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Part 1

The Business in its Environment

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Every business begins with an idea of a product or service that people will need and be willing to buy. Turning that idea into an economic activity, that will both satisfy the needs of some groups of consumers and generate profits for the owners, is the starting point of Part 1. Most businesses involve a number of people working together. Even in the early stages, therefore, they can be said to have some kind of organization, albeit a rudimentary one, such as two people in partnership. This organizational background is the focus of Chapter 1, which goes on to look at how complex organizations develop and form strategies. The organizational theme is continued in Chapter 2, with an examination of the various functions which business enterprises entail. As will be seen, developing a strategic approach for the long haul involves coordination and balance between these functions.

The most immediate environmental factors which impinge on, and interact with, a

business are its local and national environments. These form the bases of Chapters 3 and 4. In Chapter 3, the essential characteristics of a national economic system are examined, while in Chapter 4, different types of national economic systems are discussed, with an eye on how they facilitate enterprises. Case studies in these chapters present examples of businesses which have succeeded (and also some which have struggled) in differing national environments. While the great variety of economic systems across the world is a striking feature, it is also striking to see how businesses adapt in different environments. The final case study in Part 1, on Coca-Cola, brings together these themes. Coca-Cola as a business has faced challenges in terms of its organization, its responsiveness to customers' needs and its operations in different countries. This case is also an appropriate introduction to the dimensions of the international environment explored in Part 2.

1

The internal business environment

Outline of chapter

- Introduction
- What is business?
- Classification of businesses
 - Forms of business ownership
 - Classification of businesses by size
- Business organization
 - Functional approach
 - Divisional structure
 - Matrix structure
- Organizations and change: business strategy
- Hierarchies and networks
- Corporate governance
 - Governance structures
 - Governance issues in the contemporary environment
- Tools for formulating business strategy
 - PEST analysis
 - SWOT analysis
- Conclusions

Learning objectives

- 1 To identify key elements of the internal and external aspects of the business environment and their dynamic interaction.
- 2 To recognize different types of business ownership and different designs of business structure and their implications for how businesses are run.
- 3 To appreciate the many dimensions of strategic change in organizations, in the context of the changing international environment.
- 4 To understand the principles underlying corporate governance and their implications for diverse governance structures and practices.
- 5 To use simple strategic planning tools, including PEST and SWOT analysis.

Introduction

Business takes place the world over, in a huge diversity of societies and between widely varying organizations. The business environment has become more complex, with expanding and deepening ties between societies and between the many organizations within those societies. Moreover, many large organizations now see themselves as truly global in scope, not rooted in any one society. The business environment may be visualized in terms of layers, beginning with the immediate internal environment within the organization, and moving outwards to the external environment surrounding the business and influencing its organization and operations (see Figure 1.1). The external environment includes an array of dimensions, including economic, political, legal and technological factors. While only a few decades ago these external aspects were seen as centring on the home country of the business, the environmental horizon of business has now widened to take in a host of international forces, which interact with national and local factors.

Tensions exist between an organization and the external forces that impact on it, from local through to international, and these tensions are reflected in its internal environment. This chapter sets the scene by focusing on the essential elements of the internal environment, beginning with the ways in which different types of organization are formed and structured. Business organization, processes and strategy change over time, responding to changing circumstances in both the internal and external environments. This chapter covers a wide range of organizations. When we think of international business, we tend to think of large multinationals, but most of the world's businesses are very much smaller, and, increasingly, these smaller firms are becoming international in their outlook. A large American corporation such as IBM

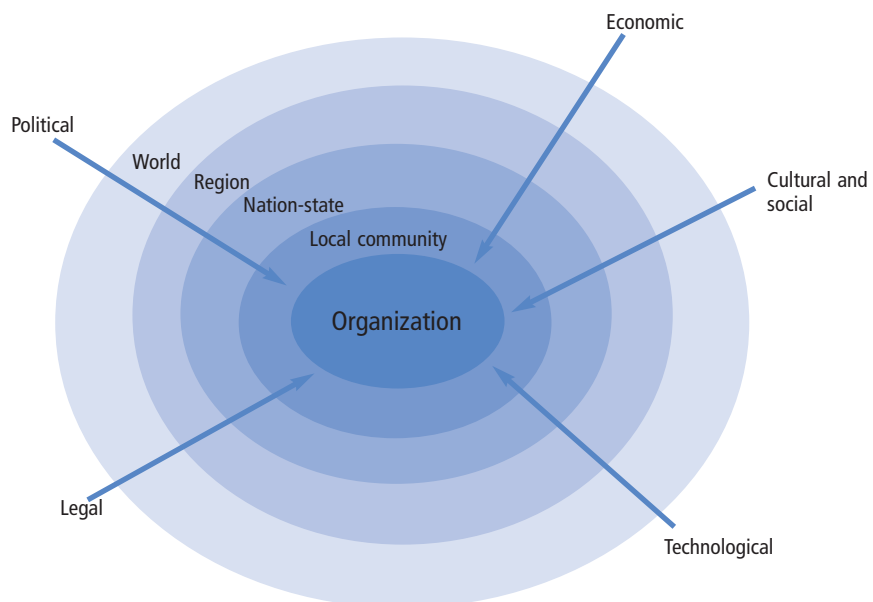


Figure 1.1 The business organization in its environment

may seem to have very little in common with a family-run firm in Hong Kong. Yet both face challenges common to businesses over the centuries, such as how to achieve a smooth-running and efficient organization and how to satisfy the needs of customers. Their responses may be different, but both will be addressing universal issues, each in its own way.

What is business?

Business refers to the vast array of economic activity, in which goods and services are supplied in exchange for some payment, usually money. It includes buying and selling, manufacturing products, extracting natural resources and farming. While the word covers business activities in general, as in the term, 'the business community', it is also used in relation to individual businesses. Businesses generally aim to make a profit, but there are also numerous not-for-profit enterprises in every society, such as charities and educational bodies. While we tend to think of business-people as private individuals, governments often engage in business activities, which are directed towards benefiting society. Business has been around a long time. Ancient societies grew prosperous largely because of thriving business activity, extending to trade with other countries (Landes, 1998). The urge to do business also seems to be universal, taking place in all societies, even in communist societies which do not officially recognize private enterprise. When we look at the variety of products and services that are taken for granted in modern consumer societies, such as motor-cars, convenience food, fashion and entertainment, we can see that all have arisen through business activities.

Typically, business begins in a small way, nurtured by a talented and enthusiastic founder, the entrepreneur, who commits his or her own funds as well as energy to the enterprise. The **entrepreneur** is:

one who creates a new business in the face of risk and uncertainty for the purpose of achieving profit and growth by identifying opportunities and assembling the necessary resources to capitalize on them. (Zimmerer and Scarborough, 1998, p. 3)

While many fall by the wayside, some go on to develop into the large enterprises that we are familiar with today. McDonald's, the fast-food restaurant, for example, started life as a single hamburger outlet in the US, in 1955, and has grown into a global company with thousands of restaurants in 120 countries. Like other successful companies, it has evolved as an organization, becoming more complex as it has grown. A large proportion of its restaurants, mainly those in the US, are run as franchises (described later in this chapter), by which individual entrepreneurs own the business and operate it under an agreement with McDonald's.

International business refers to business activities that straddle two or more countries. Businesses are increasingly looking beyond the bounds of their home country for new opportunities. A company may begin by selling its products or purchasing raw materials abroad, and go on to producing its products abroad. Or, as in the case of McDonald's, it may open restaurants abroad. Nowadays, thanks to advances in

communication technology and transport, it is easier for companies to expand a variety of business activities across national borders. However, 'going global' adds considerably to the complexity of the organization (Bartlett and Ghoshal, 1998). The domestic business does not simply grow bigger, but international activities add a new dimension, which will be reflected in the organization of the company, and how it is run. When a company expands to the extent that a large portion of its business is outside its home country, it becomes a global business. (These points will be discussed in Chapter 5.) Its shareholders, too, may be dispersed across the globe. McDonald's now derives over half its profits from outside the US, and indeed, its growth overseas is stronger than its growth at home. Amazon.com was one of the earliest internet retailers. Largely due to the perseverance and vision of its enthusiastic founder Jeff Bezos, it was able to weather the collapse in dot.com businesses in 1999 (see minifile). His innovative internet retailing model was designed for US consumers, but has evolved as the business has become internationalized.

Some businesses are conceived as international in scope at the time of their founding. Referred to as 'born-globals', these firms have become more common in the areas of information technology (Knight and Cavusgil, 2004). In contrast to the more traditional pattern of becoming established at national level before expanding internationally, these firms' managers think from the outset in terms of international resources and international markets. Picsel Technologies, described in the second minifile, is an example of a born-global enterprise. Note that it is highly entrepreneurial and innovative – characteristics that it shares with other firms of this type.

WEB ALERT!

For entrepreneurship, look at the following websites:

<http://entrepreneurship.mit.edu>

<http://www.entreworld.com>

<http://www.gemconsortium.org>

The UK Small Business Service, run by the Department of Trade and Industry, is at <http://www.sbs.gov.uk>

Business, whether national or international, consists of a number of different activities or functions. The main functions are operations, human resource management (HRM), accounting, marketing, and research and development (R&D). Each function plays a crucial part in the process of designing and producing products which meet the needs of customers, for prices they are willing to pay. In a small business, workers may well turn their hand to several different functions, while in larger organizations, there is a group of specialized workers for each function. Although they may be seen as separate specialist activities, the ability to coordinate them effectively in pursuit of the business's overall goals is a key to business success. Functions are examined in detail in the next chapter. The functional approach to organizational structures is introduced later in this chapter.

Minifile

AMAZON.COM

- 1994: Founder, Jeff Bezos starts Amazon.com with \$10,000; borrows \$44,000
- 1995: Founder's father and mother invest \$245,000
- 1995–6: Business 'angels' invest nearly \$100,000
- 1996 (May): Founder's family invest \$20,000
- 1996 (June): Two venture capital funds invest \$8 million
- 1997: Initial public offering: 3 million shares offered to the public, raising \$49.1 million
- 2002: Amazon makes its first quarterly profit

Amazon.com grew from a start-up online bookseller to one of the largest retailers on the Web in just four years. Its growth and the innovations it brought to online retailing were largely down to its charismatic founder, Jeff Bezos. In its first two years, Amazon.com was mainly kept in the Bezos family. This changed dramatically with the arrival on the scene of venture capitalists, companies which specialize in spotting 'rising stars', providing funds on a much larger scale, and taking them to the public offering stage.

