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From value chain to value net

Ian Turner, p 12

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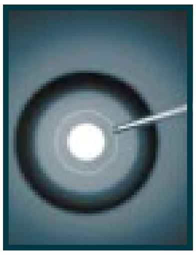
Fluid marketing organisations

To cope with the increasing fluidity and pace of modern business, marketing functions are undergoing radical change. Simplified structural and reporting lines and the use of temporary marketing teams are advocated to encourage a more entrepreneurial or venture-oriented approach. This helps firms to interface with the new kinds of intermediary business now found on the Internet. Strategies such as bundling are identified to help businesses adapt to the downward pressures on prices resulting from increasing amounts of market information and transparency.



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Iansiti[1] wrote the following about Internet-based new product development:

> *When new competitors and technologies are likely to appear overnight, when standards and regulations are in flux, when a company's entire customer-base can easily switch to other suppliers, businesses don't need a development process that resists change – they need one that embraces it.*

This article focuses on change in the marketing organisation. Homburg, Workman and Jensen[2] have highlighted the need to question traditional structures and reinforce a customer-focused approach.

The stance of Aufreiter, Lawver and Lun[3] has been more radical, concentrating on the need for a flexible approach to marketing in 'fluid organisations', where the approach of market leaders is akin to that of venture capitalists, emphasising speed, decision making and evaluation.

Inevitably, the Internet has had a huge impact on the marketing environment. With this in mind, Mahadeven[4] has examined a number of popular propositions which have emerged from successful e-businesses, and then developed a research-based framework or business model to help practising managers to understand and succeed on the Internet.

Finally, the article considers some of the suggestions outlined by de Figueiredo[5] for supporting profitable e-commerce, with a particular emphasis on customers and the products that they are prepared to buy from e-businesses.

Customer-focused organisation

Marketing has traditionally been organised hierarchically, for example by brand or product in consumer markets, by channel and customer segment, or by market research and product development. A more integrative and team approach has been used in recent years, but much of this hierarchical structure remains.

There is growing debate about the changing nature of marketing, and how businesses can best be organised so that they meet the needs of their customers. Many writers have commented on these changes, but in fact much of the research is not based on thorough research.

One exception, though, is the work of Homburg, Workman and Jensen[2], who conducted an in-depth study of the changes. They attempted to uncover the emergent marketing structures, and identified a number of key changes and considered how to implement them.

First, they argued, key account managers have become much more important. Senior managers are becoming more involved in the coordination of marketing for specific customers or segments, and multifunctional teams need to serve international customers.

Second, the role of country managers is decreasing as resources are moved to regional or international coverage. Product managers have traditionally had a prominent role in managing the whole range of marketing activities for their brand or product and its overall business performance. However, this role also seems to be declining, particularly in the consumer goods sector, because of relationship marketing and, in particular, the rise of key account management. However, in the business-to-business and services sectors, many still see product management as important and 'legitimate'.

As integration and multifunctional team working increases, a growing number of marketing activities take place outside the traditional marketing department.

Homburg, Workman and Jensen referred to this as the dispersion of marketing activities. Marketing activities, they said, move not only to new organisational departments, but also to temporary teams directed by project managers, or they shift to permanent cross-functional teams that may be responsible for processes such as customer service.

Interestingly, they comment on the customer-focused organisational approach, which 'uses groups of customers related by industry, application, usage situation ... as the basis for structuring the organisation'. In contrast to developing a market orientation, which looks mostly at culture and processes, the customer-focused organisation concentrates on the structural elements of organisations.

While marketing has always focused on customer primacy, the authors suggest, only recently have many organisations attempted to create a structure that 'is motivated by the need to come closer to the problems that the customer is trying to solve'.

A fluid marketing approach

Clearly, the authors suggest, to move from a product-focused structure to a customer-facing structure, firms must go through a number of internal reorganisations.

This is not the case, wrote Aufreiter, Lawver and Lun[3], whose more radical approach emphasised the need to be 'fluid' and to keep pace with the market's constant evolution. 'New style marketing groups', they stated, 'understand that formal structures can't drive value in fast moving environments'.

In fact, to keep in touch with market changes, the dynamic marketing organisations, which the authors refer to as venture marketing organisations (VMOs), still have brand channel responsibilities. However, 'the number of the managers, the scope of their responsibilities and the people to whom they report evolve constantly to reflect changing opportunities'.

Dell, First USA (the credit card company) and Starbucks are all, the authors explained, examples of organisations that have adopted this philosophy.

The qualities that the authors admired included the following :

- a restriction on the number of fixed reporting lines, which are replaced through the creation of new posts for specific circumstances that are then removed when the market needs change;
- a team approach to the management of market opportunities, in which the teams, or 'resource pools', are constantly transformed;
- organisational change that is regarded as the norm, and is not disruptive, which is the accepted way of taking advantage of new market opportunities;
- the provision of incentives and rewards to staff for being alert to the needs of customers and identifying business opportunities;
- team leaders who are not necessarily functional experts, and who may be short-term recruits with specialist skills.

Organisations, the authors suggested, need to embrace these qualities, and this requires there to be three key stipulations :

- Everyone at the organisation should be constantly open to new ideas, regardless of their role. It is of course ideas that help the business to create superior customer value.
- Speed is of the essence. New ideas need to be filtered and clear decisions made. Old and cumbersome product management approaches need to be avoided. The positive outcome of this is that 'the processes support entrepreneurialism by ensuring that anyone who generates an idea gets the freedom and the resources to pursue it or the clear feedback about why it has been denied'.
- VMOs should base their recruitment on roles, not specific, permanent jobs. They should look for integrators, that is, people who can coordinate ideas from conception to commercialisation, and specialists, who can be moved from team to team as and when their skills are needed.

