Manager Update

February 2006 Issue 36

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

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Faculty of Finance and Management

in association with

HENLEY MANAGEMENT COLLEGE

Tel: 020 7920 8486 Fax: 020 7920 8784

ISSN 1467-5765

Manager Update

... is produced in parallel with the Braybrooke Press publication of the same name and published quarterly. It is compiled and edited by Kevin Money, director of the Centre for Organisational Reputation and Relationships at Henley Management College.

> **Manager Update** helps the general manager keep abreast of the latest articles in specialist management journals in the key fields of strategy and organisation, marketing, accounting and finance, and human resources management.

> **Comments** and suggestions should be addressed to Judith Shackleton, telephone 020 7920 8486, e-mail judith.shackleton@icaew.co.uk, or write to:

The Faculty of Finance and Management,
The Institute of Chartered Accountants
in England and Wales,
Chartered Accountants' Hall,
PO Box 433, Moorgate Place,
London EC2P 2BJ

> **The articles** contained in this and previous issues of this publication are available (to Faculty members only) on the Faculty web site at www.icaew.co.uk/managerupdate.

Cover illustration by Lincoln Seligman (© L Seligman 2006)

Produced for the Faculty by Silverdart Ltd (see contact details on back page)

The Faculty is run by and for the members. If you enjoy this publication, and you are not already a member of (or subscribe to) the ICAEW's Faculty of Finance and Management, why not join now? If you are a member, make sure you are getting full benefit from your membership.

Among other benefits (see those listed on the back page), members receive all future Faculty publications. The extra resources and opportunities we offer can add value to your professional life, and to your career. We have around 9,000 members.

To find out more about the Faculty, please visit our web site www.icaew.co.uk/fmfac. Or else contact the Faculty team on 020 7928 8508 or e-mail us at fmfac@icaew.co.uk.

CONTENTS and EXECUTIVE SUMMARY

How to evaluate real options

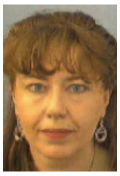
Roger Mills, professor of accounting and finance at Henley Management College.

Complex modelling has meant that options management has been little influenced by the available literature. However new attempts to find a methodology reveal how the various approaches can significantly alter the decisions made by:

- the use of replicating portfolios or market assets;
- the use of two investment types; and
- the use of a new integrated method to make the best choice in the real options environment.

The right decision in real options can have a great effect, so it is vital to go about making it in the best possible way.

Broadening the scope of branding



Susan Foreman, professor of marketing at Henley Management College.

Branding is one of the best methods of establishing business success both externally and internally. The article looks at new approaches to branding, with special reference to:

- maintaining a brand's place in the customer's mind; and
- the profits to be made from industrial branding and brand co-operation.

Making intelligent use of branding can reinforce both the outside consumer perception of a company but also the internal one of employees, leading to increased profit.

Leadership – influences and outcomes

Richard McBain, director of distance learning programmes at Henley Management College.

A leader has great influence over the way an organisation works, but the demands of his or her job can be high. Leaders should take note of contextual factors:

- the function which they operate in the business;
- their position socially, geographically, and politically; and
- their personal impact on their followers.

Executives also need to consider their style of leadership in relation to other staff in matters such as training, and the ethical attitude of the organisation.

Analysing the reasons for corporate failure

Ian Turner, professor of management studies and director of graduate business studies at Henley Management College.

Corporate failure is very common, but what causes it and can it be stopped? There are steps that can be taken to minimise the likelihood of a crisis:

- careful analysis of local and global market positions;
- ensuring maximisation of competitive advantage; and
- proactive and alert leadership which looks out for warnings.

Being aware of risks and allowing for crises within the main business plan with help inure a company against failure. The manager must take care not to react by making things worse.

How to evaluate real options

The notion of 'real options' applies option pricing theory to non-financial assets. The complexity of modelling investments as options means that, to date, options literature has had relatively little impact on management practices. Here **Roger Mills**, professor of accounting and finance at Henley Management College, examines recent attempts to find an optimum methodology for evaluating real options.

We have reviewed 'real options' in past issues. The term, coined by Stewart Myers in 1977, refers to the application of option pricing theory to the valuation of investments in non-financial or 'real' assets, where much of the value is attributable to flexibility and learning over time. This means that the opportunity inherent in a capital project can be viewed as implied contracts that allow management to choose only those actions that have positive cash flow effects. Where a difference arises, however, is that the underlying assets of the options in a capital investment decision are real assets like the development of a new plant, rather than financial assets, like stocks and shares. Thus, the options imbedded in the investment decisions are referred to as 'real options' as opposed to financial options.

> Choosing options that maximise cash-flow is crucial to the success of projects

Research undertaken in the last two decades has shown that managers in diverse fields tend to make the same kind of decision-making mistakes. The single most common is known as 'frame blindness': setting out to solve the wrong problem because a mental framework has been created for a decision that effectively means that the best option is often overlooked.[1] Here, the word 'option' is extremely relevant because practitioners and academics have argued in recent years that traditional discounted cashflow models do not, in fact, capture the value of options embedded in many corporate decisions. These options need to be considered explicitly because their value can be substantial.

> The values of options can be considerable

Options literature has, until now at least, had relatively little influence on management practices. That's partly because modelling investments as options is a highly complex subject that is generally presented in a technical fashion. However, options are of great potential relevance to managers, given that the manager's role is to use his/her skill to maximise shareholder wealth.[2] Ownership and control of an investment project can often generate follow-on opportunities in addition to the project's cash flows.

For example, along with the assets there may also be the chance to acquire less tangible benefits such as learning about other similar companies for sale. The company may also include highly skilled individuals who could be used to produce extra at little cost but with high value. Such follow-on investment opportunities are relatively intangible and speculative and their expected cash flows are rarely examined directly. Nevertheless, these opportunities may clearly be of important value.

Thus, advocates of the real options approach have maintained for years that it can arm executives and also investors with a superior method of taking decisions aimed at value improvement. Yet many feel that it has never lived up to its promise because of reasons such as its technical complexity and an absence of consensus among analysts.

Georgetown challenge

A conference at Georgetown University in the US in 2003 resulted in demand for a single, generally-accepted real options methodology. In response, Copeland and Antikarov proposed a four-step process.[3] The first step is to calculate the standard net present value of the project assuming no managerial flexibility, which results in a value estimate (and a 'branch' of a decision 'tree') for each year of the project's life. The second step estimates the volatility of the value of the project and produces a value tree designed to capture the main sources of uncertainty. The authors focus on the uncertainty about overall project value, which is driven by uncertainty in revenue growth, operating margins, operating leverage, input costs and technology.

Their key point is that, in contrast to many real options approaches, none of these variables taken alone is assumed to be a reliable surrogate for the uncertainty of the project itself.

For example, in assessing the option value of a proven oil reserve, the relevant measure of volatility is the volatility not of oil prices, but of the value of the operating entity – that is, the project value without leverage. The third step attempts to capture managerial flexibility using a decision tree that illustrates the decisions to be made, their possible outcomes, and their corresponding probabilities.

The authors illustrate various kinds of applications, including a phased investment in a chemical plant (which is treated as a compound option) and an investment in a peak-load power plant (a switching option with changing variance, which precludes the use of constant risk-neutral probabilities as in standard decision tree analysis).

The fourth and final step uses a 'no-arbitrage' approach to form a replicating portfolio with the same payouts as the real option. Yet this is only one approach to real options and, as Borison[4] notes, others also exist. He reviewed the various alternative approaches to their valuation and provided the following classifications.

The classic approach (no arbitrage, market data)[5]
This approach represents the direct application of classic option pricing from finance theory to non-financial or real investments, based on the existence of a traded replicating portfolio , and building on data drawn from that portfolio to develop option values, i.e. in much the same way as a share option can be priced by making reference to data drawn from share prices provided by the market. It assumes that capital markets are complete, and therefore that all corporate investments have equivalents in the capital markets and can be effectively hedged through this traded replicating (tracking) portfolio.

The subjective approach (no arbitrage, subjective data)[6]
This approach is based on the existence of a traded replicating portfolio, but built on data that is subjectively assessed (although the use of this data is not explicitly justified).

The marketed asset disclaimer (MAD) approach (equilibrium-based, subjective data)[7]
This approach, outlined earlier with reference to Copeland and Antikarov, does not rely on the existence of a traded replicating portfolio, but the same assumptions used to justify the application of net present value (or discounted cash flow) to capital investments are used to justify the application of real options analysis.