Bezos's vision was that Amazon.com would be not just a bookseller, but at the centre of e-shopping. He linked up with several other companies, to sell toys, sportswear, pet supplies

and electrical goods. Still, the company made losses in 1999, as costs soared more rapidly than sales. The year 2002 marked a turning point, as the company reported its first quarterly profit. Its international sales grew as internet use became more widespread. In Japan, it registered 2 million users from 2000 to 2003, making changes in its US model to adapt to the Japanese market. For example, it allowed Japanese customers to pay cash on delivery, as credit cards are less widely used in Japan than in the US. Sales of electronics and other goods now account for more than a quarter of the company's worldwide sales, which were worth \$6.9 billion in 2004. As Amazon has turned itself into more of a general online retailer, it is facing serious competition from Wal-Mart and other bricks-and-mortar rivals, who are now increasingly attracting online customers. Nonetheless, Jeff Bezos retains his characteristic optimism that Amazon is leading the way in customer service. He says that his aim is for people to think of Amazon as 'earth's most customer-centric company' (Birchall, 20 May 2005).

Sources: Brooker, K., 'Amazon vs. Everybody', *Fortune*, 44(9), 8 November 1999; Mayer, C., 'Developing the rules for corporate governance', *Mastering Management*, Part 6, Financial Times Publishing, 6 November 2000; Buckley, N., 'Amazon.com figures beat expectations', *Financial Times*, 23 July 2003; Rahman, B., 'Amazon predicts Japan will be second market', *Financial Times*, 2 July 2003; Birchall, J., 'Amazon battles to sell its expansion into retail jungle', *Financial Times*, 20 May 2005.

Classification of businesses

Businesses may be classified according to their form of ownership and also by size. The two variables are related, in that businesses of sole traders tend to be small, while company structures are more suited to large organizations. We look at each type of classification in turn.

Forms of business ownership

Three basic forms of ownership in most countries are: sole trader, partnership and limited company.

Sole trader

The simplest type of business is the **sole trader**, or self-employed person. For the sole trader, such as a small shopkeeper or small farmer, the business is highly personal, and responsibility for its success or failure rests on his or her shoulders. When the shopkeeper buys goods for the shop, or the farmer buys seed, the bill falls to be paid by him or her personally. The sole trader typically owns the building and equipment used by the business. As the business is personal to its owner, it may end when the owner retires, unless there is another family member or purchaser to carry it on. If the business fails, the personal wealth of its owner can be used to cover the business's debts, and, on the worst scenario, the owner's resources could be wiped out, in order to pay the business debts. This risk is known as 'unlimited liability', and is one of the major drawbacks of being in business as a sole trader. Thus, many sole traders decide to convert their businesses into limited companies, also motivated by the more advantageous tax position of limited companies over sole traders.

Monitoring the extent of self-employment in a country or region provides an indication of entrepreneurial activity in the society. Self-employment differs from country to country, between age groups and between the sexes. In general, men are far more likely to be self-employed than women. While there are examples of successful entrepreneurs in their twenties, the peak ages for self-employment are between 36 and 45, when people are more likely to have accumulated sufficient resources to start up a business. In 2002, about 11 per cent of workers in the UK were self-employed (Weir, 2003). Self-employment is higher in Turkey and Greece, where farming is more prevalent, as farmers are more likely to be self-employed than workers in manufacturing and service industries. Research commissioned by the European Commission indicates that, while many of us find the idea of self-employment appealing, we are put off by the risk involved (Gallup Europe, 2002). As Figure 1.2 shows, when respondents were asked whether they would prefer to be an employee or self-employed, 67 per cent in the US were more inclined towards self-employment, while the percentage is much lower in European countries. In

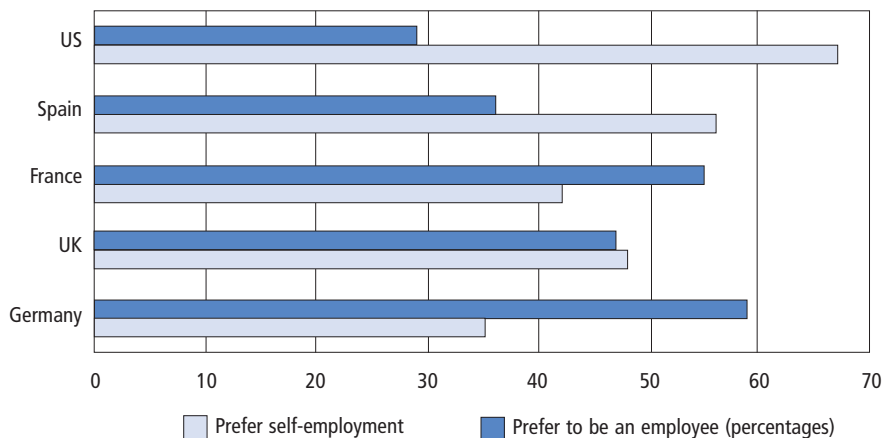


Figure 1.2 **Contrasting perceptions of self-employment**

Source: Gallup Europe (2002), 'Entrepreneurship', Eurobarometer 134, at <http://www.eosgallupeurope.com>.

Germany, in particular, the risk of failure loomed large in people's minds, as only 35 per cent preferred self-employment, while 59 per cent preferred to be employed.

For individual entrepreneurs, the franchise provides a less risky route to starting a business. The **franchise** agreement allows a businessperson to trade under the name of an established brand, backed by an established organization (the 'franchisor'), while retaining ownership of the business. Under the agreement, the business owner ('franchisee') pays fees to the franchisor organization for the right to sell its products or services. The franchisee does not have the freedom over the business that an independent owner would have, but stands a greater chance of success due to the strength of the established business 'formula' of the brand. Besides McDonald's, Burger King and other fast-food chains, there are numerous other goods and services providers, such as car rental companies, which have grown through the use of franchising.

Partnership

The **partnership** as a form of business involves two or more people carrying on a business in common, with a view to profit (Morse, 1991). A partnership may be any type of business, but has commonly been adopted by professional people such as accountants and lawyers. The partnership is called a 'firm', although this term is now used generally to refer to a company, not just a partnership. The partnership as a form is midway between the sole trader and company. Partners share the firm's profits and are all liable for its debts. While a limited partnership is possible, most partners, like the sole trader, have unlimited liability for the debts of the business. Partnership therefore rests heavily on personal trust between partners. The partnership is not a separate entity in the eyes of the law, but the partners can be sued (that is, face court proceedings) in the firm's name. To overcome the problems of unlimited liability that can arise when professional people are sued, firms take out considerable insurance cover.

Partnership is also used to describe a variety of relationships between two businesses, or between a government agency and a business. For example, a joint venture between two companies in different countries (which will be discussed in Chapter 5) may be referred to as a partnership, the basis of which is cooperation to achieve a common goal. Partnerships in this broader sense may include a variety of both formal and informal alliances between organizations.

Company

The company is the preferred form for businesses when they grow beyond a size that can be managed personally by a sole trader. The **company**, also called a corporation, is a legal entity separate from the members, or shareholders, who constitute it. Thus, the organization takes on a more impersonal character than the family business. The company is said to have 'perpetual succession', which means that it continues in existence, although its members may come and go over time (Morse, 1995, p. 5). As the company has a separate existence as a legal person, it involves greater dependence on formal documents. While there are several types of company, most companies are formed by registration, which is the filing of prescribed documents with the relevant government authority (Companies House in the UK, for example). In the US, companies register in one of the 50 states. When companies fail, they do not simply die; they must go through a legal procedure of 'winding up'.

From the point of view of a growing business, the advantage of converting into a company is that of attaining limited liability, which derives from the separate corporate status which the company enjoys. This means that the shareholder is liable only up to the amount of the face value of the shares acquired. Unlike the business owned personally by the sole trader, the company is legally owned by its **shareholders**, known as stockholders in many countries, including the US. A **share** in a company is a type of personal property, and the whole of a company's shares are its share capital, also known as **equity**.

Companies may be divided into private companies and public companies. Private companies are not allowed to offer shares to the public, whereas public companies do, although they need only offer a portion of their shares, such as 25 per cent. The private company is usually small, often with only a few shareholders who are family members. The public company is a much larger organization, and, when its shares are traded publicly on stock exchanges, it is likely to attract more public interest. Vodafone and Tesco are public companies, but there are some examples of high-profile private companies, such as the Virgin group of companies. In contrast, one of America's largest private companies, Cargill, a farm machinery company, is not widely known and sees its position as a private company as contributing to its low profile. In the UK, a public company has 'plc' after its name, to distinguish it from private companies, which are simply 'limited'.

WEB ALERT!

Companies House is at <http://www.companieshouse.gov.uk>
The website of the Virgin Group is <http://www.Virgin.com>
Cargill's website is at <http://www.cargill.com>

State-owned enterprises

State-owned enterprises (SOEs) differ from those owned by private individuals, in that they are owned and run, in effect, as limbs of government, often providing services for the public generally. They are often referred to as 'nationalized industries', like Petroleos de Venezuela, the Venezuelan state-owned oil company. These enterprises are thus in the 'public sector', while 'private sector' refers to businesses owned by private citizens. State-controlled enterprises have played an important part in economic activity in many countries, and they vary in their organization and business orientation. While they have had a reputation as sluggish and inefficient, a trend from the 1980s onwards has been for nationalized industries to be 'privatized', that is, converted into public limited companies, offering a portion of shares to the public. In many cases, the state retains a significant proportion. These privatized companies have become fitter and more responsive to consumers than they were as nationalized industries, and have also branched out into world markets. In Europe, the telecommunications industry and utilities, such as gas, water and electricity, have been privatized in this way. (Privatization is examined in more detail in Chapter 4.) Global companies which still have significant stakes owned by the state include the car maker, Renault in France and the telecommunications company, Deutsche Telekom in Germany, in which the state is the largest shareholder.