The VMOs must, though, combine fluidity with

- performance management accountability;
- clear decision making;
- measurement of the results.

Fluidity does not, of course, necessarily mean confusion or chaos. In addition, individuals and teams can be measured against specific performance targets as long as the expectations are clear.

New business models

New business models and marketing approaches for marketing on the Internet need to be considered.

Mahadeven[4] considered three levels of the Internet economy :

- *portals* (for example Yahoo.com and Askjeeves.com), which act as channels and conduits for all kinds of product, finance, and information flows between suppliers and intermediaries;
- *emerging market makers* (for example eBay.com and Priceline.com), which are similar to portals in that they facilitate transactions, but add value as knowledgeable intermediaries that provide guarantees, and are also concerned to develop trust in the transaction and security in financial exchanges (there are tremendous opportunities for market makers in the business-to-business markets, where there is 'greater scope for reducing product search costs and transactions costs');
- *product and service providers* (for example Landsend.com and Dell Online), which are able to interact with and service customers directly in both the consumer and business markets.

Mahadeven also identified three important processes, or streams, to consider when developing e-business models :

- values;
- logistics;
- revenue.

Initially, those moving into the online business world need to consider a number of sources of added value.

This value can come from online communities, which, as discussed in previous articles in this series, provide a forum for people with common interests to exchange information.

The online knowledge developed is difficult for competitors to replicate, and it helps stop contributors switching.

Transaction costs are also reduced as 'the electronic market place is an inter-organizational information system', where the search costs for information about products and prices are minimised.

Where there is asymmetry of information, the buyers and the sellers do not have equal and exhaustive information, and may not find each other in the marketplace. However, the organisation can create value by bridging the gap in information and bringing the two parties together.

In logistics, the Internet has brought disintermediation, which provides, for some, a closeness to the customer that has perhaps been missing in the past. It also brings a reduction in supply chain and transaction costs.

Has the Internet economy signalled the end of intermediaries, as some imagined it would ?

Mahadeven did not think so. He argued that it has merely brought about the creation of a new type of intermediary.

For example, some intermediaries are infomedians, gathering, storing and disseminating information to those customers unable to collect it themselves.

Metamediation is the third option to be considered. This is more evident in business-to-business markets, where businesses go beyond the role of intermediary, and provide additional services. They thus reduce the buyers' costs of searching and product comparison.

It is the revenues that are the result of this investment, including some that are not available to traditional offline businesses.

Mahadeven noted several revenue streams :

- margins that are larger than those of traditional businesses;
- revenues from on-line communities;
- advertising;
- revenue generated through variable pricing approaches;
- information asymmetry;
- free services and offerings that direct customers to other lucrative sources of income from suppliers, portals and market makers.

The dot.com continuum

de Figueiredo, in his article on the profitability of e-commerce[5], stated that 'on the Web all goods are not equal,' and it is the organisations that have a clear tie-in with market segments that will succeed in the long run. He spoke of a 'dot.com continuum', on which products can be placed.

At one end of the continuum, there are commodity products whose quality is easy to judge, and at the other there are 'look and feel' goods that are more difficult to gauge or evaluate at a distance or on the Web. He defined look and feel goods such as art or used cars where the quality of the product is difficult to measure and where consumer perceptions vary.

This approach is similar to the one proposed by Lynn Shostack in 1977 to help managers understand the marketing of services, which looked at services on a spectrum from tangible goods to intangible services. The dot.com continuum is used to highlight the appropriate strategies for maximising opportunities online and for developing competitive advantage.

Thus, for 'commodity' products, which are relatively easy for the customer to assess and whose 'quality can be easily determined by their description,' de Figueiredo suggested a low-cost strategy. The dot.com company can then take advantage of economies of scale, low-cost production, cost-effective distribution and lower overheads.

Further along the continuum, he suggested a two-step strategy to match the consumers' appetite for 'quasi-commodity' products. The consumer, he said, will look for books, CDs, videos, toys and new cars in much the same way. For example, he suggested that, when looking for books, consumers will first identify the title from those available before assessing the price and the credibility of the dot.com retailer.

The strategy suggested was one of differentiation in the first instance (where the retailer could differentiate on service), to develop the brand, and to use database and data-mining techniques and develop a 'sticky' website that encourages customers to prolong their visit. This should be followed by a combination of low-cost and differentiation strategies in the management of costs, supplier relationships coupled with loyalty programmes, and additional customer support services.

At the extreme of the continuum, where the products are look and feel with variable quality dimensions, the strategy should be one of customisation.

For this category, de Figueiredo stated the following :

> *These are products where, even if the buyer has completed her search, knows the product, and recognises the brand, she will still need to see and perhaps touch and feel the individual product that will be delivered to her home or business.*

In customising and reducing the uncertainty that the buyer may experience, the dot.com company could, for example,

- use webcam technology to show the product in its best light;
- develop competence in 'made to measure' approaches;
- build confidence by being reliable and developing its reputation.

Building on this framework, the author then explained the success and failure of traditional retailers' ventures into the online marketplace. He suggested that the barriers to entry increase from the commodities to look and feel goods.

However, he suggested that this should not be a deterrent, as those organisations that are successful in developing these segments will flourish, leaving behind the competitive melée in the commodity markets.

Whether an organisation is operating in traditional markets or as an online business, it is clear that marketing structures and organisations need to be fluid. They certainly need to be able to move with the fluctuating needs of consumers.

Iansiti concluded the following[1] :

> *In today's turbulent business environments, more and more companies need a development process that embraces change – not one that resists it.*

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Managing emotions and moods

Management is not a completely rational process. It is affected by emotions and moods. A number of studies are reviewed that analyse the way in which feelings influence staff behaviour in various settings. For example, major organisational changes can initially invoke strong negative feelings until people learn to cope more positively with the new situation. Various methods of coping behaviour can be identified and understood. Other research indicates how types of emotion and mood can influence team behaviour, the conduct of appraisals, and the success of anti-discrimination policies.

