Modul Manajemen Strategik
Chapter 9 - 12

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Chapter 9
IMPLEMENTING STRATEGIES: MARKETING, FINANCE/ACCOUNTING, R&D, MIS ISSUES

Implementing Strategies: Marketing, Finance/Accounting, R&D, and MIS Issues

A note from David

Strategies have no chance of being implemented successfully in organizations that do not market goods an d services well, in firms that cannot raise needed working capital, in firms that produce technologically inferior products, or in firms that have a weak information system. This chapter examines marketing, finance/accounting, R&D, and management information systems (MIS) issues that are central to effective strategy implementation. Special topics include market segmentation, market positioning, evaluating the worth of a business, determining to what extent debt and/or stock should be used as a source of capital, developing projected financial statements, contracting R&D outside the firm, and creating an information support system. Manager and employee involvement and participation are essential for success in marketing, finance/accounting, R&D, and MIS activities.

The Nature of Strategy Implementation The quarterback can call the best play possible in the huddle, but that does not mean the play will go for a touchdown. The team may even lose yardage unless the play is executed (implemented) well. Less than 10 percent of strategies formulated are successfully implemented! There are many reasons for this low success rate, including failing to appropriately segment markets, paying too much for a new acquisition, and falling behind competitors in R&D. Johnson & Johnson implements strategies well. Strategy implementation directly affects the lives of plant managers, division managers, department managers, sales managers, product managers, project managers, personnel managers, staff managers, supervisors, and all employees. In some situations, individuals may not have participated in the strategy-formulation process at all and may not appreciate, understand, or even accept the work and thought that went into strategy formulation. There may even be foot dragging or resistance on their part. Managers and employees who do not understand the business and are not committed to the business may attempt to sabotage strategy-implementation efforts in hopes that the organization will return to its old ways. The strategy-implementation stage of the strategic-management process is highlighted in Figure 8-1.

Current Marketing Issues

Countless marketing variables affect the success or failure of strategy implementation, and the scope of this text does not allow us to address all those issues. Some examples of marketing decisions that may require policies are as follows:

1. To use exclusive dealerships or multiple channels of distribution
2. To use heavy, light, or no TV advertising
3. To limit (or not) the share of business done with a single customer
4. To be a price leader or a price follower
5. To offer a complete or limited warranty
6. To reward salespeople based on straight salary, straight commission, or a combination salary/commission
7. To advertise online or not

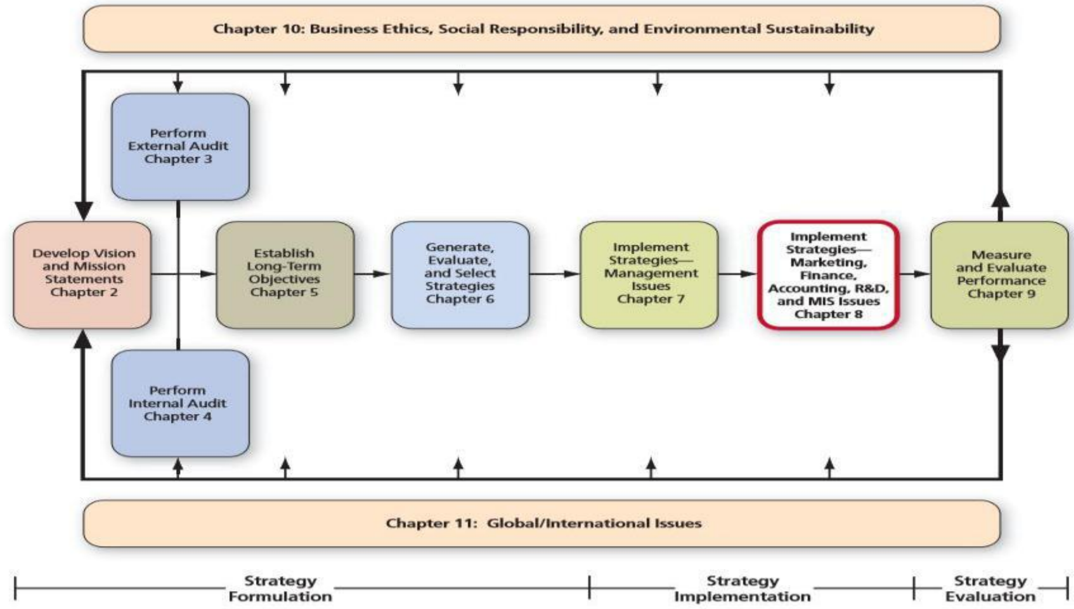
A marketing issue of increasing concern to consumers today is the extent to which companies can track individuals' movements on the Internet—and even be able to identify an individual by name and e-mail address. Individuals' wanderings on the Internet are no longer anonymous, as many persons still believe. Marketing companies such as DoubleClick, Flycast, AdKnowledge, AdForce, and Real Media have sophisticated methods to identify who you are and your particular interests.1 If

you are especially concerned about being tracked, visit the www.networkadvertising.org Web site, which gives details about how marketers today are identifying you and your buying habits.

Marketing of late has become more about building a two-way relationship with consumers than just informing consumers about a product or service. Marketers today must get their customers involved in their company Web site and solicit suggestions from customers in terms of product development, customer service, and ideas. The online community is much quicker, cheaper, and effective than traditional focus groups and surveys. Companies and organizations should encourage their employees to create wikis—Web sites that allows users to add, delete, and edit content regarding frequently asked questions and information across the firm's whole value chain of activities. The most common wiki is Wikipedia, but think of wikis as user-generated content. Know that anyone can change the content in a wiki but the group and other editors can change the content or changes that you submit.

FIGURE 8-1

A Comprehensive Strategic-Management Model



Source: Fred R. David, "How Companies Define Their Mission," *Long Range Planning* 22, no. 3 (June 1988): 40.

Firms should provide incentives to consumers to share their thoughts, opinions, and experiences on the company Web site. Encourage consumers to network among themselves on topics of their choosing on the company Web site. So the company Web site must not be all about the company—it must be all about the customer too. Perhaps offer points or discounts for customers who provide ideas and suggestions. This practice will not only encourage participation but will allow both the company and other customers to interact with "experts."

New Principles of Marketing

Today a business or organization's Web site must provide clear and simple instructions for customers to set up a blog and/or contribute to a wiki. Customers trust each others' opinions more than a company's marketing pitch, and the more they talk freely, the more the firm can learn how to improve its product, service, and marketing. Marketers today monitor blogs daily to determine, evaluate, and influence opinions being formed by customers. Customers must not feel like they are a captive audience for advertising at a firm's Web site. Table 8-1 provides new principles of marketing according to Parise, Guinan, and Weinberg.2

Wells Fargo and Bank of America in 2009 began to tweet customers, meaning they posted messages of 140 characters or less on Twitter.com to describe features of bank products. Some banks are placing marketing videos on YouTube. Discover Financial, American Express, and Citigroup all now have Facebook or My Space pages. UMB Financial of Kansas City, Missouri, tweets about everything from the bank's financial stability to the industry's prospects. Steve Furman, Discover's director of e-commerce, says the appeal of social networking is that it provides "pure, instant" communication with customers.3

When the big three U.S. automakers were asking lawmakers for bailout funding, all three firms launched extensive Internet marketing campaigns to garner support for their requests and plans for the future. Ford's online marketing campaign was anchored by the Web site www.TheFordStory.com. In addition to a new Web site of its own, Chrysler launched a new marketing YouTube Channel named Grab Democracy and also posted ad information to its blog. GM employed similar marketing tactics to drive visitors to its main Web site. Once any controversial topic arises in a company or industry, millions of people are out there googling, yahooing, aoling, youtubing, facebooking, and myspacing to find out more information in order to form their own opinions and preferences.4

Although the exponential increase in social networking and business online has created huge opportunities for marketers, it also has produced some severe threats. Perhaps the greatest threat is that any king of negative publicity travels fast online. For example, Dr Pepper recently suffered immensely when an attorney for the rock band Guns N' Roses accused the company of not following through on giving every American a soft drink if they released their album Chinese Democracy. Other examples abound, such as Motrin ads that lightheartedly talked about Mom's back pain from holding babies in slings, and Burger King's Whopper Virgin campaign, which featured a taste test of a Whopper versus a McDonald's Big Mac in remote areas of the world. Even Taco Bell suffered from its ads that featured asking 50 Cent (aka Curtis Jackson) if he would change his name to 79 Cent or 89 Cent for a day in exchange for a $10,000 donation to charity. Seemingly minor ethical and questionable actions can catapult these days into huge public relations problems for companies as a result of the monumental online social and business communications. For example, Domino's, the nation's largest pizza delivery chain, spent a month in 2009 trying to dispel the video on YouTube and Facebook showing two of its employees doing gross things to a Domino's sub sandwich, including passing gas on salami.5

In increasing numbers, people living in underdeveloped and poor nations around the world have cell phones but no computers, so the Internet is rapidly moving to cell phone platforms. This is opening up even larger markets to online marketing. People in remote parts of Indonesia, Egypt, and Russia represent the fastest growing customer base for Opera Software ASA, a Norwegian maker of Internet browsers for mobile devices. Actually, persons who cannot afford computers live everywhere in every country, and many of these persons will soon be on the Internet on their cell phones. Cell phones are rapidly becoming used for data transfer, not just for phone calls. Companies such as Nokia, AT&T, Purple Labs SA of France, Japan's Access, Vodafone Group PLC, Siemens AG, Research in Motion, and Apple are spurring this transition by developing new and improved Web-capable mobile products every day.6

TABLE 8-1 The New Principles of Marketing

1. Don't just talk at consumers—work with them throughout the marketing process.
2. Give consumers a reason to participate.
3. Listen to—and join—the conversation outside your company's Web site.
4. Resist the temptation to sell, sell, sell. Instead attract, attract, attract.
5. Don't control online conversations; let it flow freely.
6. Find a "marketing technologist," a person who has three excellent skill sets (marketing, technology, and social interaction).
7. Embrace instant messaging and chatting.

Source: Based on Salvatore Parise, Patricia Guinan, and Bruce Weinberg, "The Secrets of Marketing in a Web 2.0 World," *Wall Street Journal* (December 15, 2008): R1.

Advertising Media

Recent research by Forrester Research reveals that people ages 18 to 27 spend more time weekly on the Internet than watching television, listening to the radio, or watching DVDs or VHS tapes. Table 8-2 reveals why companies are rapidly coming to the realization that social networking sites and video sites are better means of reaching their customers than spending so many marketing dollars on traditional yellow pages or television, magazine, radio, or newspaper ads. Note the time that people spend on the Internet. And it is not just the time. Television viewers are passive viewers of ads, whereas Internet users take an active role in choosing what to look at—so customers on the Internet are tougher for marketers to reach.7

TABLE 8-2 Average Amount of Time That 18- to 27-Year-Olds Spend Weekly on Various Media (in hours)

Media	Hours
On the Internet	High-13.0
Watching television	↓
On their cell phone	
Listening to the Radio	Medium-7.0
Watching DVDs or VHSs	↓
Playing video games	
Reading magazines	Low-1.0

Source: Based on Ellen Byron, "A New Odd Couple: Google, P&G Swap Workers to Spur Innovation," *Wall Street Journal* (November 19, 2008): A1.

New companies such as Autonet Mobile based in San Francisco are selling new technology equipment for cars so the front passenger may conduct an iChat video conference while persons in the back each have a laptop and watch a YouTube video or download music or wirelessly transfer pictures from a digital camera. Everyone in the vehicle can be online except, of course, the driver. This technology is now available for installation in nearly all cars and is accelerating the movement from hard media to Webbased media. With this technology also, when the vehicle drives into a new location, you may instantly download information on shows, museums, hotels, and other attractions around you.

Growth of Internet advertising is expected to decline from a 16 percent increase in 2008 to a 5 percent increase in 2009. With this slowdown, companies are changing the restrictions they previously imposed on the categories and formats of advertising. For example, marketers are more and more allowed to create bigger, more intrusive ads that take up more space on the Web page. And Web sites are allowing lengthier ads to run before short video clips play. And blogs are creating more content that doubles also as an ad. Companies are also waiving minimum ad purchases. Companies are redesigning their Web sites to be much more interactive and are building new sponsorship programs and other enticements on their sites. Editorial content and advertising content are increasingly being mixed on blogs.

In 2009–2011, consumers will act rationally. JC Penney CEO Mike Ullman says, "Consumers now shop for what they 'need' and less for what they 'want.' And they don’t need much.” Essentials, such as food, health-care products, and beauty aids are selling, but even in those industries, consumers are shifting to less costly brands and stores. There is a need for marketers to convince consumers that their brand will make life easier or better. Consumers now often wait until prices are slashed 75 percent or more to buy. Consumers today are very cautious about how they spend their money. Gone are the days when retailers could convince consumers to buy something they do not need.

JC Penney is among many firms that today have revamped their marketing to be more digital related. Penney’s is segmenting its e-mail databases according to customers’ shopping behaviors and then sending out relevant messages. Penney’s corporate director of brand communications recently said, “Tailoring the e-mail insures that our customers are receiving timely, relevant information.”

Expectations for total U.S. advertising spending in 2009 may decline anywhere from 6.2 percent to 3 percent to about $160 billion as the fallout from global financial crises continues to cut into ad spending.8 Global ad spending is expected to decline about 0.5 percent. One bright spot, however, is online advertising expenditures that are expected to increase 5 percent in 2009 following a 16 percent increase in 2008. Companies are shifting ad dollars from newspaper, magazine, and radio to online media.

Purpose-Based Marketing

The global marketing chief at Procter & Gamble, Jim Stengel, recently started his own LLC business to try to persuade companies that the best way to sell in a weak economy is to “show customers how they can improve their lives” with your product or service. Stengel calls this “purpose-based marketing,” and hundreds of firms have now adopted this approach successfully. He says there is need in an ad to build trust and an emotional connection to the customer in order to differentiate your product or service.9

In a weak economy when consumers are more interested in buying cheaper brands, Stengel acknowledges that ads must promote price, but he says ads must also show the intrinsic value of the product or service to be cost effective. Stengel contends that ads should do both: promote low price and build emotional equity through "purpose-based appeal."

The Coca-Cola Company is leading the way to another new kind of selling in a weak economy. CEO Muhtar Kent at Coke says marketing today must "employ optimism." That is why Coca-Cola launched a new global ad campaign in 2009 appealing to consumers' longing for comfort and optimism. The new campaign features the new slogan "Open Happiness," which replaced Coke's prior popular slogan of three years, "The Coke Side of Life." The Coke CEO says marketers must use feel-good messages to counter the fallout from the economic crisis. Firms must today project to customers that their products or services offer a beacon of comfort and optimism. Coke's cola volume declined 4.0 percent in the United States in 2008. Coke Classic's U.S. volume fell about 16 percent from 1998 through 2007 as customers switched to bottled water, enhanced teas, and other alternative drinks.10

Market Segmentation

Two variables are of central importance to strategy implementation: market segmentation and product positioning. Market segmentation and product positioning rank as marketing's most important contributions to strategic management.

Market segmentation is widely used in implementing strategies, especially for small and specialized firms. Market segmentation can be defined as the subdividing of a market into distinct subsets of customers according to needs and buying habits.

TABLE 8-3 The Marketing Mix Component Variables

Product	Place	Promotion	Price
Quality	Distribution channels	Advertising	Level
Features and options	Distribution coverage	Personal selling	Discounts and allowances
Style	Outlet location	Sales promotion	Payment terms
Brand name	Sales territories	Publicity	
Packaging	Inventory levels and locations		
Product line	Transportation carriers		
Warranty			
Service level			
Other services			

Source: From E. Jerome McCarthy, *Basic Marketing: A Managerial Approach*, 9th ed. (Homewood, IL: Richard D. Irwin, Inc., 1987): 37–44. Used with permission.

Market segmentation is an important variable in strategy implementation for at least three major reasons. First, strategies such as market development, product development, market penetration, and diversification require increased sales through new markets and products. To implement these strategies successfully, new or improved market-segmentation approaches are required. Second, market segmentation allows a firm to operate with limited resources because mass production, mass distribution, and mass advertising are not required. Market segmentation enables a small firm to compete successfully with a large firm by maximizing per-unit profits and per-segment sales. Finally, market segmentation decisions directly affect marketing mix variables: product, place, promotion, and price, as indicated in Table 8-3. For example, SnackWells, a pioneer in reduced-fat snacks, has shifted its advertising emphasis from low-fat to great taste as part of its new market-segmentation strategy.

Perhaps the most dramatic new market-segmentation strategy is the targeting of regional tastes. Firms from McDonald’s to General Motors are increasingly modifying their products to meet different regional preferences within the United States. Campbell’s has a spicier version of its nacho cheese soup for the Southwest, and Burger King offers breakfast burritos in New Mexico but not in South Carolina. Geographic and demographic bases for segmenting markets are the most commonly employed, as illustrated in Table 8-4.

Evaluating potential market segments requires strategists to determine the characteristics and needs of consumers, to analyze consumer similarities and differences, and to develop consumer group profiles. Segmenting consumer markets is generally much simpler and easier than segmenting industrial markets, because industrial products, such as electronic circuits and forklifts, have multiple applications and appeal to diverse customer groups.

Segmentation is a key to matching supply and demand, which is one of the thorniest problems in customer service. Segmentation often reveals that large, random fluctuations in demand actually consist of several small, predictable, and manageable patterns. Matching supply and demand allows factories to produce desirable levels without extra shifts, overtime, and subcontracting. Matching supply and demand also minimizes the number and severity of stock-outs. The demand for hotel rooms, for example, can be dependent on foreign tourists, businesspersons, and vacationers. Focusing separately on these three market segments, however, can allow hotel firms to more effectively predict overall supply and demand.

Banks now are segmenting markets to increase effectiveness. “You’re dead in the water if you aren’t segmenting the market,” says Anne Moore, president of a bank consulting firm in Atlanta. The Internet makes market segmentation easier today because consumers naturally form “communities” on the Web.

Does the Internet Make Market Segmentation Easier? Yes. The segments of people whom marketers want to reach online are much more precisely defined than the segments of people reached through traditional forms of media, such as television, radio, and magazines. For example, Quepasa.com is widely visited by Hispanics. Marketers aiming to reach college students, who are notoriously difficult to reach via traditional media, focus on sites such as collegeclub.com and studentadvantage.com. The gay and lesbian population, which is estimated to comprise about 5 percent of the U.S. population, has always been difficult to reach via traditional media but now can be focused on at sites such as gay.com. Marketers can reach persons interested in specific topics, such as travel or fishing, by placing banners on related Web sites.

People all over the world are congregating into virtual communities on the Web by becoming members/customers/visitors of Web sites that focus on an endless range of topics. People in essence segment themselves by nature of the Web sites that comprise their “favorite places,” and many of these Web sites sell information regarding their “visitors.” Businesses and groups of individuals all over the world pool their purchasing power in Web sites to get volume discounts.

TABLE 8-4 Alternative Bases for Market Segmentation

Variable	Typical Breakdowns
	Geographic
Region	Pacific, Mountain, West North Central, West South Central, East North Central, East South Central, South Atlantic, Middle Atlantic, New England
County Size	A, B, C, D
City Size	Under 5,000; 5,000–20,000; 20,001–50,000; 50,001–100,000; 100,001–250,000; 250,001–500,000; 500,001–1,000,000; 1,000,001–4,000,000; 4,000,001 or over
Density	Urban, suburban, rural
Climate	Northern, southern
	Demographic
Age	Under 6, 6–11, 12–19, 20–34, 35–49, 50–64, 65+
Gender	Male, female
Family Size	1–2, 3–4, 5+
Family Life Cycle	Young, single; young, married, no children; young, married, youngest child under 6; young, married, youngest child 6 or over; older, married, with children; older, married, no children under 18; older, single; other
Income	Under $10,000; $10,001–$15,000; $15,001–$20,000; $20,001–$30,000; $30,001–$50,000; $50,001–$70,000; $70,001–$100,000; over $100,000
Occupation	Professional and technical; managers, officials, and proprietors; clerical and sales; craftspeople; foremen; operatives; farmers; retirees; students; housewives; unemployed
Education	Grade school or less; some high school; high school graduate; some college; college graduate
Religion	Catholic, Protestant, Jewish, Islamic, other
Race	White, Asian, Hispanic, African American
Nationality	American, British, French, German, Scandinavian, Italian, Latin American, Middle Eastern, Japanese
	Psychographic
Social Class	Lower lowers, upper lowers, lower middles, upper middles, lower uppers, upper uppers
Personality	Compulsive, gregarious, authoritarian, ambitious
	Behavioral
Use Occasion	Regular occasion, special occasion
Benefits Sought	Quality, service, economy
User Status	Nonuser, ex-user, potential user, first-time user, regular user
Usage Rate	Light user, medium user, heavy user
Loyalty Status	None, medium, strong, absolute
Readiness Stage	Unaware, aware, informed, interested, desirous, intending to buy
Attitude Toward Product	Enthusiastic, positive, indifferent, negative, hostile

Source: Adapted from Philip Kotler, *Marketing Management: Analysis, Planning and Control,* © 1984: 256. Adapted by permission of Prentice-Hall, Inc., Upper Saddle River, New Jersey.

Product Positioning

After markets have been segmented so that the firm can target particular customer groups, the next step is to find out what customers want and expect. This takes analysis and research. A severe mistake is to assume the firm knows what customers want and expect. Countless research studies reveal large differences between how customers define service and rank the importance of different service activities and how producers view services. Many firms have become successful by filling the gap between what customers and producers see as good service. What the customer believes is good service is paramount, not what the producer believes service should be.

Identifying target customers to focus marketing efforts on sets the stage for deciding how to meet the needs and wants of particular consumer groups. Product positioning is widely used for this purpose. Positioning entails developing schematic representations that reflect how your products or services compare to competitors' on dimensions most important to success in the industry. The following steps are required in product positioning:

1. Select key criteria that effectively differentiate products or services in the industry.
2. Diagram a two-dimensional product-positioning map with specified criteria on each axis.
3. Plot major competitors' products or services in the resultant four-quadrant matrix.
4. Identify areas in the positioning map where the company's products or services could be most competitive in the given target market. Look for vacant areas (niches).
5. Develop a marketing plan to position the company's products or services appropriately.

Because just two criteria can be examined on a single product-positioning map, multiple maps are often developed to assess various approaches to strategy implementation. Multidimensional scalingcould be used to examine three or more criteria simultaneously, but this technique requires computer assistance and is beyond the scope of this text. Some examples of product-positioning maps are illustrated in Figure 8-2.