SUMMARY
POINTS

Types of business ownership

- **Sole trader** – Business under the ownership and control of an individual, often extending to family members; depends on personal control and becomes harder to manage as the business grows. Example: small craft shop.
- **Partnership** – Two or more people in business together, sharing the profits; depends on trust between the partners. Example: professionals such as accountants or lawyers.
- **Private limited company** – formation of a separate legal entity, the company, through registration and filing of documents (Memorandum of Association and Articles of Association in the UK); not allowed to offer shares to the public. Example: Virgin Atlantic.
- **Public limited company (plc)** – Limited company which is registered as a plc and offers shares to the public. Example: Marks & Spencer plc.
- **State-owned enterprise (SOE)** – an entity owned and controlled by government, such as a nationalized industry; known as a public sector enterprise. Example: Petroleos de Venezuela, the state-owned oil company. Privatization is the process of selling these enterprises to private investors, although the state often retains a large stake. Example: British Telecom.

Classification
of businesses
by size

The size of a business may be determined by a variety of criteria, including number of employees, turnover and market share (Buckley, 1999). However, these criteria are interpreted differently in different national and regional contexts, largely reflecting the size of the economy. While in some contexts 499 employees is used as the upper limit for a medium-size business, in many others, an upper limit of 249 is used. A commonly used classification based on number of employees is given below:

- Micro: 0–9 employees
- Small: 10–49 employees
- Medium: 50–249 employees
- Large: 250 or more employees.

However defined, **small-to-medium size enterprises (SMEs)** provide an important source of employment and economic activity in all countries. They account for roughly 60–70 per cent of employment in OECD countries, and 30 per cent of world exports of manufactures (UNIDO, 2000). SMEs range from informal ‘micro-enterprises’ to firms working at the forefront of advanced technology. Picsel, featured in the minifile, is an example of the latter. SMEs such as Picsel are more innovative and flexible than large organizations and are often able to specialize in ‘niche’ markets. Increasingly, these opportunities have become international in scope, facilitated by advances in information and communications technology (Buckley, 1999; Gankema et al., 2000). Picsel, for example, successfully sought both financial backing and markets in Asia in the very early stages of development of its new technology.

Figure 1.3 gives a breakdown of the UK’s 1,167,000 employers in 2002. It shows

that 82.8 per cent are micro-enterprises, which, combined with small enterprises, amount to 97 per cent of all UK enterprises. However, large enterprises account for about half of all UK employment in terms of numbers employed and turnover.

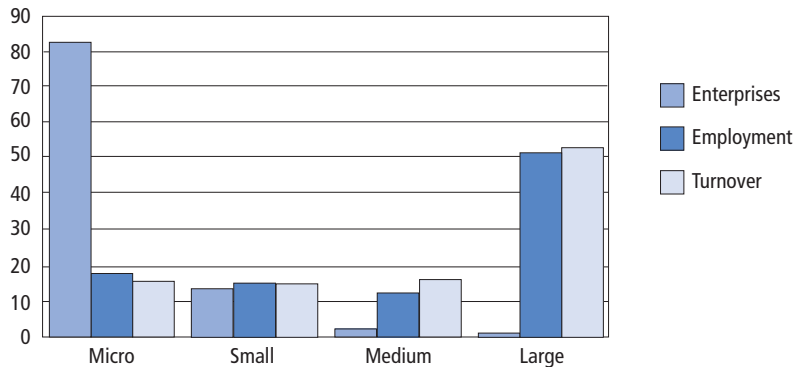


Figure 1.3 Percentage of enterprises, employment and turnover in micro, small, medium and large firms in the UK, at the start of 2002

Source: ONS (2004) *Small and Medium-sized Enterprises Statistics 2002*, at <http://www.statistics.gov.uk>.

Minifile

PICSEL TECHNOLOGIES

Picisel exemplifies a blend of entrepreneurship and innovation which has been highly successful in the rapidly changing area of computer software technology. Founded in Glasgow in 1998, the company provides multimedia software for use in mobile phones, personal digital assistants (PDAs), and other small-screen devices. Since then, it has grown from a start-up business with little more than ideas for new software products to a company with a £17 million turnover in 2005, supplying software to some of the world's biggest electronics brands, including Sony, Panasonic and Samsung. The company now has offices in California, Japan, China and Malaysia. Picisel's software, which can be embedded in a variety of mobile devices, allows users to easily access most types of content, regardless of format, changing between them with the greatest of ease.

The company's success is due to its two founders, Imran Khan, now CEO, the entrepreneurial mastermind, and Majid Anwar, the chief scientist, who developed the innovative software. Their strategy for selling the company's products and raising funding has been a major factor in their rapid growth. The two decided that the Asian market would be more promising for innovations in small-screen

devices. In 1999, they visited Japan to present their software to major manufacturers, even though its development at that time was at an early stage. Through an approach that they admit was akin to 'brinkmanship', they managed to reach agreements with Sony, NEC and Samsung. In 2001 they secured a £7.7 million investment from Softbank and Bank of Boston. This was followed in 2002, with a second round of funding from Japanese investors, who were investing in a UK company for the first time. Investors see bright prospects for growth, with the many new developments in small-screen devices and growing consumer appetite for all forms of electronic content.

Imran Khan says of their success: 'the essence of where we are is an undying faith in our technology and a belief that we will succeed. We're great salespeople also – perhaps it's part Pakistani DNA and part Scottish DNA – a combination of hard work and innovation from the Scottish side, and the entrepreneurial energy from the eastern side' (Nicholson, 2004).

Sources: Nicholson, M., 'How to make it big on the small screen' *Financial Times*, 20 January 2004; 'Picisel's £7m backing' *Daily Telegraph*, 20 May 2004; Bolger, A., 'Lining up the next development stage', *Financial Times*, 16 February 2005; Picisel website at www.picisel.com.

Business organization

An **organization** may be defined as ‘two or more people who work together in a structured way to achieve a specific goal or set of goals’ (Stoner and Freeman, 1992, p. 4). This broad definition encompasses many types of organization. It includes, for example, police forces, hospitals and schools, as well as the many types of business enterprises that make up modern consumer society. An organization run for profit aims to offer products or services that customers are willing to buy, at prices they are willing to pay. Physical resources, including plant, machinery and offices must be organized, and functions such as finance, purchasing and marketing must be coordinated, to enable the entire enterprise to function smoothly as a unit.

While every organization wishes to make the most of its expertise and resources, there is no one type of organization which can be said to be an ideal model that suits all businesses. There is a large body of organization theory, which studies ‘the structure, functioning and performance of organizations and the behaviour of groups and individuals within them’ (Pugh, 1997, p. xii). **Structure** has been defined as ‘the design of organization through which the enterprise is administered’ (Chandler, 1990, p. 14). It includes both formal and informal lines of authority. Organizational structures can be divided into three broad categories. The first is organization based simply on function. The second is the divisional structure, based on products, brands or regions. Thirdly, there is the organizational structure based on a matrix, the aim of which is to bring together the benefits of the other types. We look at each in turn.

Functional approach

In the **functional approach** to organization, business functions determine organizational structure. The importance of particular functions depends in part on the type of business. Product design and production, along with research and development, feature mainly in manufacturing firms, whereas all firms have need of finance, HRM and marketing functions. The main functions, which appear in Figure 1.4, are set out below:

- *Finance and accounting* – Control over the revenues and outgoings of the business, aiming to balance the books and generate sufficient profits for the future health of the firm. This function is far more complex in large public companies than in SMEs.
- *HRM* – Formerly known as ‘personnel management’, HRM focuses on all aspects of the management of people in the organization, including recruiting, training and rewarding the workforce.
- *Marketing* – This focuses on satisfying the needs and expectations of customers. Marketing covers a range of related functions, including advertising, pricing and distribution of goods.
- *Product design* – Product designers, mainly in manufacturing companies, are specialist engineers, who develop new products and improve existing products, from the beginnings of a single ‘prototype’, through to testing and revision of the design before large-scale production can begin.

- *R&D* – The scientific and technical research which underlies new products. Without an R&D focus, companies risk falling behind competitors in innovative new products.
- *Production and operations* – Focuses on the operational processes by which products are manufactured, such as assembly lines. Production increasingly relies on sophisticated machinery and computerized systems. Quality, safety and efficiency are major concerns of production engineers and managers.

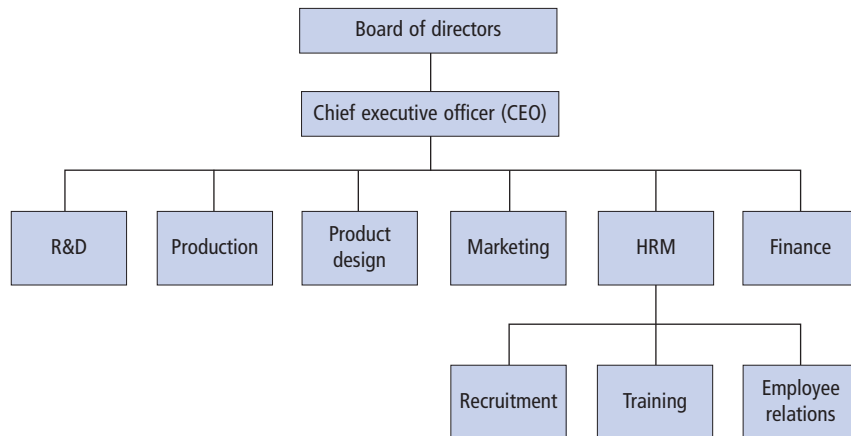


Figure 1.4 **Organization based on functional departments**

The functional organizational approach is depicted in Figure 1.4. There is a risk in this type of structure that each functional department will become inward-looking and lose sight of organizational goals. Within the formal structure, the functional specialists must be coordinated into a smooth-running whole. Central management and, in particular, its chief executive officer (CEO) is at the pinnacle of the organization. The CEO is therefore crucial in coordinating the departments.

Management is the:

process of planning, organizing, leading and controlling the work of organization members, and of using all available organizational resources to reach stated organizational goals. (Stoner and Freeman, 1992, p. 4)

The larger the company, the more cumbersome this structure becomes. For large companies, which produce a number of products in different regions of the world, this structure has given way to the more decentralized divisional structure.