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Practitioners and researchers alike have traditionally ignored or misunderstood the importance of feelings and emotions in management. Managers are more inclined to emphasise rational or intellectual processes.

However, recent research has shed light on the importance of moods and emotions in managing individuals, teams and organisations.

Both moods and emotions are types of 'affect', but they differ in important ways. Emotions, for example, are relatively brief reactions to a particular event or person. They can be characterised by their degree of pleasantness (from positive to negative) and level of arousal (in terms of intensity). Moods, by comparison, lack an object focus but are longer lasting.

The consequences of these moods and emotions may be significant in areas such as leadership, performance appraisal, coping with change, and group performance.

Managers may find it useful to develop strategies to address the emotional environment within their organisations effectively.

The role of emotion during organisational transformations

Mossholder *et al.*[1] found that the emotions of senior managers in a large organisation undergoing major change had an impact on both their personal evaluation of the transformation and their attitude to their jobs.

Organisations need to have a greater understanding of the role that emotion may play during such a period of change.

For example, a manager's level of emotional intensity or arousal increased the effects of positive or negative feelings. Those with negative feelings and a high level of arousal expressed, unsurprisingly, a significantly higher intention to leave the organisation.

In contrast, when managers were not emotionally aroused about key transformation events, their positive or negative emotional reactions were not as strongly related to evaluations of changes or to job attitudes.

Businesses, then, need to foster a culture that embraces and promotes change, or at least minimises resistance to it. Negative emotions are, of course, more likely to arise when change is forcefully imposed, or when it deflates an individual's sense of self, than when the process is self-initiated or incremental.

Those leading organisational change need to focus on communicating the benefits of the proposed transformation. By motivating individuals, and enabling them to view the emotional effect of the transformation process as positive, they will have a greater chance of avoiding an exodus of disillusioned talent.

This is easier said than done, given the fairly natural tendency of many to view change in a negative light.

Mossholder *et al.* argued that when heightened arousal is combined with a less than positive view of the transformation, strong resentment and resistance to change can ensue.

Furthermore, since emotion is an indicator of the acceptance of change, organisations should consider including measures of emotion alongside other 'softer' measures, such as performance ratings, work-related attitudes and perceptions. It should also be included alongside 'hard' measures such as sales or profitability when its impact is measured.

Emotions and the process of coping

'Coping' is the process of individuals seeking to manage internal or external demands that tax their resources. It has two major aspects :

- problem-focused coping, which seeks to manage the problem itself;
- emotion-focused coping, which seeks to regulate the individual's emotions or distress.

Scheck and Kinicki[2] researched the process of selecting coping strategies during an organisational acquisition. They identified two problem-focused (P) coping strategies and four emotion-focused (E) coping strategies :

- confrontive coping (P);
- planned-for problem solving (P);
- wishful thinking/distancing (E);
- emphasising the positive (E);
- self-blame (E);
- tension reduction/self-isolation (E).

Emotion, they stated, plays a key role in how an acquisition is viewed and in how coping strategies are chosen. For example, problem-focused coping strategies are less likely to be used when events are seen as harmful or threatening.

By contrast, negative appraisals were significantly associated with negative emotions, and the latter increased the use of emotion-focused coping strategies.

For example, when the acquisition became a reality, individuals began to see what they could do to make the best of the situation (that is, emphasising the positive), or they used various means of reducing tension, such as isolating themselves.

Several factors relating to an acquisition were viewed as threatening or harmful :

- lower perceived control by the individual over his or her life;
- decreased self-efficacy in terms of the individual's perceived ability to control a specific, threatening situation;
- more instability within the working environment.

Social support (the network of individuals and groups that an individual turns to on a regular basis or in time of need) is another factor that has an impact on the selection of coping strategies. Social support can be a significant resource that helps individuals to cope with stressful conditions and encourages the use of problem-focused strategies.

A social support network can, though, prevent an individual from thinking positively about an acquisition, and it can be linked to wishful thinking/distancing and self-blame.

Managers therefore need to take positive steps to reduce the negative emotions associated with change. In particular, they need to

- implement a communications programme that continuously and proactively updates employees on the changes in process (this should also provide timely and credible information throughout the transition);
- focus on increasing employees' perceived control, confidence and self-efficacy in relation to handling the changes associated with the transition.

The best managers probably know this instinctively. Nevertheless, it is useful to have it confirmed by research.

Do moods influence performance ratings ?

For a performance management system to be effective, staff must view the conduct of appraisals as a fair and equitable process. The competence of managers is a critical factor in this. Organisations have sought to develop the skills of their appraisers.

What influence could the moods of appraisers have on their assessments ? Fried *et al.*[3] investigated the impact of negative and positive mood predispositions of raters responsible for reviewing others in organisations.

They found that negative mood predispositions played a key role in performance ratings, and that the greater the negative affectivity of the rater was, the lower were the average ratings.

However, the reverse was not true : positive mood predisposition was unrelated to performance ratings. Catching the reviewer in a good mood did not necessarily result in a more favourable appraisal.

The implications for the selection and training of appraisers and the design of the performance management process are significant.

Organisations need to increase managers' awareness of the potential influence of mood predisposition on their ratings, and perhaps introduce some way of measuring negative affectivity.

They may also want to consider extreme mood predisposition as a factor in selecting appraisers. In addition, this may need to be taken into account when the organisation decides whether to use more than one source of performance assessment data, such as 360^{o} feedback.

Work groups and moods

Bartel and Saavedra[4] argued that, just as an individual's mood can heighten his or her motivation to achieve a goal, the collective mood may help workgroups to attain collective goals. Coordinated action is best accomplished when individuals synchronise their thoughts, feelings and behaviour.

