Managing the External Environment

3

Chapter Outline:

3-1
The Organization's Industry

3-2
The Organization's Macroenvironment

3-3
Managing Environmental Uncertainty

3-4
Environmental Scanning

3-5
Forecasting the Environment

3-6
Crisis Management

Summary
Review Questions
Endnotes

Key Terms

boundary-spanning
buffering
crisis
crisis management
culture
Delphi technique
environmental scanning
gross domestic product (GDP)
imitation
industry life cycle
judgmental forecasting
macroenvironment
multiple scenarios
population ecology
self-reference criterion
time series analysis
uncertainty

An organization cannot function effectively unless its managers understand the forces outside of the organization that influence its performance and survival. There are two components of the organization's external environment: the industry—the collection of competitors that offer similar products or services—and the complex network of political-legal, economic, social, and technological forces known as the organization's **macroenvironment**. This chapter addresses each of these components.

macroenvironment
the general environment that affects all business firms in an industry, which includes political-legal, economic, social, and technological forces

industry
a group of competitors that produces similar products or services

3-1 The Organization's Industry

Each business unit operates among a group of companies that produce competing products or services known as an **industry**. Although there are usually some differences among competitors, each industry has "rules of combat" governing such issues as product quality, pricing, and distribution. This is especially true in industries that contain a large number of firms offering standardized products and services. For example, most service stations in the United States generally offer regular unleaded, mid-grade, and premium unleaded gasoline at prices that do not differ substantially from those at nearby stations. If a rival attempts to sell different grades, it may experience difficulty securing reliable sources of supply and may also confuse consumers by deviating from the standard.

In a perfect world, each organization would operate in one clearly defined industry. In the real world, however, many organizations compete in multiple industries, and it may be difficult to clearly identify the industry boundaries. As such, the concept of primary and secondary industries may be useful in defining an industry. A primary industry may be conceptualized as a group of close competitors, whereas a secondary industry includes less direct competition. The distinction between primary and secondary industry may be based on objective criteria such as price, similarity of products, or location, but is ultimately a subjective call.

3-1a Porter's Five Forces Model

Industry factors have been found to play a major role in the performance of many companies, with the exception of those that are its notable leaders or failures.[1] As such, one needs to understand these factors at the outset before delving into the characteristics of a specific firm. Michael Porter proposed a systematic means of analyzing an industry's potential profitability known as Porter's "five forces" model. As aforementioned, this model is based on IO economics and suggests that industry structure is the primary determinant of firm performance. According to Porter, an industry's overall profitability depends on five basic competitive forces, the relative weights of which vary by industry:

1. **The intensity of rivalry among incumbent firms**: Competition intensifies when a firm identifies the opportunity to improve its position or senses competitive pressure from other businesses in its industry, which can result

in price wars, advertising battles, new product introductions or modifications, and even increased customer service or warranties.[2]

2. **The threat of new competitors entering the industry**: Unless the market is growing rapidly, new entrants intensify the fight for market share, lowering prices and, ultimately, industry profitability.

3. **The threat of substitute products or services**: Firms in one industry may be competing with firms in other industries that produce substitute products, offerings produced by firms in another industry that satisfy similar consumer needs but differ in specific characteristics.

4. **The bargaining power of buyers**: The buyers of an industry's outputs can lower that industry's profitability by bargaining for higher quality or more services and playing one firm against another.

5. **The bargaining power of suppliers**: Suppliers can extract the profitability out of an industry whose competitors may be unable to recover cost increases by raising prices.

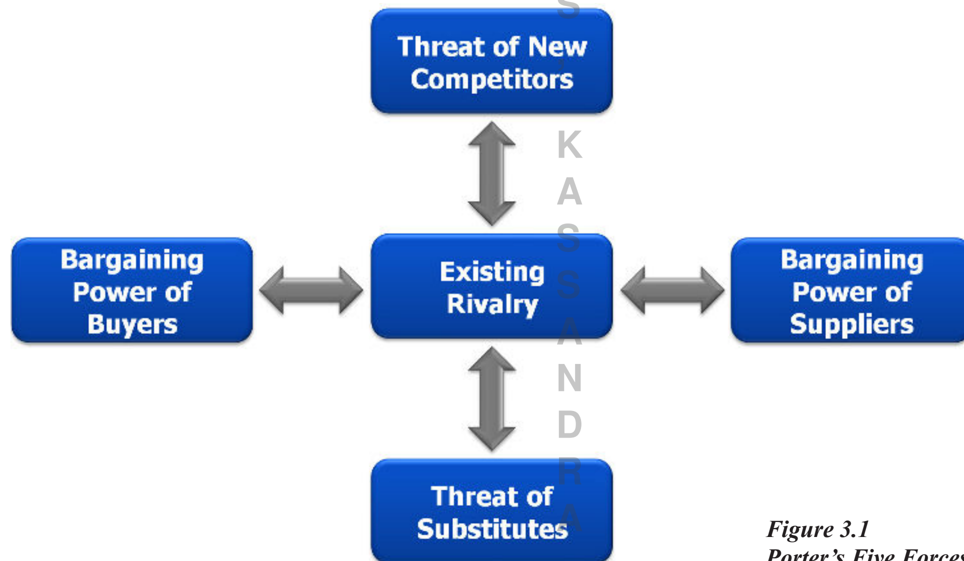


Figure 3.1
Porter's Five Forces Model

Each of the five forces suggests that potential profits within an industry may be high, moderate, or low. Analyzing the five forces for an organization's industry can help managers understand the potential for superior performance within that industry. It does not guarantee high or low performance, as there are usually substantial performance differences among organizations in the same industry. Porter's five forces model, however, provides a useful framework for thinking about the effects an industry has on an organization.

There are other valid perspectives on organizations and industries besides Porter's view. As Porter suggests, organizations functioning in a given industry generally possess a number of similarities that are not typically shared by those in other industries. Fast-food restaurants, for example, tend to be labor-intensive and cost-conscious, with established systems to provide fast, efficient service to customers. However, new organizations may "buck the trend" from to time by taking different approached designed to respond to changes in the environment more

WILLIS KASSANDRA 216175

effectively. Whereas Porter's five forces model emphasizes similarities among organizations within an industry, the **population ecology** perspective emphasizes organizational diversity and adaptation.[3] According to this view, organizations can be better understood by examining when and how they are formed, why new organizations might vary from existing ones, and ultimately why some survive when others fail. Some insight into this view can be obtained by considering the life cycle through which an industry passes.

population ecology
a perspective on organizations that emphasizes the diversity among organizations that perform similar functions and utilize common resources

3-1b Industry Life Cycle

Like organizations, industries develop and evolve over time. Not only might the group of competitors within an organization's industry change constantly, but the nature and structure of the industry can also change as it matures and its markets become better defined. An industry's developmental stage influences the nature of competition and potential profitability among competitors.[4] In theory, each industry passes through five distinct phases of an **industry life cycle**.

industry life cycle
the stages (introduction, growth, shakeout, maturity, and decline) through which industries are believed to pass

Figure 3-2

A young industry that is beginning to form is considered to be in the *introduction stage*. Demand for the industry's outputs is low because product and/or service awareness is still developing. Most purchasers are first-time buyers, and tend to be affluent, risk tolerant, and innovative. Technology is a key concern in this stage because businesses often seek ways to improve production and distribution efficiencies as they learn more about their markets. Organizations emerging in this stage often attempt to capitalize on first-mover advantages, similar to the prospector strategy discussed in a previous chapter.

Normally, after key technological issues are addressed and customer demand begins to rise, the industry enters the *growth stage*. Growth continues during this stage but tends to slow as the market demand approaches saturation. Fewer first-time buyers remain, and most purchases tend to be "upgrades" or replacements. Some of the industry's weaker competitors may not survive. Those that do establish distinctive competencies that can help distinguish them from their competitors.

Shakeout occurs when industry growth is no longer rapid enough to support the increasing number of competitors in the industry. As a result, an organization's growth is contingent on its resources and competitive positioning instead of a high growth rate within the industry. Marginal competitors are forced out, and a small number of industry leaders may emerge.

Maturity is reached when the market demand for the industry's outputs is completely saturated. Virtually all purchases are upgrades or replacements, and industry growth may be low, nonexistent, or even negative. Industry standards for

WILLIS KASSANDRA 2161TS

quality and service have been established, and customer expectations tend to be more consistent than in previous stages. The U.S. automobile industry is a classic example of a mature industry. Firms in mature industries often seek new uses for their products or services or pursue new markets, often through global expansion. Because the field has become crowded and customers have become more sophisticated, many successful organizations begin to emphasize efficiencies in order to offer greater value.

The *decline stage* occurs when demand for an industry's products and services decreases and often begins when consumers begin to turn to more convenient, safer, or higher quality offerings from organizations in substitute industries. Some firms may divest their business units in this stage, whereas others may seek to "reinvent themselves" and pursue a new wave of growth associated with a similar product or service.

The life cycle model is a useful tool for evaluating an industry's development and the types of organizations that may be most likely to succeed. The key problem with the model, however, is that identifying an industry's precise position is often difficult, and not all industries follow these exact stages or at predictable intervals.[5] For example, the U.S. railroad industry did not reach maturity for many decades and extended over a hundred years before entering decline, whereas the personal computer industry began to show signs of maturity after only seven years.

3-2 The Organization's Macroenvironment

The second component within an organization's external environment is the macroenvironment and consists of political-legal, economic, social, and technological forces. Ultimately, the effects of these forces create opportunities and threats for an organization. In general, forces in the macroenvironment affect all competitors within a given industry, although the nature of the effects can differ among firms. For example, a sharp economic decline may threaten the livelihood of a luxury automobile manufacturer, while at the same time creating an opportunity for a carmaker with substantially lower costs.

Most organizations have little, if any influence over the macroenvironment. On occasion, a large, dominant firm such as Wal-Mart may be able to exert some degree of influence over one or more aspects of the macroenvironment. For example, the giant retailer's political action committee contributed about $1 million to candidates and parties in the United States in both 2003 and 2004, presumably in an effort to influence regulation that might affect the organization.[6] However, most organizations must seek to join with others in trade and other associations in an attempt to exert some degree of influence on a particular factor in the macroenvironment.

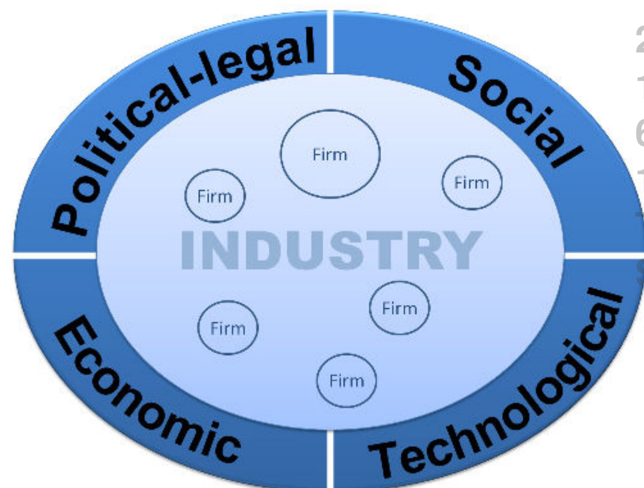


Figure 3-3

Some factors may be placed neatly into one of these interrelated categories, whereas others may straddle two or more classes. For example, automobile safety has political-legal (e.g., legislation requiring that safety standards be met), social (e.g., consumer demands for safe vehicles), and technological (e.g., innovations that may improve safety) dimensions. For clarity concerns, however, each category of macroenvironmental forces is discussed separately.

