

Manager Update

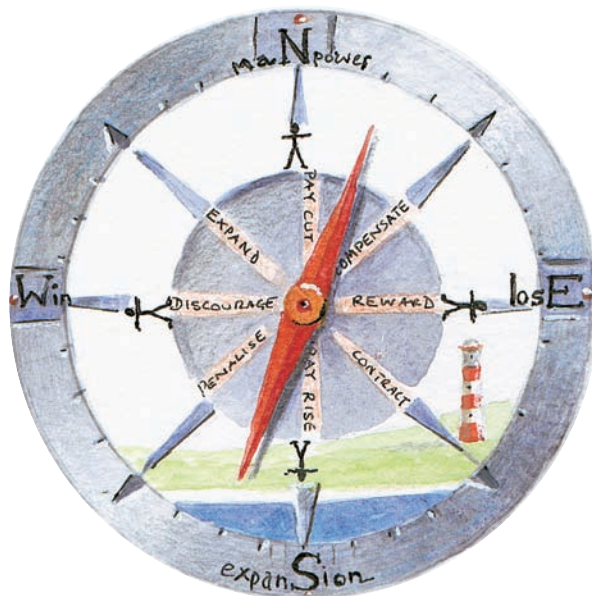
November 2005 Issue 35

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



Faculty of Finance
and Management

in association with



ACCOUNTING AND FINANCE

Is there a pensions crisis?

4

MARKETING

Driving markets and market growth

10

HUMAN RESOURCES MANAGEMENT

Organisational commitment

14

STRATEGY AND ORGANISATION

Strategies for growth and innovation

20



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.

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.

*Cover illustration by Lincoln Seligman
(© L Seligman 2005)*

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

CONTENTS and EXECUTIVE SUMMARY

ACCOUNTING AND FINANCE

page 4

Is there a pensions crisis?

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

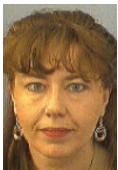
Many countries are facing potential pensions crises. Problems causing these include:

- falling equity markets;
- longer life expectancies;
- companies switching from defined benefit to defined contribution schemes; and
- governments beginning to pare benefits.

What can managers and companies do to avoid a crisis? One suggestion is to focus on corporate governance and risk management as well as on cost control and greater contributions.

MARKETING

page 10

Driving markets and market growth

Susan Foreman, professor of marketing at Henley Management College.

Marketing has an ability to capitalise on market growth and plays an important role in economic growth. Integration is key to driving growth:

- integration of customer knowledge and insights throughout the company;
- integration of brand and business strategies; and
- integration of marketing with 'go-to-market' execution.

An innovative business model taking these into account will transform and change the market.

HUMAN RESOURCES MANAGEMENT

page 14

Organisational commitment

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

How can different types of commitment be defined? In an organisation there might be:

- effective commitment;
- normative commitment; and
- the continuance component.

What can managers do to enhance commitment in various environments? An approach based on mentoring, with its proven record of reducing turnover, may provide some of the answers.

STRATEGY AND ORGANISATION

page 20

Strategies for growth and innovation

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

How can companies continue to grow and innovate? It is helpful to look at the differing approaches of:

- price-value leaders;
- relational value leaders; and
- performance value leaders.

There are many different ways for a company to achieve growth, whether in relation to its market situation, its capabilities or its appetite for risk.



Is there a pensions crisis?

How can companies continue to provide for the pensions of ageing populations? Will there be a breakdown in the provisions of pensions? And what can managers and companies do to avoid a crisis? The answer, notes **Roger Mills**, professor of accounting and finance at Henley Management College, could lie in a focus on corporate governance and risk management, as well as cost control and greater contributions.

Many commentators believe that Europe, if not the globe, is facing a potential pensions crisis as the burden of paying for the retirement of many falls on just a few and investment returns tumble. The problems, indeed, come in a variety of forms and from many directions:

- falling equity markets have challenged everything from the investment strategies used to try to boost the value of pension funds to the financial assumptions used in their valuation and the overall governance of schemes. Falling returns have also had a significant impact on the cost of providing pensions. A number of companies have been forced to shore up their funds with large cash top-ups and take charges on earnings in recognition of the shortfalls;
- people are living longer than expected, pushing up the cost of pensions, as these now have to be paid for a longer time than was the case in the past. Actuaries have always assumed each generation will live longer than the preceding one, but recent surveys indicate that the trend has dramatically accelerated;
- many companies are trying to adapt by switching from so-called defined benefit to defined contribution schemes, which place more of the burden onto the employee and generally translate into lower pensions for members. Some smaller companies are, in fact, closing their schemes altogether; and
- at the state level, numerous European countries realise they can no longer finance the current level of old age pensions. They have begun to pare benefits, placing pressure on employers to take up the slack.

What, though, of the UK system? How can we judge whether it is more or less effective than others and can we also speak of it being in crisis? According to Davis, the most important criteria for judging the system is retirement-income security, or whether the system can generate adequate incomes for those no longer working, and financing issues linked to sustainability.¹ If a system provides adequate retirement incomes but is likely to become insolvent in the future, then it is deemed unsound.

In terms of retirement income security, Davis says that the UK system is showing increasingly poor performance, owing to low levels of private pension saving, inadequate funding and regulation of defined benefit funds, the switch to defined contribution schemes and reduced employer contributions and low social security provision.² He also argues that public pensions are financially but not politically sustainable, while private funds are proving unsustainable in the current market and regulatory environment.

For Davis, though, the UK system isn't in crisis, because in some areas it remains satisfactory. Yet both current and prospective difficulties suggest that it is either not sustainable or it will not provide adequate retirement incomes in its current form.

The Pensions Commission's first report, published in October 2004, gave a similar view, arguing that with more pensioners for every worker in the future, all developed countries will need to make a difficult choice on how to pay for the additional burden.³ It outlined several unappetising options:

The UK system is suffering from low levels of private pension saving

- accept lower retirement incomes;
- consume less now, to guarantee equivalent incomes in retirement;
- ensure people work longer, to cut the funding costs of retirement; and
- tax later generations more, to pay for the higher burden of pensions.

The Pensions Commission report concluded that, “the private system is not developing to offset the state’s retreating role. Instead it is in significant decline.” The commission estimated that unless action was taken to offset government’s so-called retreat, “pensioners will on average suffer about a 30% decline in their incomes relative to average income between now and 2035.” A second problem in Britain’s reforms was that the issue of fiscal solvency was wrongly conflated with the opening up of government pensions. The overall cost to taxpayers of the British pensions system was held down by a series of cuts to the earnings-related elements of government pensions in the 1980s and 1990s. It is reckoned that the fiscal problem of Britain’s pension schemes could have been solved without introducing funded pension accounts.

The reality is that labour market changes are driving employers, employees and policymakers to confront the need for a new retirement paradigm. The old model assumed a relatively homogeneous labour force where employee benefits – and pensions in particular – were designed to reward career employees after years of loyalty and effort. When labour force growth was the norm, many firms favoured hiring plentiful younger workers over retaining more costly older employees.

It was in that context that employers developed defined benefit (DB) plans that favoured mainly full career employees, while penalising those who remained with the firm only a few years. Now, labour force ageing, combined with slower rates of workforce growth, suggests that jobs and pensions will have to be structured rather differently.

Accounting problems prevail – under-funding

The idea that working for 40 years will fund another 30 in retirement is increasingly unsustainable, as current levels of pension contributions and returns show. Yet why do most corporate pension schemes continue to promise this? One clear reason there hasn’t

been more robust debate is that accounting rules obscure the true dimensions of the issue.⁴

Many UK corporate schemes are clearly underfunded. As of 1 January 2004, some 89 companies in the FTSE 100 index offered defined benefit pension schemes, with their total deficit estimated at £42 billion. The projected deficit of all FTSE 350 companies as of 31 December 2004 was £71 billion, with the deficit for all UK pension schemes estimated at £128 billion.⁵ This is, though, as indicated earlier, a wider problem.