Workgroup mood convergence is developed through the interplay of two key processes :

1. *emotional comparison*, when individuals seek out and use cues from others to help them to interpret their own feelings;
2. *emotional contagion*, when individuals mimic and synchronise facial expressions, bodily movements and vocalisations with those of other persons, and thus tend to converge emotionally.

The authors' research showed that workgroup members and observers can assess workgroup moods with a high degree of accuracy, especially when the moods are characterised by high arousal or emotional intensity. It also showed that mood information can be communicated through people's behaviour.

The development of shared moods comes through frequent contact within the group, and the perception that members are strongly interconnected on both a task and social basis. In fact, these perceptions of interrelatedness may be both a cause and a consequence of mood convergence.

Workgroups with emotionally inexpressive members may find it more difficult to achieve mood convergence and to achieve tasks requiring a high degree of coordination. Similarly, members of diverse groups may find it more difficult to identify and interpret behavioural mood information.

Although this research did not consider the relationship between workgroup moods and particular outcomes, it is possible that collective moods could influence such factors as levels of cooperation and conflict, and absenteeism. It also suggests that managers can influence mood convergence by addressing

- the nature of a group's work;
- its pattern of interrelations;
- its context;
- its composition.

This is especially important for complex tasks requiring extensive coordination.

Emotions and leadership

George[5] argued that moods and emotions play a central role in the way people think and behave generally, and in the leadership process in particular.

Emotional intelligence (EI), she stated, is the ability to join emotions and reasoning effectively, using emotions to facilitate reasoning, and reasoning intelligently about emotions. Cognitive and emotional processes are thus interlinked.

EI has an important role in the emotionally laden leadership process, from both the perspective of a leader and a follower. For example, a leader's awareness of his or her own emotions and his ability to manage them effectively may enhance his performance.

EI may also help leaders to

- signal pressing concerns;
- process information;
- prioritise demands.

If a leader is aware of his or her own emotional state, this can help her to discount those emotions that are irrelevant to a decision.

A leader's ability to manage and change his or her emotions may help the leader to generate multiple points of view and options.

A leader can use his or her awareness of the moods of followers to

- appraise accurately how his or her colleagues are feeling;
- manage their emotional states;
- repair negative moods and restore confidence.

An increasingly important leadership activity is the development and expression of organisational culture based upon a shared set of beliefs, norms and values. All of these are emotion-laden. Consequently, the management of organisational culture is in many ways the management of emotions.

Leaders must first be able to identify these norms and values personally, and then use their own emotions and those of their followers to help build and maintain a collective and meaningful identity for the organisation.

Counter discrimination

The research of Kulik, Perry and Bourhis[6] was not really about emotions, but it is relevant to any attempt to change or suppress thoughts that may have emotional aspects. This may be necessary in training employees to counter racial, gender or age discrimination.

The research focused on the consequences of training that aimed to suppress stereotypical thoughts about older job applicants.

It drew on earlier thinking by Wegner[7], who argued that when a person tries to suppress thoughts, two parallel processes are initiated :

- a conscious operating process that searches for thoughts that are consistent with the desired mental state;
- an unconscious monitoring process that tests whether the operating process is functioning successfully.

The monitoring process requires a representation of the unwanted thoughts to be active at some level, and this is repeatedly compared with the active thoughts in a person's consciousness.

Problems can occur when the operating process, which requires greater cognitive capacity, is disrupted when a person is under time pressure, or preoccupied with another task. At times like these, attempts to suppress particular thoughts can have unintended or ironic consequences.

The authors found that efforts to suppress age-related thoughts when staff are under pressure did have negative consequences for the evaluation of older applicants, but only when the raters had been asked to suppress age stereotypes.

Interestingly, when they received no such instructions, evaluations of the older applicant were not affected by how busy the raters were.

This suggested that, in these conditions, raters spontaneously suppressed age-related thoughts, a process which may be relatively less conscious and require less effort, and hence be less vulnerable to ironic effects. Furthermore, only a specific request about an applicant's age produced ironic effects.

There are a number of implications. First, it suggests that a broad approach to such training, as opposed to an approach that focuses on one specific aspect, may avoid ironic effects. Also, specific diversity training may have negative effects when the rater is mentally preoccupied. More generally, organisations should seek to reduce the stress and cognitive load of decision makers to achieve better quality decisions.

Organisations should also perhaps consider outsourcing human resources activities such as recruitment and selection rather than add them to the usual tasks of functional and human resources managers. Although this may increase costs, it may also improve the quality of decision making, allowing human resources personnel to focus on larger strategic issues.

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From value chain to value net

The coming of the new economy means that the old idea of the value chain needs to be rethought. In many knowledge-based industries, the economics of intangibles and e-business are increasingly driving costs. Also, producers may wish to develop fewer longer-term relationships with suppliers, despite the flexibility and impermanence implied by the Web. Increasing financial transparency will allow benefits to be obtained from much faster cash flows and inventory turns. However, the drive for lower costs will have to outpace falling prices from increased commoditisation if profits are to be made.

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The concept of the value chain was first introduced and popularised by Michael Porter[1] in 1985.

Certain types of businesses, though, have always found it difficult to apply his model. It was created on the assumptions of a sequential value adding process and a 'build and sell' approach, where the end consumer is separate from the value creation process.

In fact, the traditional value chain model fitted well with 'old economy' industrial companies, but it was difficult to relate to service-based companies such as banks, insurance companies and telecommunications providers.

Alternative models have latterly included Stabell and Fjeldstad's notion of value shops and value networks[2].

The advent of the new economy means that the value chain concept needs to be reassessed once more.

