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Thinking about globalisation

Most discussion on international strategy is about globalisation, which is only one of many possible strategies. Why does it so dominate the strategy agenda as well as the thinking of managers and the general public ? This article explains some of the trigger factors driving globalisation in many industries, and shows why both large and small companies are affected by it. It also describes some of the strategic options that globalisation makes possible, especially for larger firms.

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Multinational firms and international markets

Whether they know it or not, all organisations are competing in an international marketplace for goods and services. Every initiative adopted by a well known international firm has an impact on the local markets of specific countries and regions, and on the market shares of local firms and their ability to satisfy their customers.

This is true for all commercial organisations, including small and medium-sized local enterprises. It is true for firms that carry out no activities outside their domestic market and never intend to. Not-for-profit organisations, including national and local government agencies and medical, health and charitable organisations, are equally affected. They are all competing for experienced staff, for managerial talent, for investment and for customers or donors.

A company may engage in no international activities whatsoever, and yet still be strongly affected by international trade and the strategies of multinational corporations (MNCs). Whatever the sector is (for example clothes, televisions or audit services), domestic providers of goods and services in their local markets will be affected by the most efficient potential providers of each product or service (provided that there is no protective legislation in force). Larger companies are likely to have available to them resources and capabilities (financial, human and technical) of greater sophistication and usually (although not always) of greater efficiency.

As long as no alternative provider exists in a domestic market, local providers can survive and prosper. However, as soon as international restructuring begins, local firms have to be able to provide a similar product or service at similar cost to match international competitors operating in their domestic market and selling to their local customers.

This is why, when international giant USA grocery retailer Wal-Mart entered the UK grocery retail market last year by buying the UK firm Asda, all the local grocery retail firms, including the market leaders Tesco and Sainsbury, felt extremely threatened. None of them could match Wal-Mart's economies of scale.

Local firms often try to fight back by offering additional added value to justify higher local prices to the consumer. For instance, we are all familiar with the situation where a local corner shop tries to stay in business, despite the greater product choice and cheaper prices of giant supermarkets, by staying open for longer and longer hours. Local customers are often surprisingly hard-headed and unforgiving when it comes to spending their money, and will rapidly desert long-standing favourites if they see better value elsewhere.

The UK retail firm Marks & Spencer attracted enormous criticism recently when it began withdrawing from its long-term contracts with UK suppliers to source its clothing more cheaply from Asian suppliers. It was castigated for abandoning its suppliers and putting UK jobs at risk. However, its customers had been unwilling to pay the Marks & Spencer's prices that supported those UK jobs, and had been shopping elsewhere.

Approaches to being international

It is important to recognise that there are many different ways of being international. Different approaches to international strategy suit different companies in different industries at different times. Indeed, a company may pass through many stages in its approach to being international.

The four main approaches to international strategy, structure and operations are summarised in *Table* 1, which distinguishes between the main types of organisation :

- *Multidomestics* treat each country market as independent, with each market being best serviced by a subsidiary dedicated to meeting its local needs and conditions. For example, this approach may be the most suitable one for the domestic appliances industry, because goods such as washing machines and refrigerators are heavy and bulky, leading to high transportation costs. This suggests that manufacturing these goods near to their point of distribution and sales will be more profitable than operating a globally centralised plant.
- *Global* firms emphasise worldwide strategies to benefit from operational scale. Examples are aircraft and auto-mobile manufacturers. They are heavily centralised, with direction and control emanating mainly from central headquarters so that international efficiency seeking can be managed.
- *International exporter* firms are only international in terms of their sales and marketing operations. This is often an early stage in the process of internationalisation.
- *Transnational* MNCs use very high levels of integration and coordination of their worldwide activities while still encouraging high levels of adaptation to local markets. They are particularly able to exploit parent company knowledge and capabilities through diffusion and adaptation throughout their international networks.

The Dutch consumer electronics firm Philips has gone through several stages in its own international history.

After 1945, it was multidomestic. From the mid1970s, it restructured to become more global. From the 1990s, it has been more transnational, and has allowed greater diversity between its divisions.

The appropriate international organisation for Philips' lighting division may be different from the most appropriate structure for its high-definition televisions division.

Thus MNCs may simultaneously pursue international strategies that are widely different in the various businesses and markets in which they have a presence around the world.

Table 1 Four approaches to being international

Organisational characteristics	**Multidomestic**	**Global**	**International exporter**	**Transnational**
Configuration of assets and capabilities	Decentralised, self-sufficient and nationally autonomous	Centralised and globally scaled	Centralised core abilities	Dispersed specialised interdependencies
Role of overseas operations	Sensing and exploitation of local opportunities	Implementation of parent company strategies	Purely sales	Integration of worldwide operations and differentiated country contributions
Development and diffusion of knowledge	Knowledge developed and retained within each unit	Knowledge developed at, and diffused from, the centre	Knowledge developed and retained at the centre	Centre/periphery knowledge development shared, and learning worldwide shared

[Source : Segal-Horn and Faulkner (1999).]

Benefits from global strategies

International trade is now dominated by MNCs, many of which have assets that exceed those of all but the richest national governments.

MNCs have much broader options and choices than do local firms in terms of how they manage their businesses. They can choose where to locate their business activities around the world to maximise efficiency for the company. This allows them to take advantage of specific structural conditions in various countries.

Examples of advantageous differences between countries include

- labour costs (textile workers in China);
- availability of scarce skills (software engineers in India);
- government incentives for inward investment (British and European regional development agencies);
- ease of raising capital (US venture capital markets).

In other words, MNCs have possibilities open to them in terms of how they construct their international value chains that are not available to local firms, simply because they operate across international borders. This gives them major additional potential sources of efficiency.

Of course it is precisely this international flexibility that attracts such enormous criticism of MNCs. Decisions such as that of the German car manufacturer BMW to withdraw from, and divest itself of, the UK Rover car plant in 2000, and that of the US automobile company General Motors to close its UK Vauxhall car plant in Luton, enrage UK politicians, media, trade unions and workforces.

However, the car industry is a global industry suffering from massive overcapacity, declining prices and poor profitability. The major car companies all pursue strategies through which they review and optimise their design platforms, supply chains and manufacturing capacity globally to decrease costs, remain competitive, and retain their market shares by financing a stream of new models.

These examples tell us three important things :

- They help us to understand that a *global industry*, such as the world automobile industry, is one that is *integrated* across international markets worldwide.
- They illustrate the fact that if a firm operates in a global industry, it should compete with a *global strategy*.
- They demonstrate that a well designed global strategy must be *operationally integrated* across country markets to enable the MNC to seek cross-border efficiencies in all its business activities.

Therefore, the main strategic benefit for MNCs is that they have flexibility and options. Options allow organisations to choose between ways of doing things.

For domestic firms, their domestic market is 100% of their potential market. Much domestic market strategy is defensive, and consists of trying to defend and protect existing positions while more and more of the volume of world trade is cross-border. MNCs have a wider range of strategies available to them simply because they are international and operate across borders.

Governments erect regulatory, institutional and tariff barriers to trade, while MNCs attempt to configure their international operations to exploit those barriers that are favourable to them (for example corporate tax breaks or cheaper raw material prices) and avoid those that are not.

Governments tax immobile assets and nationally based consumption, and try to set corporation taxes at levels that will provide them with useful sources of tax revenue to spend on services without prompting the corporations to shift their investments in jobs, buildings, research and technology elsewhere. MNCs can choose to do this; local firms cannot.

Flagship firms in global industries

Cooperation

In industries in which internationalisation and globalisation are at an advanced stage, such as the telecommunications, media, consumer electronics and automobile sectors, one trend that has become noticeable is a shift from competition to cooperation in the relationships between the firms in that industry.

In this latest phase of international business, firms (especially transnational organisations) are required to achieve high levels of integration and coordination across borders. This is the capability that is being emphasised in much current corporate advertising, especially that by international consulting, accounting and financial services firms, which use slogans such as the following :

- 'One idea ... from innovation to execution, our people deliver.' (Cap Gemini Ernst & Young)
- 'Wherever you are in the world, wherever you are in your life, HSBC will be there for you.' (HSBC Bank)
- 'The art of being local world-wide.' (Swedish/Swiss engineering company ABB)

These slogans imply local presence, local roots and local services combined with international reach, ideas, systems and resources that can applied for the benefit of local customers.

Such resources do not have to be directly owned by the international company; they may be accessed through an alliance or partnership with another firm. Indeed, the use of these types of international cooperative strategy have grown rapidly, so that cooperative ventures and strategic alliances are now a common feature of international business. They currently rival organic growth and mergers and acquisitions as a quick route to international growth.

The use of acquisition as a strategy is always problematic in whatever industry it occurs. Potential synergies are often unrealised as organisational and/or national cultures fail to blend, or information systems remain incompatible, or the CEOs cannot agree on which of them should run the combined new firm.

Strategic alliances and mergers and acquisitions both provide a means of acquiring instant market share and adding capabilities or resources. Any objective for an alliance may equally well be a reason for a merger or acquisition. They are simply different means to the same ends.

However, there are reasons why a firm may choose an alliance rather than an acquisition as its route to international growth.

Important differences exist between these two international pathways :

- A merger or acquisition requires capital investment up-front, whereas alliances do not.
- A merger or acquisition leads to direct control over resources, whereas alliances do not. They merely provide access to them.
- The indirect (non-financial) costs of an alliance may be very high. For example, it may take a great deal of management time to make the alliance work effectively long-term.

Because of the major potential benefits of collaboration, various types of alliance are likely to continue to grow in popularity, despite the difficulties of managing such collaborations effectively over the long term, especially when they have multiple participants.

In a strategy context, this new emphasis means that strategies based on notions of competitive advantage within an industry, as captured by Michael Porter's five forces framework, are being replaced in the international arena by more collaborative relationships.

One important difference between traditional competitive business relationships and these newer collaborative relationships is that the former tend to encourage short-term attitudes amongst industry participants, and the latter foster long-term attitudes and commitments.

Flagship firms

A new type of international collaboration has been identified by Rugman and D'Cruz (1997). They called this the *flagship firm*. A flagship firm provides direction and strategic leadership to a network consisting of four other sets of partners (see *Figure* 1) :

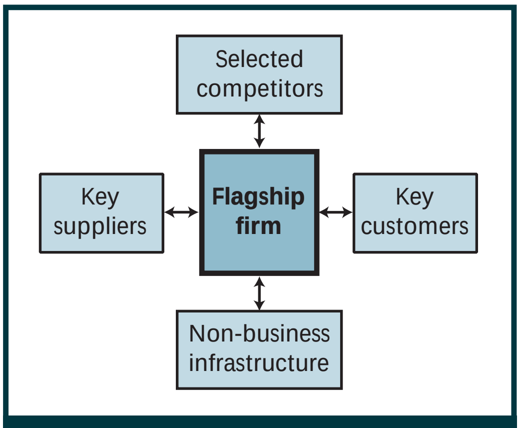

Figure 1 Five-partners flagship firm network
[Source: Adapted from Rugman and D'Cruz (1997).]