According to Hewitt, the human resources consultancy, the pension liability of one Dutch manufacturing company doubled from €1.2 billion to €2.4 billion in one year. Over the period 1995-2050, the unfunded pension liability is estimated to amount to 114% of gross domestic product (GDP) in France, 111% of GDP in Germany, and 76% of GDP in Italy. Based on these figures, the average retirement scheme member might think that many companies (and governments), will soon be bankrupt.⁶

To understand whether underfunding exists, a funding valuation is required to determine the current year’s contribution to a defined benefit pension scheme. If the valuation indicates full funding, the contribution level may be reduced or payment of a contribution waived altogether. If it indicates a shortfall, the contribution level may be increased. Thus, underfunding triggers an automatic protective mechanism with which the scheme must comply in fulfilment of the trustees’ or pension board’s responsibility, vis-à-vis the scheme members.

The result of the underfunding assessment may be seen as just an accounting number if the view is taken that those pension payments do not need to be made for many years. However, there is another problem insofar as the funding gap would be even bigger, were the liabilities not discounted at what many regard to be an unrealistic rate. Those who believe this to be the case argue that these are very long term liabilities that should be discounted by the rate at which inflation is expected to erode them. The best proxy for this rate, they say, is the yield on long term government bonds.

However, under current accounting rules, the discount rate in the UK and US is the AA corporate bond yield and, interestingly, it is a

The private system is in significant decline

Jobs and pensions will now have to be structured differently

rate that companies may pick and choose! Yields on corporate bonds are higher than on government bonds to reflect factors such as credit risk, as well as inflation, but arguably there is no justification for assuming these other factors will shrink pension liabilities.

One problem is that it may be difficult to understand that by using a higher discount rate, pension liabilities may be reduced substantially. To understand this apparently paradoxical situation, let us imagine a company that needs to provide £1 million forever and the corporate bond rate is 10%. The assumption of the provision forever allows the use of a perpetuity calculation to value the liability and the result is £10 million as a liability ($\text{£1 million}/10\%$), ie with a liability of £10 million today at a corporate bond rate of 10%, the company will have the £1 million required.

But what if the corporate bond rate is incorrect and the yield on long term government bonds is more appropriate and its value is 5%? With a need to provide £1 million with this discount rate being applicable, the value of the liability doubles to £20 million ($\text{£1 million}/5\%$).

Several underlying factors are said to account for much of the underfunding. Most fundamentally, the equity bear market has especially hit UK pension funds which generally have large stock holdings. For example, according to Davis, the UK market at end-2002 was some 50% below its peak in 2000.⁷ Underfunding has, however, been aggravated by earlier government policies, which had raised the accrued benefit obligation, notably compulsory indexation up to 5% of current and deferred pensions.

This policy was not independent of the issues of social security, in that it can be argued that such indexation was essential given the very low levels of social security pensions – unlike, for example, in the US where more generous social security offers adequate indexed benefits. Furthermore, tax policies, notably limits on overfunding to 5%, encouraged contribution ‘holidays’ by employers in the previous bull phase, when they should, many would argue, have been building up reserves. Declining bond yields and rising longevity have also helped in raising liabilities.

The strong influence of bond yields on funding levels is a relatively recent phenomenon. Until 1997, an actuarial basis of

funding calculation was used both for regulatory and accounting purposes. This was based on a sustainable income basis for assets and a partly equity-based discount rate for liabilities. A bear market would influence funding levels mainly via the impact on prospective dividends. There has since been a switch to use of a current market value basis for assets (plus prospective asset yields) and corporate bond yield discount for liabilities. This shift was reflected initially in the uniform Minimum Funding Requirement (MFR) introduced in the 1995 Pensions Act, before which there were no regulatory funding requirements.

The calculations under the MFR are made on the assumption of ensuring sufficient assets are available if the scheme is wound-up, to buy out pensioners benefits with an insurance company and provide non-pensioners with a fair actuarial value of their accrued rights that may be transferred to an alternative pension vehicle.

Valuations are made every three years, and liabilities (the accumulated benefit obligation) are valued by reference to a ‘benchmark portfolio’ of UK government bonds and equities, with the proportion of government bonds in the benchmark increasing as the scheme matures. The system requires shortfalls be corrected in three to 10 years, depending on their severity.

The requirement to match government bonds had the paradoxical effect of leading to excess demand for these securities by pension funds (while the UK government was in surplus), driving down yields and raising liabilities. From this year onwards, financial reporting standard (FRS) 17 will require pension deficits to be declared on the balance sheet at current market prices, with liabilities (the accrued benefit obligation) valued according to an AA corporate bond based benchmark.

Firms are already declaring their FRS17-based deficits, while rating agencies declare that such deficits count as debt. This implies a marked impact on credit ratings.

Firms with defined benefit funds also face a burden of topping-up assets to match liabilities. (The UK employer organisation the Confederation of British Industry (2003) projected that a doubling of 2000 contributions would be needed by 2005.) Arguably, this will limit dividends and fixed investment – and hence could affect overall UK economic growth.

Before the 1995 Pensions Act there were no regulatory funding requirements

Firms with defined benefit funds face a burden of topping up assets to match liabilities

Deficits have brought to chief executive officers a broader awareness of the risks of defined benefit obligations to and also highlight that the overall burden of regulation has increased since the mid-1980s. Under current law, for example, pensioners' interests during a wind-up have absolute priority over workers'.

So, an underfunded pension scheme whose employer is insolvent may provide full ongoing pensions but very little for workers on the point of retirement. While there has been a regulatory response, some have questioned how appropriate it is. In particular, the government announced the introduction of pension insurance to cover benefits in insolvency and not just fraud as hitherto, financed by an ex-post levy on solvent funds.

Such a system is likely to face the difficulty of moral hazard, ie that it may create incentive structures leading honest recipients to undertake excessively risky investments, which in turn give the risk of large shortfall losses to the insurer. In other words, losses may not arise merely from fraud or incompetence but the incentive structure itself. It could lead to a further flight from defined benefit funds as solvent funds fear being 'taxed' to pay for insolvent ones.

The education of pension trustees may also be an area where improvement is sorely needed. Some, indeed, have suggested many trustees don't know enough about investment matters and are over-dependent on the large consultants for decisions about asset allocation. Indeed, a government actuary showed that on average 75% of schemes had no trustees qualified or recently trained in investment matters. Consultants may also have been advocates of the sort of high equity exposures from which funds are now suffering the hangover.

In a government report on institutional investment problems, Myners pointed to the lack of investment skills among trustees of most pension funds, which was seen as contrary to satisfactory scheme governance.⁸

Notably, taking advice without ability to evaluate it was seen as contrary to effective decision-making by trustees. Myners recommended that trustees should be paid and should acquire appropriate investment skills – albeit without proposing legislation at this stage.

Managing pension fund deficits

Some companies have, though, responded very positively to pension fund deficits. For example, EON UK, part of the German power company, undertook a triennial valuation that showed it had a deficit of £728 million on a pension scheme valued at £3.7 billion and has responded by paying £420 million to top up its fund.

Where underfunding exists and making up the deficit is viewed as not being an option, a company has limited flexibility to 'manage' short term costs by making changes to the scheme's underlying assumptions. Over the long term, it can only manage costs effectively by changing the benefits and the investment/funding strategies.

Cut benefit levels

The current market environment is forcing companies to concentrate on their financial ability to provide benefits, which in many cases makes changing benefits the only viable option despite obvious employee relations issues.

Shift the risk

Where the risk is moved from the employer to the scheme members. The shift from defined benefit to defined contribution schemes is well under way in the UK, and pension reforms in Austria, Germany, Ireland and Italy are introducing individual defined contribution options for retirement saving.

Increase the contributions

Rather than through an immediate, one-time company contribution, a longer-term route might be adopted, ie through higher employee contributions.