On the one hand, discussions of the impact of the digital economy are rarely complete without reference to its impact upon the value chain and the disaggregation of value chain activities (see, for example, the work of Hagel and Singer discussed in reference 3).

On the other hand, Porter's value chain model is challenged more than ever by the new realities of the digital economy.

Cinzia Parolini[4] has made a very useful contribution to our understanding of how the value chain model is changing. In many knowledge-based industries, she says, the economics of intangibles are now increasingly driving costs.

The new economics dictate that intangible products, such as knowledge and information-related goods, which can be transacted digitally, are not susceptible to diminishing returns of scale or capacity constraints.

In fact, the value of these goods can even increase the more they are produced. The more a particular piece of software is used, for example, the more valuable it becomes.

In hi-tech sectors, the initial costs of research and development dwarf the costs of reproduction. Indeed, in some extreme cases, such as the online delivery of software, reproduction can be at zero or as near zero marginal cost as makes no difference.

Consumers will tend to favour a few suppliers and products in order to contain the problems of compatibility and benefit from standardisation.

Other features of the digital economy, stated Parolini, also have an impact on our understanding of the value chain. Information about products can be detached from the products themselves.

By contrast, traditionally, if we wanted to find out about a car and its performance, we needed to see, feel and touch the car in person. Now the experience, or at least part of it, can be simulated online.

Similarly, there has traditionally been a clear trade-off in terms of product information between 'information reach' and 'information richness', a useful distinction first introduced by Evans and Wurster[5]. The idea is that some products have been rich in information but relatively narrow in terms of the target group they reached. Therefore some high value products have been marketed individually by salesmen and sales consultants directly to high worth individuals, for example in the financial services sector.

This approach entails a great deal of interaction, customisation and personalisation of information.

By contrast, product information for mass consumer goods has tended to stress reach at the expense of richness, through mass advertising in the press and media for example.

Parolini, though, believed that this dichotomy can now be resolved through the digital economy, in other words by offering services digitally which can combine both information reach and information richness.

Consider, for example, the online share trading services that are able to offer personal and customised information to a mass market of many thousands, and at transactional costs which are extremely low.

The obvious conclusion is that universal connectivity via the Internet (a cheap mass medium for communication and digital transmission) can give extremely wide access to very rich information, which can be detached from the physical product itself.

Another interesting feature of the digital economy, stated Parolini, is that the products themselves are increasingly ‘systemic’. In other words, the value created is not simply a function of a number of sequential linear processes, as assumed in the traditional value chain model, but is dependent upon complementary products and technologies launched and offered in parallel.

The value of a computer is, then, greatly dependent upon the availability of software, and, similarly, the value of a new format for music and entertainment is significantly dependent upon the availability of a wide range of content.

Digital capital

Tapscott, Ticoll and Lowy[6] believed that the digital economy is transforming the industrial value chains of many businesses into ‘flexible b-webs.’ These demand-driven value chains, they said, are replacing the old ‘make and sell’ push models, both enabling customers to specify their needs more precisely, and allowing producers to respond rapidly to them. They claimed that ‘in contrast to the static hub and spoke models of the previous era, digital applications engender a fluid and interconnected environment of plug and play value chains’ (see reference 6, p 100).

Despite the flexibility and impermanence in the relationship between suppliers and producers implied by this, Tapscott, Ticoll and Lowy believed that most producers will wish to develop fewer longer-term supplier relationships instead, cultivating relationships with the best ones, and investing in their expertise.

Surprisingly, they claimed, this may even go as far as encouraging suppliers to share information with a producer’s competitors, as, for example, when several producers are bidding for a large piece of business, and the supplier knows that only one will be ultimately successful. This sharing of knowledge, they believed, helps lower inventory costs for everybody in the industry.

Tapscott, Ticoll and Lowy quoted impressive examples from value chain masters such as Dell and Cisco Systems.

Cisco Systems, for example, estimates that it saves $250 million per year through having its customers download software upgrades directly from its website, and several times that amount by posting all support and marketing documents (see reference 6, p 107).

Cisco Systems cleverly also builds switching costs as customers, having become familiar with the Cisco Systems customer fulfilment website, become reluctant to invest similar effort in competitors’ sites.

Similarly, Dell’s digitally supported build-to-order model enables the firm to operate with just six days of inventory, in an industry in which the average is 60–80 days.

Both Dell and Cisco Systems insist on transparency along the value chain wherever possible.

Cisco Systems’ disclosure of financial information is particularly striking, to the extent that the company is aiming to be able to close its books every 24 hours to the satisfaction of its auditors by the middle of 2001. Such financial transparency, Cisco Systems believes, optimises the supply chain, allowing everybody to benefit from much faster cash flows and inventory turns.

The syndication model

Kevin Werbach, in his recent contribution on syndication as an emerging model for business[7], took up the theme of rapidly reconfiguring value chains.

As he pointed out, there is nothing particularly new about syndication as a business model. It is widely used in newspaper publishing and in the entertainment world.

However, its use has been limited, as it only works for information goods that, unlike physical goods, are never consumed. Syndication also assumes that there are multiple distribution channels rather than a vertically integrated or monopolistic channel to market.

This is all true for the Internet, and it is not difficult to see the application of the syndication model to content.

Werbach's point, though, is that it does not stop there. Any capability that can be delivered electronically, whether it be a logistics platform, a customer fulfilment service, or an online information service, can be syndicated.

For syndication to work effectively,

- originators must create the content;
- syndicators must package the content for distribution and integrate it with the content from other originators;
- distributors must act as the channel to customers.

Syndication through this model offers a number of significant advantages over traditional outsourcing models.

As syndication deals with information goods rather than physical products, there is no limit to the number of partners or distributors to whom a company can syndicate precisely the same goods or services.