- key suppliers;
- key customers;
- selected competitors;
- the non-business infrastructure (for example educational and training institutions, trade associations, government bodies, and trade unions).

Successful flagship firms develop trust and deep collaborative relationships with these partners, which can become a shared source of long-term competitiveness.

The system has two key features :

- a flagship firm that pulls the network together and provides strategic leadership for the network as a whole;
- firms that have established key relationships with the flagship firm.

The flagship firm is always an MNC, and it provides direction for a vertically integrated chain of businesses that operate as a coordinated network. These are often in competition with other similar networks that address the same end consumer.

The flagship sets the strategy; the partners are intimately involved in implementing and achieving the strategy without having any control over it.

This process can include certain limited cooperation with direct competitors. For example, a new plant may be built and operated jointly because its cost would be too great for the partners to bear independently, and because the minimum efficient scale in the industry is greater than they could utilise independently.

Similar reasons may justify cooperation with a competitor on joint research and development projects.

We can look once again at the global car industry for an example of a flagship firm collaboration. The large automobile manufacturers are well known examples of MNCs that have adopted this flagship model of operation.

Daimler–Chrysler has developed close collaborative relationships with its key suppliers, which are often encouraged to locate their own plants close to its assembly plants.

These relationships are fundamentally cooperative rather than competitive, and all concerned operate on the assumption that they will continue indefinitely.

As these relationships are long-term, joint capital investments can be made to optimise joint operations.

The same applies to dealers at the other end of the chain. The whole chain is managed as a single system. The direction and control comes from the flagship firm, which coordinates all the activities from which all benefit. However, the network partners are expected to invest heavily in the success of the network, for example in new equipment and training.

This new approach to international competition has developed because for many global industries, the huge levels of investment and the short available time to market mean that different types of leadership and resource management are needed to compete in the global marketplace.

Only the flagship firms have the global perspective and the level of resources that are adequate to the task. What this represents is an integration of parts of the value chain between firms to reflect the complexity of competition in today's global industries.

Conclusions

In international strategy, big is very often beautiful. For example, we can see this today as MNCs fight back and regain ground lost to the dot.coms as they learn to target e-business.

Unless the management of an MNC is very incompetent, it will usually have advantages over smaller competitors, and certainly advantages over those of its competitors that operate in only one local marketplace.

MNCs control complex sets of resources. They manage those resources in order to compete in global industries with global strategies. Doing this effectively requires cross-border integration and coordination of strategic direction and all categories of resource, including human, financial and physical resources.

Increasingly, even very large MNCs do not have sufficient resources to remain competitive on their own, and they are forming long-term collaborative relationships, often with direct competitors for specific projects.

These trends will continue to develop as more industries become global and more resources are needed to compete in them successfully.

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International human resources management

As businesses become more international, they face the issues of managing staff overseas. They may have to select and develop expatriate managers, or manage employee nationals in their own countries. Policies will be affected by the cultural environment, and by the structure and nature of the business itself. The choice of staff, and the methods of selection and development, must all be part of the organisation's international human resources strategy.

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For many people, international human resources management is synonymous with expatriate management. However, it covers a far broader spectrum than this : it involves the worldwide management of people.

Although international human resources managers undertake the same activities as do their domestically based colleagues, the scope and complexity of these tasks depends on the extent of internationalisation of the organisation.

This article examines the factors that influence choices about international human resources policy and practice.

Impact of internationalisation

As we move towards a more global economy, organisations are having to rethink their traditional ways of managing people.

What would be normal custom and practice in one country might be illegal in another. Routine decisions on career development, for example, can become extremely complex in an organisation that works across 30 countries. How do we select our high-potential employees ? Who makes decisions on moves ? What kind of leadership are we trying to develop for our global company ?

In any organisation, the primary objective of the human resources management function is to ensure that the most effective use is made of the organisation's human resources (HR). To achieve this, HR professionals undertake a range of activities around

- sourcing;
- development;
- reward and performance management;
- HR planning;
- employee involvement;
- communications.

If the organisation has a strategic HR function, these activities will support and inform organisational strategy. HR professionals are also used extensively in organisational change and development initiatives.

For international organisations, these HR activities need to be coordinated across the home country and various national subsidiaries. It is necessary to take into account the needs of

- parent country nationals (PCNs);
- host country nationals (HCNs);
- third country nationals (TCNs).

Given this broader perspective, how do managers decide on appropriate international human resources management policy choices ?

A critical challenge for all international organisations is the need to achieve best fit in relation to the competing demands of global integration and coordination versus local responsiveness (the 'global versus local' debate).

From a business perspective, forces for global integration include

- operational requirements;

- strategic coordination;
- multinational customers.

By contrast, forces for local responsiveness include

- highly diverse consumer requirements;
- tailored distribution channels;
- broader social and political constraints on market entry.

From an HR perspective, many factors constrain the use of standardised HR practices, including

- differing national business systems;
- labour laws;
- national HR practices;
- education systems;
- national cultural norms.

Organisations may, however, still want to implement standardised HR systems globally. Their choice depends to a great degree on their stage of internationalisation and international mindset.

Stages of internationalisation

Although terminology differs, most writers identify four stages of internationalisation :

- *domestic* : no activities outside the home country;
- *international* : an export sales and marketing function;
- *multinational* : location of production and other facilities in fairly autonomous subsidiaries;
- *global* or *transnational* : global sourcing and location of functions, and a high degree of coordination *and* adaptation.

Bartlett and Ghoshal (1989) saw the transnational solution as more of an approach or a frame of mind than a strategic and structural response. They referred to it as a ‘new managerial mentality’.

This focus on managers’ mindsets as a critical determinant of international human resources management policy choice was reflected in the classic work of Perlmutter (1969), who identified four major mindsets :

- *Ethnocentric* : Few foreign subsidiaries have any autonomy; strategic decisions are made at headquarters. Key positions in the domestic and foreign operations are held by headquarters management personnel. In other words, subsidiaries are managed by expatriates from the home country (PCNs).
- *Polycentric* : The multinational enterprise treats each subsidiary as a distinct national entity with some decision-making autonomy. Subsidiaries are usually managed by local nationals (HCNs) who are seldom promoted to positions at headquarters. Similarly, PCNs are rarely transferred to foreign subsidiary operations.
- *Regiocentric* : This reflects the geographical strategy and structure of the multinational. Personnel may move outside their countries, but only within a particular geographic region. Regional managers may not be promoted to headquarter positions, but they enjoy a degree of regional autonomy in decision making.
- *Geocentric* : The multinational enterprise takes a worldwide approach to its operations, recognising that each part makes a unique contribution with its unique competence. It is accompanied by a worldwide integrated business, and nationality is ignored in favour of ability. PCNs, HCNs and TCNs can be found in key positions anywhere, including at the senior management level at headquarters and on the board of directors.

The creation of direct linkages between these orientations and the stages of internationalisation is tempting. For instance, the geocentric approach closely matches Bartlett and Ghoshal’s transnational concept.

In reality, things are not quite so simple. Many organisations that call themselves global have a very ethnocentric mindset. HR policy and practice emanate from the head office, as do most expatriate managers. The ‘global’ culture is, in fact, an attempt to disseminate the home country culture to all of the subsidiaries.

Case study : ethnocentric mindsets

A newly acquired French subsidiary of a USA-based multinational had been reassured that the organisation operated on a truly global basis, acknowledging and integrating the diversity of management styles apparent in its national subsidiaries.

A few months after the acquisition, the senior management team in the French company received a thick wad of documentation outlining the new competence management scheme, together with instructions that this was to be implemented in all the subsidiaries. The competency framework was extremely detailed, and it had been designed by US consultants working solely with the US parent company. Much of the terminology could not be translated into the French context.

The French management team were astounded at the arrogance of the Americans in thinking that they would bother with such an imposed and alien system.

Use of expatriates versus localisation

Historically, most international organisations adopted an ethnocentric approach to staffing. Control remained with the parent organisation, and it was exercised through the use of parent country expatriates.

Nowadays, many organisations are striving to make the best use of their global human resources and to adopt a more transnational approach.

This, in turn, raises the question of whether the continued use of expatriates is a cost-effective and ethical use of organisational resources, or whether the localisation of senior posts would be a more appropriate strategy.

Expatriates are estimated to cost three to four times as much as when the same person is employed at home. Although organisations are aware of the costs of such assignments, they are less sure of how to measure the benefits. Financial costs also arise as a result of expatriate mistakes.

There are also opportunity costs when local management talent is not developed, and staff are not promoted who

- understand the local market and political environment;
- can work effectively in the local cultural context;
- can develop long-term relationships with local customers and suppliers;
- can build a network of local contacts.

Decisions about whether to employ an expatriate or a local need to be part of a strategic international human resources management approach.

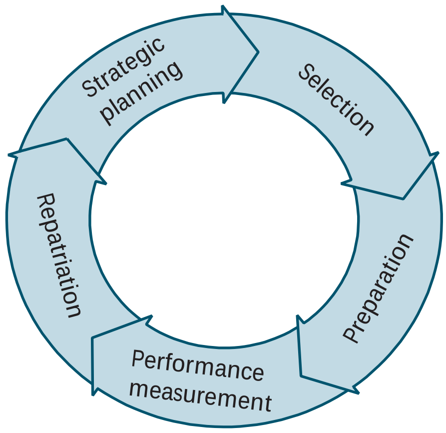

Figure 1 Expatriate cycle

Key issues in the management of expatriates

Organisations should adopt a strategic approach to the whole expatriate cycle to ensure that their expatriate management is effective (see *Figure* 1).

Planning

The cycle starts at the planning stage. Traditionally, expatriates have been sent abroad to achieve the following :

- control and coordination of operations;
- transfer of skills and knowledge;
- managerial development.

To operate strategically, organisations need to link foreign assignments more closely to strategic operational requirements.

This requires a careful assessment of whether an expatriate is the best choice in global sourcing decisions. It also implies a need to assess the cost effectiveness of expatriation.