Some rules for using product positioning as a strategy-implementation tool are the following:

1. Look for the hole or vacant niche. The best strategic opportunity might be an unserved segment.
2. Don't serve two segments with the same strategy. Usually, a strategy successful with one segment cannot be directly transferred to another segment.
3. Don't position yourself in the middle of the map. The middle usually means a strategy that is not clearly perceived to have any distinguishing characteristics. This rule can vary with the number of competitors. For example, when there are only two competitors, as in U.S. presidential elections, the middle becomes the preferred strategic position.11

An effective product-positioning strategy meets two criteria: (1) it uniquely distinguishes a company from the competition, and (2) it leads customers to expect slightly less service than a company can deliver. Firms should not create expectations that exceed the service the firm can or will deliver. Network Equipment Technology is an example of a company that keeps customer expectations slightly below perceived performance. This is a constant challenge for marketers. Firms need to inform customers about what to expect and then exceed the promise. Underpromise and then overdeliver is the key!

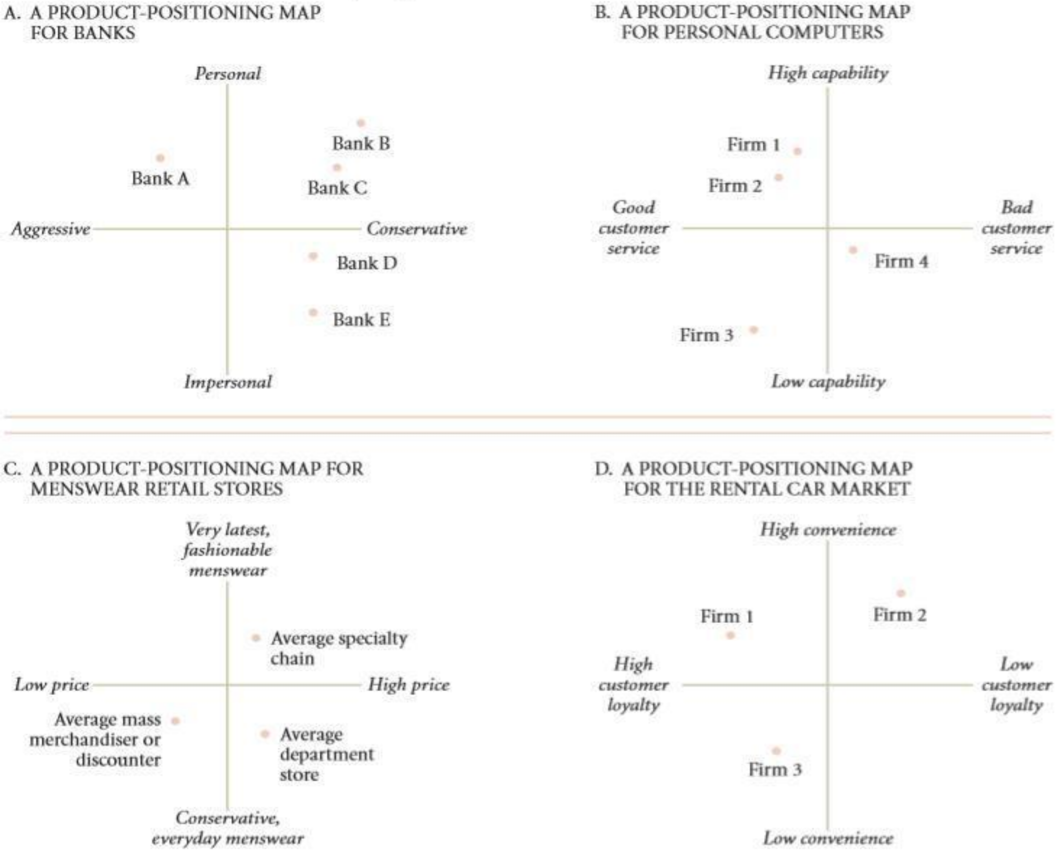
Finance/Accounting

Issues In this section, we examine several finance/accounting concepts considered to be central to strategy implementation: acquiring needed capital, developing projected financial statements, preparing financial budgets, and evaluating the worth of a business. Some examples of decisions that may require finance/accounting policies are these:

1. To raise capital with short-term debt, long-term debt, preferred stock, or common stock
2. To lease or buy fixed assets
3. To determine an appropriate dividend payout ratio
4. To use LIFO (Last-in, First-out), FIFO (First-in, First-out), or a market-value accounting approach
5. To extend the time of accounts receivable
6. To establish a certain percentage discount on accounts within a specified period of time
7. To determine the amount of cash that should be kept on hand

FIGURE 8-2

Examples of Product-Positioning Maps



Acquiring Capital to Implement Strategies

Successful strategy implementation often requires additional capital. Besides net profit from operations and the sale of assets, two basic sources of capital for an organization are debt and equity. Determining an appropriate mix of debt and equity in a firm's capital structure can be vital to successful strategy implementation. An Earnings Per Share/Earnings Before Interest and Taxes (EPS/EBIT) analysis is the most widely used technique for determining whether debt, stock, or a combination of debt and stock is the best alternative for raising capital to implement strategies. This technique involves an examination of the impact that debt versus stock financing has on earnings per share under various assumptions as to EBIT.

Theoretically, an enterprise should have enough debt in its capital structure to boost its return on investment by applying debt to products and projects earning more than the cost of the debt. In low earning periods, too much debt in the capital structure of an organization can endanger stockholders' returns and jeopardize company survival.

Fixed debt obligations generally must be met, regardless of circumstances. This does not mean that stock issuances are always better than debt for raising capital. Some special concerns with stock issuances are dilution of ownership, effect on stock price, and the need to share future earnings with all new shareholders.

Without going into detail on other institutional and legal issues related to the debt versus stock decision, EPS/EBIT may be best explained by working through an example. Let's say the Brown Company needs to raise $1 million to finance implementation of a market-development strategy. The company's common stock currently sells for $50 per share, and 100,000 shares are outstanding. The prime interest rate is 10 percent, and the company's tax rate is 50 percent. The company's earnings before interest and taxes next year are expected to be $2 million if a recession occurs, $4 million if the economy stays as is, and $8 million if the economy significantly improves. EPS/EBIT analysis can be used to determine if all stock, all debt, or some combination of stock and debt is the best capital financing alternative. The EPS/EBIT analysis for this example is provided in Table 8-5.

As indicated by the EPS values of 9.5, 19.50, and 39.50 in Table 8-5, debt is the best financing alternative for the Brown Company if a recession, boom, or normal year is expected. An EPS/EBIT chart can be constructed to determine the break-even point, where one financing alternative becomes more attractive than another. Figure 8-3 indicates that issuing common stock is the least attractive financing alternative for the Brown Company. EPS/EBIT analysis is a valuable tool for making the capital financing decisions needed to implement strategies, but several considerations should be made whenever using this technique. First, profit levels may be higher for stock or debt alternatives when EPS levels are lower. For example, looking only at the earnings after taxes (EAT) values in Table 8-5, you can see that the common stock option is the best alternative, regardless of economic conditions. If the Brown Company's mission includes strict profit maximization, as opposed to the maximization of stockholders' wealth or some other criterion, then stock rather than debt is the best choice of financing.

TABLE 8-5 EPS/EBIT Analysis for the Brown Company (in millions)

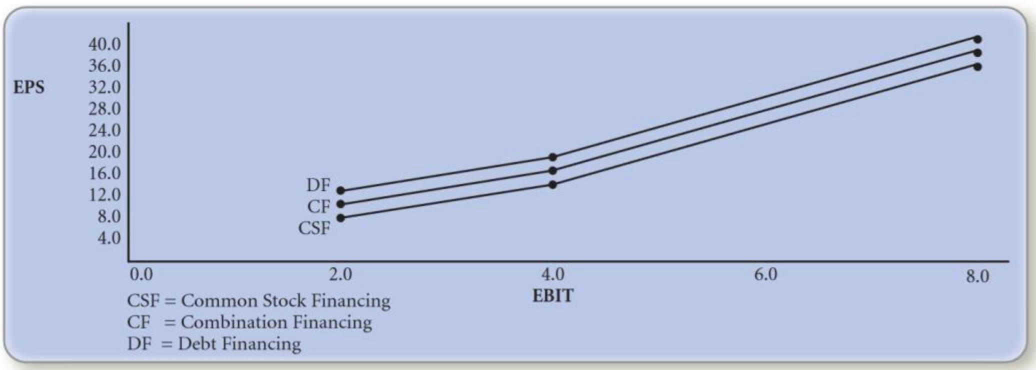
	Common Stock Financing			Debt Financing			Combination Financing		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	$2.0	$ 4.0	$ 8.0	$2.0	$ 4.0	$ 8.0	$2.0	$ 4.0	$ 8.0
Interest[a]	0	0	0	.10	.10	.10	.05	.05	.05
EBT	2.0	4.0	8.0	1.9	3.9	7.9	1.95	3.95	7.95
Taxes	1.0	2.0	4.0	.95	1.95	3.95	.975	1.975	3.975
EAT	1.0	2.0	4.0	.95	1.95	3.95	.975	1.975	3.975
#Shares[b]	.12	.12	.12	.10	.10	.10	.11	.11	.11
EPS[c]	8.33	16.66	33.33	9.5	19.50	39.50	8.86	17.95	36.14

[a]The annual interest charge on $1 million at 10% is $100,000 and on $0.5 million is $50,000. This row is in $, not %.
[b]To raise all of the needed $1 million with stock, 20,000 new shares must be issued, raising the total to 120,000 shares outstanding. To raise one-half of the needed $1 million with stock, 10,000 new shares must be issued, raising the total to 110,000 shares outstanding.
[c]EPS = Earnings After Taxes (EAT) divided by shares (number of shares outstanding).

Another consideration when using EPS/EBIT analysis is flexibility. As an organization's capital structure changes, so does its flexibility for considering future capital needs. Using all debt or all stock to raise capital in the present may impose fixed obligations, restrictive covenants, or other constraints that could severely reduce a firm's ability to raise additional capital in the future. Control is also a concern. When additional stock is issued to finance strategy implementation, ownership and control of the enterprise are diluted. This can be a serious concern in today's business environment of hostile takeovers, mergers, and acquisitions.

FIGURE 8-3

An EPS/EBIT Chart for the Brown Company



Dilution of ownership can be an overriding concern in closely held corporations in which stock issuances affect the decision-making power of majority stockholders. For example, the Smucker family owns 30 percent of the stock in Smucker's, a well-known jam and jelly company. When Smucker's acquired Dickson Family, Inc., the company used mostly debt rather than stock in order not to dilute the family ownership.

When using EPS/EBIT analysis, timing in relation to movements of stock prices, interest rates, and bond prices becomes important. In times of depressed stock prices, debt may prove to be the most suitable alternative from both a cost and a demand standpoint. However, when cost of capital (interest rates) is high, stock issuances become more attractive.

Tables 8-6 and 8-7 provide EPS/EBIT analyses for two companies—Gateway and Boeing. Notice in those analyses that the combination stock/debt options vary from 30/70 to 70/30. Any number of combinations could be explored. However, sometimes in preparing the EPS/EBIT graphs, the lines will intersect, thus revealing break-even points at which one financing alternative becomes more or less attractive than another. The slope of these lines will be determined by a combination of factors including stock price, interest rate, number of shares, and amount of capital needed. Also, it should be noted here that the best financing alternatives are indicated by the highest EPS values. In Tables 8-6 and 8-7, note that the tax rates for the companies vary considerably and should be computed from the respective income statements by dividing taxes paid by income before taxes.

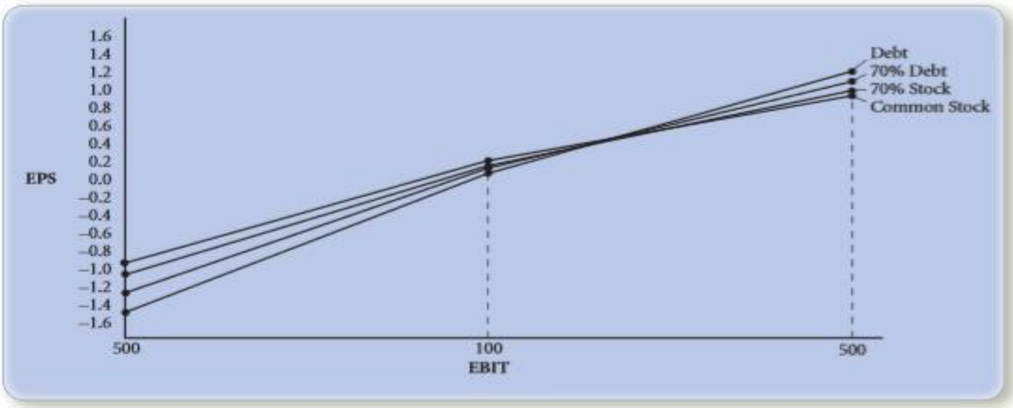
In Table 8-6, the higher EPS values indicate that Gateway should use stock to raise capital in recession or normal economic conditions but should use debt financing under boom conditions. Stock is the best alternative for Gateway under all three conditions if EAT (profit maximization) were the decision criteria, but EPS (maximize shareholders' wealth) is the better ratio to make this decision. Firms can do many things in the short run to maximize profits, so investors and creditors consider maximizing shareholders' wealth to be the better criteria for making financing decisions.

TABLE 8-6 EPS/EBIT Analysis for Gateway (M = In Millions)

Amount Needed: $1,000 M
EBIT Range: – $500 M to + $100 M to + $500 M
Interest Rate: 5%
Tax Rate: 0% (because the firm has been incurring a loss annually)
Stock Price: $6.00
# of Shares Outstanding: 371 M

	Common Stock Financing			Debt Financing		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	(500.00)	100.00	500.00	(500.00)	100.00	500.00
Interest	0.00	0.00	0.00	50.00	50.00	50.00
EBT	(500.00)	100.00	500.00	(550.00)	50.00	450.00
Taxes	0.00	0.00	0.00	0.00	0.00	0.00
EAT	(500.00)	100.00	500.00	(550.00)	50.00	450.00
#Shares	537.67	537.67	537.67	371.00	371.00	371.00
EPS	**(0.93)**	**0.19**	**0.93**	**(1.48)**	**0.13**	**1.21**

	70 Percent Stock—30 Percent Debt			70 Percent Debt—30 Percent Stock		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	(500.00)	100.00	500.00	(500.00)	100.00	500.00
Interest	15.00	15.00	15.00	35.00	35.00	35.00
EBT	(515.00)	85.00	485.00	(535.00)	65.00	465.00
Taxes	0.00	0.00	0.00	0.00	0.00	0.00
EAT	(515.00)	85.00	485.00	(535.00)	65.00	465.00
#Shares	487.67	487.67	487.67	421.00	421.00	421.00
EPS	**(1.06)**	**0.17**	**0.99**	**(1.27)**	**0.15**	**1.10**



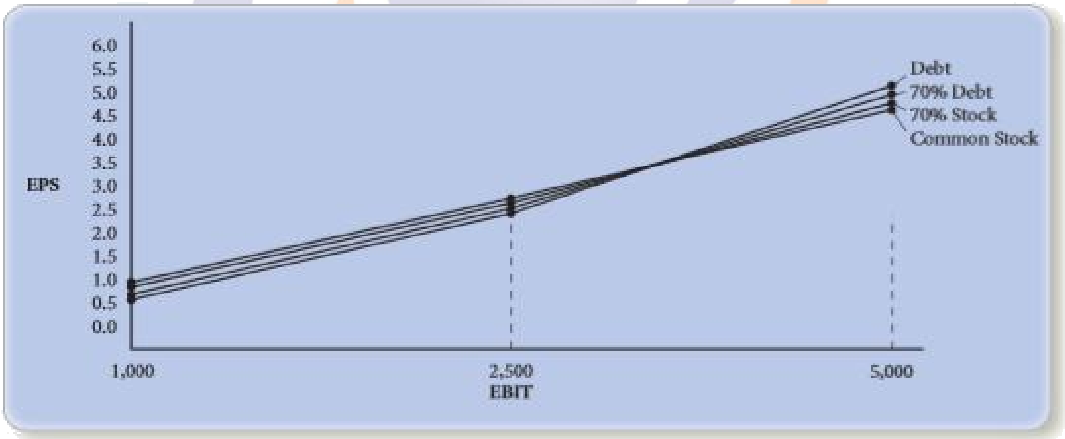
Conclusion: Gateway should use common stock to raise capital in recession or normal economic conditions but should use debt financing under boom conditions. Note that stock is the best alternative under all three conditions according to EAT (profit maximization), but EPS (maximize shareholders' wealth) is the better ratio to make this decision.

TABLE 8-7 EPS/EBIT Analysis for Boeing (M = In Millions)

Amount Needed: $10,000 M
Interest Rate: 5%
Tax Rate: 7%
Stock Price: $53.00
# of Shares Outstanding: 826 M

	Common Stock Financing			Debt Financing		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	1,000.00	2,500.00	5,000.00	1,000.00	2,500.00	5,000.00
Interest	0.00	0.00	0.00	500.00	500.00	500.00
EBT	1,000.00	2,500.00	5,000.00	500.00	2,000.00	4,500.00
Taxes	70.00	175.00	350.00	35.00	140.00	315.00
EAT	930.00	2,325.00	4,650.00	465.00	1,860.00	4,185.00
# Shares	1,014.68	1,014.68	1,014.68	826.00	826.00	826.00
EPS	**0.92**	**2.29**	**4.58**	**0.56**	**2.25**	**5.07**

	70% Stock—30% Debt			70% Debt—30% Stock		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	1,000.00	2,500.00	5,000.00	1,000.00	2,500.00	5,000.00
Interest	150.00	150.00	150.00	350.00	350.00	350.00
EBT	850.00	2,350.00	4,850.00	650.00	2,150.00	4,650.00
Taxes	59.50	164.50	339.50	45.50	150.50	325.50
EAT	790.50	2,185.50	4,510.50	604.50	1,999.50	4,324.50
# Shares	958.08	958.08	958.08	882.60	882.60	882.60
EPS	**0.83**	**2.28**	**4.71**	**0.68**	**2.27**	**4.90**



Conclusion: Boeing should use common stock to raise capital in recession (see 0.92) or normal (see 2.29) economic conditions but should use debt financing under boom conditions (see 5.07). Note that a dividends row is absent from this analysis. The more shares outstanding, the more dividends to be paid (if the firm pays dividends), which would lower the common stock EPS values.

In Table 8-7, note that Boeing should use stock to raise capital in recession (see 0.92) or normal (see 2.29) economic conditions but should use debt financing under boom conditions (see 5.07). Let's calculate here the number of shares figure of 1014.68 given under Boeing's stock alternative. Divide $10,000 M funds needed by the stock price of $53 = 188.68 M new shares to be issued + the 826 M shares outstanding already = 1014.68 M shares under the stock scenario. Along the final row, EPS is the number of shares outstanding divided by EAT in all columns.

Note in Table 8-6 and Table 8-7 that a dividends row is absent from both the Gateway and Boeing analyses. The more shares outstanding, the more dividends to be paid (if the firm indeed pays dividends). Paying dividends lowers EAT, which lowers the stock EPS values whenever this aspect is included. To consider dividends in an EPS/EBIT analysis, simply insert another row for “Dividends” right below the “EAT” row and then insert an “Earnings After Taxes and Dividends” row. Considering dividends would make the analysis more robust.

Note in both the Gateway and Boeing graphs, there is a break-even point between the normal and boom range of EBIT where the debt option overtakes the 70% Debt/30% Stock option as the best financing alternative. A break-even point is where two lines cross each other. A break-even point is the EBIT level where various financing alternative represented by lines crossing are equally attractive in terms of EPS. Both the Gateway and Boeing graphs indicate that EPS values are highest for the 100 percent debt option at high EBIT levels. The two graphs also reveal that the EPS values for 100 percent debt increase faster than the other financing options as EBIT levels increase beyond the break-even point. At low levels of EBIT however, both the Gateway and Boeing graphs indicate that 100 percent stock is the best financing alternative because the EPS values are highest.

New Source of Funding

Credit unions were not involved in the subprime-loan market, so many of them are flush with cash and are making loans, especially to small businesses. Deposits to credit unions were also up when many investors abandoned the stock market. Roughly 27 percent of the 8,147 U.S. credit unions offer business loans.12 The amount of businesses loans was up 18 percent in 2008 to $33 billion, and the average loan size was $215,000.

Many credit unions want to give more business loans, but the 1998 federal law (Credit Union Membership Access Act) caps the amount of business loans credit unions can have at 12.25 percent of their assets. Credit unions are trying to get this law changed, but of course banks are lobbying hard to have the law remain in place. Credit unions are chartered as nonprofit cooperative institutions owned by their members. Thus credit unions are taxexempt organizations. Bankers argue that allowing credit unions to give more business loans would give them an unfair competitive advantage over traditional banks.

Projected Financial Statements

Projected financial statement analysisis a central strategy-implementation technique because it allows an organization to examine the expected results of various actions and approaches. This type of analysis can be used to forecast the impact of various implementation decisions (for example, to increase promotion expenditures by 50 percent to support a market-development strategy, to increase salaries by 25 percent to support a market-penetration strategy, to increase research and development expenditures by 70 percent to support product development, or to sell $1 million of common stock to raise capital for diversification). Nearly all financial institutions require at least three years of projected financial statements whenever a business seeks capital. Aprojected income statement and balance sheet allow an organization to compute projected financial ratios under various strategy-implementation scenarios. When compared to prior years and to industry averages, financial ratios provide valuable insights into the feasibility of various strategy-implementation approaches.

Primarily as a result of the Enron collapse and accounting scandal and the ensuing Sarbanes-Oxley Act, companies today are being much more diligent in preparing projected financial statements to “reasonably rather than too optimistically” project future expenses and earnings. There is much more care not to mislead shareholders and other constituencies.13

A 2011 projected income statement and a balance sheet for the Litten Company are provided in Table 8-8. The projected statements for Litten are based on five assumptions: (1) The company needs to raise $45 million to finance expansion into foreign markets; (2) $30 million of this total will be raised through increased debt and $15 million through common stock; (3) sales are expected to increase 50 percent; (4) three new facilities, costing a total of $30 million, will be constructed in foreign markets; and (5) land for the new facilities is already owned by the company. Note in Table 8-8 that Litten's

TABLE 8-8 A Projected Income Statement and Balance Sheet for the Litten Company (in millions)

	Prior Year 2010	Projected Year 2011	Remarks
PROJECTED INCOME STATEMENT			
Sales	$100	$150.00	50% increase
Cost of Goods Sold	70	105.00	70% of sales
Gross Margin	30	45.00	
Selling Expense	10	15.00	10% of sales
Administrative Expense	5	7.50	5% of sales
Earnings Before Interest and Taxes	15	22.50	
Interest	3	3.00	
Earnings Before Taxes	12	19.50	
Taxes	6	9.75	50% rate
Net Income	**6**	**9.75**	
Dividends	2	5.00	
Retained Earnings	4	4.75	
PROJECTED BALANCE SHEET			
Assets			
Cash	5	7.75	Plug figure
Accounts Receivable	2	4.00	100% increase
Inventory	20	45.00	
Total Current Assets	27	56.75	
Land	15	15.00	
Plant and Equipment	50	80.00	Add three new plants at $10 million each
Less Depreciation	10	20.00	
Net Plant and Equipment	40	60.00	
Total Fixed Assets	55	75.00	
Total Assets	**82**	**131.75**	
Liabilities			
Accounts Payable	10	10.00	
Notes Payable	10	10.00	
Total Current Liabilities	20	20.00	
Long-term Debt	40	70.00	Borrowed $30 million
Additional Paid-in-Capital	20	35.00	Issued 100,000 shares at $150 each
Retained Earnings	2	6.75	$2 + $4.75
Total Liabilities and Net Worth	**82**	**131.75**	

strategies and their implementation are expected to result in a sales increase from $100 million to $150 million and in a net increase in income from $6 million to $9.75 million in the forecasted year.