Different investments need different approaches

The revised classic approach (two investment types)[8]
The three approaches above are all examples of alternative 'one-size-fits-all' views; their proponents argue that they are applicable in the same basic fashion to all types of corporate investments. The revised classic approach, on the other hand, is based on the view that there are two different types of corporate investments, each requiring its own approach. In particular, real options analysis should be used when investments are dominated by market-priced or public risks, and dynamic programming/decision analysis should be used when investments are dominated by corporate-specific or private risks.

The integrated approach (two risk types)[9]
The four approaches described so far originated with practitioners in finance looking to expand to real – as opposed to financial – investments. The integrated approach, on the other hand, originated with practitioners in management science looking to incorporate capital market considerations, and shareholder value in particular, into their evaluation of corporate strategy.

The integrated approach begins by recognising two types of risk associated with most corporate investments: public (or market) and private (or corporate). Unlike the classic or revised classic approaches, though, the integrated approach neither views private risk as a source of error (as does the former) does it assign investments entirely to one of two categories (as does the latter). Instead, it acknowledges that most investment problems encountered in practice have both kinds of risk – and it is designed to address that very situation.

All kinds of risk must be addressed, and an integrated method does this best

Value as a management tool?

Some, such as Copeland and Antikarov, have criticised Borison's classification of approaches. However, the problem from a managerial perspective is that while they are all intended for use in assessing real options they all appear to differ markedly in their assumptions. Unsurprisingly, general managers are often confused by the use of a single term 'real options' when it seems open to different interpretations.

The term 'real options' can cause confusion among managers

How then do the approaches differ in terms of assumptions and, more importantly perhaps, does it matter if they do? As regards the assumptions, Borison identifies two key issues: the nature of capital markets and the source of data. The classic approach is distinct in the manner described on the preceeding page.

The one difficulty with this though, as Borison points out, is that a major reason that corporate investments may be made is that they are not duplicated in the capital markets, and it is important for a valuation process to reflect this reality. The subjective approach also assumes that capital markets are complete, but draws the data for establishing a 'no-arbitrage' value for the investment from subjective judgment. The advantage is that this eliminates the task of finding the 'replicating portfolio,' but has the disadvantage of substituting a lack of consistency for the lack of accuracy in the classic approach. Common sense should dictate that if a replicating portfolio exists, it would make sense to find the name of the company and use the available market data to value the investment and the option using the classic approach, rather than relying on subjective judgment informed only by general industry information.

Does, then, the selection of one approach rather than another matter? Borison argues the different assumptions underlying the various approaches lead to different mechanics. What are these mechanics? The mechanics of the classic and subjective approaches make use of the Black-Scholes algorithm, where the following five factors are used to determine the project's option value:

Differing approaches to modelling lead to differences in valuation and then in strategy

- exercise price;
- stock price;
- time to expiration;
- project volatility; and
- risk-free rate.

The application of these five factors has been illustrated with reference to the application of the approach at Merck as follows:[10]

- *exercise price* – this represents the capital investment to be made approximately two years hence;
- *stock price* – this represents the value of the underlying asset or the present value of the cash flows from the project (excluding the capital investment to be made and the present value of the upfront fees and development costs over the next two years);
- *time to expiration* – this varied over two, three and four years, with the option being exercisable in two years at the earliest. The option was structured to expire in four years because Merck thought that competing products, making market entry unfeasible, would exist by then;
- *project volatility* – this was represented by a sample of the annual standard deviation of returns for typical biotechnology stocks obtained from an investment bank; and
- *risk-free rate* – a US Treasury rate of 4.5% was used over the two- to four-year period referred to in the time to expiration of the model.

The mechanics of the classic approach also involve the added task of actually finding the replicating portfolio. The MAD and revised classic approaches both require some effort in spreadsheet modelling and option pricing, whilst the integrated approach requires perhaps the most work, since spreadsheet modelling is required and each individual risk must be evaluated and modelled separately, using either option pricing or decision analysis. The results obtained from the different approaches following these mechanics are summarised in Table 1 (opposite)

According to Borison, the differences discussed above as far as applicability, assumptions and mechanics are not simply a matter of semantics or academic correctness. Instead, they lead to dramatic differences in valuation – that is, differences in orders of magnitude and even in sign. And they lead to dramatic differences in strategy; each of the three alternatives (investment, option, neither) is the recommended alternative on the basis of at least one approach. Borison concludes that there is confusion in the current state of real options analysis. While the various approaches are philosophically similar, they differ in fundamental and contradictory ways and, when applied, they provide fundamentally different and contradictory results.

Table 1

Approach	Net value of maximising investment	Net value of option	Value-recommendation
Classic	(18)	(1)	Neither
Subjective	50	51	Option
MAD	147	93	Investment
Revised classic	299	280	Investment
Integrated	50	105	Option

Table 2

Model	Asset value (t=0)		Volatility	Exercise price		Call value	
	Borison	Adjusted		Project	Option	Borison	Adjusted
Classical	$157	$225	25%	$175	$20	$19	$66.8
Subjective	$225	$225	30%	$175	$20	$71	$70.3
MAD	$322	$237	25%	$175	$20	$113	$66.1
Revised classical	$474	$237	25%	$175	$20	$300	$68.7
Integrated	$225	$229	25%	$175	$20	$125	$58.4

As noted above, Borison's classification of approaches has elicited criticism, including a response from Copeland and Antikarov (2005) in the same journal. The wide range of real option values observed by Borison seems to converge significantly when calculations rely on a mutually consistent set of assumptions among the five different methods. Revising Borison's calculations, Copeland and Antikarov bring the range of option values from $279 million down to $12 million, an average difference of roughly 5%. Table 2 (above) summarises the key assumptions in Borison and the relative adjustments in Copeland and Antikarov.

Copeland and Antikarov attribute most of the differences to differences in assumptions – rather than difference in real option methodology. This implies that a taxonomy of real options based on valuation approach does not really matter as far as the practising manager is concerned because the five different valuation approaches result in a marginal difference in real options values that falls within a 5% range.

Further confirmation that different approaches yield similar results was provided in preliminary research undertaken by Favato, et al. It was conducted to demonstrate the relative impact of the choice of any real option continuous pricing model compared to the sensitivity to fundamental inputs on the option value. In an attempt to avoid methodological bias, he used a biotechnology business case published by Villiger and Bogdan.[11]

The case was related to a stop/go development decision of an experimental drug at the beginning of its clinical phase of development (Phase III) for which the inputs were as follows.

Expected DCF from marketed product: $42.7 million
Value of R&D Phase III investment: $70.0million
Volatility of Phase III: 30%
Expected length of Phase III: three years
Risk-free rate: 5%
Dividends: 0.0

Favato et al input the above data in 13 different real option continuous pricing models. The choice of the model had a +/- 2% impact on the option value and while a 2% difference may be statistically significant, is it really relevant from a management point of view? To answer this question, Favato et al proceeded to verify the sensitivity of all 13 models to inputs, calculating option prices

Differences in research results are not always the fault of the methodology for inputs changing one at a time by an interval of 1% (from +5% to -5%). These values were then compared to the ones obtained from the base case, to measure the magnitude of difference. All 13 models behaved very consistently.

A 1% change in inputs was found to have the following impact on the base case option price ($42.7 million):

Value of the asset: +3.50%
Option price: -2.59%
Volatility: 2.01%
Time: 1.39%
Risk-free rate: 0.38%

Methods of calculating shareholder value have become more manager-friendly

The key observation from Favato et al's work was that, given the similarity of results from the 13 different approaches and the sensitivity analysis undertaken, changes to the inputs were far more significant than the option pricing approach used.

While this outcome represents progress towards meeting the Georgetown challenge, the jury is still out on real options. With confusion on the choice of models in many areas unresolved – not least on results – it's unsurprising that management is cautious. Furthermore, even once this choice is resolved, much remains to be done to make the real options approaches appeal to management that wishes to use them to support decisions.

Traditionally, large spreadsheets were used to drive calculations concerning developments in shareholder value, but with the passage of time the models became increasingly manager-friendly with the adoption of, and analysis by, the key value drivers such that the key influence(s) could be recognised and captured in prospective scenarios. There is a strong feeling that this convergence of approaches to accommodate manager-friendliness is essential.

Whilst the valuation method may be very important, it is only a part of the managerial challenge, in much the same way as in capital investment appraisal the evaluatory technique is only a small part of what is known as capital budgeting.