Case study : lack of strategic planning of expatriate assignments

One ‘household name’ international company took a decision at board level that it should reduce its costs by cutting the number of expensive expatriates that it employed around the world by one-quarter.

The decision was taken at main board level, but it had to be implemented by the international HR manager. 'No business manager was prepared to tell me that he was running unsuccessful operations', he said, 'so the only thing we could do was to "localise" some of the jobs'.

Within two years, he had achieved the objective. At around the same time, the company realised that, while some of the local replacements had obviously been successful, some of the changes had been (equally obviously) disastrous.

Over the next few years, the company began to increase the number of expatriates again. The international HR manager said this. 'Of course, we shouldn't have started with a decision on numbers; we should have found some way of working out which jobs needed to be filled by expatriates and which didn't. We've tended to do it mainly by intuition.'

Expatriate Portfolio

The Expatriate Portfolio framework (which was developed at Cranfield School of Management) allows corporate managers to identify how an international assignment should be managed, and whether a local or an expatriate should fill it (see *Figure* 2).

The framework outlines four types of assignment that are based on the degree of importance of the assignment to the parent organisation, and it indicates the most suitable type of appointment for each instance.

By plotting their assignment against the portfolio, managers can make more rational and sensible sourcing decisions.

Selection

Once a strategic decision to use an expatriate in an international posting has been made, the selection process starts. Research into the criteria for effective international managers consistently highlights the importance of 'soft' skills, such as

- self-awareness;
- flexibility;
- intercultural empathy;
- interpersonal skills;
- emotional stability.

However, surveys of international selection practice within organisations show that most rely on technical competence as a prime

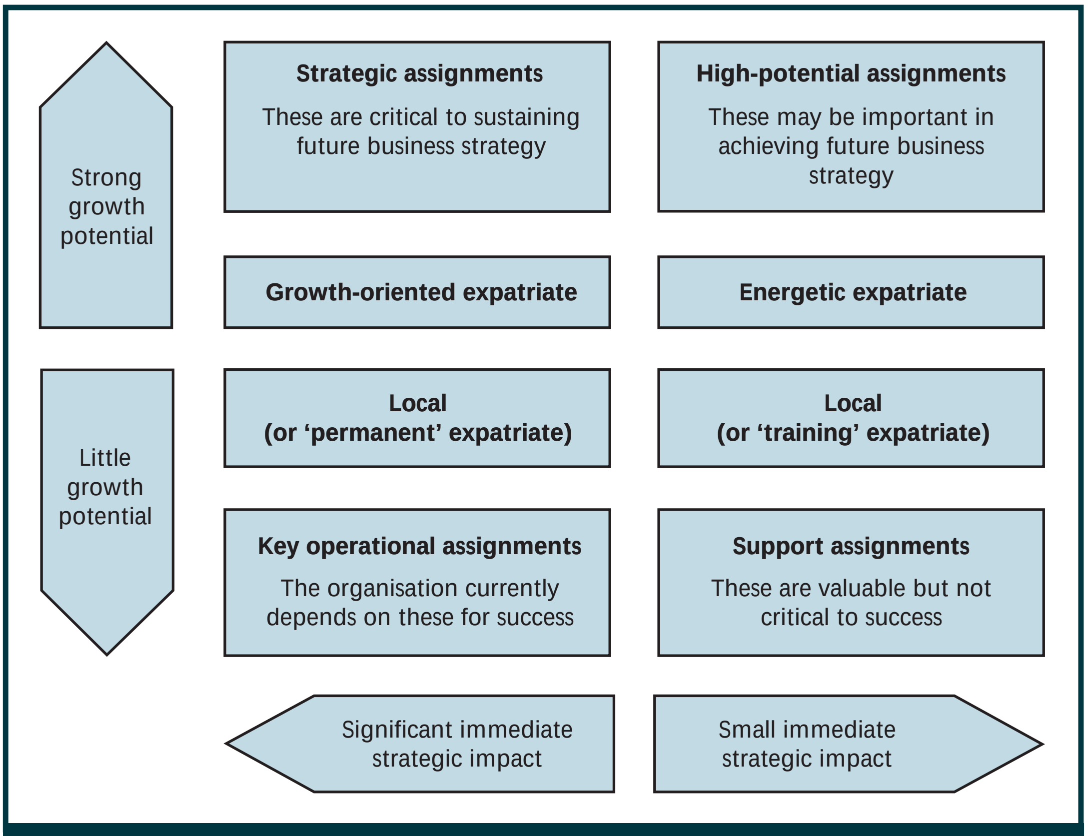

Figure 2 Expatriate Portfolio (composite)

determinant of eligibility for international assignments.

The Organization Resources Counselors 1997 survey of international assignment practice also showed that only 8% of international organisations use any form of psychological testing during the selection process.

Preparation

Predeparture training is the next part of the cycle. Effective preparation can do much to alleviate culture shock and help the expatriate and his or her family to adjust more quickly and effectively to their new environment.

In order to maximise the value of this for the expatriate and the spouse and family members, a framework has been developed by members of CReME that allows international HR managers to customise training in accordance with the unique needs of the expatriate and the assignment (see *Figure* 3).

(The Centre for Research into the Management of Expatriation (CReME) is a joint collaboration between Cranfield School of Management and Organization Resources Counselors, a New York based consultancy that specialises in expatriate management and compensation.)

Using the checklist provided by the framework, managers can assess the nature and extent of predeparture preparation required for each individual.

For instance, for a manager from a large multinational organisation going to a setup operation in Vietnam, the preparation would need to concentrate on crosscultural, language and local business briefings, together with substantial involvement from the headquarters' expatriate administration department in arranging accommodation and practical local living details.

Performance

Monitoring the performance of someone on an expatriate assignment requires an understanding of the variables that influence an expatriate's success or failure in a foreign appointment.

Three critical variables are

- the environment (for instance the culture);
- the job requirements;
- the personality characteristics of the individual.

Organisations need to be careful to balance the desire for a global standardised performance appraisal system with the local requirements of subsidiaries.

Repatriation

The final stage of the expatriate cycle is repatriation**.** For most organisations and individuals, this remains highly problematic. 57% of organisations in the Organization Resources Counselors survey reported that the job level to which expatriates were normally repatriated depended entirely on what jobs were available at the time.

Expatriates were expected to be far more proactive during their time abroad and to network in order to ensure that a position was available to them on their return. For many expatriates, the 're-entry' shock could be more traumatic than the culture shock experienced at the start of the assignment.

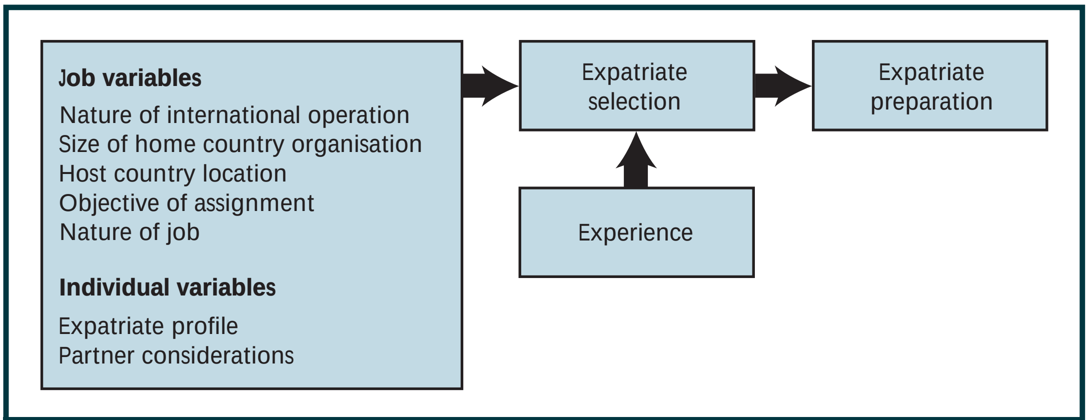

Figure 3 Harris–Brewster framework for expatriate preparation

Organisations need to pay careful attention to the way in which they handle repatriation, for two key reasons :

- The cost of losing someone who is dissatisfied with his or her position on return is significant, in purely financial terms and also in terms of the investment in human capital.
- Perhaps more importantly, expatriate assignments are seen as crucial tools in the attempt to create a transnational mindset in the organisation. Failure to disseminate the individual learning gained from a foreign assignment to others in the organisation is a clear barrier to the organisation reaching its goal of becoming a truly global operation.

Beyond expatriation : international HR management strategy

We can thus see that the management of expatriates remains a critical feature of international HR management.

However, expatriates make up only a small proportion of a global workforce, and the international HR director will need to agree an integrated international HR strategy that supports and develops the global corporate strategy.

One vital factor here is the impact of different national cultures on views about appropriate management styles and organisational processes.

Evidence from crosscultural research (see Hofstede (1991) and Trompenaars (1993)) shows significant variations in perspectives among managers from various countries. Andre Laurent (1986), for example, undertook a systematic survey of upper middle managers attending INSEAD's executive programmes.

His results showed strikingly different attitudes towards authority that varied according to the national origin of the managers. His findings showed that while a majority (over 59%) of French and Italian managers and nearly 78% of Japanese managers agreed with the statement 'it is important for a manager to have at hand precise answers to most of the questions that his subordinates may raise about their work', the majority of Swedish and US managers disagreed with it. The implications of this, in terms of perspectives of what is an appropriate management style, are obvious.

In the same way, cultural differences need to be borne in mind when decisions are taken on HR systems. Can a Western-style appraisal system be implemented throughout the world ? How do various cultures view reward ? The international HR professional must take into account the implications of cultural differences when making global HR policy decisions.

Effective international HR strategy implementation

How do we implement an international HR strategy ?

The following checklist identifies some of the critical decisions and actions required in the formulation and implementation of such a strategy.

1. Ascertain the current and intended nature of international operations in the organisation. (Is it multidomestic, international, global or transnational ?)
2. Determine the extent to which HR policies and practices should be standardised or localised in accordance with overall organisational strategy.
3. Assess the extent to which local cultural, social, political, economic and legal factors will impinge on any attempts to apply standard HR policies if integration is a key factor in the organisational strategy.
4. Ensure that a computerised database of global human resources is used if integration is desired.
5. Work with the senior management team to identify the competencies required to achieve global organisational objectives.
6. Work with national HR and line managers to formulate international HR policies and practices in the key areas of sourcing, development and reward that will embed a transnational mindset in the organisation.

In summary, the role of the international HR manager will vary, depending on the international orientation of the organisation.