WILLIS, KASSANDRA 21617TS

3-2a Political-Legal Forces

Political-legal forces include such factors as the outcomes of elections, legislation, and judicial court decisions, as well as the decisions rendered by various commissions and agencies at every level of government. Military conflicts are also included in this arena and can also influence how a number of industries operate, especially those with tight global ties. In 2003, for example, during the beginning of the war in Iraq, many American firms modified their promotional strategies, fearing that their television advertisements might be considered insensitive if aired alongside breaking coverage of the war. At the same time, others began to plan for meeting the anticipated future needs in Iraq for such products as cell phones, refrigerators, and automobiles. In late 2003, American firms began to compete vigorously for lucrative reconstruction contracts, while others prepared for increased business activity there in the coming years.[7]

Industries are often affected by legislation and other political events specific to their line of business. For example, the Highway Traffic Safety Administration in the United States constantly tests cars and trucks sold in the U.S. and works with carmakers to improve safety performance.[8] Following the sharp declines in air travel in the United States in 2001, airlines on the verge of bankruptcy campaigned for and received $15 billion in government support in 2002 and an additional $2.9 billion in 2003.[9] All societies have laws and regulations that restrict or control business operations. Relatively speaking, free market oriented nations such as the United States have fewer restrictions, but the level of regulation can be extensive in some areas. Many socialist nations have rigid guidelines for hiring and firing employees or establishing operations, and some require that a portion of what is produced in that country be exported to earn foreign exchange. These regulations are specific to each nation and create opportunities or pose threats to firms interested in operating across national boundaries.

3-2b Economic Forces

Every organization is affected by changes in the local, national, and/or global economies. The first economic consideration is that of the **gross domestic product (GDP)**, the value of a nation's annual total production of goods and services. GDP growth among nations is often interrelated, but all nations do not experience the same rate of growth. For example, while GDP levels in the West were stagnant during the late 1990s and early 2000s, China's GDP grew at a staggering pace.[10]

gross domestic product
the value of a nation's annual total production of goods and services

Consistent GDP growth generally produces a healthy economy fueled by increases in consumer spending, whereas a decline signals lower consumer spending and decreased demand for goods and services. When GDP declines for two consecutive quarters, a nation's economy is generally considered to be in a recession. A recession is not detrimental for all organizations. For example, college and university enrollments often increase as undergraduate and graduate students

WILLIS, KASSANDRA 2161TS

seek to gain an advantage in a tight job market.[11] Unfortunately, it is difficult to forecast a recession in advance, and many recessions are identified only after they have occurred.

High inflation negatively affects most, but not all businesses. High rates raise many of the costs of doing business, and continued inflation can constrict the expansion plans of businesses and trigger governmental action, such as is the case when the U.S. Federal Reserve Board raises its discount rate during inflationary periods to slow economic growth. However, oil companies may benefit during inflationary times if the prices of oil and gas rise faster than the costs of exploration, refinement, and transportation. Sharp increases in the price of heating oil sparked a resurgence in the market for coal stoves in the winter of 2000–2001.[12]

Interest rates affect the demand for many products and services, especially "high ticket" items whose costs are financed over an extended period of time, such as homes, automobiles, and appliances. At the consumer level, low short-term interest rates benefit retailers such as Wal-Mart and J.C. Penney because they also tend to lower rates on credit cards, thereby encouraging consumer spending. At the organizational level, high interest rates can hinder expansion efforts.

Recessions can be devastating for firms in many industries, but they are difficult to predict.

Organizations that transact a significant amount of business with entities outside of its borders are especially vulnerable to changes in rates of exchange between the home and other currencies. When the value of the dollar increases relative to other currencies, for example, American organizations are at a competitive disadvantage internationally, as the prices of American-made goods rise in foreign markets. In addition, American manufacturers tend to locate more of their plants abroad and make purchases from foreign sources. During this time, American consumers are more likely to purchase products produced abroad, which are less expensive than goods produced at home.

3-2c Social Forces

Social forces include such factors as societal values, trends, traditions, and religious practices and can substantially influence organizational performance. Social forces can vary widely among nations, especially as they are related to other factors. For example, smaller cars have been the vehicle of choice in European countries since the 1990s. In Europe, roads are more narrow, gasoline is more heavily taxed, and fuel economy is a greater concern. In the United States, roads are wider, gasoline is less expensive, and fuel consumption does not play as strong a role in the purchase decision. As a result, American consumers tend to demand relatively larger vehicles.[13] Fashion in China also offers another example, where styles reflect a mix of Asian, American, and European tastes.[14]

WILLIS, KASSANDRA 2161TS

Social forces often reflect societal practices that have lasted for decades or even centuries. For example, the celebration of Christmas in the Western Hemisphere provides significant financial opportunities for card companies, toy retailers, confectioners, tree growers, and gift shops. Some retailers are happy just to break even during the year and generate their profits during the Christmas shopping season.

Societal trends also include demographic changes that can affect how organizations must function in order to succeed. Consider the United States as an example. The baby boom, which lasted from 1945 through the mid-1960s, initially created opportunities for baby apparel and diaper manufacturers, private schools, and even candy and snack makers. Later, as this crop of baby boomers departed high school, universities grew at an astounding rate and organizations had large applicant pools from which to select their employees. More recently, these baby boomers have begun shopping at home more and are spending heavily on health-care needs, leisure activities, and vacations.[15]

Today, the average American is older, busier, better educated, more technologically astute, and less likely to be a member of the Caucasian race than in previous years. This trend has affected consumer demand in areas such as personal computers and educational services, and has prompted many organizations emphasizing the broad middle-age market to modify their strategic approaches to include either younger or older adults. For example, cosmetics maker Avon, confronted with a shrinking clientele, began to expand its appeal to the trendier 16- to 24-year-old market in 2002.[16] J.C. Penney, and Sears even opened stand-alone locations to provide easier access to customers too busy to plan a day at the mall.[17]

In many respects, social forces—more than other forces in the macroenvironment—have the greatest effect on organizations that produce goods for or provide services directly to consumers. Consider the American automobile industry as an example. Sport utility vehicles (SUVs) were born in the 1990s and by the end of the decade had become the vehicle of choice for many suburban families. Auto manufacturers realized, however, that SUV patrons were willing to give up some of the rugged features associated with the SUV in exchange for the additional space and softer ride associated with the previously most popular class of vehicles known as the minivan. Ford responded by introducing a redesigned Explorer with three rows of seats, additional safety gadgets, and a softer ride.[18] By 2003, Ford, General Motors, and Nissan had begun to shift attention away from large SUVs to the vehicles they often termed "crossovers" or "active lifestyle wagons."[19]

Interestingly, however, the popularity of the SUV in the United States has been attacked on the grounds of another social force, environmental responsibility. Environmentalists charge that SUVs are simply too large and fuel-inefficient, increasing the nation's dependence on external sources of oil, a reliance that may compromise the nation's ability to broker a lasting peace in the oil-rich Middle East. As a result, SUV manufacturers began to develop and produce more fuel-efficient hybrid (i.e., gasoline and electric) versions in the mid-2000s.

One of the difficulties associated with social trends, however, is that they are often difficult to identify. In some cases, two trends may even appear to be at odds with each other. For example, American consumers have been sending a mixed message of "the celery stick and the double chocolate peanut swirl" for the past decade, confusing restaurants and packaged food producers alike. Fast food restaurants responded by "supersizing" their meal combinations with extra fries and larger drinks, while at the same time expanding alternatives for

WILLIS, KASSANDRA 2161TS

items such as grilled chicken sandwiches and salads.[20] In 2004, Coca-Cola and PepsiCo began to emphasize smaller cans and bottles,[21] while McDonald's introduced low-carb menu items.[22]

During this same time, fast-food consumers began eating less at Burger King, Pizza Hut, and Taco Bell, in favor of such outlets as Subway and Panera Bread, restaurants many consumers perceived to be more healthy. Although the traditional competitors responded with more salads and low-calorie, low-fat alternatives, their "heavy and fried" images have been difficult to overcome.[23] As these U.S. fast-food icons continue to expand abroad, restaurant chains from other parts of the world, most notably Latin America, are expanding into the United States.[24]

Fast food restaurants have found it difficult to shed their "heavy and fried" images as the health and fitness trend enters its second decade.

The health and fitness trend that emerged in the 1990s facilitated the growth in a number of fitness equipment manufacturers and sports drink producers, while hurting organizations in less health-friendly industries such as tobacco and liquor. In 2002, Anheuser Busch launched Michelob Ultra, a low-carbohydrate beer, in an attempt to tap the health-conscious market,[25] while PepsiCo announced it would attempt to increase its sales of healthy snacks, including baked and low-fat offerings, to 50 percent of its total snack food sales.[26]

In the early 2000s, concern about obesity in developed nations such as the United States and the United Kingdom became more prominent. Critics charge that sedentary lifestyles and unhealthy foods—such as those produced by many fast-food restaurants—have led to increases in diabetes, heart disease, and other medical problems associated with obesity. Some claim that food processors and fast-food restaurants such as McDonald's have contributed to this phenomenon by encouraging individuals to consume larger quantities of unhealthy foods.[27] Many consumers began to pursue low-carbohydrate diets to lose weight and improve overall health. As a result, many food producers and restaurants began catering to consumer interest in "low-carb" regiments as dieter concern shifted from fat content in foods to carbohydrate content. Unilever, for example, began promoting "low-carb" Skippy peanut butter, Wishbone dressing, and Ragu spaghetti sauce.[28]

Another prominent social trend in the early 2000s is related to technological advances associated with the Internet. During this time, many traditional retailers began to experience sales declines as more consumers shopped online. As a result, retailers began searching for new ways to attract prospective buyers to their stores, discovering that many consumers were less likely to frequent a traditional retailer unless it also provided some form of entertainment value. Bass Pro Shops, for example, increased its store traffic substantially by including such amenities as a large fish tank, live bats, and even a rock-climbing wall. Mall developers began to include "activity zones" in their facilities for such attractions as skating and fitness centers. This trend of mixing retailing with entertainment is expected to continue in the coming years.[29]

The tragic events of September 11, 2001 ("9-11") also resulted in social changes that affect many organizations. Concerns over air travel safety have greatly influenced everything from flight routes to airline marketing strategies. After 9-11, Americans as a whole became more willing to accept inconveniences associated with their transactions if these inconveniences are associated with safety and security. Studies also suggest that investment and personal life strategies have become more conservative and reflective as a result of the tragedy.[30] Even

WILLIS, KASSANDRA 2161TS

"Green" social concerns have created new business opportunities in many areas; such as recycling, automobile advances, and renewable energy sources.

churches are taking notice, as the 25 percent increase in national attendance immediately following the events of September 11 had all but disappeared by the following year.[31]

General environmental concerns have also affected a number of organizations. These include the emphasis on socially responsible manufacturing and waste management practices, as well as concerns for saving private wetlands from business development.[32] Interest in both consumer recycling and the production of recyclable products heightened in the 1990s and has continued to remain a key concern in the 2000s. Many analysts question consumer willingness to pay the higher prices typically associated with environmentally friendly products.[33]

WILLIS, KASSANDRA 2161TS

3-2d Technological Forces

Technological forces include scientific improvements and innovations that affect organizations. The rate of technological change can vary considerably among organizations and can affect operations in various ways. Many organizations have capitalized on advances in technology such as computers, satellites, and fiber optics to lower costs and serve their customers more effectively.

Technological change can also decimate existing organizations and even entire industries. Historical examples of such change include the shifts from vacuum tubes to transistors, from steam locomotives to diesel and electric engines, from fountain pens to ballpoints, and from typewriters to computers.[34]

On the consumer side, estimates of global Internet access in 2003 range from 600 to 800 million individuals, the vast majority of whom reside in the United States, Canada, Europe, or Asia. Most Americans now shop online, while frequent online shoppers tend to be male, married, and college educated, between 18 and 40 years of age.[35] Online retail spending for 2003 is estimated at $52 billion, with an average annual growth rate through 2007 estimated at 21 percent.[36] Indeed, the widespread use of the Internet over the past decade is arguably the most pervasive technological force affecting business organizations since the dissemination of the personal computer.

