

### Strategic Management and Business Policy

Globalization, Innovation, and Sustainability

SIXTEENTH EDITION

Charles E. Bamford
Alan N. Hoffman
Thomas L. Wheelen
J. David Hunger







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GLOBAL EDITION

# Strategic Management and Business Policy

GLOBALIZATION, INNOVATION, AND SUSTAINABILITY

Charles E. Bamford Duke University

Alan N. Hoffman *Bentley University* 

Thomas L. Wheelen
Formerly with University of Virginia,
Trinity College, Dublin, Ireland

J. David Hunger
Formerly with Iowa State University,
St. John's University



Content Production: Nikhil Rakshit

Product Management: Steven Jackson, Ishita Sinha, Daniel Luiz, and Kajori Chattopadhyay

Product Marketing: Joanne Dieguez

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### Dedicated to

### TOM WHEELEN AND DAVID HUNGER

Tom originated this book in the late 1970s and with his friend David Hunger brought the first edition to fruition in 1982. What a ride it was! We lost both of these extraordinary men in rapid succession. After battling bone cancer, Tom died in Saint Petersburg, Florida, on December 24, 2011. David died in St. Joseph, Minnesota on April 10, 2014 after fighting cancer himself. It was the core idea from the very beginning to include the latest research and useful material written in such a way that any student could read and understand the book without outside assistance. That has been a key reason for the success of the book through its many editions. Tom and David worked in adjoining offices at the McIntire School of Commerce at the University of Virginia where their lifelong collaboration blossomed. Tom's last months were spent working with the two new co-authors to map out the direction for the then upcoming 14th edition and we were fortunate to be able to work with David through the early part of the 14th edition update until his fight against cancer took priority.

The authors would like to thank Charles & Irene Dale for their valuable contributions to this text.

Charles E. Bamford Alan N. Hoffman

To Yvonne, for your support, advice, encouragement, love, and confidence.

Chuck Bamford

To Maxwell Hoffman, the greatest son in the world and in memory of Sally J. Strawn.

To my former students: Anne Nelson, Irmina Myszkowska, Silvia Martinez, Gonzalo Jiménez & Donna Gallo . . . I am very proud of you!

Special thanks to Ladan Taheri, Kathy Connolly, Trena Depel, Raj Sisodia, Joe & Gail Goldman and Jim & Pam Schwartz.

Alan N. Hoffman

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### **Preface**

### **NEW TO THIS 16TH EDITION**

This edition of the text has:

- New detailed Skechers case replaces the former Maytag case. Significant changes are seen in Chapters 4, 5, 6, and 13. This updated and refreshed approach will greatly assist students in understanding and executing a Strategic Audit.
- New and updated vignettes on sustainability (which is widely defined as business sustainability), globalization (which we view as an expectation of business), and innovation (which is the single most important element in achieving competitive advantage) appear in every chapter of the text. Among dozens of updated ones, some of the new vignettes include:
  - Chapter 2 Innovation Issue: Innovation and Autonomous Shipping
  - Chapter 3 Sustainability Issue: Cadbury: A Sustainable Supply Chain
  - Chapter 4 Sustainability Issue: The Crisis in the Colorado River
  - Chapter 5 Global Issue: Managing Corporate Culture at Salesforce
  - Chapter 6 Global Issue: The Unending Race to the Bottom—Low-Cost Manufacturing
  - Chapter 7 Global Issue: Global Expansion Is Not Always a Path to Growth
  - Chapter 8 Innovation Issue: Some Innovations Are Solutions Looking for a Ouestion
  - Chapter 8 Global Issue: BreadTalk: From an Island Nation to the World
  - Chapter 9 Sustainability Issue: Sustainable Seafood Initiative
  - Chapter 10 Innovation Issue: Stumbles at Volkswagen Trigger a New Structure
  - Chapter 11 Innovation Issue: How to Keep Apple "Cool"
  - Chapter 11 Global Issue: Cultural Differences and the Failure of Sony Ericsson
  - Chapter 12 Innovation Issue: Johnson Matthey and Green Hydrogen
  - Chapter 12 Sustainability Issue: Bottled Water and an Environmental Catastrophe
- New and updated examples, chapter opening vignettes, and stories. Some examples of chapter opening vignettes examining companies are Toyota Motor Corporation, Hewlett-Packard, Purbani Group, Katerra, In-N-Out Burger, Kärcher, Berkshire Hathaway, Lowe's, UNIQLO, Pizza Hut, and GameStop, among others.
- **Fourteen new cases** have been added to the 16th edition to support the 18 carryover cases from past editions.
  - Four new cases on Zoom, Verizon, Scotiabank, and Covid-19 Challenges that deal with Covid-19
  - One new case on Gender Pay Equity

- One new case on Cooker Industries that deals with small business
- One new case on Toyota that deals with diversity
- One new case on Electronic Arts that involves the gaming industry
- Two new cases on Nike and Dick's Sporting Goods that deal with sports apparel
- One new case on Unilever that deals with the consumer products industry
- One new case on Restaurant Brands International that deals with the food and beverages industry
- One new case on Axis Bank that deals with CSR and banking
- One new case on CrossFit deals with the fitness industry
- **Extensive additions** have been made to the text from both strategy research and practical experience. All statistics have been updated.
- **Updated** resource-based analysis and more specifically the VRIO framework in Chapter 5 with the latest efforts in the field from both research and practitioner sources.

### CHAPTER-BY-CHAPTER UPDATES

PART 1: Introduction to Strategic Management and Business Policy	
Chapter 1 Basic Concepts of Strategic Management	<ul> <li>Updated Opening Case: Toyota Motors Co.</li> <li>Updated terminology to the overall model: Including changing environmental scanning to environmental analysis and evaluation and control to evaluation and re-assessment</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including:         <ul> <li>B-Corporations, Impacts from Covid-19, Warby-Parker, Tesla, and the mRNA vaccine efforts of Pfizer and Moderna</li> <li>Updated GLOBAL issue: Regional trade agreements and national trade barriers</li> <li>NEW section on Employment in Strategic Management</li> </ul> </li> </ul>
Chapter 2 Corporate Governance	<ul> <li>Substantially Revised Opening Case: How the Board at Hewlett-Packard Nearly Brought Down the Company</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including: Wells Fargo, CalPERS and "Golden Parachutes"</li> <li>NEW INNOVATION issue: Innovation and Autonomous Shipping</li> <li>Updated GLOBAL issue: Board Activism at Yahoo!</li> <li>Updated SUSTAINABILITY issue: CEO Pay and Corporate Performance</li> </ul>

Chapter 3 Social Responsibility & Ethics in Strategic Management	<ul> <li>Updated Opening Case: Purbani Group: A CSR Pioneer in Bangladesh</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including: Parental Leave Policies, Lego, Google, IBM, Cisco, Starbucks, and Novo-Nordisk</li> <li>Updated INNOVATION issue: Turning a Need into a Business to Solve the Need</li> <li>Updated GLOBAL issue: How Rule-Based and Relationship-Based Governance Systems Affect Ethical Behavior</li> <li>NEW SUSTAINABILITY issue: Cadbury: A Sustainable Supply Chain</li> <li>Revised Strategy Highlight: Johnson &amp; Johnson Credo</li> </ul>
PART 2: Scanning the Environment	
Chapter 4 Environmental Scanning & Industry Analysis	<ul> <li>NEW Opening Case: Katerra—Reading the Market and Changing the Housing Industry</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including: Loom Shoes, Uber, Lyft, Tesla, and ADA (Americans with Disabilities Act)</li> <li>Updated INNOVATION issue: Taking Stock of an Obsession</li> <li>Updated GLOBAL issue: SUVs Power On in China</li> <li>NEW SUSTAINABILITY issue: Crisis in the Colorado River</li> <li>Revised Strategy Highlight: Evaluating Competitive Intelligence</li> </ul>
Chapter 5 Organizational Analysis & Competitive Advantage	<ul> <li>NEW Opening Case: Understanding Competitive Advantage—In-N-Out Burger</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including: Buc-ee's, Tesla, Chilean Winemakers, CVS, and substantial Covid-19 impact analysis</li> <li>NEW INNOVATION issue: Do Iconic Products Really Die: Polaroid</li> <li>NEW GLOBAL issue: Managing Corporate Culture at Salesforce</li> <li>Updated SUSTAINABILITY issue: The Olympic Games—Lillehammer 1994 to Tokyo 2020</li> <li>NEW Organizational Analysis Case: IFAS Matrix—Skechers</li> </ul>

PART 3: Strategy Formulation	
Chapter 6 Business Strategy	<ul> <li>Updated Opening Case: Kärcher: An Evolutionary Diversification Strategy</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including:         <ul> <li>Lockheed-Martin, Diehl Defence, Saab, AES</li> <li>Corporation, and Siemens AG.</li> </ul> </li> <li>Updated INNOVATION issue: Chegg Fills Needs         <ul> <li>Before Competitors Even See the Opportunity</li> </ul> </li> <li>NEW GLOBAL issue: The Unending Race to the         <ul> <li>Bottom—Low-Cost Manufacturing</li> </ul> </li> <li>Updated SUSTAINABILITY issue: Strategic         <ul> <li>Sustainability—ESPN</li> </ul> </li> <li>NEW Organizational Analysis Case: SFAS</li> </ul>
Chapter 7 Corporate Strategy	Matrix—Skechers  NEW Opening Case: The Ultimate Portfolio— Berkshire Hathaway  Updated dozens of surveys and data points
	<ul> <li>Replaced many company examples with current issues in strategic management including: Peloton, NetApp, Things Remembered, Payless Shoe Stores and Apple iPhone</li> <li>Introduced new term: SPAC (Special Purpose Acquisition Company)</li> <li>Updated INNOVATION Issue: To Red Hat or Not NEW GLOBAL issue: Global Expansion Is Not Always a Path to Growth</li> <li>Updated SUSTAINABILITY issue: Electric Vehicles at GM</li> </ul>
Chapter 8 Functional Strategy & Strategic Choice	<ul> <li>NEW Opening Case: Strategic Re-Direction at Lowe's</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including: Aston-Martin, the Private Equity Industry, and RIM</li> <li>Updated INNOVATION issue: Some Innovations Are Solutions Looking for a Question</li> <li>NEW GLOBAL issue: BreadTalk: From an Island Nation to the World</li> <li>Updated SUSTAINABILITY issue: How Hot is Hot?</li> </ul>
PART 4: Strategy Implementation & Evaluation	
Chapter 9 Global Strategy	<ul> <li>Updated Opening Case: UNIQLO: From Japan to Asia to the World</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including: Aston-Martin, TUMI, and BMW</li> <li>Updated INNOVATION issue: Target Transforms Itself with Innovative Efforts Across the Business</li> <li>NEW SUSTAINABILITY issue: Sustainable Seafood Initiative</li> </ul>

Chapter 10 Organizing and Structure	<ul> <li>NEW Opening Case: Re-Organization in Business:         Code Term for "We Are in Trouble"</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including: 3M, J&amp;J, Sports Authority, Gateway Computers, TIVO, and Spotify</li> <li>NEW INNOVATION issue: Stumbles at Volkswagen Trigger a New Structure</li> <li>Updated GLOBAL issue: Outsourcing Comes Full Circle</li> <li>Updated SUSTAINABILITY issue: Moving Away from Plastic Bottles—Ecological Brands</li> </ul>
Chapter 11 Staffing and Directing	<ul> <li>Updated Opening Case: Workplace Discrimination and Public Image</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including: Pier 1, Nissan, Applebee's, Toys R Us, and Walgreens</li> <li>NEW INNOVATION issue: How to Keep Apple "Cool"</li> <li>Updated SUSTAINABILITY issue: Panera and the Panera Cares Community Café</li> <li>NEW GLOBAL issue: Cultural Differences and the Failure of Sony Ericsson</li> </ul>
Chapter 12 Evaluation and Re-assessment	<ul> <li>Updated Opening Case: Stuck in the Middle – Pizza Hut</li> <li>Updated dozens of surveys and data points</li> <li>Replaced many company examples with current issues in strategic management including: Walmart, Wells Fargo, and Elon Musk</li> <li>NEW INNOVATION issue: Johnson Matthey and Green Hydrogen</li> <li>Updated GLOBAL issue: Counterfeit Goods and Pirated Software: A Global Problem</li> <li>NEW SUSTAINABILITY issue: Bottled Water and an Environmental Catastrophe</li> </ul>
PART 5: Introduction to Case Analysis	•
Chapter 13 Suggestions for Case Analysis	<ul> <li>NEW Opening Case: Can GameStop Survive?</li> <li>Updated dozens of surveys and data points</li> <li>Substantial change with new example: Skechers</li> </ul>

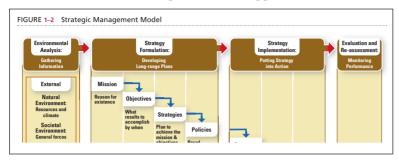
### SOLVING TEACHING AND LEARNING CHALLENGES

This genesis for this book was a conversation back in 1980 at the McIntire School of Commerce between Tom Wheelen and Dave Hunger who were both professors of strategy. It was the core idea from the very beginning to emphasize the practical application of great research material, written in such a way that a student could read, understand, and most importantly apply the lessons of the book without outside assistance. That has been a key reason for the success of the book through its many editions.

Alan Hoffman (a longtime colleague and friend of Tom) joined the book in its 12<sup>th</sup> edition and has led the entire case effort. Chuck Bamford joined the book starting with the 14<sup>th</sup> edition. He was an undergraduate student and RA for the strategy faculty at McIntire working for Tom and David in the early 1980s. The galley proofs were used in those classes and the first edition was released in 1982.

### The Issue of Understanding What Strategy Is?

Students find it difficult to structure the strategic problem on hand and ensure that all internal and external factors are considered while considering the strategic alternatives and implementation approaches.



This book contains a **Strategic Management Model** that runs through the first 12 chapters and is made operational through the **Strategic Audit**, a case analysis methodology. The Strategic Audit provides a professional framework for case analysis by examining both external and internal factors while taking the student through the generation of strategic alterna-

tives and implementation approaches. This audit now utilizes *Skechers* as the company of focus.

To help the student synthesize the many factors in a complex strategy case, we developed three useful techniques:

			Weighted		
External Factors	Weight	Weight Rating		Comments	
1	2	3	4	5	
Opportunities					
Global marketplace	.15	5	5.15	Skechers moved into regions around the world with retail stores and distribution centers	
Consumer need for shoes	.10	5	.50	Consumers consistently need new athletic and leisure shoes, and Skech- ers offers them for lower prices than competitors	

### ■ The External Factor Analysis (EFAS) Table in Chapter 4

This reduces the external opportunities and threats to the 8 to 10 most important external factors facing management.

### ■ The Internal Factor Analysis (IFAS) Table in Chapter 5

This reduces the internal strengths and weaknesses to the 8 to 10 most important internal factors facing management.

TABLE 5-2 Internal Factor Analysis Summary (IFAS Table): Skechers as Example							
Internal Factors		Weight	Rating	Weighted Score	Comments		
	1	2	3	4	5		
Strengths  Semi-autonomo management st		.05	5	.25	Allows the global brand to expand with a focus in local markets using licensing and subsidiaries		
<ul> <li>Choosing to use capital to re-inv business activiti of giving out div</li> </ul>	est into ies instead	.10	3	.30	Lends the opportunity to grow faster, but they are not investing back into marketing or R&D		

Internal Strategic Factors		Weight	Ra	ting	Weighted Score		Comments	
	1	2	2	3		4	Ę	
Strengths								
S1 Semi-autonomous management structure		.05		5	.25		Allows the global brand to expand with a focus in local markets using licensing & subsidiaries	
S2 Using excess capital to re-invest into business activities vs. paying dividends		.10		3	.30		Lends the opportunity to grow faster but they are not investing back into marketing or R&D	
S3 Low debt ratio & increasing cash flows	1	.10		3	.30		Increases stakeholder confidence & more equity means less reliance on debt	
S4 All manufacturing is outsourced		.10		5	.50		It is expensive to own manufacturing facilities	
S5 Offer paid training program and good benefits		.025		3	.075		Employee programs allow for growth and development	

### ■ The Strategic Factor Analysis Summary (SFAS) Matrix in Chapter 6

This condenses the 16 to 20 factors generated in the EFAS and IFAS tables into the 8 to 10 most important (strategic) factors facing the company. These strategic factors become the basis for generating alternatives and act as a recommendation for the company's future direction.

### Making Business Innovation Issues Relevant

Students are perpetually confused by the word *innovation* and what it really means for organizations. What is an innovation? Why is it such an important topic in Strategy (because it holds the potential for future competitive advantage)? How do we have a reasoned discussion about the topic within the context of various elements of Strategy design and implementation? We explore the many concerns and approaches through an **Innovation Issues** vignette in each chapter.

### **INNOVATION** issue

INNOVATION AND AUTONOMOUS SHIPPING

The effort to bring autonomous and semi-autonomous vehicles to the market has been moving along at a breakneck pace, outstripping government's ability to keep up with the changes. Autonomous transportation has been a significant focal point for innovation by some corporations. Among the many avenues being pursued is the shipping of goods by cargo containers.

Cargo ships are notorious for their pollution, rough working conditions, long waits to get into port, pirate takewers in some locations, and relative freedom of navigation. Over 90% of world trade is carried across the world's oceans in 90,000+ cargo vessels. More than 3% of global carbon dioxide emissions can be attributed to ocean-going ships.

If global shipping were a country, it would be the sixth largest producer of greenhouse gas emissions.

One company, Yara (based in Norway), launched the worlds first fully electric and autonomous container ship in November 2021. With this vessel, Yara will reduce diesel-powered truck haulage by 40,000 journeys a year. The vessel will operate with a skeleton crew for the first year and should be allowed to progressively reduce staff on the vessel to just a captain. The new vessels will be lighter than most ferries because they will have no sleeping area for crew.

Technology innovations in automobiles and GPS coverage are enabling opportunities to change the operation of entire industries.<sup>28</sup>

Innovation Issues boxes examine how innovative thinking is a driver of strategic change whether or not that change is good for the organization. Topics include Autonomous Shipping, turning a "need" into a business solution, examining whether products really die (via the lens of Polaroid), a look at Red Hat, Target, Volkswagen, and Apple.

### Making Business Sustainability Issues Relevant

Students are more concerned about sustainability and business sustainability efforts than ever before. How can business strategy be aimed at the triple bottom line? The triple bottom line is a framework used to evaluate performance with a broad perspective in order to create more value with all stakeholders. The three parts are: social, environmental, and financial. We explore the many concerns and approaches through a Sustainability Issues vignette in each chapter.

Sustainability Issues boxes reveal how the issues, processes, and topics impact all organizations. Topics include the disconnect between egregious CEO pay and performance, the crisis in the Colorado River, electric vehicles at GM, the Sustainable Seafood Initiative, and the failure of Panera Cares Community Cafés.