Identification of the options open to management is implicit in applying the valuation methods and our experience suggests that this is a critical issue that warrants greater attention than, until now at least, it seems to be receiving. The linkage of frameworks, like scenario analysis, with the valuation methods available is an essential part of the manager's option toolkit; knowing exactly what is to be valued is a prerequisite for a successful outcome. **MU**

References

1 Decision traps
Russo, J Edward and Shoemaker, Paul J H
Fireside edition: New York, 1989

The Eli Lilly Case
Trigeorgis, Lenos; Micalizzi, Alberto and Favato, Giampiero et al
EGEA SDA Bocconi, 1997

2 'Managerial flexibility in capital investment decisions: insight from the real options literature'
Cheung, Joseph K
Journal of Accounting Literature, vol 12, pp29-66, 1993

3 'Real options: meeting the Georgetown challenge'
Copeland, Thomas E and Antikarov, Vladimir
Journal of Applied Corporate Finance, vol 17, no 2, Morgan Stanley, pp32-51, Spring 2005

4 Borison, Adam
Journal of Applied Corporate Finance
vol 17, no 2, Morgan Stanley, Spring 2005

5 'Real options: managing strategic investment in an uncertain world'
Amram, Martha and Kulatilaka, Nalin
Boston, MA: Harvard Business School Press, 1999

6 'What's it worth? A general manager's guide to valuation'
Luehrman, Timothy
Harvard Business Review, pp132-142, May-June 1997

'Investment opportunities as real options: getting started on the numbers'
Luehrman, Timothy
Harvard Business Review, pp51-67, July-August 1998

'Strategy as a portfolio of real options'
Luehrman, Timothy
Harvard Business Review, pp89-99, September-October 1998

7 'Real options: a practitioner's guide',
Copeland, Thomas E and Antikarov, Vladimir
New York: TEXERE, 2001

8 Investment under uncertainty
Dixit, Avinash and Pindyck, Robert
Princeton, NJ: Princeton University Press, 1994

'Strategy and shareholder value creation: the real options frontier'
Amram, Martha and Kulatilaka, Nalin
Journal of Applied Corporate Finance, vol 15, no 2, pp15-28, 2000

9 'Valuing risk projects: option pricing theory and decision analysis'
Smith, James and Nau, Robert
Management Science, vol 41, no 5, pp795-816, 1995

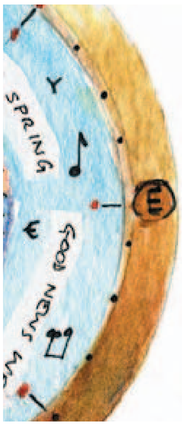
'Valuing oil properties: integrating option pricing and decision analysis approaches'
Smith, James and McCardle, Kevin
Operations Research, vol 46, no 2, pp198-217, 1995

10 'The pricing of options and corporate liabilities'
Black, Fischer and Scholes, Myron
Journal of Political Economy
81, pp637-654, 1973

11 'Real options and managerial utility'
Favato, Giampiero; Mills, Roger W and Weinstein, Bill L
Unpublished paper, Henley Centre for Value Improvement, 2005

Villiger, Ralph and Bogdan, Boris
Nature Biotechnology
vol 23, no 4, April 2005

Selected references are available to view in full at www.icaew.co.uk/managerupdate



Broadening the scope of branding

Research into brand equity and the role of branding in diverse sections demonstrates its central importance – a finding confirmed in a recent poll of top managers. New approaches to describing brand value have been developed, including a psychological approach which considers the brand as though it were a 'share' of the customer's mind, while others consider branding in the industrial context. **Susan Foreman**, professor of marketing at Henley Management College, explores the issues.

Marketing is essential to business success

Over the last two decades, marketing managers and academics have considered and debated the influence of marketing on management practice and business performance. Recent papers in journals like the Sloan Management Review and the Journal of Marketing continue this trend, reflecting on issues such as the role of marketing, its breadth and scope, its development and relationship with society and its future.

In one such article, Webster, Malter and Ganesan[1] discuss the perceived decline of marketing, arguing that movement to a cross-functional approach to marketing and the role all employees play in the marketing effort and customer-focused ethos may have led to a decline in the discipline. Webster, Malter and Ganesan show particular concern for the future of branding. Marketers, they argue, need to be much better at measuring their own performance as the current level of ambiguity can, in difficult times, lead to reductions in marketing expenditure. This in turn may lead to less work on brand development, thus diluting the power of brands, lowering levels of innovation and market power.

Despite challenges to marketing over the last two decades, the significance of branding seems undiminished. Webster, Malter and Ganesan quote a Grant Thornton survey in the US which shows that 73% of senior managers think strong brands are more important now than two years ago. This article shows the development of thinking in brand equity and also how branding plays an important role across diverse sectors, from commodities to consumer goods.

Brand equity, market share and the mind of the customer

The long-term potential of a brand in the mind of the customer is the focus of recent work by Baker, Nancarrow and Tinson,[2] who look beyond the traditional methods of assessing brand equity. They have produced a new and practical approach, which can be used in different markets to help managers measure the status, potential and value of brands. Their specific interest is in the psychological connection between the customer and the brand.

In assessing brand equity, they describe the different methods that have been developed in the past, to show managers how to build strong brands. These existing models tend to examine brand equity in terms of the brand value (the figure on the balance sheet), brand strengths (consumer attitudes and behaviour) and brand descriptions and associations. The authors suggest a parallel between the health of a brand and that of a person. Thus, just as each person has a different age and physiology, they say that it's possible to identify the basic characteristics and nature of a brand and whether brands in different markets have a brand equity surplus, deficit or parity.

To measure brand health, they draw on work by Dick and Basu,[3] who work in the areas of customer loyalty and state that there are two key dimensions to consider; behavioural (purchase habits, share of wallet, recommendations, loyalty scheme and so forth) and attitudinal dispositions (brand preference, premium pricing, intentions to purchase, satisfaction and credulity). When this is applied to brands, it is clear to see that if there are high behavioural dispositions and there are positive attitudes the result is true loyalty to a brand. At the low end of each dimension, though, no commitment to the brand is identified.

Baker, Nancarrow and Tinson also suggest that measuring a consumer's attitude towards a brand and comparing it to market share allows one to gauge whether the equity level is positive, negative or neutral. Essentially, you are comparing 'share of mind' with market share. 'Share of mind' is the predisposition or inclination of consumers towards a brand and the potential for them to make future purchases. Therefore, if you can measure 'share of mind' and compare it with actual behaviour, managers can identify whether equity is likely to increase or decline and plan accordingly.

Consequently, if 'share of mind' is greater than market share then there is an equity 'surplus' and marketers need to devise strategies to realise the potential by, for example, developing and extending the brand. In a deficit situation – where share of mind is less than market share – defensive strategies may be needed to turn the brand around. The brand is vulnerable and needs revitalising. This model of brand equity, though imperfect, does provide insights that can help managers develop brand strategies.

Branding in industrial markets

Branding is so closely associated with consumer markets that it's often perceived as inappropriate or difficult to do in industrial or business-to-business markets. Yet branding here has existed for many years. Du Pont Cisco, SAP and logistical companies like Eddie Stobart have created a distinctive corporate brand and are pioneers, proving that despite limited research and few role models, it is possible to use branding within this sector.

Increasingly, industrial goods and services organisations are trying to differentiate themselves. Two inspirational stories showing the value of branding have been published recently. McQuiston[4] shows that a commodity product can be branded and achieve successful results whilst Bengtsson and Servais[5] examine the role of co-branding in purely industrial markets. By assessing each situation it is possible to build up a picture of the issues that affect branding in industrial markets.

Complex buying processes
These exist when purchasing industrial, technical and high-value products. In this scenario, Bengtsson and Servais state that the complexity can lead the decision-maker to select a familiar supplier. This familiarity can be fostered through branding in partnership with relationship marketing. For other routine and scheduled purchases, branding still has a role but the promises a brand makes has to have a broad reach through the company.

Value
Both value and 'value-added' are important to industrial buyers. In addition to the core product – which may be complex and technical – buyers are looking for reliable support, services, excellence in distribution capability and a equivalent corporate reputation. The combined performance of each element helps to build confidence in the buyers.

Branding and the consumer are strongly linked in industrial relationships too

Personal, corporate risk/uncertainty
These factors are prevalent in industrial buying situations. Thus the perceived reliability a brand can provide can shape decisions. As Bengtsson and Servais state, emotional brand values can have an impact and industrial purchasers are not immune to something as 'fuzzy and irrational' as a brand.