The effects of the Internet are most profound in some industries, such as brokerage houses, where online companies have demonstrated huge gains in the market, or the travel industry, where the number of flights, hotels, and travel packages booked over the past decade has skyrocketed. The Internet has also spawned the advent of online banking, a much less costly means of managing transactions. As such, by 2002, a number of major banks and creditors had begun encouraging customers to pay bills online by offering free software, elimination of fees, and even sweepstakes entries with each transaction.[37] Indeed, the Internet has had a major effect on virtually every industry in the developed world.

It is difficult to overestimate the effect of andances in technology on strategic planning

Consider the Internet's affect on the airline industry as an example. As Internet usage spread, many consumers began to purchase their airline tickets online instead

Career Point

Gleaning Career Insight from the Macroenvironment

What can macroenvironmental forces tell you about career opportunities with a particular organization? Sometimes a great deal. Consider the automobile and fast food industries as examples.

The automobile industry is heavily regulated by governments for safety and fuel economy. Most consumers finance vehicle purchases, so sales of new cars typically decline when interest rates are high and increase when rates are low. Consumer tastes are constantly evolving in areas such as fuel economy, vehicle size preferences, and the like. Technological change to promote increased fuel economy via hybrid gas/electric or even hydrogen power is on the horizon.

The fast food industry is not as heavily regulated as the automobile industry, although there are concerns for cleanliness and safety. The industry is also less susceptible than the automobile industry to economic conditions. The evolution of consumer tastes is also an issue, although the concerns are associated with taste, health, and food preparation. Technology has improved the efficiency of operations in a number of fast food restaurants but does not appear to be the driving force in firm success or failure.

What do these environmental factors tell us about careers in the auto and fast food industries? The greater role played by technology in the auto industry suggests that competitors will need a significant number of highly trained and well-compensated engineers and R&D specialists to keep pace, whereas fast food outlets will likely concentrate on hiring large numbers of less skilled workers. The link between auto sales and interest rates suggests that the auto industry is more cyclical and restructurings might be more common than in fast food restaurants. Of course, changing consumer tastes suggest that decision-makers in both industries need to remain abreast of changes in consumer preferences.

WILLIS, KASSANDRA 2161TS

of utilizing the traditional intermediary, a travel agency. As airlines began investing in this much more efficient means of ticketing in the 1990s, they started to trim commissions paid to travel agencies for booking their flights. In 2003, the major U.S.-based large airlines eliminated commissions altogether for most tickets sold in the United States. Although many travel agencies moved aggressively to incorporate Internet technology and revamp their businesses, others did not survive.[38]

Technology has also prompted changes in customer service. For example, many of the touch-tone consumer hotlines of the 1990s were replaced in the early 2000s by "virtual agents" that answer calls and use speech recognition technology to either resolve a question or transfer the customer to a "real person" for additional assistance. Studies suggest that these systems improve response time by as much as 40 percent. Whereas some consumers appreciate the increased speed and are enamored by many agents' use of accents and even flirtatious personalities, others feel awkward about "talking to a computer pretending to be a person." Interestingly, some American companies have addressed this frustration by utilizing fewer technology-based systems and transferring incoming calls to their consumer hotlines and technical support centers directly to representatives in countries such as India, where labor costs are much lower.[39]

The influence of technology on organizations is discussed in greater detail later in the text.

3-3 Managing Environmental Uncertainty

Managers must develop systems to address confusion concerning the availability of appropriate information about the organization's environment. Ideally, top managers are well aware of the variety of external forces that influence an organization's activities. **Uncertainty** occurs when decision-makers lack current, sufficient, reliable information about their organization and cannot accurately forecast future changes. In reality, however, decision-makers in any organization must be able to make decisions when environmental conditions are uncertain. Some organizations, such soft drink bottlers, are typically marked by lower levels of uncertainty. Top managers in other organizations, such as biotech and aerospace firms, tend to encounter higher levels of uncertainty.

uncertainty
a state whereby decision makers lack current, sufficient, reliable information about their organization and cannot accurately forecast future changes

Environmental uncertainty as perceived by decision-makers is influenced by three key characteristics of the organization's environment. First, the environment may be classified along a simple-complex continuum. Simple environments have relatively few external factors that influence the organization and the strength of these factors tends to be low. Complex environments are marked by numerous external factors, some of which can have a major influence on the organization. Of course, many organizations may fall between these two extremes.

Second, the environment may be classified along a stable-unstable dimension. Stable environments are marked by a slow pace of change in the nature of external influences. Unstable environments are characterized by rapid change, such as when competitors constantly modify strategies, consumer tastes change quickly, or technological forces are developing constantly.

Finally, environmental uncertainty is a function of the quality or richness of information available to decision-makers.[40] This is a key concern in emerging economies where reliable data on market demand, economic forces, and consumer preferences may not be readily available. In developed nations, however, information sources such as business publications, trade associations, and governmental agencies tend to be more developed.

Considering these three environmental characteristics, uncertainty is lowest in organizations whose environments are simple and stable, and where the quality of available information available is high. In contrast, uncertainty is highest in organizations whose environments are complex and unstable, and where the quality of information is low.[41] At the one extreme, many governmental entities in developed countries may be the most simple and stable. Although governments can restructure and budgets may change from year to year, the pace of change is relatively slow and such entities are usually not influenced as greatly by external forces as many for-profit organizations. In contrast, organizations whose core is tied closely to technology tend to experience the greatest complexity and instability. Following the terrorist attacks of September 11, 2001, airlines could be added to this category because of increased regulatory pressure and fears of further attacks.

WILLIS KASSANDRA 2161617S

Organizations in environments marked by low uncertainty are managed differently than those marked by high uncertainty. When uncertainty is low, for example, greater formality and established procedures can be implemented to improve efficiency. When uncertainty is high, however, procedures are difficult to develop because processes tend to change more frequently. In this situation, decision-makers are often granted more freedom and flexibility so that the organization can adapt to its environment as it changes or as better information on the environment becomes available.

A number of techniques are available for managing uncertainty in the environment. The first consideration, however, is whether the organization should concentrate on adapting to its environment or attempting to influence it. The adaptation perspective suggests than an organization is unable to substantially influence factors in its external environment. As such, this approach is consistent with industrial organization as discussed in chapter two.

Alternatively, the influence perspective assumes that an organization can either influence its environment—a difficult task for all but large firms—or by strategic choice reduce the level of uncertainty in the environment. Influencing the environment can take many forms, such as operating only in a highly predictable niche of the market, forming strategic alliances to expand a customer base, or forming a joint venture to investigate new technologies without having to go it alone. For example, a restaurant may select a more expensive location on a well-traveled highway to reduce uncertainty associated with traffic flow at a less expensive, more remote site.

Most organizations choose an approach between the two extremes, adapting in areas where top managers are unable to influence the environment and operating only in certain domains of the environment when this is possible. Southwest Airlines, for example, reduces competitive uncertainty by concentrating on small to medium size airports and reduces global political uncertainty by operating flights only within the United States. At the same time, however, Southwest adapts to consumer tastes and economic conditions by keeping tickets affordable and easy to purchase online or by telephone.

There are other techniques to managing uncertainty that may be taken. One is **buffering**, a common approach whereby organizations establish departments to absorb uncertainty from the environment and thereby buffer its effects.[42] Purchasing departments, for example, perform a buffering role by stockpiling resources for the organization in case they become scarce.

Another technique is **imitation**, an approach whereby the organization mimics the strategy and structure of a successful key competitor. Organizations that imitate their competitors reduce the risk of making poor strategic decisions. As such, this can be an attractive approach, especially when an organization is struggling and it can mimic a highly successful competitor. Imitation can restrict an organization's

buffering
a process for managing uncertainty whereby an organization establishes departments to absorb uncertainty from the environment

imitation
an approach to managing uncertainty whereby the organization mimics the strategy and structure of a successful key competitor

WILLIS, KASSANDRA 2161TS

ability to develop its own distinctive competence, however.

Aside from these techniques, enhancing the quality and quantity of information available to an organization and the ability to disseminate it to decision-makers is a key concern. Improving the organization's ability to predict future environmental changes and respond to unanticipated crisis events is also important. These issues are discussed in greater detail in the following sections.

3-4 Environmental Scanning

Keeping abreast of changes in the external environment that affect the organization presents a key challenge to managers. **Environmental scanning** refers to collecting and analyzing information about relevant trends in the external environment. A systematic environmental scanning process organizes the flow of current information relevant to organizational decisions while providing decision-makers with an early warning system for changes in the environment. Because members of an organization often lack critical knowledge and information, they may scan the environment by interacting with outsiders, a process known as **boundary-spanning**.

environmental scanning
collecting and analyzing information about relevant trends in the external environment

boundary-spanning
the interaction by members of an organization with outsiders in order to obtain information relevant to the organization

Environmental scanning by nature is future-oriented. Unfortunately, however, the results of environmental analysis are often too general or uncertain for specific interpretation.[43] Hence, the need for *effective* environmental scanning to produce relevant information is critical.[44]

Environmental scanning can be viewed as a continuous process.[45] Top managers must plan for and identify the type of information the organization needs to support decision-making. A system for obtaining this information is then developed. Information is collected, analyzed, and disseminated to the appropriate decision-makers. Their feedback concerning the usefulness and timeliness of the information should influence the type of information required by the organization. This process is summarized in figure 3-4.

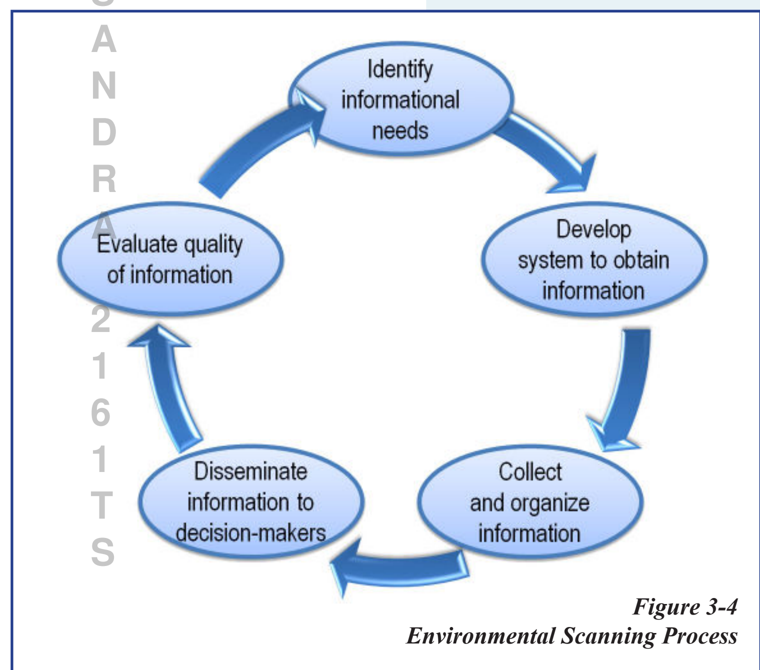


Figure 3-4
Environmental Scanning Process

Large organizations may engage in environmental scanning activities by employing one or more individuals whose sole responsibility is to obtain, process, and distribute important environmental information to its decision-makers. These individuals constantly review articles in trade journals and other periodicals, and watch for changes in competitor activities. Alternatively, however, organizations