Divisional structure

When a company has grown to the extent that it has a number of successful products in different regions, it may structure the organization into business units or divisions, which may be based on product, brand or geographical region (see Figure 1.5). Known as the **multidivisional structure**, this has been one of the major structural innovations of modern corporations, seeking to solve the problems of how to decentralize a large company, while still maintaining overall coordination of the parts. A

full account of its development is given in Alfred Chandler's *Strategy and Structure* (1990). In it he recounts the experiences of General Motors (GM) and the American chemical corporation Du Pont, which adopted the multidivisional structure in the early 1900s. The principle is that each division is headed by a division manager who has responsibility for managing the division as a profit centre in its own right. The division itself may be a separate company, known as a 'subsidiary' company, whose major shareholder is the 'parent' company. The company's executives at head office concentrate on the broader corporate aims, leaving the divisions considerable independence. The head office will have centralized functional departments, such as finance, for the group as a whole. A divisional structure based on *product divisions* has been adopted by a number of global companies, including General Electric (GE), British Telecom (BT) and Ericsson. An advantage of this approach, in theory, is the ability to coordinate activities to produce and market a particular line worldwide, but a drawback tends to be that its standardized approach overlooks differences in national markets (Birkinshaw, 2000). The Fiat case study at the end of Part 1 and the GE case study at the end of Part 3 provide contrasting examples of the way this type of structure works in reality. Both cases highlight the difficulties of coordination in practice and problems with underperforming units in highly competitive markets.

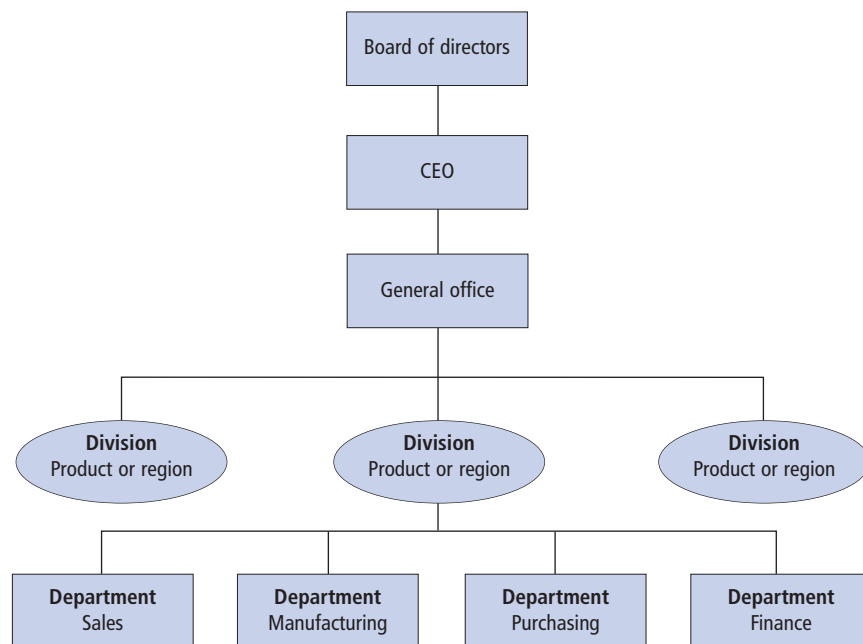


Figure 1.5 **The multidivisional structure**

The *area division* is a way of addressing different regional conditions. In this type of organization structure, country or regional managers preside over area divisions, and are responsible for all the company's activities in that area. The area may be, for example, Asia Pacific, in which case the area manager has charge of operations in

that area, including control over resources. A main advantage of the area division structure is that it is able to respond to regional needs. It also lends itself to decentralization, that is, the delegating of decision-making down to the divisions. Many global companies, including Nestlé and Unilever, have been organized in this way, although they have found it difficult to achieve economies of scale in development and production (Birkinshaw, 2000). They have tended to move towards global product divisions or a combination of geographical regions plus product divisions, as Unilever has done.

The **holding company** may also be said to be based on divisions, in that a parent company is the owner of a diverse array of subsidiary companies. However, unlike the multidivisional companies described above, the holding company exerts little control over the separate companies and provides few general functions for the group as a whole. The companies within the group operate, in effect, as independent organizations.

Matrix structure

The **matrix structure** is a way of structuring the organization to incorporate the benefits of other types of structure, such as the functional organization, product divisions and area divisions. It involves two lines of management, as indicated in Figure 1.6. The product manager must coordinate with the area manager for the launch of a new product in that region. In theory, this allows the company to respond to local trends and also derive the benefits of globally coordinated product management. In practice, however, it is difficult to reconcile these different lines of authority, and the system can lead to deadlock in decision-making (Bartlett and Ghoshal, 1990). Thus, although the matrix should theoretically provide flexibility, it can lead to inefficiency. Some companies adopt a compromise, using product divisions, but adding country

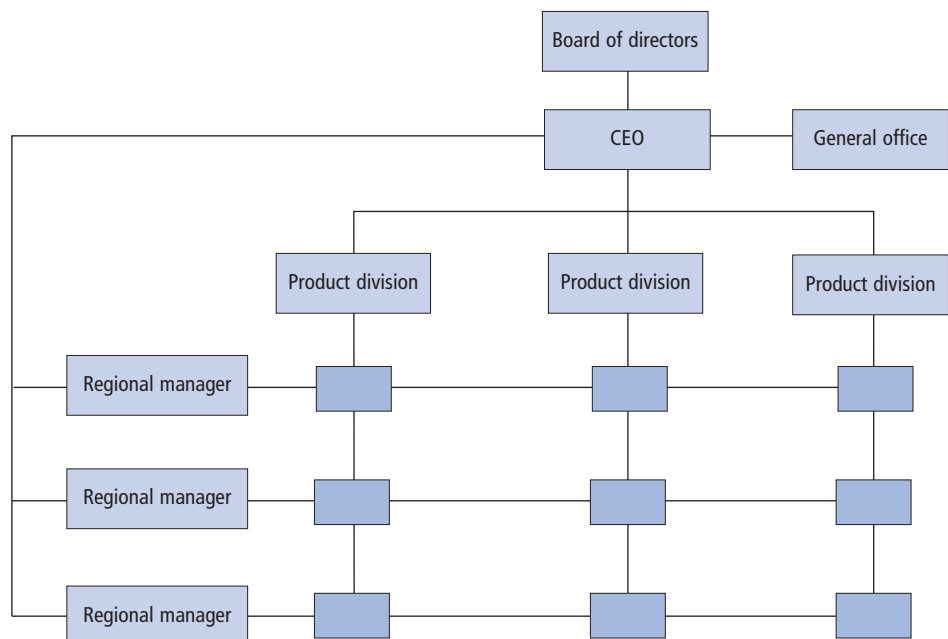


Figure 1.6 The global matrix

management where it is specifically needed, for example in developing countries such as China (Birkinshaw, 2000). In the early 1990s, the Swiss–Swedish electrical engineering company, ABB, put in place a matrix structure, but changed to a divisional structure based on products and technologies in 1998. In 2001, the company underwent a further restructuring, in which the divisions were replaced by four ‘consumer segments’, aimed at developing a greater customer orientation.

Case study 1.1 Has restructuring paid off at Procter & Gamble?

Procter & Gamble (P&G), formed by William Procter and James Gamble in Cincinnati in 1837, is one of the oldest global companies. Its famous brands include Tide, Pringles and Crest. For much of its history, the company has been innovative in producing new consumer products and new marketing techniques, such as the soap opera. However, despite its record of reliable profit growth, by the 1990s P&G had become weighed down by bureaucratic hierarchy. According to Richard Tomkins: ‘the company became formula-driven, risk-averse and inbred. Even the smallest decisions had to be referred to senior management. Individuality was frowned upon: employees learnt how to write memos, how to speak and how to think’ (*Financial Times*, 12 June 2000). Times became harder for the well-known brands, which were losing sales to copycat products and supermarket own brands. The big supermarket chains, such as Wal-Mart, grew more powerful and were able to demand lower prices from manufacturers.

In a restructuring in 1990, P&G’s chief executive closed 30 plants worldwide, cutting 13,000 jobs. This move brought down prices, but damaged employee morale and adversely affected product innovation. In 1999, a new chief executive, Durk Jager, took radical measures to dismantle the company’s multilayered bureaucracy. Aiming to recreate entrepreneurial spirit, he took power away from country-based divisions and created global product managers, with greater control over their budgets. But the change from country-based divisions to product divisions proved expensive, and the costs did not translate immediately into greater sales. Further, the radical changes had a disorienting effect on employees. It has been estimated that of P&G’s 200–300 top managers, only 20 per

cent were left doing the same job they had done 18 months previously.

Arguably, Jager did what was necessary to drag the company into the twenty-first century, but shareholders expected a speedy recovery, which was not forthcoming. After only 18 months in office, in which three profits warnings had to be issued, he was forced to go. By 2002, recovery seemed to be on track, under a new chief executive, A. G. Lafley, who took over in 2000. Lafley continued Jager’s strategy, putting faith in the global business units to generate innovation. At the same time, he has focused on the company’s leading brands which are its main earners.

Acquisitions have strengthened P&G’s competitive position in global markets. Clairol, the hair products company, was acquired in 2001 for \$4.5 billion, followed in 2003 by the acquisition of Wella, the hair care group. These two big acquisitions in the hair and beauty sector shifted the balance in the company’s portfolio. The health and beauty care businesses are now driving growth: the beauty care brands enjoyed a 41 per cent increase in volume of sales in 2004. The acquisition of Gillette in 2005 further strengthened the group’s presence in health and beauty products, adding Gillette’s razor and hair care products to the group’s portfolio. Gillette’s tradition of innovation is also a major attraction for Lafley. He says: ‘Fundamentally you have to ask yourself whether you are inherently a commodity business or an innovation business. What we’ve tried to do is accelerate innovation from within’ (Grant, 4 February 2005). The combined focus on innovation and major brands has contributed to a resurgence in growth, built on the ambitious restructuring carried out by Jager.