There are six steps in performing projected financial analysis:

1. Prepare the projected income statement before the balance sheet. Start by forecasting sales as accurately as possible. Be careful not to blindly push historical percentages into the future with regard to revenue (sales) increases. Be mindful of what the firm did to achieve those past sales increases, which may not be appropriate for the future unless the firm takes similar or analogous actions (such as opening a similar number of stores, for example). If dealing with a manufacturing firm, also be mindful that if the firm is operating at 100 percent

capacity running three eighthour shifts per day, then probably new manufacturing facilities (land, plant, and equipment) will be needed to increase sales further.

2. Use the percentage-of-sales method to project cost of goods sold (CGS) and the expense items in the income statement. For example, if CGS is 70 percent of sales in the prior year (as it is in Table 8-8), then use that same percentage to calculate CGS in the future year—unless there is a reason to use a different percentage. Items such as interest, dividends, and taxes must be treated independently and cannot be forecasted using the percentage-of-sales method.
3. Calculate the projected net income.
4. Subtract from the net income any dividends to be paid for that year. This remaining net income is retained earnings (RE). Bring this retained earnings amount for that year (NI - DIV = RE) over to the balance sheet by adding it to the prior year's RE shown on the balance sheet. In other words, every year a firm adds its RE for that particular year (from the income statement) to its historical RE total on the balance sheet. Therefore, the RE amount on the balance sheet is a cumulative number rather than money available for strategy implementation! Note that RE is the first projected balance sheet item to be entered. Due to this accounting procedure in developing projected financial statements, the RE amount on the balance sheet is usually a large number. However, it also can be a low or even negative number if the firm has been incurring losses. The only way for RE to decrease from one year to the next on the balance sheet is (1) if the firm incurred an earnings loss that year or (2) the firm had positive net income for the year but paid out dividends more than the net income. Be mindful that RE is the key link between a projected income statement and balance sheet, so be careful to make this calculation correctly.
5. Project the balance sheet items, beginning with retained earnings and then forecasting stockholders' equity, long-term liabilities, current liabilities, total liabilities, total assets, fixed assets, and current assets (in that order). Use the cash account as the plug figure—that is, use the cash account to make the assets total the liabilities and net worth. Then make appropriate adjustments. For example, if the cash needed to balance the statements is too small (or too large), make appropriate changes to borrow more (or less) money than planned.

6. List comments (remarks) on the projected statements. Any time a significant change is made in an item from a prior year to the projected year, an explanation (remark) should be provided. Remarks are essential because otherwise pro formas are meaningless.

Projected Financial Statement Analysis for Mattel,Inc.

Because so many strategic management students have limited experience developing projected financial statements, let's apply the steps outlined on the previous pages to Mattel, the huge toy company headquartered in El Segundo, California. Mattel designs, manufactures, and markets toy products from fashion dolls to children's books. The company Web site is www.mattel.com. Mattel's recent income statements and balance sheets are provided in Table 8-9 and Table 8-10 respectively.

TABLE 8-9 Mattel's Actual Income Statements (in thousands)

	2006	2005	2004
Total Revenue	$5,650,156	5,179,016	5,102,786
Cost of Revenue	3,038,363	2,806,148	2,692,061
Gross Profit	2,611,793	2,372,868	2,410,725
Operating Expenses			
Research Development	-	-	-
Selling General and Administrative	1,882,975	1,708,339	1,679,908
Non-Recurring	-	-	-
Others	-	-	-
Total Operating Expenses	-	-	-
Operating Income or Loss	728,818	664,529	730,817
Income from Continuing Operations			
Total Other Income/Expenses Net	34,791	64,010	43,201
Earnings Before Interest and Taxes	763,609	728,539	774,018
Interest Expense	79,853	76,490	77,764
Income Before Tax	683,756	652,049	696,254
Income Tax Expense	90,829	235,030	123,531
Minority Interest	-	-	-
Net Income from Continuing Ops	592,927	417,019	572,723
Non-Recurring Events			
Discontinued Operations	-	-	-
Extraordinary Items	-	-	-
Effect of Accounting Changes	-	-	-
Other Items	-	-	-
Net Income	592,927	417,019	572,723
Preferred Stock and Other Adjustments	-	-	-
Net Income Applicable to Common Shares	$592,927	$417,019	$572,723

In Tables 8-11 and 8-12, Mattel's projected income statements and balance sheets respectively for 2007, 2008, and 2009 are provided based on the firm pursuing the following strategies:

1. The company desires to build 20 Mattel stores annually at a cost of $1 million each.
2. The company plans to develop new toy products at an annual cost of $10 million.
3. The company plans to increase its advertising/promotion expenditures 30 percent over three years, at a cost of $30 million ($10 million per year).
4. The company plans to buy back $100 million of its own stock (called Treasury stock) annually for the next three years.
5. The company expects revenues to increase 10 percent annually with the above strategies. Mattel can handle this increase with existing production facilities.
6. Dividend payout will be increased from 57 percent of net income to 60 percent.
7. To finance the $380 million total cost for the above strategies, Mattel plans to use long-term debt for $150 million ($50 million per year for three years) and $230 million by issuing stock ($77 million per year for three years).

The Mattel projected financial statements were prepared using the six steps outlined on prior pages and the above seven strategy statements. Note the cash account is used as the plug figure, and it is too high, so Mattel could reduce this number and concurrently reduce a liability and/or equity account the same amount to keep the statement in balance. Rarely is the cash account perfect on the first pass through, so adjustments are needed and made. However, these adjustments are not made on the projected statements given in

TABLE 8-10 Mattel's Actual Balance Sheets (in thousands)

	2006	2005	2004
Assets			
Current Assets			
Cash and Cash Equivalents	$1,205,552	997,734	1,156,835
Short-Term Investments	–	–	–
Net Receivables	943,813	760,643	759,033
Inventory	383,149	376,897	418,633
Other Current Assets	317,624	277,226	302,649
Total Current Assets	2,850,138	2,412,500	2,637,150
Long-Term Investments	–	–	–
Property, Plant, and Equipment	536,749	547,104	586,526
Goodwill	845,324	718,069	735,680
Intangible Assets	70,593	20,422	22,926
Accumulated Amortization	–	–	–
Other Assets	149,912	178,304	201,836
Deferred Long-Term Asset Charges	503,168	495,914	572,374
Total Assets	$4,955,884	4,372,313	4,756,492
Liabilities			
Current Liabilities			
Accounts Payable	$1,518,234	1,245,191	1,303,822
Short/Current Long-Term Debt	64,286	217,994	423,349
Other Current Liabilities	–	–	–
Total Current Liabilities	1,582,520	1,463,185	1,727,171
Long-Term Debt	635,714	525,000	400,000
Other Liabilities	304,676	282,395	243,509
Deferred Long-Term Liability Charges	–	–	–
Minority Interest	–	–	–
Negative Goodwill	–	–	–
Total Liabilities	2,522,910	2,270,580	2,370,680
Stockholders' Equity			
Misc. Stocks, Options, Warrants	–	–	–
Redeemable Preferred Stock	–	–	–
Preferred Stock	–	–	–
Common Stock	441,369	441,369	441,369
Retained Earnings	1,652,140	1,314,068	1,093,288
Treasury Stock	(996,981)	(935,711)	(473,349)
Capital Surplus	1,613,307	1,589,281	1,594,332
Other Stockholders' Equity	(276,861)	(307,274)	(269,828)
Total Stockholders' Equity	2,432,974	2,101,733	2,385,812
Total Liabilities and SE	$4,955,884	4,372,313	4,756,492

Tables 8-11 and 8-12, so that the seven strategy statements above can be more readily seen on respective rows. Note the author's comments on Tables 8-11 and 8-12 that help explain changes in the numbers. The U.S. Securities and Exchange Commission (SEC) conducts fraud investigations if projected numbers are misleading or if they omit information that's important to investors. Projected statements must conform with generally accepted accounting principles (GAAP) and must not be designed to hide poor expected results. The Sarbanes-Oxley Act requires CEOs and CFOs of corporations to personally sign their firms' financial statements attesting to their accuracy. These executives could thus be held personally liable for misleading or inaccurate statements. The collapse of the Arthur Andersen accounting firm, along with its client Enron, fostered a "zero tolerance" policy among auditors and shareholders with regard to a firm's financial statements. But plenty of firms still "inflate" their financial projections and call them "pro formas," so investors, shareholders, and other stakeholders must still be wary of different companies' financial projections.14

TABLE 8-11 Mattel's Projected Income Statements (in thousands)

	2009	2008	2007	Author Comment
Total Revenue	$7,520,357	6,836,688	6,215,171	up 10% annually
Cost of Revenue	4,060,992	3,691,811	3,356,192	remains 54%
Gross Profit	3,459,365	3,144,877	2,858,979	subtraction
Operating Expenses				
Research Development	10,000	10,000	10,000	total $30M new
Selling General and Administrative	2,491,717	2,256,107	2,051,006	remains 33% + $10 M annually
Non-Recurring	-	-	-	
Others	-	-	-	
Total Operating Expenses	-	-	-	
Operating Income or Loss	957,648	878,770	797,973	subtraction
Income from Continuing Operations				
Total Other Income/Expenses Net	34,791	34,791	34,791	keep it the same
Earnings Before Interest and Taxes	992,439	913,561	832,764	addition
Interest Expense	97,823	91,423	85,442	up 7%; LTD up 7%
Income Before Tax	894,616	822,138	737,322	
Income Tax Expense	90,829	90,829	90,829	keep it the same
Minority Interest	-	-	-	
Net Income from Continuing Ops	803,787	731,309	646,493	subtraction
Discontinued Operations	-	-	-	
Extraordinary Items	-	-	-	
Effect of Accounting Changes	-	-	-	
Other Items	-	-	-	
Net Income	803,787	731,309	646,493	
Preferred Stock and Other Adjustments	-	-	-	
Net Income Applicable to Common Shares	$803,787	731,309	646,493	

On financial statements, different companies use different terms for various items, such as revenues or sales used for the same item by different companies. For net income, many firms use the term earnings, and many others use the term profits.

Financial Budgets

A financial budget is a document that details how funds will be obtained and spent for a specified period of time. Annual budgets are most common, although the period of time for a budget can range from one day to more than 10 years. Fundamentally, financial budget ing is a method for specifying what must be done to complete strategy implementation successfully. Financial budgeting should not be thought of as a tool for limiting expenditures but rather as a method for obtaining the most productive and profitable use of an organization's resources. Financial budgets can be viewed as the planned allocation of a firm's resources based on forecasts of the future. There are almost as many different types of financial budgets as there are types of organizations. Some common types of budgets include cash budgets, operating budgets, sales budgets, profit budgets, factory budgets, capital budgets, expense budgets, divisional

TABLE 8-12 Mattel's Projected Balance Sheets (in thousands)

	2009	2008	2007	Author Comment
Assets				
Current Assets				
Cash and Cash Equivalents	$3,232,406	2,972,664	2,570,635	too high, could reduce this and pay off some LTD to keep balance
Short-Term Investments	-	-	-	
Net Receivables	943,813	760,643	759,033	
Inventory	509,969	463,609	421,463	up 10% annually
Other Current Assets	317,624	317,624	317,624	keep it the same
Total Current Assets				
Long-Term Investments	-	-	-	
Property, Plant, and Equipment	596,749	576,749	556,749	up $20M annually
Goodwill	845,324	845,324	845,324	keep it the same
Intangible Assets	70,593	70,593	70,593	keep it the same
Accumulated Amortization	-	-	-	
Other Assets	149,912	149,912	149,912	keep it the same
Deferred Long-Term Asset Charges	503,168	503,168	503,168	keep it the same
Total Assets	7,169,558	6,660,286	6,194,501	
Liabilities				
Current Liabilities				
Accounts Payable	1,518,234	1,518,234	1,518,234	keep it the same
Short/Current Long-Term Debt	64,286	64,286	64,286	keep it the same
Other Current Liabilities	-	-	-	
Total Current Liabilities	1,582,520	1,582,520	1,582,520	
Long-Term Debt	785,714	735,714	685,714	up $50M annually
Other Liabilities	304,676	304,676	304,676	keep it the same
Deferred Long-Term Liability Charges	-	-	-	
Minority Interest	-	-	-	
Negative Goodwill	-	-	-	
Total Liabilities	2,672,910	2,622,910	2,572,910	
Stockholders' Equity				
Misc. Stocks, Options, Warrants	-	-	-	
Redeemable Preferred Stock	-	-	-	
Preferred Stock	-	-	-	
Common Stock	441,369	441,369	441,369	keep it the same
Retained Earnings	2,961,092	2,478,820	2,040,035	60% of NI = div
Treasury Stock	(1,296,981)	(1,196,981)	(1,096,981)	up $100M annually
Capital Surplus	2,114,307	2,037,307	1,960,307	up $77M annually
Other Stockholders' Equity	(276,861)	(276,861)	(276,861)	keep it the same
Total Stockholders' Equity	4,496,648	4,037,376	3,621,591	addition
Total Liabilities and SE	$7,169,558	6,660,286	6,194,501	addition

budgets, variable budgets, flexible budgets, and fixed budgets. When an organization is experiencing financial difficulties, budgets are especially important in guiding strategy implementation.

Perhaps the most common type of financial budget is the *cash budget*. The Financial Accounting Standards Board (FASB) has mandated that every publicly held company in the United States must issue an annual cash-flow statement in addition to the usual financial reports. The statement includes all receipts and disbursements of cash in operations, investments, and financing. It supplements the Statement on Changes in Financial Position formerly included in the annual reports of all publicly held companies. A cash budget for the year 2011 for the Toddler Toy Company is provided in Table 8-13. Note that Toddler is not expecting to have surplus cash until November 2011.

Financial budgets have some limitations. First, budgetary programs can become so detailed that they are cumbersome and overly expensive. Overbudgeting or underbudgeting can cause problems. Second, financial budgets can become a substitute for objectives. A budget is a tool and not an end in itself. Third, budgets can hide inefficiencies if based solely on precedent rather than on periodic evaluation of circumstances and standards. Finally, budgets are sometimes used as instruments of tyranny that result in frustration, resentment, absenteeism, and high turnover. To minimize the effect of this last concern, managers should increase the participation of subordinates in preparing budgets.

Evaluating the Worth of a Business

Evaluating the worth of a business is central to strategy implementation because integrative, intensive, and diversification strategies are often implemented by acquiring other firms. Other strategies, such as retrenchment and divestiture, may result in the sale of a division of an organization or of the firm itself. Thousands of transactions occur each year in which businesses are bought or sold in the United States. In all these cases, it is necessary to establish the financial worth or cash value of a business to successfully implement strategies.

All the various methods for determining a business's worth can be grouped into three main approaches: what a firm owns, what a firm earns, or what a firm will bring in the market. But it is important to realize that valuation is not an exact science. The valuation of a firm's worth is based on financial facts, but common sense and intuitive judgment must enter into the process. It is difficult to assign a monetary value to some factors—such as a loyal customer base, a history of growth, legal suits pending, dedicated employees, a favorable lease, a bad credit rating, or good patents—that may

TABLE 8-13 Six-Month Cash Budget for the Toddler Toy Company in 2011

Cash Budget (in thousands)	July	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.
Receipts							
Collections	$12,000	$21,000	$31,000	$35,000	$22,000	$18,000	$11,000
Payments							
Purchases	14,000	21,000	28,000	14,000	14,000	7,000	
Wages and Salaries	1,500	2,000	2,500	1,500	1,500	1,000	
Rent	500	500	500	500	500	500	
Other Expenses	200	300	400	200	—	100	
Taxes	—	8,000	—	—	—	—	
Payment on Machine	—	—	10,000	—	—	—	
Total Payments	$16,200	$31,800	$41,400	$16,200	$16,000	$8,600	
Net Cash Gain (Loss) During Month	−4,200	−10,800	−10,400	18,800	6,000	9,400	
Cash at Start of Month if No Borrowing Is Done	6,000	1,800	−9,000	−19,400	−600	5,400	
Cumulative Cash (Cash at start plus gains or minus losses)	1,800	−9,000	−19,400	−600	5,400	14,800	
Less Desired Level of Cash	−5,000	−5,000	−5,000	−5,000	−5,000	−5,000	
Total Loans Outstanding to Maintain $5,000 Cash Balance	$3,200	$14,000	$24,400	$5,600	—	—	
Surplus Cash	—	—	—	—	400	9,800	

not be reflected in a firm's financial statements. Also, different valuation methods will yield different totals for a firm's worth, and no prescribed approach is best for a certain situation. Evaluating the worth of a business truly requires both qualitative and quantitative skills.

TABLE 8-14 Company Worth Analysis for Mattel, Nordstrom, and Pfizer (year-end 2008, in $millions, except stock price and EPS)

Input Data	Mattel	Nordstrom	Pfizer
Shareholders' Equity	$2,117	$1,210	$57,556
Net Income (NI)	379	401	8,104
Stock Price	15	10	15
EPS	1.03	1.83	1.19
# of Shares Outstanding	358	215	6,750
Goodwill + Intangibles	815	53	21,464
Total Assets	235	0	17,721
Company Worth Analyses			
1. Shareholders' Equity + Goodwill + Intangibles	$3,167	$1,263	$ 96,741
2. Net Income × 5	1,895	2,005	40,520
3. (Stock Price/EPS) × NI	5,519	2,191	102,151
4. # of Shares Out × Stock Price	5,340	2,150	101,250
5. Four Method Average	3,988	1,902	76,049
$Goodwill/$Total Assets	17.4%	0.94%	19.3%

The first approach in evaluating the worth of a business is determining its net worth or stockholders' equity. Net worth represents the sum of common stock, additional paid-in capital, and retained earnings. After calculating net worth, add or subtract an appropriate amount for goodwill, overvalued or undervalued assets, and intangibles.

Whereas intangibles include copyrights, patents, and trademarks, goodwill arises only if a firm acquires another firm and pays more than the book value for that firm.

It should be noted that Financial Accounting Standards Board (FASB) Rule 142 requires companies to admit once a year if the premiums they paid for acquisitions, called goodwill, were a waste of money. Goodwill is not a good thing to have on a balance sheet. Note in Table 8-14 that Mattel's goodwill of $815 million as a percent of its total assets ($4,675 million) is 17.4 percent, which is extremely high compared to Nordstrom's goodwill of $53 million as a percentage of its total assets ($5,661 million), 0.94 percent. Pfizer's goodwill to total assets percentage also is high at 19.3 percent.

At year-end 2008, Mattel, Nordstrom, and Pfizer had $815 million, $53 million, and $21,464 billion in goodwill, respectively, on their balance sheets. Most creditors and investors feel that goodwill indeed should be added to the stockholders' equity in calculating worth of a business, but some feel it should be subtracted, and still others feel it should not be included at all. Perhaps whether you are buying or selling the business may determine whether you negotiate to add or subtract goodwill in the analysis. Goodwill is sometimes listed as intangibles on the balance sheet, but technically intangibles refers to patents, trademarks, and copyrights, rather than the value a firm paid over book value for an acquisition, which is goodwill. If a firm paid less than book value for an acquisition, that could be called negative goodwill—which is a line item on Mattel's balance sheets.

The second approach to measuring the value of a firm grows out of the belief that the worth of any business should be based largely on the future benefits its owners may derive through net profits. A conservative rule of thumb is to establish a business's worth as five times the firm's current annual profit. A five-year average profit level could also be used.

When using the approach, remember that firms normally suppress earnings in their financial statements to minimize taxes.

The third approach is called the price-earnings ratio method. To use this method, divide the market price of the firm's common stock by the annual earnings per share and multiply this number by the firm's average net income for the past five years.

The fourth method can be called the outstanding shares method. To use this method, simply multiply the number of shares outstanding by the market price per share and add a premium. The premium is simply a per-share dollar amount that a person or firm is willing to pay to control (acquire) the other company. A pharmaceutical company based in Tokyo, Astellas Pharma Inc., recently launched an unsolicited takeover of biotechnology company CV Therapeutics Inc., based in Palo Alto, California. Astellas offered $16 a share, or nearly $1 billion, which represented a 41 percent premium over CV's closing stock price of $11.35 on the Nasdaq stock market. The CEO of Astellas said, "We are disappointed that CV's board of directors has rejected outright what we believe is a very compelling all-cash proposal that would deliver stockholders significant immediate value that we believe far exceeds what CV can achieve as a stand-alone company."

Business evaluations are becoming routine in many situations. Businesses have many strategy-implementation reasons for determining their worth in addition to preparing to be sold or to buy other companies. Employee plans, taxes, retirement packages, mergers, acquisitions, expansion plans, banking relationships, death of a principal, divorce, partnership agreements, and IRS audits are other reasons for a periodic valuation. It is just good business to have a reasonable understanding of what your firm is worth. This knowledge protects the interests of all parties involved.

Table 8-14 provides the cash value analyses for three companies—Mattel, Nordstrom, and Pfizer—for year-end 2008. Notice that there is significant variation among the four methods used to determine cash value. For example, the worth of the toy company Mattel ranged from $1,895 billion to $5,519 billion. Obviously, if you were selling your company, you would seek the larger values, while if purchasing a company you would seek the lower values. In practice, substantial negotiation takes place in reaching a final compromise (or averaged) amount. Also recognize that if a firm's net income is negative, theoretically the approaches involving that figure would result in a negative number, implying that the firm would pay you to acquire them. Of course, you obtain all of the firm's debt and liabilities in an acquisition, so theoretically this would be possible.

Deciding Whether to Go Public

Going public means selling off a percentage of your company to others in order to raise capital; consequently, it dilutes the owners' control of the firm. Going public is not recommended for companies with less than $10 million in sales because the initial costs can be too high for the firm to generate sufficient cash flow to make going public worthwhile. One dollar in four is the average total cost paid to lawyers, accountants, and underwriters when an initial stock issuance is under $1 million; 1 dollar in 20 will go to cover these costs for issuances over $20 million.

In addition to initial costs involved with a stock offering, there are costs and obligations associated with reporting and management in a publicly held firm. For firms with more than $10 million in sales, going public can provide major advantages: It can allow the firm to raise capital to develop new products, build plants, expand, grow, and market products and services more effectively.