### **SUSTAINABILITY** issue

THE CRISIS IN THE COLORADO RIVER

The Colorado River provides fresh water to over 40 million people and 6,300 square milies of farmland in the United States as well as Mexico. Back in 1922, seven states (Upper Basin—Colorado, Wyoming, Utah, and New Mexico and Lower Basin—Arizona, California, and Nevada) created an allocation agreement that the river simply cannot support in the long term. The area has been suffering under a two-decade long drought and overuse beyond allocations by the lower basin states. The primary dam in the region is Lake Mead. Water levels have fallen to levels not seen since it was initially filled. By mid-2022, the lake was in danger of becoming a so-called "dead pool" where the intake systems for the damn were no longer under water.

The impact on a wide variety of industries could be quite significant. There are 38 S&P 500 Index companies worth some US\$1 trillion based in the area. Sharp reductions in water usage could have significant impacts on these busi-

Today, Las Vegas uses less water than it did 15 years ago despite a dramatic increase in population. To put the usage in context, the state of Nevada withdraws the equivalent of 30 inches from the lake per year while California withdraws 44 feet per year and Arizona uses 28 feet. Beyond the water usage issue, the dam also generates a significant portion of the region's electricity. Water flow decreases will impact the amount of electricity produced.

Conservation efforts that are a direct result of the depletion of natural resources hit the bottom line of organizations. Caesars Entertainment reported in 2019 that on top of its other water reduction efforts, it would cost up to US\$15 million to significantly reduce water use at just four large casinos in the region. A reduction in water to farming would have ripple effects across the country. In addition, there are some counterarouments to reduc-

### Making Global Strategy Issues Relevant

Students search for the relevance of strategic moves in a global context as well as how it might assist in their future careers. This text focuses on specific elements of Global Strategy in Chapter 9. In addition, we explore many concerns and approaches through a Global Issues vignette in each chapter.

### **GLOBAL** issue

SUVS POWER ON IN CHINA

U.S. and European automakers are looking to China for most of their growth potential in the next two decades. The Chinese middle class exceeded 700 million in 2018 (latest available statistics). That is a market that is equivalent to the ENTIRE population of the Unites States AND every country in the European Union combined.

This growing middle class in China (it stood at less than 300 million in 2012) has spurred a huge demand for sport utility vehicles (SUVs). Ford, BMW, Mercedes-Benz, and Porsche are all selling SUVs at a significant clip. The success of these brands sourred Chinese auto makers to dramati-

in China that has been seen in the United States, with women in particular being drawn to the flexibility of the SUV. A Ford spokesperson said that "... SUVs offer great appeal as the whole family can be transported safely and in style." The sharp increase in demand has drawn in the ultra-high-end car companies as well. Maserati and Lamborghini have both announced new SUVs for the Chinese market.

BMW has approached the market with products that they sell around the world, including the BMW X5. This is an example of a global organization. On the other

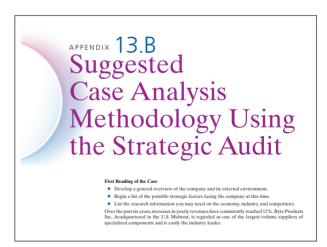
Global Issues boxes reveal how some of the issues, processes, and topics are relevant to the world's largest companies. Topics include applications of the material to China and SUVs, global culture issues at Salesforce, the race to the bottom seeking low-cost manufacturing, BreadTalk's move into China, and the movement of counterfeit goods.

### Understanding How to Analyze a Company (Case Analysis)

Students don't know how to start an analysis of a case. They read the case and our goal is to get them past the superficial, face-validity look at it and have them dig deeply into the case in order to craft together real insights. How do they do this and how do they keep a strategic focus on this effort? Chapter 13 is one of the most sought after chapters from this text.

### **Suggestions for Case Analysis (Chapter 13)**

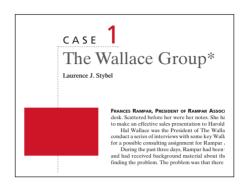
Suggestions for in-depth case analysis provide a complete listing of financial ratios, recommendations for oral and written analysis, and ideas for further research. A detailed approach for case analysis is provided in Appendix 13.B (end of Chapter 13). It contains step-by-step procedures on how to use a strategic audit in analyzing a case. This appendix includes an example of a student-written strategic audit. Tens of thousands of students around the world have applied this methodology to case analysis with great success.



### Relevant Cases

Faculty know that there are thousands of cases available. Finding ones that have been curated for the topics at hand, have been well-researched, and most importantly class-tested are hard to come by.

Timely, well-researched, and class-tested cases deal with interesting companies and industries. Many of the cases are about well-known, publicly held corporations—ideal subjects for further research by students wishing to "update" the cases. All cases are about actual organizations. The firms range in size from large, established multinationals to small, entrepreneurial ventures, and cover a broad variety of issues. As an aid to case analysis, we propose the strategic audit as an analytical technique.



### **DEVELOPING EMPLOYABILITY SKILLS**

Every aspect of an organization is impacted by strategy. Strategy (at its core) is about getting customers/clients to go past your competitors and buy from you. Every position in the organization must fundamentally understand the elements of the strategy and enable the organization to deliver on the strategy promise.

While a deep understanding of strategy will put you in a stronger position to be successful in any organization, there are also very clear employment paths that rely on the work you will do in this course. These include internal strategy groups, business analysis, mergers & acquisitions (M&A), consulting, and business development (BD).

Strategy design and implementation is the core reason for the success of any organization. The better you understand the processes used to truly separate an organization from its competitors, the more value you can provide.

### INSTRUCTOR RESOURCES

For more information and resources, visit www.pearson.com/en-gb.html.

### **ACKNOWLEDGMENTS**

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We are especially thankful to the many students who tried out the cases we chose to include in this book. Their comments helped us find any flaws in the cases before the book went to the printer. Several faculty have shared invaluable insights into use of this book on a practical level. We would like to thank John P. Agosta at St. John's University for his insights.

We also offer a big thanks to the many case authors who have provided us with excellent cases for the 16th edition of this book. We consider many of these case authors to be our friends. A special thanks to you!! The adage is true: The path to greatness is through others.

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Lastly, to the many strategy instructors and students who have relayed to us their thoughts about teaching the strategy course: We have tried to respond to your problems and concerns as best we could by providing a comprehensive yet usable text coupled with recent and complex cases. To you, the people who work hard in the strategy trenches, we acknowledge our debt. This book is yours.

C. E. B.

Durham, North Carolina

A. N. H.

Wellesley Hills, Massachusetts

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### About the Authors

CHARLES E. BAMFORD, Ph.D. (University of Tennessee), MBA (Virginia Tech), and BS (University of Virginia). Chuck worked in industry for 12 years prior to pursuing his Ph.D. His last position was as the Manager of Business Analysis (Mergers & Acquisitions, Dispositions, and Business Consulting) for Dominion Bankshares Corporation (now Wells Fargo). He is an Adjunct Professor of Strategy at Duke University (Fuqua) where he teaches in both the MBA and EMBA programs. He was previously a professor at the *University of Notre Dame*, *University of Richmond*, *Texas Christian University*, and *Tulane University*, among others. He has been honored with 22 Professor of the Year Awards. He was named a Noble Foundation Fellow in Teaching Excellence and a Poets & Ouants EMBA Favorite Professor.

In 2013, Chuck founded Bamford Associates, LLC on a full-time basis. He has worked with tens of thousands of managers with organizations in more than 20 countries in the development of implementable strategic plans and an entrepreneurial orientation to growth.

His research has been published in the Strategic Management Journal, Journal of Business Venturing, Entrepreneurship Theory & Practice, Journal of Business Research, Journal of Business Strategies, Journal of Technology Transfer, and Journal of Small Business Management, among others. Chuck has co-authored five other books including the popular press book The Strategy Mindset 2.0 and the fiction novel Some Things Are Never Forgiven.

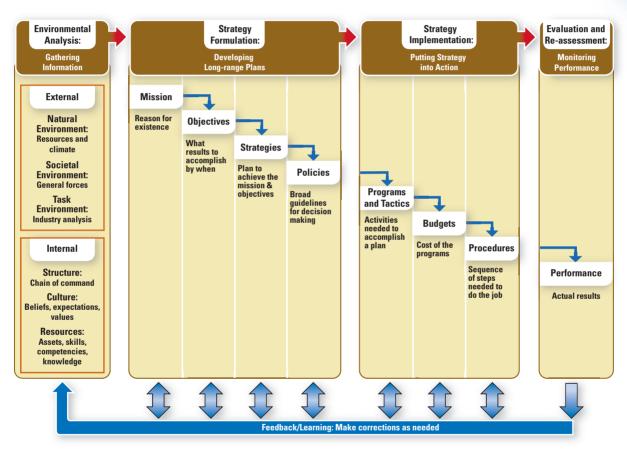
ALAN N. HOFFMAN, MBA, DBA (Indiana University), is Professor Emeritus of Strategic Management at Bentley University in Waltham, Massachusetts. He is the former Director of the MBA Program at Bentley University. He served as the course coordinator and Visiting Professor of Strategic Management for the Global Strategy course in the OneMBA Program at the Rotterdam School of Management at Erasmus University, Rotterdam, The Netherlands. He is also the owner of Dr. Alan N. Hoffman Investment Management, founded in 1995. His major areas of interest include strategic management, global competition, investment strategy, design thinking, and technology. Professor Hoffman is coauthor of The Strategic Management Casebook and Skill Builder textbook (with Hugh O'Neill). His academic publications have appeared in the Academy of Management Journal, Human Relations, the Journal of Business Ethics, the Journal of Business Research, and Business Horizons. He has authored more than 40 strategic management cases, including The Boston YWCA, Ryka Inc., Liz Claiborne, Ben & Jerry's, Cisco Systems, Sun Microsystems, Palm Inc., Handspring, eBay, AOL/ Time Warner, McAfee, Apple Computer, TiVo Inc., Wynn Resorts, TomTom, Blue Nile, GE, Amazon, Netflix, Delta Airlines, A123, Tesla Motors, Chipotle, Staples, Target, Sonic Restaurants, Harley Davidson, and Whole Foods Market. He is the recipient of the 2004 Bentley University Teaching Innovation Award for his course: "The Organizational Life Cycle-The Boston Beer Company Brewers of Samuel Adams Lager Beer." He taught strategic management in many executive programs and also taught business to artists at The Massachusetts College of Art and Design.

THOMAS L. WHEELEN, May 30, 1935–December 24, 2011. DBA, MBA, BS Cum Laude (George Washington University, Babson College, and Boston College, respectively), College, MBA (1961); Boston College, BS cum laude (1957). Teaching Experience: Visiting Professor-Trinity College-University of Dublin (Fall 1999); University of South Florida-Professor of Strategic Management (1983-2008); University of Virginia-McIntire School of Commerce; Ralph A. Beeton Professor of Free Enterprise (1981–1985); Professor (1974–1981); Associate Professor (1971–1974); and Assistant Professor (1968–1971); Visiting Professor-University of Arizona (1979–1980 and Northeastern University (Summer 1975, 1977, and 1979). Academic, Industry, and Military Experience: University of Virginia College of Continuing Education: (1) Coordinator for Business Education (1978–1983, 1971–1976)—approved all undergraduate courses offered at seven Regional Centers and approved faculty; (2) Liaison Faculty and Consultant to the National Academy of the FBI Academy (1972–1983) and; (3) developed, sold, and conducted over 200 seminars for local, state, and national governments, and companies for the McIntire School of Commerce and Continuing Education. General Electric Company—various management positions (1961–1965); U.S. Navy Supply Corps (SC)-Lt. (SC) USNR-assistant supply officer aboard nuclear support tender (1957–1960). Publications: (1) Monograph, An Assessment of Undergraduate Business Education in the United States (with J. D. Hunger), 1980; (2) Books: 60 books published; 14 books translated into eight languages (Arabic, Bahasa-Indonesian, Chinese, Chinese Simplified, Greek, Italian, Japanese, Portuguese, and Thai); (3) Books—co-author with J. D. Hunger—five active books: Strategic Management and Business Policy, 10th edition (2006); Cases in Strategic Management and Business Policy, 10th edition (2006); Concepts in Strategic Management and Business Policy, 10th edition (2006); Strategic Management and Business Policy, 10th edition; International Edition (2006); and Essentials of Strategic Management, 3rd edition (2003); (4) Co-editor: Developments in Information Systems (1974) and Collective Bargaining in the Public Sector (1977); and (5) Co-developer of software-STrategic Financial ANalyzer (ST. FAN) (1993, 1990, 1989-different versions); (6) Articles—authored over 40 articles that have appeared in such journals as the Journal of Management, Business Quarterly, Personnel Journal, SAM Advanced Management Journal, Journal of Retailing, International Journal of Management, and the Handbook of Business Strategy; (6) Cases—have about 280 cases appearing in over 83 text and case books, as well as the Business Case Journal, Journal of Management Case Studies, International Journal of Case Studies and Research, and the Case Research Journal. Awards: (1) Fellow elected by the Society for Advancement of Management in 2002; (2) Fellow elected by the North American Case Research Association in 2000; (3) Fellow elected by the Text and Academic Authors Association in 2000; (4) the 1999 Phil Carroll Advancement of Management Award in Strategic Management from the Society for Advancement of Management; (5) 1999 McGuffey Award for Excellence and Longevity for Strategic Management and Business Policy, 6th edition, from the Text and Academic Authors Association; (6) 1996/97 Teaching Incentive Program Award for teaching undergraduate strategic management; (7) Fulbright, 1996–1997, to Ireland but had to turn it down; (8) Endowed Chair, Ralph A. Beeton Professor, at University of Virginia (1981–1985); (9) a Sesquicentennial Associateship research grant from the Center for Advanced Studies at the University of Virginia, 1979–1980; (10) Small Business Administration (Small Business Institute), supervised undergraduate team that won District, Regional III, and Honorable Mention Awards; and (11) awards for two articles. Associations: Dr. Wheelen served on the Board of Directors of the Adhia Mutual Fund, the Society for Advancement of Management, and on the Editorial Board and as Associate Editor of SAM Advanced Management Journal. He served on the Board of Directors of Lazer Surgical Software Inc. and the Southern Management Association, and on the Editorial Boards of the Journal of Management and Journal of Management Case Studies, the Journal of Retail Banking, the Case Research Journal, and the Business Case Journal. He was Vice President of Strategic Management for the Society for the Advancement of Management, and President of the North American Case Research Association. Dr. Wheelen was a member of the Academy of Management, Beta Gamma Sigma, the Southern Management Association, the North American Case Research Association, the Society for Advancement of Management, the Society for Case Research, the Strategic Management Association, and the World Association for Case Method Research and Application. He has been listed in Who's Who in Finance and Industry, Who's Who in the South and Southwest, and Who's Who in American Education.

J. DAVID HUNGER, Ph.D. (Ohio State University), is currently Strategic Management Scholar in Residence at Saint John's University in Minnesota. He is also Professor Emeritus at Iowa State University where he taught for 23 years. He previously taught at George Mason University, the University of Virginia, and Baldwin-Wallace College. He worked in brand management at Procter & Gamble Company, as a selling supervisor at Lazarus Department Store, and served as a Captain in U.S. Army Military Intelligence. He has been active as a consultant and trainer to business corporations, as well as to state and federal government agencies. He has written numerous articles and cases that have appeared in the Academy of Management Journal, International Journal of Management, Human Resource Management, Journal of Business Strategies, Case Research Journal, Business Case Journal, Handbook of Business Strategy, Journal of Management Case Studies, Annual Advances in Business Cases, Journal of Retail Banking, SAM Advanced Management Journal, and Journal of Management, among others. Dr. Hunger is a member of the Academy of Management, the North American Case Research Association, the Society for Case Research, the North American Management Society, the Textbook and Academic Authors Association, and the Strategic Management Society. He is past-President of the North American Case Research Association, the Society for Case Research, and the Iowa State University Press Board of Directors. He also served as a Vice President of the U.S. Association for Small Business and Entrepreneurship. He was Academic Director of the Pappajohn Center for Entrepreneurship at Iowa State University. He has served on the editorial review boards of SAM Advanced Management Journal, the Journal of Business Strategies, and the Journal of Business Research. He has served on the board of directors of the North American Case Research Association, the Society for Case Research, the Iowa State University Press, and the North American Management Society. He is co-author with Thomas L. Wheelen of Strategic Management and Business Policy and Essentials of Strategic Management plus Concepts in Strategic Management and Business Policy and Cases in Strategic Management and Business Policy, as well as Strategic Management Cases (PIC: Preferred Individualized Cases), and a monograph assessing undergraduate business education in the United States. The 8th edition of Strategic Management and Business Policy received the McGuffey Award for Excellence and Longevity in 1999 from the Text and Academic Authors Association. Dr. Hunger received the Best Case Award given by the McGraw-Hill Publishing Company and the Society for Case Research in 1991 for outstanding case development. He is listed in various versions of Who's Who, including Who's Who in the United States and Who's Who in the World. He was also recognized in 1999 by the Iowa State University College of Business with its Innovation in Teaching Award and was elected a Fellow of the Teaching and Academic Authors Association and of the North American Case Research Association.

Strategic
Management
and Business
Policy

## Basic Concepts of Strategic Management



### Learning Objectives

### After reading this chapter, you should be able to:

- **1-1.** Discuss the benefits of strategic management
- **1-2.** Explain how globalization, innovation, and environmental sustainability influence strategic management
- **1-3.** Discuss the differences between the theories of organizations
- **1-4.** Discuss the activities where learning organizations excel
- **1-5.** Describe the basic model of strategic management and its components

- **1-6.** Identify some common triggering events that act as stimuli for strategic change
- **1-7.** Explain strategic decision-making modes
- **1-8.** Use the strategic audit as a method of analyzing corporate functions and activities
- **1-9.** Explain the employment opportunities in Strategic Management

### **Toyota Motor Corporation**

Kiichiro Toyoda founded the Toyota Motor Corporation in 1937. Headquartered in Aichi Prefecture, Japan, the company is now headed by Akio Toyoda, the president and representative director, and has capital of around \$179 billion. Its primary business activities revolve around automotive manufacturing.

In 1935, Sakichi Toyoda, the founder of Toyota Industries, set certain "Guiding Principles" to reflect Toyota's organizational culture and values and to serve as the basis for its corporate management philosophy. They can be summed up as faithfulness to duties, studiousness and creativity, practicality, maintaining a warm and friendly workplace, respect for spiritual matters, and gratitude. These were first revised in 1992 and again in 1997 to support its operations in a multicultural environment. Specifically, they were modified in response to societal changes and the company's business structure, which supports its global vision, strategies, and operations worldwide. At the heart of the "Toyota Way" are two pillars: continuous improvement and respect for people. These are supported by five values: taking on challenges, continuous improvement (*kaizen*), seeing for oneself (*genchi genbutsu*), respect, and teamwork.

