Fundamentals of Strategic Management

CHAPTER 1

Chapter Outline

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What do Circuit City, Washington Mutual, Saab, Blockbuster, General Motors, Radio Shack, and Borders have in common? All of these recognized companies filed for bankruptcy within the past decade. While the situation surrounding each firm is different—and some of them have since recovered—each one made important strategic mistakes.Perhaps luck plays a role in company downturns, but those with strong, competent strategic leadership usually fare the best.

This text is about developing a systematic, strategic perspective for managing an organization. It is applicable for leaders of manufacturing and service firms, and the concepts presented herein are useful in nonprofit and government organizations as well. These ideas vary in complexity, but understanding and applying them can enhance the odds of success.

Strategic management is more important than ever. Today's business world is global, Internet-driven, and obsessed with speed, and the challenges it creates for top managers are often complex, ambiguous, and unstructured. Add to this the incessant allegations of top management wrongdoings, economic stagnation, and increasing executive compensation, and it is easy to see why leaders are under great pressure to respond to strategic problems quickly, decisively, and responsibly. Indeed, the need for effective strategic management has never been more pronounced.

Mission statements vary widely. Compare and contrast many of the mission statements of *Fortune 500* firms at *www.missionstatements.com/fortune_500_mission_statements.html.*

This chapter introduces the notion of strategic management, highlights its importance, and presents a five-step process for strategically analyzing an organization. The remaining chapters expand on the five steps in the process, with special emphasis on their application to ongoing enterprises.

What Is Strategic Management?

mission The reason for an organization's existence. The mission statement is a broadly defined but enduring statement of purpose that identifies the scope of an organization's operations and its offerings to affected groups (i.e., stakeholders, as defined later in the book).

strategy Top management's plans to attain outcomes consistent with the organization's mission and goals.

competitive advantage A situation whereby a business unit's successful strategies cannot be easily duplicated by its competitors.

strategic management The continuous process of determining the mission and goals of an organization within the context of its external environment and its internal strengths and weaknesses, formulating and implementing strategies, and exerting strategic control to ensure that the organization's strategies are successful in attaining its goals.

Each organization exists for a purpose. Its **mission** is articulated in a broadly defined but enduring statement of purpose that identifies the scope of an organization's operations and its offerings to affected groups and entities. Most established organizations have developed a formal mission statement, a concept discussed in greater detail in Chapter 5.

Strategy refers to top management's plans to develop and sustain **competitive advantage**—a situation whereby a firm's successful strategies cannot be easily duplicated by its competitors[1]—so that the organization's mission is fulfilled.[2] Following this definition, it is assumed that an organization has a plan, its source of competitive advantage is understood, and that its members understand the reason for its existence. These assumptions may appear self-evident, but many strategic problems can be traced to fundamental misunderstandings associated with defining the strategy. Debates over the nature of the organization's competitive advantage, its mission, and whether or not a strategic plan is really needed can be widespread.[3] As such, comments such as "We're too busy to focus on developing a strategy" or "I'm not exactly sure what my company is really trying to accomplish" can be overheard in many organizations.

Strategic management is a broader term than strategy and is a process that includes top management's analysis of the organization's environment prior to formulating a strategy, as well as the plan for implementation and control of the strategy. Put another way, the difference between a strategy and the strategic management process is that the latter includes considering what must be done before a strategy is formulated through assessing whether or not the success of an implemented strategy was successful. The strategic management process can be summarized in five steps, each of which is discussed in greater detail in subsequent chapters of the book (see Figure 1-1):[4]

1. **External analysis:** Analyze the opportunities and threats or constraints that exist in the organization's external environment, including industry and forces in the external environment.
2. **Internal analysis:** Analyze the organization's strengths and weaknesses in its internal environment. Consider the context of managerial ethics and corporate social responsibility.
3. **Strategy formulation:** Formulate strategies that build and sustain competitive advantage by matching the organization's strengths and weaknesses with the environment's opportunities and threats.
4. **Strategy execution:** Implement the strategies that have been developed.
5. **Strategic control:** Measure success and make corrections when the strategies are not producing the desired outcomes.