WILLIS, KASSANDRA 2161TS

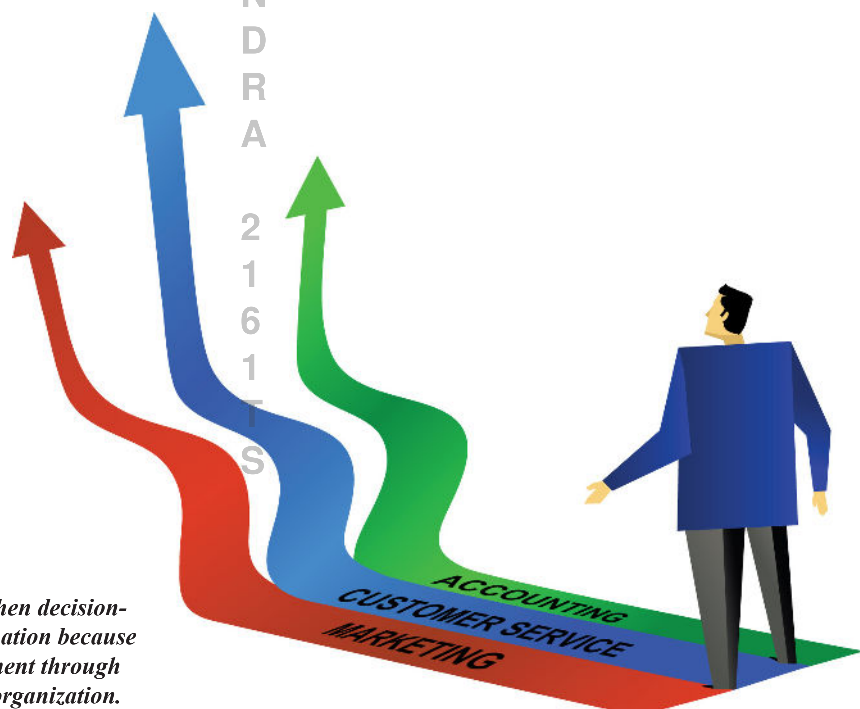
may contract with a research organization that offers environmental scanning services and provides them with real-time searches of published material associated with their organizations, key competitors, industries. In contrast, decision-makers at many smaller organizations must rely on trade publications or periodicals such as the *Wall Street Journal* to remain abreast of changes that may affect their organizations.

A potential lack of objectivity can be a concern when decision-makers evaluate environmental information because they selectively perceive their environment through the lens of their own experiences and organization. Managers with expertise in various functional areas tend to be more interested in and elevate information pertaining to their functions. For example, marketing managers may see the need for immediate changes in the marketing strategy to respond to changes in products offered by competitors, whereas operations managers may argue for the immediate implementation of a new cost-reducing technology.[46]

Interestingly, environmental scanning often identifies relationships among key industry influences in two or more forces. For example, heightened consumer concerns for automobile safety—a social force—could foster legislative action—a political-legal force—to require that automobile manufacturers add side airbags to all vehicles within a five-year period, an action that may be facilitated by improved manufacturing techniques—a technological force. Environmental scanners should be less concerned about classifying external activities as one force or another and more concerned about obtaining timely, accurate information for organizational decision-makers.

Today, a key problem created by environmental scanning is often one of determining which information available warrants attention. Consider that it is not uncommon for a major American organization to be referenced in over a thousand news stories in a given week. Deciding which stories to read can be a daunting task.

For small organizations and for those competing in global markets, however, a greater problem might be the lack of reliable information on environmental conditions and trends. In China, for example, research house Euromonitor International reported that 23 billion liters of soft drinks were consumed in 2002, whereas a Coca-Cola study concluded the level to be 39 billion liters.[47] Discrepancies such as this can create great difficulties for decision-makers.



Lack of objectivity can be a concern when decision-makers evaluate environmental information because they selectively perceive their environment through the lens of their own experiences and organization.

WILLIS, KASSANDRA 2161TS

3-5 Forecasting the Environment

It is important for decision-makers in an organization not only to understand how the environment affects an organization today, but also how it may influence the organization in the future. As such, environmental scanning activities are most useful when they not only reveal current conditions, but also aid in forecasting future trends and changes. A number of forecasting techniques can be used, four of which are discussed briefly here:

Time series analysis attempts to examine the effects of historical trends such as population growth, technological innovations, or changes in disposable personal income on key organizational variables such as firm costs, sales, profitability, and market share. Time series analysis incorporates such factors as seasonal fluctuations, weather conditions, and holidays to the firm's performance, and can often reveal the effect of economic cycles on organizational performance. Time series analysis is most useful when trends can be quantified (e.g., temperature, population) and are believed to be developing at a consistent pace.

time series analysis
an empirical forecasting procedure in which certain historical trends are used to predict variables such as a firm's sales or market share

The **Delphi technique** is often employed when specialized expertise is required to forecast the future.[48] If the trend to be forecasted lies within a particular field, then experts in the area can be identified and independently surveyed about the likelihood and nature of the trend, as well as its prospective effect on the organization. After the initial results from experts are tabulated, they are redistributed to a panel of experts for follow-up assessments until a consensus about the trend is reached.

Delphi technique
a forecasting procedure whereby experts are independently and repeatedly questioned about the probability of some event's occurrence until consensus is reached regarding the particular forecasted event

When relationships between variables are complex, difficult to identify, or cannot be adequately quantified, an organization may utilize **judgmental forecasting,** the use of a variety of sources including customers, suppliers, or trade association to provide qualitative information about future trends. For instance, sales representatives may be asked to forecast sales growth based on their knowledge of customers' expansion plans. Surveys may also be mailed to suppliers or trade associations to obtain their judgments on specific trends. Data is then compiled into a composite forecast. Although judgmental forecasting effectively obtains input from a variety of sources, it is often difficult to draw clear conclusions due to the qualitative nature of the trend and the variety of sources that might be employed in the data collection process.

judgmental forecasting
a forecasting procedure whereby employees, customers, suppliers, and/or trade associations serve as sources of qualitative information regarding future trends

In **multiple scenarios**, managers formulate several competing descriptions of future events and trends.[49] In doing so, strategic managers are required to identify the key forces in the environment, determine how they are interrelated, estimate their influence on future events, and ask "what if…" questions with each scenario. Decision-makers then develop contingency plans that usually specify trigger points such as changes in sales or competitor activity that initiate the implementation-particular aspects of a plan.[50]

multiple scenarios
a forecasting procedure in which management formulates several plausible hypothetical descriptions of sequences of future events and trends

In practice, managers may utilize a combination of methods to predict environmental changes that will affect their organizations. There is no consensus on the most effective forecasting method, and most experts agree that each method can be useful in the appropriate situation.

WILLIS, KASSANDRA 2161TS

3-6 Crisis Management

Forecasting methods are primarily used to project market conditions and performance levels that are at least somewhat predictable. Unfortunately, however, any organization can be faced with a **crisis**, a disruption that physically affects an organization, its basic assumptions, or its core activities.[51] How an organization addresses a crisis may determine its ultimate survival. Although a crisis can be initiated by factors internal or external to the organization, there are often multiple factors involved. **Crisis management** refers to the process of planning for and implementing the response to a wide range of negative events that could severely affect an organization.

crisis
any disruption that physically affects an organization, its basic assumptions, or its core activities

crisis management
the process of planning for and implementing the response to a wide range of negative events that could severely affect an organization

WILLIS, KASSANDRA 2161TS

3-6a Types of Crises

The terrorist attacks of September 11, 2001, highlighted the need for organizations to anticipate, prepare for, and respond to crisis events.[52] For some organizations, the attack resulted not only in the tragic loss of a substantial number of employees, but also a loss of key facilities and data.[53] Bioterrorism—the use of biological agents for terrorist purposes—has become a major concern for top executives. One recent survey reported that approximately two thirds of executives are not confident that their organizations would be safe in the event of a biological or chemical attack, even though 80 percent of the organizations in question have crisis management plans in place.[54]

Of course, terrorism is but one crisis that can affect an organization. In addition, a number of other potential organizational crises should be considered, such as fires and other natural disasters, economic crises (e.g., extortion, boycotts, bribery), information crises (e.g., computer system sabotage, copyright infringement, counterfeiting), and political unrest such as urban riots.[55] The effects of crises on an organization can vary widely around the world and can be especially traumatic in emerging nations where organizations may be less likely to have the resources and infrastructure to deal with them.[56]

In addition to the events of September 2001, a number of large organizations have faced major crises at some time during the past few decades. In 1984, for example, gas leaked from a methyl isocyanate tank at a Union Carbide plant in Bhopal, India, killing approximately 3,800 persons and totally or partially disabling about 2,700 more. It was later learned that the leak occurred when a disgruntled employee sought to spoil a batch of the chemical by adding water to the storage tank. The incident was reported to officials at company headquarters in the United States after a 12-hour delay, an event which sparked a widespread view that Union Carbide was negligent and "covering up" details. India's Supreme Court later provided a $470 million settlement for victims and their families.[57]

In 1989, the Exxon Valdez tanker hit a reef in William Sound, Alaska, spilling approximately 250,000 barrels of oil. Although there was no loss of human life,

Best Practices

Crisis Management at McDonald's

It is usually easier to locate examples of ineffective or nonexistent crisis management practices in organizations than it is to identify examples of successful crisis planning. Fast food giant McDonald's has not always been noted for its success in this area, but demonstrated effective crisis management in 2004.

In April of that year, McDonald's chief executive Jim Cantalupo died suddenly from a heart attack. Less than six hours later, McDonald's board of directors named president and chief operating officer Charlie Bell as his successor. The board had already intended for Bell to succeed Cantalupo at some point, but its quick, decisive action quelled many fears about the future of the leading fast-food chain. Hence, the board not only made a quick decision, but it had already thought about and planned for succession.

McDonald's response highlights the importance not only of planning for CEO succession, but also of preparing for unexpected medical emergencies, especially with regard to top executives. Many experts suggest that a firm's board should always be prepared for an unexpected loss of the top two executives in their firms and that they should not even fly on the same aircraft.

WILLIS, KASSANDRA 2161TS

the loss of animal and bird life was extensive, and the negative press was damaging. The company's untested crisis management plan said such a spill could be contained in five hours, but it was not implemented for two days. Exxon eventually spent about $2 billion to clean up the spill and another $1 billion to settle legal claims associated with the disaster.[58]

In 2003, The New Delhi Center for Science and Environment published a report asserting that local samples of Pepsi and Coke products contained pesticide residues at 30 times the acceptable limits in Europe. India's Parliament stopped serving the beverages and India nationalist activists in Allahabad smashed bottles and vandalized the property of a Coke distributor. Daily sales dropped by about one-third in less than two weeks, further curtailing efforts by the soft drink giants to spawn consumption of a product in a country where the average resident consumes less than one soft drink per month. The soft drink giants questioned the methodology and credentials of the group's laboratory, a response that did little to palliate the adverse effect of the crisis.[59]

3-6b The Crisis Management Process

The key to managing crises effectively is to plan in advance. As such, it is helpful to view crisis management as a three-step process. *Before the crisis*, organizations should develop a crisis management team to develop and plan for worst-case scenarios and define standard operating procedures that should be implemented prior to any crisis event. For example, top managers anticipating labor unrest at a company facility may hire additional security guards or contract with a private agency to provide additional security.

Proactive organizations that continually assess their vulnerabilities and threats and develop crisis management plans tend to be adequately equipped when a crisis occurs. Proper preparation requires research of the literature, of the industrial sector, and of the company itself. Information is needed to properly prepare for the crisis events. When managers understand which crisis events are more likely to occur, they can plan for the event more effectively and foster a business culture that is ready to meet the challenge if and when a crisis occurs.[60]

During the crisis, an organizational spokesperson should communicate effectively with the public to minimize the effect of the crisis. For example, after being unprepared when Tylenol capsules laced with cyanide killed seven people in 1982, Johnson & Johnson prepared more effectively and responded to a 1986 lacing incident by acknowledging the crisis with the public and instructing all consumers to return products for a refund.[61] Presentations to the public should be prompt, honest, professional, and streamlined through a single person or office.

After the crisis, communication with the public should continue as needed, and the cause of the crisis should be uncovered. Understanding the cause can help executives minimize the likelihood that the crisis will occur again and improve preparation for the crisis if it does.[62]

Summary

Each organization is affected by factors in its external environment, including the collection of competitors known as the industry. Porter's five forces model offers a framework for evaluating the industry's structure and its influence on the organization.