In 1997, due to an economic crisis in Thailand, a regional hub of Toyota's auto manufacturing industry in the ASEAN trade bloc, Toyota Motor Thailand Co., Ltd. (TMT) faced huge losses. To overcome the crisis, TMT first requested and received two capital injections, totaling US\$200 million, from the Toyota Motor Corporation in Japan. However, since the automotive market was down by about 75%, TMT had to use a job-sharing approach to retain its skilled, though redundant, workforce, observing a "no lay-off" policy. It also kept to the policy by sending about 200 idle associates to Japan for training while others assisted their local dealers. To avoid further losses, TMT focused on 100% localization of parts and took advantage of export opportunities. Undertaking new business reforms—such as online management of vehicle supply and demand and the formation of project teams in finance and marketing—helped boost new vehicle sales. For dealers and suppliers, TMT granted credit lines and short-term loans.

Concerned by the threat to the jobs of many of his subjects, the then king of Thailand, Bhumibol Adulyadej, granted a purchase order to TMT to produce a Toyota Soluna (Vios). Instead of selling the vehicle, TMT presented it to the king as a gift; the King, in turn, granted \$17,518 (600,000 baht) to TMT to help establish the Rachamongkol Rice Mill, a project spearheaded by the vice chairman of TMT, Ninnart Chaithirapinyo. As an ongoing TMT-CSR activity, the mill still helps rice farmers maintain their crop prices while benefiting TMT's associates as well as

the overall community. Put another way, TMT overcame the crisis of 1997 by using *kaizen* (continuous improvement in small consecutive stages) to strengthen its competitiveness and improve communication among top management and all of its associates.

However, despite its strong guiding principles, Toyota recognized a need for change: The drive for fast growth led to a drop in quality, the famed Toyota Production System led to overreliance and complacency, the *genchi genbutsu* approach created too many layers of management, and cost reduction pressures created too many uncontrolled local suppliers. In 2007, using the guiding principles as a basis, the company created its Global Vision 2020, which outlined the expectations of employees as well as the medium- and long-term management plan. Fundamentally, the Global Vision 2020 sought to create harmony between Toyota's activities on the one hand and people, society, and the global environment on the other.

Toyota's divisional organization structure is based on varied business operations, but it is linked to traditional Japanese organizational structures. In 2013, in response to the safety issues and resulting product recalls crisis of 2009, involving some 4 million vehicles, the centralized hierarchical structure underwent significant changes to become more decentralized. Toyota's new organizational structure has the following main characteristics: global hierarchy, geographic divisions, and product-based divisions. The company is now more capable of responding to regional market conditions and is empowered to speedily respond to issues and to provide higher-quality products. The increased decision-making power of regional heads may reduce the Toyota headquarters' control over the global organization, but this organizational structure facilitates business resilience and continued growth.

Toyota moved on from the recall crisis, and by the 2010s, it had 52 overseas manufacturing companies across 28 countries and regions, and its products sold in over 170 countries. This period also saw the beginnings of a new focus that Toyota President Akio Toyoda has dubbed "CASE" (Connected, Autonomous/Automated, Shared, Electric). Speaking in December 2019 of a major change in the Toyota business model, Toyoda contrasted the company's past focus on vehicle manufacturing with a new approach. The new Toyota includes the development of integrated public transport systems, the creation of systems to improve car sharing and cab services, and even support robots in hospitals and in the home environment to help those with disabilities.<sup>1</sup>

### The Study of Strategic Management

**1-1.** Discuss the benefits of strategic management

**Strategic management** is a set of managerial decisions and actions that help determine the long-term performance of an organization. It includes environmental analysis (both external and internal), strategy formulation (focusing on a few competitive advantages while ensuring that the organization also meets the table-stakes expectations of customers), strategy implementation (the complex effort to align employee action to deliver on the strategy promise of the organization), as well as evaluation and reassessment. Originally called *business policy*, strategic management has advanced substantially with the concentrated efforts of researchers and practitioners. Today, we recognize both a science and an art to the application of strategic management techniques.

### PHASES OF STRATEGIC MANAGEMENT

The concepts and processes of effective strategic management have been developed over many decades by both researchers and practitioners. They are used successfully by the largest business organizations in the world as well as the newest startups. Over time, business practitioners and academic researchers have expanded and refined these concepts. One of the most critical drivers of business success is the leadership team's ability to design and implement a strategy for the company. Increasing risks of error, costly mistakes, and even economic ruin are causing today's leaders to take strategic management seriously in order to keep their companies competitive in an increasingly volatile environment that must deal with everything from new competitors to pandemics.

As organizations develop, they appear to evolve through the following four **phases** of strategic management:<sup>2</sup>

Phase 1—Basic financial planning: Managers initiate serious planning when they are requested to propose the following year's budget. Projects are proposed on the basis of very little analysis, with most information coming from within the firm. The sales force usually provides the small amount of environmental information used in this effort. Such simplistic operational planning only pretends to be strategic management, yet it is quite time consuming. Normal company activities are often suspended for weeks while managers try to cram ideas into the proposed budget. The time horizon is often only one year.

Phase 2—Forecast-based planning: As annual budgets become less useful at stimulating long-term success, managers attempt to propose five-year plans. In addition to internal information, managers gather any available environmental data—usually on an ad hoc basis—and extrapolate current trends. This phase is also time consuming, often involving a full month or more of managerial activity to make sure all the proposed budgets fit together. The process gets very political as managers compete for larger shares of limited funds. Seemingly endless meetings take place to evaluate proposals and justify assumptions. The time horizon is usually three to five years, with most of it being guesswork.

Phase 3—Externally oriented (strategic) planning: Frustrated with highly political five-year plans that consistently fail to deliver results, top management takes control of the planning process by initiating a formal strategic planning system. The company seeks to increase its responsiveness to changing markets and competition by thinking and acting with more processes and rigor. Planning is taken out of the hands of lower-level managers and concentrated in a planning staff whose task is to develop strategic plans that are well grounded. Consultants might provide the sophisticated and innovative techniques that the planning staff uses to gather information and forecast future trends. Organizations start competitive intelligence units. Upper-level managers meet once a year at a resort "retreat" led by key members of the planning staff to evaluate and update the current strategic plan. Such top-down planning emphasizes formal strategy formulation and leaves the implementation issues to lower-management levels. Top management typically develops long-term plans with help from consultants but minimal input from lower levels.

**Phase 4—Strategic management:** Realizing that even the best strategic plans are worthless without the input and commitment of lower-level managers, top management forms planning groups of managers and key employees at many levels, from various departments and workgroups. They develop and integrate a

series of plans focused on emphasizing the company's true competitive advantages while simultaneously addressing areas of the organization that have fallen behind competitors. Strategic plans are expected to detail the implementation, evaluation, and control issues. Rather than attempting to perfectly forecast the future, the plans emphasize probable scenarios and contingency strategies. The sophisticated (though often flawed) annual five-year strategic plan revision is replaced with a continuous process at all levels of the organization throughout the year. Strategic information, previously available only centrally to top management, is used by people throughout the organization. Instead of a large, centralized planning staff, internal and external planning consultants are available to help guide group strategy discussions. Although top management may still initiate the strategic planning process, the resulting strategies may come from anywhere in the organization. Planning is typically interactive across levels and is no longer strictly top down. People at all levels are now involved.

### BENEFITS OF STRATEGIC MANAGEMENT

Strategic management emphasizes long-term performance. Many companies can manage short-term bursts of high performance, but only a few can sustain it over a longer period of time. Since the release of the original *Fortune 500* companies listing in 1955, more than 1,800 companies have made the list. In 2021, 39 new companies joined the list for the first time, meaning, of course, that 39 others fell from the list.<sup>3</sup> Interestingly, 53 companies have been on the list every year since its start. To be successful in the long run, companies must not only be able to *execute* current activities to satisfy an existing market, but they must also *adapt* those activities to satisfy new and changing markets.<sup>4</sup>

Research reveals that organizations that engage in strategic management processes generally outperform those that do not.<sup>5</sup> The attainment of an appropriate match, or "fit," between an organization's environment and its strategy, structure, and processes has positive effects on the organization's performance.<sup>6</sup> Strategic planning becomes increasingly important as the environment becomes more unstable.<sup>7</sup> For example, studies of the impact of deregulation on the U.S. railroad and trucking industries found that companies that changed their strategies and structures as their environment changed outperformed companies that did not change.<sup>8</sup>

A survey of nearly 50 corporations in a variety of countries and industries found the three most highly rated benefits of strategic management to be:

- A clearer sense of strategic direction for the firm.
- A sharper focus on what really separates the organization from its competitors.
- An improved understanding of a rapidly changing environment.<sup>9</sup>

A survey by McKinsey & Company of 800 executives found that formal strategic planning processes improved overall satisfaction with strategy development. To be effective, however, strategic management need not always be a formal process. It can begin with a few simple questions:

- Where is the organization now? (Not where do we hope it is!)
- If no significant changes are made, where will the organization be in one year? Two years? Five years? Ten years? Are the answers acceptable?
- If the answers are not acceptable, what specific actions should management undertake? What are the risks and payoffs involved?

The Bain & Company's 2017–2018 Management Tools and Trends survey of 14,700 global executives from more than 70 countries in North America, Europe, Asia, Africa, the Middle East, and Latin America revealed that strategic planning was the number one tool used by decision makers. Not surprisingly, customer relationship management was second. These two tools go hand in hand as we are trying to differentiate in order to attract customers past our competitors. A study by Joyce, Nohria, and Roberson of 200 firms in 50 subindustries found that devising and maintaining an engaged, focused strategy was the first of four essential management practices that best differentiated between successful and unsuccessful companies. Based on these and other studies, it can be concluded that strategic management is one of the more effective approaches for long-term organizational success.

Research into the planning practices of companies in the oil industry found that the real value of modern strategic planning is more in the *strategic thinking* and *organizational learning* that is part of a future-oriented planning process than in any resulting written strategic plan.<sup>13</sup> Small companies, in particular, may plan informally and irregularly. Nevertheless, studies of small- and medium-sized businesses reveal that the greater the level of planning intensity, as measured by the presence of a formal strategic plan, the greater the level of financial performance, especially when measured in terms of sales increases.<sup>14</sup>

Planning the strategy of large, multidivisional corporations can be complex and time consuming and, depending upon the industry dynamics, can have a very long impact. Strategic plans in the global oil industry tend to cover four to five years. The planning horizon for oil exploration is even longer—up to 15 years. Because of the relatively large number of people affected by a strategic decision in a large firm, a formalized, more sophisticated system is needed to ensure that strategic planning leads to successful performance. Otherwise, top management becomes isolated from developments in the business units, and lower-level managers lose sight of the corporate mission and objectives.

### Globalization, Innovation, and Sustainability: Challenges to Strategic Management

1-2. Explain how globalization, innovation, and environmental sustainability influence strategic management

In the not too distant past, a U.S. business could be successful by focusing only on making and selling goods and services within its national boundaries. International considerations were minimal. Profits earned from exporting products out of one's home country were considered frosting on the cake, but not really essential to corporate success. During the 1960s, most U.S. companies organized themselves around a number of product divisions that made and sold goods only in the United States. All manufacturing and sales outside the United States were typically managed through one international division.

Similarly, for a very long time, many established companies viewed innovation as the domain of the new entrant. The efficiencies that came with size were considered to be the core competitive advantage of the large organization. That view has proven to be a recipe for failure. The ability to create unique value and grow an organization organically requires innovation skills. A strategic management approach suggests that if an organization stands still, it will be run over by the competition. What was extraordinary last year is the standard expectation of customers this year. We have watched many

large corporations succumb to the lack of innovation in their organization. Sears was the dominant retailer in the United States for more than 70 years. As of late 2021, it is still in bankruptcy and is on the verge of becoming the latest example of iconic companies disappearing. IBM was a company that dominated mainframe computing and was fortunate enough to find a visionary CEO when the mainframe market was crushed by the advent of the PC. That CEO (Louis V. Gerstner, Jr.) transformed the organization with innovation that was cultural, structural, and painful for the company employees. Innovation is rarely easy, and it is almost never painless. Nonetheless, it is a core element of successful strategic management efforts.

Lastly, until the latter part of the 20th century, a business firm could be very successful without considering sustainable business practices. Companies dumped their waste products in nearby streams or lakes and freely polluted the air with smoke containing noxious gases. Responding to complaints, governments eventually passed laws restricting the freedom to pollute the environment. Lawsuits forced companies to stop old practices. Nevertheless, until the dawn of the 21st century, most executives considered pollution abatement measures to be a cost of business that should be either minimized or avoided. Rather than clean up a polluting manufacturing site, they often closed the plant and moved manufacturing offshore to a developing nation with fewer environmental restrictions. The issues of recycling and refurbishing, as well as a company's responsibility to both the local inhabitants and the environment where it operated, were not considered mainstream business approaches, because it was felt these concerns did not help maximize shareholder value. In those days, the word *sustainability* was used to describe competitive advantage, not the environment.

Today, one of the more popular terms used to describe a business's sustainability is the **triple bottom line**. This phrase was first used by John Elkington in 1994 to suggest that companies prepare three different bottom lines in their annual report.<sup>16</sup>

- Traditional Profit/Loss
- People Account—The social responsibility of the organization
- Planet Account—The environmental responsibility of the organization

This triple bottom line has become increasingly important to business today. Companies seek Leadership in Energy and Environmental Design (LEED) certification for their buildings and mold a reputation for being a business that is friendly to the world. LEED certification is available for all structures and includes a number of levels depending upon the efforts made to have a building be self-sustaining or to have as little impact (the smallest footprint) on the environment as possible. Another growing business approach is that of the B Corporation. Certified B Corporations are businesses that meet certain social and environmental performance measures, along with public transparency aimed at creating a balance of profitability and sustainability. 18

#### IMPACT OF GLOBALIZATION

**Globalization**, the integrated internationalization of markets and corporations, has changed modern business. As Thomas Friedman points out in *The World Is Flat*, jobs, knowledge, and capital are now able to move across borders with far greater speed and far less friction than was possible only a few years ago.<sup>19</sup>

The interconnected nature of the global financial community meant that the mortgage lending problems that were so rampant at U.S. banks led to a global financial crisis that started in 2008 and impacted economies for years. The worldwide availability

of the Internet and supply-chain logistical improvements, such as containerized shipping, mean that companies can now locate anywhere and work with multiple partners to serve any market. The weaknesses in that system were exposed during the worldwide Covid-19 pandemic. Supply lines that were tightly managed for minimal stock-on-hand unraveled as the world went into repeated lockdowns and then surges of consumer demand.

For companies seeking a low-cost approach, the internationalization of business has been a new avenue for competitive advantage. Nike and Reebok manufacture their athletic shoes in various countries throughout Asia for sale on every continent. Many other companies in North America and Western Europe are outsourcing their manufacturing, software development, or customer service to companies in China, Eastern Europe, or India. English language proficiency, lower wages in India, and large pools of talented software programmers now enable IBM to employ an estimated 100,000 people in its global delivery centers in Bangalore, Delhi, or Kolkata to serve the needs of clients in Atlanta, Munich, or Melbourne.<sup>20</sup> Instead of using one international division to manage everything outside the home country, large corporations are now using matrix structures in which product units are interwoven with country or regional units. Today, international assignments are considered key for anyone interested in reaching top management.

The formation of regional trade associations and agreements, such as the European Union, USMCA, Mercosur, Andean Community, CAFTA, and ASEAN, changed how international business was conducted. See the **Global Issue** feature to learn how regional trade associations are pushing corporations to establish a manufacturing presence wherever they wish to market goods or else face significant tariffs. These associations have led to the increasing harmonization of standards so that products can more easily be sold and moved across national boundaries. International considerations have led to the many global airline alliances and to the acquisition of the Anheuser-Busch Companies by the Belgium company InBev, creating AB InBev, among many others.

#### IMPACT OF INNOVATION

**Innovation**, as the term is used in business, is meant to describe new products, services, methods, and organizational approaches that allow the business to achieve extraordinary returns. PWC's Strategy& group reported that in 2018, R&D spending among the Global Innovation 1000 increased 11.4%, to a record high of US\$782 billion. <sup>21</sup> They also found that the 88 companies that earned the classification of high-leverage innovators in 2017:

- had sales growth 2.6 times as high as other companies on the Global Innovation 1000 list and
- experienced growth in the market capitalization 2.9 times as high
- while their R&D intensity (R&D expenditures as a percentage of sales) was lower than their industry median.

Innovation is the machine that generates business opportunities in the market; however, it is the implementation of potential innovations that truly drives businesses to be remarkable. Although there is a value in being a first mover, there is also a tremendous value in being a fast follower with the right implementation. PC tablets had been developed and sold for more than two decades before the iPad stormed the market. Many

# **GLOBAL** issue

#### REGIONAL TRADE AGREEMENTS & NATIONAL TRADE BARRIERS

Formed as the European Economic Community in 1957, the **European Union (EU)** is one of the most significant trade associations in the world. It is going through some significant re-setting now that the United Kingdom (which includes Northern Ireland) has left the organization. The U.K. never adopted the euro as its currency but was one of the most important members. The goal of the EU is the complete economic integration of its 27 member countries so that goods made in one part of Europe can move freely without ever stopping for a customs inspection. The EU includes Austria, Belgium, Bulgaria, Cyprus, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden. Albania, Macedonia, Montenegro, Serbia, and Turkey are candidate countries in the process of applying. The EU is less than half the size of the United States of America but encompasses 50% more people. One currency, the euro, is being used throughout the region as members agreed to integrate their monetary systems. The steady elimination of barriers to free trade is providing the impetus for a series of mergers, acquisitions, and joint ventures among business corporations. The requirement of at least 60% local content to avoid tariffs has forced many U.S. and Asian companies to abandon exporting in favor of having a strong local presence in Europe.

Canada, the United States, and Mexico were affiliated economically under the former North American Free Trade Agreement (NAFTA). The goal of NAFTA was to improve trade among the three member countries rather than complete economic integration. Launched in 1994, the agreement required all three members to remove all tariffs among themselves over 15 years, but they were allowed to have their own tariff arrangements with nonmember countries. Cars and trucks had to have 62.5% North American content to qualify for duty-free status. The agreement did not prevent the imposition of other tariffs such as those imposed upon Mexico and Canada by the Trump administration. Transportation restrictions and other regulations were significantly reduced. The agreement was renegotiated and renamed in 2018. The new agreement is known as the United States-Mexico-Canada Agreement, or **USMCA** and must be approved by all three countries' legislative bodies.<sup>22</sup> A number of Asian and European corporations, such as Sweden's Electrolux, have built manufacturing facilities in Mexico to take advantage of the country's lower wages and easy access to the entire North American region.