Optimise the investment strategy

The company needs to develop a funding plan that matches current conditions and an investment strategy that takes into account the company's risk appetite. The funding plan and investment strategy complement each other and must be consistent, including rules for:

- setting contributions as financial conditions vary over time as well as in the immediate future; and
- gearing funding objectives for the long term (assuming both that the employer is a going concern and will continue in business for the foreseeable future, as well as the possibility of the fund having to wind-up today).

Deficits have brought an awareness of the risks of defined benefit obligations

Improvement may be needed in the education of pension trustees

Issues for multinational companies

Dealing with pension cost issues is particularly challenging for multinational corporations.¹⁰ Seeking to control costs and reduce risk, an increasing number of multinational corporations are taking a global approach to managing their pension plans. In 2000, 50% of multinationals surveyed by Mercer Investment Consulting had some form of centralised global process. Just two years later, the number had risen to 84%.

Global management of pension plans does not mean one worldwide plan or a single plan design. Instead, multinationals have developed policies and procedures that seek to align global financial objectives with a local company's ability to provide competitive benefits.

Managing pension plans globally poses a number of challenges, including the authority vested in local trustee boards rather than the employer; differing terminology and different meanings for the same phrase (eg 'cash balance' plans); and the role of unions, work councils and other employee groups. Successfully managing retirement plans on a global basis requires local market knowledge, broad global resources, and good communication between local and head offices.

Multinational corporations have been paying particular attention to four key aspects of the global management of pension plans:

- strategy;
- governance;
- cost reduction; and
- risk management.

Strategy

More and more multinationals are setting global pension guidelines – for example, a preference for defined contribution plans instead of defined benefit plans – as these provide the company with the greatest control over costs and liabilities. Other companies have set a policy of conforming to the local competitive practice in each country in which they operate, without specifying a particular kind of plan to be used worldwide.

Yet another element of global pension strategy is the degree of integration of company retirement plans with local social security programmes. Many companies have moved their plans away from direct integration with public pension systems because of unsustain-

able benefit levels in many 'pay as you go' state programmes. If private plans are designed to offset state pensions, shrinking public contributions will automatically drive up the cost of company plans.

Governance

The increasing salience of transparency and accountability in today's business environment has prompted multinational executives to pay close attention to the way fiduciaries make decisions on behalf of plan members. Key governance issues include setting clear guidelines around the role and authority of fiduciaries, plan trustees and management bodies.

Many multinationals have become very specific in terms of best practice guidelines, documentation of decision making and communication responsibilities. Some corporations have a centralised internal group that monitors local compliance with global policies. Some use third parties for analysis, monitoring and reporting, and others have global corporate representatives serving on local trustee boards.

Cost reduction

This is one of the main drivers of global management of pension plans. For example, using a global custodian as a source of consistent, easily accessed information for monitoring plans can reduce pension costs. Looking at investments more broadly across countries can avoid some transaction costs and actuarial fees can be reduced.

Risk management

Linked to governance is the issue of managing investment, interest rate and other risks to pension plans. The recent volatility in pension plans will be exacerbated by the global movement toward 'mark to market' valuation of assets and liabilities and full, current recognition of plan changes, income, and expenses. Despite the long term nature of pension liabilities, short term market fluctuations will have a significant impact on reported pension costs.

General observations

The above illustrates the fallibility of judgments about markets, the structure of funds, the balance between short and long term, and not least increased longevity. Clearly, short term perceptions about the performance of equity or bond markets, assumptions about

Many multinationals have become very specific in terms of best practice guidelines

Volatility in pension plans will be exacerbated by 'market to market' valuation

the relationship between employers and employees and many other factors have governed the judgments and actions taken in the past. Indisputably, where there are short term and immediate crises, being deft at short term manoeuvre is a clear management skill.

However, companies and governments need to prepare positions that are flexible and should evaluate several possible future scenarios. Not all futures can be prepared for; and certainly not all equally. Nonetheless, this review of the various causes that contribute to one or more pensions crises, reveals more than can be summarised with the aphorism that hindsight is always 20:20. It reveals that wider-ranging assumptions had to be developed and their consequences evaluated. Although scenario thinking is speculative, it widens the range of factors that should be

considered – thereby widening the consideration of potential threats and opportunities.

To illustrate the point, expert actuaries made predictions about longevity that were wrong. In conditions of uncertainty, moreover, even when there are several competing projections, each based on assumptions, splitting the difference between extreme outcomes and adopting a ‘middle’ base-case position can be no better than a single line prediction. Such actuarial projections were disputable when they were made, although obviously objections were ruled out. Hence the development of pensions policies for governments and companies, and in particular the depiction of options, ought not to repeat the methodological rigidity from the recent past but be cast on a more expansive and flexible approach to the risk management of pensions. **MU**

Companies and governments need to prepare positions that are flexible

References

- 1 ‘Policy and implementation issues in reforming pension systems’
Davis, E Philip
Working paper no 31, London: European Bank for Reconstruction and Development, 1998
- 2 ‘Is there a pensions crisis in the UK?’
Davis, E Philip
Keynote address for the Japan Pension Research Council meeting in Tokyo, 18-19 September 2003, Brunel University and NIESR, 9 September 2003
- 3 Pensions Commission (2004), *Pensions, Challenges and Choices*
- 4 ‘Pension shocker for workers under 50’
Financial Times, March 29 2005,
<http://news.ft.com/cms/s/9ab4240a-9fee-11d9-b355-00000e2511c8.html>
- 5 ‘FTSE 350 – UK pension scheme deficits and trends’
Mercer Human Resources Consulting
9 February 2005
- 6 ‘Tackling the pension funding crisis (Europe)’
Hewitt
April 2003,
http://was4.hewitt.com/hewitt/resource/rpt-spubs/subrptspubs/pension_funding.ht
- 7 ‘Comparing bear markets, 1973 and 2000’,
Davis, E Philip
National Institute Economic Review, 183, pp78-89, 2003
- 8 ‘Report on institutional investment’,
Myners, Paul
2003, London: HM Treasury
- 9 ‘Will you still feed me?’
Prickett, R
Financial Management
March 2005, pp11-14
- 10 ‘Reducing risk and costs: global management of pension plans’
Kilrain, Susan J and Archibald, Giles
Mercer Human Resources Consulting, 2004

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



Driving markets and market growth

Growing a business is a key priority of the marketing function. But how can companies continue to grow through a focus on marketing? And what can managers do to ensure this happens? To grow, companies need to move from being market-driven to driving markets themselves, notes **Susan Foreman**, professor of marketing at Henley Management College. In practice, this means a multidisciplinary approach that draws on branding, customer relationships and understanding market trends.

This article focuses on marketing's ability to capitalise on market growth and its role in generating economic growth. This analysis is not a new one for managers and has been present throughout the history of commercial endeavour. It was Levitt,¹ in his classic article 'Marketing myopia' (first published in 1960), who stated that, "every major industry was once a growth industry...in every case the reason growth is threatened, slowed, or stopped, is not because the market is saturated. It is because there has been a failure of management."

This article was reprinted in 2004 by the *Harvard Business Review* because, it said, the ideas were as relevant today as they were almost half a century ago. Indeed, the challenges noted by Levitt of innovation, customer value and growth persist and are features of companies often described as 'market-driving' companies. These are known for their innovation, understanding of risk and their ability to offer a totally new value proposition to customers.² In championing the role of marketing in market-orientated companies to market-driving companies, Wind states that marketing can indeed be the engine of growth.³

Generating market growth

Driving markets and market growth are key features of contemporary marketing thought, as is the notion that marketing activities can also play a role in generating economic growth. Do marketing strategies and tactics really have an impact? Bharadwaj, Clark and Kulviwat certainly think the question is worth investigating. They argue that uncertainty around marketing's impact on

company performance has limited its development and helped minimise its effect on strategic decision-making. Indeed, some critics say the discipline is materialistic, morally, ethically or environmentally objectionable and even just plain wasteful.

In examining the role of marketing, Bharadwaj, Clark and Kulviwat first look at the nature of economic growth.⁴ They note that it is normally characterised in three ways:

- growth of firms through competition for market share;
- growth of all firms and markets caused by growth in the business cycle; and
- pure growth over and above the points above-mentioned.