Research and Development (R&D) Issues

Research and development (R&D) personnel can play an integral part in strategy implementation. These individuals are generally charged with developing new products and improving old products in a way that will allow effective strategy implementation. R&D employees and managers perform tasks that include transferring complex technology, adjusting processes to local raw materials, adapting processes to local markets, and altering products to particular tastes and specifications. Strategies such as product development, market penetration, and related diversification require that new products be successfully developed and that old products be significantly improved. But the level of management support for R&D is often constrained by resource availability.

Technological improvements that affect consumer and industrial products and services shorten product life cycles. Companies in virtually every industry are relying on the development of new products and services to fuel profitability and growth.15 Surveys suggest that the most successful organizations use an R&D strategy that ties external opportunities to internal strengths and is linked with objectives. Well-formulated R&D policies match market opportunities with internal capabilities. R&D policies can enhance strategy implementation efforts to:

1. Emphasize product or process improvements.
2. Stress basic or applied research.
3. Be leaders or followers in R&D.
4. Develop robotics or manual-type processes.
5. Spend a high, average, or low amount of money on R&D.
6. Perform R&D within the firm or to contract R&D to outside firms.
7. Use university researchers or private-sector researchers.

Pfizer Inc. has only a few new drugs in its pipeline to show for its $7.5 billion R&D budget, so the firm is laying off 5,000 to 8,000 of its researchers and scientists in labs around the world. Cash-strapped consumers are filling fewer prescriptions and are turning more and more to generic drugs. Pfizer is bracing for the 2011 expiration of its patent on cholesterol fighter Lipitor, the world's top-selling drug that alone accounts for a quarter of Pfizer's roughly $48 billion in annual revenue. Pfizer's $7.5 billion R&D budget is the largest of any drug maker. The firm recently scrapped two drugs nearly ready to go to market—insulin spray Exubera and a Lipitor successor drug—after spending billions to develop them. Research areas that Pfizer is exiting include anemia, bone health, gastrointestinal disorders, obesity, liver disease, osteoarthritis, and peripheral artery disease.

There must be effective interactions between R&D departments and other functional departments in implementing different types of generic business strategies. Conflicts between marketing, finance/accounting, R&D, and information systems departments can be minimized with clear policies and objectives. Table 8-15 gives some examples of R&D activities that could be required for successful implementation of various strategies. Many U.S. utility, energy, and automotive companies are employing their research and development departments to determine how the firm can effectively reduce its gas emissions.

TABLE 8-15 Research and Development Involvement in Selected Strategy-Implementation Situations

Type of Organization	Strategy Being Implemented	R&D Activity
Pharmaceutical company	Product development	Test the effects of a new drug on different subgroups.
Boat manufacturer	Related diversification	Test the performance of various keel designs under various conditions.
Plastic container manufacturer	Market penetration	Develop a biodegradable container.
Electronics company	Market development	Develop a telecommunications system in a foreign country.

Many firms wrestle with the decision to acquire R&D expertise from external firms or to develop R&D expertise internally. The following guidelines can be used to help make this decision:

1. If the rate of technical progress is slow, the rate of market growth is moderate, and there are significant barriers to possible new entrants, then in-house R&D is the preferred solution. The reason is that R&D, if successful, will result in a temporary product or process monopoly that the company can exploit.
2. If technology is changing rapidly and the market is growing slowly, then a major effort in R&D may be very risky, because it may lead to the development of an ultimately obsolete technology or one for which there is no market.
3. If technology is changing slowly but the market is growing quickly, there generally is not enough time for in-house development. The prescribed approach is to obtain R&D expertise on an exclusive or nonexclusive basis from an outside firm.
4. If both technical progress and market growth are fast, R&D expertise should be obtained through acquisition of a well-established firm in the industry.16

There are at least three major R&D approaches for implementing strategies. The first strategy is to be the first firm to market new technological products. This is a glamorous and exciting strategy but also a dangerous one. Firms such as 3M and General Electric have been successful with this approach, but many other pioneering firms have fallen, with rival firms seizing the initiative.

A second R&D approach is to be an innovative imitator of successful products, thus minimizing the risks and costs of start-up. This approach entails allowing a pioneer firm to develop the first version of the new product and to demonstrate that a market exists. Then, laggard firms develop a similar product. This strategy requires excellent R&D personnel and an excellent marketing department.

A third R&D strategy is to be a low-cost producer by mass-producing products similar to but less expensive than products recently introduced. As a new product is accepted by customers, price becomes increasingly important in the buying decision. Also, mass marketing replaces personal selling as the dominant selling strategy. This R&D strategy, requires substantial investment in plant and equipment but fewer expenditures in R&D than the two approaches described previously.

R&D activities among U.S. firms need to be more closely aligned to business objectives. There needs to be expanded communication between R&D managers and strategists. Corporations are experimenting with various methods to achieve this improved communication climate, including different roles and reporting arrangements for managers and new methods to reduce the time it takes research ideas to become reality.

Perhaps the most current trend in R&D management has been lifting the veil of secrecy whereby firms, even major competitors, are joining forces to develop new products. Collaboration is on the rise due to new competitive pressures, rising research costs, increasing regulatory issues, and accelerated product development schedules. Companies not only are working more closely with each other on R&D, but they are also turning to consortia at universities for their R&D needs. More than 600 research consortia are now in operation in the United States. Lifting of R&D secrecy among many firms through collaboration has allowed the marketing of new technologies and products even before they are available for sale. For example, some firms are collaborating on the efficient design of solar panels to power homes and businesses.

Management Information Systems (MIS)

Issues Firms that gather, assimilate, and evaluate external and internal information most effectively are gaining competitive advantages over other firms. Having an effective management information system (MIS) may be the most important factor in differentiating successful from unsuccessful firms. The process of strategic management is facilitated immensely in firms that have an effective information system.

Information collection, retrieval, and storage can be used to create competitive advantages in ways such as cross-selling to customers, monitoring suppliers, keeping managers and employees informed, coordinating activities among divisions, and managing funds. Like inventory and human resources, information is now recognized as a valuable organizational asset that can be controlled and managed. Firms that implement strategies using the best information will reap competitive advantages in the twenty-first century.

A good information system can allow a firm to reduce costs. For example, online orders from salespersons to production facilities can shorten materials ordering time and reduce inventory costs. Direct communications between suppliers, manufacturers, marketers, and customers can link together elements of the value chain as though they were one organization. Improved quality and service often result from an improved information system.

Firms must increasingly be concerned about computer hackers and take specific measures to secure and safeguard corporate communications, files, orders, and business conducted over the Internet. Thousands of companies today are plagued by computer hackers who include disgruntled employees, competitors, bored teens, sociopaths, thieves, spies, and hired agents. Computer vulnerability is a giant, expensive headache.

Dun & Bradstreet is an example company that has an excellent information system. Every D&B customer and client in the world has a separate nine-digit number. The database of information associated with each number has become so widely used that it is like a business Social Security number. D&B reaps great competitive advantages from its information system.

In many firms, information technology is doing away with the workplace and allowing employees to work at home or anywhere, anytime. The mobile concept of work allows employees to work the traditional 9-to-5 workday across any of the 24 time zones around the globe. Affordable desktop videoconferencing software allows employees to “beam in” whenever needed. Any manager or employee who travels a lot away from the office is a good candidate for working at home rather than in an office provided by the firm. Salespersons or consultants are good examples, but any person whose job largely involves talking to others or handling information could easily operate at home with the proper computer system and software.

Many people see the officeless office trend as leading to a resurgence of family togetherness in U.S. society. Even the design of homes may change from having large open areas to having more private small areas conducive to getting work done.17

Chapter 10
STRATEGY REVIEW, EVALUATION AND CONTROL

Strategy Review, Evaluation, and Control

A note from David

The best formulated and best implemented strategies become obsolete as a firm's external and internal environments change. It is essential, therefore, that strategists systematically review, evaluate, and control the execution of strategies. This chapter presents a framework that can guide managers' efforts to evaluate strategic-management activities, to make sure they are working, and to make timely changes. Management information systems being used to evaluate strategies are discussed. Guidelines are presented for formulating, implementing, and evaluating strategies. Family Dollar Stores evaluates strategies well.

The Nature of Strategy Evaluation The strategic-management process results in decisions that can have significant, longlasting consequences. Erroneous strategic decisions can inflict severe penalties and can be exceedingly difficult, if not impossible, to reverse. Most strategists agree, therefore, that strategy evaluation is vital to an organization's well-being; timely evaluations can alert management to problems or potential problems before a situation becomes critical. Strategy evaluation includes three basic activities: (1) examining the underlying bases of a firm's strategy, (2) comparing expected results with actual results, and (3) taking corrective actions to ensure that performance conforms to plans. The strategy-evaluation stage of the strategic-management process is illustrated in Figure 9-1.

Adequate and timely feedback is the cornerstone of effective strategy evaluation. Strategy evaluation can be no better than the information on which it is based. Too much pres sure from top managers may result in lower managers contriving numbers they think will be satisfactory. Strategy evaluation can be a complex and sensitive undertaking. Too much emphasis on evaluating strategies may be expensive and counterproductive. No one likes to be evaluated too closely! The more managers attempt to evaluate the behavior of others, the less control they have. Yet too little or no evaluation can create even worse problems. Strategy evaluation is essential to ensure that stated objectives are being achieved. In many organizations, strategy evaluation is simply an appraisal of how well an organization has performed. Have the firm's assets increased? Has there been an increase in profitability? Have sales increased? Have productivity levels increased? Have profit margin, return on investment, and earnings-per-share ratios increased? Some firms argue that their strategy must have been correct if the answers to these types of questions are affirmative. Well, the strategy or strategies may have been correct, but this type of reasoning can be misleading because strategy evaluation must have both a long-run and short-run focus. Strategies often do not affect short-term operating results until it is too late to make needed changes.

It is impossible to demonstrate conclusively that a particular strategy is optimal or even to guarantee that it will work. One can, however, evaluate it for critical flaws. Richard Rumelt offered four criteria that could be used to evaluate a strategy: consistency, consonance, feasibility, and advantage. Described in Table 9-1, consonance and advantage are mostly based on a firm's external assessment, whereas consistency and feasibility are largely based on an internal assessment. Strategy evaluation is important because organizations face dynamic environments in which key external and internal factors often change quickly and dramatically. Success today is no guarantee of success tomorrow! An organization should never be lulled into complacency with success. Countless firms have thrived one year only to struggle for survival the following year. Organizational trouble can come swiftly, as further evidenced by the examples described in Table 9-2.

TABLE 9-1 Rumelt's Criteria for Evaluating Strategies

Consistency

A strategy should not present inconsistent goals and policies. Organizational conflict and interdepartmental bickering are often symptoms of managerial disorder, but these problems may also be a sign of strategic inconsistency. Three guidelines help determine if organizational problems are due to inconsistencies in strategy:

- If managerial problems continue despite changes in personnel and if they tend to be issue-based rather than people-based, then strategies may be inconsistent.
- If success for one organizational department means, or is interpreted to mean, failure for another department, then strategies may be inconsistent.
- If policy problems and issues continue to be brought to the top for resolution, then strategies may be inconsistent.

Consonance

Consonance refers to the need for strategists to examine *sets of trends*, as well as individual trends, in evaluating strategies. A strategy must represent an adaptive response to the external environment and to the critical changes occurring within it. One difficulty in matching a firm's key internal and external factors in the formulation of strategy is that most trends are the result of interactions among other trends. For example, the day-care explosion came about as a combined result of many trends that included a rise in the average level of education, increased inflation, and an increase in women in the workforce. Although single economic or demographic trends might appear steady for many years, there are waves of change going on at the interaction level.

Feasibility

A strategy must neither overtax available resources nor create unsolvable subproblems. The final broad test of strategy is its feasibility; that is, can the strategy be attempted within the physical, human, and financial resources of the enterprise? The financial resources of a business are the easiest to quantify and are normally the first limitation against which strategy is evaluated. It is sometimes forgotten, however, that innovative approaches to financing are often possible. Devices, such as captive subsidiaries, sale-leaseback arrangements, and tying plant mortgages to long-term contracts, have all been used effectively to help win key positions in suddenly expanding industries. A less quantifiable, but actually more rigid, limitation on strategic choice is that imposed by individual and organizational capabilities. In evaluating a strategy, it is important to examine whether an organization has demonstrated in the past that it possesses the abilities, competencies, skills, and talents needed to carry out a given strategy.

Advantage

A strategy must provide for the creation and/or maintenance of a competitive advantage in a selected area of activity. Competitive advantages normally are the result of superiority in one of three areas: (1) resources, (2) skills, or (3) position. The idea that the positioning of one's resources can enhance their combined effectiveness is familiar to military theorists, chess players, and diplomats. Position can also play a crucial role in an organization's strategy. Once gained, a good position is defensible—meaning that it is so costly to capture that rivals are deterred from full-scale attacks. Positional advantage tends to be self-sustaining as long as the key internal and environmental factors that underlie it remain stable. This is why entrenched firms can be almost impossible to unseat, even if their raw skill levels are only average. Although not all positional advantages are associated with size, it is true that larger organizations tend to operate in markets and use procedures that turn their size into advantage, while smaller firms seek product/market positions that exploit other types of advantage. The principal characteristic of good position is that it permits the firm to obtain advantage from policies that would not similarly benefit rivals without the same position. Therefore, in evaluating strategy, organizations should examine the nature of positional advantages associated with a given strategy.

Source: Adapted from Richard Rumelt, "The Evaluation of Business Strategy," in W. F. Glueck (ed.), *Business Policy and Strategic Management* (New York: McGraw-Hill, 1980): 359–367. Used with permission.

TABLE 9-2 Examples of Organizational Demise

A. Some Large Companies That Experienced a Large Drop in Revenues in 2008 vs. 2007		B. Some Large Companies That Experienced a Large Drop in Profits in 2008 vs. 2007	
Molson Coors Brewing	–23%	UAL	–1,427%
Citigroup	–29%	Sonic Automotive	–818%
Morgan Stanley	–29%	Citigroup	–865%
Goldman Sachs Group	–39%	CBS	–1,036%
Fannie Mae	–48%	Rite Aid	–4,122%
Freddie Mac	–71%	Pilgrim's Pride	–2,224%
Weyerhaeuser	–32%	Centex	–1,090%
Centex	–41%	Harrah's Entertainment	–939%
Pulte Homes	–32%	American International Group	–1,701%
Massachusetts Mutual Life	–26%	Gannett	–730%
Allstate	–20%	OfficeMax	–899%
American International Group	–90%	Brunswick	–806%
Hartford Financial	–64%	Brightpoint	–822%
Atria Group	–58%	Owens Corning	–974%

Strategy evaluation is becoming increasingly difficult with the passage of time, for many reasons. Domestic and world economies were more stable in years past, product life cycles were longer, product development cycles were longer, technological advancement was slower, change occurred less
frequently, there were fewer competitors, foreign companies were weak, and there were more regulated industries. Other reasons why strategy evaluation is more difficult today include the following trends:

1. A dramatic increase in the environment’s complexity
2. The increasing difficulty of predicting the future with accuracy
3. The increasing number of variables
4. The rapid rate of obsolescence of even the best plans
5. The increase in the number of both domestic and world events affecting organizations
6. The decreasing time span for which planning can be done with any degree of certainty1

A fundamental problem facing managers today is how to control employees effectively in light of modern organizational demands for greater flexibility, innovation, creativity, and initiative from employees.2 How can managers today ensure that empowered employees acting in an entrepreneurial manner do not put the well-being of the business at risk? Recall that Kidder, Peabody & Company lost $350 million when one of its traders allegedly booked fictitious profits; Sears, Roebuck and Company took a $60 million charge against earnings after admitting that its automobile service businesses were performing unnecessary repairs. The costs to companies such as these in terms of damaged reputations, fines, missed opportunities, and diversion of management’s attention are enormous.

When empowered employees are held accountable for and pressured to achieve specific goals and are given wide latitude in their actions to achieve them, there can be dysfunctional behavior. For example, Nordstrom, the upscale fashion retailer known for outstanding customer service, was subjected to lawsuits and fines when employees underreported hours worked in order to increase their sales per hour—the company’s primary performance criterion. Nordstrom’s customer service and earnings were enhanced until the misconduct was reported, at which time severe penalties were levied against the firm.

The Process of Evaluating Strategies

Strategy evaluation is necessary for all sizes and kinds of organizations. Strategy evaluation should initiate managerial questioning of expectations and assumptions, should trigger a review of objectives and values, and should stimulate creativity in generating alternatives and formulating criteria of evaluation.3 Regardless of the size of the organization, a certain amount of management by wandering around at all levels is essential to effective strategy evaluation. Strategy-evaluation activities should be performed on a continuing basis, rather than at the end of specified periods of time or just after problems occur. Waiting until the end of the year, for example, could result in a firm closing the barn door after the horses have already escaped.

Evaluating strategies on a continuous rather than on a periodic basis allows benchmarks of progress to be established and more effectively monitored. Some strategies take years to implement; consequently, associated results may not become apparent for years. Successful strategies combine patience with a willingness to promptly take corrective actions when necessary. There always comes a time when corrective actions are needed in an organization! Centuries ago, a writer (perhaps Solomon) made the following observations about change:

There is a time for everything, A time to be born and a time to die, A time to plant and a time to uproot, A time to kill and a time to heal, A time to tear down and a time to build, A time to weep and a time to laugh, A time to mourn and a time to dance, A time to scatter stones and a time to gather them, A time to embrace and a time to refrain, A time to search and a time to give up, A time to keep and a time to throw away, A time to tear and a time to mend, A time to be silent and a time to speak, A time to love and a time to hate, A time for war and a time for peace.4

Managers and employees of the firm should be continually aware of progress being made toward achieving the firm’s objectives. As critical success factors change, organizational members should be involved in determining appropriate corrective actions. If assumptions and expectations deviate significantly from forecasts, then the firm should renew strategy-formulation activities, perhaps sooner than planned. In strategy evaluation, like strategy formulation and strategy implementation, people make the difference. Through involvement in the process of evaluating strategies, managers and employees become committed to keeping the firm moving steadily toward achieving objectives.

A Strategy-Evaluation Framework

Table 9-3 summarizes strategy-evaluation activities in terms of key questions that should be addressed, alternative answers to those questions, and appropriate actions for an organization to take. Notice that corrective actions are almost always needed except when (1) external and internal factors have not significantly changed and (2) the firm is progressing satisfactorily toward achieving stated objectives. Relationships among strategy-evaluation activities are illustrated in Figure 9-2.

Reviewing Bases of Strategy

As shown in Figure 9-2, reviewing the underlying bases of an organization's strategy could be approached by developing a revised EFE Matrix and IFE Matrix. A revised IFE Matrix should focus on changes in the organization's management, marketing, finance/accounting,production/operations, R&D, and management information systems strengths and weaknesses. A revised EFE Matrix should indicate how effective a firm's strategies have been in response to key opportunities and threats. This analysis could also address such questions as the following:

TABLE 9-3 A Strategy-Evaluation Assessment Matrix

Have Major Changes Occurred in the Firm Internal Strategic Position?	Have Major Changes Occurred in the Firm External Strategic Position?	Has the Firm Progressed Satisfactorily Toward Achieving Its Stated Objectives?	Result
No	No	No	Take corrective actions
Yes	Yes	Yes	Take corrective actions
Yes	Yes	No	Take corrective actions
Yes	No	Yes	Take corrective actions
Yes	No	No	Take corrective actions
No	Yes	Yes	Take corrective actions
No	Yes	No	Take corrective actions
No	No	Yes	Continue present strategic course

1. How have competitors reacted to our strategies?
2. How have competitors' strategies changed?
3. Have major competitors' strengths and weaknesses changed?
4. Why are competitors making certain strategic changes?
5. Why are some competitors' strategies more successful than others?
6. How satisfied are our competitors with their present market positions and profitability?
7. How far can our major competitors be pushed before retaliating?
8. How could we more effectively cooperate with our competitors?

Numerous external and internal factors can prevent firms from achieving long-term and annual objectives. Externally, actions by competitors, changes in demand, changes in technology, economic changes, demographic shifts, and governmental actions may prevent objectives from being accomplished. Internally, ineffective strategies may have been chosen or implementation activities may have been poor. Objectives may have been too optimistic. Thus, failure to achieve objectives may not be the result of unsatisfactory work by managers and employees. All organizational members need to know this to encourage their support for strategy-evaluation activities. Organizations desperately need to know as soon as possible when their strategies are not effective. Sometimes managers and employees on the front lines discover this well before strategists. External opportunities and threats and internal strengths and weaknesses that represent the bases of current strategies should continually be monitored for change. It is not really a question of whether these factors will change but rather when they will change and in what ways. Here are some key questions to address in evaluating strategies:

1. Are our internal strengths still strengths?
2. Have we added other internal strengths? If so, what are they?
3. Are our internal weaknesses still weaknesses?
4. Do we now have other internal weaknesses? If so, what are they?

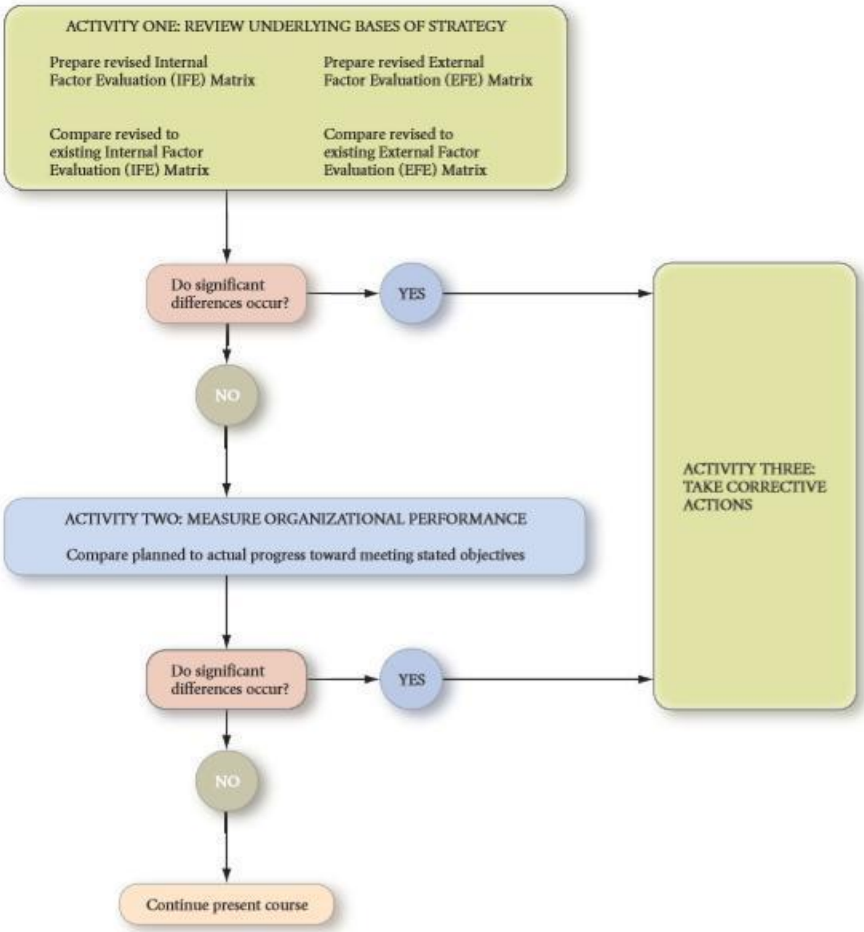
5. Are our external opportunities still opportunities?
6. Are there now other external opportunities? If so, what are they?
7. Are our external threats still threats?
8. Are there now other external threats? If so, what are they?
9. Are we vulnerable to a hostile takeover?