Relationships
These are an important part of branding in consumer markets. It can be argued that they are more important in a business-to-business context. A series of successful purchases can be the starting-point for developing trust in the long term, which leads to mutually successful and enduring partnerships.

Networks
Networks of partners and intermediaries need to be managed to ensure that they are delivering value and promises made to buyers.

Reputation and the corporate brand
Buyers do not just buy products – they want reliability and thus they buy peace of mind when they buy an industrial brand. This in turn helps to build loyalty. They buy from people who are well-known and reputable.

Bengtsson and Servais suggest that a branding strategy can work in the industrial sector. It can be successful when two suppliers work together by linking their separate products and then promote them as one package in a co-branding strategy. By collaborating, they are promising that together they can add value, going beyond the basic functionality of the product. They are making promises to the buyer, by stating that the two products are compatible, and that the

Brand collaboration adds value in the industrial sector co-brand has additional benefits for the buyer. They imply a level of quality derived from compatibility and reduce the amount of work buyers need to do when sourcing and testing products. The result is reduced effort risk and uncertainty for the buyer. For their part, the suppliers decrease the chance of buyers switching to alternatives and thus improve their own competitive position compared with their rivals.

Brands make things easier for the buyer – and for the business

Some industrial goods are complex, distinctive, technically interesting and make a fascinating basis for branding. However, can simple commodities be successfully branded? McQuiston has investigated the branding of basic flat hot rolled steel produced by a company called Rautaruukki. They started a branding exercise by talking to their customers. Their research helped them to understand that the customers really wanted more than just steel: they also wanted a 'bundle' containing a high-quality core product, a logistical solution and customer support services.

The company therefore developed a 'total solution' for the customer, was able to build on its existing reputation and produced 'one package with a single identifiable brand'. They simplified the buying process, assured quality, and reduced the buyers' uncertainty, anxiety and perceived risk. The result was an increase in sales from approximately 10,000 to 80,000 tons in eight years.

Branding to attract talent

The use of corporate branding to attract talented employees is also generating considerable interest. Managers are now being urged to invest in a branding strategy that will appeal to the sort of employees who can bring a company the intellectual and creative capabilities it needs to develop its competitive advantage. This can lead a company to have three levels of branding: the corporate brand, the product brand and the employee brand. This is leading some managers to see their employees – rather than the customer – as the organisation's first customer. The simple logic suggests that if the internal customer (the employee) is happy and motivated then they will be able to satisfy the needs of the external customer.

Brands extend to the identity of the company itself

Berthon, Ewing and Hah[6] build on the existing work in internal marketing that advocates careful matching of employees, their jobs and the goals of the company and suggest that branding strategies should be used to attract the best employees.

They develop this and add that companies should differentiate themselves in the eyes of new recruits by highlighting the attributes of the company and the job roles and emphasising emotional benefits which might reduce part of the perceived risk and uncertainty of moving jobs.

It is this notion of developing such employer attractiveness that becomes the focus of their research as they develop a questionnaire that employers can use to help them understand what factors are attractive to talented people. This can then be used as a basis for developing a brand position that would appeal to the recruits they need. An employer, they argue, should consider:

- *interest value* – whether the recruit perceives the company to be an exciting, novel, creative and innovative place to work;
- *social value* – the perception of working atmosphere, whether it is noted for its collegiality, teamwork. Is it known as a 'fun' place to work?
- *economic value* – the financial benefits and overall package associated with working for one company when compared to another;
- *development value* – whether a company has a good reputation for staff development and for valuing people; and
- *application value* – the extent of the learning environment. Where a graduate can, for example, apply their learning or more experienced employee can pass on their experience. As Berthon, Ewing and Hah state, there is a 'customer-orientated and humanitarian' perspective.

Companies can develop their job offering, target recruits and create advertising messages and hopefully get noticed in the marketplace ahead of their competitors once they understand how they are perceived. According to Berthon, Ewing and Hah the management strategy of human talent is very important. Therefore, a branding strategy can augment the work of the Human Resources department.

Corporate branding and reputation

A corporate approach to branding has existed since branding's early days. For some companies (such as IBM, Nokia and Virgin) it is a key part of their strategic marketing approach. Others, like Unilever and Sony, have developed dual strategies for building the corporate identity, image and brand alongside individual product brands.

Interestingly, Argenti and Druckenmiller[7] have identified a resurgence in the emphasis on corporate branding. In their investigation, 94% of senior executives said that it was becoming more important and of that number, 30% were actively working on their corporate branding strategy. The reasons behind this resurgence are interesting. Argenti and Druckenmiller state that:

- *product markets* are changing and with the need to introduce new products to the market quickly, the corporate brand can provide the credibility other newly introduced brands cannot supply. Furthermore, the pace of change for technology companies has emphasised the corporate brand's role in providing consistency and continuity;
- *corporate communications* need to be managed carefully as managers are increasingly aware that existing communications to customers need to be matched with an equally sophisticated approach to shareholder, investors and analysts;
- at a time of *structural change* (such as a merger or acquisition), a strong corporate brand for the new identity sends clear messages to employees, stakeholders and the marketplace; and
- *activism* is more prevalent now than ever before and to address these concerns, Argenti and Druckenmiller suggest that a corporate approach is easier to manage and more effective at a corporate level than at an individual product brand level.

One of the more compelling reasons behind the development of corporate brands for Argenti and Druckenmiller is the crucial role they are playing in developing reputation. Corporate brands can also allow companies to express their contribution to society or corporate social responsibility. The authors found 69% of the executives they contacted said corporate social responsibility was fundamental to future success, credibility and profitability. 'When customers get what they expect from a company time and time again (ie, the corporate brand promise is kept), reputation is strengthened.'

Just as marketing has broadened its scope, branding too is seen to provide benefits beyond its traditional and dominant role in consumer markets. It has a role to play in developing customer relationships both inside companies and outside them. As branding theory and practice develops and matures it may also be applicable to other areas of marketing.

Keeping the brand 'promise' is key to continued success

Webster, Malter and Ganesan state that brand value and equity models are being used to help managers develop marketing strategies and assess marketing's contribution to shareholder value. Further work on equity, metrics and measures to assess the effectiveness of marketing actions – and demonstrating its contribution to financial performance and customer satisfaction – will help not only to reinforce the importance of branding but also support the wider marketing cause. **MU**

References

1 'The decline and dispersion of marketing competence'
Webster, Frederick E Jnr; Malter, Alan J and Ganesan, Shankar
MIT *Sloan Management Review*
vol 46, issue 4, pp35-43, Summer 2005

2 'The mind versus market share guide to brand equity'
Baker, Colin; Nancarrow, Clive and Tinson, Julie
International Journal of Market Research
vol 47, issue 5, pp525-540, 2005

3 'Customer loyalty: toward an integrated conceptual framework'
Dick, Alan S and Basu, Kunal, *Journal of the Academy of Marketing Science*, vol 22, issue 2, pp99-113, 1994

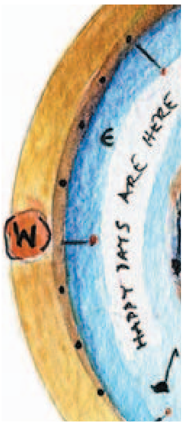
4 'Successful branding of a commodity product: the case of RAEX LASER steel'
McQuiston, Daniel H
Industrial Marketing Management, vol 33, issue 4, p345, May 2004

5 'Co-branding on industrial markets'
Bengtsson, Anders and Servais, Per
Industrial Marketing Management
vol 34, issue 7, pp706-714, October 2005

6 'Captivating company: dimensions of attractiveness in employer branding'
Berthon, Pierre; Ewing, Michael and Hah, Li Lian, *International Journal of Advertising*, vol 24, issue 2, pp151-173, May 2005

7 'Reputation and the corporate brand'
Argenti, Paul A and Druckenmiller, Bob, *Corporate Reputation Review*, vol 6, issue 4, p368, 2004

Selected references are available to view in full at www.icaew.co.uk/managerupdate



Leadership – influences and outcomes

How does the broader context of a leader's job demands affect performance? Recent studies have located the chief influences on leadership in the environment, and successful leaders are those who best understand and adapt to this environment, who possess 'contextual intelligence'. But most scholars agree that the executive environment has changed significantly from the early 1990s. **Richard McBain**, director of distance learning programmes at Henley Management College, examines the increasing pressures on executive performance.