They strive to show that rather than being a burden to society, marketing actually has a role to play in driving economic growth. They begin their research by examining the nature of growth in a number of strategic marketing models; diffusion of innovation, market share and growth models and the impact of advertising on market demand and growth. They find that in most cases, market growth is assumed rather than supported by the evidence. The cumulative effect of routine marketing activities across the whole economy over a period of time does, they argue, create market growth.

Traditional economic models of growth have concentrated on external factors such as population growth, political stability, and the development of institutions, natural resources and the economic mix. More recent models of economic growth include the role of human actions ie knowledge generation and dissemination, learning, education, research, research

Marketing has a role to play in driving economic growth

and development, inventions and innovations. As the authors note, marketing has a role to play in a number of these areas:

- marketers routinely generate knowledge about customers and competition through marketing research, adding to 'pure' growth in the economy;
- marketers use customer insights to support investments in research and development. They develop new products to meet customer needs and thus also contribute to pure economic growth;
- marketers also, they say, generate growth in the economy by distributing information about products and services to the public through advertising and promotions; and
- marketers generate growth when they distribute new products and the related proprietary technologies available to competitors in the marketplace and other companies.

Indeed, without such stimuli, the authors argue, economic growth could well be slower! Therefore, from this standpoint, policy makers should review their perceptions of the role marketing plays in the economy. Far from being a 'deadweight in the societal equation', companies pursuing market share and promoting innovation and competitiveness contribute to market growth and make a positive impact on society.

From market-driven to market-driving

Market-driving strategies have always been at the heart of early definitions of marketing and these were often linked to innovation. According to Levitt, companies shouldn't be content simply to satisfy customers: they should also think about taking them in new directions and opening their eyes to new possibilities. Through this, Carrillat, Jaramillo and Locander say they increase the value proposition to the customer and improve their own business systems.⁵

So what is a market-driving company and what does it do? It is usually one that has an active impact on the marketplace and its actions create change that brings superior performance when compared with competitors. IKEA, Southwest Airlines, Amazon, Swatch and Starbucks are often highlighted as market-driving companies because they are perceived to have changed, transformed or created markets through business innovation.⁶ In developing such a company, Carrillat,

Jaramillo and Locander emphasise the importance of transformational leadership, which is needed to create a vision, provide intellectual stimulation, and develop a culture of shared norms and values. Leadership and culture are key tools in the armoury of the market driving company.

Transformational leadership has an important role in setting the innovative agenda for the company and ensuring that the vision is communicated and embraced throughout the company. Here, the focus is not on charisma but on ensuring that the company can apply its ideas to the marketplace and stimulating the intellectual capacity and human capital in the company. Or, as Carrillat, Jaramillo and Locander state, "to generate new concepts and ideas that alter the market structure."

Company culture is also an important element in generating a market-driving strategy. The first step, the authors say, is to create an environment that focuses on creativity, entrepreneurship, innovation and risk-taking. A transition phase then follows before more formal processes take over, as the culture develops into a market-based one. Here, the focus will be on internal communication and cross-disciplinary working where everyone (regardless of discipline) concentrates on achieving goals and making an impact on the market.

After completing these phases, companies move into what can be called the implementation stage of their market-driving strategies. The company must now develop new business models to create value for the customer, whilst simultaneously creating significant barriers to competitors, such as bringing innovations to the market that disrupt their flow and the business cycle. Such transformational change that disrupts the marketplace cannot be generated by one function or discipline in the company – all need to work together to achieve it.

A cross-disciplinary approach to driving growth

The belief that a market orientation is an important part of a company's culture represented an important step change in marketing theory in the 1990s. Simply put, it placed customers at the heart of the whole organisation and linked success in meeting customer needs to business performance. The concept of an inter-departmental approach to meeting customers' needs – which emphasised the need

Marketers use customer insights to support investments in R&D

A market-driving company has an active impact on the marketplace

A cross-functional approach to marketing problems can drive growth

for everyone in the organisation to understand customers' needs and desires and engender responsiveness from all parts of the organisation – was central to the theory.

This interdepartmental/cross-disciplinary approach is even more crucial in a market-driving company. In turning his attention to the need for a cross-functional perspective to marketing and business problems, Wind implicitly challenges whether the interdepartmental approach demanded by a market orientation has been achieved in practice. He suggests that whilst a continuing focus on functions and specific disciplines has led to the development of some in-depth knowledge and expertise in companies and in the educational world, there is more work to be done before many companies can claim that this knowledge is shared throughout the organisation and that companies are able to show a holistic approach to business problems.

In examining the role of marketing in the organisation and its relationship with other functions, Wind explains the benefits of being focused and highlights the advances in theory and practice that can emerge from a specific and disciplined approach. Along with Neubauer though,⁷ he states that managers should be wary, because “being functionally narrow is a mistake,” as it limits creativity and a firm's ability to grow.

A number of leading companies are striving to develop a multifunctional approach to their work. They realise that developing integrated solutions that are formed by experts from across functions and disciplines can create value both for the customer and the company. Wind highlights a McKinsey study, which states that integration is the key to driving growth:

- integration of customer knowledge and insights throughout the company;
- integration of brand and business strategies; and
- integration of marketing with ‘go-to-market execution.’

Wind argues that the way managers think and the frameworks used to guide decision making may be limiting companies' possibilities and restricting growth. In showing how a cross-functional approach can work, he focuses on a number of marketing issues that not only lend themselves to a holistic approach but which can also act as a catalyst for growth. He suggests that there are a number

of fundamental growth decisions to make, all of which have marketing at their core.

Existing markets, for example, may diminish in size and scope, while new ones materialise. As a result, managers will need to think strategically about expanding their current markets or developing the range of products and services they offer in the current marketplace. A cross-functional approach to marketing problems, Wind argues, can drive growth and help a company distinguish itself from competitors. Key issues that can be addressed are discussed below.

Developing a market-driven vision and value proposition

Here the customer is at the heart of the way the company is organised and is the driving force behind the decision-making in all departments and functions. Many successful technology companies could, Wind argues, be even more successful if they were to put the customer – rather than the product – at the heart of the company; here, the customer is considered a co-producer.

Marketing innovations

Innovations in core marketing areas can bring growth to the company. For example, changes in pricing strategies – once a core element of the marketing ‘toolbox’ – have become strategic drivers of market growth for some companies in, for example, the airline industry, where so-called discount airlines have won market share from more traditional carriers. This has led to a redesigning of the distribution system, partnership arrangements, revenue models and destination management.

Marketing and IT working together

Wind states that by bringing these two areas of the business together, value and growth can be generated. He notes that there are a number of key issues for managers to consider:

- ‘customerisation’ – here, customers are brought into the company to contribute to the design of new products;
- communities – using the on-line environment to encourage customers to interact with each other and with employees in the company;
- channels – engaging customers in the distribution system so that customers can ‘call, click or visit’;
- choice – by combining personal service and technology, companies can help customers to make the ‘right’ choices; and

‘Channels’ involve engaging customers in the distribution system

- competitive value and convenience – customers' experience of 24-hour service (on-line banking) and new and different pricing systems (on-line auctions) have improved choice and changed customers' perceptions of value.

The success of these strategies, which Wind calls convergence strategies, may be derived from the balance they seem to strike between the old and the new. Take, for example, his simple but powerful example of our continued use of multiple methods of communication, in that someone might use fountain pen and paper, e-mail, the internet and a digital pen and paper all in the same day.

Customer interaction and relationships

This approach involves the customer in the company and emphasises the shift from one-way transactions to the much vaunted 'relationship' approach. This encourages customers to share their knowledge and skills with the company and develop what Wind calls 'customer-managed' relationships, where the customer is in charge. When this works well, he says, customers are likely to become strident advocates for the company.

Wind states that companies need to rethink their structures to implement this market-led value and growth strategy. They should, he argues, put stakeholders at the core of the business and use the understanding gained from these groups to drive the vision, value

propositions and the business model to help exceed customer expectations. Persuading marketing managers to speak to operations people and technologists to the customer will often require a culture-shift in the organisation to foster a cross-disciplinary approach.