Sources: Tomkins, R., 'Revenge of the Proctoids', *Financial Times*, 12 June 2000; 'Durk's dismissal', *Financial Times*, 12 June 2000; Jones, A., 'Consumed by the consumer', *Financial Times*, 23 May 2001; Buckley, N., 'Reconditioned P&G is continuing to shine', *Financial Times*, 30 October 2002; Buckley, N., 'Change of focus boosts P&G', *Financial*

Times, 3 August 2004; Roberts, D., and Grant, J., 'P&G looks to gain strength through unity', *Financial Times*, 31 January 2005; Grant, J., "'We can build a juggernaut' – P&G and Gillette lead the way through a new retail landscape', *Financial Times*, 5 February 2005.

Case questions

In what ways did Procter & Gamble's organizational culture and structure need to be changed?

How has Jager's strategy now been vindicated?

WEB ALERT!



Procter & Gamble's website is <http://www.pg.com>

Organizations and change: business strategy

No two organizations, even two with similar outward structures, will be run in exactly the same way. Differences in behaviour, values and overall atmosphere are part of a business's **organizational culture**, and are particularly evident in situations of turbulence and uncertainty. Some businesses become set in their ways, assuming that structures and processes which served well in the past will continue to do so into the future. In a competitive environment, they are likely to lose out to more efficient and innovative rivals. Forward-looking organizations look for ways to reform their structures and improve communications within the organization and with its customers. Change may be radical or it may be gradual, that is, introduced incrementally, step by step. If an organization has been 'drifting' for a number of years, then looming crisis may dictate that it needs a radical shake-up involving restructuring. Changes need not involve entire restructuring, but involve a redefinition of the aims of the company within the existing structures. It is easier to change structures than to change organizational culture, which represents engrained ways of doing things. A takeover may be the catalyst of radical change in structure and processes. Or, if one division is underperforming, a merger with another division may be advisable. The timing of change and decisions as to whether it should be revolutionary or incremental are issues of strategy.

Strategy is often thought of simply as planning, but in fact it is much broader in scope. It encompasses not just physical changes such as shutting down a division, but also changes of corporate focus and attitudes on the part of the workforce. Chandler defined strategy as:

the determination of the basic long-term goals and objectives of an enterprise, and the

adoption of courses of action and the allocation of resources necessary for carrying out these goals. (Chandler, 1990, p. 13)

Chandler believed that structure follows strategy. His reasoning was that if a company sees new opportunities created by the changing environment, say by technological change, it alters its strategy and then changes its structure accordingly. This approach views strategy as a 'top-down' process. However, in a rapidly changing environment, strategies may emerge as events unfold. Strategy is often a combination of 'deliberate' strategy, that which has been originally intended, and 'emergent' strategy, which has arisen from events not part of the intended strategy (Mintzberg, 2000). In this way, some large organizations, such as ICI, found that strategy emerged slowly, as changes in beliefs and structure became settled (Pettigrew, 1997). Case study 1.2 on Honda's success in America shows the importance of accident and good luck in shaping strategy.

Awareness of changes taking place in the environment and new opportunities is captured in the concept of **strategic thinking**, which can be defined as bringing together all the information available from those within the organization and converting that knowledge into a vision of the aims the business should pursue. As Mintzberg explains:

in the case of emergent strategy, because big strategies can grow from little ideas (initiatives), and in strange places, not to mention at unexpected times, almost anyone in the organization can prove to be a strategist. (Mintzberg, 2000, p. 26)

Experience suggests, therefore, that strategy is more diffuse and complex than the idea of planning suggests. The flexible organization with open communication, able to adapt its strategy to the changing environment, is more likely to spot and exploit new opportunities than one with a rigid structure.

Case study 1.2 Honda and the US motorcycle market

It had been accepted that Honda's penetration of the US motorcycle market had been based on a deliberate strategy to target the bottom end of the US market, with the 50cc Supercub. However, research by Richard Pascale in 1984 revealed a different story. He found from speaking to Honda's executives that they were confident that the Honda 50 was a brilliant design, but they had had difficulties in raising production capacity in Japan. When they went to the US in 1959, they set themselves a target of exporting just 6000 machines per year for several years, leaving the actual timescale unspecified. They reckoned on 25 per cent of each of their four products: the 50cc Supercub, and the 125cc, 250cc and 305cc machines.

The dramatic success of the 50cc came about through 'accident, good luck and the Honda US executives' willingness to respond to events and learn from the market' (Barwise, 1997). They concentrated first on selling the larger bikes, as they thought they were more suitable for the US market, where everything was bigger and more luxurious. However, these machines started to break down, as they were being driven harder and longer than in Japan. The Honda executives themselves used the Honda 50s to ride around Los Angeles on errands. They attracted attention, including a call from a Sears buyer. While they were apprehensive that the small bikes would dent the macho image of their machines, they felt

compelled to sell them when their bigger bikes were struggling. Surprisingly, the retailers buying the Honda 50 were not motorcycle dealers, but sporting goods stores.

Honda enjoyed an initial design advantage in Japan, along with an efficient production line. But its seemingly unplanned success in the US demonstrates that successful strategy may emerge, rather than be the result of deliberate strategy. For Honda, successful strategy was a combination of opportunism and design.

Kay concludes that the lesson of Honda is: 'that a business with a distinctive capability that

develops innovative products to exploit that capability and recognizes the appropriate distribution channels for such innovations can take the world by storm' (Kay, 2004).

Sources: Barwise, P. (1997) 'Strategic investment decisions and emergent strategy', *Mastering Management*, Part 15, Financial Times/Pitman, pp. 562–71; Pascale, R.T., 'Perspectives on strategy: the real story behind Honda's success', *California Management Review*, Spring 1984, pp. 47–72; Kay, J., 'Driving through the spin on Honda's success', *Financial Times*, 16 November 2004.

Case question

What do we learn about emergent strategy from Honda's success with the Honda 50 in the US?

WEB ALERT!



Honda's main website is <http://www.honda.com>

Its motorcycle website is <http://powersports.honda.com>

SUMMARY POINTS



Varying approaches to strategy

The **planning approach** holds that:

- strategy formation should be a controlled and conscious formalized process
- responsibility for the overall process rests with the chief executive in principle, although responsibility for its execution rests with staff planners in practice
- detailed strategic plans that result from this process are then implemented.

The **emergent strategy approach** holds that:

- strategy is a combination of intended and unintended. Some intended strategy is not realized. The part that is realized is deliberate strategy
- much realized strategy emerges from events that were not part of the intended strategy. This is emergent strategy.

Sources: Mintzberg, H. (2000) *The Rise and Fall of Strategy*, London, Pearson Education; Barwise, P. (1997) 'Strategic investment decisions and emergent strategy' *Mastering Management*, Financial Times/Pitman, pp. 562–71.



CRITICAL PERSPECTIVES

Strategic change

The reason so few firms sustain their position is that change is extraordinarily painful and difficult for any successful organization. Complacency is much more natural. The past strategy becomes ingrained in organizational routines. Information that would modify or challenge it is not sought or filtered out. The past strategy takes on an aura of invincibility and becomes rooted in company culture. Suggesting change is tantamount to disloyalty. Successful companies often seek predictability and stability. They become preoccupied with defending what they have, and any change is tempered by the concern that there is much to lose ... Few companies make significant improvements and strategy changes voluntarily; most are forced to. The pressure to change is more often environmental than internal. (Porter, 1998b, p. 52)

■ Think of some actual companies that have fallen into the situation described by Porter. Did they successfully change strategy, and, if so, how?

Hierarchies and networks

Whatever their structure, large companies, in order to manage their growing complexities, tend to become hierarchical. A **hierarchy** essentially differentiates people in terms of power in a vertical fashion. Those at the top are the chief decision-makers in the organization, whereas those at the bottom, who carry out the routine activities of the business, have little decision-making power. There may be many layers of management and supervision in between. Each worker in the hierarchy has a definite position, with lines of authority above and below, in a system known as **bureaucracy**. When we think of bureaucracies, we think of the benefits of efficiency, with each task fitting into an overall whole, as in an assembly line. But we also tend to think of bureaucracies as inflexible and dependent on procedural formalities. They function best in unchanging environments, but in the context of a rapidly changing competitive environment, companies are shifting away from the bureaucratic model in order to introduce more flexibility and more open communication and quicker responses to customer needs.

One of the obvious reforms of bureaucratic structures is to reduce the number of layers, or flatten the structure. The structure may be flattened by reducing layers in the middle if there are too many layers of middle management. Or the power to take decisions may be decentralized to lower levels, through empowerment, one of the major developments in HRM thinking. **Empowerment** holds that employees at all levels in the organization are 'responsible for their own actions, and should be given authority to make decisions about their work' (Peiperi, 1997). The rationale behind empowerment is that those at the lower levels have considerable knowledge of oper-

ational matters, and so are able to respond more quickly. Recent theory stresses that one of the organization's major assets is knowledge, which is dispersed throughout its structure. Managers therefore need to look for ways to allow this knowledge to be tapped and channelled, for example into new products or new ways of doing things. It is increasingly recognized that products are not the sole preserve of product engineers, but involve cross-functional cooperation. Empowerment also allows the formation of cross-functional links.

At the organizational level, empowerment ties in with the **network organization** (Jackson and Schuler, 2000). The network organization does not really represent a new type of structure, but a new way of looking at the lines of communication and informal links within the preceding structural frameworks. **Networking** is 'the informal overlay that cuts across whatever formal structure is chosen' (Birkinshaw, 2000, p. 4). Thus project teams may be drawn from different functional groups or different area divisions. It may speed up decision-making, which in any large organization tends to become sluggish and slow. Positional structure still exists, but project activities which cross structural boundaries bring the flexibility needed for dynamic processes (Fukuyama, 1999). The tools for networking are enhanced by the use of email communications, which can cut across divisional boundaries. A project team can thus be assembled from various locations across the globe. Network organizations are also more likely to develop links with other organizations, creating networks across organizational boundaries (Jackson and Schuler, 2000). It is often said that networks rely on 'social capital', that is, shared norms and relationships of trust, rather than formal authority structures.

SUMMARY POINTS



Hierarchies vs. networks

- **Hierarchies** are based on formal rules and lines of authority in centralized bureaucratic structures. There is little delegation from the centre. This type of organization becomes inflexible, unable to respond to a changing environment.
- The **network organization** relies on shared norms and values, rather than formal rules. Networks allow information to flow freely within the organization. Informal, self-directed groups of workers provide a more flexible means of coordination within the organization than formal hierarchies.