Measuring Organizational Performance

Another important strategy-evaluation activity is measuring organizational performance. This activity includes comparing expected results to actual results, investigating deviations from plans, evaluating individual performance, and examining progress being made toward meeting stated objectives. Both long-term and annual objectives are commonly used in this process. Criteria for evaluating strategies should be measurable and easily verifiable. Criteria that predict results may be more important than those thatreveal what already has happened. For example, rather than simply being informed that sales in the last quarter were 20 percent under what was expected, strategists need to know that sales in the next quarter may be 20 percent below standard unless some action is taken to counter the trend. Really effective control requires accurate forecasting. Failure to make satisfactory progress toward accomplishing long-term or annual objectives signals a need for corrective actions. Many factors, such as unreasonable policies, unexpected turns in the economy, unreliable suppliers or distributors, or ineffective strategies, can result in unsatisfactory progress toward meeting objectives. Problems can result from ineffectiveness (not doing the right things) or inefficiency (poorly doing the right things). Many variables can and should be included in measuring organizational performance. As indicated in Table 9-4, typically a favorable or unfavorable variance is recorded monthly, quarterly, and annually, and resultant actions needed are then determined. Determining which objectives are most important in the evaluation of strategies can be difficult. Strategy evaluation is based on both quantitative and qualitative criteria. Selecting the exact set of criteria for evaluating strategies depends on a particular organization's size, industry, strategies, and management philosophy. An organization pursuing a retrenchment strategy, for example, could have an entirely different set of evaluative criteria from an organization pursuing a market-development strategy. Quantitative criteria commonly used to evaluate strategies are financial ratios, which strategists use to make three critical comparisons:

FIGURE 9-2

A Strategy-Evaluation Framework



(1) comparing the firm’s performance over different time periods, (2) comparing the firm’s performance to competitors’, and (3) comparing the firm’s performance to industry averages. Some key financial ratios that are particularly useful as criteria for strategy evaluation are as follows:

1. Return on investment (ROI)
2. Return on equity (ROE)
3. Profit margin
4. Market share
5. Debt to equity
6. Earnings per share
7. Sales growth
8. Asset growt

TABLE 9-4 A Sample Framework for Measuring Organizational Performance

Factor	Actual Result	Expected Result	Variance	Action Needed
Corporate Revenues				
Corporate Profits				
Corporate ROI				
Region 1 Revenues				
Region 1 Profits				
Region 1 ROI				
Region 2 Revenues				
Region 2 Profits				
Region 2 ROI				
Product 1 Revenues				
Product 1 Profits				
Product 1 ROI				
Product 2 Revenues				
Product 2 Profits				
Product 2 ROI				

But some potential problems are associated with using quantitative criteria for evaluating strategies. First, most quantitative criteria are geared to annual objectives rather than long-term objectives. Also, different accounting methods can provide different results on many quantitative criteria. Third, intuitive judgments are almost always involved in deriving quantitative criteria. For these and other reasons, qualitative criteria are also important in evaluating strategies. Human factors such as high absenteeism and turnover rates, poor production quality and quantity rates, or low employee satisfaction can be underlying causes of declining performance. Marketing, finance/accounting, R&D, or management information systems factors can also cause financial problems. Some additional key questions that reveal the need for qualitative or intuitive judgments in strategy evaluation are as follows:

1. How good is the firm's balance of investments between high-risk and low-risk projects?
2. How good is the firm's balance of investments between long-term and short-term projects?
3. How good is the firm's balance of investments between slow-growing markets and fast-growing markets?
4. How good is the firm's balance of investments among different divisions?
5. To what extent are the firm's alternative strategies socially responsible?
6. What are the relationships among the firm's key internal and external strategic factors?
7. How are major competitors likely to respond to particular strategies?

Taking Corrective Actions

The final strategy-evaluation activity, taking corrective actions, requires making changes to competitively reposition a firm for the future. As indicated in Table 9-5, examples of changes that may be needed are altering an organization's structure, replacing one or more key individuals, selling a division, or revising a business mission. Other changes could include establishing or revising objectives, devising new policies, issuing stock to raise capital, adding additional salespersons, differently allocating resources, or developing new performance incentives. Taking corrective actions does not necessarily mean that existing strategies will be abandoned or even that new strategies must be formulated.

The probabilities and possibilities for incorrect or inappropriate actions increase geometrically with an arithmetic increase in personnel.

Any person directing an overall undertaking must check on the actions of the participants as well as the results that they have achieved. If either the actions or results do not comply with preconceived or planned achievements, then corrective actions are needed.5

No organization can survive as an island; no organization can escape change. Taking corrective actions is necessary to keep an organization on track toward achieving stated objectives. In his thought-provoking books Future Shock and The Third Wave, Alvin Toffler argued that business environments are becoming so dynamic and complex that they threaten people and organizations with future shock, which occurs when the nature, types, and speed of changes overpower an individual's or organization's ability and capacity to adapt. Strategy evaluation enhances an organization's ability to adapt successfully to changing circumstances. Taking corrective actions raises employees' and managers' anxieties. Research suggests that participation in strategy-evaluation activities is one of the best ways to overcome individuals' resistance to change. According to Erez and Kanfer, individuals accept change best when they have a cognitive understanding of the changes, a sense of control over the situation, and an awareness that necessary actions are going to be taken to implement the changes.6 Strategy evaluation can lead to strategy-formulation changes, strategy-implementation changes, both formulation and implementation changes, or no changes at all. Strategists cannot escape having to revise strategies and implementation approaches sooner or later. Hussey and Langham offered the following insight on taking corrective actions:

Resistance to change is often emotionally based and not easily overcome by rational argument. Resistance may be based on such feelings as loss of status, implied criticism of present competence, fear of failure in the new situation, annoyance at not being consulted, lack of understanding of the need for change, or insecurity in changing from well-known and fixed methods. It is necessary, therefore, to overcome such resistance by creating situations of participation and full explanation when changes are envisaged.7

Corrective actions should place an organization in a better position to capitalize upon internal strengths; to take advantage of key external opportunities; to avoid, reduce, or mitigate external threats; and to improve internal weaknesses. Corrective actions should have a proper time horizon and an appropriate amount of risk. They should be internally consistent and socially responsible. Perhaps most important, corrective actions strengthen an organization's competitive position in its basic industry. Continuous strategy evaluation keeps strategists close to the pulse of an organization and provides information needed for an effective strategic-management system. Carter Bayles described the benefits of strategy evaluation as follows:

Evaluation activities may renew confidence in the current business strategy or point to the need for actions to correct some weaknesses, such as erosion of product superiority or technological edge. In many cases, the benefits of strategy evaluation are much more far-reaching, for the outcome of the process may be a fundamentally new strategy that will lead, even in a business that is already turning a respectable profit, to substantially increased earnings. It is this possibility that justifies strategy evaluation, for the payoff can be very large.8

TABLE 9-5 Corrective Actions Possibly Needed to Correct Unfavorable Variances

1. Alter the firm's structure
2. Replace one or more key individuals
3. Divest a division
4. Alter the firm's vision and/or mission
5. Revise objectives
6. Alter strategies
7. Devise new policies
8. Install new performance incentives
9. Raise capital with stock or debt
10. Add or terminate salespersons, employees, or managers
11. Allocate resources differently
12. Outsource (or rein in) business functions

The Balanced Scorecard

Introduced earlier in the Chapter 5 discussion of objectives, the Balanced Scorecard is an important strategy-evaluation tool. It is a process that allows firms to evaluate strategies from four perspectives: financial performance, customer knowledge, internal business processes, and learning and growth. The Balanced Scorecard analysis requires that firms seek answers to the following questions and utilize that information, in conjunction with financial measures, to adequately and more effectively evaluate strategies being implemented:

1. How well is the firm continually improving and creating value along measures such as innovation, technological leadership, product quality, operational process efficiencies, and so on?
2. How well is the firm sustaining and even improving upon its core competencies and competitive advantages?
3. How satisfied are the firm's customers?

A sample Balanced Scorecard is provided in Table 9-6. Notice that the firm examines six key issues in evaluating its strategies: (1) Customers, (2) Managers/Employees, (3) Operations/Processes, (4) Community/Social Responsibility, (5) Business Ethics/Natural Environment, and (6) Financial. The basic form of a Balanced Scorecard may differ for different organizations. The Balanced Scorecard approach to strategy evaluation aims to balance long-term with short-term concerns, to balance financial with nonfinancial concerns, and to balance internal with external concerns. It can be an excellent management tool, and it is used successfully today by Chemical Bank, Exxon/Mobil Corporation, CIGNA Property and Casualty Insurance, and numerous other firms. The Balanced Scorecard would be constructed differently, that is, adapted, to particular firms in various industries with the underlying theme or thrust being the same, which is to evaluate the firm's strategies based upon both key quantitative and qualitative measures.

TABLE 9-6 An Example Balanced Scorecard

Area of Objectives	Measure or Target	Time Expectation	Primary Responsibility
Customers			
1.			
2.			
3.			
4.			
Managers/Employees			
1.			
2.			
3.			
4.			
Operations/Processes			
1.			
2.			
3.			
4.			
Community/Social Responsibility			
1.			
2.			
3.			
4.			
Business Ethics/Natural Environment			
1.			
2.			
3.			
4.			
Financial			
1.			
2.			
3.			
4.			

Published Sources of Strategy-Evaluation Information

A number of publications are helpful in evaluating a firm's strategies. For example, Fortune annually identifies and evaluates the Fortune 1,000 (the largest manufacturers) and the Fortune 50 (the largest retailers, transportation companies, utilities, banks, insurance companies, and diversified financial corporations in the United States). Fortune ranks the best and worst performers on various factors, such as return on investment, sales volume, and profitability. In its March issue each year, Fortune publishes its strategy-evaluation research in an article entitled "America's Most Admired Companies." Eight key attributes serve as evaluative criteria: people management; innovativeness; quality of products or services; financial soundness; social responsibility; use of corporate assets; long-term investment; and quality of management. In October of each year, Fortune publishes additional strategy-evaluation research in an article entitled "The World's Most Admired Companies." Fortune's 2009 evaluation in Table 9-7 reveals the firms most admired (best managed) in their industry. The most admired company in the world in 2009 was Nike, followed by Anheuser-Busch, Nestle, and Procter & Gamble.9 Another excellent evaluation of corporations in America, "The Annual Report on American Industry," is published annually in the January issue of Forbes. It provides a detailed and comprehensive evaluation of hundreds of U.S. companies in many different industries.BusinessWeek,Industry Week, and Dun's Business Monthalso periodically publish detailed evaluations of U.S. businesses and industries. Although published sources of strategy-evaluation information focus primarily on large, publicly held businesses, the comparative ratios and related information are widely used to evaluate small businesses and privately owned firms as well.

TABLE 9-7 **The Most Admired Company in Various Industries (2009)**

Industry	The Most Admired Company
Apparel	Nike
Beverages	Anheuser-Busch
Consumer food products	Nestle
Soaps and cosmetics	Procter & Gamble
Credit card services	Visa
Insurance	Berkshire Hathaway
Megabanks	Bank of America
Forest and paper products	International Paper
Pharmaceuticals	Johnson & Johnson
Petroleum refining	Exxon Mobil
Electronics	General Electric
Food services	McDonald's
Railroads	Union Pacific
Motor vehicles	BMW
Industrial and farm equipment	Caterpillar
Airlines	Continental Airlines
Aerospace and defense	United Technologies
Metals	Alcoa

Source: Based on Adam Lashinsky, "The World's Most Admired Companies," *Fortune* (March 16, 2009): 81–91.

Characteristics of an Effective Evaluation System

Strategy evaluation must meet several basic requirements to be effective. First, strategyevaluation activities must be economical; too much information can be just as bad as too little information; and too many controls can do more harm than good. Strategy-evaluation activities also should be meaningful; they should specifically relate to a firm's objectives. They should provide managers with useful information about tasks over which they have control and influence. Strategy-evaluation activities should provide timely information; on occasion and in some areas, managers may daily need information. For example, when a firm has diversified by acquiring another firm, evaluative information may be needed frequently. However, in an R&D department, daily or even weekly evaluative information could be dysfunctional. Approximate information that is timely is generally more desirable as a basis for strategy evaluation than accurate information that does not depict the present. Frequent measurement and rapid reporting may frustrate control rather than give better control. The time dimension of control must coincide with the time span of the event being measured. Strategy evaluation should be designed to provide a true picture of what is happening. For example, in a severe economic downturn, productivity and profitability ratios may drop alarmingly, although employees and managers are actually working harder. Strategy evaluations should fairly portray this type of situation. Information derived from the strategy-evaluation process should facilitate action and should be directed to those individuals in the organization who need to take action based on it. Managers commonly ignore evaluative reports that are provided only for informational purposes; not all managers need to receive all reports. Controls need to be action-oriented rather than information-oriented. The strategy-evaluation process should not dominate decisions; it should foster mutual understanding, trust, and common sense. No department should fail to cooperate with another in evaluating strategies. Strategy evaluations should be simple, not too cumbersome, and not too restrictive. Complex strategy-evaluation systems often confuse people and accomplish little. The test of an effective evaluation system is its usefulness, not its complexity. Large organizations require a more elaborate and detailed strategy-evaluation system because it is more difficult to coordinate efforts among different divisions and functional areas. Managers in small companies often communicate daily with each other and their employees and do not need extensive evaluative reporting systems. Familiarity with local environments usually makes gathering and evaluating information much easier for small organizations than for large businesses. But the key to an effective strategy-evaluation system may be the ability to convince participants that failure to accomplish certain objectives within a prescribed time is not necessarily a reflection of their performance. There is no one ideal strategy-evaluation system. The unique characteristics of an organization, including its size, management style, purpose, problems, and strengths, can determine a strategy-evaluation and control system's final design. Robert Waterman offered the following observation about successful organizations' strategy-evaluation and control systems:

Successful companies treat facts as friends and controls as liberating. Morgan Guaranty and Wells Fargo not only survive but thrive in the troubled waters of bank deregulation, because their strategy evaluation and control systems are sound, their risk is contained, and they know themselves and the competitive situation so well. Successful companies have a voracious hunger for facts. They see information where others see only data. They love comparisons, rankings, anything that removes decision making from the realm of mere opinion. Successful companies maintain tight, accurate financial controls. Their people don't regard controls as an imposition of autocracy but as the benign checks and balances that allow them to be creative and free.10

Contingency Planning

A basic premise of good strategic management is that firms plan ways to deal with unfavorable and favorable events before they occur. Too many organizations prepare contingency plans just for unfavorable events; this is a mistake, because both minimizing threats and capitalizing on opportunities can improve a firm's competitive position. Regardless of how carefully strategies are formulated, implemented, and evaluated, unforeseen events, such as strikes, boycotts, natural disasters, arrival of foreign competitors, and government actions, can make a strategy obsolete. To minimize the impact of potential threats, organizations should develop contingency plans as part of their strategy-evaluation process. Contingency plans can be defined as alternative plans that can be put into effect if certain key events do not occur as expected. Only high-priority areas require the insurance of contingency plans. Strategists cannot and should not try to cover all bases by planning for all possible contingencies. But in any case, contingency plans should be as simple as possible. Some contingency plans commonly established by firms include the following: If a major competitor withdraws from particular markets as intelligence reports indicate, what actions should our firm take?

1. If our sales objectives are not reached, what actions should our firm take to avoid profit losses?
2. If demand for our new product exceeds plans, what actions should our firm take to meet the higher demand?
3. If certain disasters occur—such as loss of computer capabilities; a hostile takeover attempt; loss of patent protection; or destruction of manufacturing facilities because of earthquakes, tornadoes or hurricanes—what actions should our firm take?

4. If a new technological advancement makes our new product obsolete sooner than expected, what actions should our firm take?

Too many organizations discard alternative strategies not selected for implementation although the work devoted to analyzing these options would render valuable information. Alternative strategies not selected for implementation can serve as contingency plans in case the strategy or strategies selected do not work. U.S. companies and governments are increasingly considering nuclear-generated electricity as the most efficient means of power generation. Many contingency plans certainly call for nuclear power rather than for coaland gas-derived electricity.

When strategy-evaluation activities reveal the need for a major change quickly, an appropriate contingency plan can be executed in a timely way. Contingency plans can promote a strategist's ability to respond quickly to key changes in the internal and external bases of an organization's current strategy. For example, if underlying assumptions about the economy turn out to be wrong and contingency plans are ready, then managers can make appropriate changes promptly.

In some cases, external or internal conditions present unexpected opportunities. When such opportunities occur, contingency plans could allow an organization to quickly capitalize on them. Linneman and Chandran reported that contingency planning gave users, such as DuPont, Dow Chemical, Consolidated Foods, and Emerson Electric, three major benefits: (1) It permitted quick response to change, (2) it prevented panic in crisis situations, and (3) it made managers more adaptable by encouraging them to appreciate just how variable the future can be. They suggested that effective contingency planning involves a seven-step process:

1. Identify both beneficial and unfavorable events that could possibly derail the strategy or strategies.

2. Specify trigger points. Calculate about when contingent events are likely to occur.

3. Assess the impact of each contingent event. Estimate the potential benefit or harm of each contingent event.
4. Develop contingency plans. Be sure that contingency plans are compatible with current strategy and are economically feasible.
5. Assess the counterimpact of each contingency plan. That is, estimate how much each contingency plan will capitalize on or cancel out its associated contingent event. Doing this will quantify the potential value of each contingency plan.
6. Determine early warning signals for key contingent events. Monitor the early warning signals.
7. For contingent events with reliable early warning signals, develop advance action plans to take advantage of the available lead time.11

Auditing

A frequently used tool in strategy evaluation is the audit. Auditing is defined by the American Accounting Association (AAA) as “a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria, and communicating the results to interested users.”12

Auditors examine the financial statement of firms to determine whether they have been prepared according to generally accepted accounting principles (GAAP) and whether they fairly represent the activities of the firm. Independent auditors use a set of standards called generally accepted auditing standards (GAAS). Public accounting firms often have a consulting arm that provides strategy-evaluation services. The SEC in late 2009 charged General

Electric with accounting fraud, specifically for inflating its earnings and revenues in prior years. GE has agreed to pay $50 million to settle the charges. (Students—when preparing projected financial statements as described in Chapter 8, do not inflate the numbers.)

The new era of international financial reporting standards (IFRS) appears unstoppable, and businesses need to go ahead and get ready to use IFRS. Many U.S. companies now report their finances using both the old generally accepted accounting standards (GAAP) and the new IFRS. "If companies don't prepare, if they don't start three years in advance," warns business professor Donna Street at the University of Dayton, "they're going to be in big trouble." GAAP standards comprised 25,000 pages, whereas IFRS comprises only 5,000 pages, so in that sense IFRS is less cumbersome. This accounting switch from GAAP to IFRS in the United States is going to cost businesses millions of dollars in fees and upgraded software systems and training. U.S. CPAs need to study global accounting principles intensely, and business schools should go ahead and begin teaching students the new accounting standards.

All companies have the option to use the IFRS procedures in 2011, and then all companies are required to use IFRS in 2014, unless that timetable is changed. The U.S. Chamber of Commerce supports the change, saying it will lead to much more cross-border commerce and will help the United States compete in the world economy. Already the European Union and 113 nations have adopted or soon plan to use international rules, including Australia, China, India, Mexico, and Canada. So the United States likely will also adopt IFRS rules on schedule, but this switch could unleash a legal and regulatory nightmare. The United States lags the rest of the world in global accounting. But a few U.S. multinational firms already use IFRS for their foreign subsidiaries, such as United Technologies (UT). UT derives more than 60 percent of its revenues from abroad and is already training its entire staff to use

IFRS. UT has redone its 2007 through 2009 financial statements in the IFRS format.

Movement to IFRS from GAAP encompasses a company's entire operations, including auditing, oversight, cash management, taxes, technology, software, investing, acquiring, merging, importing, exporting, pension planning, and partnering. Switching from GAAP to IFRS is also likely to be plagued by gaping differences in business customs, financial regulations, tax laws, politics, and other factors. One critic of the upcoming switch is Charles Niemeier of the Public Company Accounting Oversight Board, who says the switch "has the potential to be a Tower of Babel," costing firms millions when they do not even have thousands to spend.

Others say the switch will help U.S. companies raise capital abroad and do business with firms abroad. Perhaps the biggest upside of the switch is that IFRS rules are more streamlined and less complex than GAAP. Lenovo, the China-based technology firm that bought IBM's personal computer business, is a big advocate of IFRS. Lenovo's view is that they desire to be a world company rather than a U.S. or Chinese company, so the faster the switch to IFRS, the better for them. The bottom line is that IFRS is coming to the United States, sooner than later, so we all need to gear up for this switch as soon as possible.13

Twenty-First-Century Challenges in Strategic Management

Three particular challenges or decisions that face all strategists today are (1) deciding whether the process should be more an art or a science, (2) deciding whether strategies should be visible or hidden from stakeholders, and (3) deciding whether the process should be more top-down or bottom-up in their firm.14

The Art or Science Issue

This textbook is consistent with most of the strategy literature in advocating that strategic management be viewed more as a science than an art. This perspective contends that firms need to systematically assess their external and internal environments, conduct research, carefully evaluate the pros and cons of various alternatives, perform analyses, and then decide upon a particular course of action. In contrast, Mintzberg's notion of "crafting" strategies embodies the artistic model, which suggests that strategic decision making be based primarily on holistic thinking, intuition, creativity, and imagination.15 Mintzberg and his followers reject strategies that result from objective analysis, preferring instead subjective imagination. "Strategy scientists" reject strategies that emerge from emotion, hunch, creativity, and politics. Proponents of the artistic view often consider strategic planning exercises to be time poorly spent. The Mintzberg philosophy insists on informality, whereas strategy scientists (and this text) insist on more formality. Mintzberg refers to strategic planning as an "emergent" process whereas strategy scientists use the term "deliberate" process.16

The answer to the art versus science question is one that strategists must decide for themselves, and certainly the two approaches are not mutually exclusive. In deciding which approach is more effective, however, consider that the business world today has become increasingly complex and more intensely competitive. There is less room for error in strategic planning. Recall that Chapter 1 discussed the importance of intuition and experience and subjectivity in strategic planning, and even the weights and ratings discussed in Chapters 3, 4, and 6certainly require good judgment. But the idea of deciding on strategies for any firm without thorough research and analysis, at least in the mind of this writer, is unwise. Certainly, in smaller firms there can be more informality in the process compared to larger firms, but even for smaller firms, a wealth of competitive information is available on the Internet and elsewhere and should be collected, assimilated, and evaluated before deciding on a course of action upon which survival of the firm may hinge. The livelihood of countless employees and shareholders may hinge on the effectiveness of strategies selected. Too much is at stake to be less than thorough in formulating strategies. It is not wise for a strategist to rely too heavily on gut feeling and opinion instead of research data, competitive intelligence, and analysis in formulating strategies.