It is critical, therefore, that managers working in this field should be able to interpret international organisational strategy and develop international HR policies and practices that support that focus.

As a strategic partner, the international HR manager should equally advise senior management of any mismatch between stated organisation internationalisation goals and actual international HR practice.

As one example, a major European airline found that, although it had a stated business objective of being a global organisation, its actual HR policies and practices were almost completely ethnocentric !

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  The most up-to-date collection on the topic, including contributions from many of Europe's leading scholars.

Key account management

Key accounts are those that are particularly important to the business, because of their size or their strategic significance. These customers may be managed in a different way from the others to guarantee their continued support. This article provides some frameworks for examining and managing key account relationships. It suggests that strong relationships can often contribute to retention of customers and development of the business.

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Is KAM (key account management) just another managerial TLA (three-letter acronym) ?

Surely this is not just another one of those over-hyped, instant business solutions that is supposed to resolve our business ills. Of course it has the potential to fall into the category of solutions that includes, for example, BPR (business process reengineering), TQM (total quality management) and, if we go back far enough, MBO (management by objectives).

This is the problem with apparently instant solutions. If they fail to deliver instantly, then they are rapidly dispatched into history. As managers, we should appreciate that life cannot be that simple. We work in complex, challenging, fast-moving businesses and industries. Surely it should strain our credulity to think that there might be a 'one size fits all' solution.

Thus the implication of this discussion is that if there is some value to be gained from KAM, or indeed any of the other techniques, then we need to think carefully and ask ourselves the question of whether or not the technique should apply to the context of our own business.

For decades, many organisations have employed large account managers or national account managers. This begs the question of how KAM differs from simply selling to large clients.

The article starts by discussing what a key account may mean for your business, and why the management of key accounts differs from selling. It then considers the context in which KAM may be appropriate for your organisation, and this suggests that there is a range of selling styles that may be relevant to your business.

It also looks at a KAM model that helps us to recognise the type of relationship that we may have with our key account. The article concludes by considering how we might measure the success of a KAM programme.

Why key account management ?

We must all have noticed that the business world is becoming ever more challenging. We can identify a number of critical factors :

- the trend to globalisation;
- more demanding and sophisticated clients;
- increasing product parity, with less differentiation between competing products and services;
- technology and communications tools that are hastening change;
- market saturation, increases in buyer power, and pressure on profitability.

Many managers will be able to identify with these trends, and vouch for the effect that they are having on their business.

They are a consequence of maturity, where demand is largely satisfied and suppliers into a market address their efforts primarily to gaining clients from their competitors rather than attracting the few new clients that enter the market. In addition, the client base

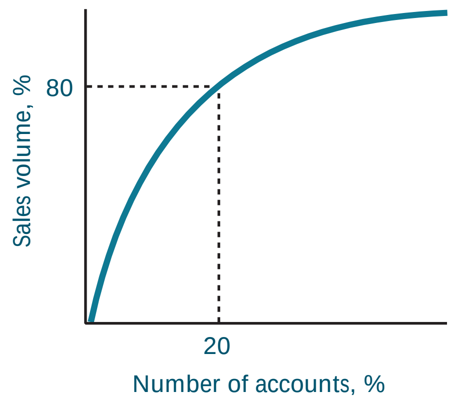

Figure 1 Client accounts : 80:20 analysis

consolidates, and those that are left become larger and, by dint of their survival, smarter and perhaps more aggressive.

If we were to conduct a simple 80:20 analysis of our client base, it would be quite likely that we could identify a few large clients that were important to our business (see *Figure* 1).

The size and value of an account can thus be two criteria that we can use to determine its key account status. However, this does not differentiate key account status from the national/large account status with which we are familiar.

Key accounts often have additional attributes that make them particularly important to us.

For example, in the food industry, if a company is known to be an accredited supplier to Marks & Spencer, then, in spite of Marks & Spencer's recent problems, its reflected reputation confers a high credibility and status on the supplier.

The key account may be relatively small, but entail working in an expanding area of the market or developing new technology that could unlock volumes of business in the future. It must be more attractive to be seen to be working with small, growing accounts and building the relationship as those accounts grow, with the opportunities that this presents to acquire preferred supplier status.

There may be a particularly large and appropriate client for your services that is located relatively near you. If you do not have this obvious account, does this raise questions about your credibility as a supplier in the minds of other potential clients ?

Size is important, but it is not everything.

With a key account, we are concerned about its strategic importance to the business, in other words, not just its value today, but its value tomorrow, and its value to the business overall.

In the tough business conditions that we face today, account retention is an important factor, particularly in an industry in which new clients are not emerging.

If the product or service that we sell is poorly differentiated from those of our competitors, then perhaps the critical difference between us and other potential suppliers is that we have an established relationship with the customer. Failing to manage that relationship and allowing our client actively to decide to leave us is a major transgression in these circumstances.

Selling and KAM

Not all clients are the same. Some can be large and very important, while others may be less significant but still valuable.

Some recent research demonstrates that companies do deal with a wide range of clients, and as a consequence adopt a range of selling styles (see Brodie *et al.* (1997)). This perspective appeals to our common sense, and demonstrates why KAM is not a universal solution.

One of the first things that we need to understand as a first step in applying an appropriate relationship management solution is the type of client with which we are dealing.

As the matrix in *Figure* 2 shows, we can look at clients rather simplistically. We can have clients whose sizes range from very small to very large, with gradations between.

The clients, as we will see from the relational development model below, may adopt a range of styles. Those that are transaction driven have a win/lose perspective and are interested solely in making the best possible deal. At the other end of the spectrum are the relationally driven clients. They believe in working together in a cooperative fashion to generate value that is of benefit to both parties.

By examining the matrix, we can quickly see the role for KAM. The implication is that only a few clients will achieve key account status. If there are more than a select few, they cease to be key accounts !

Just as we have a portfolio of products and/or services, so we have a portfolio of clients, and we may well apply different solutions to meet these various needs.

With a large transactional buyer, for example, it is often desirable to capture the business, but we want to ensure that we achieve this on terms that are acceptable to us. Our sales manager or sales director could well negotiate this.

With a smaller account, the business may still be attractive, particularly if we can reduce the costs of servicing it. With our relationally driven small buyers, we can adopt what is called an interaction style of selling. Here we generate opportunities to maintain contact with the client cost-effectively and perhaps grow the account.

For example, we could use social events or business exhibitions as ways of maintaining contact with our clients without incurring the high costs of individual face-to-face contact.

For the small, transactional and often price-driven buyer, we perhaps need not do much more than sell at an attractive price. We may only need a telephone to sell to them, or perhaps a relatively cheap but effective direct mail or Internet-based marketing campaign. This will enable us to communicate quickly and cheaply with our buyer.

Here we can structure the terms so that our internal sales force or call centre can offer a mutually attractive deal. One large manufacturing company established an internal sales force, and offered an attractive price in return for a minimum order size, cash with the order, and midweek delivery, when capacity was under-utilised.

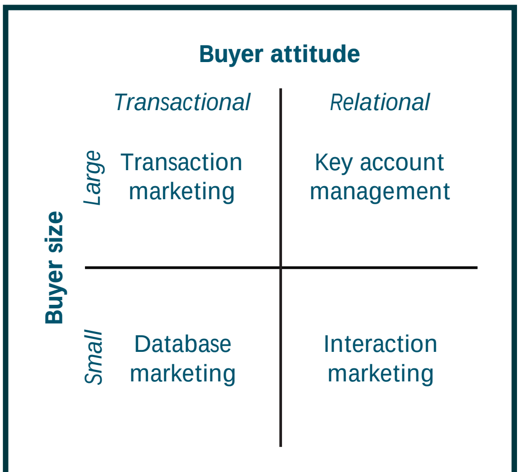

Figure 2 Analysing clients : formulating the sales and marketing approach

This is a generic overview of how we can consider clients.

It shows that, by gaining insight into the nature of our client base, we can cost-effectively manage the resources required to service the client's needs with respect to the value of the business that we obtain.

To develop our own unique view, we may wish to consider, for instance,

- how and why clients buy;
- the nature of our client base in comparison with the market;
- how we and our competitors approach the market.

In effect, this consists of carrying out a client and market audit as a basis for reviewing strategy.

Relational development model

If we specifically consider key accounts, the relational development model shown in *Figure* 3 (see overleaf) helps us to understand the various stages of relationship development from the very early, exploratory phase through to the integrated phase (see McDonald and Rogers (1998)).

It is at the integrated stage that companies operate almost as one, with joint project teams, open communication, sharing of sensitive information, and interlinked systems and processes. There are relatively few examples of this.

Table 1 overleaf shows some of the criteria and identifying features of each of the KAM stages.

Some common mistakes and misconceptions relating to the relational development model are that it in some way implies that a more advanced style of relationship is somehow 'better', and that we should therefore aim for all our accounts to operate at the integrated stage.

This is not the case. We should be aware that while we might want to have an involved relationship with a particular client, that client might be content with a basic style of relationship.

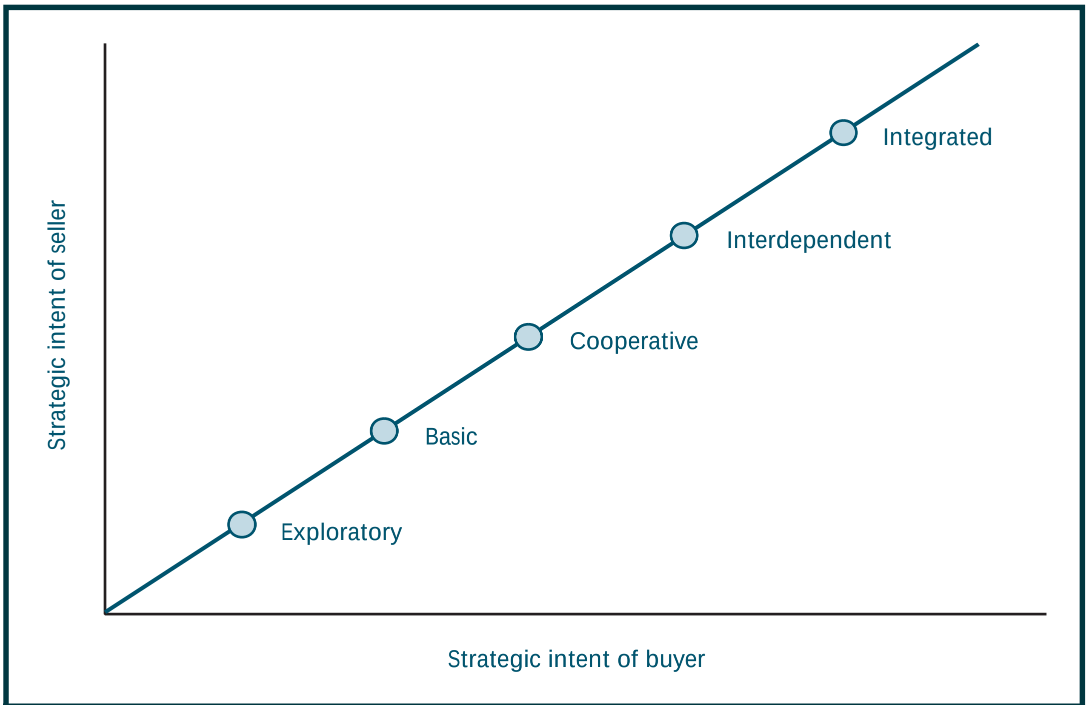

Figure 3 Relational development model

The conclusion is that we should seek to understand the nature of the relationship sought by our client by using the framework shown in *Table* 1. We can then apply the appropriate resources, and consider whether or not additional resources are likely to improve the quality of the relationship to our mutual benefit.