CRITICAL PERSPECTIVES

Empowerment

We believe that empowerment without a *shared sense of direction* can lead to anarchy. While bureaucracy can strangle initiative and progress, so too can a large number of empowered but unaligned individuals who are working at cross-purposes ... The notion of a shared direction, what we call a 'strategic intent', reconciles the needs of individual freedom and concerted, coordinated effort ...

Employees want a sense of direction just as much as they want freedom of empowerment. (Hamel and Prahalad, 1994, p. 319)

■ In this passage, Hamel and Prahalad point out the negative side of empowerment. How valid are their comments?

Corporate governance

Corporate governance refers to the structures and processes by which ultimate control and decision-making in the company are exercised. The word ‘governance’ stems from analogy with a political system, in which those in positions of authority are held accountable to the citizenry. In a company, directors and managers are accountable to the shareholders as owners. These structures and processes reflect broader perspectives on the company’s role in society, however, which have come to be highlighted in the wider debate on corporate governance in recent years. This section, therefore, examines the systems first, and then explores the wider issues.

Governance structures

A typical structure of a public company in the US or UK is set out in Figure 1.7. Ultimate responsibility for the company’s activities lies with the **directors**, who collectively constitute a board of directors, elected by the company’s shareholders at their annual general meeting (AGM). The AGM affords an opportunity for shareholders to question directors on company policies and performance. Corporate governance differs from business to business, and is influenced by national economic, social, cultural and legal environments. In Germany and other European countries, a two-tier board of directors is the norm. A supervisory board holds the ultimate authority for major decisions, while a management board is the ‘engine of management’ (Charkham, 1994). While the single board in the Anglo-American type of structure is based on the principle of representing shareholders’ interests, the supervisory board in the German system encompasses not just shareholder interests, but also includes employee and trade union representatives. This point will be developed further in the next section.

The OECD’s *Principles of Corporate Governance* state that there is no single model that suits all companies (OECD, 2004, p. 13). However, there are general principles generally recognized as good practice. These are set out in the summary box below. Directors may be active managers in the company (called ‘executive’ directors in the US) or independent (‘non-executive’) directors. It is generally thought that a ‘balanced’ board, consisting of both executive and independent directors, representing both insider and outsider perspectives, represents best practice. A proportion of independent directors is usually recommended in national codes of corporate governance and in the OECD’s *Principles of Corporate Governance*. Also recommended as good practice is the separation of the roles of chairman and CEO, whereby the chairman is independent of the CEO. However, many companies, particularly American

ones, combine the roles in a single person. This practice can be seen in a number of the case studies in this book, for example those on GE, Nike and Apple Computers. Case study 1.3 on the Disney Corporation highlights this issue, along with a number of other current governance issues, including independent directors and responsiveness to shareholders.

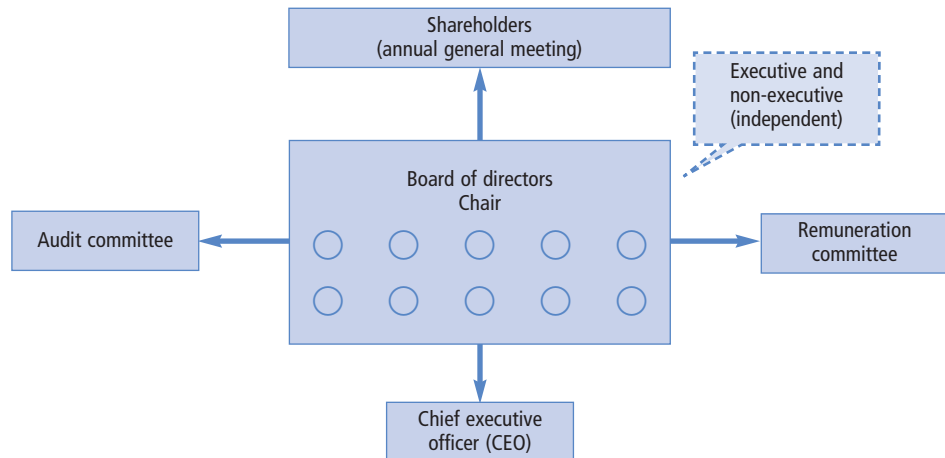


Figure 1.7 Corporate governance structure typical of an American or UK company

SUMMARY POINTS



OECD Principles of Corporate Governance

The corporate governance framework should:

- promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities
- ensure equitable treatment of all shareholders
- recognize the rights of stakeholders established by law or through mutual agreement
- ensure timely and accurate disclosure is made on all material matters regarding the corporation
- ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders.

Source: OECD (2004) *OECD Principles of Corporate Governance* (Paris: OECD).

When businesses grow and become more complex organizations, founders often come to the realization that they need to bring in professional managers, even though this entails reducing their control of the organization. Founder owners may also see their ownership stake reduced if the organization becomes a public company, as outside investors become shareholders. A divide thus develops between ownership and control, in that outside shareholders gain increasing ownership stakes, while

control tends to shift to professional managers, as occurred in the Disney Corporation. This phenomenon was first examined by Berle and Means in their seminal work in the 1930s (Berle and Means, 1932). Companies adopted the practice of issuing shares and share options to managers as part of their remuneration, to align their interests with the owners. Some companies adopt a system of different classes of shares, often aimed at maintaining family control, so that some shares may have little or no voting power. In Ford Motor Company, for example, the Ford family own 3.9 per cent of the stock, but control 40 per cent of the votes. While we might think it odd that investors would buy non-voting shares, they have usually been content to see share values rising and reap the profits when they come to sell their shares. Falling stock markets, however, from 2000 onwards, have led to shareholders becoming more aware of their voice – or lack of it – in corporate affairs, and to directors being reminded that they are ultimately accountable to shareholders as owners. Recent years have therefore seen a rise in shareholder activism, as the Disney case study shows, driven to a significant degree by financial institutions, such as pension funds, that hold large stakes in public companies. There are diverse perspectives on shareholder activism. On the one hand, advocates point to shareholder democracy as a healthy development, while, on the other, directors complain that shareholders tend to have a short-term perspective, making it difficult for managers to focus on long-term value. The P&G case study illustrates this dilemma.

WEB ALERT!

The OECD has a comprehensive website on corporate governance at <http://www.oecd.org>. *Corporate Governance Principles* may be found here, as well as *Guidelines for Multinational Enterprises*

The European Commission's website on corporate governance is http://europa.eu.int/comm/internal_market/company/index

There are also a number of websites which take the shareholder perspective. In the UK, the Pensions Investment Research Consultants (PIRC) is at <http://www.pirc.co.uk>. The California Public Employees Retirement System (CalPERS), the highly active investors, at <http://www.calpers.ca.gov>

Another investor-oriented website, designed for both individual and institutional investors, is at <http://www.corpgov.net>

All directors, whether executive or non-executive, are responsible for oversight of the company's activities. While they oversee corporate strategy, they are also responsible for seeing that the company meets financial reporting requirements. Corruption scandals involving Enron, the energy trading company, in the US in 2001, and Parmalat, the Italian dairy company in 2003, have raised awareness of corporate governance issues, including the need for transparent processes of accountability, to maintain public confidence in corporations. Enron had a corporate governance system which looked admirable on paper. However, its senior executives were able to steer the company towards their own goals, and the bodies which should have provided a check on their actions (such as the board and auditors) failed to do so. Board members, although formally independent, all had financial ties with the company,

and failed to exert control on senior executives. While Enron directors amassed personal fortunes, ordinary shareholders, many of them employees of the company, found their shares worthless when the company collapsed.

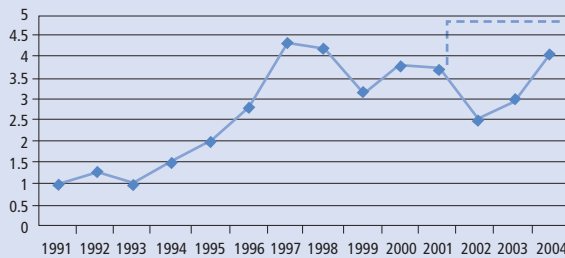
Enron and Parmalat, while both large organizations with many subsidiaries and affiliated companies, present contrasting governance perspectives. Enron was a management-dominated company, while Parmalat was founded as a family company, and its structures remained family-dominated, as is common in Italy (see the case study on Fiat at the end of Part 2). According to the OECD, more than 75 per cent of all registered companies in industrialized countries are family businesses (Becht et al., 2003). While most of these are SMEs, in many, including even large public companies, founders and family members retain large shareholdings and exert ultimate control. It has been estimated the one-third of the Fortune 500 largest companies in the US are family-controlled. Many European companies are also family-dominated: examples are the French car maker, PSA Peugeot-Citroën and the Italian car maker, Fiat. About 50–60 per cent of all employees in industrialized economies work for family companies (Becht et al., 2003). By contrast, in companies where there are widely diversified shareholders, who view their holdings simply as an investment, directors see maximization of shareholder value as their primary goal. This shareholder-centred view of corporate governance has been prominent in the US and UK.

Case study 1.3 Disney Corporation: it all started with a mouse

Walt Disney, the founder of the Walt Disney Company in 1923, is famously quoted as saying to his successors in the company: 'I only hope that we never lose sight of one thing – that it all started with a mouse.' The business was started by Walt Disney and his brother, who rented a small studio to produce animated films, introducing its most famous character, Mickey Mouse, in 1928. It was in animated films that the studio excelled, and on which its reputation and brand are based. The company has grown into a \$28-billion-a-year media and entertainment empire, consisting of film studios, theme parks and resorts, a television network and consumer products divisions. Much of this development has taken place under the leadership of Michael Eisner, who took over as chief executive in 1984. He is credited with the huge expansion of the theme parks and resorts. However, from the late 1990s, the company's performance took a downturn (see figure). New competitors in the theme park business, combined with the

downturn in tourism following the World Trade Center attacks of 11 September 2001, affected theme park attendance. Wavering consumer confidence has affected the consumer products division, which needs new characters beyond Mickey Mouse – now in his seventies – to reinvigorate the Disney brand. The loss-making television network, ABC, having been a leading network in the 1970s and 80s, noted for nurturing creative ideas, fell behind the other major networks in the US. There has been a 'brain drain' of creative talent in the flagship animation division.