In addition to the industry, each organization is affected by four sets of forces in its macroenvironment. Political-legal forces include various forms of legislation and judicial rulings, such as the decisions of various commissions and agencies at all levels of government. Economic forces include the effects of factors such as inflation, interest rates, and exchange rates. Social forces include traditions, values, societal trends, and a society's expectations of business. Technological forces include such factors as the Internet, as well as scientific improvements and innovations that affect firm operations and/or products and services in a given industry.

Environmental scanning is the process of researching and analyzing macroenvironmental changes so that managers can take this information into account when making decision. Understanding the present state of an organization's environment is only part of the process, however. It is also important to understand how changes might influence an organization in the future. A number of forecasting techniques, including time series analysis, the Delphi technique, judgmental forecasting, and multiple scenarios, can assist in assessing how future trends may affect firms in a particular industry.

Unfortunately, some environmental events are difficult to predict and can have substantial effects. Therefore, each organization should form a crisis management team and consider various crisis scenarios as part of its effort to remain abreast of changes in the environment.

WILLIS, KASSANDRA 2161TS

Review Questions & Exercises

1. How might the concept of primary and secondary industries be applied to a fast-food restaurant such as McDonald's?
2. In what industry life cycle stage would you classify the airline industry? How might this stage affect some of the strategic decisions made by a particular airline within the industry?
3. Using your college or university as an example, explain how political-legal, economic, technological, and social forces have affected its operations over the past decade.
4. What steps should your college or university officials take to prepare the institution for potential crises?

Glossary

- **Boundary-spanning:** The interaction by members of an organization with outsiders in order to obtain information relevant to the organization.
- **Buffering:** A process for managing uncertainty whereby an organization established departments to absorb uncertainty from the environment.
- **Crisis**: Any disruption that physically affects an organization, its basic assumptions, or its core activities.
- **Crisis Management**: The process of planning for and implementing the response to a wide range of negative events that could severely affect an organization.
- **Delphi Technique:** A forecasting procedure whereby experts are independently and repeatedly questioned about the probability of some event's occurrence until consensus is reached regarding the particular forecasted event.
- **Environmental Scanning:** Collecting and analyzing information about relevant trends in the external environment.
- **Gross Domestic Product (GDP):** The value of a nation's annual total production of goods and services.
- **Imitation:** An approach to managing uncertainty whereby the organization mimics the strategy and structure of a successful key competitor.
- **Industry Life Cycle:** The stages (introduction, growth, shakeout, maturity, and decline) through which industries are believed to pass.

WILLIS KASSANDRA 2161TS

- **Judgmental Forecasting:** A forecasting procedure whereby employees, customers, suppliers, and/or trade associations serve as sources of qualitative information regarding future trends.
- **Macroenvironment:** The general environment that affects all business firms in an industry, which includes political-legal, economic, social, and technological forces.
- **Multiple Scenarios:** A forecasting procedure in which management formulates several plausible hypothetical descriptions of sequences of future events and trends.
- **Population Ecology:** A perspective on organizations that emphasizes the diversity among organizations that perform similar functions and utilize common resources.
- **Time Series Analysis:** An empirical forecasting procedure in which certain historical trends are used to predict variables such as a firm's sales or market share.
- **Uncertainty:** A state whereby decision-makers lack current, sufficient, reliable information about their organization and cannot accurately forecast future changes.

WILLIS, KASSANDRA 2161TS

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WILLIS, KASSANDRA 21617TS

Goals & Organizational Effectiveness

4

Chapter Outline:

4-1
The Organization's Mission, Goals, & Objectives

4-2
The Case for Goals & Objectives

4-3
Goals & Stakeholders

4-4
The Agency Problem

4-5
Organizational Effectiveness

4-6
Controlling Organizational Effectiveness

Summary
Review Questions
Glossary
Endnotes

Key Terms

agency problem
balanced scorecard
best practices
CEO duality
comparative advantage
competitive benchmarking
concurrent control
corporate governance
diversification
employee stock ownership plan (ESOP)
feedback control
feedforward control
formal organization
goals
informal organization
leveraged buyout (LBO)
mission
objectives
organizational capacity
organizational control
organizational effectiveness
stakeholders
takeover
top management team

It has been said many times before that, “if you don’t know where you’re going, any road will get you there.” This admonition is true for organizations. Its leaders must understand and articulate the desired results from organizational activities if they expect them to be successful. This chapter discusses three key considerations to help leaders identify where an organization should be headed: (1) setting the mission, goals, and objectives, (2) conceptualizing organizational effectiveness and determining how to measure it, and (3) initiating organizational control when the organization is not as effective as it should be.

4-1 The Organization’s Mission, Goals, and Objectives

WILLIS, KASSANDRA 2161TS

Organizations are more likely to function effectively when their purpose and resources are well understood by their members. Toward this end, a mission, goals, and objectives should be developed for each organization. The **mission** is the reason for the firm’s existence. The organization’s **goals** represent the desired general ends toward which efforts in the organization are directed. **Objectives**, sometimes called operative goals, are specific, and often quantified, versions of goals. Unlike goals, objectives are verifiable and specific, and are developed so that managers can measure performance.

mission
the reason for an organization’s existence. The mission statement is a broadly defined but enduring statement of purpose that identifies the scope of an organization’s operations and its offerings to the various stakeholders

goals
desired general ends toward which efforts are directed

objectives
specific, verifiable, and often quantified versions of a goal

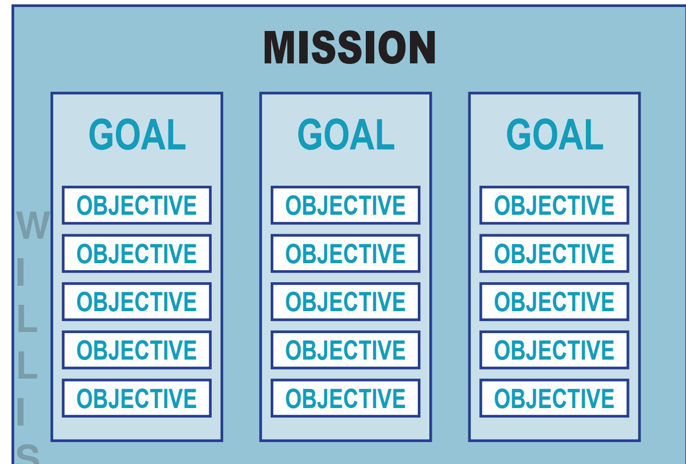
An organization’s mission, goals, and objectives should be intertwined. For example, the mission of a fast-food restaurant chain might be to “provide high-quality food with consistent, and rapid service to consumers in the southeastern United States at a profit.” Management may establish a goal “to expand the size of the organization by adding new outlets.” From this goal, a number of specific objectives may be derived, such as “to increase the number of stores by 20 percent each year for the next five years.” The restaurant chain may have another goal, “to be known as the innovative leader in the industry.” On the basis of this goal, one of the specific objectives may be “to have 15 percent of sales each year come from seasonal offerings or new products developed during the preceding two years.”

As is apparent, the mission is generally viewed as enduring and long-term in nature. At the other end of the spectrum, objectives are seen as short-term with a fixed duration. In this respect, goals fit neatly between the mission and objectives, but the length of their duration can vary depending on context. Broadly speaking, *short-term goals* look about a year into the future, *intermediate-term goals* look about three to five years into the future, and *long-term goals* look six to ten years down the road. It should be noted that the notion of short, intermediate, and long with respect to the duration of goals is relative, however.

It is important to distinguish the concepts of mission, goals, and objectives from the concept of strategy. Whereas the mission, goals, and objectives emphasize the desired ends of organizational activity at various levels, the strategy connotes the organizational approach that will be taken to achieve the ends. The concepts are related and may even use some of the same language, but they should be differentiated.

It is also important to note the fine line between goals and objectives in contemporary business expression. Some leaders may even use the terms interchangeably. Although it is necessary to understand the key principle behind the distinction between terms—the need to incorporate measures into the equation—the use of different terms is not necessarily problematic as long as everyone in the organization understands their meanings.

Objectives are typically set in a number of areas. Most notably, organizations usually develop performance objectives utilizing measures such as profit, market share, and stock price. Managers often develop objectives for improvements in areas such as productivity, innovation and new product development, product quality, resource attainment, employee welfare, and social responsibility.



The mission is the reason for the company's existence. Goals are general ends needed to obtain the mission. Objectives are specific milestones needed to reach the goals.

Without verifiability and specificity, objectives will not provide clear direction for the organization. For example, if a manager states a departmental objective as "increases average order size to existing customers," it will not always be easy to tell whether or not the department has been successful. Would the department be successful if the average order increased by only one percent while inflation rose by five percent? Would the department be successful if the average order increased by ten percent but fifteen percent of the customers switched to competitors? Without specifics, individuals are left to debate success or failure based on their own perspectives of what happened and why.

Interestingly, specific and verifiable objectives can also lead to debates over the appropriateness of the measures used. For example, if the previous objective was revised to "increase sales to existing customers by ten percent," some might argue that sales representatives will have an incentive to ignore new customers in an effort to meet the stated objective. Hence, it is conceivable that pursuit of the objective could actually work against other departmental goals. Simply stated, a sales rep could pursue one objective at the expense of another. For this reason, it is essential that objectives not only be specific and verifiable, but that the most appropriate measures are selected.

4-2 The Case for Goals and Objectives

It has been argued that setting goals and objectives can be an arduous, cumbersome, and time-consuming process. However, goals and objectives are necessary for three main reasons.

First, they provide direction, guidance, and legitimacy for the organization. Without such guidance, employees will determine for themselves what should be done, why it should be done, and how their activities fit into the larger picture of organizational survival. For example, clerks at a department store's customer service desk often make decisions concerning whether customers without receipts or returning damaged goods should receive refunds. Without goals and objectives that embody the activities of the department, different clerks will inevitably make inconsistent judgments when faced with similar situations.

WILLIS KASSANDRA 216175

Career Point

Organizational Goals & Career Goals

What are your career goals? Should you be concerned about your organization's mission, goals, and the like? It depends on the company.

Organizations often disseminate a mission, goals, values, and other written statements as a means of guiding the firm's strategic and daily activities. An organization whose mission is "to provide customers with a level of value unsurpassed by any competitors" is setting guidelines for its decision-makers. If value to the customer is at the forefront, then managers must determine whether the ultimate customer value associated with any activity will surpass the costs incurred. These activities can include anything from production and equipment purchase decisions to how much is budgeted for employee travel.

Unfortunately many organizations create elaborate goals and mission statements as a formality or "gimmick." In the former case, everything is filed away at company headquarters and decisions are not affected. In the latter case, statements such as "the customer is king" or "our goal is zero defects" are plastered throughout the organization, but employees soon learn that objectives have not been set to measure whether or not the goals are being attained. In this situation, published goals can actually have a negative effect, as they are not only widely ignored but may create the impression among employees that the organization lacks any serious direction.

Ideally it is best to work for an organization whose goals are clearly defined, serve as real guidelines for decisions, and are compatible with individual goals. When you consider employment with an organization, you should ask not only for a short list of company goals, but how the organization is pursuing them.

WILLIS, KASSANDRA 2161TS

Second, goals create unity across functional and geographical units of the organization. Without organizational goals, units divided by function or geography are more likely to move in different direction and compete for resources instead of working together toward a common purpose. The existence of goals does not guarantee that a common purpose will be achieved, but it improves the likelihood that it will be pursued.

Customers typically come into contact with members of different departments within an organization. In many cases, these members may be located in different geographical locations. When each member of the organization, regardless of department or location, understands its goals, a higher level of consistency is likely to be achieved.