Another common error is to over-service clients, on the basis that this will escalate the relationship or that it is a requirement of the client. Needless to say, clients are hardly likely to complain if they are over-serviced and if we choose to waste our resources.

Outcomes

By adopting a KAM approach, we commit to working with our clients in a different way. This introduces the notion of retaining clients, and recognising that new clients are no longer being invented and that the cost of gaining clients is actually very high.

Why should our clients wish to stay with us ? The answer is not lower prices, although that may well be a consequence of our involvement. It is much more to do with whether we continue to deliver value to our

Table 1 Diagnosing and managing key account stages

Exploratory KAM	**Basic KAM**	**Cooperative KAM**	**Interdependent KAM**	**Integrated KAM**	**Decoupling KAM**
Selling company must match a key account manager to its key contact	Key account manager's personal skills are needed	Key account manager must establish high-level contacts and fulfil a consultancy role	Key account manager must manage others delivering services to the customer	Focus teams at all levels, key account manager coordinates	Key account manager may manage exit plan
Buying company will look for product knowledge and knowledge of its business	Key account manager must establish integrity	Key account manager must be perceived to have authority	Key account teams assume importance	Focus teams self-managing, key account manager coordinates	Change of key account manager may retrieve the situation

client. The price then simply becomes the mechanism whereby we divide the extra value generated between us.

We can generate value by working together to take out unnecessary cost, or alternatively by working in different ways that helped to create new value.

The polyester films business of Du Pont worked with food producers to develop resealable packaging. This offered real benefits in terms of food freshness and product quality. The packaging component of the total cost of the food product was relatively low.

As a result of the innovation, they were able to increase the price that they realised for their product by a factor of six, so valuable was their innovation perceived to be.

If we are to manage our key accounts for value, this implies more than a simple consideration of top-line revenue.

Conventionally, we look at profitability in a number of ways, for example by product, business unit or geographical territory. However, it is clients that generate profit, and none of them more so than our key accounts. Hence it is desirable, perhaps using the facility of modern enterprise resource planning systems, to construct a client-based profit and loss account.

A US manufacturer of industrial fragrances recently developed an activity-based costing system to improve its understanding of client profitability. This showed that, with two particular accounts, one had a margin on sales of 30%, and the second had one of 60%, which implied that the high-margin client must have been the most profitable.

However, the manufacturer actually lost money on the account with the highest margin. The company president said

> *… we lost money on the 60% account because of the amount of work we did for them, the number of samples, the number of requests, number of compoundings related to their orders, the job was nuts. The other guy – high volume, low margin, very little work, a ton of money.*

When considering a KAM programme, we should therefore manage differently, and measure success by different criteria. These could include

- a measure of client retention and client turnover;
- the opportunity for profitability now and in the future from the key account;
- a true understanding of client-based profitability;
- insight into and understanding of how the client became and remains profitable, and how we may add value;
- a critical analysis of the costs of servicing the client.

Conclusions

KAM is a process that can help us to manage large customers and other important clients. It should not be applied universally to our client base.

Success requires insight into and understanding of both the marketplace and the needs of the client.

If we work in different ways, then we should also measure the outcome in different ways.

If this makes KAM sound a little more challenging than an off-the-shelf, spray-on solution, then it is the first and one of the most important insights into developing new management methods in a rapidly changing and dynamic business environment.

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Further reading

- **'Processual issues in key account management : underpinning the customer facing organisation'**

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- **‘Selling to and managing key accounts’**

  Shipley, D and Palmer, R A in *The CIM Handbook of Selling and Sales Strategy* Jobber, D (ed.) (1997) Butterworth–Heinemann, pp 89–103

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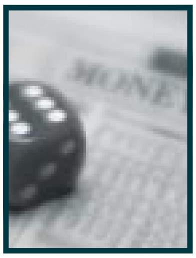
Option contracts

Financial options such as stock options and currency options provide investors and corporate managers with a means of controlling the level of financial risk that they encounter and enhancing overall shareholder wealth. This article looks at the types of option available in financial markets, their uses in practice, and how they may be priced by corporate and financial users.



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Since the 1970s, global financial markets have seen a dramatic growth in the levels and types of financial instrument that can help investors and corporate managers optimise their financial decisions.

Option contracts, which are available in the form of share (stock) options, interest rate options and currency options, are one notable example. This article describes the characteristics and uses of options.

In general, financial users can utilise options as a risk management/insurance device

- to protect themselves against the possibility of future uncertainties;
- as a calculative gamble with extensive upside potential, to maximise shareholder value.

The article also discusses how these instruments may be priced in financial markets, and how option pricing theory is becoming important in other areas of finance, such as corporate investment decisions.

Options : the basics

An option is a contract that gives the owner the *right* to buy and sell some asset at a prespecified, fixed price. (In the case of a share option, an 'asset' consists of shares in a particular company; in the case of a currency option, an 'asset' is the currency of a particular country, and so on.)

Options can be differentiated from other types of instrument such as forward contracts, where the holders of the instruments are *obliged* to buy or sell the assets.

A special terminology is associated with options :

- There are two types of option : *call* options and *put* options. While call options give the holder the right to buy an asset, put options confer the right to sell an asset.
- The fixed price specified on an option (the price at which the asset may be bought (for a call option) or sold (for a put option)) is called the option's *exercise price*. If the actual asset price is less than the exercise price, the option is said to be trading *out of the money*; conversely, if it exceeds the exercise price, the option is said to be trading *in the money*. When the two prices are equal, the option is trading *at the money*.
- Option contracts are valid only for a specified time period. The date after which an option may no longer be exercised is called its *expiration date*.
- *US-style* options can be exercised at any time up to and including the expiration date. *European-style* options, which are less common, can only be exercised on the expiration date. (These option styles have little relationship to the geographical locations of the financial markets from which they are sourced. US options, for example, are more popular than European options in Europe.)

Overall, there are two types of option contract : one gives the right to buy an asset, and the other one gives the right to sell an asset (these are called call options and put options, respectively). There are also two styles of option : US and European (depending on when they can be exercised).

While a variety of complex option derivatives have been developed in recent years, all of these are derived from these two basic types of option.

Further options can be acquired from traded exchanges (*exchange-traded* options), or they can be tailored to the needs of the individual investor or institution (*over the counter* options).

To acquire an option, potential holders usually have to pay an up-front premium.

Options characteristics

The hypothetical value of an option, if it were to expire today, is called its *intrinsic value*. This is the value that can be generated by exercising the option.

Call options

For a call option, the intrinsic value is calculated as

current price of asset – exercise price of asset specified in option, or 0

If the exercise price is greater than the current price of the asset (that is, the option is trading out of the money), the option has an intrinsic value of 0, because in this case it is not worth exercising the option, and once it is allowed to lapse, it will not have any value. (As a result, intrinsic values are never negative.)

Figure 1 shows the pay-offs of a call share option when the up-front premium for the option is 30p and the exercise price is £1.00. (The same principles apply to interest rate and exchange rate options.)

If the actual share price is £1.30, the option holder breaks even. The intrinsic value of 30p is set off by the premium paid towards the option.

From then on, for every 1p rise in the share price, the holder of the option can sell the share and earn a gain of 1p. If the share price is equal to or less than £1.00, the intrinsic value of the option is 0p, and the holder only loses out to the extent of the premium already paid (that is, 30p).

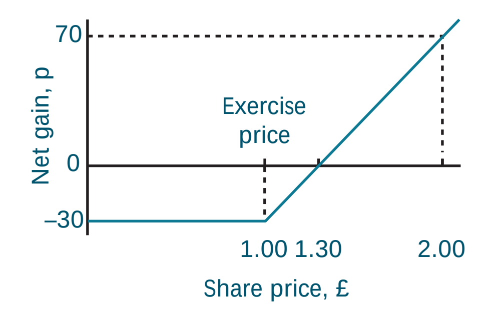

Figure 1 Profile of a call option

Put options

The situation for a put option is opposite to that for a call option. The intrinsic value of a put option is calculated as

exercise price of asset specified in the option – current price of asset, or 0

If the exercise price is less than the current price of the asset (that is, the option is trading in the money), the option has an intrinsic value of 0, because again it is not worth exercising and will be allowed to lapse.

Figure 2 shows the pay-offs of a put share option when the up-front premium for the option is 30p and the exercise price is £1.30.

If the actual share price is £1.00, the option holder breaks even. The intrinsic value of 30p is set off by the premium paid towards the option.

If the share price falls by 1p to £0.99, the investor makes a gain of 1p, because s/he can sell the 99p share at £1.30, having paid a premium of 30p. If the share price is more than £1.00, the intrinsic value of the option is 0p, and the holder loses out only to the extent of the level of premium already paid (that is, 30p).

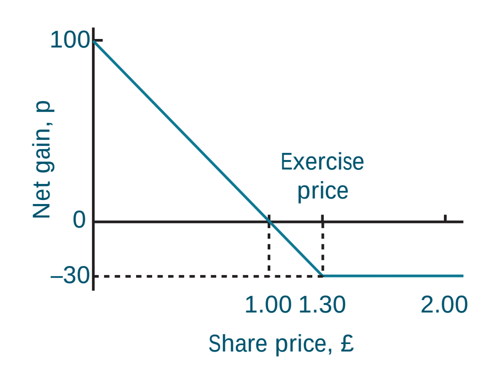

Figure 2 Profile of a put option

Uses of options

The characteristics of put and call options identified above allow investors and firms to do the following :

1. They can protect themselves from unfavourable changes in the price of the asset that they are concerned with without giving up the potential to make a gain if a favourable change materialises (*financial risk management*).
2. They can generate extensive returns from investment in an asset whose price is expected to rise, while capping the risk at the cost of the option if the expected favourable change does not materialise (the *gearing effect*).