As online syndication can be automated and the products transmitted digitally, the networks can be created, expanded and integrated much more quickly than in the old economy.

This means, though, that syndication relationships can change quickly. According to Werbach, companies can play multiple roles within a syndication network, and it is likely that those roles will change very, very rapidly.

The key strategic decision is that of how a company places itself along the syndication network. Unlike in the old economy, where companies sought to position themselves at a point on the distribution chain where resources were scarce and profitability high, the new syndication network is predicated upon information abundance.

Werbach stated the following (see reference 7, p 91) :

> *There are no limits on the shelf space on the Net, every store is accessible to every shopper, the lanes of supply and distribution are wide open, and even the tiniest new company can achieve enormous scale in almost no time. Because the constraints of physical inventory and location do not apply, creating and maintaining scarcities isn't an option. The most valuable niches in syndication networks turn out to be those that maximise the number and strength of the company's connections to other companies and to customers. And because those connections are always changing, even the most successful businesses will rarely be able to stay put for long.*

He concluded that companies need to rethink their core capabilities in the new economy. Instead of treating core capabilities as sources of proprietary advantage, to be protected and guarded at all costs, such capabilities should, he argued, be syndicated in the new economy of abundance. In the process, a company's competitors can become its customers.

This conclusion probably would not cut much ice with Cisco Systems. According to Tapscott, Ticoll and Lowy at least, it defines its value proposition as 'advice and the intellectual property around it'.

Cisco Systems relies heavily on partnerships and acquisitions, but once it has built a product, it is reportedly ultra-aggressive about controlling the core technology and software designs that constitute the genetic coding of its solutions (see reference 6, p 104).

Best practice in Europe

As Zott, Amit and Donlevy made clear in a recent article[8], most e-commerce strategies research tends to be heavily biased towards the USA, because Internet penetration in Europe lags behind that across the Atlantic.

However, there are now sufficient numbers of companies across Europe, successful or otherwise, for worthwhile research findings to be forthcoming.

Zott, Amit and Donlevy characterised e-commerce as a virtual market. In common with others mentioned above, they defined the characteristics of the virtual market in terms of information reach and information richness.

However, their research adds an additional characteristic : digital representation. Digital representation means that there is an absence of physical contact in a virtual market, and there are a number of consequences of this :

- The consumer (and in some cases the supplier) has increased anonymity in transactions.
- The consumer has greater control over divulging personal information.
- There is a lack of direct human contact between the customer and the supplier. Processes such as receiving and executing orders can be automated.
- Virtual storefronts can be used.

How successful companies are in exploiting these market characteristics depends on how good their strategies are, in terms of either making the business model more efficient, or enabling the business to retain customers more effectively.

Zott, Amit and Donlevy offered pointers on how business models may go in the future. They believed, for example, that if one company in a particular market moves to offer comprehensive competitor pricing information, then that will quickly become the norm in that industry, and consumers will demand it. If consumers cannot find that on the company's own website, then they will turn to other intermediaries to provide that information for them.

The authors found that many of the companies studied in Europe were not fully exploiting all the value creating strategies available to them. For example, there were ways in which they could

- better exploit the asymmetry of information between players;
- make the transaction more convenient for the consumer;
- make greater use of loyalty programmes and virtual communities, which represent untapped opportunities for creating additional value.

Cost transparency : the Internet's real threat

Many say that the Internet is the enemy of profits. Indrajit Sinha believes that, by encouraging cost transparency and making the buyer's search for information more efficient, the Internet encourages the commoditisation of industries.

One response to this is to engage in variable or smart pricing practices, in other words, charge a premium to those consumers who are willing to pay more.

However, Sinha believes that, in an environment in which the Internet encourages customers to share pricing information, smart pricing strategies could give rise to widespread perceptions of unfairness.

As he has pointed out, 'for most consumers fixed prices are a security blanket that helps them feel they are being treated fairly – or at least no worse than the next customer'[9].

Instead of differential pricing, Sinha believes that other strategies may be more effective in meeting the challenge of cost transparency.

One option is bundling additional goods and services with the product, thus making it difficult for consumers to make an explicit price comparison.

In fact, Sinha considers that the bundling of value-added items plus product innovation is likely to be the most successful strategy for maintaining brand loyalty and relatively high profit margins.

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Reflections on Economic Value Added

Many major companies now use Economic Value Added, not only in investment appraisal, but also in more general methods of performance evaluation. This extends even to executive compensation. The method of calculating EVA is explained and compared with similar methods. Research is reviewed on how the technique produces results over time, and on how easy it is to use for business unit performance and throughout organisations.

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Economic Value Added (EVA®) has, in recent years, attracted enormous attention as a potential means of delivering improved company performance. (EVA is a registered trademark of Stern Stewart.) A number of studies illustrate its rise to prominence.

One of the most striking was by Davis[1], who reported that over one-quarter of the 153 companies he surveyed used EVA, although just ten years ago, virtually no businesses used the system. European companies have also adopted EVA[2].

The interest of London-based Tate & Lyle, a global giant in sweeteners and starches, was sparked a few years ago by a magazine article on the subject. Now EVA is used to analyse all proposed capital expenditures and divestitures at the firm.

Another noteworthy EVA adopter was German electrical conglomerate Siemens. It introduced EVA as a measurement tool, but it was not easy. The assets of its groups, for example, are all headquartered in Germany, but the groups are scattered in many foreign countries, and in most countries are consolidated in a single subsidiary.

Measuring group performance at Siemens meant reallocating each of these foreign assets to the appropriate group. Determining the cost of capital, which varies from 8% to 11% depending on the riskiness of the group, was a complex exercise.

During the first year, there was no company-wide EVA bonus, but individual groups (16 at the time) were allowed to provide an EVA bonus; about half did. Now top management at corporate, group and divisional levels have an EVA bonus system as the variable portion of their compensation.