Eisner held combined roles of chairman and chief executive, while, in the vice-chairman's seat, was Roy Disney, nephew of the founder and still a substantial shareholder. The board consisted mainly of insiders and personal associates of Eisner. Roy Disney has been a leading critic of Eisner, and the corporate governance of the company generally, voicing concerns of many, including the institutional shareholders, who hold 30 per cent of Disney stock. They have criticized



11 September 2001: terrorist attacks

**Disney's operating income
1991–2004 (estimate for 2004)**

Source: Burt, 8 November 2004.

Eisner's autocratic management style for destroying morale in the company. They also point to poor investment decisions which affected shareholder value.

From 2001, changes in corporate governance were made, to reflect recommended best practice. Enlargement of the board to thirteen members was followed by the introduction of more independent directors in 2004. The company announced that all but three directors are independent, and it has adopted a code of business ethics. These moves, however, did not dampen criticism of Eisner. In March 2004, he was forced to step down as chairman when 43 percent of the shareholders voted against his reappointment. Under pressure, the board then voted to split the roles of chairman and chief executive. This move, however, still did not placate the shareholders, particularly as the new chairman voted in, George Mitchell, was rejected by 24 per cent of the shareholders. Mitchell, former Senate majority leader in the US Congress, had been a director of companies associated with poor corporate governance, including Xerox, where accusations of manipulating financial results led to six officials paying \$22 million in fines. CalPERS, the California public pension fund and a Disney shareholder, called for Mitchell's resignation.

Roy Disney resigned from the board in 2004, but as a substantial shareholder, he has been vocal in a 'Save Disney' campaign. Throughout the upheaval, Disney directors have been stalwart in their defence of Eisner's management. In 2004, he promised to increase profit growth by impressive figures of 30 per cent, and could point to the fact that core businesses were doing well: ABC was gaining ground on its rivals, and box office takings were rising. However, shareholders,

it has become apparent, are interested in more than just seeing rising share price. As one global corporate governance adviser has said of the directors: 'They're suddenly going to have to prove publicly they do pay attention to ownership issues. Whether the stock price is going up or down in the short term is not the issue at Disney. The issue is that too much power is accumulated in the hands of one individual' (Wine, 5 March 2004). The Disney board, packed as it was with friends and supporters of Eisner, offered little prospect of proper oversight. ABC's founder, reflecting on the current situation at Disney, has said: 'Good outside directors will always try to do what's good for the company. Management directors are always tempted to do what's good for themselves' (Parkes et al., 2002).

In 2005, the board announced that Eisner would step down as CEO, and that Robert Iger, chief operating officer (COO) and preferred candidate of Eisner, was the unanimous choice of the board for the post of CEO. Roy Disney and another former director, Stanley Gold, launched legal proceedings against the Disney directors, claiming that the choice of Iger was a foregone conclusion and that no proper selection process had taken place.

Sources: Parkes, C., Grimes, C. and Burt, T. 'The fairytale may end in tears as Eisner's Magic Kingdom shows signs of crumbling', *Financial Times*, 24 September 2002; Burt, T. 'Disney banks on its mouse to roar again', *Financial Times*, 15 November 2003; Burt, T. 'Disney in boardroom shake-up', *Financial Times*, 8 January 2004; Burt, T. and Parkes, C. 'A "resounding victory" for shareholders', *Financial Times*, 5 March 2004; Wine, R. 'Rise of the corporate crusaders', *Financial Times*, 5 March 2004; Burt, T. 'Calm amid the storm: despite a bruising year, Eisner remains sure of his strategy', *Financial Times*, 8 November 2004; Gapper, J. 'A tale of intrigue at the court of Disney's king', *Financial Times*, 28 February 2005; Parkes, C., 'Legal challenge to Disney board', *Financial Times*, 10 May 2005.

Case questions

**What were the corporate governance problems at Disney?
To what extent have they been solved?**

WEB ALERT!



Disney's corporate website is at <http://corporate.disney.go.com>
Disney's main website is <http://disney.go.com>



CRITICAL PERSPECTIVES

Corporate governance

An effective corporate governance system requires a system of checks and balances, assuring that the right questions get asked (“Do we need to revise our corporate strategy? Our asset mix? Our organizational structure? Our allocation of resources? How is the CEO doing? How is the board doing?”) of the right people (those with the fewest conflicts of interest, and the authority to make the decisions and see they get implemented) ... A corporate governance system that is not effective is one in which questions are raised too late, or not at all, or are decided by people who are unable to evaluate them properly. (Monks and Minow, 1996, p. 261)

■ What is meant by a system of checks and balances in the context of corporate governance? How does the presence of a majority of independent (non-executive) directors on the board ensure that effective checks and balances are carried out?

Governance issues in the contemporary environment

In addition to accountability to shareholders, corporate governance has taken on broader implications, as managers have become more aware of the interrelationships between the internal and external environment of the company. This broader concept is that of stakeholders. A **stakeholder** may be anyone, even the community generally, who has an interest in the company, direct or indirect. Besides shareholders, those with a *direct* affect on the company include employees, trade unions, customers (who may be businesses such as retailers), consumers (who purchase products from retailers) and suppliers. The company is likely to have contractual or other formal links with these groups, which represent coherent sets of interests (see Figure 1.8). In countries with a two-tier board structure, the position of employees is formally recognized, but this stakeholder model of governance is limited, in that it does not bring in other stakeholder groups besides employees. *Indirect* stakeholders, while they are affected by the company's operations, cover a range of broader soci-

etal interests which enjoy fewer direct channels of communication with managers. They include the local community, society generally and the ecological environment affected by the company's operations. These indirect stakeholders are shown as dotted lines in Figure 1.8. Often, especially in overseas operations, these stakeholders have little organizational capacity and few means to voice their concerns. Non-governmental organizations (NGOs) have stepped in to raise stakeholder issues in many cases, arguing that they fall within corporate responsibility. The extent of responsibility to both direct and indirect stakeholders has become a far-reaching issue, and is discussed further in Chapter 14.

The interests of some stakeholder groups may potentially conflict with others. For example, moving production to a cheaper location may please shareholders and customers, but harm employees who have lost jobs. Reconciling the interests of shareholders and other stakeholders has thus become an important consideration for corporate strategy.

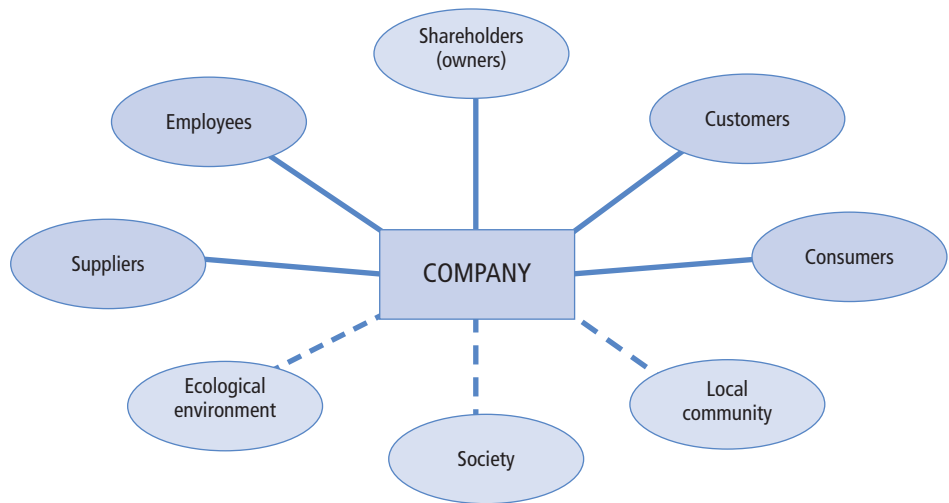


Figure 1.8 Shareholder and stakeholder perspectives on corporate governance

SUMMARY POINTS



Contemporary corporate governance issues

Shareholder perspective:

- shareholder value is the primary aim of the company, in keeping with the role of shareholders as owners
- directors accountable to shareholders through board structure
- trend towards more active investors, as shareholders seek to promote active monitoring of directors and the voicing of shareholder concerns.

Stakeholder perspective:

- stakeholders represent a range of broader interests which impact directly or indirectly on the company

- in some countries, a two-tier board is established (for example Germany), and employees are represented on the supervisory board
- a broad view of stakeholder interests encompasses specific groups, such as employees, and more heterogeneous interests, such as society and community, affected by the company's operations.

Tools for formulating business strategy

Business strategy must take into account both the external and internal environment of the organization. Two traditional tools, PEST analysis and SWOT analysis are given below. While both tend to oversimplify the processes, they do serve to highlight major issues.

PEST analysis

Analysis of the external environment may be expressed by the acronym **PEST**, standing for political, economic, sociocultural, and technological factors. Also known as 'environmental scanning', the PEST analysis is a useful tool for monitoring and evaluating forces which affect the organization over the long term. Research has shown that environmental scanning is linked to company performance (Thomas et al., 1993). Below are the headings, with a few questions that arise under each one:

- *Political and legal environment* – Is the existing government a stable one, and what is the strength of any opposition to it? What constraints has the government imposed on business, or is it likely to impose in the future? In the European Union (EU), what forthcoming legislation, such as new law on mergers, is likely to affect the business?
- *Economic environment* – Is the economy growing, or is there a recession looming? Are wages and consumer spending rising? Which sectors of the economy are growing and which sectors are not? Which regions of the country are experiencing the best growth? Is there high unemployment?
- *Sociocultural environment* – Is the society culturally diverse? What are the educational levels of the population generally? To what extent do women have educational opportunities and play an active part in business life? What is the pattern of family life – is there a large proportion of single-parent families, or are extended families the norm?
- *Technological environment* – What is the level of technology education and training, which would influence the recruitment of skilled staff? Is technological innovation encouraged? What funding is available, from government and elsewhere, for technology development? How computer-literate is the society generally?