This approach needs to consider and involve everyone in the metrics and performance measures developed to meet strategic objectives. Organisation and culture, governance, value creation competences, technology and resources should all be managed in a cross-disciplinary way to create a broader outlook on business challenges and give less play to functional boundaries.

For Levitt, a successful customer-oriented organisation needs human organisation and leadership or, in Carrillat, Jaramillo and Locander's terms, talent management and a transformational leader. Wind advocates a cross-functional approach that involves everyone. Levitt is perhaps most eloquent when he says that managers should drive their ideas throughout the organisation "with the kind of flair that stimulates the people in it." Survival, he says, is easy. The trick is to "survive gallantly...a leader has to have a vision of grandeur, a vision that can produce eager followers...In business, the followers are the customers." Clearly, he's encouraging managers to strive for the innovative business model that will transform and change the market. **MU**

A successful customer-oriented organisation needs leadership

References

- 1 'Marketing myopia'
Levitt, Theodore
Harvard Business Review, (originally published 1960) July/August 2004, vol 82, issue 7/9, p138
- 2 'From market-driven to market-driving'
Kumar, Nirmalya, Scheer, Lisa and Kotler, Philip
European Management Journal
2000, vol 18, no 2, pp129-142
- 3 'Marketing as an engine of business growth: a cross-functional perspective'
Wind, Yoram, *Journal of Business Research*, 2005, 58, pp863-873
- 4 'Marketing, marketing growth and endogenous growth theory'
Bharadwaj, Sundar, Clark, Terry and Kulviwat, Songpol
Journal of the Academy of Marketing Science, vol 33, no 3, pp347-359
- 5 'Market-driving organizations: a framework'
Carrillat, Francois A, Jaramillo, Fernando and Locander, William B
Academy of Marketing Science Review
2004, <http://www.amsreview.org/articles/carrillat05-2004.pdf>
- 6 Marketing as strategy: understanding the CEO's agenda for driving growth and innovation
Kumar, Nirmalya, 2004, Harvard Business School Press
- 7 'Banking on breadth: CEO's stress need for cross-functional perspectives'
Kumar, Nirmalya, Scheer, Lisa and Kotler, Philip, *European Management Journal*, 2000, vol 18, no 2, pp129-142



Organisational commitment

Organisational commitment has long been established as a key factor leading to organisational success. But how can you define it and what components make it up? And how does the creation of new working environments – such as the setting up of call centres – affect commitment? Most importantly, what can managers do to enhance commitment in these and more traditional environments? **Richard McBain**, director of distance learning programmes at Henley Management College, argues that an approach based on mentoring may provide some of the answers.

What is organisational commitment?

The importance of gaining the commitment of employees to the organisation and its goals has emerged as a central tenet of contemporary approaches to human resource management and a key area for research. This article will review recent research into the nature of organisational commitment, its outcomes and the factors that facilitate its development. It will also recognise that changes in the organisational context and in the psychological contract between employers and employees are having an impact.

There is no single definition of commitment but typically the emphasis is upon positive attitudes towards an organisation rather than on behavioural commitment. An early and very influential view is that of Mowday et al for whom organisational commitment represents an individual's identification with, and involvement in, an organisation.¹

For them, organisational commitment is underpinned by three factors: a strong belief in, and acceptance of, the organisation's goal and values; a willingness to exert considerable effort on behalf of the organisation; and a strong desire to retain membership in the organisation. Also influential has been Allen and Meyer's three-component model:²

- affective commitment refers to employees' emotional attachment to, identification with and involvement in, the organisation;

- normative commitment is based on feelings of loyalty and obligation; and
- continuance component refers to the commitment based on the costs that employees associate with leaving the organisation.

A useful recent critique of the current state of research into organisational commitment is provided by Swailes.³ He argues that measures of organisational commitment often seem to focus on the reasons for commitment or on its outcomes, rather than on the commitment itself. Thus, an intention to remain with an organisation may be seen more as a consequence of commitment than a defining characteristic; and in any case, loyalty is different from commitment.

Furthermore, the changing nature of the psychological contract means that the notion of committed employees with a strong intent to remain with an organisation is less relevant today than in the early 1970s. Although situational characteristics seem to have more influence than dispositional characteristics in the development of organisational commitment, the link between the bases of commitment and their outcomes is something of a 'black box' that requires further fieldwork.

Swailes proposes a four-level model of the commitment process, which may serve as a basis for future research:

- the reasons for membership of an organisation or group: these are typically personalised and difficult to identify;

Measures of organisational commitment focus on reasons or outcomes of commitment

- the bases of commitment: belief in organisational goals, identification, feelings of loyalty, allegiance and economic ties to the organisation;
- the components of organisational commitment: congruence between organisational and personal goals and effort directed at innovation – although the particular components may differ according to occupational group and level of responsibilities; and
- the outcomes of organisational commitment: for example, creative and innovative change, customer satisfaction, service quality, organisational citizenship and effective stakeholder management.

The remainder of this article will focus on recent research into the antecedents and outcomes of organisational commitment, beginning with factors facilitating the development of organisational commitment.

Person-environment fit and organisational commitment

The first factor to be considered is one that has been the subject of a considerable amount of research. Kristof-Brown et al carried out a meta-analysis of 172 studies into person-organisation fit, or “the compatibility between an individual and a work environment that occurs when their characteristics are well matched.”⁴ Fit may be seen in terms of similarity of characteristics, or a match between the demands or needs of the environment and the abilities of the individual.

Several different types of person-environment fit have been identified, notably: person-job (PJ), person-organisation (PO), person-group (PG) and person-supervisor (PS) fit. The key findings of the meta-analysis in relation to organisational commitment, including a number of other outcomes are as follows:

- person-job fit is strongly associated with job satisfaction and organisational commitment; and negatively, with intent to quit. It has a moderate relationship with satisfaction with co-workers and supervisor as well as organisational identification. It is more modestly associated with overall performance;
- person-organisation fit is strongly related to job satisfaction and organisational commitment and is more moderately cor-

related with intent to quit. The relationship with most other attitudes is moderate;

- person-group fit has moderate correlations with job satisfaction, organisational commitment and intent to quit;
- person-supervisor fit has a stronger relationship with job satisfaction than organisational commitment;
- job satisfaction is more strongly related to person-job fit than to person-organisation, person-group and person-supervisor fit; and
- organisational commitment is most strongly related to person-organisation fit than to person-job, person-group and person-supervisor fit.

Person-job fit is strongly associated with job satisfaction

Person-environment fit is important, because it influences individuals’ attitudes, decisions and behaviours within organisations. However, it is complex and multiple types of fit that influence individual outcomes. This study shows that managers seeking to maximise the benefits of fit, for example on organisational commitment, should consider the impact of different aspects of the environment or types of fit on desired outcomes.

In addition, since the four types of fit were only moderately related to each other, the study supports the capability of individuals to compartmentalise at least partially their reactions to various aspects of the work environment.

Person-environment fit influences attitudes, decisions and behaviours

Cultural differences

Another study focused on purely situational influences on commitment. Lok and Crawford examined whether differences in leadership, organisational culture and national culture impacted on managers’ perceptions of job satisfaction and commitment.⁵

Their study of a sample of 337 managers in Hong Kong and Australia produced a number of important findings:

- the organisational culture for Australian managers was more likely to be innovative and supportive rather than bureaucratic, and they also scored more highly than Hong Kong managers on job satisfaction and organisational commitment. This is consistent with studies that have shown western firms have flatter organisational

Mentoring may foster the adoption of organisational goals and values

structures and low power distance and that there is a strong positive link between empowerment, job satisfaction and commitment;

- however, there did not seem to be a significant difference between the Australian and Hong Kong samples in terms of leadership style and the Hong Kong managers did not report a more bureaucratic organisational culture. This is surprising, given that previous studies have suggested that Confucian values, high power distance, autocratic decision making style and family ownership in Chinese firms would provide a stronger bureaucratic culture and initiating structure leadership style in the organisation. One possible explanation of this is the high proportion of Hong Kong managers in the sample working for multinational corporations;
- organisational culture, leadership and some demographic variables (such as age and gender) did impact upon job satisfaction and organisational commitment. Overall, an innovative and supportive organisational culture and a considerate leadership style had a positive effect on job satisfaction and commitment, with the impact being stronger in the Australian sample; and
- an initiating structure leadership style had a negative impact on job satisfaction overall, although there is no significant difference on the impact of leadership style on job satisfaction and commitment between Australian and Hong Kong managers.