The Visible or Hidden Issue

An interesting aspect of any competitive analysis discussion is whether strategies themselves should be secret or open within firms. The Chinese warrior Sun Tzu and military leaders today strive to keep strategies secret, as war is based on deception. However, for a business organization, secrecy may not be best. Keeping strategies secret from employees and stakeholders at large could severely inhibit employee and stakeholder communication, understanding, and commitment and also forgo valuable input that these persons could have regarding formulation and/or implementation of that strategy. Thus strategists in a particular firm must decide for themselves whether the risk of rival firms easily knowing and exploiting a firm's strategies is worth the benefit of improved employee and stakeholder motivation and input. Most executives agree that some strategic information should remain confidential to top managers, and that steps should be taken to ensure that such information is not disseminated beyond the inner circle. For a firm that you may own or manage, would you advocate openness or secrecy in regard to strategies being formulated and implemented? There are certainly good reasons to keep the strategy process and strategies themselves visible and open rather than hidden and secret. There are also good reasons to keep strategies hidden from all but top-level executives.

Strategists must decide for themselves what is best for their firms. This text comes down largely on the side of being visible and open, but certainly this may not be best for all strategists and all firms. As pointed out in Chapter 1, Sun Tzu argued that all war is based on deception and that the best maneuvers are those not easily predicted by rivals. Business and war are analogous. Some reasons to be completely open with the strategy process and resultant decisions are these:

1. Managers, employees, and other stakeholders can readily contribute to the process. They often have excellent ideas. Secrecy would forgo many excellent ideas.
2. Investors, creditors, and other stakeholders have greater basis for supporting a firm when they know what the firm is doing and where the firm is going.
3. Visibility promotes democracy, whereas secrecy promotes autocracy. Domestic firms and most foreign firms prefer democracy over autocracy as a management style.
4. Participation and openness enhance understanding, commitment, and communication within the firm.

Reasons why some firms prefer to conduct strategic planning in secret and keep strategies hidden from all but the highest-level executives are as follows:

1. Free dissemination of a firm's strategies may easily translate into competitive intelligence for rival firms who could exploit the firm given that information.
2. Secrecy limits criticism, second guessing, and hindsight.
3. Participants in a visible strategy process become more attractive to rival firms who may lure them away.

4. Secrecy limits rival firms from imitating or duplicating the firm's strategies and undermining the firm.

The obvious benefits of the visible versus hidden extremes suggest that a working balance must be sought between the apparent contradictions. Parnell says that in a perfect world all key individuals both inside and outside the firm should be involved in strategic planning, but in practice particularly sensitive and confidential information should always remain strictly confidential to top managers.17 This balancing act is difficult but essential for survival of the firm.

The Top-Down or Bottom-Up Approach

Proponents of the top-down approach contend that top executives are the only persons in the firm with the collective experience, acumen, and fiduciary responsibility to make key strategy decisions. In contrast, bottom-up advocates argue that lower- and middle-level managers and employees who will be implementing the strategies need to be actively involved in the process of formulating the strategies to ensure their support and commitment. Recent strategy research and this textbook emphasize the bottom-up approach, but earlier work by Schendel and Hofer stressed the need for firms to rely on perceptions of their top managers in strategic planning.18 Strategists must reach a working balance of the two approaches in a manner deemed best for their firms at a particular time, while cognizant of the fact that current research supports the bottom-up approach, at least among U.S. firms. Increased education and diversity of the workforce at all levels are reasons why middle- and lower-level managers—and even nonmanagers—should be invited to participate in the firm's strategic planning process, at least to the extent that they are willing and able to contribute.

Chapter 11
BUSINESS ETHICS/SOCIAL RESPONSIBILITY/ ENVIRONMENTAL SUSTAINABILITY

Business Ethics/ Social Responsibility/ Environmental Sustainability

A note from David

Although the three sections of this chapter (Business Ethics, Social Responsibility, and Sustainability) are distinct, the topics are quite related. Many people, for example, consider it unethical for a firm to be socially irresponsible. Social responsibility refers to actions an organization takes beyond what is legally required to protect or enhance the well-being of living things. Sustainability refers to the extent that an organization's operations and actions protect, mend, and preserve rather than harm or destroy the natural environment. Polluting the environment, for example, is unethical, irresponsible, and in many cases illegal. Business ethics, social responsibility, and sustainability issues therefore are interrelated and impact all areas of the comprehensive strategicmanagement model, as illustrated in Figure 10.1 on page 312.

A sample company that adheres to the highest ethical standards and that has excelled during the recent weak economy is Walt Disney. Disney in March 2009 published an elaborate corporate social responsibility/business ethics/sustainability report that can be found online at http://disney.go.com/crreport/home.html. In that report, the Disney CEO says:

Our Corporate Responsibility team has developed a cohesive strategy for the company with that in mind, incorporating existing outreach, safety, nutrition, environmental and labor programs and working with executives across Disney, ABC and ESPN to coordinate and strengthen our company-wide efforts. They've organized our approach around five broad areas—Children & Family, Content & Products, Environment, Community and Workplaces—with the goal of further embedding corporate responsibility into Disney's business DNA, making sure it continues to be taken into consideration in decisions big and small.1

Business Ethics

Good ethics is good business. Bad ethics can derail even the best strategic plans. This chapter provides an overview of the importance of business ethics in strategic management. Business ethics can be defined as principles of conduct within organizations that guide decision making and behavior. Good business ethics is a prerequisite for good strategic management; good ethics is just good business!

A rising tide of consciousness about the importance of business ethics is sweeping the United States and the rest of the world. Strategists such as CEOs and business owners are the individuals primarily responsible for ensuring that high ethical principles are espoused and practiced in an organization. All strategy formulation, implementation, and evaluation decisions have ethical ramifications.

Newspapers and business magazines daily report legal and moral breaches of ethical conduct by both public and private organizations. Being unethical can be very expensive. For example, some of the largest payouts for class-action legal fraud suits ever were against Enron ($7.16 billion), WorldCom ($6.16 billion), Cendant ($3.53 billion), Tyco ($2.98 billion), AOL Time Warner ($2.5 billion), Nortel Networks ($2.47 billion), and Royal Ahold ($1.09 billion). A company named Coast IRB LLC in Colorado recently was forced to close after the Food and Drug Administration (FDA) discovered in a sting operation that the firm conducted a fake medical study.

Coast is one of many firms paid by pharmaceutical firms to oversee clinical trials and independently ensure that patient safety is protected.

Other business actions considered to be unethical include misleading advertising or labeling, causing environmental harm, poor product or service safety, padding expense accounts, insider trading, dumping banned or flawed products in foreign markets, not providing equal opportunities for women and minorities, overpricing, moving jobs overseas, and sexual harassment.

Code of Business Ethics

A new wave of ethics issues related to product safety, employee health, sexual harassment, AIDS in the workplace, smoking, acid rain, affirmative action, waste disposal, foreign business practices, cover-ups, takeover tactics, conflicts of interest, employee privacy, inappropriate gifts, and security of company records has accentuated the need for strategists to develop a clear code of business ethics. Internet fraud, hacking into company computers, spreading viruses, and identity theft are other unethical activities that plague every sector of online commerce.

United Technologies has a 21-page code of ethics and a vice president of business ethics. Baxter Travenol Laboratories, IBM, Caterpillar Tractor, Chemical Bank, ExxonMobil, Dow Corning, and Celanese are firms that have formal codes of business ethics. A code of business ethics is a document that provides behavioral guidelines that cover daily activities and decisions within an organization.

Merely having a code of ethics, however, is not sufficient to ensure ethical business behavior. A code of ethics can be viewed as a public relations gimmick, a set of platitudes, or window dressing. To ensure that the code is read, understood, believed, and remembered, periodic ethics workshops are needed to sensitize people to workplace circumstances in which ethics issues may arise.2 If employees see examples of punishment for violating the code as well as rewards for upholding the code, this reinforces the importance of a firm's code of ethics. The Web site www.ethicsweb.ca/codes provides guidelines on how to write an effective code of ethics.

An Ethics Culture

An ethics "culture" needs to permeate organizations! To help create an ethics culture, Citicorp developed a business ethics board game that is played by thousands of employees worldwide. Called "The Word Ethic," this game asks players business ethics questions, such as how do you deal with a customer who offers you football tickets in exchange for a new, backdated IRA? Diana Robertson at the Wharton School of Business believes the game is effective because it is interactive. Many organizations have developed a codeof-conduct manual outlining ethical expectations and giving examples of situations that commonly arise in their businesses.

Harris Corporation and other firms warn managers and employees that failing to report an ethical violation by others could bring discharge. The Securities and Exchange Commission (SEC) recently strengthened its whistle-blowing policies, virtually mandating that anyone seeing unethical activity report such behavior. Whistle-blowing refers to policies that require employees to report any unethical violations they discover or see in the firm.

An unidentified whistle-blower in 2009 filed a lawsuit against Amgen Inc., accusing the biotechnology company of illegal marketing of its blockbuster drugs Enbrel and Aranesp. The drug company Wyeth co-markets Enbrel with Amgen, and was named as a defendant too, along with wholesale drug distributor

AmerisourceBergen Corp., online health-information provider WebMD Health Corp., and others. The federal whistle-blower law protects the identity of the plaintiff. In the drug industry, such suits are often filed by former employees.

One reason strategists' salaries are high is that they must take the moral risks of the firm. Strategists are responsible for developing, communicating, and enforcing the code of business ethics for their organizations. Although primary responsibility for ensuring ethical behavior rests with a firm's strategists, an integral part of the responsibility of all managers is to provide ethics leadership by constant example and demonstration. Managers hold positions that enable them to influence and educate many people. This makes managers responsible for developing and implementing ethical decision making. Gellerman and Drucker, respectively, offer some good advice for managers:

All managers risk giving too much because of what their companies demand from them. But the same superiors, who keep pressing you to do more, or to do it better, or faster, or less expensively, will turn on you should you cross that fuzzy line between right and wrong. They will blame you for exceeding instructions or for ignoring their warnings. The smartest managers already know that the best answer to the question "How far is too far?" is don't try to find out.3

A man (or woman) might know too little, perform poorly, lack judgment and ability, and yet not do too much damage as a manager. But if that person lacks character and integrity—no matter how knowledgeable, how brilliant, how successful— he destroys. He destroys people, the most valuable resource of the enterprise. He destroys spirit. And he destroys performance. This is particularly true of the people at the head of an enterprise. For the spirit of an organization is created from the top. If an organization is great in spirit, it is because the spirit of its top people is great. If it decays, it does so because the top rots. As the proverb has it, "Trees die from the top." No one should ever become a strategist unless he or she is willing to have his or her character serve as the model for subordinates.4

No society anywhere in the world can compete very long or successfully with people stealing from one another or not trusting one another, with every bit of information requiring notarized confirmation, with every disagreement ending up in litigation, or with government having to regulate businesses to keep them honest. Being unethical is a recipe for headaches, inefficiency, and waste. History has proven that the greater the trust and confidence of people in the ethics of an institution or society, the greater its economic strength. Business relationships are built mostly on mutual trust and reputation. Shortterm decisions based on greed and questionable ethics will preclude the necessary selfrespect to gain the trust of others. More and more firms believe that ethics training and an ethics culture create strategic advantage.

Ethics training programs should include messages from the CEO or owner of the business emphasizing ethical business practices, the development and discussion of codes of ethics, and procedures for discussing and reporting unethical behavior. Firms can align ethical and strategic decision making by incorporating ethical considerations into longterm planning, by integrating ethical decision making into the performance appraisal process, by encouraging whistle-blowing or the reporting of unethical practices, and by monitoring departmental and corporate performance regarding ethical issues.

Bribes

Bribery is defined by Black's Law Dictionary as the offering, giving, receiving, or soliciting of any item of value to influence the actions of an official or other person in discharge of a public or legal duty. A bribe is a gift bestowed to influence a recipient's conduct. The gift may be any money, good, right in action, property, preferment, privilege, emolument, object of value, advantage, or merely a promise or undertaking to induce or influence the action, vote, or influence of a person in an official or public capacity. Bribery is a crime in most countries of the world, including the United States.5

Siemens AG, the large German engineering firm, recently was fined $800 million for routinely offering bribes to various companies around the world to win overseas contracts. The U.S. Justice Department and the SEC brought suit against Siemens under the U.S. Foreign Corruptions Act. The Siemens fine was 20 times larger than any previous bribery penalty. The SEC claimed that Siemens made at least 4,283 bribe payments totaling $1.4 billion between 2001 and 2007. These bribes allegedly were paid to government officials in 10 countries.

Paying bribes is considered both illegal and unethical in the United States, but in some foreign countries, paying bribes and kickbacks is acceptable. Tipping is even considered bribery in some countries. Important antibribery and extortion initiatives are advocated by many organizations, including the World Bank, the International Monetary Fund, the European Union, the Council of Europe, the Organization of

American States, the Pacific Basin Economic Council, the Global Coalition for Africa, and the United Nations.

The U.S. Justice Department in mid-2009 increased its prosecutions of alleged acts of foreign bribery. Businesses have to be much more careful these days. For years, taking business associates to lavish dinners and giving them expensive holiday gifts and even outright cash may be expected in many countries, such as South Korea and China, but there is now stepped-up enforcement of bribery laws. Kellogg Brown and Root (KBR) and Halliburton recently paid $579 million for bribing officials in Nigeria.

Love Affairs at Work

A recent Wall Street Journal article recapped current American standards regarding bosssubordinate love affairs at work.6 Only 5 percent of all firms sampled had no restrictions on such relationships; 80 percent of firms have policies that prohibit relationships between a supervisor and a subordinate. Only 4 percent of firms strictly prohibited such relationships, but 39 percent of firms had policies that required individuals to inform their supervisors whenever a romantic relationship begins with a coworker. Only 24 percent of firms required the two persons to be in different departments.

In Europe, romantic relationships at work are largely viewed as private matters and most firms have no policies on the practice. However, European firms are increasingly adopting explicit, American-style sexual harassment laws. The U.S. military strictly bans officers from dating or having sexual relationships with enlistees. At the World Bank, sexual relations between a supervisor and an employee are considered "a de facto conflict of interest which must be resolved to avoid favoritism." World Bank president Paul Wolfowitz recently was forced to resign due to a relationship he had with a bank staff person.

The United Nations (UN) in mid-2009 was struggling with its own sexual-harassment complaints as many women employees say the organization's current system for handling complaints is arbitrary, unfair, and mired in bureaucracy. Sexual harassment cases at the UN can take years to adjudicate, and accusers have no access to investigative reports. The UN plans to "soon" make changes to its internal justice system for handling harassment complaints; the UN aspires to protect human rights around the world.

Social Responsibility

Some strategists agree with Ralph Nader, who proclaims that organizations have tremendous social obligations. Nader points out, for example, that Exxon/Mobil has more assets than most countries, and because of this such firms have an obligation to help society cure its many ills. Other people, however, agree with the economist Milton Friedman, who asserts that organizations have no obligation to do any more for society than is legally required. Friedman may contend that it is irresponsible for a firm to give monies to charity.

Do you agree more with Nader or Friedman? Surely we can all agree that the first social responsibility of any business must be to make enough profit to cover the costs of the future because if this is not achieved, no other social responsibility can be met. Indeed, no social need can be met by the firm if the firm fails.

Strategists should examine social problems in terms of potential costs and benefits to the firm, and focus on social issues that could benefit the firm most. For example, should a firm avoid laying off employees so as to protect the employees' livelihood, when that decision may force the firm to liquidate?

Social Policy

The term social policyembraces managerial philosophy and thinking at the highest level of the firm, which is why the topic is covered in this textbook. Social policy concerns what responsibilities the firm has to employees, consumers, environmentalists, minorities, communities, shareholders, and other groups. After decades of debate, many firms still struggle to determine appropriate social policies.

The impact of society on business and vice versa is becoming more pronounced each year. Corporate social policy should be designed and articulated during strategy formulation, set and administered during strategy implementation, and reaffirmed or changed during strategy evaluation.7

In 2009, the most admired companies for social responsibility according to Fortune magazine were as follows:

1. Anheuser-Busch
2. Marriott International
3. Integrys Energy Group
4. Walt Disney
5. Herman Miller
6. Edison

7. Starbucks
8. Steelcase
9. Union Pacific
10. Fortune Brands8

From a social responsibility perspective, these were the least admired companies in 2009:

1. Circuit City Stores
2. Family Dollar Stores
3. Dillard's
4. Sears Holdings
5. Tribune
6. Hon Hai Precision Industry
7. Fiat 8. PEMEX 9. Surgutneftegas
8. Huawei Technologies9

Firms should strive to engage in social activities that have economic benefits. Merck & Co. once developed the drug ivermectin for treating river blindness, a disease caused by a fly-borne parasitic worm endemic in poor tropical areas of Africa, the Middle East, and Latin America. In an unprecedented gesture that reflected its corporate commitment to social responsibility, Merck then made ivermectin available at no cost to medical personnel throughout the world. Merck's action highlights the dilemma of orphan drugs, which offer pharmaceutical companies no economic incentive for profitable development and distribution. Merck did however garner substantial goodwill among its stakeholders for its actions.

Social Policies on Retirement

Some countries around the world are facing severe workforce shortages associated with their aging populations. The percentage of persons age 65 or older exceeds 20 percent in Japan, Italy, and Germany—and will reach 20 percent in 2018 in France. In 2036, the percentage of persons age 65 or older will reach 20 percent in the United States and China. Unlike the United States, Japan is reluctant to rely on large-scale immigration to bolster its workforce. Instead, Japan provides incentives for its elderly to work until ages 65 to 75. Western European countries are doing the opposite, providing incentives for its elderly to retire at ages 55 to 60. The

International Labor Organization says 71 percent of Japanese men ages 60 to 64 work, compared to 57 percent of American men and just 17 percent of French men in the same age group.

Sachiko Ichioka, a typical 67-year-old man in Japan, says, “I want to work as long as I’m healthy. The extra money means I can go on trips, and I’m not a burden on my children.” Better diet and health care have raised Japan’s life expectancy now to 82, the highest in the world. Japanese women are having on average only 1.28 children compared to 2.04 in the United States. Keeping the elderly at work, coupled with reversing the old-fashioned trend of keeping women at home, are Japan’s two key remedies for sustaining its workforce in factories and businesses. This prescription for dealing with problems associated with an aging society should be considered by many countries around the world. The Japanese government is phasing in a shift from age 60 to age 65 as the date when a person may begin receiving a pension, and premiums paid by Japanese employees are rising while payouts are falling. Unlike the United States, Japan has no law against discrimination based on age.

Japan’s huge national debt, 175 percent of gross domestic product (GDP) compared to 65 percent for the United States, is difficult to lower with a falling population because Japan has fewer taxpaying workers. Worker productivity increases in Japan are not able to offset declines in number of workers, thus resulting in a decline in overall economic production. Like many countries, Japan does not view immigration as a good way to solve this problem.

Japan’s shrinking workforce has become such a concern that the government just recently allowed an unspecified number of Indonesian and Filipino nurses and caregivers to work in Japan for two years. The number of working-age Japanese—those between ages 15 and 64—is projected to shrink to 70 million by 2030, from 82 million in 2009. Using foreign workers is known as gaikokujin roudousha in Japanese. Many Filipinos have recently been hired now to work in agriculture and factories throughout Japan. The percentage of foreign workers to the total population is 20 percent in the United States, nearly 10 percent in Germany, 5 percent in the United Kingdom, and less than 1 percent in Japan. But most Japanese now acknowledge that this percentage must move upward, and perhaps quickly, for their nation’s economy to prosper.10

Environmental Sustainability

The strategies of both companies and countries are increasingly scrutinized and evaluated from a nautral environment perspective. Companies such as Wal-Mart now monitor not only the price its vendors offer for products, but also how those products are made in terms of environmental practices. A growing number of business schools offer separate courses and even a concentration in environmental management.

Businesses must not exploit and decimate the natural environment. Mark Starik at George Washington University says, "Halting and reversing worldwide ecological destruction and deterioration is a strategic issue that needs immediate and substantive attention by all businesses and managers. According to the International Standards Organization (ISO), the word environment is defined as "surroundings in which an organization operates, including air, water, land, natural resources, flora, fauna, humans, and their interrelation." This chapter illustrates how many firms are gaining competitive advantage by being good stewards of the natural environment.

Employees, consumers, governments, and society are especially resentful of firms that harm rather than protect the natural environment. Conversely people today are especially appreciative of firms that conduct operations in a way that mends, conserves, and preserves the natural environment. Consumer interest in businesses preserving nature's ecological balance and fostering a clean, healthy environment is high.

No business wants a reputation as being a polluter. A bad sustainability record will hurt the firm in the market, jeopardize its standing in the community, and invite scrutiny by regulators, investors, and environmentalists. Governments increasingly require businesses to behave responsibly and require, for example, that businesses publicly report the pollutants and wastes their facilities produce.

In terms of megawatts of wind power generated by various states in the United States, Iowa's 2,791 recently overtook California's 2,517, but Texas's 7,118 megawatts dwarfs all other states. Minnesota also is making substantial progress in wind power generation. New Jersey recently outfitted 200,000 utility poles with solar panels, which made it the nation's second-largest producer of solar energy behind California. New Jersey is also adding solar panels to corporate rooftops. The state's $514 million solar program will double its solar capacity to 160 megawatts by 2013. The state's goal is to obtain 3 percent of its electricity from the sun and 12 percent from offshore wind by 2020.

What Is a Sustainability Report?

Wal-Mart Stores is one among many companies today that annually provides a sustainability report that reveals how the firm's operations impact the natural environment. This document discloses to shareholders information about Wal-Mart's firm's labor practices, product sourcing, energy efficiency, environmental impact, and business ethics practices.

It is good business for a business to provide a sustainability report annually to the public. With 60,000 suppliers and over $350 billion in annual sales, Wal-Mart works with its suppliers to make sure they provide such reports. Wal-Mart monitors not only prices its vendors' offer for products, but also the vendors' social-responsibility and environmental practices. Many firms use the Wal-Mart sustainability report as a benchmark, guideline, and model to follow in preparing their own report.