Numerical examples are given below to illustrate the two key uses of options described above.

The first example demonstrates the use of foreign currency put options, and the second one deals with stock call options.

These illustrate the use of the various forms and types of options available.

Financial risk management

Suppose that a UK firm has just purchased some machinery from the US at a price of \$150 000, and payment is due in three months time.

The pound–dollar exchange rate today is £1:\$1.44, but it has been volatile over the past few months, and the company fears that it may have to pay more than the £104 000 it has budgeted for if the volatility of the exchange rate continues.

This is a critical situation for the firm, as the potential change in the asset price, in sterling terms, can make an otherwise profitable project unprofitable. What choices does the firm have ?

One option is to just wait and see; another is to use options. The firm can use foreign currency options to avoid possible negative consequences arising from the exchange rate in three months time.

Table 1 gives information for foreign currency options lasting for a three month period for a contract size of £25 000.

(Options traded on exchanges have a standard size of £25 000.)

Table 1 Financial information for call and put foreign exchange options

Exercise price, \$	Call option premium, ¢	Put option premium, ¢
1.45	10.85	1.38
1.50	7.50	5.13
1.55	4.20	7.56

The firm can hedge its foreign exchange risk by buying put options with an exercise price of \$1.50 = £1 so as to ensure a maximum payment of 150 000/1.50 = £100 000.

(The firm would buy *put* options in this case because they give the holder the right to *sell* the asset (sterling), which is what the firm will hope to do in three months for a return of US dollars.)

As the standard contract size is £25 000, the company will have to buy four options. The up-front premium payable immediately for these options is 4 × 25 000 × 5.13¢ = \$5 130, which in sterling terms is 5 130/1.44 = £3 563.

Table 2 (see overleaf) compares the outcomes of this hedging scenario with a no hedging scenario, on the assumption that exchange rates of (a) £1:\$1.58, (b) £1: \$1.42 and (c) £1: \$1.40 actually materialise on the date of payment.

It is apparent from *Table* 2 that the firm, having paid a premium of £3 563 for four put options, has assured itself a maximum asset price in sterling terms of £103 563.

This amount complies with the firm's maximum allowable price of £104 000, and it is attainable regardless of the spot market rate on the date of payment (for example in situations (b) and (c)).

If the spot market rate is more favourable than the exercise price (as in situation (a)), it is in the firm's interests to use the spot market and allow the option to lapse. In this case, the costs of a no hedge strategy are lower than those of an option-based hedging strategy. A premium of £3 563 has been paid for the latter.

However, this amount is equivalent to the premiums paid for various types of insurance in which firms or individuals are protected from excessive costs or losses if particular situations arise. By paying this premium of £3 563, the firm has assured itself a maximum asset price of £103 563, regardless of what actually happens in the market.

Table 2 Risk management opportunity with options

Actual foreign exchange rate	No hedge in place		Hedge with put option	
	Asset price in £ terms	Total cost to firm	Asset price if option exercised (up-front premium paid: £3 563)	Total cost to firm
£1:$1.58	150 000/1.58 = £94 937	£94 937	150 000/1.50 = £100 000 Decision: Cheaper to trade at spot than exercise the option, so allow option to lapse	94 937 + 3 563 = £98 500
£1:$1.42	150 000/1.42 = £105 634	£105 634	150 000/1.50 = £100 000 Decision: Cheaper to exercise the option than trade at spot, so exercise option	100 000 + 3 563 = £103 563
£1:$1.40	150 000/1.40 = £107 143	£107 143	150 000/1.50 = £100 000 Decision: Cheaper to exercise the option than trade at spot, so exercise option	100 000 + 3 563 = £103 563

Call options also protect firms from adverse movements in exchange rates (or interest rates and so on) while retaining the potential to allow the firm to benefit from any favourable movements that may materialise. Just as put options are suited to situations in which payments are made in a foreign currency, call options are appropriate when future revenues in a foreign currency are expected.

Gearing effect

Consider the following information about XYZ plc. The share price of the firm is £1.00, and the premium on its call options with an exercise price of 88p is 12p.

Expecting a *rise* in the share price of the company, a corporate investor can benefit from this situation

1. by buying the actual shares at £1.00;
2. by buying the call options at a premium of 12p;
3. by combining 1 and 2.

Table 3 shows the outcomes of the two extreme positions (1 and 2). It is based on the assumption that an investor has a maximum of £12 000 to invest, and that actual share prices materialise as (a) £1.20, (b) £0.99, and (c) £0.80.

The call option strategy as presented above allows investors to magnify potential gains when an expected, favourable change in the price of an asset actually materialises.

In case (a), in which the share price rises to £1.20 (from £1.00), an investor who has bought options with an exercise price of £0.88 at £0.12 each will generate a return of 167% on his or her investment. This return is considerably superior to the shares-based strategy, in which s/he will earn a return of only 20%.

However, with the option-based strategy, although it is capped at the cost of the options, the level of risk is also higher. If the share price actually falls, the investor makes larger losses on his or her investment than s/he would with a shares-based strategy.

(If the share price decreases, but is higher than the exercise price, the actual sterling level of loss is the same for both strategies. However, as the level of investment in the option-based strategy is smaller, the percentage loss for this strategy is higher.)

In essence, then, investors should use options in this context only when they are confident of the future direction of the prices of the asset that they are concerned with.

Put options work in much the same way as call options. They can be used to gain benefit from situations in which asset prices are expected to *fall* in much the same way as call options can be used to derive benefit from situations of rising asset prices.

Table 3 Gearing effect of options

Actual share price	Strategy 1: Buy company shares Total investment: £12 000 Number of shares: 12 000/1.00 = 12 000	Strategy 2: Buy call options Number of options: 12 000 (based on number of shares) Total investment: £12 000 × 0.12 = £1 440
Increases to £1.20		**Intrinsic value of options: 1.20 – 0.88 = 0.32**
Revenue from strategy, £	1.20 × 12 000 = 14 400	0.32 × 12 000 = 3 840
Cost of strategy, £	1.00 × 12 000 = 12 000	0.12 × 12 000 = 1 440
Gain from strategy, £	14 400 – 12 000 = 2 400	3 840 – 1 440 = 2 400
Return on investment, %	2 400 / 12 000 = 20	2 400 / 1 440 = 167
Decreases to £0.99		**Intrinsic value of options: 0.99 – 0.88 = 0.11**
Revenue from strategy, £	0.99 × 12 000 = 11 880	0.11 × 12 000 = 1 320
Cost of strategy, £	1.00 × 12 000 = 12 000	0.12 × 12 000 = 1 440
Loss from strategy, £	11 880 – 12 000 = 120	1 320 – 1 440 = 120
Loss on investment, %	120 / 12 000 = 1	120 / 1 440 = 8.3
Decreases to £0.80		**Intrinsic value of options: 0.80 – 0.88 = 0**
Revenue from strategy, £	0.80 × 12 000 = 9 600	0 × 12 000 = 0
Cost of strategy, £	1.00 × 12 000 = 12 000	0.12 × 12 000 = 1 440
Loss from strategy, £	9 600 – 12 000 = 2 400	0 – 1 440 = 1 440
Loss on investment, %	2 400 / 12 000 = 20	1 440 / 1 440 = 100

Rather than investors selling the assets themselves in response to a potential fall in price, they can buy options with the right to sell the assets (put options) at a fraction of the price.

This strategy allows them to avoid the losses associated with the potential fall in the share price, yet maintain the opportunity to profit from a rise in the asset price if it materialises.

Option pricing

So far, we have looked at the characteristics and uses of options without paying much attention to how the market value of an option can be determined.

Black and Scholes option pricing model

In the 1970s, when options were essentially new ground, two US researchers, Black and Scholes, developed a formula with which to price options. Although there have been numerous versions since, their contribution remains paramount to option pricing theory.

The Black and Scholes option pricing formula for a US call option is

$$C = SN(d_1) - Xe^{-rt}N(d_2)$$

where

C = price of a call option
S = current market price of asset
X = exercise price specified on option
r = risk-free rate of interest
e = base of natural log function
t = time in years to expiration of option
Nd_1 and Nd_2 = area under curve for a Z value of d_1 and d_2

d_1 and d_2 are calculated as

$$d_1 = [\log(S/X) + rt]/\sigma t^{1/2} + [(1/2)\sigma t^{1/2}]$$

$$d_2 = d_1 - \sigma t^{1/2}$$

where

σ = volatility (standard deviation) of the price of the asset

The corresponding values are then looked up in the area under the curve table to determine the Nd_1 and Nd_2 values.

The value of a put option with the same exercise price and expiry date as a corresponding call option is calculated as

$$P = C + X(1 + r)^{-t} - S$$

where

P = price of a put option

The mathematical derivation of the Black and Scholes option pricing formulae is beyond the scope of this paper, but the rest of this section considers the five variables that influence the market value of an option.

Market value of an option

First, the intrinsic value of an option, that is, the value if the option were to be exercised now, will influence the market value of the option. As explained above, this value is itself dependent upon the price of the asset and the exercise price specified in the option.

For call options, the higher the share price is, the higher is the intrinsic value and consequently the higher is the market value of the call option. The opposite is true for the exercise price.

It is apparent that the intrinsic value of the option is based on the notion that the option will be exercised now. If the option were exercised at maturity, we would be concerned with the exercise price of the asset at maturity.

To determine the intrinsic value in this instance, we would discount this future exercise price to quote it in present value terms. The risk-free rate of interest is therefore a relevant variable in the valuation. The higher the rate of discount is, the smaller is the exercise price and consequently the higher is the market value of the call option.

The time to expiration of the option and the volatility of the price of the asset (that is, the standard deviation) are also relevant variables. A longer time period to maturity and high volatility of the asset price increase the chance that the price of the asset at expiration will be high.

Table 4 Factors that affect the market value of options

Variable	Call options market value	Put options market value
Asset price ↑	↑	↓
Exercise price ↑	↓	↑
Risk-free rate of return ↑	↑	↓
Time to expiration ↑	↑	↑
Asset price volatility ↑	↑	↑

(While there is an equal chance that the price of the asset will be low, we are not concerned with this situation because in this case the option will be allowed to lapse and its intrinsic value will be 0.)

As mentioned above, the higher the price of the asset is, the higher is the market value of the call option.

Table 4 summarises the effects of changes in the variables that may affect the value of a call option. The situation for a put option is converse, because in this instance the higher the asset price is, the lower is the intrinsic value of the option and consequently the lower is the market value of the option.

In recent years, option pricing theory has been applied to other areas of finance such as the valuation of debt and equity and corporate investment decisions.

When making investment decisions, managers are often confronted with choices about, for instance, whether to expand production capacity, or abandon or postpone a project once it is underway.

These situations are similar to options in that managers have the flexibility and choice to undertake (or not) each of the options depending on their ability to create value, and the level of value generated can be determined on the basis of new information that becomes available as the project goes on.

Conclusions

Financial options, which are available as put and call options in financial markets, are characterised by opportunities to protect firms and investors from adverse movements in future asset prices without the possibility of potential gains being forgone.

At the same time, if financial investors can accurately forecast the future direction of asset price changes, they too can benefit from options, as these instruments increase the level of returns from asset price changes.

Option pricing models developed by financiers such as Black and Scholes determine the market value of options. These models have since been applied to other areas of finance, and have proven to be a useful framework for the analysis of strategic decisions such as investment decisions and debt and equity valuation.

Further reading

- ***Finance***

  Bodie, Z and Merton, R (2000)
  Prentice Hall

  A US work that reviews options, their uses, and pricing.

- ***Investment Appraisal and Financial Decisions***

  Lumby, S and Jones, C (1998)
  Chapman and Hall, 6th edn.

  A basic review of options.

- **'Applications of option pricing theory : twenty five years later'**

  Merton, R *American Economic Review* (1998) pp 323–349

  An excellent review of the applications of option pricing, particularly to corporate investment decisions.

Leadership : what's the big deal ?

This article focuses on why organisations need leaders. It considers employees' psychological need for leadership, and the necessity for someone to define tasks and set boundaries. The context of the leader within an organisation, interaction with stakeholder groups, and the need to manage relationships sensitively in a political environment are also discussed. The article finally considers the role of the leader as a figurehead in the organisation.

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How would you describe your 'fantasy leader' ? Does he or she sort out everything for everyone, or does s/he adopt a more hands-off, encouraging from afar, role ? Even from that distance, does he or she know the precise moment when you need his or her help, encouragement or advice ?

Is the leader completely unbiased, fair and wise ? Can he or she see into the future, know at all times what the competition is doing and make sound business decisions accordingly ?

Is the leader your dad, your granddad, your mother, your grandmother, your best friend, your confidante and your mentor all rolled up into one ?

If you think other people might be expecting all this of *you*, do you get the heebie-jeebies, pass the buck to someone else, and say 'you be the leader now !'.

In my work as a consultant, when I pose the question 'what's wrong around here ?', 'lack of leadership' consistently vies for one of the top three responses. Often, the further up the organisation's hierarchy I am working, the more frequently the complaint is voiced. Senior managers seem just as prone as more junior managers within the company to making statements such as the following :

- 'We don't know what direction to go in.'
- 'I'm unclear as to what my priorities should be.'
- 'Whose opinions should we listen to, the board's, or the shareholders', or the City analysts' ?'

Even CEOs invariably complain about the need for real leadership from the board to help them to weigh up City analysts' views against operational realities so that they can exercise their leadership imperative.

In the end, does leadership really matter, or is it just the person who voices his or her opinion most loudly who decrees organisational direction and priorities ?

More has been written about leadership than almost any other management or organisational behaviour topic. However, the questions about the essence of what it is, whether it is in-born or developmental, and how to make it more effective, are all left without definitive answers.

Instead of adding yet more verbiage to the elusive question of definitions, or how aspirants might enhance their own style and its effectiveness, this article considers what leadership might be *for*, and why it is so important to us as human beings.

Leadership fulfils a multitude of human needs, and this contribution examines three of them :

- the psychological;
- the political;
- the symbolic.

The psychological need for leadership

The complaint about lack of leadership is often couched in terms of direction setting, that is, because of lack of leadership, individuals do not know how to order their priorities. A little probing often reveals that the issue is more deeply rooted than that, and that there is a longing for a clarity around boundaries of both an organisational and personal nature.

The request for direction is often a call for limit setting in terms of what the organisation is, and what it is *not*. Psychologically, leadership is needed to articulate the boundary between the organisation and 'other'. This discrimination is vital if people within an organisation are to feel safe enough make appropriate decisions.

Such boundaries are important if any creative endeavour is to flourish. That might sound strange, as much 'creativity training' focuses on 'boundaryless thinking' or 'blue-sky dreaming'. However, the tension introduced by the pull between the boundary and what is beyond it produces the most fertile environment for creative work.

Individuals need to know what is *not* feasible, permissible, or do-able, and use their knowledge of this limit as a spring-board from which to develop novel approaches and solutions.

The leader's role is critical in establishing and holding the boundary so that creative work can take place.

Holding boundaries is also critical in the realm of decision making. Most people argue that effective leadership is about making important decisions. In fact, the fear of having to make decisions on issues about which they know little or nothing is often what makes people shy away from the leadership role.

However, although there are times when the leader has to make a decision on his or her own, the best decisions (or at least those which have a higher rate of implementation) involve groups of people, all with their own unique insight into the particular dilemma.

Group decision making requires the leader to 'hold' a space in which different viewpoints and suggestions can be aired and discussed safely in an enquiring way. Decisions often emerge spontaneously when a group of people are able to review all the information that they have available to them collectively when deciding between options. The leader's role, then, is to ensure that all the information is available, and facilitate the ensuing conversation.

Boundary setting is vital if employees and subordinates are to feel safe at the personal level as well as the organisational level. On a day-to-day basis, the leader must act as a container for many unpleasant emotions which arise in the normal course of organisational life.

It is important for leaders to remember that they do not need to have all the answers, but that subordinates will feel psychologically more secure if the leader is able to 'hold' a discussion about the pain of redundancy, the unfairness of organisational restructuring, or more personal bereavements or life crises.

This calls for a great deal of emotional maturity on the part of the leader. Much has been written recently about the notion of emotional intelligence, and this capacity to contain, share, and express emotions appropriately is a key element of the psychological function that leaders fulfil.

Psychologically, the role of the leader can be a fraught one. The role, as distinct from the personality in the role, carries masses of psychological baggage for those who are led, as suggested by the above discussion about one's fantasy leader. Subordinates inevitably have largely unconscious fantasies about the power and proclivities of the leader, and those in the role can be caught in the midst of dynamics for which they are not personally responsible.

For example, followers may unconsciously transfer unresolved issues with their father, or their school headmaster or mistress on to you, solely because of the position of power you are in. This can lead them to rail against you and test your leadership (particularly when under stress), because that is their unconscious way of dealing with authority.

Others (particularly those working within an organisational culture that encourages dependency) unconsciously believe you are responsible for 'taking care' of everything, and if you do not do this, they can become irrationally angry or resentful of you. The anger or resentment is seldom expressed in a straightforward manner, but it may leak out in the form of substandard work, missed deadlines, or other unhelpful behaviours.

These psychological needs of leadership are increasingly complicated by new styles of organisation structure, such as matrix management or working in project management teams, in which the leader often has more responsibility than authority.

In these cases, establishing some sort of boundary, by either insisting on weekly team meetings or creating some way of establishing your team as a unique unit, can be crucial in providing for this psychological need.

The political need for leadership, reading and working the context

Leadership does not exist within a vacuum. This is the essence of situational leadership models.

The same kind of leadership style will not work equally well on all occasions; the leader has to understand as much about the followers and the context in which they operate as possible. Beyond effective leadership as a function of responding to the immediate needs of subordinates, however, the leader needs to fulfil a broader, more political function.

Some leaders think they are doing their firm a favour by not engaging in political behaviour. They believe that they achieve more for the business by keeping their head down and 'getting the job done'.

Certainly each organisational context is different, and the culture will determine what level of political behaviour is appropriate. However, even in the least 'political' of firms, one of the key roles of the leader, at whatever level of the organisation he or she is operating, is to develop the kind of political savvy that will enable the leader to steer his or her unit through the clashes of values and differing perspectives that are endemic to organisational life.

Unless the leader develops a sense of the unspoken values, bases of power and web of relationships in the organisation, he or she runs the risk of being overlooked and under-resourced, which will affect not only the leader but the team.

Acting politically can be a key factor in establishing the type of boundary that a team or unit needs within an organisation. It requires the leader to have a good appreciation of the linkages and motivations of those above him or her in the hierarchy and the leader's peers across the organisation, so that the leader can carve out the space and time that his or her unit or team will need in order to flourish.

The teams that find themselves most over-stretched and pressurised are often not those who work for the most overtly political leaders, but those who are the most innocent in political matters.

I am not advocating back-stabbing or covert behaviour. I am suggesting that there is a wise way of working politically that entails honing skills of 'reading' what is going on in the organisation, and having a proclivity to search for win–win outcomes.

This kind of political behaviour strives to see the bigger picture affecting organisational dynamics. Its aim is to uncover common ground between divided parts of the organisation, and remind factions of the larger goals that need to be served, rather than cater to a single group of stakeholders.

To enhance their political leadership, leaders must pay attention to a range of factors operating both inside and outside the organisation. The following are examples :

- What is your own power base ? What are the power bases of your superiors, subordinates and peers ?
- What are the spoken and unspoken agendas of these people ?
- What professional and personal alliances exist ?
- What stakeholder groups, internal to and outside of the organisation, have power ? How is it exercised ?
- What is the history of the organisation ? (For instance, why is it that when you mention accounts from 1987 everyone breathes in sharply ?)
- Why have you been hired, to do what job, from both rational and irrational perspectives ? (For example, from a rational perspective, your job description might look as if you have been hired to 'manage an organisational change process', but from an irrational perspective, you might seem to have been hired to be a scapegoat for an organisation that is failing.)

There are many more dynamics to consider, but these are good starting points for reading the organisation politically.

The symbolic need for leadership

The symbolic need for leadership goes beyond the emotional or political into something deeper. It is a function of the more primitive or instinctual need that humans experience around power and authority.

One of the key ways in which this is expressed is through the 'figurehead' function. As figurehead, the leader holds the representation of the organisation to both the internal and external world.

This is perhaps one of the reasons why Glen Hoddle ran into so much difficulty for expressing the views he held; they were just not congruent with his figurehead role as manager of the England football team.

The symbolic nature of Mrs Thatcher's leadership lives on. It had such significance that the tenth anniversary of her downfall was widely noted in the autumn of 2000.

Certainly the structural readjustment which occurred under her leadership continues to affect us today, even though she no longer leads the country.

Organisations can often hear the echoes of previous leaders long after they are gone, and their mythology and opinions can still affect organisational machinations, occasionally aiding the organisation, but more often constraining it from being able to move on.

The symbolic role of the leader is often used instrumentally in times of engineered organisational change. Board members realise that, in order for the company to be seen to be serious about 'change', the old leader must go.

The new leader has a unique opportunity to make highly symbolic gestures about his or her reign in the early weeks of taking on the role.

The apocryphal story of John Harvey Jones signalling his intention to change the ICI culture radically by wearing wild ties to work was one example of this phenomenon.

Sometimes leaders are surprised by the extent to which their behaviours are analysed and interpreted by followers.

This is because of the highly symbolic nature of the role. Subordinates will often read unintended meanings into the wording of memos, the way a leader dresses, and his or her start and leaving times.

'Management by walking about' and visits by the boss are important because of the symbolic meaning they carry ('s/he cares about us and what we're doing').

Leadership : a big deal after all ?

At its best, leadership enables the creativity and expressiveness of the human spirit to flourish within a social context. It is a living construction, a need humans share with many of their animal cousins, and it is probably at its source just as instinctive a drive.

Its importance at work is that the leader represents that which is human in organisations. At a recent talk I attended, the American writer Wendell Berry reminded me of the difference between corporations and people :

> *Corporations do not have hearts and souls. They do not feel pain when employees are made redundant, or when customers are hurt by the products they produce. They do not have a conscience … They cannot feel, they have no empathy.*

I would continue by suggesting that the humans working for companies have these capacities. The implication for leaders in organisations is that they have a responsibility to embody and enact these human qualities if organisations are to have any ethical or humane basis of action.

So, what is the big deal ? The big deal is about the difference leadership can make. Its quality and atunedness to the unique needs that it satisfies can make the difference between organisations that protect and enhance the human spirit at work, and those that frustrate, belittle or harm our human potential and possibilities.

Further reading

- **'Owl, fox, donkey, sheep : political skills for managers'**

  Baddeley, S and James, K *Management Education and Development* Vol 18 No 1 (1987) pp 3–19

  A clearly written and succinct model for developing 'wise' political behaviour; demonstrates that there is clearly a way to be political without selling your soul.

- ***Emotional Intelligence***

  Goleman, D P (1996) Bloomsbury

  The book that kicked off the whole emotional intelligence' idea; an extremely useful read for those struggling with the idea that leaders need to know anything about emotions and how to handle them !

- ***The Tao of Leadership***

  Heider, J (1992) Wildwood House

  Presents 81 *succinct lessons about leadership, with the* Tao Te Ching *as its inspiration* : e*asy to read and assimilate, and a lovely book to have around for inspiration and thoughts beyond 'have vision'.*

NEW ...

MQOnline

In response to the very positive feedback we have received from the membership about *Management Quarterly*, the Faculty has launched a new initiative : *MQOnline*.

MQOnline is a web-based series of streamed multimedia lectures that cover and expand upon the subjects addressed in the *Management Quarterly* journal. These 20–30 minute lectures can be accessed via the Faculty website.

MQOnline has been live since September, and it commenced with a series of finance lectures covering aspects of the cost of capital and shareholder value. The next set of lectures, covering the marketing syllabus, is currently being finalised, and should be available shortly.

Please try *MQOnline* and tell us what you think. Comments should be addressed to Chris Jackson at chris.jackson@icaew.co.uk.

The Faculty of Finance and Management

The Institute of Chartered Accountants in England & Wales

OUTLINE SYLLABUS

Management Quarterly is designed to be a three-year endeavour, setting out key management techniques in core disciplines. Over that time, it is expected that the content may develop and change. However, here we set out the current anticipated syllabus for the journal.

Strategy

What is strategy ? ✔ *Part* 1, *October* 1998

What does corporate HQ do ? ✔ *Part* 2, *January* 1999

Strategic alliances ✔ *Part* 3, *April* 1999

Competitive strategy ✔ *Part* 4, *July* 1999

Strategic analysis tools – the external environment ✔ *Part* 5, *October* 1999

Strategic analysis – assessing internal resources ✔ *Part* 6, *January* 2000

Assessing internal capabilities ✔ *Part* 7, *April* 2000

Strategic choice ✔ *Part* 8, *July* 2000

Strategic decision making ✔ *Part* 9, *October* 2000

Strategic change ✔ *Part* 10, *January* 2001

Globalisation ✔ *Part* 11, *April* 2001

The future of strategy

Human resources management

Introduction to people management ✔ *Part* 1, *October* 1998

Changing roles and responsibilities ✔ *Part* 2, *January* 1999

Strategic HRM and the management of change ✔ *Part* 3, *April* 1999

Performance management: motivating and monitoring ✔ *Part* 5, *October* 1999

Developing the organisation ✔ *Part* 6, *January* 2000

Personal development and people management competencies ✔ *Part* 7, *April* 2000

Dealing with conflict ✔ *Part* 8, *July* 2000

The role of trade unions and collective representation ✔ *Part* 9, *October* 2000

The European Union and social policy ✔ *Part* 10, *January* 2001

International HRM ✔ *Part* 11, *April* 2001

Ethics and corporate governance

Marketing

Marketing in today's world ✔ *Part* 1, *October* 1998

Marketing planning ✔ *Part* 2, *January* 1999

Understanding customers – the consumer ✔ *Part* 3, *April* 1999

Understanding customers – the organisation ✔ *Part* 4, *July* 1999

Relationship marketing ✔ *Part* 5, *October* 1999

Market research and information technology ✔ *Part* 6, *January* 2000

Market segmentation and positioning ✔ *Part* 7, *April* 2000

Analytical tools for marketing ✔ *Part* 8, *July* 2000

Managing the marketing mix 1 ✔ *Part* 9, *October* 2000

Managing the marketing mix 2 ✔ *Part* 10, *January* 2001

Key account management ✔ *Part* 11, *April* 2001

Branding and international marketing

OUTLINE SYLLABUS – *Continued*

Finance

Planning and reporting ✔ *Part* 1, *October* 1998

Operating and business systems ✔ *Part* 2, *January* 1999

Interest and discounted cash flow ✔ *Part* 3, *April* 1999

The cost of equity ✔ *Part* 4, *July* 1999

The cost of capital ✔ *Part* 5, *October* 1999

Shareholder value ✔ *Part* 6, *January* 2000

Valuation of companies ✔ *Part* 7, *April* 2000

Financial instruments ✔ *Part* 8, *July* 2000

International finance ✔ *Part* 9, *October* 2000

Strategic issues in acquisitions ✔ *Part* 10, *January* 2001

Options ✔ *Part* 11, *April* 2001

Venture capital

Articles are being commissioned to cover a range of other management topics. Further material on people management that concentrates on the individual rather than the organisation is also included.

Copies of the journal articles referred to can generally be obtained through the Institute library. A charge is made for these articles, based on the number of pages to be copied.

IN THE NEXT ISSUE ...

Strategy *The future of strategy*

The strategy series has covered many strategic models. This article looks at current research to see what strategists may be recommending in the future. It also discusses resource-based theory and other models.

Human Resources Management *Ethics and corporate governance*

The importance of ethical and governance issues is growing in corporate life. This contribution examines why this is, and goes on to discuss the impact of these issues on business and how they may develop in the future.

Marketing *Branding and international marketing*

Various types of brand are discussed, for example for products and services and the business-to-business and corporate sectors. The article considers how brand loyalty is built. It then reviews the implications of managing a brand in an international market.

Finance *Venture capital*

The nature of the venture capital industry is discussed, and the way in which deals are structured is explained. The contribution focuses on how management buyouts and buy-ins work, and other types of deal are also covered.

Systems *Knowledge management*

Knowledge management can make a significant contribution to business success if it is made relevant to people and their ‘day job’. This article looks at how managers can use business processes as a basis for managing knowledge.

MANAGEMENT QUARTERLY

Management Quarterly aims to deliver the basic building blocks in core management disciplines. It is produced in association with Cranfield School of Management. Each issue will usually contain articles on strategy, human resources, marketing and finance, with other occasional subjects such as project management and knowledge management. Over a three-year period this will build up to a comprehensive overview of practical business knowledge, and modern management ideas.

Management Quarterly will provide a comprehensive grounding in the knowledge needed to operate a successful business. It will enable the reader to understand current issues and debates in these areas, and distinguish core ideas from current fads. A wide ranging programme of CPE will be provided that will be suitable for members both in business and advising businesses.

Each part of *Management Quarterly* will be self-standing and include recommended further reading. Writers are selected from Cranfield School of Management and other leading business schools. Experts in each field explain and discuss the relevance, practicality and usefulness of key new concepts and ideas, thus enabling the senior executive to keep really up to date. A message board is available on the faculty Internet site. Chartered accountants often have limited reading time. *Management Quarterly* is succinct and the writers will direct the reader to other, and often fuller, expositions on the subject. The programme is no substitute for an MBA but it will follow some of the major threads on an MBA.

Management Quarterly will act as an aide-memoire for members, provide new ideas, and encourage good practice, but the Faculty cannot accept responsibility for the accuracy or completeness of issues of *Management Quarterly*. Being general in nature, the points made in *Management Quarterly* may or may not be relevant to specific circum-stances. Responses from the membership will be a very important part of the successful development of the series. Comments please, to Chris Jackson on 020 7920 8486 (or by e-mail to chris.jackson@icaew.co.uk).

Management Quarterly is compiled and edited by Ruth Bender, who joined Cranfield School of Management as a lecturer in 1994, having completed her MBA there. Prior to this, she was a corporate finance partner in Grant Thornton. Ruth is a member of the Faculty committee. The executive editor is Chris Jackson.

Feedback

Comments and suggestions should be addressed to Chris Jackson BA FCA, Head of Faculty, telephone 020 7920 8486, e-mail chris.jackson@icaew.co.uk, or write to the Faculty at the address below.

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Faculty members

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

Parts of *Management Quarterly* published to date are :

Part 1 :	October 1998	Part 7 :	April 2000
Part 2 :	January 1999	Part 8 :	July 2000
Part 3 :	April 1999	Part 9 :	October 2000
Part 4 :	July 1999	Part 10 :	January 2001
Part 5 :	October 1999	Part 11 :	April 2001
Part 6 :	January 2000		

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

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