The study of leaders – and leadership – is an enduring, if ever changing, business topic. According to Turner and Muller[1] six main schools of leadership theory have emerged over the last 70 years. These include the 'trait' school which focuses on the abilities, personality and physical appearance of leaders; the 'contingency' school, for which effective leadership depends on the situation; and the 'visionary' school, which has been characterised by the distinction between transactional and transformational leadership.[2]

The leader's position and skills are of great strategic importance

This article will consider some recent research into leadership. It begins by considering the impact of the broader context on leaders and their success, and also the perceived demands of the job of the leader, as a factor explaining strategic actions and behaviour.

The article will also consider some new research into the relationship between leadership, successful projects and change programmes and finally, examine research into the outcomes and influences on transformational leadership and its link to the relationship between leaders and followers.

The importance of reading the context

Mayo and Nohria[3] argue that great leadership is a 'function of the circumstances in which businesses and their top executives operate' (p. 49). They call the leader's ability to understand this backdrop 'contextual intelligence'. In a study of 1000 successful business leaders in the US between 1900 and 2000, they found that this contextual intelligence was key to their success and that three distinct leadership archetypes could be identified:

- *the entrepreneur*: often ahead of their time, skilled at sensing emerging opportunities – or the potential of nascent technologies – and who build successful enterprises through perseverance and determination;
- *the manager*: skilled at reading and exploiting the context of their times, spotting opportunities to expand the scale and scope of an established business through disciplined resource allocation and execution; and
- *the leader*: confronted change and identified latent potential in businesses, finding ways to breathe new life into them.

The authors say that six contextual factors are particularly influential: government intervention, global events, demographics, social mores, technology and labour. Yet, they argue, if context influences business, it is also the case that great leaders can influence the context. One practical implication is that an organisation seeking to fill a key leadership position should both understand the contextual environment behind a candidates' record and also consider the context it currently faces.

Thus, the 'manager' type may be the most suitable type of candidate for CEO if a company is seeking to maximise growth, while in times of crisis or decline the 'leader' type may be the more obvious choice.

Explaining strategic actions and behaviour of leaders

For Mayo and Nohria the current context has changed significantly since the 1990s. 'Executives at the beginning of the new millennium face the potential for increased regulation, reticent consumers, constant global uncertainty and vast demographic changes. The euphoria and delirium of the 1990s have been replaced with caution, pragmatism, and conservatism' (p. 60). An increasing focus on competence and results may be accompanied by increasing pressure on executives to perform. Hambrick et al[4] note that a time of greater vulnerability to dismissal and increasing executive incentives is also one in which CEOs have been criticised for aggressive and even dubious acts.

The authors argue that the difficulties executives experience in their jobs have often been largely ignored, so they have developed the concept of 'executive job demands' (EJD) to help to understand executive behaviour. The view that executives can comprehend their strategic situation – and pursue logical actions to address these – may be most appropriate when executive job demands are low to moderate. Assumptions of 'bounded rationality' on the other hand – according to which executives filter and interpret the overwhelming stimuli confronting them either by relying on their personal experiences or by imitating the actions of others – may be most appropriate under conditions of high executive job demands.

Executive job demands represent the degree to which a given executive experiences his or her job as difficult or challenging in terms of workload, rather than qualitative demands such as role ambiguity or conflicting obligations. They will depend on the degree to which the executive's capabilities are appropriate for the context, and three sets of characteristics (two contextual and one personal) impact on EJD:

- *task challenges*: conditions that make it difficult for an executive to attain a given level of performance, arising from environmental factors (especially scarcity, complexity and dynamism) or from the organisation itself (resource limitations and complexity);
- *performance challenges*: relating to the level of performance required of the executive, arising principally from the firm's owners and directors; and
- *executive aspirations*: the executive's drive to perform, arising from personality factors or internal locus of control.

The authors have developed a number of propositions for further research into the consequences of EJD for strategic decision-making and leadership behaviours, including the following:

- the greater the level of EJD, the more an executive's personal characteristics will impact upon strategic choices. There is also the greater tendency to imitate the strategic actions of other firms and to more extreme and variable strategic behaviours. Those executives who have performed well under conditions of high job demands will become more confident and will engage in riskier strategic behaviours; and
- in terms of leadership behaviour, high EJD will be associated with greater pressures being placed on others and the greater the executive's attention will be to convey confidence and calm. In contrast, the lower the job demands, the more an executive will seek to enhance the impression of having high job demands.

Analysing the job demands can help explain executive behaviour

The practical implications of the notion of EJD could be to understand their potentially counterproductive effects and to develop appropriate executive compensation plans. It could also aid the understanding of top management team dynamics and the rise of executive stress.

Leadership behaviours and the success of projects and change

How does leadership behaviour impact upon the success of projects and change programmes? Turner and Muller[5] note that while there has been a revival of interest in project success factors, the literature rarely focuses on the leadership style and competence of the project manager, in marked contrast to general management literature.

This may be because of the unique, novel and transient nature of projects, or because many studies are based on project managers' opinions, and project managers do not recognise themselves, their leadership styles or their competence as a contributor to success. Nevertheless, much has been written on the project manager and his or her leadership style and competence. The key conclusions from their review of the literature include:

The personal qualities of the manager are very important

- the project manager's competence, including personality and leadership style, is related to success as a project manager;
- different project leadership styles are appropriate at each stage of the project life cycle;
- specific leadership styles are appropriate for multicultural projects;
- project managers have a leadership role in creating an effective working environment for the project team;
- project managers prefer task-oriented to people-oriented leadership styles; and
- the project manager's leadership style influences his or her perception of success in different situations.

The recent study by Higgs and Rowland[6] throws more light onto the relationship between leadership behaviour on the success of change initiatives – a particularly relevant question given both the growing need for change in organisations and the failure of many, if not most, change initiatives.

Their case study research of 40 informants in seven organisations provided 70 'change' stories, which were analysed to identify approaches to change and leadership behaviour. Change, they say, is not necessarily a linear process and organisations are systems tending to states of stable equilibrium. Change is a complex and often emergent process, which cannot necessarily be implemented on a top-down or uniform basis in an organisation.

Based upon the level of complexity and control involved, we can distinguish four approaches to change:

Change in an organisation is complex and not always linear

- *directive*: seeking high control and adopting a simplistic top-down approach;
- *master*: recognises complexity and seeks a planned and uniform implementation across the organisation;
- *DIY*: involving localised and opportunistic initiatives and a simplistic approach; and
- *emergent*: adopting low levels of central control, a recognition of complexity, it is characterised by the use of networks, often informal, uses innovation and experimentation, and involves groups that may lie outside the mainstream of an organisation.

Furthermore, the research identified three clusters of leadership behaviours:

- *shaping behaviour*: involving directive behaviours and a leader-centric focus;
- *framing change*: the leader is a sense-giver and sense-maker who establishes starting points for change, designs and manages the change journey, and communicates guiding principles; and
- *creating capacity*: the leader creates an overall framework for change, creates individual and organisational capabilities, through coaching for example, and by communication and creating connections.

This research identifies a number of key points:

- an 'emergent' approach is the most effective in high-magnitude changes impacting on a large number of people and multiple parts of the organisation;
- framing change is the most effective style both for high-magnitude change, accounting for 52% of the variance in change success, and in short-term change, accounting for 42% of the variance;
- in long-term change initiatives within organisations facing continuing change, a 'master' approach – combined with leadership behaviours that create capacity – appears most effective;
- approaches to change based on a simplistic model (the DIY and directive approaches) are less effective in most scenarios than more complex models (the master and emergent approaches). An emergent approach is the most successful in most contexts, while the simplistic DIY approach appears to be unsuccessful in any context; and
- the shaping behaviour approach to leadership can impair the success of an intervention.

This study demonstrates the relationship between change approaches and leadership behaviours. It supports the view that top-down programmatic change based on assumptions of linearity does not work. Recognition of the complexity of change is important for effective change strategies.

An emergent approach is strongly related to success in most contexts, although it often arises in the context of a more structured and planned approach to change that is going off course.

Finally, this study supports the view that the top-down leader-centric model of leadership is less appropriate than a more supportive and transformational approach to leadership.