The sequential order of the steps is logical. A thorough understanding of the organization and its environment is essential if the appropriate strategy is to be developed, put into action, and controlled. One could transpose the first two steps and analyze the internal environment before the external environment, the logic being that comprehending the organization informs the strategic assessment of factors outside of the firm. The external environment is analyzed before the internal environment in Figure 1-1, however, because internal goals, resources, and competencies are viewed vis-à-vis rivals and are understood

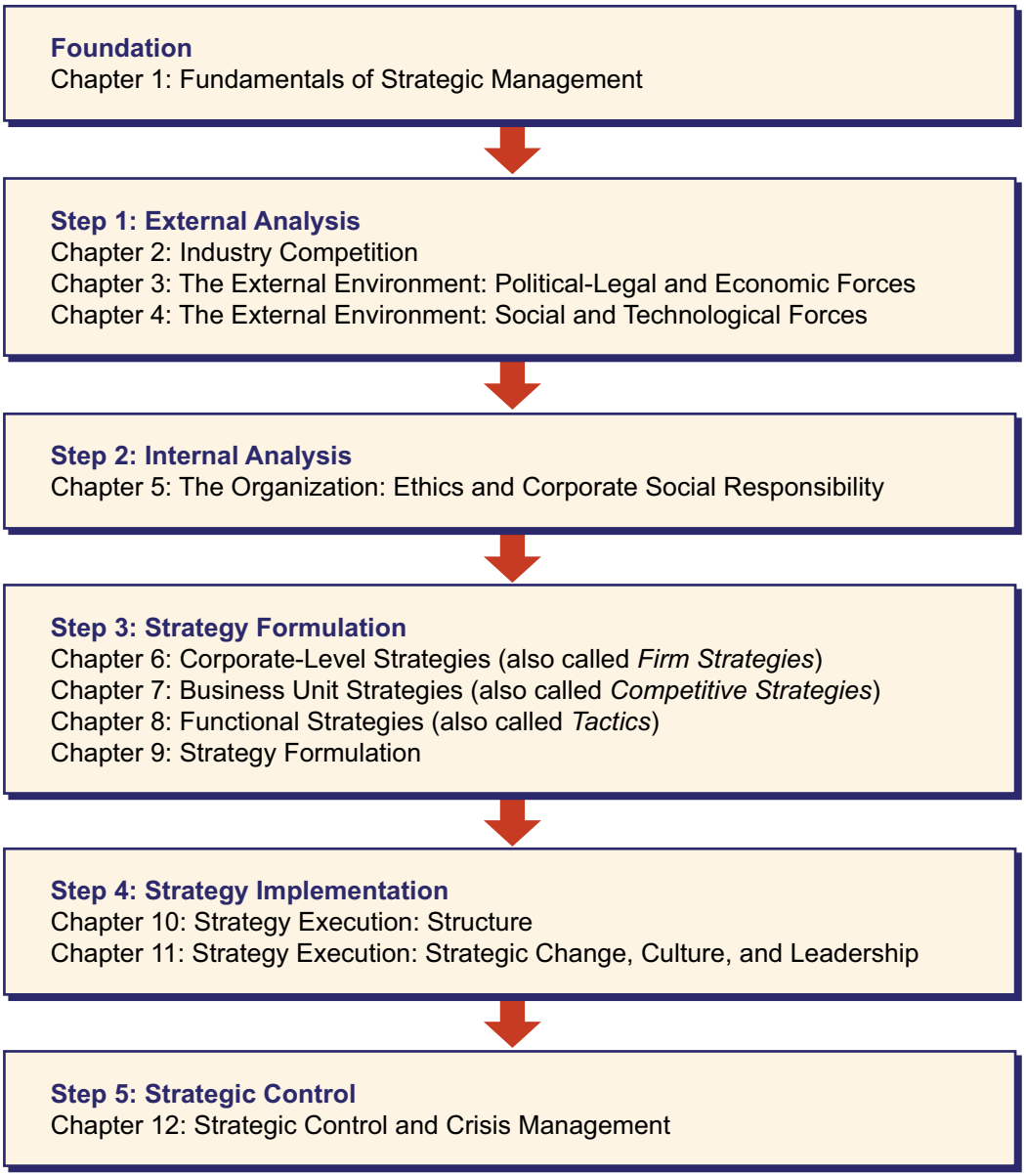

FIGURE 1-1
Organization of the Book

within the context of the industry and the factors that drive it. This dilemma resembles the "chicken and egg" argument; in reality, analysis of the external and internal environments occurs simultaneously.

The notion of strategic management can be linked to two key economic concepts. The first is what economists and investors call the **efficient market hypothesis**, or the idea that all individuals or firms in a market earn the same returns in the long run. For investors, this means that everyone has access to the same information, so it is impossible to *consistently* "buy low and sell high." For firms, this means that special benefits or high profits result from either randomness or strategic resources that can be copied by other rivals as well. While there is some rationale to the efficient market hypothesis—and a thorough review of extant research is beyond the scope of this book—completely accepting it minimizes the value of strategic planning. If the hypothesis is not entirely accurate, then firms whose managers plan effectively can enjoy higher-than-average profits over a period of time.

efficient market hypothesis The idea that all individuals or firms in a market earn the same returns in the long run.