Third, goals and objectives motivate employees by encouraging workers to work toward their attainment. They set benchmarks for employee performance and challenge them to put forth maximum effort to reach them. When operational objectives are set for a one percent defect rate, for example, production workers can monitor success or failure easily and may be motivated to produce higher quality goods in an effort to meet the objective.

An organization's leadership should be proactive in developing its goals and objectives. At first glance it might appear that all organizations have goals and that most are well understood by their members.

Unfortunately this is not the case. In some organizations, goals are inferred but never specified because decision-makers do not take the time to identify them. It should be noted that goals emerge anyway in these organizations—at least to some extent—as individual members of the organization seek to identify ends toward which activity should be directed.

The problem with allowing goals to emerge is twofold . First, the goals that develop, either explicit or implicit, might not be appropriate for the organization. Consider an electronics components manufacturer as an example. Without strong leadership, the goals that evolve might emphasize the retention of two or three key customers because they account for a large percentage of revenues and members of the organization have become accustomed to working with them in the past. It is possible, however, that the organization might be better suited to reduce its dependence on these prime customers by cultivating additional accounts. Without forethought and planning, goals aimed at expanding the reach of the organization are not likely to develop.

Second, if goals are allowed to emerge, it is likely that competing sets of goals will evolve for different factions within the organization. The goals "developed" by production employees will probably concern production issues, those developed by the sales department will probably emphasize revenue generation, and so on. Hence, without central leadership in the development of goals, an organization can easily end up with counterproductive or contradictory goals.

In sum, managers should understand the importance of goals and objectives, and should seek to develop them in a proactive manner. Goals and objectives that are clear and appropriate for an organization can play a great role in improving its effectiveness. When goals or objectives are unclear, inconsistent, or simply do not exist, however, organizational effectiveness is likely to suffer as a result.

WILLIS, KASSANDRA 2161TS

4-3 Goals and Stakeholders

Establishing a mission, goals, and objectives may appear to be a non-controversial task. However, various **stakeholders**—individuals or groups who are affected by or can influence an organization's operations—have different perspectives on the purpose of an organization and can complicate the process. As a result, the task can become quite complex.

stakeholders
individuals or groups who are affected by or can influence an organization's operations

Top managers are responsible for establishing and communicating a vision for the organization that integrates the views of the various stakeholders. Hence, decision-makers of profit-seeking organizations should be concerned not only with the shareholders' primary objective of profits, but also with attaining the goals of other stakeholders as well.[1] Ultimately, the mission, goals, and objectives that eventually emerge should balance the pressures from the different stakeholder groups.

Various stakeholders often have different, even conflicting goals for an

organization.[2] This occurs because each stakeholder group—including stockholders, members of the board of directors, managers, employees, suppliers, creditors, and customers—views the organization from a different perspective. Table 4-1 suggests what some of the goals might be for key stakeholders in a typical organization.

TABLE 4-1 Suggested Goals of Stakeholders

Stakeholders	Goals
Customers	The organization should provide high-quality products and services at the most reasonable prices possible.
General public	The organization should provide goods and services with minimum environmental costs, increase employment opportunities, and contribute to social and charitable causes.
Suppliers	The organization should establish long-term relationships with suppliers and purchase from them at prices that allow the suppliers to remain profitable.
Employees	The organization should provide good working conditions, equitable compensation, and opportunities for advancement.
Creditors	The organization should maintain a healthy financial posture and a policy of on-time payment of debt.
Shareholders	The organization should produce a higher-than-average return on equity.
Board of Directors	Current directors should be retained and should be shielded from a legal liability.
Managers	The organization should allow managers to benefit financially from the growth and success of the company.

It is easy to see how stakeholder goals can conflict with one another. Following table 4-1, for example, shareholders are generally interested in maximum profitability, whereas creditors are more concerned with long-term survival so that their loans will be repaid. Customers wish to purchase high quality products at the lowest possible prices, whereas the general public may seek to require a firm to incorporate costly measures to cut pollution, a move that can ultimately raise prices. In addition, some individuals may be represented by disparate stakeholder groups. For example, employees may own shares of stock in a firm and also purchase its products. Top managers must reconcile these differences while pursuing its own set of goals, which typically includes quality of work life and career advancement.

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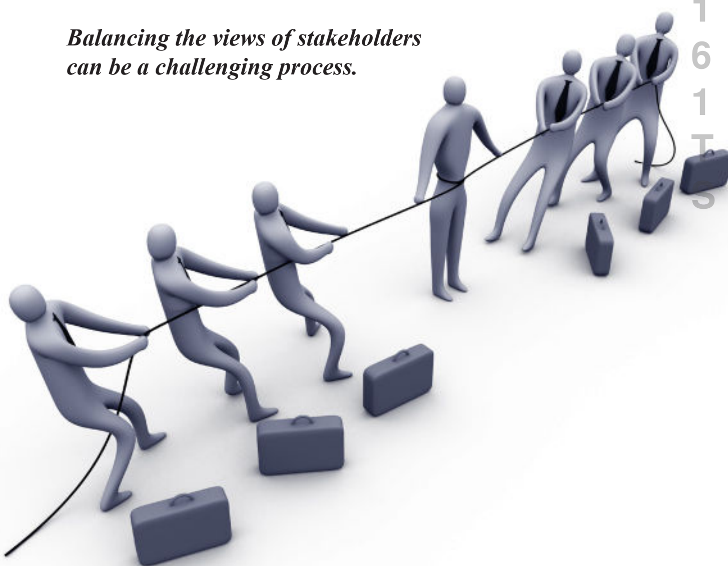

Balancing the views of stakeholders can be a challenging process.

Organizations create value for various parties, including employees through wages and salaries, shareholders through profits, customers through value derived via its goods and services, and even governments through taxes. Organizations, however, should not seek to maximize the value delivered to any single stakeholder at the expense of those goals of other groups.[3] Those that do so may enjoy desirable short-term results, but can jeopardize their long-term survival and profitability. For example, an organization that emphasizes the

financial interests of shareholders over the monetary needs of employees can alienate employees, motivating the top performers to seek employment elsewhere, thereby threatening the continued performance of the organization. Likewise, establishing long-term relationships with suppliers may restrict the organization's ability to remain flexible and change suppliers when necessary so that it can offer innovative products to customers. Top management is charged not only with the task of resolving opposing shareholder demands, but also with doing so in a manner conducive to long-term success for the organization. [4]

Balancing the various goals of an organization's stakeholders can be difficult. In a publicly traded organization, for example, top managers and the board of directors are primarily accountable to the firm's shareholders. As such, top managers are responsible for generating financial returns, and board members are charged with oversight of the firm's management. Some have argued, however, that this traditional *shareholder-driven* perspective is too narrow, and that financial returns are actually maximized when a *customer-driven* perspective is adopted, a view that is consistent with the marketing concept.[5] In other words, an organization should not focus on generating profits per se, but on satisfying customers, a process that ultimately increases profits in the long term. Consumer advocate and frequent U.S. Presidential candidate Ralph Nader has argued for more than 30 years that large corporations must be more responsive to customers' needs.[6]

WILLIS, KASSANDRA 2161TS

4-4 The Agency Problem

Ideally, top management should attempt to maximize the return to shareholders on their investment while simultaneously satisfying the interests of other stakeholders. However, because absentee owners (i.e., the shareholders) in publicly-held firms hire professionals to manage their organizations, some experts question the extent to which these managers pursue profits for the organization rather than seeking to satisfy their own personal goals.[7] In many instances, managers' goals of greater salaries and stability may be in direct opposition to shareholders' goals of high organizational performance. For this reason, it is not uncommon to see successful small organizations seeking to stay small so the owner can remain personally in charge of the major business decisions.

The **agency problem** refers to a situation in which a firm's managers—the "agents" of the owners—do not always act in the best interests of the shareholders. The extent to which the problem adversely affects most organizations is widely debated and factors associated with the problem can vary from country to country.[8] Indeed, some argue that management primarily serves its own interests, whereas others contend that managers share the same interests as the shareholders. These two perspectives are briefly discussed in sections 4-4a and 4-4b.

agency problem
a situation in which a firm's top managers (i.e., the "agents" of the firm's owners) do not act in the best interests of the shareholders

4-4a Management Serves Its Own Interests

According to one perspective, top managers tend to make decisions that ultimately increase their own salaries and other rewards. Hence, top managers are likely to grow their firms even if growth is not the optimal strategy because executive salaries tend to be higher in larger firms.[9]

Executives may also pursue **diversification**, increasing the size of their firms by acquiring other companies. Diversification not only increases a firm's size but may also improve its survivability by spreading risk among business units operating in different markets. However, diversification pursued only to spread risk is generally not in the best interest of shareholders since they always have the option of reducing their financial risks by purchasing shares in other corporations.[10] This perspective does not suggest that top managers are unconcerned with firm performance, but rather that top managers may deemphasize it when personal considerations are also involved in a decision.

diversification
the process of acquiring companies to increase a firm's size

The extent to which this perspective is accurate can create an advantage for relatively small, entrepreneurial organizations whose owners actively manage the firm. Because owners and managers are one and the same, no agency problem exists. For this reason such organizations may be able to compete aggressively and successfully with their larger rivals, especially if they concentrate their efforts on limited domains within a given market.

4-4b Management and Stockholders Share the Same Interests

Because managers' livelihoods are directly related to the success of an organization, one can argue that managers generally share the same interests as the stockholders. Because management rewards rise with firm performance, managers by definition are most concerned with organization performance, not individual concerns. Many experts argue that managerial jobs are structured in ways that force managers to attempt to enhance profits.[11]

4-4c Resolving the Agency Problem

Historically, the agency problem was not a concern in the early years of the industrial revolution. During that time owners and their family members served as active supervisors. Organizations tended to be small and ownership was not typically dispersed. When non-family members were secured as managers, they were usually watched closely by an owner. Hence, the agency problem became pervasive only when the corporate form of ownership became more widely spread.

Today, the debate over whether top managers are primarily

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Best Practices

Employee Ownership in American Firms

The National Center for Employee Ownership (NCEO) publishes a list of the Employee Ownership Top 100, including U.S.-based firms that are at least 50 percent employee-owned through an ESOP, stock purchase plan, or other broad-based ownership plans.

Florida-based Publix Supermarkets is one of the largest firms on the list. The grocery chain operates about 800 stores in Florida, Alabama, Georgia, South Carolina, and Tennessee. Publix ownership is distributed to employees through ESOPs and stock purchase plans. Almost 100,000 employees are shareholders, comprising almost two-thirds of the total number of shareholders for the firm.

Although a significant portion of the company is owned by non-employees, Publix circumvents some of the concerns associated with the agency problem by distributing ownership widely among its employees. Because they are both managers and owners, decision-makers have an incentive to act in the best interest of the shareholders.

Interestingly, four of the top ten employee-owned companies as of 2004 are grocery chains. In addition to Publix, Hy-Vee, Price Chopper, and Brookshire Brothers are also on the list.

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concerned with their firms' returns or their own interests continues. Most managers, however, acknowledge truth in both perspectives. In reality, differences in perspective are a matter of degree. It is also likely that the degree to which the agency problem exists is related to factors such as the industry in which an organization competes, the size of the firm, and even its position in the organizational life cycle.

Ultimately, resolving the different perspectives on the agency problem is a philosophical and experiential endeavor. Some managers may argue for the existence of a serious agency problem while others in the same organization may not perceive the problem to be significant. Regardless of perspective, manager and shareholder goals may be easily aligned when managers also own part of a firm. Hence, one of the most common suggestions for aligning the goals of top management and those of shareholders is to award shares of stock or stock options to top management, transforming professional managers into shareholders. Many companies have adopted **employee stock ownership plans (ESOPs)** to distribute shares of the company's stock to managers and other employees over a period of time.