This study shows that organisational culture and leadership styles are important organisational antecedents of job satisfaction and organisational commitment, and also that national culture can influence the relationship between demographic, leadership and organisational culture variables on the one hand and on job satisfaction and commitment on the other.

Supervisory mentoring relationships offer certain advantages

Mentoring and turnover

Mentoring involves a relationship between a senior experienced colleague and a less experienced junior colleague. Mentors provide career support such as coaching, challenging assignments, exposure and sponsorship, together with psychosocial support. Previous research has shown that mentoring relationships may facilitate organisational socialisation and organisational commitment, as well as reduce turnover and intentions to

quit, but the factors affecting the relationship between mentoring and commitment remain unclear.

Payne and Huffman set out to explore the relationship between mentoring, organisational commitment and actual turnover over time.⁶ Both affective and continuance commitment may help to explain why mentoring may reduce turnover. In terms of affective commitment: mentoring may foster the adoption of organisational goals and values; protégés seem better able to cope with the stress of career management and therefore hold more positive attitudes to their work environment; moreover mentors serve as role models, which generates respect, which in itself may translate into positive work attitudes.

Mentoring may also be an antecedent of continuance commitment: the disruption of a personal relationship may be a perceived cost of leaving an organisation; and protégés may be less likely to search for employment alternatives because of benefits gained with their current employers.

Payne and Huffman carried out a longitudinal study of 1,334 US Army officers. High levels of mentoring activity were reported, with the majority of relationships being with a supervisor or line manager. The key results of the study were that:

- mentoring relationships were associated with higher levels of organisational commitment and lower levels of turnover one year later;
- protégés had higher levels of both affective and continuance commitment;
- protégés with supervisor mentors had higher levels of affective commitment than protégés with non-supervisor mentors, but the type of support provided by the mentor, whether career-focused or psychosocial, did not have a significant impact on levels of either affective or continuance commitment; and
- the impact of mentoring on turnover can partly be explained by the development of affective commitment, but not by continuance commitment.

The findings regarding supervisory relationships are interesting, partly because much previous research stresses the importance of an off-line relationship. However, supervisory mentoring relationships offer certain advantages leading to higher levels of

organisational commitment: they may provide more opportunities for mentoring; line managers or supervisors may have a greater knowledge of protégés and may be able to provide more career support than non-supervisory mentors; and supervisors may be able to role-model successful managerial behaviours specific to department or organisation and provide an opportunity to develop networks.

While previous studies have suggested that assigned mentoring may be less successful, formal mentoring programmes using supervisors as mentors may therefore still offer significant potential, and organisations may also want to incorporate mentoring into formal roles and responsibilities of managers. Training and guidance for mentors as well as follow-up support for protégés may reduce the risks of an unsuccessful formal mentorship programme.

Call centres

The focus now turns to a consideration of the outcomes of organisational commitment, beginning with service quality. The notion of the service-profit chain has contributed to a growing appreciation of the role of customer-contact employees in achieving customer satisfaction and loyalty, along with organisational growth and profitability.

The quality of service delivered in customer-contact businesses cannot be separated from the quality of the service provider; customer satisfaction and service quality perceptions are largely determined by the discretionary behaviour of customer-contact employees during a service encounter. Call centres are increasingly used by service providers, but satisfaction with call centre service is often low and call centre jobs can be very stressful. Therefore, the issues of service quality, commitment and job satisfaction in call centres are important ones for research.

Malhotra and Mukherjee set out to test the relative importance of job satisfaction and organisational commitment to service quality and to explore how different forms of commitment influence the willingness of customer-contact employees to engage in discretionary efforts which, in turn, are reflected in service quality.⁷ The key findings of their research on 342 employees in four telephone call centres of a major UK retail bank were that:

- both organisational commitment and job satisfaction had an impact on service quality and together explained 14.5% of service quality perceptions;
- the only component of organisational commitment that had a significant relationship to service quality was affective commitment; and
- affective commitment was more important than job satisfaction in determining the service quality of customer contact employees.

This study contributes to the growing body of research establishing and confirming the links between internal and external marketing. It supports the view that satisfied and committed employees lead to satisfied and committed customers.

The main implication of this research is that service organisations should strive to develop the affective component of commitment amongst their customer employees, alongside their job satisfaction as part of their internal marketing strategy.

Salesperson performance

Another example of recent research into the outcomes of organisational commitment considers its impact on salesperson performance. A sales force may constitute a large part of a firm's marketing budget and is key to organisational success. Jaramillo, et al conducted a meta-analysis of 51 studies with an overall sample of 14,169 from 14 countries including the US, UK and China, to synthesise research investigating the relationship between organisational commitment and salesperson job performance.⁸ Key findings from the meta-analysis were that:

- organisational commitment and job performance were modestly correlated;
- the relationship was positive for both sales and non-sales employees, but is stronger for the former than for the latter;
- organisational commitment explained approx 6% of the variance in the job performance of sales people. Although a relatively small proportion, this is consistent with other studies looking at the effects of personal, contextual and attitudinal factors. The stronger relationship for sales people may be due to higher levels of motivation or to the greater level of control that they have on their job outcomes, together with the greater visibility of their

Organisations may want to incorporate mentoring into the formal roles of managers

Organisational commitment and job performance were modestly correlated

National culture influences the relationship between organisational commitment and job performance

- outcomes, which may be translated into higher performance; and
- national culture influences the relationship between organisational commitment and job performance and the commitment-performance relationship is stronger for collectivist than for individualist cultures. This may be explained by the impact of national culture on job performance through the employee's work-related values and attitudes and through organisational design, management style, management decision making, work-values and processes.

The significance of this research is that it lends credence to the notion that it is beneficial for sales managers to develop strategies that improve the organisational commitment of sales people. Other research suggests that management styles that allow sales people to decide when and how to work, and that promote employee participation in decision-making, are likely to generate positive job attitudes and enhance organisational commitment.

Readiness for change

Finally, we consider the link between organisational commitment and change. Madsen, Miller and John argue that, "embracing constant and continuous change is now a necessity for business success; however, to do this, an organisation must be in a continued state of change readiness... [and] for organisational readiness individual employees must also be open, prepared and ready for change." An individual is ready for change when he or she understands, believes and intends to change because of a perceived need.

Accordingly, it is essential for managers to know how to create readiness for change. Madsen and colleagues investigated the relationship between readiness for change and two possible influential factors: organisational commitment and social relationships

in the workplace – the latter focuses on employees' feelings, attitudes and perceptions (positive or negative) toward workplace colleagues with whom they work directly or indirectly.

The key findings in their study of 464 employees in four organisations in different industries were that:

- organisational commitment was strongly correlated to readiness for organisational change;
- the three components of organisational commitment were correlated with readiness for change with involvement in the organisation being the most important factor;
- social relations in the workplace were correlated with organisational commitment and there was a slight relationship between social relations and readiness for change; and
- readiness for change was also linked to demographic characteristics. Moreover, levels of organisational commitment increased with age and education.

This research has a number of important implications. To begin with, during periods of major change, organisations should take steps to increase organisational identification, involvement and loyalty in order to heighten readiness for change. Likewise, positive feelings, attitudes and perceptions towards workplace peers, subordinates and supervisors may create an environment more conducive to individual willingness and openness for organisational change involvement and supportiveness. In this process, direct and persuasive communication, encouraging the active participation of employees in decision making and the building of perceptions of self-efficacy, as well as managing information about the change, both internal and external, will be helpful. **MU**

For references, see page 19.