Transformational leadership and leader-member exchange – influences and outcomes

We can identify two contrasting perspectives on leadership. One is 'leader-focused' and seeks to explain individual, group and organisational performance by reference to leader behaviours. The other focuses on the relationship between the leader and follower.[7] Transformational leadership (TL) theory is an example of the former. Transformational leaders develop a compelling vision of an organisation's future. Through processes of identification and internalisation followers align their values, beliefs and attitudes with that vision. Leader-member exchange (LMX) is an example of a relationship-based approach and involves the processes of role making and social exchange.

Managers or supervisors develop close relationships with only a few subordinates, and while social exchanges in low-LMX relationships are limited to the requirements of the employment contract, high-LMX relationships develop mutual trust, respect and obligation. Such relationships result in support beyond that specified in formal job descriptions.[8] A subordinate may gain access to the leaders' network of trusted relationships, and may be given more autonomy and responsibility. These intrinsic and extrinsic rewards play a role in shaping employee behaviour and attitudes and may contribute to higher task performance and organisational citizenship behaviours (OCB).

Wang et al's[9] study of 162 leader-follower dyads in organisations in the People's Republic of China, integrates the transactional leadership and LMX literatures by examining whether transformational leadership works through LMX to impact on follower task performance and OCB. Their findings support this view and suggest that the effect of transactional leadership depends on how each follower personally experiences and interprets these leadership behaviours.

The practical implications of this research are that LMX-enhancing TL strategies should be part of leadership development programmes, because it is through developing stronger social bonds that transactional leaders impact on follower performance, and that leadership programmes which seek to develop the quality of leader-follower relationships may also be enhanced by incorporating training in transformational leadership skills.

Another factor which influences the quality of leader-member relationships are the schemas or 'implicit leadership theories' (ILTs), representing traits and abilities (such as sensitive, dynamic, strong and intelligent), characterising the ideal business leader and which are developed through socialisation and past experiences with leaders.

The leader's relationships with other workers are highly influential

Individuals use them as benchmarks to help them to understand and respond to managerial behaviour. In a longitudinal study of employees in seven British companies, Epitropaki et al[10] showed that the closer employees perceived their actual manager's profile to be to the ILTs they endorsed, the better the quality of LMX. In addition, a difference between implicit and demonstrated leadership traits impacts on employee job satisfaction, organisational commitment and well-being. The longitudinal study design suggests that it is the implicit-explicit leadership traits difference that affects LMX and not the other way around.

Managers could benefit from this research by learning which traits are included in their subordinates' implicit leadership profile and how their subordinates expect them to behave. Management training programmes that increase managers' awareness of the importance of ILTs – and training programmes that develop managers to achieve organisationally-accepted leadership prototypes – might also be a useful supplement to less formal socialisation processes.

The final piece of research considered seeks to establish if there is a relationship between transformational leadership and the development of an ethical climate in organisations, and to explore the link between altruism, integrity and transformational leadership (Engelbrecht et al[11]). The ethical climate of an organisation is its moral atmosphere. It comprises shared perceptions of right and wrong, as well as assumptions about how moral concerns should be addressed.

The moral attitudes of leadership influence the ethical tone of the entire organisation

There are good reasons for arguing for a link between transactional leadership, altruism, integrity and the ethical climate of an organisation: the transactional leader may be seen as a role model displaying the behaviours required to reinforce ethical behaviour. Altruism is a core value of transactional leadership, not only because the transactional leader should sacrifice his or her own gain so that others may gain, but because such leadership should motivate followers to transcend their own self-interests for the sake of the organisation. Likewise, integrity (which is the consistency of personal beliefs and values in daily working behaviour and in organisational aims), is a core value of such leadership.

Ethical leadership is productive as it promotes integrity in all staff members

The key findings from their study of 200 responses medium to large South African companies from a wide range of sectors are that:

- altruism and transactional leadership are significantly related, with the former explaining approximately 40% of the variance in the latter;
- transactional leadership explains approximately 23% of the variance in ethical climate – the more unit leaders demonstrate transactional leadership, the stronger the ethical climate in their units; and
- the integrity of the leader doesn't seem to impact on the relationship between transactional leadership and ethical climate, although integrity accounts for 22% variance in transactional leadership.

Ethical values, therefore, seem to play a positive role in developing transactional leadership. In turn, transactional leadership has a positive relationship with the ethical climate in an organisation.

This suggests that organisations should create and develop ethical leaders. Top management, therefore, must be committed to a clear code of ethical conduct; recruit, select and promote leaders with core ethical values; develop performance standards that reward ethical behaviour and encourage training in ethical leadership skills. **MU**

References

1 'The project manager's leadership style as a success factor on projects: a literature review'
Turner, J R and Muller, R
Project Management Journal
vol 36, issue 1, pp49-61, 2005

2 'From transactional to transformational leadership: learning to share the vision'
Bass, Bernard M
Organisational Dynamics, vol 18, issue 3, pp19-31, 1990

3 'Zeitgeist leadership'
Mayo, Anthony J and Nohria, Nitin
Harvard Business Review, pp45-60, October 2005

4 'Executive job demands: new insights for explaining strategic dimensions and leader behaviors'
Hambrick, Donald C; Finkelstein, Sydney and Mooney, Ann C
Academy of Management Review
vol 30, issue 3, pp472-491, 2005

5 Turner and Muller, op cit

6 'All changes great and small: exploring approaches to change and its leadership'
Higgs, Malcolm and Rowland, Deborah
Journal of Change Management, vol 5, issue 2, pp121-151, 2005

7 'Leader-member exchange as a mediator of the relationship between transformational leadership and followers' performance and organizational citizenship behavior'
Wang, Hui; Law, Kenneth S; Hackett, Rick D; Wang, Duanxu and Chen, Zhen Xiong
Academy of Management Journal, vol 48, issue 3, pp420-432, 2005

8 'From ideal to real: a longitudinal study of the role of implicit leadership theories on leader-member exchanges and employee outcomes'
Epitropaki, Olga and Martin, Robin
Journal of Applied Psychology, vol 90, issue 4, pp659-676, 2005

9 Wang, Hui et al, op cit

10 Epitropaki, Olga and Martin, Robin, op cit

11 'The effect of ethical values on transformational leadership and ethical climate in organisations'
Engelbrecht, A S; van Aswegen, A S and Theron, C C
South African Journal of Business Management, vol 36, issue 2, pp19-26, 2005

Selected references are available to view in full at www.icaew.co.uk/managerupdate

Analysing the reasons for corporate failure

What are the causes of corporate failure, and can they be avoided? Numerous studies reveal the alarmingly high failure rate of business initiatives, and corporate survival rates have recently declined across the major European economies. **Ian Turner**, professor of management studies and director of graduate business studies at Henley Management College, looks at the range of explanations for failure, before considering whether failure can sometimes even be 'good'.

After addressing growth strategies in the last article, we'll now review recent writing on corporate failures. What are the causes of company failure and how can these be stopped? In what ways can companies learn from failure? Of course, not all failures *in* business actually lead to the failure *of* the business. There are, though, many examples in recent times of growth strategies that failed. Unilever, for example, embarked upon its well-publicised Path to Growth strategy in 2000. Since then, it has not only failed to grow profitably but has also seen its European sales decline. Part of the problem was in not being quicker to address emerging market trends, such as the one for low-carb diets. Similarly, Volkswagen embarked on a burst of growth in the late '90s by acquiring other well-known automobile brands, only to find these began competing against each other as competition intensified by the middle of this decade.

Do successful growth strategies automatically lead to a boost to profits? Not necessarily. As Greenwald and Kahn[1] point out in a recent article, multinational media giants like Disney, Viacom and Time Warner often posted spectacular annual revenue growth in the decade between 1994 and 2004, while the low accompanying shareholder returns indicated that in fact, they weren't generating true shareholder value. Why? The authors maintain that companies operating in global markets are often destined to have lower returns than more traditional companies operating in 'local markets'. They contrast the performance of these big media companies with traditional US newspaper companies, whose revenue growth was much more modest, but who managed to generate positive shareholder returns over the same period.

The authors' definition of local, though, may not necessarily be that of most people. They define markets as local, both in the literal geographic sense of the term but also in the sense of markets limited to a single product or handful of related products. Competitive advantage, they argue, occurs through capturing customers, proprietary technology or economies of scale which are easier in narrow local markets than on a global scale.

Thus, if advantage depends on economies of scale – and this requires a producer to operate above a certain level of production – this minimum efficient scale is more likely to be achieved in large-scale markets. In a restricted market, on the other hand, economies of scale are much less easy to achieve, as they tend to require a much larger percentage of the market. This can be difficult to reach without competing against incumbents. Indeed, they would maintain that many sustainable sources of advantage are based upon local or regional presence, even in industries such as retail, pharmaceuticals and consumer goods, which are ostensibly global. Moreover, more and more of what we purchase is made up of services rather than products and as services tend more often to be provided on a local basis, strategy and competitive advantage will increasingly depend on a local presence.