A merger in December 1997 brought EVA to Diageo, the firm created by the fusion of Grand Metropolitan and Guinness. It created a huge consumer products corporation with 85 000 employees and an annual turnover of about £14 billion.

Diageo owns a number of famous brand names, such as Guinness stout, Johnny Walker scotch whisky, and the Burger King chain of fast food restaurants.

Chief Executive John McGrath had begun his campaign of ‘managing for value’ when he held the same post at Grand Metropolitan. Prior to McGrath’s leadership, Grand Metropolitan had made a string of good, brand name acquisitions, but had found earnings and share price lagging. The Diageo board heartily endorsed the renewal of McGrath’s crusade following the merger.

Calculation of EVA

Early in the 20th century, Alfred Sloan of General Motors put forward the concept of residual income as a measure of divisional performance as an extension to return on investment (ROI).

The idea behind residual income is that an explicit capital charge on an investment needs to be deducted when computing ROI. The rationale behind this calculation is that, as the costs associated with sales, labour, overheads and taxes are deducted in arriving at the return, so too should the cost associated with the capital tied up by the investment.

Then the residual income is calculated as follows :

residual income = net operating profit after tax – capital employed × cost of capital

For the calculation, the net operating profit after tax (NOPAT) and capital employed are taken from the profit and loss account and balance sheet respectively. These are normally prepared according to Generally Accepted Accounting Principles (GAAP).

One feature of applying GAAP is that it requires a prudent approach to be taken on all items of expenditure. In other words, if the outlay will not benefit future time periods, it should be written off immediately as an expense, and should not be carried forward as an asset on the balance sheet.

The result of this, though, is that the profit and loss account and balance sheet may not accurately state the true economic position of the business.

To correct the sometimes distorting impact of applying GAAP, Stern Stewart, the proponents of EVA, make a number of adjustments to the accounting statements. Instead of writing off research and development immediately, for example, they state that it should be capitalised and written off against profit over its useful economic life.

The end result of these adjustments is a NOPAT and capital employed that are based more on the economic realities of the business than on just pure accounting principles.

EVA calculations, in comparison with residual income, focus upon what might be seen as economic corrections to NOPAT and the capital employed. (One illustration of the calculation of EVA, for Rhône–Poulenc, can be found in reference 3.) In other words,

EVA = economic net operating profit after tax – (economic capital employed × cost of capital)

The most common types of adjustment are reviewed further below.

How does EVA measure up ?

Despite the enthusiasm for EVA, its claimed superiority in comparison with earnings is not undisputed. Although Stern Stewart have long argued the case for abandoning traditional measures (and a good illustration of this was provided by Joel Stern's articles in the Sunday Times[4]), the conclusions of quite recent research cast doubts on the advisability of doing this.

Chen and Dodd examined the EVA performance of 566 US companies, and compared the information usefulness of EVA with accounting earnings and residual income. They drew the following conclusions[5] :

- Although improving EVA performance is associated with a higher stock return, the association is not as perfect as is claimed by EVA advocates.
- EVA is more powerful than traditional measures of accounting profit in explaining stock return. However, accounting earnings are still of significant incremental information value in addition to EVA.
- Not only is EVA similar to residual income in concept, but the two metrics are also empirically comparable.

More recently, Biddle, Bowen and Wallace researched whether EVA beats earnings, and looked at the evidence on associations with stock returns and firm values[6]. They tested the view that EVA is more highly associated with stock returns and firm values than accrual earnings.

Their results did not support claims that EVA dominates earnings in relative information content. In fact, they suggested quite the opposite, that earnings generally outperform EVA.

Other concerns also surround EVA. Some of its advocates suggest that it should be linked with activity-based costing and the Balanced Scorecard[7]. Shinder and McDowell of Stern Stewart Europe, argue the following in their conclusions :

> *These frameworks* [activity-based costing, the Balanced Scorecard and EVA] *help focus managers on performing better. Regardless of whether one of these tools has been implemented, the other two should be considered.*

However, an interesting study[8] by Dodd and Johns raises concerns over the link between EVA and these tools in practice. Given that prior studies, such as those just mentioned, had examined the claims by Stern Stewart of stock return associations, Dodd and Johns decided to focus their attention upon some of the 'softer' statements about EVA.

In particular, they studied a claim by Bennett Stewart of Stern Stewart that 'before you know it, what jumps out is a new culture'.

Their exploratory research, involving mail surveys to chief financial officers of 1300 US corporations over a three-year period, sought to examine potential differences between EVA adopters and non-adopters.

They found significant differences between the two groups. As expected, traditional financial measures, such as

- payback period;
- contribution margin;
- return on investment;
- return on sales;

were used more frequently by non-adopters of EVA, probably, the authors stated, because 'EVA supposedly more efficiently replaces these outdated metrics'.

However, one unexpected finding related to the use of non-financial metrics by the two groups. The data from the study suggested that EVA adopters are placing less emphasis on quality and customer satisfaction.

Does this then mean that management once again believes that organisations can be run by financial numbers alone ? If so, EVA may be returning to what Johnson described as the era of 'remote control management in the dark age of relevance lost'[9].

Dodd and Johns concluded by suggesting that EVA adoption may foster an environment in which the pursuit of higher EVAs overtakes the pursuit of quality and fulfilment of other company needs.

They did, however, recognise some potential limitations of their study, particularly as their analysis was only based on a limited number of EVA adopters. Their number was not, in fact, publicly disclosed, so the firms studied might have represented either the thin or thick end of the EVA adopter wedge.

The risk that participants might not be representative of non-participants also raised uncertainty over the study's generalisation of the population.