References

- 1 'The measurement of organizational commitment'
Mowday, Richard, Porter, Lyman and Steers, Richard
Journal of Vocational Behaviour 1979, 14, pp224-247
- 2 'The measurement and antecedents of affective, continuance and normative commitment to the organization'
Allen, Natalie J and Meyer, John P
Journal of Occupational Psychology, vol 66, (1), 1990, pp1-18
- 3 'Organizational commitment: a critique of the construct and measures'
Swales, Stephen
International Journal of Management Reviews, 4, (2), 2002, pp155-178
- 4 'Consequences of individuals' fit at work: a meta-analysis of person-job, person-organization, person-group, and person-supervisor fit'
Kristof-Brown, Amy L, Zimmerman, Ryan D and Johnson, Erin C
Personnel Psychology 58, 2005, pp281-342
- 5 'The effect of organisational culture and leadership style on job satisfaction and organisational commitment: a cross-national comparison'
Lok, Peter and Crawford, John
Journal of Management Development, 23, (3/4), 2004, pp321-338
- 6 'A longitudinal examination of the influence of mentoring on organizational commitment and turnover'
Payne, Stephanie C and Huffman, Ann
Academy of Management Journal, 2005, 48, (1), pp158-168
- 7 'The relative influences of organisational commitment and job satisfaction on service quality of customer-contact employees in banking call centres'
Malhotra, Neeru and Mukherjee, Avinandan
Journal of Services Marketing, 18, (2/3), 2004, pp162-174
- 8 'A meta-analysis of the relationship between organizational commitment and salesperson job performance: 25 years of research'
Jaramillo, Fernando, Mulki, Jay Prakash and Marshall, Greg W
Journal of Business Research, 58, 2005, pp705-714
- 9 'Readiness for organizational change: do organizational commitment and social relationships in the workplace make a difference'
Madsen, Susan R, Miller, Duane and John, Cameron R
Human Resources Development Quarterly, 16, (2), 2005, pp213-233

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



Strategies for growth and innovation

How can companies continue to grow and innovate? How can they continue to maximise the potential of established western markets while at the same time expanding into emerging markets such as those in China and India? A focus on simplicity, developing tailored strategies and taking account of the dangers of innovation provides some practical answers, writes **Ian Turner**, professor of management studies and director of graduate business studies at Henley Management College.

In the last *Manager Update* we focused on recent articles examining growth strategies and how desirable – and difficult – achieving growth can be for businesses. The results of the latest McKinsey Global Survey of Business Executives (*McKinsey Quarterly* August 2005) echo this.¹ The survey respondents – all senior executives from global firms – are generally bullish about prospects for growth, citing increasing affluence in developing economies and technological innovation as major determinants of opportunities for economic growth.

Clearly, though, growth expectations vary according to the sector of the economy in which companies are active. Healthcare, for example, appears to have the greatest potential for top line growth in the next five years, perhaps reflecting demographic trends in the population and innovations in the pharmaceutical and biotechnology industries.

Conversely, growth expectations for industries such as chemicals, manufacturing and automobiles are relatively low. Unsurprisingly, many saw China as the key market for growth for the next five years. Equally attractive though, particularly amongst smaller companies, is the vast potential of the more developed – but slower growing – US market.

Less positively, the survey reveals some serious concerns about what could constrain growth, including more intense competition and increasingly demanding customers. The high cost and low availability of talented workers is also a major concern for many executives. Interestingly, many companies are betting on organic growth, rather than

joint ventures or acquisitions, to achieve future expansion. Amongst the most favoured sources of growth is likely to be innovation, according to the respondents.

How CEOs manage growth agendas

The *Harvard Business Review* also recently interviewed the chief executive officers (CEOs) of five leading companies about the challenge of growth in an era of what might be termed commoditisation. As one author notes, "It's one thing if you have an inherent cost advantage like Dell or Wal-Mart, but most companies don't; for them commoditisation is a deadly game. When you're constantly scrambling to make your margins you have to strain to think about the top line."²

For these executives, differentiation – through one of three inter-related approaches of innovation, deepening customer relationships and bundling products and services – is the best response to such 'commoditisation.'

The interviewees revealed some interesting perspectives on growth. Thus, while most of the companies covered in the article had used acquisitions aggressively to grow in the past, there was a general feeling that these were most useful for entering new markets and that top line growth would really only come from innovation.

As Robert Greifeld, president and CEO of NASDAQ remarked: "Innovation creates first movers who reap first mover profit margins. It shakes up competitive stasis and propels even mature businesses forward, and it is mercifully tolerant of mistakes. For

Differentiation is the best response to 'commoditisation'

companies focused on organic growth, failure in reasonable proportion to success is a sign of health. Mergers and acquisitions (M&A) by contrast must be implemented meticulously, according to an exhaustive plan. M&A is a poor growth strategy for companies harbouring even the slightest doubt about their ability to execute.”³

Kenneth Freeman, chairman of Quest Diagnostics, froze all acquisitions for three years while he concentrated on instilling business discipline and process-thinking into his operations after being appointed chief executive of Quest in the mid-1990s, saying the company “had to earn the right to grow.”⁴

Such a strategy is echoed by Kenneth Lewis of the Bank of America. Lewis saw growth coming from focusing on quality and productivity, on the principle that only customers that give high satisfaction scores are likely to remain customers and increase their business with the company.

Delivering what matters most

The conclusions of a recently published study by Barwise and Meehan support such views.⁵ This book’s premise is that the concept of differentiation in business is widely misunderstood and the authors attack the view that companies should be seeking to identify and compete on so-called ‘unique selling propositions’ (USPs). In a market economy which is transparent and hyper-competitive, they say, it is unlikely that USPs will indeed remain ‘unique’ for very long.

Successful companies, according to the authors, are those that identify the ‘generic category benefits’ in any product market, ie the things that really matter to customers, and are consistently able to deliver them. They highlight firms like Toyota and Tesco, companies that do not necessarily have the most distinctive product offering – or even the most valuable brands in their industries – but which are consistently able to outperform competitors.

Take Toyota: the company is fast on its way to becoming the world’s largest car manufacturer, according to the *Financial Times*. It controls more than 40% of the automobile market in most South-East Asian countries – where the market is growing most rapidly – and worldwide makes more profit each year than General Motors, Daimler-Chrysler and Ford

combined (*Financial Times*, 1 August, 2005). Yet how does the company manage to do this? Its brands may not be aspirational, nor its products highly innovative, but the ownership experience of its cars is better than that of its main competitors. This is achieved by focusing relentlessly on improving both the quality of product and, more importantly, the service quality.

Toyota’s approach echoes Barwise and Meehan’s central message that in most industries, there’s still a huge gulf between what companies say they will do and the frequently disappointing reality of what customers actually experience. They document this by looking at the official customer satisfaction index for the US which, despite recent improvements, still has not fully recovered to its position of 10 years ago and remains below the 75% customer satisfaction figure. Similarly, there is a huge gulf between the best performing companies in any industry and the rest. Most companies, the authors argue, can continue to grow organically by innovating their offering and understanding more clearly and measuring more relentlessly customer expectations and habits – and then delivering on them.

Much of this is intuitive: anyone who has had to change their bank account or has waited hours for their washing machine to be repaired will probably have experienced the frequent disconnection between the promise and actual reality of customer service. Indeed, the trend towards outsourcing, and in some cases off-shoring, has meant that controlling the end-user experience has become even more difficult.

Which way should you grow?