South American countries are also working to harmonize their trading relationships with each other and to form trade associations. The establishment of the **Mercosur (Mercosul** in Portuguese) free-trade area among Argentina, Brazil, Paraguay, Uruguay, and Venezuela brings together a group that includes 295 million people and US\$3.5 trillion in combined GDP. As of 2022, Boliva is an associate member. The **Andean Community** (Comunidad Andina de Naciones) is a free-trade alliance composed of Columbia, Ecuador, Peru, and Bolivia (until its acceptance into Mercosur). On May 23, 2008, the **Union of South American Nations** was formed to unite the two existing free-trade areas with a secretariat in Ecuador and a parliament in Bolivia. It consists of 12 South American countries.

In 2004, the five Central American countries of El Salvador, Guatemala, Honduras, Nicaragua, and Costa Rica, plus the United States, signed the **Central American Free Trade Agreement (CAFTA)**. The Dominican Republic joined soon thereafter. Previously, Central American textile manufacturers had to pay import duties of 18%–28% to sell their clothes in the United States unless they bought their raw material from U.S. companies. Under CAFTA, members can buy raw material from anywhere, and their exports are duty free. In addition, CAFTA eliminated import duties on 80% of U.S. goods exported to the region, with the remaining tariffs being phased out over 10 years.

The Association of Southeast Asian Nations (ASEAN)—composed of Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam—is in the process of linking its members into a borderless economic zone by 2020. Increasingly referred to as ASEAN+3, ASEAN now includes China, Japan, and South Korea in its annual summit meetings. The ASEAN nations negotiated linkage of the ASEAN Free Trade Area (AFTA) with the existing free-trade area of Australia and New Zealand. With the EU extending eastward and NAFTA extending southward to someday connect with CAFTA and the Union of South American Nations, pressure is building on the independent Asian nations to join ASEAN.

people forget that Apple released the Newton tablet back in 1992.<sup>23</sup> The timing was simply not right back in 1992. Consumers had no idea how the Newton could really be used and were not looking for that solution. Many elements have to come together for an innovation to bring long-term success to a company.

#### IMPACT OF SUSTAINABILITY

**Sustainability** refers to the use of business practices to manage the triple bottom line, as was discussed earlier. That triple bottom line involves (1) the management of traditional profit/loss; (2) the management of the company's social responsibility; and (3) the management of its environmental responsibility.

The company has a relatively obvious long-term responsibility to the shareholders of the organization. That means that the company has to be able to thrive despite (or because of) changes in the industry, society, and the physical environment. This is the focus of a significant part of strategy in business.

A sustainable approach to business incorporates a responsibility to its employees, its customers, and the community in which it operates. Companies that have embraced sustainable practices have seen dramatic increases in risk mitigation and innovation, as well as an overall positive impact on employees as a result of corporate social responsibility. A survey managed by GreenBiz in association with the National Environmental Education Foundation found that employees at companies who focused on business sustainability reported 57% applied more effort in their jobs and 87% were less likely to leave the company. In addition, more than 50% of companies place at least some or a great deal of value on a job candidate's sustainability knowledge.<sup>24</sup> A Gallup research study found that these engaged organizations had 3.9 times the earnings per share (EPS) growth rates when compared to organizations with lower engagement in the same industry.<sup>25</sup>

Organizations have a responsibility to treat the environment well if for no other reason than that of its long-term liability and perhaps even viability. This is usually defined as trying to achieve (or approach) zero impact on the environment. Recycling, increased use of renewable resources, reduction of waste, and refitting buildings to reduce their impact on the environment, among many other techniques, are included in this element of the triple bottom line. The most recognized worldwide standard for environmental efficiency is the ISO 14001 designation. It is not a set of standards, but a framework of activities aimed at effective environmental management.<sup>26</sup>

Porter and Reinhardt warn that "in addition to understanding its emissions costs, every firm needs to evaluate its vulnerability to climate-related effects such as regional shifts in the availability of energy and water, the reliability of infrastructures and supply chains, and the prevalence of infectious diseases." NOAA's National Centers for Environmental Information (NCEI) reports that since 1980, the United States has sustained 308 weather and climate disasters where the overall damage costs reached or exceeded US\$1 billion (including adjustments based on the Consumer Price Index to 2021). The cumulative costs for these events exceed US\$2.0 trillion. More interesting is that 50 of these disasters have occurred in the past three years.<sup>28</sup>

A core element in strategy design is addressing the ability of the organization to prepare for possible disruptions to their position in the market. While obvious disruptions would include competitor moves, regulatory changes, political changes, technological disruptions, and customer shifts, another major area is environmental changes (which includes pandemics).

## Theories of Organizational Adaptation

**1-3.** Discuss the differences between the theories of organizations

Globalization, innovation, and sustainability present real challenges to the strategic management of businesses. How can any one company keep track of all the changing technological, economic, political-legal, and sociocultural trends around the world in order to make the necessary adjustments? This is not an easy task. Various theories have been proposed to account for how organizations obtain fit with their environment and how these approaches have been used to varying degrees by researchers trying to understand firm performance. The theory of **population ecology** suggests that once an organization is successfully established in a particular environmental niche, it is unable to adapt to changing conditions. Inertia prevents the organization from changing in any significant manner. The company is thus replaced (is bought out or goes bankrupt) by other organizations more suited to the new environment. Although it is a popular theory in sociology, research fails to support the arguments of population ecology.<sup>29</sup> Institution theory, in contrast, proposes that organizations can and do adapt to changing conditions by imitating other successful organizations. Many examples can be found of companies that have adapted to changing circumstances by imitating an admired firm's strategies and management techniques.<sup>30</sup> The theory does not, however, explain how or by whom successful new strategies are developed in the first place. The strategic choice perspective goes a significant step further by proposing that not only do organizations adapt to a changing environment but also they have the opportunity and power to reshape their environment. This perspective is supported by research indicating that the decisions of a firm's management have at least as great an impact on firm performance as overall industry factors.<sup>31</sup> Because of its emphasis on managers making rational strategic decisions, the strategic choice perspective is the dominant one taken in strategic management. Its argument that adaptation is a dynamic process fits with the view of **organizational learning theory**, which says that an organization adjusts defensively to a changing environment and uses knowledge offensively to improve the fit between itself and its environment. This perspective expands the strategic choice perspective to include people at all levels becoming involved in providing input into strategic decisions.<sup>32</sup>

In agreement with the concepts of organizational learning theory, an increasing number of companies are realizing that they must shift from a vertically organized, top-down type of organization to a more horizontally managed, interactive organization. They are attempting to adapt more quickly to changing conditions by becoming "learning organizations."

# Creating a Learning Organization

**1-4.** Discuss the activities where learning organizations excel

Strategic management has now evolved to the point that its primary value is in helping an organization operate successfully in a dynamic, complex environment. To be competitive in dynamic environments, corporations are becoming less bureaucratic and more flexible. In stable environments such as those that existed in the not-too-distant past, a competitive strategy simply involved defining a competitive position and then defending it. As it takes less and less time for one product, service, approach, or technology to replace another, companies know now that there is no such thing

as a permanent competitive advantage. Many agree with Richard D'Aveni, who says in his book *Hypercompetition* that any sustainable competitive advantage lies not in doggedly following a centrally managed five-year plan but in stringing together a series of strategic thrusts (as Apple does by cutting into the sales of its own offerings with periodic introductions of new products).<sup>33</sup> This means that organizations must develop *strategic flexibility*—the ability to shift from one dominant strategy to another.<sup>34</sup>

Strategic flexibility demands a long-term commitment to the development and nurturing of critical resources and capabilities. It also demands that the company become a **learning organization**—an organization skilled at creating, acquiring, and transferring knowledge aimed at modifying its behavior to reflect new knowledge and insights. Organizational learning is a critical component of competitiveness in a dynamic environment. It is particularly important to innovation and new product development.<sup>35</sup>
Learning organizations are skilled at four main activities:

- Solving problems systematically
- Experimenting with new approaches
- Learning from their own experiences and past history as well as from the experiences of others
- Transferring knowledge quickly and efficiently throughout the organization.<sup>36</sup>

Business historian Alfred Chandler proposes that high-technology industries are defined by "paths of learning" in which organizational strengths derive from learned capabilities.<sup>37</sup> According to Chandler, companies spring from an individual entrepreneur's knowledge, which then evolves into organizational knowledge. This organizational knowledge is composed of three basic strengths: technical skills; functional knowledge, such as production and marketing; and managerial expertise. This knowledge leads to new areas in which the company can succeed and creates an entry barrier to new competitors. Chandler believes that once a corporation has built its learning base to the point where it has become a core company in its industry, entrepreneurial startups are rarely able to successfully enter. Thus, organizational knowledge becomes a competitive advantage that is difficult to understand and imitate.

Strategic management practices are essential for learning organizations to avoid stagnation through continuous self-examination and experimentation. People at all levels, not just top management, participate in strategic management—helping to scan the environment for critical information, suggesting changes to strategies and programs to take advantage of environmental shifts, and working with others to continuously improve work methods, procedures, and evaluation techniques. The Toyota production system is famous for empowering employees to improve. If an employee spots a problem on the line, they pull the cord, which immediately starts a speedy diagnosis. The line continues if the problem can be solved within one minute. If not, the production line is shut down until the problem is solved. At Toyota, they learn from their mistakes as much as they learn from their successes. Improvements are sent to all factories worldwide.<sup>38</sup>

Organizations that are willing to experiment and are able to learn from their experiences are more successful than those that are not.<sup>39</sup> This was seen in a study of U.S. manufacturers of diagnostic imaging equipment. The most successful firms were those that improved products sold in the United States by incorporating some of what they had learned from their manufacturing and sales experiences in other countries. The less successful firms used their foreign operations primarily as sales outlets, not as important sources of technical knowledge.<sup>40</sup> Research also reveals that multidivisional corporations that establish ways to transfer knowledge across divisions are more innovative than other diversified corporations that do not.<sup>41</sup>

## Basic Model of Strategic Management

Strategic management consists of four distinct, but interconnected elements:

- Environmental analysis
- Strategy formulation
- Strategy implementation
- Evaluation and reassessment

**Figure 1–1** illustrates how these four elements interact; **Figure 1–2** expands each of these elements and serves as the model for this book. This model is both rational and prescriptive. It is a planning model that presents what an organization *should* do in terms of the strategic management processes, not what any particular one may actually do. The rational planning model predicts that as environmental uncertainty increases, organizations that work diligently to analyze more accurately the changing situation in which they operate and act on those insights will outperform those that do not. Empirical research studies support this model. <sup>42</sup> The terms used in **Figure 1–2** are explained in the following pages.

#### 1-5. Describe the basic model of strategic management and its components

#### **ENVIRONMENTAL ANALYSIS**

Environmental analysis is the monitoring, analyzing, and disseminating of information from the external and internal environments to key people within the organization. Its purpose is to identify strategic factors—those external and internal elements that will assist in the analysis of the strategic decisions of the organization. One of the simpler ways to represent the outcomes of environmental analysis is through a SWOT diagram. SWOT is an acronym used to present the particular Strengths, Weaknesses, Opportunities, and Threats that appear to be strategic factors for a specific organization. The external environment consists of variables (opportunities and threats) that are outside the organization and not typically within the short-run control of top management. These variables form the context within which the organization exists. Figure 1–3 depicts some key environmental variables. They may be general forces and trends within the natural or societal environments or specific factors that operate within an organization's specific task environment—often called its *industry*. Some effective techniques available for the examination of these environmental variables are the focus of Chapter 4.

The **internal environment** of an organization consists of variables (strengths and weaknesses) that are within the organization itself and are within the short-run control of top management. These variables form the context in which work is done. They include the corporation's structure, culture, capabilities, and resources. Key strengths form a set of core competencies that the organization can use to gain competitive advantage. Although strategic management is fundamentally concerned with what constitutes



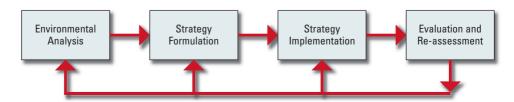
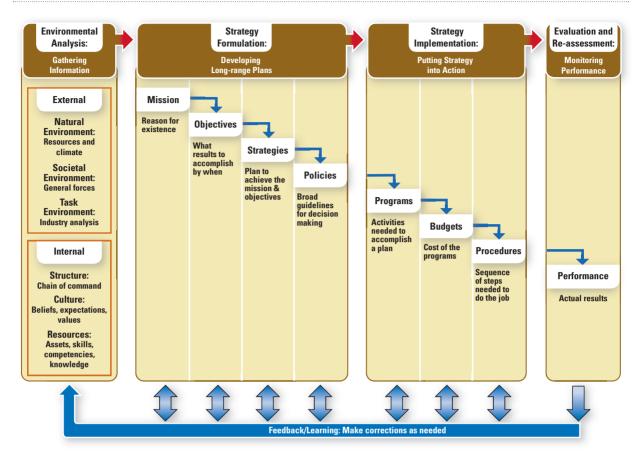


FIGURE 1-2 Strategic Management Model



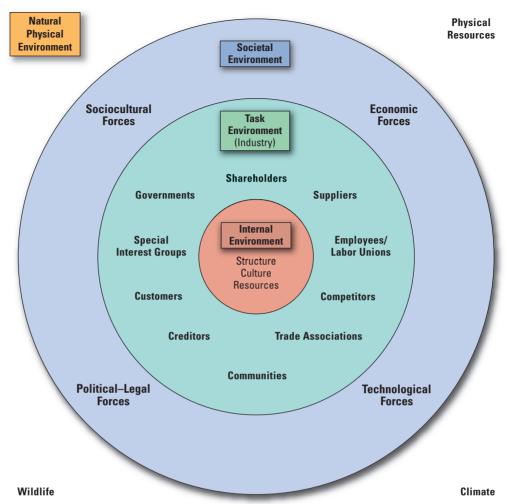
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an organization's strengths, weaknesses, opportunities, and threats, the methods to analyze each have developed substantially in the past four decades. No longer do we simply list the SWOT variables and have employees try to populate the quadrants. Each of the four is rich with processes and techniques that will allow for a robust and sophisticated understanding of the company. This will be examined in detail beginning with **Chapter 5** of the text.

#### STRATEGY FORMULATION

**Strategy formulation** is the process of investigation, analysis, and structured decision making that provides an organization with the criteria for attaining a competitive advantage. It includes defining the competitive advantages of the business, identifying weaknesses that are impacting the company's ability to deliver conventional operations to customers, crafting the corporate mission, specifying achievable objectives, and setting policy guidelines.





#### **Mission: Stating Purpose**

An organization's **mission** is the purpose or reason for the organization's existence. It clearly states what separates the company from its competitors. A well-written mission statement defines the fundamental, unique purpose that sets a company apart from other firms of its type. Research reveals that firms with mission statements containing explicit descriptions of their competitive advantages have significantly higher growth than firms without such statements.<sup>43</sup> Part of that is the value a mission statement has to succinctly focus employees on what matters most. Some believe that a mission statement may also include the firm's values and philosophy about how it does business and treats its employees; however, that is usually better kept as a separate document. A well-crafted mission statement describes what the company is now and what it wants to become — management's strategic vision of the firm's near-term future. The mission statement promotes a sense of shared expectations in employees and communicates a public image to important stakeholder groups in the company's task environment. Some people like to consider vision and mission as two different concepts: Mission describes what the organization is now; vision describes what the organization would like to become.44

Some great examples of effective mission statements:

Warby Parker: To offer designer eyewear at a revolutionary price, while leading the way for socially conscious businesses<sup>45</sup>

Tesla: To accelerate the world's transition to sustainable energy<sup>46</sup>

While a mission may be defined narrowly or broadly in scope, a *broad* mission statement is usually generic and states something like "Serve the best interests of shareowners, customers, and employees." A broadly defined mission statement such as this keeps the company from restricting itself to one field or product line, but it fails to clearly identify either what it makes or which products/markets it plans to emphasize. Broad statements are relatively useless while narrow statements provide direction and communication value to the organization.

#### **Objectives: Listing Expected Results**

**Objectives** are the end results of planned activity. They should be stated as *action verbs* and tell employees what is to be accomplished and when, with appropriate metrics. The achievement of corporate objectives should result in the fulfillment of a corporation's mission. In effect, this is what society gives back to the corporation when the corporation does a good job of fulfilling its mission. Coca-Cola established their Vision 2020 plan back in 2009, where they laid out specific objectives including reducing the overall carbon footprint of their business operations by 15% by 2020, as compared to the 2007 baseline, and reducing the impact of their packaging by maximizing their use of renewable, reusable, and recyclable resources to recover the equivalent of 100% of their packaging. This type of focus has made Coca-Cola a perennial member of the Fortune 500, one of the Fortune 50 Most Admired Companies, one of Barron's Most Respected Companies in the World, and a Diversity, Inc. Top 50 company.<sup>47</sup>

The term *goal* is often used interchangeably with the term *objective*. In this book, we prefer to differentiate the two terms. In contrast to an objective, we consider a *goal* as an open-ended statement of what one wants to accomplish, with no quantification of what is to be achieved and no time criteria for completion. For example, a simple statement of "increased profitability" is thus a goal, not an objective, because it does not state how much profit the firm wants to make the next year. A good objective should be action-oriented and begin with the word *to*. An example of an objective is "to increase the percentage of on-time shipments to 90% by 2025."

Some of the areas in which an organization might establish its goals and objectives are:

- Profitability (**EBITDA**—Earnings before Interest, Taxes & Depreciation)
- Efficiency (low costs, etc.)
- Growth (increase in total assets, sales, etc.)
- Shareholder wealth (dividends plus stock price appreciation)
- Utilization of resources (Return on Equity (ROE) or Return on Investment (ROI))
- Reputation (being considered a "top" firm)
- Contributions to employees (employment security, wages, diversity)
- Contributions to society (taxes paid, participation in charities, providing a needed product or service)
- Market leadership (market share)
- Technological leadership (innovations, creativity)

- Survival (avoiding bankruptcy)
- Personal needs of top management (using the firm for personal purposes, such as providing jobs for relatives)

#### **Strategy: Defining the Competitive Advantages**

An organization must analyze the external environment in order to determine the groups that constitute the perfect customer (that is, the customer that instantly gets the value proposition and is willing to pay for it) for the business as it exists today, who the most direct competitors are for that customer, what the company does that is necessary to compete, and what the company does that truly sets it apart from its competitors. Once fully examined, these elements can be rephrased into the strengths of the business, the understanding of its weaknesses relative to its competitors, what opportunities would be most prudent, and what threats might affect the business's primary competitive advantages.

The **strategy** of an organization forms a comprehensive main approach that states how the business will achieve its mission and objectives. It maximizes competitive advantage and minimizes competitive disadvantage. Pfizer, the giant drug company, has embraced the need for this type of approach. Faced with the rapid fall-off of its biggest blockbuster drugs (patents expiring), Pfizer was faced with the question of how to generate the R&D to create new drugs. Historically, the company had relied upon its cadre of scientists, but this changed in the past few years. Pfizer moved aggressively to acquire drug makers in the emerging biosimiliar market (small molecule biologics made from living cells). Pfizer's late stage biosimiliar drugs have a very good chance of allowing the company to capture a significant part of what is expected to be a US\$61 billion market by 2025. This is the crucial new ground from which they hope to replace such blockbusters as Lipitor, which saw its sales drop from US\$12 billion in 2012 to just over US\$2 billion in 2015 after the patent expired. Interestingly, Pfizer (along with Moderna) embraced a new MRNA approach to rapidly develop and deploy a vaccine for Covid-19 and its variants. This approach promises many uses that have changed the fortunes of the company.