Stock option plans and high salaries may bring the interests of top management and stockholders closer together.[12] Top executives must deliver high performance for the organization in order to protect

employee stock ownership plans (ESOP)
a formal program that transfers shares of stock to a company's employees.

their salaries and option plans. Research supports this notion, suggesting that as managerial stock ownership rises, the interests of managers and shareholders begin to converge to some extent.[13] Many organizations pursue compensation models designed to bring the two sides together, such as those that emphasize stock options and profit sharing for managers instead of fixed pay levels.

4-5 Organizational Effectiveness

The concepts of goals and objectives—as well as the agency problem—assume that the outcomes of an organization's activities can be readily understood. The idea of organizational performance is primarily associated with financial and market-oriented measures. Organizational effectiveness is an elusive, broader term and can mean different things to different people. We define **organizational effectiveness** as the extent to which an organization utilizes its resources effectively to accomplish its goals and objectives. Although traditional metrics such as profits, market share, and stock price are useful in assessing organizational effectiveness, other factors such as productivity, creativity, and human capital are also considered.

organizational effectiveness
the extent to which an organization utilizes its resources effectively to accomplish its goals and objectives

The notion of organizational effectiveness cannot be fully understood without also recognizing its relationship to organizational resources. **Organizational capacity** refers to an organization's ability to remain effective and sustain itself over the long term. It is possible for an organization to be highly effective with limited capacity, although this is typically not the case. In practice, organizations seek to acquire valuable resources to build capacity and ultimately improve effectiveness.

organizational capacity
an organization's ability to remain effective and sustain itself over the long term

There are many ways top managers can foster organizational effectiveness. First, its leaders can build trust and autonomy among its members. Trust leads to increased autonomy and free sharing of information, and ultimately greater job satisfaction, organizational commitment, and personal performance.[14] Second, its leaders can create a productive and supportive work environment, including factors such as comfortable and sufficient office space, ergonomic awareness, and an emphasis on training and development. Of course, there are costs associated with these activities, and they should be taken into account. However, the costs can be offset in many cases by improvements in effectiveness. Third, its leaders can build capacity. Pressures to meet short-term financial goals often relegate capacity building to a back seat position. Many organizations invest capital only in outcomes that can be immediately measured or quantified. Instead, these organizations should invest in activities and resources that can serve as the foundation for *long-term* organizational effectiveness.

WILLIS, KASSANDRA 2161T

4-5a Measuring Organizational Effectiveness

Although concepts such as organizational effectiveness and capacity are broad enough to assist managers in communicating about their organizations, both are notoriously difficult to measure. For this reason, some managers emphasize only basic financial and accounting measures such as return on assets and sales growth. One problem with this approach is that each measure tells only a piece of the story. Astute managers examine multiple measures—some non-financial—when evaluating an organization's outcomes. In general, performance is associated with profit measures whereas organizational effectiveness is considered with other factors as well.

Because individual measures of performance and effectiveness can provide a limited snapshot of the firm, a number of companies have begun using a **balanced scorecard** approach, whereby measurement is not based on a single quantitative factor, but on an array of quantitative and qualitative factors, such as return on assets, market share, organizational capacity, customer loyalty and satisfaction, speed, and innovation.[15]

balanced scorecard
an approach to measuring performance or organizational effectiveness based on an array of quantitative and qualitative factors, such as return on assets, market share, organizational capacity, customer loyalty and satisfaction, speed, and innovation

Four primary perspectives are inherent within the balanced scorecard approach. The *financial perspective* is concerned with traditional performance measures such as profitability, return on investment, and improvement in stock price. The *customer* perspective considers such factors as customer service, loyalty, and satisfaction. The *learning and growth* perspective evaluates such areas as the degree to which an organization is engaged in continuous improvement and is able to retain its most valuable human resources. The *internal business process* perspective emphasizes the value an organization delivers to its customers and shareholders.[16]

As can be seen, the balanced scorecard is concerned not only with the traditional performance measures as captured in the financial perspective, but also with broader, "softer" measures that can be easily overlooked when a firm is focused solely on short-term financial performance. Interestingly, one can argue that high marks along the other three perspectives can position the organization for superior financial performance in the long term. The key to employing a balanced scorecard is to select a combination of performance measures tailored specifically to the organization. In other words, each organization's members should develop a reasonable number of simple measures that collectively reflect the organization's effectiveness.[17]

Another problem with measuring organizational performance is that one measure can be pursued to the detriment of another. The common goals of growth and profitability represent an example of this phenomenon. Many firms pursue growth by investing in R&D or new product development, or by slashing prices to gain customers. Either approach tends to reduce profits, at least in the short term. This reality was reflected in Ford's decision to cut North American production in the early 2000s and sacrifice market share in order to enhance profits. Ford's market

WILLIS, KASSANDRA 2161TS

share declined from about 22 percent in 2001 to below 19 percent in 2004, but profits increased steadily during this same period.[18]

One approach to measuring organizational effectiveness involves the examination of three key organizational processes: (1) Controlling the external environment, (2) maintaining efficiency within operations, and (3) fostering innovation.[19] Specific goals can be developed to move the organization toward greater effectiveness in each of these realms.

Controlling the external environment is difficult for any organization to do, especially smaller ones. The key to effective control, however, is the ability of a firm to secure the resources to produce and market its products or services. As such, traditional performance indicators such as stock price, market share, revenue growth, and return on assets may be used to reflect the control dimension. Managers may set goals such as increasing profits or market share as means of pursuing effectiveness in control.

Maintaining efficiency is concerned with more technical issues. Within this realm, managers are concerned with an organization's ability to produce a high quantity and quality of products or services relative to the amount of input it consumes. As such, managers should evaluate changes in technology on a continuous basis to reduce costs and increase quality. Efficiency is measured by such indicators as quality, production costs, and customer service. Managers may set goals such as reducing product defects, cutting delivery time, and improving customer satisfaction as means of pursuing efficiency.

Whereas efficiency is primarily concerned with improving existing products, services, and processes, innovation is concerned with the identification of new and better ones. As such, managers can foster innovation by developing the organization's human, physical, and organizational resources. Innovative firms minimize conflict, support worthy initiatives, and empower employees to make better decisions. As such, indicators such as rate of new product development and employee coordination are often used to reflect an organization's level of innovation.

Although it is not difficult to identify prospective indicators for each of the three processes, measuring them is far from easy, especially for innovation. For example, developing new products is an activity generally presumed to reflect innovation with a firm. However, it is difficult to determine precisely how many new products should be developed within a given time period. In addition, the ultimate success or failure of new product introductions, as well as the costs to develop and move them to market, should also be considered.

The interrelationships among these three broad measures—control, efficiency, and innovation—cannot be overstated. For example, an organization that excels in control by securing the appropriate resources may be in a better position to utilize them to produce more efficiently or to create new products or services. Hence, managers may wish to emphasize excellence in one realm should realize that they may be sacrificing excellent in the other two.

Production efficiency cam be measured by examining indicators such as units per time period, cost per unit, and defective rates

WILLIS, KASSANDRA 61TS

4-6 Controlling Organizational Effectiveness

Organizational control consists of determining the extent to which organizational effectiveness is attained and taking corrective measures to improve effectiveness if needed. Organizational control is similar to but broader than strategic control, which emphasizes the extent to which strategies are effective. Whereas strategies at various levels may emphasize a limited number of goals, organizational control is concerned with issues and processes that may not be considered strategic.

organizational control
determining the extent to which organizational effectiveness is attained and taking corrective measures to improve effectiveness if needed

Organizational control can be exerted through three primary means. Control can be exerted through strategic control, from the board of directors through proper oversight, and from outside of the organization via takeover. Control measures taken by managers within the organization are usually more effective and efficient. These measures are summarized in table 4-2 and discussed in greater detail below.

Table 4-2. Sources of Organizational Control

Level	Nature of Organizational Control	Emphasis of Control
Within the Management Ranks of the Organization	Strategic Control	Ensure that strategies at all levels (firm, business, and functional) contribute to organizational effectiveness and that organizational divisions are properly managed.
Board of Directors	Strategic and Organizational Oversight	Ensure that firm-level strategies contribute to organizational effectiveness and that top managers represent the wishes of the shareholders.
Outside of the Organization	Takeovers	Outsiders acquire the organization and implement major changes to improve effectiveness.

4-6a Exercising Control Within the Organization

Organizational control within the organization is generally concerned with the strategy of the organization. Although control may be instituted at other management levels, it is usually initiated by the chief executive and/or members of the **top management team**. It should be noted that the chief executive is the individual ultimately responsible for the organization's management but rarely acts alone. In most organizations, a *team* of top-level executives—including members of the board of directors, vice presidents, and various line and staff managers are also involved. Most top executives build a top management team to add different perspectives and improve decision quality.[20]

top management team
the team of top-level executives—including members of the board of directors, vice presidents, and various line and staff managers—all of whom play instrumental roles in managing the organization

Organizational control from within the organization can be initiated in a number of ways. One is **competitive benchmarking**—the process of measuring a firm's performance against that of the top performers, usually in the same industry. After determining the appropriate benchmarks, goals can be set to meet or exceed them. **Best practices**—processes or activities that have been successful in other organizations—may be adopted as a means of improving performance.

competitive benchmarking
the process of measuring a firm's performance against that of the top performers, usually in the same industry

best practices
processes or activities that have been successful in other organizations

Benchmarking tends to occur most frequently at the top of an organization, but can also occur at middle and lower management levels. At the top level, factors such as profitability, market share, and revenue growth may be applied. The most appropriate performance benchmarks are those associated with the strategy's success, and those over which the organization has control. The importance of specificity cannot be overstated, however. For example, if market share is identified as a key indicator of the success or failure of a growth strategy, a specific market share should be identified, based on past performance and/or industry norms. Without specificity, it is difficult to assess the effectiveness of a strategy after it is implemented if clear targets are not identified in advance.

The data required to set benchmarks is often readily available. For example, *Fortune* magazine annually publishes the most- and least-admired American corporations with annual sales of at least $500 million in such diverse industries as electronics, pharmaceuticals, retailing, transportation, banking, insurance, metals, food, motor vehicles, and utilities. Corporate dimensions are evaluated along factors such as quality of products and services, innovation, quality of management, market share, financial returns and stability, social responsibility, and human resource management effectiveness. Publications such as *Forbes, Industry Week, Business Week*, and the *Industry Standard* also provide performance scorecards based on similar criteria. Although such lists generally include only large, publicly traded companies, they can offer high-quality strategic information at minimal cost to the strategic managers of all organizations, regardless of size. Published information on areas such as quality, innovation, and market share can be particularly useful measures.

Consumer Reports is also an excellent source of product quality data, evaluating hundreds of products from cars to medicine each year. Because *Consumer Reports* accepts no advertising, its evaluations are relatively free of bias, rendering it an excellent source of product quality information. Even if an organization's products or services are not evaluated, its managers can still gain insight on the quality of products and services produced by competitors, suppliers, and buyers.

Specific published information may also exist for organizations in select industries. One of the best known is the "Customer Satisfaction Index" released annually by J.D. Power for the automobile industry. A survey of new-car owners each year examines such variables as satisfaction with various aspects of vehicle performance; problems reported during the first 90 days of ownership; ratings of dealer service quality; and ratings of the sales, delivery, and condition of new vehicles.[21] Numerous Internet sites—such as Virtualratings.com—offer quality ratings associated with a number of industries for everything from computers to university professors.