The Global Reporting Initiative recently issued a set of detailed reporting guidelines specifying what information should go into sustainability reports. The proxy advisory firm Institutional Shareholder Services reports that an increasing number of shareholder groups are pushing firms to provide sustainability information annually.

Wal-Mart also now encourages and expects its 1.35 million U.S. employees to adopt what it calls Personal Sustainability Projects, which include such measures as organizing weight-loss or smoking-cessation support groups, biking to work, or starting recycling programs. Employee wellness can be a part of sustainability.

Wal-Mart is installing solar panels on its stores in California and Hawaii, providing as much as 30 percent of the power in some stores. Wal-Mart may go national with solar power if this test works well. Also moving to solar energy is department-store chain Kohl's Corp., which is converting 64 of its 80 California stores to using solar power. There are big subsidies for solar installations in some states.

Home Depot, the world's second largest retailer behind Wal-Mart, recently more than doubled its offering of environmentally friendly products such as all-natural insect repellent. Home Depot has made it much easier for consumers to find its organic products by using special labels similar to Timberland's (the outdoor company) Green Index tags. Another huge retailer, Target, now offers more than 500 choices of organic certified food and has 18 buildings in California alone powered only by solar energy. The largest solar power plant in North America is the one in Nevada that powers Nellis Air Force Base outside Las Vegas.11

Managers and employees of firms must be careful not to become scapegoats blamed for company environmental wrongdoings. Harming the natural environment can be unethical, illegal, and costly. When organizations today face criminal charges for polluting the environment, they increasingly turn on their managers and employees to win leniency. Employee firings and demotions are becoming common in pollution-related legal suits. Managers were fired at Darling International, Inc., and Niagara Mohawk Power Corporation for being indirectly responsible for their firms polluting water. Managers and employees today must be careful not to ignore, conceal, or disregard a pollution problem, or they may find themselves personally liable.

Lack of Standards Changing

A few years ago, firms could get away with placing "green" terminology on their products and labels using such terms as organic, green, safe, earth-friendly, nontoxic, and/or natural because there were no legal or generally accepted definitions. Today, however, such terms as these carry much more specific connotations and expectations. Uniform standards defining environmentally responsible company actions are rapidly being incorporated into our legal landscape. It has become more and more difficult for firms to make "green" claims when their actions are not substantive, comprehensive, or even true. Lack of standards once made consumers cynical about corporate environmental claims, but those claims today are increasingly being challenged in courts. Joel Makower says, "One of the main reasons to truly become a green firm is for your employees. They're the first group that needs assurance than any claims you make hold water."12

Around the world, political and corporate leaders now realize that the "business green" topic will not go away and in fact is gaining ground rapidly. Strategically, companies more than ever must demonstrate to their customers and stakeholders that their green efforts are substantive and set the firm apart from competitors. A firm's performance facts and figures must back up their rhetoric and be consistent with sustainability standards.

Obama Regulations

The Obama administration is imposing strict regulations requiring firms to conserve energy. Federal government buildings are being refitted with energy-efficient improvements. Alternative-energy firms are busy with new customers every day as the federal stimulus package includes adding alternative-energy infrastructure. Venture capitalists and lenders are funding new "clean technology" business start-ups, including solar power, wind power, biofuels, and insulation firms. Such firms are boosting marketing efforts, expanding geographically, and hiring more staff. Venture capital investments in clean technology companies totaled $8.4 billion in 2008, up nearly 40 percent from 2007.

A wide variety of firms are participating in this clean energy growth business, such as Seattle-based Verdiem Corporation. That firm sells software that provides centralized control over power consumption, such as remotely turning off computer monitors left on overnight.13 General Electric plans to achieve $20 billion in sales by 2011 in eco-friendly technologies that include cleaner coal-fired power plants, a diesel-and-electric hybrid locomotive, and agricultural silicon that cuts the amount of water and pesticide used in spraying fields. This is double GE's sales today in "green" products. GE has a goal to improve its energy efficiency by 30 percent between 2005 and 2012.

The Environmental Protection Agency recently reported that U.S. citizens and organizations annually spend more than about $200 billion on pollution abatement. Environmental concerns touch all aspects of a business's operations, including workplace risk exposures, packaging, waste reduction, energy use, alternative fuels, environmental cost accounting, and recycling practices.

Managing Environmental

Affairs in the Firm The ecological challenge facing all organizations requires managers to formulate strategies that preserve and conserve natural resources and control pollution. Special natural environment issues include ozone depletion, global warming, depletion of rain forests, destruction of animal habitats, protecting endangered species, developing biodegradable products and packages, waste management, clean air, clean water, erosion, destruction of natural resources, and pollution control. Firms increasingly are developing green product lines that are biodegradable and/or are made from recycled products. Green products sell well.

Managing as if "health of the planet" matters requires an understanding of how international trade, competitiveness, and global resources are connected. Managing environmental affairs can no longer be simply a technical function performed by specialists in a firm; more emphasis must be placed on developing an environmental perspective among all employees and managers of the firm. Many companies are moving environmental affairs from the staff side of the organization to the line side, thus making the corporate environmental group report directly to the chief operating officer. Firms that manage environmental affairs will enhance relations with consumers, regulators, vendors, and other industry players, substantially improving their prospects of success.

Environmental strategies could include developing or acquiring green businesses, divesting or altering environment-damaging businesses, striving to become a low-cost producer through waste minimization and energy conservation, and pursuing a differentiation strategy through green-product features. In addition, firms could include an environmental representative on their board of directors, conduct regular envrionmental audits, implement bonuses for favorable environmental results, become involved in environmental issues and programs, incorporate environmental values in mission statements, establish environmentally oriented objectives, acquire environmental skills, and provide environmental training programs for company employees and managers.

Should Students Receive Environmental Training?

The Wall Street Journal reports that companies actively consider environmental training in employees they hire. A recent study reported that 77 percent of corporate recruiters said "it is important to hire students with an awareness of social and environmental responsibility." According to Ford Motor Company's director of corporate governance, "We want students who will help us find solutions to societal challenges and we have trouble hiring students with such skills."

The Aspen Institute contends that most business schools currently do not, but should, incorporate environmental training in all facets of their core curriculum, not just in special elective courses. The institute reports that the University of Texas, the University of North Carolina, and the University of Michigan, among others, are at the cutting edge in providing environmental coverage at their respective MBA levels. Companies favor hiring graduates from such universities.

Findings from research suggest that business schools at the undergraduate level are doing a poor job of educating students on environmental issues. Business students with limited knowledge on environmental issues may make poor decisions, so business schools should address environmental issues more in their curricula. Failure to do so could result in graduates making inappropriate business decisions in regard to the natural environment. Failing to provide adequate coverage of natural environment issues and decisions in their training could make those students less attractive to employers.14

Reasons Why Firms Should "Be Green"

Preserving the environment should be a permanent part of doing business for the following reasons:

1. Consumer demand for environmentally safe products and packages is high.
2. Public opinion demanding that firms conduct business in ways that preserve the natural environment is strong.
3. Environmental advocacy groups now have over 20 million Americans as members.
4. Federal and state environmental regulations are changing rapidly and becoming more complex.
5. More lenders are examining the environmental liabilities of businesses seeking loans.

6. Many consumers, suppliers, distributors, and investors shun doing business with environmentally weak firms.
7. Liability suits and fines against firms having environmental problems are on the rise.

Be Proactive,Not Reactive

More firms are becoming environmentally proactive—doing more than the bare minimum to develop and implement strategies that preserve the environment. The old undesirable alternative of being environmentally reactive—changing practices only when forced to do so by law or consumer pressure more often today leads to high cleanup costs, liability suits, reduced market share, reduced customer loyalty, and higher medical costs. In contrast, a proactive policy views environmental pressures as opportunities and includes such actions as developing green products and packages, conserving energy, reducing waste, recycling, and creating a corporate culture that is environmentally sensitive.

New required diesel technology has reduced emissions by up to 98 percent in all new big trucks, at an average cost increase of $12,000 per truck. “Clean air is not free,” says Rich Moskowitz, who handles regulatory affairs for the American Trucking Association, which supports the transition.15

ISO 14000/14001 Certification

Based in Geneva, Switzerland, the International Organization for Standardization (ISO) is a network of the national standards institutes of 147 countries, one member per country. ISO is the world’s largest developer of sustainability standards. Widely accepted all over the world, ISO standards are voluntary because ISO has no legal authority to enforce their implementation. ISO itself does not regulate or legislate.

Governmental agencies in various countries, such as the Environmental Protection Agency (EPA) in the United States, have adopted ISO standards as part of their regulatory framework, and the standards are the basis of much legislation. Adoptions are sovereign decisions by the regulatory authorities, governments, and/or companies concerned.

ISO 14000refers to a series of voluntary standards in the environmental field. The ISO 14000 family of standards concerns the extent to which a firm minimizes harmful effects on the environment caused by its activities and continually monitors and improves its own environmental performance. Included in the ISO 14000 series are the ISO 14001 standards in fields such as environmental auditing, environmental performance evaluation, environmental labeling, and life-cycle assessment.

ISO 14001 is a set of standards adopted by thousands of firms worldwide to certify to their constituencies that they are conducting business in an environmentally friendly manner. ISO 14001 standards offer a universal technical standard for environmental compliance that more and more firms are requiring not only of themselves but also of their suppliers and distributors.

The ISO 14001 standard requires that a community or organization put in place and implement a series of practices and procedures that, when taken together, result in an environmental management system (EMS). ISO 14001 is not a technical standard and as such does not in any way replace technical requirements embodied in statutes or regulations. It also does not set prescribed standards of performance for organizations. Not being ISO 14001 certified can be a strategic disadvantage for towns, counties, and companies because people today expect organizations to
minimize or, even better, to eliminate environmental harm they cause.16 The major requirements of an EMS under ISO 14001 include the following:

1. Show commitments to prevention of pollution, continual improvement in overall environmental performance, and compliance with all applicable statutory and regulatory requirements.
2. Identify all aspects of the organization's activities, products, and services that could have a significant impact on the environment, including those that are not regulated.
3. Set performance objectives and targets for the management system that link back to three policies: (1) prevention of pollution, (2) continual improvement, and (3) compliance.
4. Meet environmental objectives that include training employees, establishing work instructions and practices, and establishing the actual metrics by which the objectives and targets will be measured.
5. Conduct an audit operation of the EMS.
6. Take corrective actions when deviations from the EMS occur.

Electric Car Networks Are Coming

In August 2009, President Obama announced $2.4 billion in funding for electric car manufacturing. Grants will go to 11 companies in Michigan and 7 in Indiana that are matching the funds. The company Better Place is building a network of 250,000 electric car recharging stations in the San Francisco/Oakland Bay Area. Each station is about the size of a parking meter.

The company has already built such networks in Denmark, Israel, and Australia. City officials in the Bay Area expect that region to lead the United States in electric cars in the near future. The stations are essential because most electric cars need recharging after about 40 miles. Better Place is also building about 200 stations in the Bay Area where electric car batteries can be switched out within 15 minutes, so no waiting is needed for recharging. Even with petroleum prices at low levels, expectations are for the United States and other countries to switch to electric cars quite aggressively over the next 10 years—for pollution minimization reasons and to take advantage of government incentives and eventual mandates.

General Motors and Chrysler are pouring money into developing electric plug-in vehicles. GM is expected to launch its Chevy Volt in late 2010 in the United States. Nissan Motor Co. and Toyota Motor Co. are also quickly developing electric cars.

The Chinese auto maker BYD Co. recently unveiled the country's first all-electric vehicle for mass market. The company's F3DM vehicle runs off batteries that can be charged from a regular electrical outlet. BYD plans to sell this car in the United States in 2010. BYD sold about 10,000 F3DMs in 2009 at a price of 150,000 yuan, or $22,000 each. BYD is headquartered in Shenzhen.

Hawaii is creating an electric car network for the islands that by 2012 is expected to wean the state from near-complete dependence on oil for its energy needs. The firm Better Place is creating 70,000 to 100,000 recharging points throughout the islands to support plug-in electric cars. Under the Hawaii Clean Energy Initiative, the state intends to cut its dependence on oil to 30 percent by 2030. Hawaiians pay very high electricity prices because costly oil is burned to produce power. Electric cars have a driving range of 40 miles between charges, which is suitable for Hawaii.17

AT&T Inc. in 2009 committed to spend $565 million over 10 years to replace its 7,100 passenger cars with 8,000 hybrid-electric and natural gas vans to perform its installation and repair activities. The company is paying on average 29 percent more for these vehicles than it would for gasoline-powered models, but this expense will be offset by lower fuel costs, less emissions, and enhanced public image. The AT&T strategy will reduce carbon emissions by 211,000 metric tons over 10 years. AT&T is working with natural gas providers to build up to 40 fueling stations across its operating region. There are only about 110,000 natural gas vehicles in the United States compared to over 10 million such vehicles worldwide. This bold move by AT&T expands on similar initiatives by United Parcel Service and PG&E.18

The March 2009 Copenhagen Meeting

More than 2,000 scientists convened together in Copenhagen in March 2009 and warned the world that global warming is worse than expected. They strongly encouraged companies and governments to “vigorously” implement all economic and technological tools available to cut emissions of heat-trapping greenhouse gases. By the end of this century, scientists warn, sea levels will rise at least 20 inches and possibly as much as 39 inches unless companies and governments implement policies to radically reduce greenhouse gas emissions.

The Kyoto Protocal expires in 2012, and the results of this March 2009 Copenhagen Meeting are expected to replace that agreement. Near-coastal areas worldwide will be under water by the end of this century if drastic actions are not implemented soon worldwide to curb greenhouse gas emissions from companies, cars, trucks, power-generating plants, and planes.

Table 10-1 reveals the impact that bad environmental policies have on two of nature’s many ecosystems.

TABLE 10-1 Songbirds and Coral Reefs Need Help

Songbirds
Be a good steward of the natural environment to save our songbirds. Bluebirds are one of 76 songbird species in the United States that have dramatically declined in numbers in the last two decades. Not all birds are considered songbirds, and why birds sing is not clear. Some scientists say they sing when calling for mates or warning of danger, but many scientists now contend that birds sing for sheer pleasure. Songbirds include chickadees, orioles, swallows, mockingbirds, warblers, sparrows, vireos, and the wood thrush. "These birds are telling us there's a problem, something's out of balance in our environment," says Jeff Wells, bird conservation director for the National Audubon Society. Songbirds may be telling us that their air or water is too dirty or that we are destroying too much of their habitat. People collect Picasso paintings and save historic buildings. "Songbirds are part of our natural heritage. Why should we be willing to watch songbirds destroyed any more than allowing a great work of art to be destroyed?" asks Wells. Whatever message songbirds are singing to us today about their natural environment, the message is becoming less and less heard nationwide. Listen when you go outside today. Each of us as individuals, companies, states, and countries should do what we reasonably can to help improve the natural environment for songbirds.[19] A recent study concludes that 67 of the 800 bird species in the United States are endangered, and another 184 species are designated of "conservation concern." The birds of Hawaii are in the greatest peril.
Coral Reefs
Be a good steward of the natural environment to save our coral reefs. The ocean covers more than 71 percent of the earth. The destructive effect of commercial fishing on ocean habitats coupled with increasing pollution runoff into the ocean and global warming of the ocean have decimated fisheries, marine life, and coral reefs around the world. The unfortunate consequence of fishing over the last century has been overfishing, with the principal reasons being politics and greed. Trawl fishing with nets destroys coral reefs and has been compared to catching squirrels by cutting down forests because bottom nets scour and destroy vast areas of the ocean. The great proportion of marine life caught in a trawl is "by-catch" juvenile fish and other life that are killed and discarded. Warming of the ocean due to carbon dioxide emissions also kills thousands of acres of coral reefs annually. The total area of fully protected marine habitats in the United States is only about 50 square miles, compared to some 93 million acres of national wildlife refuges and national parks on the nation's land. A healthy ocean is vital to the economic and social future of the nation—and, indeed, all countries of the world. Everything we do on land ends up in the ocean, so we all must become better stewards of this last frontier on earth in order to sustain human survival and the quality of life.[20]

Chapter 12
GLOBAL/INTERNATIONAL ISSUES

Global/International Issues

A note from David

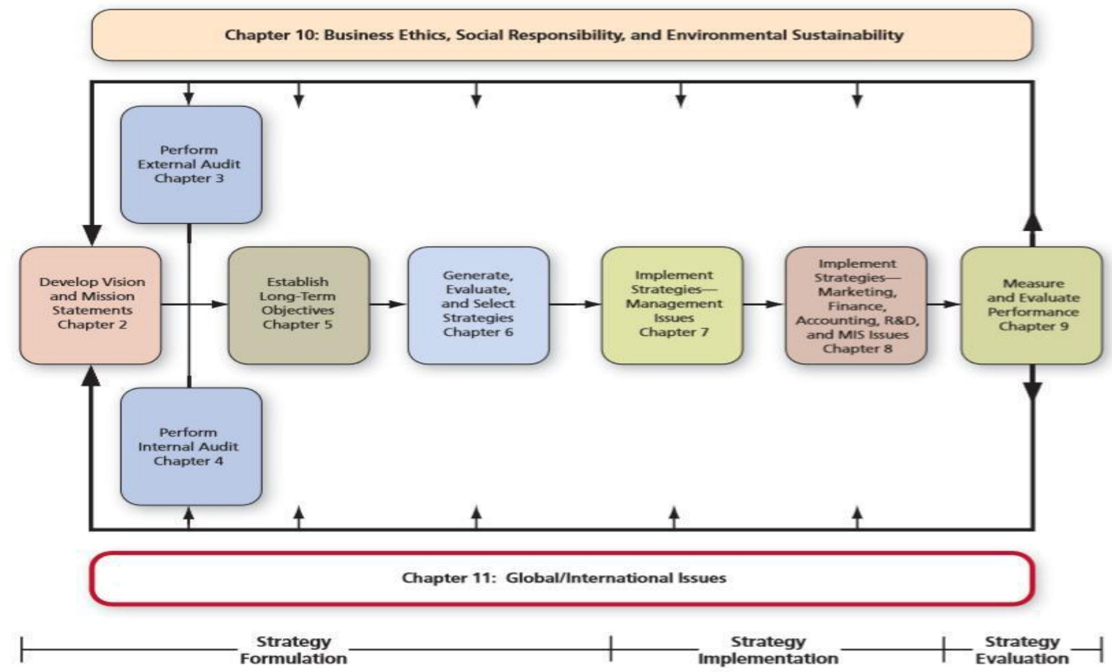
As illustrated in Figure 11-1, global considerations impact virtually all strategic decisions. The boundaries of countries no longer can define the limits of our imaginations. To see and appreciate the world from the perspective of others has become a matter of survival for businesses. The underpinnings of strategic management hinge on managers gaining an understanding of competitors, markets, prices, suppliers, distributors, governments, creditors, shareholders, and customers worldwide. The price and quality of a firm's products and services must be competitive on a worldwide basis, not just on a local basis. As indicated above, Marriott International is an example global business that performed outstandingly well during the recent global recession. The World Trade Organization (WTO) in March 2009 issued the most pessimistic report on global trade in its 62-year history: that global trade would drop by 9 percent or more in 2009.1

A world market has emerged from what previously was a multitude of distinct national markets, and the climate for international business today is more favorable than in years past. Mass communication and high technology have created similar patterns of consumption in diverse cultures worldwide. This means that many companies may find it difficult to survive by relying solely on domestic markets.

It is not exaggeration that in an industry that is, or is rapidly becoming, global, the riskiest possible posture is to remain a domestic competitor. The domestic competitor will watch as more aggressive companies use this growth to capture economies of scale and learning. The domestic competitor will then be faced with an attack on domestic markets using different (and possibly superior) technology, product design, manufacturing, marketing approaches, and economies of scale.2

FIGURE 11-1

A Comprehensive Strategic-Management Mode



Source: Fred R. David, "How Companies Define Their Mission," *Long Range Planning* 22, no. 3 (June 1988): 40.

Multinational Organizations

Organizations that conduct business operations across national borders are called international firms or multinational corporations. The strategic-management process is conceptually the same for multinational firms as for purely domestic firms; however, the process is more complex for international firms due to more variables and relationships. The social, cultural, demographic, environmental, political, governmental, legal, technological, and competitive opportunities and threats that face a multinational corporation are almost limitless, and the number and complexity of these factors increase dramatically with the number of products produced and the number of geographic areas served.

More time and effort are required to identify and evaluate external trends and events in multinational corporations than in domestic corporations. Geographic distance, cultural and national differences, and variations in business practices often make communication between domestic headquarters and overseas operations difficult. Strategy implementation can be more difficult because different cultures have different norms, values, and work ethics. Multinational corporations (MNCs) face unique and diverse risks, such as expropriation of assets, currency losses through exchange rate fluctuations, unfavorable foreign court interpretations of contracts and agreements, social/political disturbances, import/ export restrictions, tariffs, and trade barriers. Strategists in MNCs are often confronted with the need to be globally competitive and nationally responsive at the same time. With the rise in world commerce, government and regulatory bodies are more closely monitoring foreign business practices. The U.S. Foreign Corrupt Practices Act, for example, monitors business practices in many areas.

Before entering international markets, firms should scan relevant journals and patent reports, seek the advice of academic and research organizations, participate in international trade fairs, form partnerships, and conduct extensive research to broaden their contacts and diminish the risk of doing business in new markets. Firms can also offset some risks of doing business internationally by obtaining insurance from the U.S. government's Overseas Private Investment Corporation (OPIC). Philips Electronics NV is one of many firms moving into emerging markets. A few of Philips's acquisitions in the year 2008 alone were Medel in Italy, Meditronics in India, Alpha X-Ray Technologies in India, Dixtal Biomedica & Tecnologia in Brazil, Shenzhen Goldway Industrial in China, and VMI-Sistemes Medicos in Brazil.

Advantages and Disadvantages of International Operations

Firms have numerous reasons for formulating and implementing strategies that initiate, continue, or expand involvement in business operations across national borders. Perhaps the greatest advantage is that firms can gain new customers for their products and services, thus increasing revenues. Growth in revenues and profits is a common organizational objective and often an expectation of shareholders because it is a measure of organizational success. Potential advantages to initiating, continuing, and/or expanding international operations are as follows:

1. Firms can gain new customers for their products.
2. Foreign operations can absorb excess capacity, reduce unit costs, and spread economic risks over a wider number of markets.
3. Foreign operations can allow firms to establish low-cost production facilities in locations close to raw materials and/or cheap labor.
4. Competitors in foreign markets may not exist, or competition may be less intense than in domestic markets.

5. Foreign operations may result in reduced tariffs, lower taxes, and favorable political treatment.
6. Joint ventures can enable firms to learn the technology, culture, and business practices of other people and to make contacts with potential customers, suppliers, creditors, and distributors in foreign countries.
7. Economies of scale can be achieved from operation in global rather than solely domestic markets. Larger-scale production and better efficiencies allow higher sales volumes and lower-price offerings.
8. A firm’s power and prestige in domestic markets may be significantly enhanced if the firm competes globally.