> Local presence is of growing importance as consumer focus moves from products to services

The prevalence of corporate failure

Many corporate observers need no reminding of the failure rate of business initiatives such as acquisitions, business process re-engineering or diversification. But, as Paul Ormerod reminds us: 'Failure is the most fundamental feature of both biological systems and human social and economic organisations.

'Of all the species that have ever existed 99.99% have failed in the most dramatic way. They are extinct. In America, more than 10%

of all companies fail every year, with more than 10,000 closing every week.'[2]

Knott and Posen[3] argue that this 10% figure needs perspective, as 11% of existing firms in the US are new each year, so the overall stock is actually growing at a net rate of 1%. Moreover, failure is disproportionately skewed towards newer and younger companies. In the US, for example, 51% of firms exit the market within the first four years of their life and there would appear to be a well-established relationship between the age and size of an organisation and its risk of failure.

Corporate life expectancy in Europe has declined in recent years

According to Sheth and Sisodia,[4] corporate life expectancy across major European economies has declined in recent years. In Germany, for example, it has dropped to 18 years from 45, in France to 9 from 13 and in the UK to 4 from 10 years. While they say much of this is because of mergers and acquisitions, they argue many of the acquisitions themselves are prompted by corporate failure or, to use their expression, 'distressed selling rather than strategic buying'. No doubt to the chagrin of consultants and advisors worldwide, they argue many companies succeed by accident rather than design. Take, for example, the early business histories of many now well-established corporations. They cite the example of Microsoft, whose current world dominance owed much to the success of MS-DOS, an operating system which the infant Microsoft provided for IBM in the early '80s after first acquiring it from a local software company for a trivial sum and re-branding it as a Microsoft product.

Companies succeed because by chance or circumstance their internal capabilities and assets seem to match the opportunities in the environment at that particular time. As such, they can just as easily fail if they prove unable or unwilling to change their culture, processes, systems and structure. This phenomenon, variously described as the dominant logic, active inertia and blind spots, is the prime cause for decline and failure, the authors argue. Sheth and Sisodia also believe that companies which focus on the narrow interests of a few stakeholders at the expense of others are unlikely to achieve long-term success. In the long run, they argue, success generally requires the engagement both in a material sense – and on an emotional basis – of the organisation's key stakeholders.

Companies' actions during lulls can determine long-term success

Other reasons for failure include changes to the environment, including six prime 'change drivers' affecting the business landscape with varying degrees of speed and impact, the authors say. Interestingly, they believe that many companies focus too much on technology and globalisation as the prime drivers for change. While these are clearly important, it is generally faster-moving external forces like regulation, capital markets and competition which have the most impact upon a company's ability to survive or fail. When facing major seismic shifts in a company's business environment, companies that continue to practice so-called status quo management are doomed, Sheth and Sisodia argue. Instead, they urge 'anticipatory management', which may be fine as a concept but much more difficult in practice.

This approach requires not only anticipating trends in advance but also launching major changes in structure, systems and processes in an organisation which is currently performing acceptably.

Sure ways to lose your competitive advantage

Ma and Karri[5] argue that top management generally bears the main responsibility for corporate failure, usually through ignorance of their own sources of competitive advantage, gross negligence, arrogance, overconfidence and self-aggrandisement. Major environmental shifts are also caused by pure bad luck, eg, through acts of God like hurricanes or terrorist activity like 11 September 2001, both of which can impact unpredictably but seriously on companies and their ability to survive. Again, the key to mastering such shocks would appear to lie in proactive anticipation and constant self-critical questioning. 'Only the paranoid survive' as Andy Grove, founder of Intel, famously once said.

Strategy as active waiting

For Donald Sull,[6] it is companies' actions during lulls between the periods of radical change that can determine their long-term success. He argues that major changes, whether they are 'golden opportunities' or 'sudden death threats' are relatively rare events that occur just once or twice a decade. Given their relative infrequency, Sull argues that companies should engage in a strategy of so-called 'active waiting.' 'Like an advancing army, a company proceeding into an unpredictable future can follow a general direction, probe the future for potential opportunities and threats, keep resources in reserve, remain battle-ready, and, when the big opportunity or threat arises, strike hard.' [7]

Thus, in addition to engaging in small-scale experimentation and other grass roots initiatives, companies in periods of calm and stability should maintain relentless pressure on operational excellence, cutting costs and improving efficiency wherever possible. They should also build up a war chest to deploy rapidly in the face of either major opportunity or a sudden death threat to their existence. This clearly supports the idea that companies which are well-established and resource-rich are better able to weather potential sources of failure when they arise.

Organisational failure as failed turnaround

To Sheppard and Chowdhury[8] corporate failure is not about the environment or the organisation per se, but rather about a failure of alignment between the organisation and its environmental realities. Since an organisation generally has the time and opportunity to make adjustments when a misalignment occurs – through, for example, a turnaround strategy – organisational failure must therefore by definition stem from a failure to successively implement the turnaround. Even in industries that are subject to radical unforeseen shocks, such as the airline industry after 9/11, there were some companies which were able to adjust and others which went out of business because they were not properly positioned in the industry or because their turnaround strategies were ineffective, the authors argue.

These authors have developed a four-stage sequential model of the turnaround process. In the first stage, performance declines, leading into the next stage where corrective action is taken in response to the perceived reduction in performance, and to a third transitional stage during which all the necessary actions to effect a turnaround have to be put in place. In the fourth and final stage, the outcome of these interactions becomes apparent and leads either to a turnaround or corporate failure.

They illustrate this model by reference to the Canadian retail industry, highlighting in particular the demise of T. Eaton Co. Ltd., a very well established Canadian department store which dominated its market for 130 years, only to succumb to competitive pressures in the late '90s. The Eaton story is a familiar one to followers of retail stores on both sides of the Atlantic. The company's position, once supreme in Canada, was eroded by speciality niche competitors on the one hand and new entrants piling aggressively into the bottom end of the market on the other. Attempts to address emerging segments generally resulted in the loss of its traditional customer base.

Eaton's decline proved unstoppable in part, because it failed to act radically or quickly enough during the second stage of the turnaround process. Management failed to perceive the gravity of the situation or was unable to cull enough underperforming stores or failed to raise sufficient new capital quickly enough to refurbish and revamp the remaining stores and reposition the company for success. The company eventually went into receivership in 1999 and lingered on for a few years as a brand within the Sears' empire, before finally disappearing in 2003.

Forward-looking and proactive management can plan for disasters and survive them

At first blush the most striking aspect of the story is how a company that once dominated its market – and was the largest privately held department store chain in the world – could go bankrupt. More interestingly, perhaps though, is that it took the company over 50 years to fail. 'Such a long time-span supports the academic insight and conventional wisdom that symptoms of decline, and eventual failure, start appearing many years before the failing firm's ultimate death.'[9]

The other main insight in this study is that to arrest long-term decline, turnaround actions need to be taken as early as possible and be sufficiently aggressive to provide a temporary breathing space, thus allowing the company to build a platform for longer-term strategies. Leave the short-term turnaround actions too late, and decline can turn into an ever-descending spiral from which any return is unlikely.

The role of boards in failing organisations

Boards too can be responsible for errors and failure

For Kamel Mellahi[10] the focus of responsibility for failing organisations lies with top management. Mellahi has also developed a four-stage model of corporate failure but based around the behaviour of company boards. The stages pass from conception, when the seeds of the crisis are sown, through early strategic errors, through the warning signals stage, where the initial mistakes were compounded with other failed strategies, through the rebellion stage, where in response to sharp decreases in the company's share price the board challenges the

CEO and his decisions. The final stage is collapse where performance deteriorates markedly and ultimately leads to bankruptcy.

The way that managers react to and deal with approaching crises often worsens the situation

Mellahi illustrates this model with an unusual research approach investigating the fate of HIH, which until 2001 was Australia's second largest insurance company and in that year became the largest corporate failure in the history of Australia. The very prominence of HIH and the wide impact of its demise prompted the establishment of a Royal Commission to investigate its collapse. It is the copious volumes of data collected by this Royal Commission which provide the material for Mellahi's research and the development of the model.