The typical larger business addresses three types of strategy: corporate, business, and functional.

- Corporate strategy describes a company's overall direction in terms of growth and the management of its various businesses. Corporate strategies generally fit within the three main categories of stability, growth, and retrenchment.
- Business strategy usually occurs at the business unit or product level, and it emphasizes improvement of the competitive position of an organization's products or services in the specific industry or market segment served by that business unit. Business strategies may fit within the two overall categories: competitive and cooperative strategies. For example, Staples, the U.S. office supply store chain, has used a competitive strategy to differentiate its retail stores from its competitors by adding services to its stores, such as copying, UPS shipping, and hiring mobile technicians who can fix computers and install networks. British Airways has followed a cooperative strategy by forming an alliance with American Airlines in order to provide global service. Cooperative strategy may be used to provide a competitive advantage in situations where the cooperating entities are not in direct competition for customers. Intel, a manufacturer of computer microprocessors, uses its alliance (cooperative strategy) with Microsoft to differentiate itself (competitive strategy) from AMD, its primary competitor.
- Functional strategy is the approach taken by a functional area to achieve corporate and business unit objectives and strategies by maximizing resource productivity. It is

concerned with developing and nurturing a distinctive set of resources/capabilities to provide a company or business unit with a competitive advantage. Examples of research and development (R&D) functional strategies are technological followership (imitation of the products of other companies) and technological leadership (pioneering an innovation) such as was accomplished by Pfizer and Moderna with their use of mRNA to create a Covid vaccine that was far more able to provide protection, in one-tenth the time of what was thought possible.<sup>49</sup> For years, Magic Chef had been a successful appliance maker by spending little on R&D but by quickly imitating the innovations of its competitors. This helped the company keep its costs lower than those of its competitors and consequently to compete with lower prices. In terms of marketing functional strategies, Procter & Gamble (P&G) is an expert at marketing "pull"—the process of spending huge amounts on advertising in order to create customer demand. This supports P&G's competitive strategy of differentiating its products from those of its competitors.

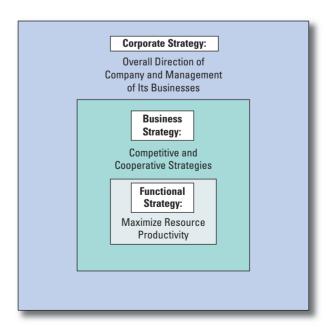
Organizations use all three types of strategy simultaneously. A **hierarchy of strategy** is a grouping of strategy types by level in the organization. Hierarchy of strategy is a nesting of one strategy within another so that they complement and support one another. (See **Figure 1–4**.) Functional strategies support business strategies, which, in turn, support the corporate strategy(ies).

#### **Policies: Setting Guidelines**

A **policy** is a broad guideline for decision making that links the formulation of a strategy with its implementation. Companies use policies to make sure that employees throughout the firm make decisions and take actions that support the organization's mission, objectives, and strategies. When Cisco decided on a strategy of growth through acquisitions, it established a policy to consider only companies with no more than 75 employees, 75% of whom were engineers. <sup>50</sup> Consider the following company policies:

■ **3M:** 3M says researchers should spend 15% of their time working on something other than their primary project. (This supports 3M's strong product development strategy.)

FIGURE 1–4 Hierarchy of Strategy



- Google: Google's health care plan includes their onsite medical staff. Any employee who feels ill at work can make an appointment with the doctor at the Googleplex. This supports the Google HRM functional strategy to support its employees.
- **Starbucks:** All Starbucks employees are offered a Total Pay Package that includes a 401(k) savings plan, stock options, and an employee stock purchase plan. This goes a long way toward their goal of having every employee feel like a partner in the business.
- **Ryanair:** Ryanair charges for everything a passenger might want or need on a flight. The only thing you get with your ticket is the right to a seat on the plane (and that seat depends upon how fast you can run across the tarmac to the plane).

Policies such as these provide clear guidance to managers throughout the organization. (Strategy formulation is discussed in greater detail in **Chapter 6, 7, and 8.**)

#### STRATEGY IMPLEMENTATION

**Strategy implementation** is a process by which strategies and policies are put into action through the development of programs, budgets, and procedures. This process might involve changes within the overall culture, structure, and/or management system of the entire organization. Except when such drastic organization-wide changes are needed, however, the implementation of strategy is typically executed by middle- and lower-level managers, with review by top management. Sometimes referred to as *operational planning*, strategy implementation involves day-to-day decisions in resource allocation.

#### **Programs and Tactics: Defining Actions**

A **program** or a **tactic** is a statement of the activities or steps needed to support a strategy. The terms are interchangeable. In practice, a program is a collection of tactics where a tactic is the individual action taken by the organization as an element of the effort to accomplish a plan. A program or tactic makes a strategy action oriented. It may involve restructuring the organization, changing the company's internal culture, or beginning a new research effort. Boeing's strategy to regain industry leadership with its 787 Dreamliner meant that the company had to increase its manufacturing efficiency in order to keep the price low. To significantly cut costs, management decided to implement a series of tactics:

- Outsource approximately 70% of manufacturing.
- Reduce final assembly time to three days (compared to 20 for its 737 plane) by having suppliers build completed plane sections.
- Use new, lightweight composite materials in place of aluminum to reduce inspection time.
- Resolve poor relations with labor unions caused by downsizing and outsourcing.

Another example is a set of programs or tactics used by automaker BMW to achieve its objective of increasing production efficiency by 5% each year: (a) shorten new model development time from 60 to 30 months, (b) reduce preproduction time from a year to no more than five months, and (c) build at least two vehicles in each plant so that production can shift among models depending upon demand.

#### **Budgets: Costing Programs**

A **budget** is a statement of an organization's programs in terms of dollars. Used in planning and control, a budget lists the detailed cost of each program. Many organizations

demand a certain percentage return on investment, often called a "hurdle rate or required rate of return" before management will approve a new program. This is done so that the new program has the potential to significantly add to the corporation's profit performance and thus build shareholder value. The budget not only serves as a detailed plan of the new strategy in action but also specifies through proforma financial statements the expected impact on the firm's financial future.

#### **Procedures: Detailing Activities**

**Procedures**, sometimes termed Standard Operating Procedures (SOP), are a system of sequential steps or techniques that describe in detail how a particular task or job is to be done. They typically detail the various activities that must be carried out in order to complete the organization's program. The home improvement retailer Home Depot noted that sales were lagging, and they believed it was because its stores were full of clogged aisles, checkout lines were too long, and too few salespeople were available for customers. Management changed its procedures for restocking shelves and pricing the products. Instead of requiring its employees to do these activities at the same time they were working with customers, management moved these activities to when the stores were closed at night. Employees were then able to focus on increasing customer sales during the day. Both UPS and FedEx put such an emphasis on consistent, quality service that both companies have strict rules for employee behavior, ranging from how a driver dresses to how keys are held when approaching a customer's door. (Strategy implementation is discussed in more detail in **Chapter 9 and 10.**)

#### **EVALUATION AND REASSESSMENT**

**Evaluation and reassessment** is a process in which corporate activities and performance results are monitored so that actual performance can be compared with desired performance. Managers at all levels use the resulting information to take corrective action and resolve problems. Although evaluation and reassessment is the final major element of strategic management, it can also pinpoint weaknesses in previously implemented strategic plans and thus stimulates the entire process to begin again.

**Performance** is the end result of activities.<sup>51</sup> It includes the actual outcomes of the strategic management process. The practice of strategic management is justified in terms of its ability to improve an organization's performance, typically measured in terms of measures such as profits and return on investment. For evaluation and reassessment to be effective, managers must obtain clear, prompt, and unbiased information from the people below them in the organization's hierarchy. Using this information, managers compare what is actually happening with what was originally planned in the formulation stage.

Starbucks had created a mystique around the enjoyment of coffee and the influence of leadership. Carefully designed stores and an experience that encouraged people to stay and chat had built Starbucks into a powerhouse. Howard Schultz (founder and CEO) stepped down from active management of the business. Jim Donald took over as CEO and drove the company toward efficiency, pricing growth, and diversification. The company went from an American success story to one with a 97% drop in net income and same store sales in negative territory. Despite a well-known e-mail from Schultz to Donald in 2007 encouraging him to return to core elements of the business, things did not improve. In January 2008, Schultz replaced Donald as CEO. In February 2008, all 7,100 + Starbucks in North America shut their doors for a three-hour video conference with Schultz so they could reset the Starbucks experience. He shut down

almost 1,000 outlets and instituted a series of moves aimed at returning the company to its preeminent position. The turnaround at Starbucks has been a remarkable story of regaining the cache they almost lost.<sup>52</sup>

The evaluation and reassessment of performance completes the strategic management model. Based on performance results, management may need to make adjustments in its strategy formulation, in implementation, or more likely both. (Evaluation and reassessment is discussed in more detail in **Chapter 12**.)

#### FEEDBACK/LEARNING PROCESS

Note that the strategic management model depicted in Figure 1-2 includes a feedback/learning process. Arrows are drawn coming out of each part of the model and taking information to each of the previous parts of the model. As any organization develops strategies, programs, and the like, it often must go back to revise or correct decisions made earlier in the process. Poor performance (as measured in evaluation and reassessment) usually indicates that something has gone wrong with either strategy formulation or implementation. It could also mean that a key variable, such as a new competitor, a change in the environment, or a significant regulatory change has occurred. Just after Shultz took back the reins at Starbucks, the recession hit and the mantra in the United States became, "save money, don't buy Starbucks." The business was built on an image as the comfortable place away from home but had trended toward becoming a fast-food operation. Schultz eliminated hot sandwiches, which were filling the place with the smell of burnt cheese instead of coffee, refocused on the services provided by the baristas, started grinding coffee on-site to add the smells so loved at a Starbucks, and put in new coffee machines that allowed baristas to talk with customers. Starbucks reassessed the environment and found a better way to profitably apply its core competencies.

### Initiation of Strategy: Triggering Events

1-6. Identify some common triggering events that act as stimuli for strategic change After much research, Henry Mintzberg concluded that strategy formulation is not a regular, continuous process: "It is most often an irregular, discontinuous process, proceeding in fits and starts. There are periods of stability in strategy development, but also there are periods of flux, of groping, of piecemeal change, and of global change." This view of strategy formulation as an irregular process can be explained by the very human tendency to continue on a particular course of action until something goes wrong or a person is forced to question their actions. A period of strategic drift may result from inertia on the part of the organization, or it may reflect management's belief that the current strategy is still appropriate and needs only some fine-tuning.

Most large organizations tend to follow a particular strategic orientation for a period of years before making a significant change in direction.<sup>54</sup> This phenomenon, called *punctuated equilibrium*, describes large organizations as evolving through relatively long periods of stability (equilibrium periods) punctuated by relatively short bursts of fundamental change (revolutionary periods).<sup>55</sup> After this rather long period of fine-tuning an existing strategy, some sort of shock to the system is needed to motivate management to seriously reassess the organization's situation.

A **triggering event** (or discontinuity) is something that acts as a stimulus for a change in strategy. Some possible triggering events are:<sup>56</sup>

- **New CEO:** By asking a series of embarrassing questions, a new CEO cuts through the veil of complacency and forces people to question the very reason for the corporation's existence.
- External intervention: A firm's bank suddenly refuses to approve a new loan or suddenly demands payment in full on an old one. A key customer complains about a serious product defect.
- Threat of a change in ownership: Another firm may initiate a takeover by buying a company's common stock.
- **Performance gap:** A *performance gap* exists when performance does not meet expectations. Sales and profits either are no longer increasing or may even be falling.
- Strategic inflection point: Coined by Andy Grove, past-CEO of Intel Corporation, a strategic inflection point is what happens to a business when a major change takes place due to the introduction of new technologies, a different regulatory environment, a change in customers' values, or a change in customers' preferences.<sup>57</sup>

# Strategic Decision Making

**1-7.** Explain strategic decision-making modes

A distinguishing characteristic of strategic management is its emphasis on strategic decision making. As organizations grow larger and more complex, with more uncertain environments, decisions become increasingly complicated and difficult to make. In agreement with the strategic choice perspective mentioned earlier, this book proposes a strategic decision-making framework that can help people make these decisions regardless of their level and function in the organization.

#### WHAT MAKES A DECISION STRATEGIC?

Unlike many other decisions, **strategic decisions** deal with the long-term future of an entire organization and have three characteristics:

- **Rare:** Strategic decisions are unusual and typically have no precedent to follow.
- Consequential: Strategic decisions commit substantial resources and demand a great deal of commitment from people at all levels.
- Directive: Strategic decisions set precedents for lesser decisions and future actions throughout an organization.<sup>58</sup>

One example of a strategic decision with all of these characteristics was that made by Genentech, a biotechnology company that had been founded in 1976 to produce protein-based drugs from cloned genes. After building sales to US\$9 billion and profits to US\$2 billion in 2006, the company's sales growth slowed, and its stock price dropped in 2007. The company's products were reaching maturity, with few new ones in the pipeline. To regain revenue growth, management decided to target autoimmune diseases, such as multiple sclerosis, rheumatoid arthritis, lupus, and 80 other ailments for which there was no known lasting treatment. This was an enormous opportunity, but also a very large risk for the company. Existing drugs in this area either were not effective for many

patients or caused side effects that were worse than the disease. Competitors like Amgen and Novartis were already vying for leadership in this area. A number of Genentech's first attempts in the area had failed to do well against the competition.

The strategic decision to commit resources to this new area was based on a report from a British physician that Genentech's cancer drug Rituxan eased the agony of rheumatoid arthritis in five of his patients. CEO Arthur Levinson was so impressed with this report that he immediately informed Genentech's board of directors. He urged them to support a full research program for Rituxan in autoimmune disease. With the board's blessing, Levinson launched a program to study the drug as a treatment for rheumatoid arthritis, MS, and lupus. The company (now a subsidiary of Roche) deployed a third of its researchers to pursue new drugs to fight autoimmune diseases. In 2006, Rituxan was approved to treat rheumatoid arthritis and captured 10% of the market. The research mandate was to consider ideas others might overlook. This has led to a series of FDA-approved drugs for breast cancer and vision loss. "There's this tremendous herd instinct out there," said Levinson. "That's a great opportunity, because often the crowd is wrong." "59"

#### MINTZBERG'S MODES OF STRATEGIC DECISION MAKING

Some strategic decisions are made in a flash by one person (often an entrepreneur or a powerful chief executive officer) who has a brilliant (hopefully) insight and is quickly able to convince others to adopt their idea. Other strategic decisions seem to develop out of a series of small incremental choices that over time push an organization more in one direction than another. According to Henry Mintzberg, the three most typical approaches, or modes, of strategic decision making are entrepreneurial, adaptive, and planning (a fourth mode, logical incrementalism, was added later by Quinn):<sup>60</sup>

- Entrepreneurial mode: Strategy is made by one powerful individual. The focus is on opportunities; problems are secondary. Strategy is guided by the founder's own vision of direction and is exemplified by large, bold decisions. The dominant goal is growth of the corporation. Amazon.com, founded by Jeff Bezos, is an example of this mode of strategic decision making. The company reflects Bezos' vision of using the Internet to market everything that can be bought. Another example would be Elon Musk with Tesla and SpaceX. Each is driven by Musk's vision of the electric vehicle and reusable, commercial space transportation.
- Adaptive mode: Sometimes referred to as "muddling through," this decision-making mode is characterized by reactive solutions to existing problems, rather than a proactive search for new opportunities. Much bargaining goes on concerning the priority of objectives. Strategy is fragmented and is developed to move the organization forward incrementally. This mode is typical of most universities, many large hospitals, a large number of governmental agencies, and a surprising number of large organizations. Encyclopedia Britannica Inc. operated successfully for many years in this mode, but it continued to rely on the door-to-door selling of its prestigious books long after dual-career couples made that marketing approach obsolete. Only after it was acquired in 1996 did the company change its door-to-door sales to television advertising and then Internet marketing. The company now charges libraries and individual subscribers for complete access via its website and has apps for the iPad and iPhone that cost users around US\$17 per year in a subscription format. In May 2012, the company stopped producing the bound set of encyclopedias that had been in print for over 244 years.<sup>61</sup>
- Planning mode: This decision-making mode involves the systematic gathering of appropriate information for situation analysis, the generation of feasible alternative

strategies, and the rational selection of the most appropriate strategy. It includes both the proactive search for new opportunities and the reactive solution of existing problems. IBM under CEO Louis Gerstner is a great example of the planning mode. When Gerstner accepted the position of CEO in 1993, he realized that IBM was in serious difficulty. Mainframe computers, the company's primary product line, were suffering a rapid decline both in sales and market share. One of Gerstner's first actions was to convene a two-day meeting on corporate strategy with senior executives. An in-depth analysis of IBM's product lines revealed that the only part of the company that was growing was services, but it was a relatively small segment and not very profitable. Rather than focusing on making and selling its own computer hardware, IBM made the strategic decision to invest in services that integrated information technology. IBM thus decided to provide a complete set of services from building systems to defining architecture to actually running and managing the computers for the customer—regardless of who made the products. Because it was no longer important that the company be completely vertically integrated, it sold off its DRAM, disk-drive, and laptop computer businesses and exited software application development. Since making this strategic decision in 1993, 80% of IBM's revenue growth has come from services. Most of this is chronicled in an outstanding business practices book written by Gerstner himself entitled Who Says Elephants Can't Dance? It should be one of the top reads for anyone really interested in this topic.<sup>62</sup>

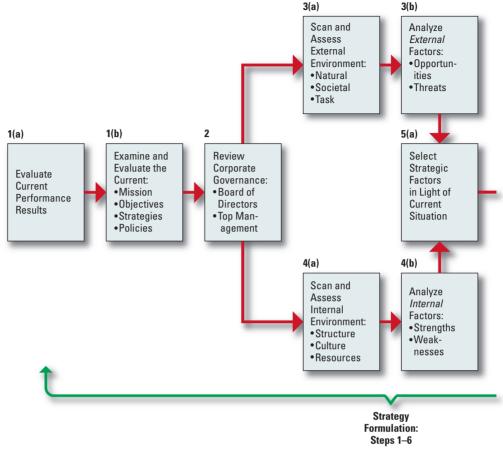
Logical incrementalism: A fourth decision-making mode can be viewed as a synthesis of the planning, adaptive, and, to a lesser extent, the entrepreneurial modes. In this mode, top management has a reasonably clear idea of the corporation's mission and objectives, but, in its development of strategies, it chooses to use "an interactive process in which the organization probes the future, experiments, and learns from a series of partial (incremental) commitments rather than through global formulations of total strategies." Thus, although the mission and objectives are set, the strategy is allowed to emerge out of debate, discussion, and experimentation. This approach appears to be useful when the environment is changing rapidly and when it is important to build consensus and develop needed resources before committing an entire corporation to a specific strategy. In his analysis of the petroleum industry, Grant described strategic planning in this industry as "planned emergence." Corporate headquarters established the mission and objectives but allowed the business units to propose strategies to achieve them.<sup>64</sup>

#### STRATEGIC DECISION-MAKING PROCESS: AID TO BETTER DECISIONS

Good arguments can be made for using the entrepreneurial, adaptive modes, or logical incrementalism approaches in certain specific situations.<sup>65</sup> This book proposes, however, that in most situations the planning mode, which includes the basic elements of the strategic management process, is a more rational, better tested, and more complete method for making strategic decisions. Research indicates that the planning mode is not only more analytical and less political than are the other modes but also more appropriate for dealing with complex, changing environments.<sup>66</sup> We therefore propose the following eight-step **strategic decision-making process** to improve the making of strategic decisions (see **Figure 1–5**):

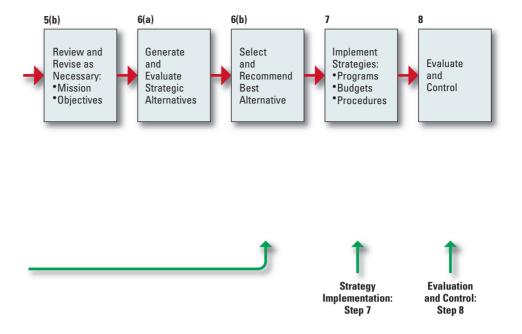
Evaluate current performance results in terms of (a) return on investment, profitability, and other appropriate performance measures, and (b) the current mission, objectives, strategies, and policies.