The second concept is that of **subjective value**, or the idea that a resource's value is determined by the individual or organization possessing it, not an objective measure that would be the same for all firms. For example, having a highly trained workforce with strong

subjective value The idea that a resource's value is determined by the individual or organization possessing it; not an objective measure that would be the same for all firms.

technical skills is of greater value to an organization that emphasizes technology in production than to one whose approach is labor intensive. The notion of subjective value explains why one firm is willing to pay a premium (i.e., more than the value based on the current stock price) to acquire another firm; its managers believe that the firm offers greater value if it is possessed by the acquiring firm. The efficient market hypothesis explains why companies with similar resources tend to perform at similar levels, but the notion of subjective value explains why substantial performance variation can exist among similar firms.

A distinction between outside and inside perspectives on strategy is also relevant. *Outsiders* analyzing a firm should apply a systematic approach that progresses through these steps in order. Doing so develops to a holistic understanding of the firm, its industry, and its strategic challenges.

Inside organizations, strategies are being formulated, implemented, and controlled simultaneously while external and internal factors are continually reassessed. In addition, changes in one stage of the strategic management process will inevitably affect other stages as well. After a planned strategy is implemented it often requires modification as conditions change. Hence, because these steps are so tightly intertwined, *insiders* tend to treat all of the steps as a single integrated, ongoing process.[5]

Consider the strategic management process at a fast-food restaurant chain. At any given time, top managers are likely assessing changes in consumer taste preferences and food preparation, analyzing the activities of competitors, working to overcome firm weaknesses, controlling remnants of a strategy implemented several years ago, implementing a strategy crafted months earlier, and formulating strategic plans for the future. Although each of these activities can be linked to a distinct stage in the strategic management process, they occur simultaneously.

business model The economic mechanism by which a business hopes to sell its goods or services and generate a profit.

An effective strategy is built on the foundation of the organization's **business model**, the mechanism whereby the organization seeks to earn a profit by selling its goods or services. While all firms seek to produce a product or service and sell it at a price higher than its production and overhead costs, a business model is stated in greater detail. For example, a magazine publisher might adopt a "subscription model," an "advertising model," or perhaps some combination of the two. Profits would be generated primarily from readers under the subscription model but from advertisers under the advertising model. As we can see, identifying a firm's business model can become more complex when intricate details are considered. Progressive firms often devise innovative business models that extract revenue—and ultimately profits—from sources not identified by competitors.

Consider the *razor and blades* business model invented by Gillette. A company gives away or deeply discounts a product—the razor—while planning to profit from future sales of required replacement or complementary products—the blades. Customers willing to sign a two-year service contract might receive a deeply discounted cell phone. Computer printers are typically sold below production cost, but customers must periodically replace the ink cartridges—high margin items. This model is not foolproof, however. In a competitive marketplace, customers may be able to purchase the required complementary products at lower prices from rivals not under pressure to recoup initial losses. Interestingly, online companies like Harry's and Dollar Shave Club are challenging the razor and blades business model with a new way to purchase shaving supplies.

Successful business models can change over time, and many of the changes are Internet driven. For example, since early 2000, a number of authors have strayed from the traditional business model whereby book publishers offer contracts and pay royalties of 10–15 percent. Leveraging advances in publishing software, social media, and a strong online retail book market, they have opted for a "self-publishing" model. Enterprising authors who publish their own work also shoulder the initial risk, but can net as much as a 70 percent return on e-book sales from companies like Amazon.com. The total print book and e-book output of self-publishers in the UNITED STATES rose from about 50,000 titles in 2006 to over 125,000 in 2010 and over 450,000 in 2013.[6] Smashwords' Mark Coker contends that self-published e-books will capture 50 percent of the market by 2020.[7]

Consider the auto industry. Tesla sells its electric vehicles to consumers in the United States directly through the Internet. Tesla is pursuing this approach both out of necessity—the small

carmaker lacks a nationwide dealer network—and a desire to improve efficiency. Industry groups have attempted to block the move, arguing that carmakers should not be allowed to "bypass" franchised auto retailers. In some states, laws restricting direct sales have been in place for years to protect the territorial rights of local franchises. Tesla has no franchisees and its leadership has argued that such laws violate the company's right to sell products in the way it deems appropriate.[8]

South Africa's SMD (*www.smd.co.za*) sells vehicles on behalf of insurance companies direct to the public. These vehicles are often damaged—some substantially—and require repair. SMD's customers may be willing to do some of the work themselves or to tolerate a few dents. Hence, SMD is making vehicle ownership affordable to an underserved lower-income category of South Africans.