Excercising strategic control requires that anticipated performance be compared to actual performance

An organization's top managers may seek to change how activities are performed, both formally and informally. The **formal organization**—the official structure of relationships and procedures used to manage organizational activity—can facilitate or impede a firm's success. When problems occur, it may be necessary to implement changes within the existing formal organization or consider changing it altogether.

formal organization the official structure of relationships and procedures used to manage organizational activity

For minor and less complex problems, managers can implement changes within the formal organization before an activity begins, while it is occurring, and after an activity has already occurred. Needless to say, it is generally desirable to institute a control measure as early as possible. A **feedforward control** anticipates problems and is initiated prior to an occurrence of an activity. For example, most major airlines have instituted preventative maintenance programs designed to reduce flight delays and crashes.

feedforward control a measure that anticipates problems and is initiated prior to an occurrence of an activity

A **concurrent control** seeks to correct a problem while it is occurring. Supervision is a common means of exercising concurrent control. Even when constant direct supervision is not required, managers often "walk around" their departments from time to time to learn about potential problems in their early stages.

concurrent control a measure that seeks to correct a problem while it is occurring

Although it is best to anticipate a problem and correct it before it occurs—or at least while it is occurring—this is not always possible. A **feedback control** seeks to correct a problem after it has occurred and prevent it from happening again. For example, a task force may be appointed to investigate reasons contributing to a major breakdown in a production facility and reduce the chance that it occurs again.

feedback control a measure that seeks to correct a problem after it has occurred and prevent it from happening again

When problems are acute, however, changing the organization's structure may be desirable, as discussed in chapter five. Substantial structural changes cannot be easily implemented and typically require a large amount of training and development. Top managers at many of these firms underestimated the complications associated with transforming their organizational structures into a more complex matrix structure.

In contrast to the formal organization, the **informal organization** refers to the norms, behaviors, and expectations that evolve when individuals and groups come into contact with one another.[22] The informal organization is dynamic and flexible and does not require managerial decree to change. When top executives use the formal organization effectively, the informal organization tends to reinforce the formal organization and promote the same values. However, when the organization's value system is unclear or even contradictory, the informal organization will ultimately develop its own set of values and rewards. For example, every organization claims to reward high job performance. However, when promotions and pay increases go to individuals who have the greatest seniority (regardless of performance level), employees will lose motivation and develop their own set of informal rules concerning what will and will not be rewarded.

informal organization the norms, behaviors, and expectations that evolve when individuals and groups come into contact with one another

Managers at all levels must recognize that they can *influence*, but cannot control,

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the informal organization. Interestingly, the most effective means of influencing the informal organization is to develop and promote a formal organization that is consistent with the core values of the firm. The informal organization becomes dysfunctional when it develops means to address inconsistencies in the formal organization.[23]

4-6b Corporate Governance and the Board of Directors

corporate governance
the board of directors, institutional investors, and block holders who monitor firm strategies to ensure managerial responsiveness

Corporate governance refers to the board of directors, institutional investors (e.g., pension and retirement funds, mutual funds, banks, insurance companies, among other money managers), and large shareholders known as blockholders who monitor organizational strategies and performance to ensure effective management. Boards of directors and institutional investors are generally the most influential in a typical governance system. Because institutional investors own more than half of all shares of publicly traded firms, they tend to wield substantial influence. Blockholders tend to hold less than 20 percent of all firm shares, so their influence is proportionally less than that of institutional investors.[24] Nonetheless, both institutional investors and blockholders are in a position to influence decision-making to an extent that few individual shareholders can.

Boards often include both inside (i.e., firm executives) and outside directors. Insiders bring company-specific knowledge to the board, whereas outsiders bring independence and an external perspective. Over the past several decades, the composition of the typical board has shifted from one controlled by insiders to one controlled by outsiders, allowing board members to oversee managerial decisions more effectively.[25] Furthermore, when additional outsiders are added to insider-dominated boards, CEO dismissal is more likely when corporate performance declines[26] and outsiders are more likely to pressure for corporate restructuring.[27]

Many experts argue that one organization's board members should limit their service on other boards. In the 1990s, the number of corporate board members with memberships in other boards began to increase dramatically. With outside directors of the largest 200 firms commanding an average of $152,000 in cash and equity in 2001, a number of companies became concerned about both potential conflicts of interest and the amount of time each individual can spend with the affairs of each company. As a result, many companies have begun to limit the number of board memberships their own board members may hold. By 2002, approximately two-thirds of corporate board members at the largest 1500 U.S. companies did not hold seats on other boards[28] This change has been underscored by the Sarbanes-Oxley Act of 2002, which requires that firms include more independent directors on their boards and make new disclosures on internal controls, ethics codes and the composition of their audit committees on annual reports. A number of analysts have noted positive changes among boards as a result of this legislation in terms of both independence and expertise.[29]

WILLIS, KASSANDRA 2161TS

Boards of directors are composed of officials elected by the shareholders and are responsible for monitoring activities in the organization, evaluating top managers, and establishing the broad strategic direction for the firm. As such, boards are responsible for selecting, compensating, and replacing the chief executive officer, advising top management on strategic issues, and monitoring managerial and company performance as representatives of the shareholders. A number of critics charge, however, that board members do not always fulfill their legal roles.[30] One reason is that board members are nominated by the CEO, who expects them to support his or her strategic initiatives. Another reason is the generous compensation they often receive.[31]

When boards are controlled by insiders, a "rubber stamp" mentality can develop, whereby directors do not aggressively challenge executive decisions as they should. This is particularly true when the CEO also serves as chair of the board, a practice known as **CEO duality**.[32] Insider board members—especially those who report to the CEO—may be less willing to exert control when the CEO also serves as chair of the board. In the absence of CEO duality, however, insiders may be more likely to contribute to board control.

CEO duality
a situation in which the CEO also serves as the chair of the board

Pressure on directors to acknowledge shareholder concerns has increased over the past two decades. The major source of pressure in recent years has come from institutional investors. By virtue of the size of their investments, they wield considerable power and are more willing to use it than ever before.

It should be noted, however, that some board members have played effective stewardship roles. Many directors promote strongly the best interests of the firm's shareholders, as well as those of various other stakeholder groups as well. By conscientiously carrying out their duties, effective directors can ensure that management remains focused on company performance.[33]

A number of recommendations have been made on how to promote effective governance. It has been suggested that outside directors be the only ones to evaluate the performance of top managers against established mission and goals, that all outside board members should meet alone at least once annually, and that boards of directors should establish appropriate qualifications for board membership and communicate these qualifications to shareholders. For institutional shareholders, it is recommended that institutions and other shareholders act as owners and not just investors,[34] that they not interfere with day-to-day managerial decisions, and that they evaluate the performance of the board of directors regularly.[35]

WILLIS, KASSANDRA 21617TS

4-6c Takeovers

When shareholders conclude that the top managers with ineffective board members are mismanaging the firm, institutional investors, blockholders, and other shareholders may sell large portions of their shares, substantially lowering the market price of the company's stock.[36] Depressed prices often lead to a

takeover, a purchase of a controlling quantity of a firm's shares by an individual, a group of investors, or another organization. Takeovers may be attempted by outsiders or insiders (i.e., managers), and may be friendly or unfriendly. A friendly takeover is one in which the prospective buyer(s) work with the board to negotiate a transaction. In contrast, an unfriendly takeover is one in which the target firm resists the sale. In this instance, one or more individuals may purchase enough shares in the target firm to either force a change in top management or to manage the firm themselves. Interestingly, groups that seek to initiate unfriendly takeovers often include current or former firm executives.

In many cases, sudden takeover attempts rely heavily on borrowed funds to finance the acquisition, a process referred to as a **leveraged buyout (LBO)**. LBOs strap the company with heavy debt and often lead to a partial divestment of some of the firm's subsidiaries or product divisions to lighten the burden.[37] Top managers often become wary of LBOs if share prices drop precipitously, thereby enabling would-be investors to acquire the firm at a lower cost.

Corporate takeovers provide a system of checks and balances often required to initiate changes in ineffective management. Proponents argue that the threat of LBOs can pressure managers to operate their firms more efficiently.[38] However, the debt created by a takeover can cause management to pursue activities that are expedient in the short run but not best for the firm in the long run. In addition, the extra debt required to finance an LBO tends to increase the likelihood of bankruptcy for a troubled firm.[39]

takeover
the purchase of a controlling quantity of shares in a firm by an individual, a group of investors, or another organization. Takeovers may be friendly or unfriendly

leveraged buyout (LBO)
a takeover in which the acquiring party borrows funds to purchase a firm

Summary

An organization's mission outlines the reason for its existence. A clear purpose provides managers with a sense of direction and can guide all of the organization's activities. Goals represent the desired general ends toward which organizational efforts are directed. However, managers, shareholders, and board members do not always share the same goals. Top management must attempt to reconcile and satisfy the interests of each group of stakeholders.

The concept of organizational effectiveness evaluates the extent to which an organization accomplishes its goals and objectives. Measuring organizational effectiveness is a complex process and should include a number of factors, not only accounting and financial performance measures. One approach, the balanced scorecard, evaluates other dimensions of performance beyond the financial realm.

When effectiveness is not attained, control measures are necessary. Organizational control can be initiated from within the organization's management ranks, through its board of directors, or from outside of the organization through takeovers. Generally speaking, control closest to the source of the problem is the most desirable.

WILLIS, KASSANDRA 21614TS

Review Questions & Exercises

1. Do missions often change over time? Should missions remain constant? Why or why not?
2. What is organizational effectiveness and how is it measured?
3. Why do stakeholders in the same organization often have different goals? Would it not be best if they shared the same goals? Explain.
4. Which control form—feedforward, concurrent, or feedback—is most desirable? Which is most effective? Explain.

WILLIS, KASSANDRA 216ITS

Glossary

- **Agency Problem:** A situation in which a firm's top managers (i.e., the "agents" of the firms' owners) do not act in the best interests of the shareholders.
- **Balanced Scorecard:** An approach to measuring performance or organizational effectiveness based on an array of quantitative and qualitative factors, such as return on assets, market share, organizational capacity, customer loyalty and satisfaction, speed, and innovation.
- **Best Practices:** Processes or activities that have been successful in other organizations.
- **CEO Duality:** A situation in which the CEO also serves as the chair of the board.
- **Competitive Benchmarking**: The process of measuring a firm's performance against that of the top performers, usually in the same industry.
- **Concurrent Control:** A measure that seeks to correct a problem while it is occurring.
- **Corporate Governance:** The board of directors, institutional investors, and block holders who monitor firm strategies to ensure managerial responsiveness.
- **Diversification:** The process of acquiring companies to increase a firm's size.
- **Employee stock ownership plan (ESOP):** A formal program that transfers shares of stock to a company's employees.
- **Feedback Control:** A measure that seeks to correct a problem after it has occurred and prevent it from happening again.
- **Feedforward Control:** A measure that anticipates problems and is initiated prior to an occurrence of an activity.

- **Formal Organization:** The official structure of relationships and procedures used to manage organizational activity.

- **Goals:** Desired general ends toward which efforts are directed.

- **Informal Organization:** The norms, behaviors, and expectations that evolve when individuals and groups come into contact with one another.

- **Leveraged buyout (LBO):** A takeover in which the acquiring party borrows funds to purchase a firm.

- **Mission:** The reason for an organization's existence. The mission statement is a broadly defined but enduring statement of purpose that identifies the scope of an organization's operations and its offerings to the various stakeholders.

- **Objectives:** Specific, verifiable, and often quantified versions of a goal.

- **Organizational Capacity:** An organization's ability to remain effective and sustain itself over the long term.

- **Organizational Control:** Determining the extent to which organizational effectiveness is attained and taking corrective measures to improve effectiveness if needed.

- **Organizational Effectiveness:** The extent to which an organization utilizes its resources effectively to accomplish its goals and objectives.

- **Stakeholders:** Individuals or groups who are affected by or can influence an organization's operations.

- **Takeover:** The purchase of a controlling quantity of shares in a firm by an individual, a group of investors, or another organization. Takeovers may be friendly or unfriendly.

- **Top Management Team:** The team of top-level executives—including members of the board of directors, vice presidents, and various line and staff managers—all of whom play instrumental roles in managing the organization.

WILLIS, KASSANDRA 21617TS

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WILLIS, KASSANDRA 2161TS