#### FIGURE 1–5 Strategic Decision-Making Process



SOURCE: T. L. Wheelen and J. D. Hunger, "Strategic Decision-Making Process." Copyright © 1994 and 1977 by Wheelen and Hunger Associates. Reprinted by permission.

- **Review corporate governance**—that is, the performance of the firm's board of directors and top management.
- Scan and analyze the external environment to determine the strategic factors that pose opportunities and threats. This includes a detailed analysis of the competitive set.
- Analyze the internal environment to determine the strategic factors that are potentially strengths (especially unique resources and core competencies) and weaknesses (those elements of the business that have fallen below the expectations of customers).
- Analyze strategic factors to (a) pinpoint problem areas and (b) review and revise the corporate mission and objectives, as necessary.
- Generate, evaluate, and select the best alternative strategies in light of the analysis conducted in the previous step.
- **Implement selected strategies** via programs, budgets, and procedures.
- **Evaluate implemented strategies** via feedback systems, and the control of activities to ensure their minimum deviation from plans.



# The Strategic Audit: Aid to Strategic Decision Making

1-8. Use the strategic audit as a method of analyzing corporate functions and activities

One effective means of putting the strategic decision-making process into action is through an approach known as the *strategic audit*. A **strategic audit** provides a comprehensive checklist of questions, by area or issue, that enables a systematic analysis to be made of various organizational functions and activities. (See **Appendix 1.A** at the end of this chapter.) Note that the numbered primary headings in the audit are the same as the numbered blocks in the strategic decision-making process in **Figure 1–5**. Beginning with an evaluation of current performance, the audit continues with environmental analysis, strategy formulation, and strategy implementation, and it concludes with evaluation and reassessment. A strategic audit is a type of management audit and is extremely useful as a diagnostic tool for pinpointing organization-wide problem areas and for highlighting potential strengths and weaknesses.<sup>67</sup> A strategic audit can help determine why a certain area is creating problems for the organization and help generate solutions to the problem.

A strategic audit is not all inclusive, but it asks many of the critical questions needed for a detailed strategic analysis of any business. Some questions, or even some areas, might be inappropriate for a particular company; in other cases, the questions may be insufficient for a complete analysis. However, each question in a particular area of a strategic audit can be broken down into an additional series of sub-questions. An analyst can develop responses to these sub-questions when they are needed for a complete strategic analysis of a company.

# Employment in Strategic Management

**1-9.** Explain the employment opportunities in Strategic Management

There are no areas of an organizational operation that are not impacted by its strategy. Strategy (at its core) is about getting customers/clients to go past your competitors and buy from you. Every employee in the organization must fundamentally understand the elements of the strategy and work to enable the organization to deliver on the strategy promise.

Put yourself in the position of having started a new job with a new employer. You have day-to-day responsibilities that are outlined in your job description. You want to move up in the organization and you want to do a job that provides you some real visibility with the Senior Leadership Team (SLT). How do you do that? What do you think the SLT cares about most? What are they trying to accomplish?

Every person who works in an organization represents and is a "salesperson" for that organization. The more that you can connect your activities with the strategy of the organization, the more successful your efforts will be. While a deep understanding of strategy will put you in a stronger position to be successful in any organization, there are also very clear employment paths that rely on the work you will do in this course. These include internal strategy groups, business analysis, mergers and acquisitions (M&A), consulting, and business development (BD).

Most large organizations have internal consulting/advising groups that are often described as business analysis departments. The individuals in these groups work as internal consultants for the organization. This might be something as specific as figuring out how to drive costs down or as general as improving the marketability of some product/service. The process/skills developed in this course and in this book will help prepare you for these groups. These types of positions in addition to some experience will allow you to have an opportunity to be a part of the strategy design and implementation of organizations.

These more specific groups include the Strategy Group, which is traditionally charged with developing and reporting on the Strategic Plan for the organization. Another very common group is the M&A group, which is charged with researching, negotiating, and incorporating acquisitions into the organization. Finally, many organizations employ separate BD groups, whose responsibility is to research and recommend new directions for the organization.

There are also career paths that are exclusively focused on the application of strategy design and implementation. These are generally focused on consulting and a big area of recruiting by the big strategy consulting firms is done at the undergraduate level. The *Economic Times* reported that consulting firms in general and strategy consulting firms in particular are hiring a record number of undergraduate business majors. Many of the larger consulting companies actively recruit undergraduates. The positions allow you to work with more senior consultants in the strategy and operations fields. These roles allow for significant growth and, for a group of selected individuals, they offer to pay for your MBA if you agree to come back in a senior consulting role after you graduate.

Not only are the jobs fundamentally interesting as you get to work with a variety of businesses in short, project-based efforts, but the total compensation for those in their first year out of their undergraduate degree is typically between US\$80,000 and US\$100,000.<sup>69</sup>

Strategy design and implementation is the core reason for the success of any organization. The better you understand the processes used to truly separate an organization from its competitors, the more value you can provide.

# End of Chapter SUMMARY

Strategy scholars Donald Hambrick and James Fredrickson propose that a good strategy has five elements, providing answers to five questions:

- Arenas: Where will we be active?
- Vehicles: How will we get there?
- Differentiators: How will we win in the marketplace?
- Staging: What will be our speed and sequence of moves?
- Economic logic: How will we obtain our returns?<sup>70</sup>

This chapter introduces you to a well-accepted model of strategic management (Figure 1–2) in which environmental analysis leads to strategy formulation, strategy implementation, and evaluation and reassessment. It further shows how that model can be put into action through the strategic decision-making process (Figure 1–5) and a strategic audit (Appendix 1.A). As pointed out by Hambrick and Fredrickson, "strategy consists of an integrated set of choices." The questions "Where will we be active?" and "How will we get there?" are dealt with by a company's mission, objectives, and corporate strategy. The question "How will we win in the marketplace?" is the concern of business strategy. The question "What will be our speed and sequence of moves?" is answered not only by business strategy and tactics but also by functional strategy and by implemented programs, budgets, and procedures. The question "How will we obtain our returns?" is the primary emphasis of the evaluation and reassessment element of the strategic management model. Each of these questions and topics will be dealt with in greater detail in the chapters to come. Welcome to the study of strategic management!

#### KEY TERMS

Andean Community (p. 38) Association of Southeast Asian Nations (ASEAN) (p. 38) budget (p. 48) business strategy (p. 46) Central American Free Trade Agreement (CAFTA) (p. 38) corporate strategy (p. 46) EBITDA (p. 45) environmental analysis (p. 42) European Union (EU) (p. 38) evaluation and reassessment (p. 49) external environment (p. 42) functional strategy (p. 46) globalization (p. 36) hierarchy of strategy (p. 47) innovation (p. 37) institution theory (p. 40)

learning organization (p. 41) Mercosur/Mercosul (p. 38) mission (p. 44) North American Free Trade Agreement (NAFTA) (p. 38) objectives (p. 45) organizational learning theory (p. 40) performance (p. 49) phases of strategic management (p. 33) policy (p. 47) population ecology (p. 40) procedures (p. 49) program (p. 48) strategic audit (p. 55) strategic choice perspective (p. 40)

internal environment (p. 42)

strategic decision-making process (p. 53) strategic decisions (p. 51) strategic factors (p. 42) strategic management (p. 32) strategy (p. 46) strategy formulation (p. 43) strategy implementation (p. 48) sustainability (p. 39) SWOT diagram (p. 42) tactic (p. 48) triggering event (p. 51) triple bottom line (p. 36) Union of South American Nations (p. 38) United States-Mexico-Canada Agreement (p. 38) vision (p. 44)

#### DISCUSSION QUESTIONS

- **1-1.** How do the three elements of globalization, innovation, and sustainability impact your understanding of strategy?
- **1-2.** Organizational strategy can be divided roughly into two categories: (a) formulation and (b) implementation. Although there is legitimate crossover between the two, how would you characterize the issues involved in each effort?
- **1-3.** Why is strategic management considered important for global market competition?
- **1-4.** How does strategic management typically evolve in a company?

- **1-5.** Define strategic flexibility and explain its implications. Why is organizational learning important to the long-term development of the strategic flexibility of organizations that intend to enter overseas markets?
- **1-6.** Why are strategic decisions different from other kinds of decisions?
- **1-7.** What is the most preferred planning mode of strategic decision making for organizations competing internationally?
- **1-8.** What are the potential employment opportunities available to graduates with a solid understanding of strategy design and implementation?

#### STRATEGIC PRACTICE EXERCISES

Advanced economies are contending with one of the worst financial recessions in modern times. Many industrialized nations respond with austerity measures to adjust the deficit caused by greater spending during the years of cheap and available credit facilities. New industrial policies are also implemented at national and regional levels to police banks and financial institutions as a means of avoiding further economic problems in the future. Austerity measures and policy changes have forced industries and business practices to change. How do you think these act as strategic change stimuli?

- **1-9.** What changes do you think this might cause in the immediate task environment for a business operating within the financial service industry? Look at the *Financial Times* online for information.
- **1-10.** How do these changes impact on corporate, business, and functional strategies of financial service businesses? Are these changes going to affect you as a customer?
- **1-11.** How do you think a learning organization would act in this dynamic environment? What survival chances do stagnant organizations have?

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# Strategic Audit of a Corporation

#### I. Current Situation

#### A. Current Performance

How did the corporation perform in the past year overall in terms of return on investment, market share, and profitability?

#### **B. Strategic Posture**

What are the corporation's current mission, objectives, strategies, and policies?

- 1. Are they clearly stated, or are they merely implied from performance?
- 2. **Mission:** What business(es) is the corporation in? Why?
- 3. **Objectives:** What are the corporate, business, and functional objectives? Are they consistent with each other, with the mission, and with the internal and external environments?
- 4. **Strategies:** What strategy or mix of strategies is the corporation following? Are they consistent with each other, with the mission and objectives, and with the internal and external environments?
- 5. **Policies:** What are the corporation's policies? Are they consistent with each other, with the mission, objectives, and strategies, and with the internal and external environments?
- 6. Do the current mission, objectives, strategies, and policies reflect the corporation's international operations, whether global or multidomestic?

#### II. Corporate Governance

#### A. Board of Directors

- 1. Who is on the board? How many are internal (employees) or external members?
- 2. Which board members own significant shares of stock? What percentage?
- 3. Is the stock privately held or publicly traded? Are there different classes of stock with different voting rights?

SOURCE: T. L. Wheelen and J. D. Hunger, *Strategic Audit of a Corporation*, Copyright © 1982 and 2005 by Wheelen and Hunger Associates. Thomas L. Wheelen, "A Strategic Audit," paper presented to Society for Advancement of Management (SAM). Presented by J. D. Hunger and T. L. Wheelen in "The Strategic Audit: An Integrative Approach to Teaching Business Policy," *Academy of Management* (August 1983). Published in "Using the Strategic Audit," by T. L. Wheelen and J. D. Hunger in *SAM Advanced Management Journal* (Winter 1987), pp. 4–12. Reprinted by permission of the copyright holders. Revised 1988, 1994, 1997, 2000, 2002, 2004, 2005, 2009, and 2013.

- 4. What do the board members contribute to the corporation in terms of knowledge, skills, background, and connections? If the corporation has international operations, do any board members have international experience? Are board members concerned with environmental sustainability?
- 5. How long have the board members served on the board?
- 6. What is their level of involvement in strategic management? Do they merely rubber-stamp top management's proposals, or do they actively participate and suggest future directions? Do they evaluate management's proposals in terms of environmental sustainability?

#### **B.** Top Management

- 1. What person or group constitutes top management?
- 2. What are top management's chief characteristics in terms of knowledge, skills, background, and style? If the corporation has international operations, does top management have international experience? Are executives from acquired companies considered part of the top management team?
- 3. Has top management been responsible for the corporation's performance over the past few years? How many managers have been in their current position for less than three years? Were they promoted internally or externally hired?
- 4. Has top management established a systematic approach to strategic management?
- 5. What is top management's level of involvement in the strategic management process?
- 6. How well does top management interact with lower-level managers and with the board of directors?
- 7. Are strategic decisions made ethically in a socially responsible manner?
- 8. Are strategic decisions made in an environmentally sustainable manner?
- 9. Do top executives own significant amounts of stock in the corporation?
- 10. Do you believe that top management is sufficiently skilled to cope with likely future challenges?

# III. External Environment: Opportunities and Threats (SWOT)

#### A. Natural Physical Environment: Sustainability Issues

- 1. What forces from the natural physical environment are currently affecting the corporation and the industries in which it competes? How would you categorize current or future threats? Opportunities?
  - a. Climate, including global temperature, sea level, and freshwater availability
  - b. Weather-related events, such as severe storms, floods, and droughts
  - c. Solar phenomena, such as sunspots and solar wind
- 2. Do these forces have different effects in other regions of the world?

#### **B. Societal Environment**

- 1. What general environmental forces are currently affecting both the corporation and the industries in which it competes? Which present current or future threats? Opportunities?
  - a. Economic
  - b. Technological

- c. Political-legal
- d. Sociocultural
- 2. Are these forces different in other regions of the world?

#### C. Task Environment

- What forces drive industry competition? Are these forces the same globally or do they vary from country to country? Rate each force as high, medium, or low.
  - a. Threat of new entrants
  - b. Bargaining power of buyers
  - c. Threat of substitute products or services
  - d. Bargaining power of suppliers
  - e. Rivalry among competing firms
  - f. Relative power of unions, governments, special interest groups, etc.
- 2. What key factors in the immediate environment (that is, customers, competitors, suppliers, creditors, labor unions, governments, trade associations, interest groups, local communities, and shareholders) are currently affecting the corporation? Which are current or future threats? Opportunities?

# D. Summary of External Factors (List in the EFAS Table 4-5, p. 154)

Which of these forces and factors are the most important to the corporation and to the industries in which it competes at the present time? Which will be important in the future?

# IV. Internal Environment: Strengths and Weaknesses (**SW**OT)

#### A. Corporate Structure

- 1. How is the corporation structured at present?
  - a. Is the decision-making authority centralized around one group or decentralized to many units?
  - b. Is the corporation organized on the basis of functions, projects, geography, or some combination of these?
- 2. Is the structure clearly understood by everyone in the corporation?
- 3. Is the present structure consistent with current corporate objectives, strategies, policies, and programs, as well as with the firm's international operations?
- 4. In what ways does this structure compare with those of similar corporations?

#### **B.** Corporate Culture

- 1. Is there a well-defined or emerging culture composed of shared beliefs, expectations, and values?
- 2. Is the culture consistent with the current objectives, strategies, policies, and programs?
- 3. What is the culture's position on environmental sustainability?
- 4. What is the culture's position on other important issues facing the corporation (that is, on productivity, quality of performance, adaptability to changing conditions, and internationalization)?
- 5. Is the culture compatible with the employees' diversity of backgrounds?
- 6. Does the company take into consideration the values of the culture of each nation in which the firm operates?

#### C. Corporate Resources

#### 1. Marketing

- a. What are the corporation's current marketing objectives, strategies, policies, and programs?
  - i. Are they clearly stated or merely implied from performance and/or budgets?
  - ii. Are they consistent with the corporation's mission, objectives, strategies, and policies, and with internal and external environments?
- b. How well is the corporation performing in terms of analysis of market position and marketing mix (that is, product, price, place, and promotion) in both domestic and international markets? How dependent is the corporation on a few customers? How big is its market? Where is it gaining or losing market share? What percentage of sales comes from developed versus developing regions? Where are current products in the product life cycle?
  - i. What trends emerge from this analysis?
  - ii. What impact have these trends had on past performance and how might these trends affect future performance?
  - iii. Does this analysis support the corporation's past and pending strategic decisions?
  - iv. Does marketing provide the company with a competitive advantage?
- c. How well does the corporation's marketing performance compare with that of similar corporations?
- d. Are marketing managers using accepted marketing concepts and techniques to evaluate and improve product performance? (Consider product life cycle, market segmentation, market research, and product portfolios.)
- e. Does marketing adjust to the conditions in each country in which it operates?
- f. Does marketing consider environmental sustainability when making decisions?
- g. What is the role of the marketing manager in the strategic management process?

#### 2. Finance

- a. What are the corporation's current financial objectives, strategies, policies, and programs?
  - i. Are they clearly stated or merely implied from performance and/or budgets?
  - ii. Are they consistent with the corporation's mission, objectives, strategies, and policies, and with internal and external environments?
- b. How well is the corporation performing in terms of financial analysis? (Consider ratio analysis, common size statements, and capitalization structure.) How balanced, in terms of cash flow, is the company's portfolio of products and businesses? What are investor expectations in terms of share price?
  - i. What trends emerge from this analysis?
  - ii. Are there any significant differences when statements are calculated in constant versus reported dollars?
  - iii. What impact have these trends had on past performance and how might these trends affect future performance?
  - iv. Does this analysis support the corporation's past and pending strategic decisions?
  - v. Does finance provide the company with a competitive advantage?
- c. How well does the corporation's financial performance compare with that of similar corporations?
- d. Are financial managers using accepted financial concepts and techniques to evaluate and improve current corporate and divisional performance? (Consider financial leverage, capital budgeting, ratio analysis, and managing foreign currencies.)
- e. How does finance adjust to the conditions in each country in which the company operates?