Of course, there is a right and a wrong way to grow and such choices are likely to differ according to the company and sector. According to George Day, successful growth strategies are based upon accurate identification of the company’s value proposition. There’s not much point trying to emulate a Wal-Mart or a Dell, for example, if a company’s capability is in innovation or customer service. Day distinguishes three types of value proposition which characterise how companies can achieve their successful growth strategies:

- price-value leaders – these firms build successful cost-based business models which

Growth comes from a focus on quality and productivity

There is a right and a wrong way to grow

Companies grow when they have a unique proposition

are transferable to other market spaces. Thus Easy Jet, which started in cheap flights, has expanded into other areas such as car rentals and cruise ships, where the company can also make use of its yield management techniques;

- relational value leaders – these firms offer customers integrated solutions and in the process, take away some of their customers' risk; and
- performance value leaders – these companies compete through continuous innovation, typically through investing in research and development and product innovation.

Success typically comes from building on existing value propositions rather than trying to adopt one or other of the other recipes, Day says. "Long-term winners sustain their growth by edging out from the core...Price players should look for growth segments within the markets they already serve. Relational players can look for latent customer needs they can solve well. Performance players will want to embrace technological discontinuities. To achieve superior profitability you need to beat your competition in at least one of these value arenas and equal them in the other two."⁶

Stop kissing frogs

Clearly, though, looking for new growth avenues can also entail significant business risk. Campbell and Park have studied the downside of growth strategies built on internal corporate venturing.⁷ According to their research, the premise that to be successful, corporates should behave like venture capitalists in exploiting new business opportunities through internal corporate venturing units is flawed. The problem, they claim, is that there are simply not enough real business opportunities which have a reasonable likelihood of success when subjected to searching questions about their strategic suitability.

Indeed, depending on which authority you consult, the failure rate for such corporate venturing could be 90-99%. Rather than 'kissing lots of frogs' and hoping a few turn into handsome princes, the authors say, companies might be better off at focusing on deliberate strategy decisions and investing wholeheartedly in major strategic moves, such as, for example, when financial services company Prudential launched its on-line bank Egg.

Campbell and Park urge patience and a more realistic approach to growth. "Managers must let go of the seductive grow, grow, grow view of business. Companies grow when they have a unique proposition that enables them to outperform competitors. During this phase, management's duty is to exploit that advantage as fully as possible. In the mature and die phases, the art is to return as much money to the financial market as possible, while still keeping a watchful eye out there for other unique propositions."

The dangers of innovation

While Barwise and Meehan might not necessarily agree, these conclusions are echoed in the work of Michael Treacy.⁸ He believes that 'breakthrough' innovation should be the last – rather than the first – resort of companies. Since the point of innovation is growth and all innovation entails some risk for companies, managers should, he says, first ask themselves if they can increase the company's revenues without 'resorting' to innovation. Even if a company uses innovation as a growth strategy, there are some approaches which are naturally high-risk.

Breakthrough product innovations, for example, typically entail both a technological risk and a marketplace risk. Radical innovations are often unnecessary: small incremental product innovations can also be more effective at locking in existing customers and preventing customer churn; whilst more radical innovations – like the 'new' Coke for example, run the risk of upsetting loyal customers or leaving them cold. "The time to launch a big innovation is not when they're necessary for your business but when they're essential to the marketplace," Treacy says. "If foisted on a market that is not ready for them, big innovations can take years to catch on. Video firm providers have been learning that lesson for more than 25 years."⁹

In summary, the inter-related issues of growth and innovation are clearly back on the agenda. There are many ways for a company to achieve growth: which solution is chosen is clearly related to a company's market situation, its capabilities and its appetite for risk. Acquisitions – and mergers in particular – carry a high risk of failure and require good change-management skills. Alliances can be less risky and entail less commitment from firms but for this reason they often fail to deliver attractive returns.

The inter-related issues of growth and innovation are back on the agenda

Organic growth can be a slow process and less exciting for top leaders, but innovation can boost growth rates – at least for a time. Breakthrough innovations leading to unique propositions are rare and will disrupt prevailing patterns of competition. First-mover advantages are attractive, but only if the

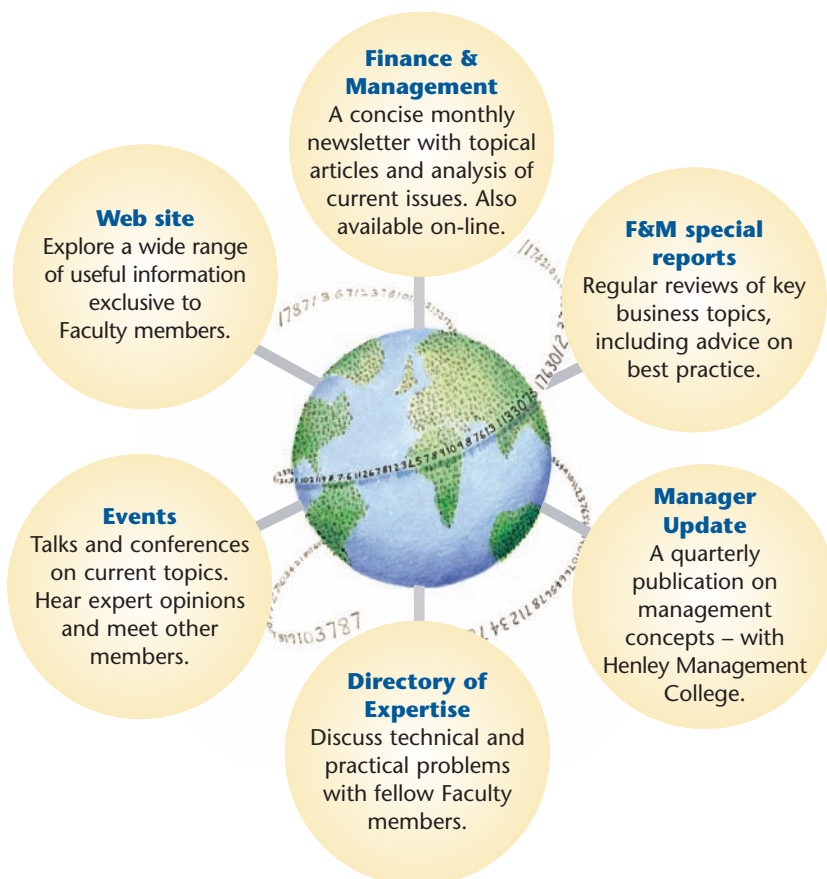
position can be adequately defended from imitators. Incremental innovations in products and particularly improvements in service delivery and the customer experience appear to be much less spectacular, but can serve companies well and be surprisingly difficult to copy. **MU**

Organic growth can be a slow process

References

- | | | | |
|---|---|---|--|
| 1 | 'Global survey of business executives', McKinsey, 2005 | 6 | 'Which way should you grow?', Day, George S, <i>Harvard Business Review</i> , Jul/Aug 2004, pp24-26 |
| 2 | 'How CEOs manage growth agendas', Gulati, Ranjay, <i>Harvard Business Review</i> , Jul/Aug, vol 82, issue 7/8, pp124-133, 2004 | 7 | 'Stop kissing frogs' Campbell, Andrew and Park, Robert, <i>Harvard Business Review</i> , July/Aug 2004, vol 82, issue 7/8, pp27-29 |
| 3 | Gulati, op. cit., p8 | 8 | 'Innovation as a last resort', Treacy, Michael, <i>Harvard Business Review</i> , Jul/Aug 2004, vol 82, issue 7/8, pp29-31 |
| 4 | Gulati, op. cit., p3 | 9 | Treacy, op. cit., p30 |
| 5 | 'Simply better: winning and keeping customers by delivering what matters most' Barwise, Patrick and Meehan, Sean, 2004, Harvard Business School Press | | |

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

MAKE YOUR FACULTY **WORK** FOR YOU ...... 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 Hayley Smith.

© Braybrooke Press 2005. All rights reserved. No part of this work covered by copyright may be reproduced or copied in any form or by any means (including graphic, electronic or mechanical, photocopying recording, recorded taping or retrieval information systems) without written permission of the copyright holder. The views expressed herein are not necessarily shared by the Council of the Institute or by the Faculty. Articles are published without responsibility on the part of the publishers or authors for loss occasioned by any person acting or refraining from acting as a result of any view expressed therein.

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