Answers to these – and many other – questions present an environmental profile of any society, which differentiate it from other societies, even those in the same geographic region. The PEST analysis is thus particularly useful for strategic managers in international businesses which operate in a number of different national environments. Figure 1.9 provides a summary of the key variables in the international environment.

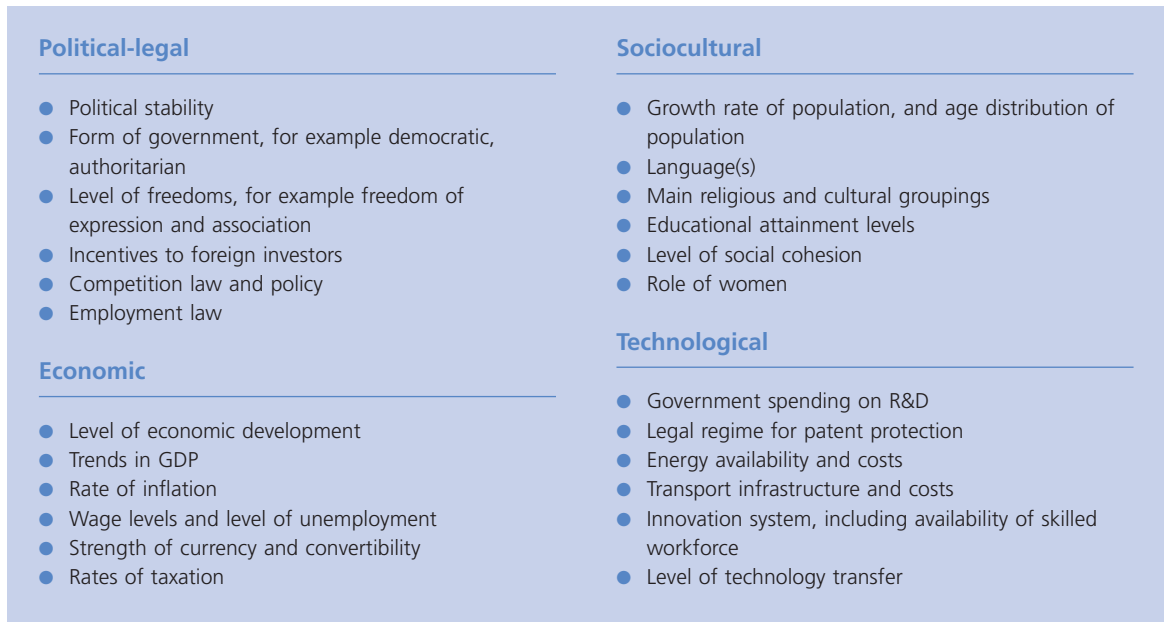


Figure 1.9 PEST analysis in the international business environment

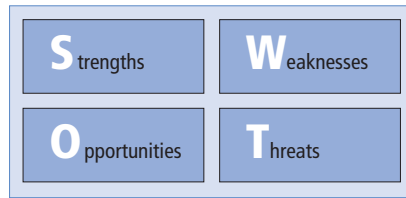
The PEST analysis, while helpful as a tool, clearly does not cover all relevant aspects of the business environment. Legal factors are commonly grouped with political factors, as in the summary above. By expanding the acronym to LE PEST C, we can include legal factors as a separate heading, followed by ecological factors. Lastly, the competitive environment is added, to provide the basis of more comprehensive environmental scanning. These headings form the framework for the chapters of this book, with the addition of a separate chapter on the financial environment. The ecological environment is dealt with in Chapter 13.

Clearly, if a business is considering expanding in its home market, it will already have a good deal of knowledge about each of these aspects of the environment. On the other hand, if it is considering expanding to Vietnam, for example, it will probably know little. The more knowledge it acquires, the better, in order to avoid making costly mistakes. When the firm has done its research on Vietnam, it must ask itself, why should this firm in particular do business there?

SWOT analysis

The **SWOT** analysis is a commonly used planning tool, which assesses the firm's strategic profile in terms of its strengths, weaknesses, opportunities and threats. Focusing on both internal and external environments, it serves to highlight a firm's distinctive competences, which will enable it to gain competitive advantage.

The SWOT analysis is usually expressed as a matrix: strengths and weaknesses in the top boxes relate to the company itself, while opportunities and threats, in the lower boxes, reflect relevant aspects of the external environment. These are set out in Figure 1.10.

Figure 1.10 **SWOT analysis**

Some of the key issues which are addressed in a SWOT analysis are:

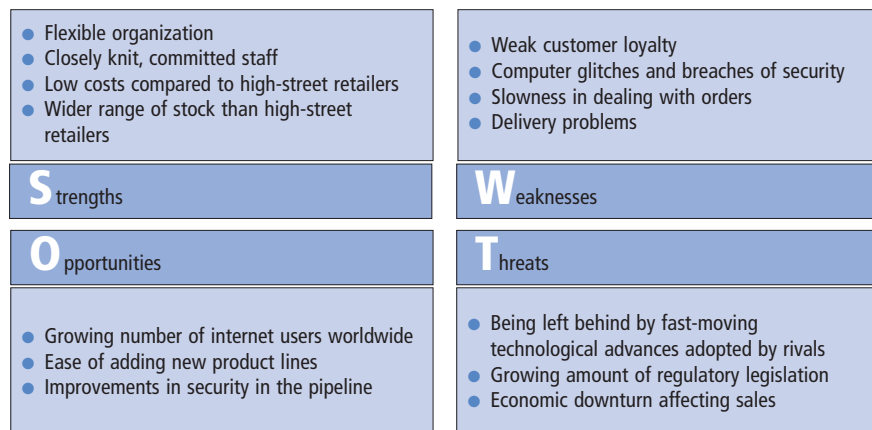
External environment – opportunities and threats:

- What are the main factors in the societal environment (political-legal, economic, sociocultural and technological)?
- What is the market strength of competitors?
- What new products or services, both those of the firm and its competitors, are in the pipeline?
- What is the level of consumer demand and can it be expected to remain stable?
- What is the likely threat of new entrants in the market for the firm's products?

Internal environment – strengths and weaknesses:

- Does the organization have a structure that helps it to achieve its objectives?
- Does it have clear marketing objectives and strategy?
- Does the organization use IT effectively in all aspects of its activities?
- Does its investment in R&D match or exceed that of competitors?
- Does the organization meet its financial objectives?
- To what extent does the firm have clear HRM objectives and strategies in areas such as employee motivation, staff turnover and provision of training?

Figure 1.11 sets out an example of a SWOT analysis for an online wine retailer, which runs no bricks-and-mortar outlets.

Figure 1.11 **SWOT analysis for a business selling wine online**

In this example, the SWOT analysis will be useful in formulating strategy to take advantage of opportunities, such as growing markets from new internet users. It will also help to minimize the effects of threats or anticipated threats. The SWOT analysis shows there are lingering doubts in the minds of many consumers about buying goods and services online, and many dot.com companies have struggled to build a customer base. It only takes one highly publicized security failure to damage consumer confidence. Consumers may also have more mundane worries, such as that of cases of wine being left on the doorstep when they are not at home. The online wine merchant must therefore endeavour to use the advantages of online selling, such as that of greater, more flexible product range, to compensate for the perceived drawbacks. Strategic options should therefore emerge in the SWOT analysis.

The SWOT analysis can be carried out in planning teams or by groups of executives (Piercy and Giles, 1989), and their impressions can be quite different. It has been found that higher level managers tend to take a broad overview, seeing organizational factors as strengths, while lower level ones single out marketing and financial factors (Mintzberg, 2000, p. 276). This suggests that people's views are influenced by their own position in the business, and the SWOT exercise can serve to widen the perspectives of participants in the planning process.

While this chapter has focused on the internal environment of the organization, it has emerged that key aspects such as structure, processes, change and strategy are tied in with many aspects of the external environment, so that change becomes an interactive process. It has also emerged that the activities of any organization consist of a number of different functions which form part of the interactive process. Each of the functional activities interacts with the external environment as well as with the other functions within the organization. Understanding these interactions is the subject of the next chapter.

Conclusions

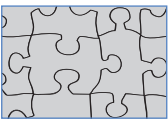
- 1 Business covers a wide range of economic activity, including buying and selling goods, manufacturing products and providing services. International business refers to those activities between organizations in two or more countries.
- 2 Businesses may be sole traders, partnerships or companies. Typically, businesspeople set out as sole traders and convert the business to a limited company.
- 3 When they expand, businesses become more formally structured. Business organizations may be designed on a functional, multidivisional or matrix structure. No single structure can be said to suit all businesses.

- 4 Business strategy may evolve in many ways, emerging over time, rather than simply being the product of formal planning. Flexible organizations are more likely to be able to adapt strategy to the changing environment than rigid, hierarchical organizations.
- 5 While shareholder value is a key focus of company executives, companies have a broad range of other stakeholders, including employees, customers, and the community at large. The task of corporate governance, therefore, can often be seen as one involving balancing many stakeholder interests.
- 6 Two common tools used in formulating strategy are the PEST and SWOT analyses. Although they oversimplify complex processes, they serve to focus on key elements of strategic planning.



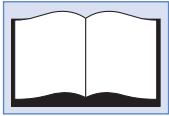
Review questions

- 1 What are the advantages and disadvantages of being a sole trader?
- 2 What are the aspects of the limited company which distinguish it from other types of business ownership?
- 3 Why are SMEs important to the economy?
- 4 Explain the reasons behind the adoption of a multidivisional structure for large companies.
- 5 What is a matrix structure? Assess its advantages and drawbacks in practice for the large organization.
- 6 What is meant by 'emergent strategy', and how does it differ from a strategic planning approach?
- 7 Contrast the bureaucratic organization with the network organization. Why is networking now seen as preferable from the organizational point of view, as well as from the perspective of individual employees?
- 8 How does corporate governance differ from the day-to-day management of a company?
- 9 Explain the shareholder and stakeholder perspectives on corporate governance.
- 10 What is the function of a PEST analysis?



Assignments

- 1 Assume that you are the CEO of a large international company in the media industry, which owns satellite television stations in Europe, Asia, and the Americas. Assess the advantages and disadvantages of different types of corporate structures for the company.
- 2 Construct a SWOT analysis for a small company which makes animated cartoons.



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