between shareholder returns and cash flow measures (particularly those reliant upon free cash flow) than accounting measures. Unlike accounting measures cash flow is not subject to the influence of accounting rules which vary both within countries and between them.

The link between value based measures like SVA and EVA has been explored more recently. For example, the relationship between EVA and market value has been endorsed by O'Byrne.[13] The findings of his recent research challenge the suggestion of other researchers that earnings, without regard to the amount of capital employed to generate those earnings, are sufficient to explain differences in investor returns. His research shows that changes in EVA explain more of the variation in ten-year stock returns than do changes in earnings, and dramatically more of the variation in five-year returns. Specifically, his research showed that the level of EVA explains more of the variation in market values than the level of earnings. For example, his study found that five-year changes in EVA explain 55 % of five-year changes in market value, whereas five-year earnings changes explain only 24%. When ten-year changes in EVA were compared to ten-year changes in earnings, EVA accounted for 74% of variation in market value as compared with 64% for earnings.

Such findings fly in the face of other studies which emphasise the importance of earnings.[14] So also do the results of recent research at the Henley Management College.[15] Using a sample of 98 firms listed on the London Stock Exchange over the period 1979 to 1992, strong evidence was found that cash flow variables have incremental information content beyond that contained in accrual earnings. Accrual earnings were also found to have information content beyond that contained in cash flows. Both accrual earnings and cash flows were found to be important determinants of stock returns for UK companies.

However, as with many things in finance the jury is still out. For example, Sloan's US research has indicated that stock prices react as if investors use earnings, but largely ignore the incremental information in free cash flow.[16] From such research Sloan draws the cautious conclusion that stock prices behave as if investors place too much emphasis on current earnings in generating forecasts of future free cash flow.[17]

The debate will doubtless continue. Approaches like EVA are gaining increasing prominence; however, we should not lose sight of the fact that it is not a new idea. 'Rather, [it is] further proof that great ideas never die. Alfred Sloan, the General Motors Corp patriarch, knew EVA - though not by name - in the 1920s; General Electric Co was flirting with return-on-capital systems in the 1950s. [In fact,] accountants have long known a closely related acronym—RI, or residual income.'[18]

REFERENCES

1 **'The need for an interpreter'**
Cairns, D, *Financial Times*, 19 September 19, 1996, p 13

2 See also ***A Guide to Applying International Accounting Standards***
Cairns, D, Accountancy Books, 1996

3 **'US Exchange Open For New Business'**
Adams, J *Corporate Finance*, July 1996, pp14–16

4 **'Choose the market to suit your company'**
Corporate Finance, July 1996, pp 16–20

5 *Manager Update* Vol 5, No 3, Spring 1994, pp 36-46, Braybrooke Press

6 **'Improving Shareholder Wealth'**
Management Accounting Issues, Paper 11, *Management Accounting Practices Handbook* The Society of Management Accountants of Canada, 1995

7 **'Sua Empressa Da Dinheiro?'**
Gomes, M T *Exame* Edition 613, 3 July 1996, pp 60–61

8 **'The Real Key to Creating Wealth'**
Tully, S *Fortune*, September 20, 1993, p 27

9 *Manager Update*, Vol 5, No 3, Spring 1994, p 39, Braybrooke Press

10 ***The Quest for Value: A Guide for Senior Managers***
Stewart, III, Bennett, G,Harper Collins, 1991

11 **'Strategic Value Analysis - Shareholder value and economic value added - what's the difference?'**
Mills, R W, Print, C F *Management Accounting* February 1995, pp 35–37

12 ***The Quest for Value: A Guide for Senior Managers***
Stewart, III, Bennett, G, Harper Collins, 1991, pp 3, 112–180, 741

13 'EVA **and Market Value'**
O'Byrne, S F *Bank of America Journal of Applied Corporate Finance* Spring 1996, pp 116–125

14 **'Aggregate Accounting Earnings Can Explain Most of Security Returns: The Case of Long Return Intervals'**
Easton, P, Harris, T, Ohlson, J *Journal of Accounting and Economics* Vol 15, 1992

15 ***An Empirical Examination of the Explanatory Power of Accrual Earnings Versus Cash Flows: UK Industrial Sector***
Madani, H H, Ph D thesis, Henley Management College/Brunel University, 1996

16 **'Do Stock Prices Reflect Information in Accruals and Cash Flows About Future Earnings?'**
Sloan, R *Accounting Review* 1996

17 **'Using Earnings and Free Cash Flow to Evaluate Corporate Performance'**
Sloan, R *Bank of America Journal of Applied Corporate Finance* Spring 1996, pp 70–78

18 **'All about EVA'**
McConville, D J *Industry Week* April 13–14, 1994, pp 1–3

Each member of the Faculty in the year of publication will receive one copy of every *Manager Update* published by the Faculty free of charge. Copies are not available to non-Faculty members.

Manager Updates published to date are:

Issue 1: April 1997

Any members who have not received the above should contact Chris Jackson at the Faculty using the contact details set out below.

Comments and suggestions should be addressed to Chris Jackson BA FCA, Secretary to the Faculty, telephone 0171-920 8486, e-mail CDJackson@icaew.co.uk, or write to the Faculty of Finance and Management, Institute of Chartered Accountants in England & Wales, PO Box 433, Chartered Accountants' Hall, Moorgate Place, London EC2P 2BJ. (The ICAEW web site is located at http://www.icaew.co.uk)

This issue of Manager Update *is produced by Doyle & Co, Colchester and printed by Spottiswoode Ballantyne, Colchester on behalf of the Faculty of Finance and Management of the Institute of Chartered Accountants in England and Wales.*

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES