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Spin-offs and spin-outs

Ian Turner, p 11

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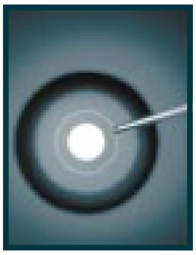
Brand communities, loyalty and relationships

How can a marketing department increase shareholder value ? One key marketing asset is brand equity. What is the role of the marketing mix in its creation ? Is brand management different on the Web ? Businesses need to learn how to build brand-based Web communities online, and new marketing skills will be required to do this. However, the payback in customer loyalty and brand loyalty can be considerable, even on the Web.



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> *Marketing has not had the impact in the boardroom that its importance justifies. The major reason is that marketers have failed to show how marketing activities and costs influence shareholder value.*[1]

Marketing, and its role in a company's success, have recently come under the microscope. Some writers give marketing professionals a bad press. Others say that they are essential to a company's success.

Doyle[1], for example, suggested that marketers should adopt a 'shareholder value' approach. In other words, they should explicitly detail how marketing can benefit the health of their organisation. This approach may well help to win over sceptics on the board. He went on to describe what he saw as the four main marketing 'assets' :

- Marketing knowledge is important in the competitive environment of customer intelligence and future market opportunities.
- Brands are assets that can be long-term cash cows, as they attract customers who will often pay price premiums.
- Customer loyalty is also a key asset. Doyle (quoting Reichheld[2]) emphasised the profitability of less-price-conscious and loyal customers who cost less to serve than they do to acquire in the first instance.
- Strategic relationships, collaborators and partners are also important.

These assets are difficult to build up in a short space of time, but add to the company's long-term competitive advantage. The shareholder value analysis is, then, on the marketer's side; she or he can show senior management that investment in these intangible and information-based marketing assets can positively affect the share price. By contrast, conventional accounting and an emphasis on more tangible assets can sometimes lead to a focus on short-term gain.

This article considers three of the assets :

- brand equity and the role of the marketing mix;
- the implications of branding and relationships in online communities;
- brand loyalty, with particular emphasis on the Web.

Brand equity

Brand equity, 'the incremental utility or value added to a product by its brand name'[3], is prominently discussed in the marketing literature, and is a great company asset.

Yoo, Donthu and Lee have argued that much work has been done on understanding value, but surprisingly little has been carried out on the role of the marketing mix in creating brand equity. For example, in the consumer electrical goods market, they explored the links between the marketing efforts,

- pricing;
- distribution;
- advertising spend;

and their impact on the dimensions of brand equity,

- brand quality;
- loyalty :
- awareness;

and, ultimately, the effect on the value of brand equity.

Their findings, which used the marketing mix approach, supported what we marketers thought we already knew. Namely, factors such as price and perceptions of quality are inextricably linked. Thus, when a brand is being built, constant or increased prices are the marketers' best ally. Price reduction strategies might create customer uncertainty, because 'cheaper must mean lower quality – right ?'.

When studying store image and distribution intensity, the authors found that, as with price, an outlet's image is closely tied to perceptions of quality. For some luxury goods, a selective approach is better for developing brand equity. Surprisingly, however, for others, intensive distribution increases both brand equity and customer satisfaction.

Advertising is often key in all this. Intensive distribution needs the support of advertising that focuses on developing brand equity. Brands that are heavily advertised also influence the consumer's beliefs, attitudes and loyalty towards the product; 'one of the major reasons for a decrease in consumer loyalty is the decrease in advertising'.

Branding and online communities

The role of the brand manager is changing, from managing brand

- identity;
- personality;
- values;
- attributes;

to managing the brand community on the Web.

A previous article in this series[4] looked at online communities as customers and the implications for marketing strategies. McWilliam[5] has focused on building brand-based Web communities, the 'living manifestation of the brand's personality and relationship with customers'.

In the past, maintaining a direct relationship with consumers, especially those a thousand miles away, was not always easy. Today, the Internet has revolutionised communications, allowing an organisation to

- tailor its messages to specific customers;
- reward individuals for loyalty;
- recognise 'the passage of time and the strengthening of the relationship'.

Online communities are also sources of 'free' information direct from the customer, and 'real time' rather than historical data, on the basis of which a company can make decisions.

McWilliam wrote that building relationships with consumers and brand-based communities is dependent upon various factors :

- 'High involvement' products and services, such as photography, DIY, cars and music, may well attract members to a community. 'Low involvement' products, that is, routine purchases, such as washing-up liquid, probably will not.
- It should be possible to segment communities and focus on topics of specific interest to community members.

A key management concern in relation to communities is the control of external communications. Decisions about this will depend on the current personality of the brand and where it is going[6]. If the brand is seen as 'rebellious', for example, the community approach may be pretty unrestricted. For a more conventional brand, there may be tighter control on dialogue.

In fact, a struggle for control of a community is a possibility. The customer may seek to control the relationship. On the other hand, from the organisation's point of view, there needs to be a balance between unfettered freedom of expression and the real value that it will gain from open communication with customers. Those developing brand communities need to ask themselves some searching questions. Can the organisation tolerate negative comments or unfavourable comparisons ? How will it manage feedback abuse and avoid possible hate sites ?

Managing brand communities often demands new skills of marketing managers. The following are examples :

- *Community leadership* : This is a facilitating role that consists of managing the experience and maintaining the community, in other words, acquiring the 'right' members and retaining them.

- *Editorial design and development* : Brand managers will need to manage the experience, and ensure that content and design are sufficiently stimulating and fresh to maintain the interest of members.

McWilliam suggested that communities need

- libraries;
- online reference material;
- a history;
- archives;
- events to maintain the members' interest.

Volunteers are important contributors and 'hosts' in a brand community. They

- keep the community close to its roots;
- encourage key members to participate;
- edit;
- act as discussion moderators.

Brand managers must manage a mix of paid employees and volunteers with differing objectives. This type of model can be found in the non profit sector.

McWilliam believes that online communities are a new marketing tool for managing brands by building on relationships and the social aptitude of customers. Ultimately, this could be more important than conventional brand management and extension strategies.

Brand loyalty on the Web

According to Reichheld and Schefter[7], Web marketing has until now been focused on acquiring and replacing customers who do not think twice about defecting to other brands. Loyalty 'is on the fast track towards extinction'.

Conventional customer acquisition already requires a considerable amount of resources, for example to generate leads with a view to converting them into satisfied customers. This process costs even more on the Web, and until e-businesses build relationships and loyalty, they will not make a profit.

Loyal customers, whether traditional or online, are like 'gold dust'. They spend more, and will pay premiums. They do not cost organisations much, and spread a positive image of the brand by word of mouth. In fact, far from being a waste of money, investing in Web customers is worthwhile, as they can be loyal to the brand.

Reichheld and Sasser's[8] work has shown that a 5% increase in customer retention can increase profits by a startling 25–95%. Applying their methods on loyalty, retention and defections to four e-commerce sectors, they found that customers do not, in fact, switch 'at the click of the mouse'. Visiting and purchasing from e-businesses, like conventional shopping, becomes part of a customer's routine. Those customers with stable purchase patterns in conventional channels actually increase their spend when they move online. The broadcast nature of email favours referrals and positive word of mouth communication.

Reichheld and Schefter highlighted a number of factors for e-businesses to consider when using loyalty to build profits :

- *Trust* : Because of the distance, uncertainty, intangible nature, and perceived risk of exchanges on the Internet, trust is paramount. In fact, it is the most important factor for customers, in the business-to-business and the e-tailing sectors. Thus businesses that keep their promises will ultimately build up good and profitable relationships with their customers.
- *Target* : Online businesses are advised to target their audience and avoid looking at the mass market of online customers. In other words, they should segment the market and focus on loyalty-oriented customers, and maintain a relationship until it becomes profitable. That said, it takes two years to defray the costs of acquiring a customer, and most defect within three years.
- *Loyalty* : The Internet is a source of real-time information about customer behaviour, and, more importantly, it can record their actions. The organisation can then see who the loyal visitors are, tailor its products to them, and build up a profitable relationship with them.
- *The big picture* : Companies are also advised to resist spinning off their Internet businesses. Customers do not distinguish between purchases, and view the different transaction opportunities as part of the whole experience. 'Integration strengthens loyalty.'

Balance and perspective

McWilliam has suggested that communities can replace relationships on the Web, and Reichheld and Schefter have told us that loyalty is essential for survival.

Lapointe[9], though, has reminded us that there is life away from e-business, and in fact many customers are still looking for conventional 'real' relationships. Customers still want to know their suppliers. His view is not Luddite; it simply stresses the need for balance between the virtual and the real, and high-tech and 'high-touch' approaches.

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Rewards, retention and performance

Organisations must have an effective strategy to attract, retain and motivate people, their greatest asset. The battle for talent has begun, and is likely to intensify. Organisations need people who can embrace sophisticated working methods, including advanced IT systems, and continuously develop new skills. In the new economy in particular, high flyers are turning their backs on the prestigious old economy employers. Retention and reward strategies need to be revised.

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The battle for talent

Organisations can no longer just state that people are their greatest asset; they must have an effective strategy for attracting, retaining and motivating them. The battle for talent has begun, and it is likely to intensify[1].

A competitive global economy is reducing unemployment. Organisations urgently need people who can embrace sophisticated working methods, including advanced IT systems, and continuously develop new skills. As a consequence, employee power is growing, especially in the new economy, where 'hot' talent can command very high levels of reward.

The career aspirations of these high flyers may be changing, though. Increasingly, they are turning their backs on the large and prestigious 'old economy' organisations, preferring the excitement and 'upside' of a new dot.com.

Only 39% of Harvard's MBA class of 1999 went into investment banks or consultancies, and many did not even bother to complete their studies[1]. Even successful 'new economy' companies such as Microsoft have seen people desert to the new start-ups.

The war for talent is now so intense that some organisations even refuse to put the names of key employees on their websites[1], which is a clear indication that the Internet enables employees to market themselves and, more dangerously, provides competitors with a hotline to potential new recruits. However, such trends are only relevant in Silicon Valley, according to reference 1.

This is not the case, alas. Loss of key personnel is an issue for organisations everywhere, and it is costly. To the financial implications of a departure are added the negative impact on the social and intellectual capital of the organisation. Consequently, companies need a sound retention strategy.

Key to this is an effective reward system, and yet this is no easy thing to manage or implement. Change in organisations and the business environment often accelerates at a faster pace than the rate of change in an organisation's design and management of its pay systems (see reference 2, pp 7–12).

As work today is increasingly knowledge-based, there is a need to reward those who contribute to the organisation's intellectual assets.

A reward system that both helps to create a learning organisation and allows a company to develop and retain valuable human capital is imperative.

Improving retention

A recent IDS study showed that the average staff turnover rate in the UK is currently 20% per annum, although there is considerable variation between industries and sectors. Turnover is higher in smaller establishments, and it is up to around 50% in the wholesale and retail trades.

The financial costs of this turnover can be up to 150% of salary for key staff. Add in the non-financial costs, including loss of key skills, disruption, and the impact upon staff morale, and the overall cost of a departure to an organisation can be considerable.

Because of these costs, companies should carry out external benchmarking and gather information on internal factors affecting staff turnover, by, for example, monitoring wastage rates and carrying out exit interviews and attitude surveys.

The following measures may help to improve staff retention :

- Pay competitive rates, and consider other types of compensation such as retention bonuses and share option schemes.
- Put together an attractive employee benefits package.
- Recruit the right people in the first place.
- Pay more attention to induction processes, especially in the critical first few weeks.
- Provide career paths, more interesting work, and support for personal development.
- Offer more flexible work options and implement family-friendly policies as work/life balance issues come to the fore.
- Provide good line management.
- Evaluate the effectiveness of the measures taken.

Not all employee turnover is a bad thing, however. An acceptable level that is dependent on the organisation and the labour market allows the entry of new blood and new ideas, and creates new opportunities for careers, staff development, and restructuring.

Squabbling over pay is generally not the main reason behind someone leaving an organisation; money becomes an issue only when there are other sources of dissatisfaction. Salaries must, however, be seen as fair and competitive. Pay and retention strategies also need to be integral with other human resources activities.

In one example, One2One found that a new performance measurement system in one of its call centres that was based on a balanced performance scorecard, a competitive salary and benefits package, and a commitment to skills development contributed to a turnover rate that was significantly lower than that in many other call centres[3].

Organisations in leading edge areas may need to use more innovative tactics to hold on to key staff, especially to stop defections to competitors or new start-ups. The establishment of dot.com subsidiaries and the provision of in-house venture funds and incubator finance schemes[1] are examples of such strategies.

What are rewards : going beyond pay and benefits ?

Organisations obviously do not successfully attract and retain people just by offering the right pay and benefits. However, increasing competition for talented employees will result in the growing importance of other forms of reward.

Weiler and Tuffli[4] believe that a holistic approach is needed that focuses not only on pay, but also on

- benefits;
- learning and development opportunities;
- the work environment.

They suggested that many companies have not yet adopted an integrated approach to rewards design. Furthermore, many employees believe that their needs are not being met in key areas, namely in terms of having

- satisfying and challenging work;
- training and development opportunities;
- a competitive base salary.

Weiler and Tuffli concluded that a well designed package should

- reflect the employees’ priorities;
- reinforce business strategy;
- promote desired behaviours;
- avoid mixed signals.

The pay and benefits provide a baseline for comparison on their own, but the main attraction is the rest of the package.

It should include learning and development opportunities, which can be a powerful tool in attracting employees and building the relationship between the individual and the organisation.

The work environment, another of the factors, is the most difficult to define, but it ‘may be the only reward category that can truly differentiate often at minimal cost – and help achieve employer-of-choice objectives’. In fact, those companies known as ‘models of employee excellence’ are typically associated with a distinctive culture and work environment. A key aspect of this successful work environment is effective communication, particularly between the management and workforce.

Reward may very well be more than just pay and benefits, but the knowledge economy is also forcing changes in compensation methods. Reward will increasingly be based on skills and knowledge, and it will be innovative.

Some companies, 'looking to encourage knowledge sharing and bolster employee productivity, are assigning specific dollar values to intellectual contributions'[5].

One example is the IBM Global Services scheme. An employee who creates a knowledge document that is used by another worker to win new business is eligible to split a $5000 reward. Such schemes require the following :

- sophisticated systems for knowledge capture and management;
- metrics;
- a procedure for review.

However, they are on the rise.

Organisations are also beefing up more traditional forms of compensation to attract the talent that they want. Thus for key people, companies offer

- stock options, the 'laser-guided Cruise missile' of rewards;
- long-term loyalty bonuses;
- more attractive pensions.

However, the costs of such rewards need to be assessed carefully. Old economy companies cannot offer the almost unlimited upside of the dot.coms, and the rewards may still be a drain on corporate profits, as not all labour cost measures are charged to employment costs[1].

Designing performance management and reward systems

Certain key principles underpin an effective reward and performance management system.

Hendry *et al.*[6], however, identified two key issues which can undermine the design of rewards and incentives and the effectiveness of appraisal and competency systems :

- The first is an obsession with control, which is based on a mentality that sees people as 'human resources' rather than 'resourceful humans'.
- The second is the maintenance of the link between individual behaviour and organisational performance. The effective linking of rewards to a performance management system requires a clear 'line of sight' between individual behaviour and corporate performance. It also requires a view of corporate performance which looks at ends as well as means, and which is not limited to accounting measures. For many line managers, though, performance management is synonymous with the appraisal process. In other words, it is time-consuming, bureaucratic, paper-driven and top-down, with little relevance to organisational performance and goals.

Accordingly, Hendry *et al.* proposed a number of principles as a guide to approaching rewards that support organisational performance :

1. Performance management is about improving performance.
2. The focus should be on a few key measures that make a difference.
3. Performance management should be a goal-driven process. The clarification and communication of objectives, rather than measurement, are key.
4. It may not be necessary to attach specific rewards to the achievement of objectives.
5. Performance management is about people and motivation. The system can get in the way.
6. Performance management is a management process, and the key is the relationship between the manager and his or her people. Performance management systems are often an elaborate means of destroying that relationship.

New strategies for pay

New principles and more strategic direction in the development of pay systems are necessary.

Lawler[2] believes that a misaligned pay strategy

- fails to add value;
- generates high costs;

- leads to inappropriate and misdirected behaviour.

He identified three key trends relating to individuals in organisations :

- Increasingly, people have roles and general areas of responsibility that they perform flexibly, rather than stable activities that could be described as 'jobs'.
- Individuals do not have a traditional loyalty contract with their organisation. Instead, they have a temporary relationship, and attempt to maximise their rewards while adding to their skills and capabilities.
- More diversity in the workforce means that there are wide differences in what individual employees want from their work, and how people want to be treated by reward systems.

Thus, he stated, no single pay system or set of practices can provide the answer. However, organisations need to take three major strategic positions for effective pay practices in the future :

1. Person-based pay should be used to reward individuals for their skills, knowledge and competencies relative to their external market value.
2. Multiple pay for performance approaches should be used, with variable pay and stock as rewards.
3. Reward systems should be tailored to the individuals who an organisation wishes to attract and retain. The 'one size fits all' approach is not suitable for a diverse workforce. Individuals should have a considerable amount of choice in terms of the reward packages they are offered.

Person-based pay represents a move away from job-evaluation technology. A key challenge for organisations is to develop good measurements of knowledge, skills and competencies. Lawler envisaged detailed intranet-based descriptions of the skills and knowledge that individuals will need to be effective in their roles. Skills and knowledge profiles of employees will also be similarly available for

- market pricing;
- the assignment of work;
- the development of individuals.

However, to reiterate, no single plan can fit all organisations. Also, pay for performance is not always a realistic objective, although it should be an important part of most organisations' reward systems. It needs to reflect the organisation's

- strategy;
- structure;
- business processes;
- management style.

An effective pay for performance system is likely to include multiple pay for performance plans that propose a variety of awards in line with the organisation's objectives. Variable pay plans should also be used to reward performance, rather than merit pay permanently incorporated into base pay regardless of future performance. Organisations also need to decide whether to reward individuals, groups, business units or the organisation as a whole. In fact, all types of reward may have a place in their methods.

An individual performance pay system requires that the employee's attainment be measured, which is not always easy, especially in a role-based organisation. Indeed, individual performance related pay schemes are likely to fall into disuse as they do not fit well into lateral, team-based organisations. By contrast, broadly based pay plans are likely to become more popular, as will

- team-based pay;
- profit sharing;
- bonuses based on business unit and operating unit performance.

Recognising the three strategic positions is the first step towards creating a strategic reward system. The next step is to develop actual pay practices that adhere to them and fit with the management style, structure and strategy of the organisation.

Pay and performance

Two recent surveys strongly suggested that a strategic approach should be taken to rewards and organisational performance.

Towers Perrin[7] found that companies in the top quartile in terms of total shareholder return over a three year period adopted a number of common pay practices :

- They gave high-performing people a disproportionately large share of the merit budget.
- They used performance ratings to determine the level of variable award and stock option participation.
- They used a broader range of rewards.

Watson Wyatt Worldwide[8] found that, of 30 key people practices linked to increases of up to 30% in shareholder value, the second most significant was the presence of clear rewards and accountability. Companies that

- paid compensation above market rates;
- linked pay to business strategy;
- used employee performance to set pay;
- linked profit-sharing plans to company performance;

were able to increase their market value.

In a sense, these two surveys confirmed what is already known. The challenge for organisations now is to design reward systems that will meet the changing needs of their increasingly diverse workforces. They should also use the reward strategy to encourage the new values and behaviours required in the knowledge economy. What has not changed, though, is the need to have a clear 'line of sight' between the performance and the reward.

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Spin-offs and spin-outs

With the growth in e-business, the fashion for hiving off parts of an organisation and making them more directly accountable to financial markets has grown. Some parts of a business, when granted autonomy and managed by a dedicated management team, should ultimately generate more shareholder value. This is the logic, but what does the evidence indicate ? Similarly, the fashion for cross-border mergers suggests that the winning companies will be those that consolidate and increase their scale in key markets, including e-business markets. What does the evidence reveal ?

With the growth in e-business, the fashion for hiving off parts of an organisation and making them more directly accountable to financial markets has received a boost. Some parts of a business, when granted autonomy and managed by a dedicated management team, should ultimately generate more shareholder value. This is the logic, at least.

Happily, the research evidence suggests this is often the case, at least in the case of spin-offs, where a company sells its entire stake in a subsidiary to the public.

It also holds true for equity carve-outs, where a portion of the equity is sold on the open market, with the parent company retaining a majority stake, albeit via a separate system of corporate accountability.

The evidence is a little less clear, though, when it comes to ‘tracking stocks’. This is where a separate class of stock is created to reflect the financial performance of the subsidiary company, but no separate corporate governance structure is instituted (see reference 1, pp 98–105).

In their recent article[1], Anslinger, Bonini and Patsalos-Fox argued that many companies actually now restructure before market pressures require them to. This may be because of

- failure to attract talented individuals to a part of the business which is regarded as peripheral to the core business;
- a lack of congruence between the parent’s business model and the subsidiary’s business model;
- greater discipline in making capital investment decisions;
- a reluctance to invest in part of the business which is regarded as non-core (especially when it is clear that, to survive and grow, the business requires a major investment, for example during a consolidation phase of an industry).

However, spin-offs can create interesting organisational dilemmas. In previous articles in this series, we discussed the problem of incumbent companies seeking to develop new businesses. Often, these spin-offs will operate as a unit separate from the core business, and so they are not stifled by the culture of the established business. Spin-offs can also have a demotivating effect though. Those at the new entity may well receive attractive performance incentives such as equity stakes or options. This can be demotivating for those who remain at the core business without such perks.

In addition, there are strategic issues that must be considered before a business is spun off. Crucially, there needs to be a clear decision on the appropriate market focus for each of the businesses, so that they do not end up bidding against each other.

Other strategic issues are raised, for example, when there is a value chain relationship between the parent company and the former subsidiary. This can be critical to the spin-off’s success. For example, General Motors span off EDS at a time when it was contributing more than one-third of General Motors’ revenue.

Anslinger, Bonini and Patsalos-Fox warned of the dangers of separation when the business is too closely entangled with the parent :

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> *If the level of interaction is high because technologies, services and brands are shared, these agreements can become so complicated there may be little value in separating. Indeed extra costs can outweigh the carve-outs benefits which in any event accrue mostly to the subsidiary.*
> (reference 1, p 103)

Ironically, the parent company will often give with one hand and take back with the other. It may decide to give the subsidiary business greater autonomy only to maintain control by nominating its senior executives to the board.

Although this is understandable, this can hinder the development of the subsidiary. For example, the parent company may insist on maintaining a majority stake in the business when what the subsidiary actually urgently requires is greater liquidity to fund acquisitions.

Spin-offs and the Internet

Rick Chavez and colleagues from Viant, an e-commerce strategy consultancy, have analysed the phenomenon of Internet spin-offs[2].

Before the Internet bubble burst in March 2000, many companies, especially in the USA, had either spun off their Internet businesses or were thinking about it. Some, such as the book retailer Barnes & Noble, were able to raise enough funds from the IPO to soak up the cumulative losses made since setting up their dot.com alter egos. However, if Chavez, Leiter and Kiely are right, many of these companies may well regret their decision further down the line.

> *What if the new business's ability to leverage the operations and assets of its parent company is critical for success ? What if creating a different group of shareholders and performance metrics for the spin-off hampers the parent from pursuing a 'clicks and bricks' strategy later on ? And what if spinning off a digital business means forfeiting an opportunity to 'infect' the parent company's culture with the values and energy needed to compete in the new economy ?* (reference 2, pp 19–31)

Incumbent companies have, explained Chavez, Leiter and Kiely, a whole range of solutions open to them for developing e-business. These include total integration, through separate subsidiaries, to various kinds of spin-off. The solution adopted depends on what the authors call the '3Cs' of e-commerce structuring :

- *Control* : The parents must exercise control to co-ordinate and integrate the businesses and to leverage assets between online and offline businesses.
- *Currency* : Currency is the funding that is needed to promote the growth of the online business.
- *Culture* : This is giving the e-business the autonomy to respond flexibly to the marketplace.

The currency criterion was compelling, at least until March 2000. E-commerce start-ups were able to secure stock market funding on the sort of terms that established businesses could not even dream of. Now, though, dot.com start-ups are having more difficulty in persuading backers to finance their ventures.

The logic of control for e-business spin-offs is also likely to be different from that for traditional non-core activity spin-offs. In many instances, Internet-based businesses could end up competing directly with the parent, or, even worse, usurping it.

Just how much control the parent decides to exercise over the e-business depends on three elements :

1. the strategies which the businesses adopt on markets, pricing and segmentation;
2. the businesses' operations, that is, how much of the business activities are shared;
3. the assets, such as brands, intellectual property and customer information, which are held in common.

Control is likely to be most in demand when the e-business is, in effect, cannibalising the company's core customer base. This has been the case, for example, with online share dealers, where not only is the e-business dependent upon the parent's assets, but there is also a requirement for very close co-ordination of pricing and marketing strategy between the Web and the offline businesses.

Conversely, when both the product and customer base are entirely new, the needs of currency and culture will often outweigh a requirement for greater control. Examples of this are Digital Equipment's spin-off of Alta Vista, the search engine, and Dixon's spin-off of the Internet service provider Freeserve.

Starting up in high gear

Of course, not everybody believes that large companies can nurture new talent through to successful businesses.

Vinod Khosla, for example, the brain behind well known businesses such as Sun Microsystems, Excite and Amazon.com, thinks that many large companies are at a structural disadvantage in this respect[3].

He argued that most in-house incubators run by existing companies are merely a form of outdoor relief for frustrated executives ! These may help retain key employees, but they are unlikely to spawn successful companies. In fact, most large companies do not really have the necessary skills or experience to build a small company into something really big, he said.

Once the first rush of enthusiasm for the Internet has subsided, and the early start-ups have collapsed, the ultimate victors in cyberspace will be those with an established brand and an existing customer base. This has been the recent argument of many experts. Khosla, though, is unimpressed by this view. For him, a major flaw of most large businesses is that they still see technology as a dependent variable rather than as a driver of business strategy.

In fact, technology, and the use of the Internet and digital technology in particular, should be a central plank in any company's competitive strategy. It is the chief information officer, rather than the marketing executive or the finance director, who should be second in command to the CEO.

In addition, most large companies are pretty risk averse, and do not have executives with the experience or courage to rely on instinct rather than formal planning processes to make critical business decisions.

The dubious logic of global mega-mergers

Barely a day goes by without a new cross-border merger in the telecommunications, financial services, pharmaceutical or automobile industries being announced in the business press. The logic of these mergers or acquisitions is, apparently, that, as barriers to trade come down and markets become truly global, the long-term winners will be those companies that are able to secure a commanding position as the market consolidates around fewer larger players.

This is not quite the case, stated Ghemawat and Ghadar, who believe that the logic underpinning these transactions may be flawed[4]. After examining statistical evidence from more than 20 different industries, they claimed that concentration on a worldwide basis has actually been declining.

However, although Ghemawat and Ghadar's thesis has much merit as a caveat to some of the more mindless acquisitions of recent years, it is based on statistical sleight of hand. It is true that, following market integration, there is often a shake-out and a reduction in the number of competitors. Nevertheless, the net effect may still be that more product offerings are available to consumers in the combined market after integration than were available in the separate markets before.

The statistical evidence does not always seem to tally with the real experience of industries over recent years. According to Ghemawat and Ghadar's statistics, the period 1955–80 was a period of continual deconcentration in the automobile industry. In fact, in most countries at this time, large players successfully absorbed or drove out smaller players.

For example, Chrysler in the USA, British Leyland in the UK and Fiat in Italy all raised levels of concentration in their respective markets. This is probably not reflected in the statistical analysis used by Ghemawat and Ghadar, owing to the rise of the Japanese automotive manufacturers during this period.

The automotive industry has not been the only one to experience increased concentration. The aerospace, news and media industries, and the food and drinks sectors, have all seen consolidation.

There seems to be a very real economic imperative that is driving companies to merge or acquire in order to achieve global scale. This is not just herd behaviour, empire building, or the desire to exploit a company's high share price while the going is good (although it is impossible to deny that these motives do play their part !).

The case for global mega-mergers, or perhaps more properly the case for global acquisitions, would be easier to make if their success rate were higher. Ghemawat and Ghadar's evidence suggested that mergers and acquisitions, and in particular cross-border ones, have a depressingly low success rate. They frequently fail to achieve their ambitious objectives, and in some cases they can end with a well publicised and costly divorce, as, for example, with BMW and Rover.

Avoid the rush to global acquisitions, said Ghemawat and Ghadar, even when global consolidation is demonstrated beyond doubt. Instead, explore other generic strategies, such as the following :

- Pick up the scraps in the form of spin-offs and divestments following the mega-merger of other competitors.
- Concentrate on the home market.
- Keep your eye on the ball (devoting managerial time and effort to improving the existing business rather than post-merger integration).
- Make friends using alliances rather than acquisitions as a chosen route to scale.
- Appeal to the referee, for example by enlisting the support of regulators and competition authorities in situations where a mega-merger can be shown to reduce levels of competition.
- Adopt fast follower strategies, that is, wait for others to take the first step before following in their wake and learning from their mistakes.
- Sell out where it makes more sense to be acquired rather than to acquire another company.

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Developments in cost and management accounting

As banks have come under increased competitive pressure, both internationally and from new types of financial service organisation, they have had to resort to cost management techniques that are more common in other sectors. One of these is lean manufacturing, which is used widely in the automotive industry. Banks are also using segmentation analysis to improve branch profitability. There is more general debate about whether activity-based costing or absorption costing is more appropriate.

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Some authors seem to think that banks and financial institutions have escaped the revolution in cost management. Many banks have used new cost and management accounting methods, for example activity-based costing[1] (ABC), and concentrated on cost cutting, often through mergers and acquisitions. However, such methods may have blinded them to other cost management approaches.

The improvement of performance through revenue generating initiatives is also clearly now a focus for many. Branch profitability analysis is one important approach that can be used when analysing key sources of revenue generation (see reference 2, pp 22–31).

In addition, although banks and financial institutions have used new methods such as ABC, there is not total agreement on ABC's popularity or, indeed, on its impact. The continued importance of absorption costing is also an issue.

Cost management in banks and financial institutions

Goland, Hall and Clifford believe that cost cutting initiatives simply produce a 'quick fix effect'[3].

Admittedly, there may be a surge of activity, a quick improvement in earnings, and a rising stock price. However, things then pretty quickly return to normal, with productivity stagnating until the next wave of cost cuts.

In fact, the authors stated, bankers need only look at the manufacturing sector, where rates of improvement are often far higher, for examples of how to squeeze out better productivity levels.

They believe that the main reason for the higher productivity levels in the automobile industry, for example, is the lean manufacturing system of operational management developed by Japanese car maker Toyota.

Lean manufacturing, according to its supporters, is about simultaneous improvement in quality and service, that is, a continuous pursuit leading to reduced costs.

Goland, Hall and Clifford noted four defining characteristics of the system :

- waste awareness;
- continuous quality assurance;
- just-in-time;
- level production.

Objectives of lean manufacturing are to remove waste from the following :

- over-production;
- unnecessary motion;
- repairs;
- over-processing;
- waiting;
- excess inventory;
- non-essential transportation.

Continuous quality assurance means checking and intervening in the manufacturing process as an ongoing task.

Just-in-time entails supplying each process with exactly the right quantity of what it needs when it needs it.

Level production involves minimising the peaks and troughs in production volume to ensure optimum capacity utilisation and the fastest possible throughput.

Lean manufacturing can be just as useful in the financial services industry as in the automotive industry, and Goland, Hall and Clifford illustrated this with reference to the processing of cheques and loans. In fact, they stated, cheque processing is not too dissimilar from an assembly line, as both consist of a physical process.

One North American financial institution, they noted, gained considerably from adopting the lean manufacturing method, at very little cost. By applying just-in-time principles, the bank was able to spread the flow of unprocessed cheques evenly throughout the day. Previously, it had often faced a backlog of unprocessed cheques at 5.30 p.m..

The authors also showed that lean manufacturing highlighted and freed up 'phantom time', that is, time previously taken up by waiting or reduced maintenance and rework. In fact, capacity at the organisation more than doubled, without there even being a need to invest in new equipment.

The residential mortgage underwriting business, call centres in retail banks, and other financial institutions could, they stated, make similar improvements in productivity, service, costs and quality.

Indeed, the approach that has transformed manufacturing across the globe could well offer similar advantages to the banking industry.

Segmenting bank branches for profitability analysis

Technological advances, such as the development of the Internet, have put the banking industry under severe pressure. It is also likely that these developments will continue to have a big impact on the structure and delivery of financial services, although some degree of face-to-face human contact, at least for the foreseeable future, will probably be essential.

Shih and Tavakol argued that, despite these technological developments, branch profitability analysis will be as important as ever[2]. For them, segmentation analysis can help in branch banking, making sure that decisions on the allocation of resources are based on well informed analysis.

This analysis can be used to show, quite simply, that different branches serve different markets and market segments, and probably also have different economics. A bank needs to segment its branches into categories reflecting fundamental economic differences to measure a given branch's performance effectively.

Shih and Tavakol identified three important steps in identifying similar branches using segmentation analysis :

1. Identify the factors that will be used to classify segments.
2. Confirm the validity of the data used to classify branches.
3. Develop a systematic way of determining whether differences in values for any given factor are material.

The first step is to define accurate and effective key segmentation indicators. These indicators must characterise the businesses and markets that the branch actually serves.

Note, though, that expectations or assumptions based on proxy measures, such as market areas, can be deceptive. For example, a branch might be serving a particular segment that is not really representative of the market area.

In fact, it should be possible to obtain key segmentation indicators from the balance sheet and transaction data for each branch. The advantage of this is that such data should be objectively testable.

Shih and Tavakol stressed that data must be consistent and replicated over time before valid conclusions can be drawn from it.

There may also be a place for the personal judgement of operating managers in the process, even though this may be highly subjective. An iterative process between objective analysis and managerial feedback has the advantage of helping to build trust and credibility in the numbers for the people most affected by them.

Profitability, however, should not be used as a segmentation indicator. Ultimately, the goal is to explain profitability, and thus it cannot be used as an assumption.

The second part of the segmentation process entails validating and reclassifying branch data on the basis of preliminary results. Records maintained by a branch might not accurately reflect its customers' true situations, and their use would lead to false conclusions. Some customers, for example, might be registered as customers of the branch where they opened their account while actually using a branch on the other side of the country.

The third step is to develop a systematic way of determining whether differences in values for any given factor are material.

Cluster analysis is the most relevant statistical approach for this, and it has been used extensively in retail industries. For example, food retailers use this technique to decide which range of products to tempt customers (and their children) with at supermarket checkout tills.

For bank branch analysis, though, cluster analysis means studying the key segmentation indicators at each branch. The analysis should then show whether the differences are great enough to allow branches to be classified into various segments.

The authors noted that this is no quick or routine task, and success depends strongly on data being accurate. This is an opportunity to consult line management and see if the cluster analysis results broadly agree with their own observations and thoughts.

The ultimate objective is to develop branch profitability indicators sufficiently to reveal the drivers of branch performance. Usually, this is achieved most quickly by identifying the top and bottom performers in each segment. Comparisons between these two can show what characteristics separate the high performers from the underachievers.

The authors proposed ranking branches in each cluster into four or five groups, according to standard profitability measures. Three of these are

- net income;
- Economic Value Added (EVA, a Stern Stewart registered trademark);
- return on equity.

The economic value approach has the advantage of making an adjustment for capital requirements and risk.

Shih and Tavakol cited one institution that used to regard a branch located in every wealthy enclave as its flagship branch because it earned the largest gross operating profits. If the capital requirements of the branch were factored in, though, its ranking fell from first to break-even.

In summary, the authors suggested six steps for effective branch profitability analysis :

1. Define the key segmentation indicators.
2. Validate and reclassify branch data.
3. Group branches statistically on the basis of key segmentation indicators.
4. Develop branch profitability indicators.
5. Identify differences between the best and worse performers in each branch segment.
6. Uncover key performance drivers by branch segment.

The segmentation approach will become more important, the authors stated, as branch banks evolve in both form and function.

They also predicted the growing importance of other distribution channels, advances in customer convenience, and big reductions in transaction costs. They felt, however, that no other channel will ever completely replace the central marketing role of the branch office.

For most companies, gathering detailed customer information is an arduous task that is time-consuming and costly.

This is not the case for banks, which are able routinely (and relatively simply) to gather a wealth of information about their customers. The banks are thus able to use this information effectively, for example in cluster analysis, and they should be able to develop even more powerful predictive models to translate the data into new strategies for enhancing profitability and shareholder value.

They should also be able to realise good returns on the investment in branch profitability analysis.

Why the continued use of absorption costing ?

Curiously, absorption costing remains an important management accounting method, despite its disadvantages. In fact, the 'mainstream' of management accounting, exemplified by leading textbooks, exam syllabuses and a vast amount of empirical research, struggles to explain why it is still being used at all.

Lucas has written about several contributing reasons[4].

First, management has become 'fixated' on the cost systems developed for inventory valuation for financial reporting purposes. The problem, however, is that it is well over a decade since Kaplan and Johnson's ideas were disseminated and the comparative advantages of ABC made known to the world.

Sociological reasons might also explain the continued use of absorption costing. Lucas quoted Laughlin and Lowe, who argued that the functionalist, technical perspective adopted by some accounting researchers could be a factor. For example, this perspective might blind them to the complex web of social factors associated with absorption costing, which can contribute to the design and maintenance of accounting systems.

On the other hand, the continued use of absorption costing may simply be due to solid, practical business reasons.

The system does have certain well known disadvantages though, summarised by Lucas as follows :

- Indirect costs are misallocated because they are assigned to products on the basis of production volume measures.
- Non-attributable general overheads are assigned to particular products rather than being treated as period expenses.

Lucas referred to Horngren, who defended the continued use of absorption costing. First, he stated, the cost of implementing and maintaining an alternative system, such as ABC, often outweighs the benefits obtained by improved accuracy.

For example, when manufacturing overhead costs are relatively small in relation to profit margins, the accuracy of allocation should not have too much of an impact on managerial decisions such as product abandonment. (However, this implies that we would expect to find that ABC is more common in sectors with high overhead costs relative to profit margins. Unfortunately, the empirical evidence does not actually support this.)

Second, Horngren also thought that there is often a reasonably strong correlation between overhead costs and production volume measures, even if there is not a direct cause and effect relationship. Production volumes can, then, be a fairly accurate proxy for activity cost drivers.

Also, product costs will not be seriously distorted if simpler (and thus cheaper) absorption costing systems are used. Indeed, Tom Kennedy[5] pointed out that many companies have investigated and actually dropped ABC, giving further weight to Horngren's argument.

In relation to the second of the well known disadvantages of absorption costing, cost allocations can be proxies for the opportunity cost of using the firm's capacity resources on a particular job or product. Indeed, the inclusion of an overhead charge, plus profit mark-up, may well be the best starting point for pricing.

Thus, with an agreed price, management can then see if the budget's assumptions about the general state of trade still apply, or if demand for the item requires a change in the margin. Such changes to the costing margin might reflect competitive conditions in the marketplace and job size. In other words, larger jobs would receive discounts, with smaller ones being charged a premium.

Lucas also looked at the role of accounting systems in organisations. Rather than being about providing information inputs into a rational process, in which goals are predetermined and means for their achievement evaluated, they may in fact provide ex post rationalisation for actions already taken. Thus, through the retrospective creation of goal statements, past actions are made to appear sensible to the decision maker and those to whom she or he is accountable.

Absorption costing may also help create an organisational history and resolve uncertainty about the past.

In fact, the processes associated with accounting in organisations might be interpreted as a way of understanding what has happened in the past and attaching meaning to past actions. Thus, by the same token, future actions may be justified by the same explanations that helped make sense of previous ones. The rituals of accounting, then, could justify current organisational behaviour.

Absorption costing does remain popular, but recent literature has focused more on the role of activity-based costing.

Richard Bull, for example, began his argument for ABC in a recent article[6] by stating that it 'has become an essential tool of the management accountant'. Not so, said Tom Kennedy, writing in the same issue. He believes that the system is not, in fact, as popular as its supporters would suggest.

Worldwide adoption rates for ABC, he wrote, have peaked at 20%, and the number of firms giving it further consideration is declining. The logic of the ABC model also raises serious questions, he stated, and more research is needed to evaluate its true impact on a firm's bottom line[5].

In the USA, a number of academics believe that ABC should replace traditional management accounting systems. In the UK, however, others make a strong case for a more evolutionary approach. For example, ABC may not be appropriate in all organisations because of its stringent preconditions.

The practice of management accounting can avoid any notion of crisis if accountants can react positively to change and search for innovative methods in a market-oriented context.

The fact, though, that there are two opposing views of what should be contemporary management accounting practice is a clear indication that further research is needed on the topic.

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