- f. How does finance cope with global financial issues?
- g. What is the role of the financial manager in the strategic management process?

#### 3. Research and Development (R&D)

- a. What are the corporation's current R&D objectives, strategies, policies, and programs?
  - i. Are they clearly stated or merely implied from performance or budgets?
  - ii. Are they consistent with the corporation's mission, objectives, strategies, and policies, and with internal and external environments?
  - iii. What is the role of technology in corporate performance?
  - iv. Is the mix of basic, applied, and engineering research appropriate given the corporate mission and strategies?
  - v. Does R&D provide the company with a competitive advantage?
- b. What return is the corporation receiving from its investment in R&D?
- c. Is the corporation competent in technology transfer? Does it use concurrent engineering and cross-functional work teams in product and process design?
- d. What role does technological discontinuity play in the company's products?
- e. How well does the corporation's investment in R&D compare with the investments of similar corporations? How much R&D is being outsourced? Is the corporation using value-chain alliances appropriately for innovation and competitive advantage?
- f. Does R&D adjust to the conditions in each country in which the company operates?
- g. Does R&D consider environmental sustainability in product development and packaging?
- h. What is the role of the R&D manager in the strategic management process?

#### 4. Operations and Logistics

- a. What are the corporation's current manufacturing/service objectives, strategies, policies, and programs?
  - i. Are they clearly stated or merely implied from performance or budgets?
  - ii. Are they consistent with the corporation's mission, objectives, strategies, and policies, and with internal and external environments?
- b. What are the type and extent of operations capabilities of the corporation? How much is done domestically versus internationally? Is the amount of outsourcing appropriate to be competitive? Is purchasing being handled appropriately? Are suppliers and distributors operating in an environmentally sustainable manner? Which products have the highest and lowest profit margins?
  - i. If the corporation is product-oriented, consider plant facilities, type of manufacturing system (continuous mass production, intermittent job shop, or flexible manufacturing), age and type of equipment, degree, and role of automation and/or robots, plant capacities and utilization, productivity ratings, and availability and type of transportation.
  - ii. If the corporation is service-oriented, consider service facilities (hospital, theater, or school buildings), type of operations systems (continuous service over time to the same clientele or intermittent service over time to varied clientele), age and type of supporting equipment, degree and role of automation and use of mass communication devices (diagnostic machinery, video machines), facility capacities and utilization rates, efficiency ratings of professional and service personnel, and availability and type of transportation to bring service staff and clientele together.
- c. Are manufacturing or service facilities vulnerable to natural disasters, local or national strikes, reduction, or limitation of resources from suppliers, substantial cost increases of materials, or nationalization by governments?
- d. Is there an appropriate mix of people and machines (in manufacturing firms) or of support staff to professionals (in service firms)?
- e. How well does the corporation perform relative to the competition? Is it balancing inventory costs (warehousing) with logistical costs (just-in-time)?

Consider costs per unit of labor, material, and overhead; downtime; inventory control management and scheduling of service staff; production ratings; facility utilization percentages; and number of clients successfully treated by category (if service firm), or percentage of orders shipped on time (if product firm).

- i. What trends emerge from this analysis?
- ii. What impact have these trends had on past performance and how might these trends affect future performance?
- iii. Does this analysis support the corporation's past and pending strategic decisions?
- iv. Do operations provide the company with a competitive advantage?
- f. Are operations managers using appropriate concepts and techniques to evaluate and improve current performance? Consider cost systems, quality control and reliability systems, inventory control management, personnel scheduling, Total Quality Management (TQM), learning curves, safety programs, and engineering programs that can improve efficiency of manufacturing or of service.
- g. Do operations adjust to the conditions in each country in which it has facilities?
- h. Do operations consider environmental sustainability when making decisions?
- i. What is the role of the operations manager in the strategic management process?

#### 5. Human Resources Management (HRM)

- a. What are the corporation's current HRM objectives, strategies, policies, and programs?
  - i. Are they clearly stated or merely implied from performance and/or budgets?
  - ii. Are they consistent with the corporation's mission, objectives, strategies, and policies and with internal and external environments?
- b. How well is the corporation's HRM performing in terms of improving the fit between the individual employee and the job? Consider turnover, grievances, strikes, layoffs, employee training, and quality of work life.
  - i. What trends emerge from this analysis?
  - ii. What impact have these trends had on past performance and how might these trends affect future performance?
  - iii. Does this analysis support the corporation's past and pending strategic decisions?
  - iv. Does HRM provide the company with a competitive advantage?
- c. How does this corporation's HRM performance compare with that of similar corporations?
- d. Are HRM managers using appropriate concepts and techniques to evaluate and improve corporate performance? Consider the job analysis program, performance appraisal system, up-to-date job descriptions, training and development programs, attitude surveys, job design programs, quality of relationships with unions, and use of autonomous work teams.
- e. How well is the company managing the diversity of its workforce? What is the company's record on human rights? Does the company monitor the human rights record of key suppliers and distributors?
- f. Does HRM adjust to the conditions in each country in which the company operates? Does the company have a code of conduct for HRM for itself and key suppliers in developing nations? Are employees receiving international assignments to prepare them for managerial positions?
- g. What is the role of outsourcing in HRM planning?
- h. What is the role of the HRM manager in the strategic management process?

#### 6. Information Technology (IT)

- a. What are the corporation's current IT objectives, strategies, policies, and programs?
  - i. Are they clearly stated or merely implied from performance and/or budgets?
  - ii. Are they consistent with the corporation's mission, objectives, strategies, and policies, and with internal and external environments?

- b. How well is the corporation's IT performing in terms of providing a useful database, automating routine clerical operations, assisting managers in making routine decisions, and providing information necessary for strategic decisions?
  - i. What trends emerge from this analysis?
  - ii. What impact have these trends had on past performance and how might these trends affect future performance?
  - iii. Does this analysis support the corporation's past and pending strategic decisions?
  - iv. Does IT provide the company with a competitive advantage?
- c. How does this corporation's IT performance and stage of development compare with that of similar corporations? Is it appropriately using the Internet, intranet, and extranets?
- d. Are IT managers using appropriate concepts and techniques to evaluate and improve corporate performance? Do they know how to build and manage a complex database, establish websites with firewalls and virus protection, conduct system analyses, and implement interactive decision-support systems?
- e. Does the company have a global IT and Internet presence? Does it have difficulty with getting data across national boundaries?
- f. What is the role of the IT manager in the strategic management process?

# D. Summary of Internal Factors (List in the IFAS Table 5–2, p. 188)

Which of these factors are core competencies? Which, if any, are distinctive competencies? Which of these factors are the most important to the corporation and to the industries in which it competes at the present time? Which might be important in the future? Which functions or activities are candidates for outsourcing?

### V. Analysis of Strategic Factors (SWOT)

# A. Situational Analysis (List in SFAS Matrix, Figure 6–1, pp. 202–205)

Of the external (EFAS) and internal (IFAS) factors listed in III.D and IV.D, which are the strategic (most important) factors that strongly affect the corporation's present and future performance?

#### **B.** Review of Mission and Objectives

- 1. Are the current mission and objectives appropriate in light of the key strategic factors and problems?
- 2. Should the mission and objectives be changed? If so, how?
- 3. If they are changed, what will be the effects on the firm?

# VI. Strategic Alternatives and Recommended Strategy

#### A. Strategic Alternatives

- 1. Can the current or revised objectives be met through more careful implementation of those strategies presently in use (for example, fine-tuning the strategies)?
- 2. What are the major feasible alternative strategies available to the corporation? What are the pros and cons of each? Can corporate scenarios be developed and

agreed on? (Alternatives must fit the natural physical environment, societal environment, industry, and corporation for the next three to five years.)

- a. Consider stability, growth, and retrenchment as corporate strategies.
- b. Consider cost leadership and differentiation as business strategies.
- Consider any functional strategic alternatives that might be needed for reinforcement of an important corporate or business strategic alternative.

#### **B.** Recommended Strategy

- 1. Specify which of the strategic alternatives you are recommending for the corporate, business, and functional levels of the corporation. Do you recommend different business or functional strategies for different units of the corporation?
- 2. Justify your recommendation in terms of its ability to resolve both long- and short-term problems and effectively deal with the strategic factors.
- 3. What policies should be developed or revised to guide effective implementation?
- 4. What is the impact of your recommended strategy on the company's core and distinctive competencies?

#### VII. Implementation

# A. What Kinds of Programs or Tactics Should Be Developed to Implement the Recommended Strategy?

- 1. Who should develop these programs/tactics?
- 2. Who should be in charge of these programs/tactics?
- B. Are the Programs/Tactics Financially Feasible? Can Pro Forma Budgets Be Developed and Agreed On? Are Priorities and Timetables Appropriate to Individual Programs/Tactics?
- C. Will New Standard Operating Procedures Need to Be Developed?

#### VIII. Evaluation and Reassessment

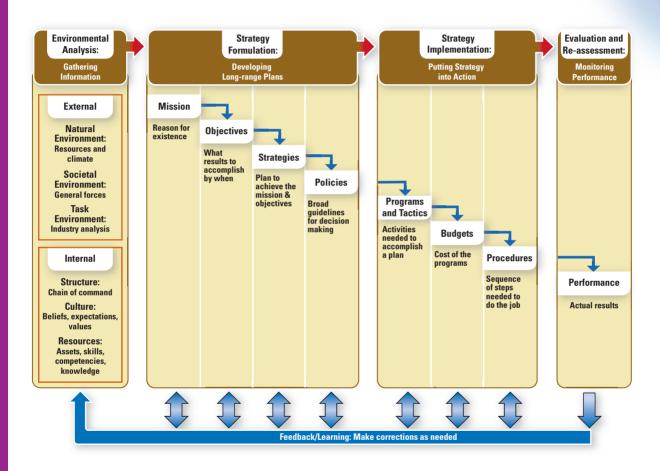
# A. Is the Current Information System Capable of Providing Sufficient Feedback on Implementation Activities and Performance? Can It Measure Strategic Factors?

- 1. Can performance results be pinpointed by area, unit, project, or function?
- 2. Is the information timely?
- 3. Is the corporation using benchmarking to evaluate its functions and activities?

# B. Are Adequate Control Measures in Place to Ensure Conformance with the Recommended Strategic Plan?

- 1. Are appropriate standards and measures being used?
- 2. Are reward systems capable of recognizing and rewarding good performance?

# Corporate Governance



# Learning Objectives

#### After reading this chapter, you should be able to:

- **2-1.** Describe the role and responsibilities of the board of directors in corporate governance
- **2-2.** Explain how the composition of a board can affect its operation
- **2-3.** Describe the impact of the Sarbanes—Oxley Act on corporate governance in the United States
- 2-4. Discuss trends in corporate governance
- **2-5.** Explain how executive leadership is an important part of strategic management

#### How the Board at Hewlett-Packard Nearly Brought Down the Company

The Board of Directors is ultimately responsible for the actions of an organization and, for the most part, the activities of the board remain hidden from view. That has certainly not been the case at Hewlett-Packard Company, the Palo Alto pioneer in technology.

Lewis Platt was only the fourth CEO in the history of the company, and like his predecessor (John A. Young), he was a long-time engineering employee of the company. Under his leadership, the company prospered as it had through most of its 50-year history up to that point. With the support of the board, he spun off the Medical Instruments division and made tentative moves toward the new information age, but was slow to recognize the importance of the Internet.

In 1999, along with the board of directors, he decided to look outside the company for the first time and try to hire a visible, passionate leader for the staid engineering-oriented firm. On July 19, 1999, HP announced that Carly Fiorina would be the new CEO, making her the first woman to head a DOW 30 company. Fiorina made her name at Lucent Technologies where she was President of a company that made a remarkable turnaround in the face of the huge changes in technology of the day.

Some of the same board members that hired her then turned vocally and visibly against her in one of the most public proxy battles of our times when she announced a US\$25 billion merger with Compaq Computer Company in September 2001. Walter Hewlett and Lewis Platt openly opposed the merger. They felt the plan to move HP into an innovation machine in the Internet age would now be sidelined so that the company could put most of its resources in a low margin, shrinking PC manufacturing business. Wall Street hated the idea. HP stock lost 18% of its value on the day the merger was announced and many analysts in the industry thought this was a bad move. Fiorina forced the merger forward with the support of the majority of the board of directors.

On February 22, 2002, the HP Board of Directors sent a very public and stinging letter of criticism against Walter Hewlett to all of its shareholders. Hewlett responded by taking out ads in major newspapers opposing the acquisition. In the end, the merger was approved, but by only a scant 3% majority. Most M&A deals are approved with wide majorities, always with the hope that they will be positive for the organization. One study found that 95% of deals are approved by shareholders once the deal is announced.

The history of acquisitions is not a good one. Very few bring real value to the companies that are the acquirer. The bigger the acquisition, the more likely this is the case. Such was the fate of HP. By the end of 2004, the board was fed up with Carly Fiorina's inability to move the new, huge HP forward. The board began meeting in private without their high-profile CEO. On February 6, 2005, the board met with Fiorina at Chicago's O'Hare Hyatt Hotel and expressed their frustration with her leadership and her unwillingness to work with the board of directors on the future of the company. The next day they asked her to resign.

Believing that it was a failure of execution, the board moved to hire someone with strict operating credentials. The result was Mark Hurd, the 25-year veteran CEO at NCR Corporation. Hurd roared into the company, eliminating 15,000+ jobs, cutting R&D, and attempting to automate consulting services. A leak of information discussed at a board of director's strategy meeting in late 2005 led then–Board Chair Patricia Dunn and CEO Mark Hurd to initiate an investigation of fellow board members. Using detectives who posed as reporters, they obtained phone records of those people on the board that they suspected, and the spying scandal exploded into the open.

Dunn was fired from her board seat in 2006 and *Newsweek* magazine put her on the cover with the title "The Boss Who Spied on Her Board." Mark Hurd escaped any serious repercussions from the scandal and announced a new, very strict code of conduct for the corporation.

By all accounts, Mark Hurd was successful at turning the company around and was named one of the best CEOs in 2009; board efforts also were relatively quiet. However, another scandal broke: Hurd was accused of sexual harassment by an HP marketing consultant. While the board found that he did not actually violate the company's sexual-harassment policies, they did find that he submitted inaccurate expense reports intended to conceal the relationship. He was forced to resign in August 2010 by a powerful but small group of directors.

In the wake of the Hurd resignation, there was a major board shakeup. Four directors involved in forcing the Hurd resignation resigned their board seats and five new board members were named. In November, 2010, the board named Leo Apotheker as the new CEO. He was the former head of Global Field Operations at SAP but he did not last long at HP. The board fired him in just over 10 months. Apotheker's move to push forward the HP TouchPad tablet was a commercial failure at the same time that HP phones were taking a beating in the market. In a stunning announcement in September 2011, he let the world know that HP would exit the PC business entirely. HP was the leader in PC sales both within the United States and globally. The outrage was immediate and overwhelming. The company reversed position two weeks later, but the board was appalled at his lack of leadership. After firing Apotheker, the board named one of its own members, former eBay CEO Meg Whitman to run the company.

The board turmoil did not end. After a contentious annual meeting in 2013, the Chair of the Board stepped down and two other board members resigned. In 2014,

Meg Whitman was named Chair of the Board and two new members were added at the same time that the company was in the process of the most significant layoffs in its history. From 2011 when Whitman took over as CEO to 2015, the company laid off more than 55,000 employees. Effective November 1, 2015, the company split into two publicly traded companies in an effort to separate the slow-growing PC and printer business from the potentially fast-growing cloud technology and cybersecurity businesses. One company, called Hewlett-Packard Enterprise, consists of the services arm and by 2021 had achieved 12% compounded annual growth. The other company, called Hewlett-Packard Inc., consists of the PC and Printer operations, and has seen its compounded annual growth rate stagnate at 5.6%.

One of the most important responsibilities that a board of directors has is to effectively recruit and work with management to lead the business. The CEO revolving door at HP has cost the company more than US\$83 million in severance pay for CEOs that the board no longer wants to run the company. *CNN Money* reported in 2012 that "Before Apotheker ever came to HP, the company was known for its fractious board. Individual directors would cycle in and out, yet somehow the group seemed constantly divided by personal rivalries, bickering, and leaks to the press."

#### Role of the Board of Directors

**2-1.** Describe the role and responsibilities of the board of directors in corporate governance

A *corporation* is a mechanism established to allow different parties to contribute capital, expertise, and labor for their mutual benefit. The investor/shareholder participates in the profits (in the form of dividends and stock price increases) of the enterprise without taking responsibility for the operations. Management runs the company without being responsible for personally providing the funds. To make this possible, laws have been passed that give shareholders limited liability and, correspondingly, limited involvement in a corporation's activities. That involvement does include, however, the right to elect directors who have a legal duty to represent the shareholders and protect their interests. As representatives of the shareholders, directors have both the authority and the responsibility to establish basic corporate policies and to ensure that they are followed.<sup>2</sup>

The board of directors, therefore, has an obligation to approve all decisions that might affect the long-term performance of the corporation. This means that the corporation is fundamentally governed by the *board of directors* overseeing *top management*, with the concurrence of the *shareholder*. The term **corporate governance** refers to the relationship among these three groups in determining the direction and performance of the corporation.<sup>3</sup>

Increasingly, shareholders, activist investors, and various interest groups have seriously questioned the role of the board of directors in corporations. They are concerned that inside board members may use their position to feather their own nests and that outside board members often lack sufficient knowledge, involvement, and enthusiasm to do an adequate job of monitoring and providing guidance to top management. Instances of widespread corruption and/or questionable accounting practices at Enron, Global Crossing, WorldCom, Tyco, Bernard L. Madoff Investment Securities, Wells Fargo, and Qwest, among others, seem to justify their concerns. While not crossing the line of

illegality, the board at HP appeared to be incapable of deciding about the direction of the business and repeatedly moved CEOs in and out as its ideas changed.

The general public has not only become more aware and more critical of many boards' apparent lack of responsibility for corporate activities, but it has also begun to push government to demand accountability. As a result, the board as a rubber stamp of the CEO or as a bastion of a patronage selection system is slowly being replaced by more active, more professional boards.