Enhanced prestige can translate into improved negotiating power among creditors, suppliers, distributors, and other important groups. The availability, depth, and reliability of economic and marketing information in different countries vary extensively, as do industrial structures, business practices, and the number and nature of regional organizations. There are also numerous potential disadvantages of initiating, continuing, or expanding business across national borders, such as the following:

1. Foreign operations could be seized by nationalistic factions.
2. Firms confront different and often little-understood social, cultural, demographic, environmental, political, governmental, legal, technological, economic, and competitive forces when doing business internationally. These forces can make communication difficult in the firm.
3. Weaknesses of competitors in foreign lands are often overestimated, and strengths are often underestimated. Keeping informed about the number and nature of competitors is more difficult when doing business internationally.
4. Language, culture, and value systems differ among countries, which can create barriers to communication and problems managing people.
5. Gaining an understanding of regional organizations such as the European Economic Community, the Latin American Free Trade Area, the International Bank for

Reconstruction and Development, and the International Finance Corporation is difficult but is often required in doing business internationally.

6. Dealing with two or more monetary systems can complicate international business operations.

The Global Challenge

Foreign competitors are battering U.S. firms in many industries. In its simplest sense, the global challenge faced by U.S. business is twofold: (1) how to gain and maintain exports to other nations and (2) how to defend domestic markets against imported goods. Few companies can afford to ignore the presence of international competition. Firms that seem insulated and comfortable today may be vulnerable tomorrow; for example, foreign banks do not yet compete or operate in most of the United States, but this too is changing.

America's economy is becoming much less American. A world economy and monetary system are emerging. Corporations in every corner of the globe are taking advantage of the opportunity to obtain customers globally. Markets are shifting rapidly and in many cases converging in tastes, trends, and prices. Innovative transport systems are accelerating the transfer of technology. Shifts in the nature and location of production systems, especially to China and India, are reducing the response time to changing market conditions.

More and more countries around the world are welcoming foreign investment and capital. As a result, labor markets have steadily become more international. East Asian countries are market leaders in labor-intensive industries, Brazil offers abundant natural resources and rapidly developing markets, and Germany offers skilled labor and technology. The drive to improve the efficiency of global business operations is leading to greater functional specialization. This is not limited to a search for the familiar low-cost labor in Latin America or Asia. Other considerations include the cost of energy, availability of resources, inflation rates, tax rates, and the nature of trade regulations.

Many countries became more protectionist during the recent global economic recession. Protectionism refers to countries imposing tariffs, taxes, and regulations on firms outside the country to favor their own companies and people. Most economists argue that protectionism harms the world economy because it inhibits trade among countries and invites retaliation. When China joined the World Trade Organization in 2001, that country agreed to respect copyright protections and liberalize restrictions on the import and distribution of foreign-made goods. However, Chinese counterfeiters still can be criminally prosecute for commercial piracy only when caught in possession of at least 500 counterfeit items.3 In China, pirated goods such as Nike running shoes, new Hollywood movies on DVD, and Microsoft software can be purchased for a fraction of their actual prices on many streets. China still has substantial barriers to sales of authentic U.S.-made copyrighted products. Former U.S. Trade Representative Susan Schwab says, “This is more than a handbag here or a logo item there; it is often theft on a grand scale.” China’s counterfeit trade practices contribute to an annual bilateral trade deficit of about $250 billion with the United States. Chinese pirating of products is an external threat facing many firms.

Advancements in telecommunications are drawing countries, cultures, and organizations worldwide closer together. Foreign revenue as a percentage of total company revenues already exceeds 50 percent in hundreds of U.S. firms, including Exxon/Mobil, Gillette, Dow Chemical, Citicorp, Colgate-Palmolive, and Texaco. A primary reason why most domestic firms are engaging in global operations is that growth in demand for goods and services outside the United States is considerably higher than inside. For example, the domestic food industry is growing just 3 percent per year, so Kraft Foods, the second largest food company in the world behind Nestle, is focusing on foreign acquisitions.

Shareholders and investors expect sustained growth in revenues from firms; satisfactory growth for many firms can only be achieved by capitalizing on demand outside the United States. Joint ventures and partnerships between domestic and foreign firms are becoming the rule rather than the exception!

Fully 95 percent of the world's population lives outside the United States, and this group is growing 70 percent faster than the U.S. population. The lineup of competitors in virtually all industries is global. General Motors, Ford, and Chrysler compete with Toyota and Hyundai. General Electric and Westinghouse battle Siemens and Mitsubishi. Caterpillar and John Deere compete with Komatsu. Goodyear battles Michelin, Bridgestone/Firestone, and Pirelli. Boeing competes with Airbus. Only a few U.S. industries—such as furniture, printing, retailing, consumer packaged goods, and retail banking—are not yet greatly challenged by foreign competitors. But many products and components in these industries too are now manufactured in foreign countries. International operations can be as simple as exporting a product to a single foreign country or as complex as operating manufacturing, distribution, and marketing facilities in many countries.

Globalization

Globalization is a process of doing business worldwide, so strategic decisions are made based on global profitability of the firm rather than just domestic considerations. A global strategy seeks to meet the needs of customers worldwide, with the highest value at the lowest cost. This may mean locating production in countries with the lowest labor costs or abundant natural resources, locating research and complex engineering centers where skilled scientists and engineers can be found, and locating marketing activities close to the markets to be served. A global strategy includes designing, producing, and marketing products with global needs in mind, instead of considering individual countries alone.

A global strategy integrates actions against competitors into a worldwide plan. Today, there are global buyers and sellers, and the instant transmission of money and information across continents. It is clear that different industries become global for different reasons. The need to amortize massive R&D investments over many markets is a major reason why the aircraft manufacturing industry became global. Monitoring globalization in one's industry is an important strategic-management activity.

Knowing how to use that information for one's competitive advantage is even more important. For example, firms may look around the world for the best technology and select one that has the most promise for the largest number of markets. When firms design a product, they design it to be marketable in as many countries as possible. When firms manufacture a product, they select the lowest-cost source, which may be Japan for semiconductors, Sri Lanka for textiles, Malaysia for simple electronics, and Europe for precision machinery.

A Weak Economy

A weak economy still plagues many countries around the world. The British pound reached a 23-year low against the U.S. dollar in January 2009. Two consecutive quarters of a decline in real gross domestic product is commonly used as a definition of a recession, and the last quarter of 2008 marked this occurrence in the United Kingdom. The speed and breadth at which the United Kingdom's economy shrunk makes economists think the UK recession could last through 2012. Like the U.S. government, the UK government has poured hundreds of billions of pounds into stimulus and financial bailout measures. Further interest rate cuts by the Bank of England are expected soon, although the bank's rates are already the lowest in the bank's 315-year history. The pound's fall has done little to boost exports. David Sandall, a businessman in Cheshire, Northern England, says, "It doesn't matter what the price of something is if your customer hasn't got the money." And that is the primary situation in the United Kingdom's two largest trading regions—Europe and the United States.

Unemployment rates are high across the United States and around the world. Consumer spending remains low and cautious while banks continue to be reluctant to loan money. Stock prices have rebounded, but many investors still have an appetite only for government securities. New corporate profit warnings and bankruptcies spell continued recession in many countries.

United States versus Foreign Business Cultures

To compete successfully in world markets, U.S. managers must obtain a better knowledge of historical, cultural, and religious forces that motivate and drive people in other countries. In Japan, for example, business relations operate within the context of Wa, which stresses group harmony and social cohesion. In China, business behavior revolves around guanxi, or personal relations. In South Korea, activities involve concern for inhwa, or harmony based on respect of hierarchical relationships, including obedience to authority.4

In Europe, it is generally true that the farther north on the continent, the more participatory the management style. Most European workers are unionized and enjoy more frequent vacations and holidays than U.S. workers. A 90-minute lunch break plus 20-minute morning and afternoon breaks are common in European firms. Guaranteed permanent employment is typically a part of employment contracts in Europe. In socialist countries such as France, Belgium, and the United Kingdom, the only grounds for immediate dismissal from work is a criminal offense. A six-month trial period at the beginning of employment is usually part of the contract with a European firm. Many Europeans resent pay-for-performance, commission salaries, and objective measurement and reward systems. This is true especially of workers in southern Europe. Many Europeans also find the notion of team spirit difficult to grasp because the unionized environment has dichotomized worker–management relations throughout Europe.

A weakness of some U.S. firms in competing with Pacific Rim firms is a lack of understanding of Asian cultures, including how Asians think and behave. Spoken Chinese, for example, has more in common with spoken English than with spoken Japanese or Korean. U.S. managers consistently put more weight on being friendly and liked, whereas Asian and European managers often exercise authority without this concern. Americans tend to use first names instantly in business dealings with foreigners, but foreigners find this presumptuous. In Japan, for example, first names are used only among family members and intimate friends; even longtime business associates and coworkers shy away from the use of first names. Table 11-1 lists other cultural differences or pitfalls that

U.S. managers need to know about. U.S. managers have a low tolerance for silence, whereas Asian managers view extended periods of silence as important for organizing and evaluating one's thoughts. U.S. managers are much more action oriented than their counterparts around the world; they rush to appointments, conferences, and meetings—and then feel the day has been productive. But for many foreign managers, resting, listening, meditating, and thinking is considered productive.

TABLE 11-1 Cultural Pitfalls That May Help You Be a Better Manager

- Waving is a serious insult in Greece and Nigeria, particularly if the hand is near someone's face.
- Making a "good-bye" wave in Europe can mean "No," but it means "Come here" in Peru.
- In China, last names are written first.
- A man named Carlos Lopez-Garcia should be addressed as Mr. Lopez in Latin America but as Mr. Garcia in Brazil.
- Breakfast meetings are considered uncivilized in most foreign countries.
- Latin Americans are on average 20 minutes late to business appointments.
- Direct eye contact is impolite in Japan.
- Don't cross your legs in any Arab or many Asian countries—it's rude to show the sole of your shoe.
- In Brazil, touching your thumb and first finger—an American "Okay" sign—is the equivalent of raising your middle finger.
- Nodding or tossing your head back in southern Italy, Malta, Greece, and Tunisia means "No." In India, this body motion means "Yes."
- Snapping your fingers is vulgar in France and Belgium.
- Folding your arms across your chest is a sign of annoyance in Finland.
- In China, leave some food on your plate to show that your host was so generous that you couldn't finish.
- Do not eat with your left hand when dining with clients from Malaysia or India.
- One form of communication works the same worldwide. It's the smile—so take that along wherever you go.

Sitting through a conference without talking is unproductive in the United States, but it is viewed as positive in Japan if one's silence helps preserve unity. U.S.
managers place greater emphasis on short-term results than foreign managers. In marketing, for example, Japanese managers strive to achieve "everlasting customers," whereas many Americans strive to make a onetime sale. Marketing managers in Japan see making a sale as the beginning, not the end, of the selling process. This is an important distinction. Japanese managers often criticize U.S. managers for worrying more about shareholders, whom they do not know, than employees, whom they do know. Americans refer to "hourly employees," whereas many Japanese companies still refer to "lifetime employees." Rose Knotts recently summarized some important cultural differences between U.S. and foreign managers:5

1. Americans place an exceptionally high priority on time, viewing time as an asset. Many foreigners place more worth on relationships. This difference results in foreign managers often viewing U.S. managers as “more interested in business than people.”
2. Personal touching and distance norms differ around the world. Americans generally stand about three feet from each other when carrying on business conversations, but Arabs and Africans stand about one foot apart. Touching another person with the left hand in business dealings is taboo in some countries. American managers need to learn the personal-space rules of foreign managers with whom they interact in business.
3. Family roles and relationships vary in different countries. For example, males are valued more than females in some cultures, and peer pressure, work situations, and business interactions reinforce this phenomenon.
4. Business and daily life in some societies are governed by religious factors. Prayer times, holidays, daily events, and dietary restrictions, for example, need to be respected by American managers not familiar with these practices in some countries.
5. Time spent with the family and the quality of relationships are more important in some cultures than the personal achievement and accomplishments espoused by the traditional U.S. manager.
6. Many cultures around the world value modesty, team spirit, collectivity, and patience much more than the competitiveness and individualism that are so important in the United States.
7. Punctuality is a valued personal trait when conducting business in the United States, but it is not revered in many of the world’s societies. Eating habits also differ dramatically across cultures. For example, belching is acceptable in some countries as evidence of satisfaction with the food that has been prepared. Chinese culture considers it good manners to sample a portion of each food served.
8. To prevent social blunders when meeting with managers from other lands, one must learn and respect the rules of etiquette of others. Sitting on a toilet seat is viewed as unsanitary in most countries, but not in the United States. Leaving food or drink after

dining is considered impolite in some countries, but not in China. Bowing instead of shaking hands is customary in many countries. Some cultures view Americans as unsanitary for locating toilet and bathing facilities in the same area, whereas Americans view people of some cultures as unsanitary for not taking a bath or shower every day.

9. Americans often do business with individuals they do not know, unlike businesspersons in many other cultures. In Mexico and Japan, for example, an amicable relationship is often mandatory before conducting business.

In many countries, effective managers are those who are best at negotiating with government bureaucrats rather than those who inspire workers. Many U.S. managers are uncomfortable with nepotism and bribery, which are practiced in some countries. The United States has gained a reputation for defending women from sexual harassment and minorities from discrimination, but not all countries embrace the same values.

American managers in China have to be careful about how they arrange office furniture because Chinese workers believe in feng shui, the practice of harnessing natural forces. U.S. managers in Japan have to be careful about nemaswashio, whereby Japanese workers expect supervisors to alert them privately of changes rather than informing them in a meeting. Japanese managers have little appreciation for versatility, expecting all managers to be the same. In Japan, “If a nail sticks out, you hit it into the wall,” says Brad Lashbrook, an international consultant for Wilson Learning.

Probably the biggest obstacle to the effectiveness of U.S. managers—or managers from any country working in another—is the fact that it is almost impossible to change the attitude of a foreign workforce. “The system drives you; you cannot fight the system or culture,” says Bill Parker, president of Phillips Petroleum in Norway.

The Mexican Culture

Mexico is an authoritarian society in terms of schools, churches, businesses, and families. Employers seek workers who are agreeable, respectful, and obedient, rather than innovative, creative, and independent. Mexican workers tend to be activity oriented rather than problem solvers. When visitors walk into a Mexican business, they are impressed by the cordial, friendly atmosphere. This is almost always true because Mexicans desire harmony rather than conflict; desire for harmony is part of the social fabric in worker–manager relations. There is a much lower tolerance for adversarial relations or friction at work in Mexico as compared to the United States.

Mexican employers are paternalistic, providing workers with more than a paycheck, but in return they expect allegiance. Weekly food baskets, free meals, free bus service, and free day care are often part of compensation. The ideal working condition for a Mexican worker is the family model, with people all working together, doing their share, according to their designated roles. Mexican workers do not expect or desire a work environment in which self-expression and initiative are encouraged. Whereas U.S. business embodies individualism, achievement, competition, curiosity, pragmatism, informality, spontaneity, and doing more than expected on the job, Mexican businesses stress collectivism, continuity, cooperation, belongingness, formality, and doing exactly what you’re told.

In Mexico, business associates rarely entertain each other at their homes, which are places reserved exclusively for close friends and family. Business meetings and entertaining are nearly always done at a restaurant. Preserving one’s honor, saving face, and looking important are also exceptionally important in Mexico. This is why Mexicans do not accept criticism and change easily; many find it humiliating to acknowledge having made a mistake. A meeting among employees and managers in a business located in Mexico is a forum for giving orders and directions rather than for discussing problems or participating in decision making. Mexican workers want to be closely supervised, cared for, and corrected in a civil manner. Opinions expressed by employees are often regarded as back talk in Mexico. Mexican supervisors are viewed as weak if they explain the rationale for their orders to workers.

Mexicans do not feel compelled to follow rules that are not associated with a particular person in authority they work for or know well. Thus signs to wear earplugs or safety glasses, or attendance or seniority policies, and even one-way street signs are often ignored. Whereas Americans follow the rules, Mexicans often do not.

Life is slower in Mexico than in the United States. The first priority is often assigned to the last request, rather than to the first. Telephone systems break down. Banks may suddenly not have pesos. Phone repair can take a month. Electricity for an entire plant or town can be down for hours or even days. Business and government offices may open and close at odd hours. Buses and taxis may be hours off schedule. Meeting times for appointments are not rigid. Tardiness is common everywhere. Effectively doing business in Mexico requires knowledge of the Mexican way of life, culture, beliefs, and customs.

The Japanese Culture

The Japanese place great importance on group loyalty and consensus, a concept called Wa. Nearly all corporate activities in Japan encourage Wa among managers and employees. Wa requires that all members of a group agree and cooperate; this results in constant discussion and compromise. Japanese managers evaluate the potential attractiveness of alternative business decisions in terms of the long-term effect on the group's Wa. This is why silence, used for pondering alternatives, can be a plus in a formal Japanese meeting. Discussions potentially disruptive to Wa are generally conducted in very informal settings, such as at a bar, so as to minimize harm to the group's Wa. Entertaining is an important business activity in Japan because it strengthens Wa. Formal meetings are often conducted in informal settings. When confronted with disturbing questions or opinions, Japanese managers tend to remain silent, whereas Americans tend to respond directly, defending themselves through explanation and argument.

Most Japanese managers are reserved, quiet, distant, introspective, and other oriented, whereas most U.S. managers are talkative, insensitive, impulsive, direct, and individual oriented. Americans often perceive Japanese managers as wasting time and carrying on pointless conversations, whereas U.S. managers often use blunt criticism, ask prying questions, and make quick decisions. These kinds of cultural differences have disrupted many potentially productive Japanese–American business endeavors. Viewing the Japanese communication style as a prototype for all Asian cultures is a stereotype that must be avoided.

Communication Differences Across Countries

Americans increasingly interact with managers in other countries, so it is important to understand foreign business cultures. Americans often come across as intrusive, manipulative, and garrulous; this impression may reduce their effectiveness in communication. Forbes recently provided the following cultural hints from Charis Intercultural Training:

1. Italians, Germans, and French generally do not soften up executives with praise before they criticize. Americans do soften up folks, and this practice seems manipulative to Europeans.
2. Israelis are accustomed to fast-paced meetings and have little patience for American informality and small talk.
3. British executives often complain that American executives chatter too much. Informality, egalitarianism, and spontaneity from Americans in business settings jolt many foreigners.
4. Europeans feel they are being treated like children when asked to wear name tags by Americans.
5. Executives in India are used to interrupting one another. Thus, when American executives listen without asking for clarification or posing questions, they are viewed by Indians as not paying attention.
6. When negotiating orally with Malaysian or Japanese executives, it is appropriate to allow periodically for a time of silence. However, no pause is needed when negotiating in Israel.

7. Refrain from asking foreign managers questions such as “How was your weekend?” That is intrusive to foreigners, who tend to regard their business and private lives as totally separate.6

Americans have more freedom to control their own fates than do the Japanese. Life in the United States and life in Japan are very different; the United States offers more upward mobility to its people. This is a great strength of the United States, as indicated here:

America is not like Japan and can never be. America’s strength is the opposite: It opens its doors and brings the world’s disorder in. It tolerates social change that would tear most other societies apart. This openness encourages Americans to adapt as individuals rather than as a group. Americans go west to California to get a new start; they move east to Manhattan to try to make the big time; they move to Vermont or to a farm to get close to the soil. They break away from their parents’ religions or values or class; they rediscover their ethnicity. They go to night school; they change their names. 7

Worldwide Tax Rates

The lowest corporate tax rates among developed countries reside in Europe, and European countries are lowering tax rates further to attract investment. The average corporate tax rate among European Union countries is 26 percent, compared with 30 percent in the Asia-Pacific region and 38 percent in the United States and Japan. Ireland and the former Soviet-bloc nations of Eastern Europe recently slashed corporate tax rates to nearly zero, attracting substantial investment. Germany cut its corporate tax rate from 39 percent in 2007 to just under 30 percent in 2008. Great Britain cut its corporate tax rate to 28 percent from 30 percent. France cut its rate from 34 percent to 27 percent in 2008.

Other factors besides the corporate tax rate obviously affect companies’ decisions to locate plants and facilities. For example, the large and affluent market and efficient infrastructure in Germany and Britain attract companies, but the high labor costs and strict labor laws keep other companies away.

Ralph Gomory, president of the Alfred P. Sloan Foundation and a former top executive at IBM, warns of a growing divergence between the interests of U.S. corporations and interests of the U.S. government. Specifically, he says U.S. trade liberalization/ globalization policies for the last two decades have encouraged corporations to seek the lowest-cost locations for their operations. The new 1,200-worker Intel semiconductor plant in Vietnam is just one example among thousands. Gomory says the United States must use the corporate income tax to reward companies that invest in jobs here, especially high-tech jobs, and must penalize companies that move facilities overseas. We must make it in the self-interest of companies to invest in America, Gomory says. Otherwise, living standards here will inevitably decline and America will severely weaken economically.8

Joint Ventures in India

The government of India is highly in debt, 80 percent of GDP, and is cutting expenses to curtail spending, so the gap between rich and poor is widening further. (The U.S. federal debt is about 65 percent of GDP.) But India's middle class is growing, so foreign firms continue to invest. Nissan Motor is building a factory in Chennai in conjunction with Mahindra & Mahindra Ltd., India's largest maker of jeeps and tractors. The factory began operating in 2009.

Joint ventures remain mandatory for foreign companies doing business in India. Verizon Business India, a joint venture between Verizon and Videocon Group of Mumbai, is rapidly expanding its phone and Internet services in India to compete more fiercely with AT&T and other telecom companies. Almost 20 million new cell phone customers are added in India every quarter, about the same rate of increase as in China—compared with only about 2.8 million new cell phone customers added in the United States quarterly. India's Reliance Communications Ltd. is in a battle with Britain's Vodafone Group PLC for control of India's fourth-largest cellular service, Hutchison

Essar. But Vodafone must find a local partner because Indian law restricts foreign firms to 74 percent ownership of any India-based firm.

Most joint ventures among firms in India and foreign firms fail. Of 25 major joint ventures between foreign and Indian companies between 1993 and 2003, only three survive today. The Indian government has eased the joint-venture restriction in the investmentbanking industry, but not in other areas. Even Wal-Mart has an Indian partner, Bharti Enterprises Ltd. Heavy friction exists in virtually all joint-ventures in India. John Band, president of Zoom Cortex in Mumbai, says, "Anyone that gets into a joint venture in India should assume it will fail and should be comfortable with the terms of what happens when it does fail." 9

Due to tourism growing 12 percent annually, hotel chains are scrambling to get established in India. Hilton Hotels just established a joint venture with New Delhi–based DLF Ltd. to develop 75 hotels in India in 2007–2010. Marriott, Four Seasons, and Carlson Companies are also establishing joint ventures in India and building hotels rapidly.