The authors also recognised that the differences between the groups (adopters and non-adopters) might have existed prior to the introduction of EVA.

What is more, the research design did not allow for a pre-post analysis of the measurements used.

EVA adjustments and calculations

There are also questions about the calculation of EVA. It can be calculated for an entire business or for its business units. Stern Stewart recommends that adjustments be made to remove factors over which operating managers have little or no control, for example

- interest income and expense;
- gains and losses on currency exchange;
- headquarters expenses.

Similarly, capital employed must reflect the actual amount of capital, including working capital and fixed assets, attributable to the operating unit.

In fact, other adjustments are also needed to correct those anomalies created by generally accepted accounting principles, resulting in a NOPAT that is closer to true economic earnings.

Accounting rules, for example, require companies to expense all research and development costs, even though they are more properly thought of as investments in future products. Consequently, a NOPAT adjustment might be used that capitalises research and development outlays and amortises them over a number of years.

One of the key issues associated with EVA adjustments is that at least 160 of them have been identified by EVA proponents. However, Young stated that the number of recommended adjustments has been declining in recent years. Corporate executives are resistant to the idea of diverging from GAAP-based numbers. Back-testing and simulation have also illustrated that most of the proposed adjustments have little, if any, impact on profits[10].

According to Young, the most commonly proposed adjustments are

- non-recurring gains and losses;
- research and development;
- deferred taxes;
- provisions for warranties and bad debts;
- LIFO reserves;
- goodwill;
- depreciation;
- operating leases.

Young questioned the potential adjustments though, and argued that a new standard should be adopted because of the cost of deviating from GAAP. He clearly pointed out, with reference to actual illustrations, that most of these eight adjustments offer few advantages over unadjusted figures. He also argued that some, such as deferred taxes, may even be counter-productive.

He offered four criteria that a corporate user should consider before adopting any particular adjustment :

- The distortion or bias caused by applying GAAP must cause managers to engage in dysfunctional behaviour.
- The adjustment must reduce the likelihood of such behaviour.
- The benefits obtained from improving managerial incentives must more than offset the costs of deviating from GAAP.
- The adjustment must be a more efficient means of achieving the desired result than alternative mechanisms or controls.

Clearly, Young had reservations about the adoption of adjustments internally, although he did recognise a more compelling case for external users, such as analysts. However, his parting line is telling :

> *In short, the residual income measure first proposed by Alfred Sloan* 75 *years ago is likely to offer the same advantages as today's highly touted EVA product*.

Further empirical research also questioned whether EVA adjustments are necessary. Instead of calculating EVA on the basis of economic versions of the profit and loss account and balance sheet, Bacidore *et al.*[11] proposed that the capital charge should be calculated on the basis of market values rather than adjusted book values.

This gives what is termed Refined Economic Value Added (REVA). A key argument for using market value is that investors could liquidate their holdings in a firm for market value and invest the proceeds in other opportunities. Otherwise, investors lose an opportunity to earn the cost of capital on the market value of the firm at the start of their holding period.

The empirical study by Bacidore *et al.* was based on using the Stern Stewart Performance 1000 database for the years 1982–92. They randomly selected 1000 firms, and calculated the EVA, the REVA, and the risk-adjusted abnormal stock return. Their research found that REVA contains information not captured in EVA that is relevant for predicting abnormal stock returns.

Executive compensation

One key feature of EVA is the emphasis that is placed on executive compensation.

For example, Shaked, Allen and Leroy argued that a critical factor in translating EVA measurements into corporate success is to make them the basis of an incentive compensation plan that encourages managers to think and act like owners, rather than employees[12].

In other words, managers are then rewarded for creating value, unlike in conventional incentive schemes, which tie bonuses to the achievement of a target negotiated with upper management or the board. This process can, some think, corrupt planning and budgeting by perversely encouraging managers to understate the true potential for their business.

A much better incentive, say EVA proponents, is to pay managers for improvements in EVA with no caps or limits on what they can earn. A properly constructed bonus plan can effectively turn managers into the owners of the individual units under their control. The result is that they become more entrepreneurial and operate with a renewed sense of urgency. Budgets and plans are then based on strategy, rather than the hopes and fears surrounding an annual bonus.

According to Shaked, Allen and Leroy, at Honeywell, senior executive compensation is tied not only to the company's performance, but also to its ranking among similar firms. Assessing performance relative to other companies solves the problem of penalising senior management for macroeconomic events, such as a cyclical downturn or recession, which are out of their control.

Second-level executives (typically key division managers) play a major role in creating value, but have little direct share-holder responsibility. Their incentive compensation should partly be based on stock options, but to a larger degree on EVA to reward their positive influence on share-holder value.

Middle and upper middle managers are generally responsible for a given level of capital, and have profit and loss responsibility. Since unit operating income or operating cash can be determined, the most direct measure for such managers is argued as being unit EVA. According to Shaked, Allen and Leroy, a portion of division/unit managers' compensation should be tied to company-wide EVA. This reduces the conflicts between business units and functions, and encourages cooperation.

Implementing EVA

Although rolling out EVA might look easy, there are many potential pitfalls in using it to drive corporate planning, budgeting, control, and compensation systems. An illustration of this was provided by Birchard[13].

Georgia–Pacific (a $13 billion maker of pulp, paper and building products in Atlanta, GA, USA) implemented EVA, and began measuring financial performance with EVA more than a decade ago.

It started making incentive payments to managers on the basis of the EVA numbers. However, before the programme could be extended to the rest of the workforce, dissatisfied executives abolished it, as they did not understand how the new measure was calculated. More importantly, they could not figure out how to use EVA themselves as a guide to affect corporate financial results.

Its perceived complexity was well illustrated by Birchard when he stated that one consultant likened a diagram of the EVA calculation to the wiring pattern for a Boeing 747.

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