#### RESPONSIBILITIES OF THE BOARD

Laws and standards defining the responsibilities of boards of directors vary from country to country. For example, board members in Ontario, Canada, face more than 100 provincial and federal laws governing director liability. The United States, however, has no clear national standards or federal laws. Specific requirements of directors vary, depending on the state in which the corporate charter is issued. There is, nevertheless, a developing worldwide consensus concerning the major responsibilities of a board. An article by Spencer Stuart written by an international team of contributors suggested the following five **board of director responsibilities**:

- 1. Effective board leadership including the processes, makeup, and output of the board
- 2. Strategy of the organization
- 3. Risk vs. initiative and the overall risk profile of the organization
- 4. Succession planning for the board and top management team
- 5. Sustainability<sup>4</sup>

These suggested responsibilities agree with a survey by the National Association of Corporate Directors, in which U.S. CEOs reported that the four most important issues boards should address are corporate performance, CEO succession, strategic planning, and corporate governance. Directors in the United States must make certain, in addition to the duties just listed, that the corporation is managed in accordance with the laws of the state in which it is incorporated. Because more than half of all publicly traded companies in the United States are incorporated in the state of Delaware, this state's laws and rulings have more impact than do those of any other state. Directors must also ensure management's adherence to laws and regulations, such as those dealing with the issuance of securities, insider trading, and other conflict-of-interest situations. They must also be aware of the needs and demands of constituent groups so that they can achieve a judicious balance among the interests of these diverse groups while ensuring the continued functioning of the corporation.

In a legal sense, the board is required to direct the affairs of the corporation but not to manage them. It is charged by law to act with **due care**. If a director or the board as a whole fails to act with due care and, as a result, the corporation is in some way harmed, the careless director or directors can be held personally liable for the harm done. This is no small concern given that one survey of outside directors revealed that more than 40% had been named as part of lawsuits against corporations. In 2015, the courts ruled that shareholders could pursue claims against Zynga (Farmville and Words with Friends among many others). Based upon the testimony of at least a half-dozen confidential witnesses, it appears that Zynga management intended to hide information detrimental to the price of the stock. Shareholders claim that insiders (Members of the Senior Management Team and Board of Directors) were allowed to sell \$593 million in stock before a post-IPO lockup was to expire. The stock dropped 75% over the next

four months as declining user activity information was released.<sup>8</sup> Most corporations have found that they need directors' and officers' liability insurance in order to attract people to become members of boards of directors.

#### Role of the Board in Strategic Management

How does a board of directors fulfill their many responsibilities? The *role of the board* of directors in strategic management is to carry out three basic tasks:

- Monitor: By acting through its committees, a board can keep abreast of developments inside and outside the corporation, bringing to management's attention developments it might have overlooked. A board should, at the minimum, carry out this task.
- Evaluate and influence: A board can examine management's proposals, decisions, and actions; agree or disagree with them; give advice and offer suggestions; and outline alternatives. More active boards perform this task in addition to monitoring.
- **Initiate and determine:** A board can delineate a corporation's mission and specify strategic options to its management. Only the most active boards take on this task in addition to the two previous ones.

#### **Board of Directors' Continuum**

A board of directors is involved in strategic management to the extent that it carries out the three tasks of monitoring, evaluating, and influencing, and initiating and determining. The **board of directors' continuum** shown in **Figure 2–1** shows the possible degree of involvement (from low to high) in the strategic management process. Boards can range from phantom boards with no real involvement to catalyst boards with a very high degree of involvement. Research suggests that active board involvement in strategic management is positively related to a corporation's financial performance and its credit rating. Definition of the process of the possible of the possible degree of involvement.

FIGURE 2-1 Board of Directors' Continuum

DEGREE OF INVOLVEMENT IN STRATEGIC MANAGEMENT  Low (Passive)					High (Active)
Phantom	Rubber Stamp	Minimal Review	Nominal Participation	Active Participation	Catalyst
Never knows what to do, if anything; no degree of involvement.	Permits officers to make all decisions. It votes as the officers recom- mend on action issues.	Formally reviews selected issues that officers bring to its attention.	Involved to a limited degree in the performance or review of selected key decisions, indicators, or programs of management.	Approves, questions, and makes final decisions on mission, strategy, policies, and objectives. Has active board committees. Performs fiscal and management audits.	Takes the leading role in establishing and modifying the mission, objectives, strategy, and policies. It has a very active strategy committee.

SOURCE: T. L. Wheelen and J. D. Hunger, "Board of Directors' Continuum," Copyright © 1994 by Wheelen and Hunger Associates. Reprinted by permission.

Highly involved boards tend to be very active. They take their tasks of monitoring, evaluating, and influencing, and initiating and determining very seriously; they provide advice when necessary and keep management alert. As depicted in **Figure 2–1**, their heavy involvement in the strategic management process places them in the active participation or even catalyst positions. Although 74% of public corporations have periodic board meetings devoted primarily to the review of overall company strategy, the boards may not have had much influence in generating the plan itself.<sup>11</sup>

As a board becomes less involved in the affairs of the corporation, it moves farther to the left on the continuum (see **Figure 2–1**). On the far left are passive phantom or rubber-stamp boards that typically do not initiate or determine strategy unless a crisis occurs. In these situations, the CEO who also often serves as Chair of the Board (although we see the same situation in active boards), personally nominates all directors and works to keep board members under their control by giving them the "mushroom treatment"—throw manure on them and keep them in the dark!

Generally, the smaller the corporation, the less active is its board of directors in strategic management.<sup>12</sup> In an entrepreneurial venture, for example, the privately held corporation may be 100% owned by the founders—who also manage the company. In this case, there is no need for an active board to protect the interests of the ownermanager shareholders—the interests of the owners and the managers are identical. In this instance, a board is really unnecessary and only meets to satisfy legal requirements. If stock is sold to outsiders to finance growth, however, the board becomes more active. Key investors want seats on the board so they can oversee their investment. To the extent that they still control most of the stock, however, the founders dominate the board. Friends, family members, and key shareholders usually become members, but the board acts primarily as a rubber stamp for any proposals put forward by the owner-managers. In this type of company, the founder tends to be both CEO and Chair of the Board and the board includes few people who are not affiliated with the firm or family.<sup>13</sup> This cozy relationship between the board and management should change, however, when the corporation goes public and stock is more widely dispersed. The founders, who are still acting as management, may sometimes make decisions that conflict with the needs of the other shareholders (especially if the founders own less than 50% of the common stock). In this instance, problems could occur if the board fails to become more active in terms of its roles and responsibilities. This situation can occur in large organizations as well. Even after the high-profile IPO, Facebook was still more than 50% controlled by founder Mark Zuckerberg and he used his position to make significant strategic decisions without input from the board of directors. In 2012, just ahead of the IPO of Facebook, he bought Instagram for roughly US\$1 billion and only then informed the board of his move. 14

## **Board of Directors Composition**

**2-2.** Explain how the composition of a board can affect its operation

The boards of most publicly owned corporations are composed of both inside and outside directors. **Inside directors** (sometimes called *management directors*) are typically officers or executives employed by the corporation. **Outside directors** (sometimes called *non-management directors*) may be executives of other firms but are not employees of the board's corporation. Although there is yet no clear evidence indicating that a high proportion of outsiders on a board results in improved financial performance, <sup>15</sup> there is a trend in the United States to increase the number of outsiders on boards and to reduce

the total size of the board. The board of directors of a typical large U.S. corporation has an average of 10 directors, 2 of whom are insiders. For the very largest companies, those with more than US\$10 billion in market capitalization, the average board had 11.2 members. In 1998, there were no non-executives (outside directors) that served as Chair of the Board for the S&P 500 companies. By 2012, these outsiders comprised 23% of the Chair positions. Not surprisingly, in 1998, 84% of the S&P 500 companies had their CEO in a dual role as Chair. By 2012, that number had dropped to 56% and by 2017, it had dropped to 50%. In the contraction of the second service of the second seco

Outsiders thus account for 80% of the board members in large U.S. corporations (approximately the same as in Canada). Boards in the United Kingdom typically have 5 inside and 5 outside directors, whereas in France boards usually consist of 3 insiders and 8 outsiders. Japanese boards, in contrast, contain 2 outsiders and 12 insiders. The board of directors in a typical small U.S. corporation has 4 to 5 members, of whom only 1 or 2 are outsiders. Research from large and small corporations reveals a negative relationship between board size and firm profitability. 22

People who favor a high proportion of outsiders firmly believe that outside directors are less biased and more likely to evaluate management's performance objectively than are inside directors. This is the main reason why the U.S. Securities and Exchange Commission (SEC) in 2003 required that a majority of directors on the board be independent outsiders. The SEC also required that all listed companies staff their audit, compensation, and nominating/corporate governance committees entirely with independent, outside members. This view agrees with agency theory, which states that problems arise in corporations because the agents (top management) are not willing to bear responsibility for their decisions unless they own a substantial amount of stock in the corporation. The theory suggests that a majority of a board needs to be from outside the firm so that top management is prevented from acting selfishly to the detriment of the shareholders. For example, proponents of agency theory argue that managers in management-controlled firms (contrasted with owner-controlled firms in which the founder or family still own a significant amount of stock) select less risky strategies with quick payoffs in order to keep their jobs.<sup>23</sup> This view is supported by research revealing that manager-controlled firms (with weak boards) are more likely to go into debt to diversify into unrelated markets (thus quickly boosting sales and assets to justify higher salaries for themselves). These actions result in poorer long-term performance than would be seen with owner-controlled firms.<sup>24</sup> Boards with a larger proportion of outside directors tend to favor growth through international expansion and innovative venturing activities than do boards with a smaller proportion of outsiders.<sup>25</sup> Outsiders tend to be more objective and critical of corporate activities. For example, research reveals that the likelihood of a firm engaging in illegal behavior or being sued declines with the addition of outsiders on the board.<sup>26</sup> Research on family businesses has found that boards with a larger number of outsiders on the board tended to have better corporate governance and better performance than did boards with fewer outsiders.<sup>27</sup>

In contrast, those who prefer inside over outside directors contend that outside directors are less effective than are insiders because the outsiders are less likely to have the necessary interest, availability, or competency. **Stewardship theory** proposes that, because of their long tenure with the corporation, insiders (senior executives) tend to identify with the corporation and its success. Rather than use the firm for their own ends, these executives are thus most interested in guaranteeing the continued life and success of the corporation. (See the **Strategy Highlight** feature for a discussion of agency theory contrasted with stewardship theory.) Excluding all insiders but the CEO reduces the opportunity for outside directors to see potential successors in action or to obtain alternate points of view of management decisions. Outside directors may sometimes serve on

# **INNOVATION** issue

#### INNOVATION AND AUTONOMOUS SHIPPING

The effort to bring autonomous and semi-autonomous vehicles to the market has been moving along at a breakneck pace, outstripping government's ability to keep up with the changes. Autonomous transportation has been a significant focal point for innovation by some corporations. Among the many avenues being pursued is the shipping of goods by cargo containers.

Cargo ships are notorious for their pollution, rough working conditions, long waits to get into port, pirate takeovers in some locations, and relative freedom of navigation. Over 90% of world trade is carried across the world's oceans in 90,000+ cargo vessels. More than 3% of global carbon dioxide emissions can be attributed to ocean-going ships.

If global shipping were a country, it would be the sixth largest producer of greenhouse gas emissions.

One company, Yara (based in Norway), launched the world's first fully electric and autonomous container ship in November 2021. With this vessel, Yara will reduce diesel-powered truck haulage by 40,000 journeys a year. The vessel will operate with a skeleton crew for the first year and should be allowed to progressively reduce staff on the vessel to just a captain. The new vessels will be lighter than most ferries because they will have no sleeping area for crew.

Technology innovations in automobiles and GPS coverage are enabling opportunities to change the operation of entire industries.<sup>28</sup>

so many boards that they spread their time and interest too thin to actively fulfill their responsibilities. A recent survey of corporate directors found that 44% served on two or more public company boards, with 5% serving on four or more public company boards.<sup>29</sup> Research indicates that firm performance decreases as the number of directorships held by the average board member increases.<sup>30</sup> Although only 40% of surveyed U.S. boards currently limit the number of directorships a board member may hold in other corporations, 60% limit the number of boards on which their CEO may be a member.<sup>31</sup>

# STRATEGY highlight

#### AGENCY THEORY VERSUS STEWARDSHIP THEORY IN CORPORATE GOVERNANCE

Managers of large, modern, publicly held corporations are typically not the owners. In fact, most of today's top managers own only nominal amounts of stock in the corporation they manage and that stock has often been granted to them as a part of their Board compensation. The real owners (shareholders) elect boards of directors who hire managers as their agents to run the firm's day-to-day activities. Once hired, how trustworthy are these executives? Do they put themselves or the firm first? There are two significant schools of thought on this.

**Agency Theory.** As suggested in the classic study by Berle and Means, top managers are, in effect, "hired hands" who are very likely more interested in their personal welfare than that of the shareholders. For example, management might emphasize strategies, such as acquisitions, that increase

the size of the firm (to become more powerful and to demand increased pay and benefits) or that diversify the firm into unrelated businesses (to reduce short-term risk and to allow them to put less effort into a core product line that may be facing difficulty) but that result in a reduction of dividends and/or stock price.

Agency theory is concerned with analyzing and resolving two problems that occur in relationships between principals (owners/shareholders) and their agents (top management):

Conflict of interest arises when the desires or objectives of the owners and the agents conflict. For example, attitudes toward risk may be quite different. Agents may shy away from riskier strategies in order to protect their jobs.

**2.** *Moral hazard* refers to the situation where it is difficult or expensive for the owners to verify what the agents are actually doing.

According to agency theory, the likelihood that these problems will occur increases when stock is widely held (that is, when no one shareholder owns more than a small percentage of the total common stock), when the board of directors is composed of people who know little of the company or who are personal friends of top management, and when a high percentage of board members are inside (management) directors.

To better align the interests of the agents with those of the owners and to increase the corporation's overall performance, agency theory suggests that top management have a significant degree of ownership in the firm and/or have a strong financial stake in its long-term performance. In support of this argument, research indicates a positive relationship between corporate performance and the amount of stock owned by directors.

**Stewardship Theory.** In contrast, stewardship theory suggests that executives tend to be more motivated to act in the best interests of the corporation than in their own

self-interests. Whereas agency theory focuses on extrinsic rewards that serve lower-level needs, such as pay and security, stewardship theory focuses on the higherorder needs, such as achievement and self-actualization. Stewardship theory argues that senior executives over time tend to view the corporation as an extension of themselves. Rather than use the firm for their own ends, these executives are most interested in guaranteeing the continued life and success of the corporation. The relationship between the board and top management is thus one of principal and steward, not principal and agent ("hired hand"). Stewardship theory notes that in a widely held corporation, the shareholders are free to sell their stock at any time. In fact, the average share of stock is held less than 10 months. A diversified investor or speculator may care little about risk at the company level—preferring management to assume extraordinary risk so long as the return is adequate. Because executives in a firm cannot easily leave their jobs when in difficulty, they are more interested in a merely satisfactory return and put heavy emphasis on the firm's continued survival. Thus, stewardship theory argues that in many instances top management may care more about a company's long-term success than do more short-term-oriented shareholders.<sup>32</sup>

Those who question the value of having more outside board members point out that the term *outsider* is too simplistic because some outsiders are not truly objective and should be considered more as insiders than as outsiders. For example, there can be:

- 1. Affiliated directors, who, though not really employed by the corporation, handle the legal or insurance work for the company or are important suppliers (and thus dependent on the current management for a key part of their business). These outsiders face a conflict of interest and are not likely to be objective. As a result of actions by the U.S. Congress, the Securities and Exchange Commission, the New York Stock Exchange, and NASDAQ, affiliated directors are being banned from U.S. corporate boardrooms. U.S. boards can no longer include representatives of major suppliers or customers or even professional organizations that might do business with the firm, even though these people could provide valuable knowledge and expertise. The New York Stock Exchange decided in 2004 that anyone paid by the company during the previous three years could not be classified as an independent outside director. The supplier of the previous three years could not be classified as an independent outside director.
- **2. Retired executive directors**, who used to work for the company, such as the past CEO who is partly responsible for much of the corporation's current strategy and who probably groomed the current CEO as their replacement. In the recent past, many boards of large firms kept the firm's recently retired CEO on the board for a year or two after retirement as a courtesy, especially if the CEO performed well. It is almost certain, however, that this person will not be able to objectively evaluate the corporation's performance. Because of the likelihood of a conflict of interest, only 30% of boards in the Americas and 28% in Europe now include the former CEO on their boards.<sup>35</sup>

**3. Family directors,** who are descendants of the founder and own significant blocks of stock (with personal agendas based on a family relationship with the current CEO). The Schlitz Brewing Company, for example, was unable to complete its turnaround strategy with a non-family CEO because family members serving on the board wanted their money out of the company, forcing it to be sold.<sup>36</sup>

The majority of outside directors are active or retired CEOs and COOs of other corporations. Others are major investors/shareholders, academicians, attorneys, consultants, former government officials, and bankers. Given that 66% of the outstanding stock in the largest U.S. and UK corporations is now owned by institutional investors, such as mutual funds and pension plans, these investors are taking an increasingly active role in board membership and activities.<sup>37</sup> Institutional investors are also powerful in many other countries. In Germany, bankers are represented on almost every board—primarily because they own large blocks of stock in German corporations. In Denmark, Sweden, Belgium, and Italy, however, investment companies assume this role.

Boards of directors have been working to increase the number of women and people of color serving on boards, and well they should. A 2012 study of 2360 companies found that shares of companies with female board members outperformed comparable businesses with all-male boards by 26% worldwide over a six-year time period. This has gotten the attention of big investors. Since 2017, CalPERS has voted against 438 directors at 141 companies based on the companies' failure to respond to CalPERS efforts to urge greater board diversity and, effective in January 2020, all publicly listed companies with headquarters in the state of California were required to have at least one woman on their board of directors<sup>39</sup>

By 2021, women held approximately 30% of the corporate board seats for companies based in the United States on the S&P 500, while that number was nearly identical at 29.5% of seats in the European Union. A quick look at some specific countries:

France: 43.3%
Sweden: 38%
U.K.: 34.3%
India: 16.6%<sup>40</sup>

A 2018 Deloitte study of the board makeup of the Fortune 500 revealed that people of color hold 19.5% of the corporate board of directors seats. <sup>41</sup> The globalization of business is also having an impact on board membership. According to the Spencer Stuart executive recruiting firm, 33% of U.S. boards had an international director. <sup>42</sup> Europe was the most "globalized" region of the world, with most companies reporting one or more non-national directors. <sup>43</sup> Although Asian and Latin American boards are still predominantly staffed by nationals, they are working to add more international directors. <sup>44</sup>

The 2018 U.S. Spencer Stuart Board Index found that the average compensation for S&P 500 non-employee directors was US\$295,000 with 60% of that in stock award or options and the remainder in cash. <sup>45</sup> Directors serving on the boards of small companies usually received much less compensation (around US\$10,000). One study found directors of a sample of large U.S. firms to hold, on average, 3% of their corporations' outstanding stock. <sup>46</sup>

The vast majority of inside directors are the chief executive officer and either the chief operating officer (if not also the CEO) or the chief financial officer. Presidents or vice presidents of key operating divisions or functional units sometimes serve on the board. Few, if any, inside directors receive any extra compensation for assuming this extra duty. Very rarely does a U.S. board include any lower-level operating employees.