This approach is used to test two theoretical approaches to corporate failure. The first is called prospect theory, which holds that in the face of a threatened failure managers become more prone to taking risk: like gamblers, the more they lose the wilder their betting behaviour becomes, so that disaster is often reinforced and commitment to a failing course of action is escalated.

The second theoretical perspective is known as 'threat – rigidity effect theory'. This holds that in the face of a threatening situation like a crisis, managers become paralysed and cling to the status quo or outmoded 'rules of thumb'. In both cases the role of a board of directors is to act with vigilance to prevent either excessively risky behaviour on the one hand, or the challenge of corporative inertia on the other hand.

Mellahi was able to find evidence to support both these theories in the HIH case. In particular, it seemed to support the notion that as companies get further and further into trouble, the CEO's power to control the board increases and the board's ability to influence events drastically decreases. He offers some positive recommendations from the research, albeit ones that are not easy to implement. Boards of directors should be vigilant in looking for early-warning signals of trouble.

Early signs of problems should be constantly watched for

They should actively seek out business warning signals rather than waiting for them to spring to their notice. 'Group-think' should be actively combated by encouraging contention in the board and limiting the number of years board members can serve. 'Knowledge malnutrition' – where directors have insufficient knowledge about the company to take an informed view of the risks involved – should be actively combated. Mellahi urges independent views to be sought before major strategic decisions like acquisitions.

Creative errors and heroic failures

Yet not all failures in business are necessarily catastrophic, as Kriegesmann[11] et al point out in their recent article. While there is a rhetorical commitment in many organisations to innovation and change, often behaviours and policies can induce risk-averse behaviour, stifling the very innovation which companies seek to promote. Certainly there are many types of error in business, which should not be tolerated, particularly if a series of errors occurs through the inability or unwillingness of individuals or managers to learn from their experience.

On the other, there are other types of errors or failures – such as those that occur through changing circumstances, so called 'system errors', or what the authors call 'creative errors' or 'successful failures' – with manageable and calculated risks. They illustrate their ideas with an example from BMW in Germany, where in one plant a 'Creative Error of the Month' award was established to enable people to bring forward well-considered initiatives with calculated risk analysis attached to them and create an opportunity to learn in a blame-free environment, even in the event that the innovation does not succeed.

Unfortunately, if Baumard and Starbuck[12] are to be believed, organisations prove depressingly incapable of learning from small failures and, if anything, even less from large failures! Indeed, they contend that even when learning does occur it often teaches companies the wrong lessons. The authors illustrate the point with their longitudinal research into both large and small failures in large multi-divisional European telecommunications companies.

Such businesses, they conclude, are intensely political and thus managers can use failures to bolster their own power positions. 'Managers agreed to try experiments that did not challenge their core beliefs, and accordingly, the experiments propagated the core beliefs. Failed experiments became ideological playgrounds where people sought new ways to reinforce existing beliefs about past successes…managers interpreted the small failures as demonstrating the foolishness of attempts to deviate from the firm's core beliefs'. Thus, far from stimulating innovation, the small-scale experiments actually prevented testing of fundamental assumptions about the business.

Evidence that contradicted core beliefs was often discarded and experiments chosen that were likely to sustain beliefs. Large failures, if anything, supported even less learning than the small ones, since large failures were almost always attributed to exogenous causes and not managerial actions.

Is failure good?

As already mentioned, the vast majority of all new firms fail. Generally, the literature on entrepreneurship, from Schumpeter onwards, has interpreted this as the inevitable, if regrettable, by-product of the process of creative destruction. The literature on innovation holds that successful entrepreneurs will provide economic benefits by satisfying existing needs or even creating new consumer needs.

Could unsuccessful ventures, even though they may be failures individually, also have a generally positive impact on the public good? It is well-known that the airline and rail industries, for example, which have often failed over decades to generate shareholder value, have enabled the creation of a vast range of associated industries which have generated enormous economic and social benefits. Knott and Posen[13] test their hypothesis that failure can be good by examining the US banking industry. They found evidence to support the three different mechanisms for promoting benefits from failed companies identified in the literature:

- the 'selection' effect, which holds that firms who survive from a large population of companies ought to be better performers than those that survive from a smaller population because the excess entry of competitors in any industry will tend to yield ultimately superior survivor companies;
- the 'competition' effect, which holds that competition amongst companies leads to competitive pressures to innovate; and
- the 'spillover' effect, which holds that the value of investments made by failed companies is subsequently appropriated by survivor companies through, for example, benefiting from investments in training, R&D and marketing.

Failure is not always a bad thing: it can lead to new opportunities

According to Baumard and Starbuck, companies which prove resolutely resistant to learning from their own failures can, paradoxically, benefit significantly from the failure of other companies, as demonstrated by Knott and Posen's research. **MU**

References

1 'All strategy is local'
Greenwald, Bruce and Kahn, Judd
Harvard Business Review, pp94-104, September 2005

2 'Organizational failure',
Ormerod, Paul cited in Wilkinson, Adrian and Mellahi, Kamel, *Long Range Planning*, vol 38, p235, 2005

3 'Is failure good?'
Knott, Anne Marie and Posen, Hart E
Strategic Management Journal, vol 26, issue 7, pp617-641, July 2005

4 'Why good companies fail'
Sheth, Jagdish and Sisodia, Rajendra
European Business Forum, issue 22, pp25-30, Autumn 2005

5 'Leaders beware: some sure ways to lose your competitive advantage'
Ma, Hao and Karri, Ranjan
Organisational Dynamics, vol 34, issue 1, pp63-76, 2005

6 'Strategy as active waiting'
Sull, Donald N, *Harvard Business Review*, pp121-129, December 2005

7 Sull, op cit, p124

8 'Riding the wrong wave: organizational failure as a failed turnaround', Sheppard, Jerry P and Chowdhury, Shamsud D, *Long Range Planning*, vol 38, issue 3, pp239-260, June 2005

9 Sheppard and Chowdhury, op cit, p253.

10 'The dynamics of boards of directors in failing organizations'
Mellahi, Kamel
Long Range Planning, vol 38, pp261-279, 2005

11 'Creative errors and heroic failures: capturing their innovative potential'
Kriegesmann, Bernd; Kley, Thomas and Schwering, Markus G
Journal of Business Strategy, vol 26, issue 3, pp57-63, 2005

12 'Learning from failures: why it may not happen'
Baumard, Philippe and Starbuck, William H
Long Range Planning, vol 38, pp281-298, 2005

13 Knott and Posen, op cit

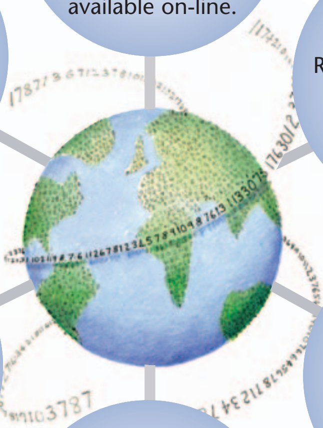
Selected references are available to view in full at www.icaew.co.uk/managerupdate

MAKE YOUR FACULTY WORK FOR YOU ...

Finance & Management
A concise monthly newsletter with topical articles and analysis of current issues. Also available on-line.

Web site
Explore a wide range of useful information exclusive to Faculty members.

F&M special reports
Regular reviews of key business topics, including advice on best practice.



Events
Talks and conferences on current topics. Hear expert opinions and meet other members.

Manager Update
A quarterly publication on management concepts – with Henley Management College.

Directory of Expertise
Discuss technical and practical problems with fellow Faculty members.

... TO LEARN MORE, VISIT WWW.ICAEW.CO.UK/FMFAC

"The Faculty consistently produces a range of thoroughly good, practical publications as well as providing useful, enjoyable events. I would commend it to anyone in business."

Nigel Turnbull, author of the Turnbull report and a non-executive director of various companies.

Manager Update

... is produced on behalf of the Faculty by Silverdart Ltd, Unit 211, Linton House, 164-180 Union Street, London SE1 0LH. Tel: 020 7928 7770; fax: 020 7928 7780; contact: Alex Murray or Charlotte Compton.

www.icaew.co.uk/fmfac

The Faculty of Finance and Management,
The Institute of Chartered Accountants
in England and Wales,
Chartered Accountants' Hall,
PO Box 433, Moorgate Place,
London EC2P 2BJ

Telephone: 020 7920 8486
Fax: 020 7920 8784
E-mail: fmfac@icaew.co.uk

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

TECPLM5010