The emergence of new Internet-based business models has created a number of serious challenges, however. Many websites do not receive revenue directly from patrons but instead from advertisers, based on traffic generated through the site. "Paying for clicks" has its merits because advertisers are only required to compensate sites when prospective customers actually respond to an ad. However, tens of thousands of dubious websites have emerged in the last few years, each supported by "botnets," armies of hijacked computers from unknown locations across the globe. The botnets create phony web traffic to advertisers, enabling the proprietors of these illegitimate sites to collect payments. The most sophisticated botnets appear to be real online consumers, pausing to view advertisements, clicking from site to site, watching videos, and even putting items in shopping carts. Hence, advertisers are paying for faux web traffic. Given the technological complexity and global nature of the problem, prosecuting perpetrators of this crime has been elusive.[9]

Business models can also include the concept of social entrepreneurship. Superior performance can be defined in a number of ways beyond profitability. Indeed, a number of entrepreneurs define success in part by examining the effects that their products and services have on individuals or specific groups, such as the poor—the "bottom of the pyramid." TOMS donates a pair of shoes to the poor for each one purchased, a pair of glasses for each pair of TOMS eyewear purchased, and a week of clean water for each bag of coffee purchased. From a social perspective, this business model can be judged on both profitability and alleviation of poverty. From a marketing standpoint, this business model targets consumers who wish to purchase from firms that embody a social orientation.

While a successful strategy is built on the firm's business model, crafting one can be a challenge. Realistically, a number of factors are typically associated with successful strategies. Some of these factors including the following:

1. The organization's competitive environment is well understood, in detail.
2. Strengths and weaknesses are assessed in a thorough and realistic manner.
3. The strategy is consistent with the mission and goals of the organization.
4. Plans for putting the strategy into action are designed with specificity before it is implemented.
5. Possible future changes in the proposed strategy—a process called strategic control—are evaluated before the strategy is adopted.

Careful consideration of these factors reinforces the interrelatedness of the steps in the strategic management process. Each factor is most closely associated with one of the five steps, yet they fit together like pieces of a puzzle. The details associated with the success factors—and others—will be discussed in greater detail in subsequent chapters.

While some of these success factors are associated with the competitive enviroment in profit-seeking firms, strategic management is not limited to for-profit organizations. Top managers of any organization, regardless of profit or nonprofit status, must understand the organization's environment and its capabilities and develop strategies to assist the enterprise in attaining its goals. Former Drexel University President Constantine Papadakis, for example, was widely considered to be leading strategic thinker among university

top executives. The innovative Greek immigrant promoted Drexel through aggressive marketing, while campaigning for an all-digital library without books. In many respects, he managed the university in the same way that other executives manage profit-seeking enterprises. His annual salary was close to $1,000,000 in the years preceding his death in 2009, making him one of the highest paid university presidents in the country.[10]

Intended and Realized Strategies

A critical challenge facing organizations is the reality that strategies are not always implemented as originally planned. Sometimes, strategic decisions seem to evolve incrementally. In this respect, strategy formulation can be seen as an iterative process where decision makers take actions, make sense of those actions afterwards, and then decide how to proceed.

intended strategy The original strategy top management plans and intends to implement.

realized strategy The strategy that top management actually implements.

Henry Mintzberg introduced two terms to help clarify the shift that often occurs between the time a strategy is formulated and the time it is implemented. An **intended strategy** (i.e., what management originally planned) may be realized just as it was planned, in a modified form, or even in an entirely different form. Occasionally, the strategy that management intends is actually realized, but the intended strategy and the **realized strategy**—what management actually implements—usually differ.[11] Hence, the original strategy may be realized with desirable or undesirable results, or it may be modified as changes in the firm or the environment become known.

The gap between the intended and realized strategies usually results from unforeseen environmental or organizational events, better information that was not available when the strategy was formulated, or an improvement in top management's ability to assess its environment. Although it is important for managers to formulate responsible strategies based on a realistic and thorough assessment of the firm and its environment, things invariably change along the way. Hence, it is common for such a gap to exist, creating the need for constant strategic action if a firm is to stay on course. Instead of resisting modest strategic changes when new information is discovered, managers should search for new information and be willing to make such changes when necessary. This activity is part of strategic control, the final step in the strategic management process.

Henry Mintzberg has contributed greatly to our current understanding of strategic thinking. His views often challenge the conventional wisdom. Consider his five Ps for strategy at *www.mindtools.com/pages/article/mintzberg-5ps.htm.*

Scientific and Artistic Perspectives on Strategic Management

There are two different perspectives on the approach that top executives should take to strategic management. Most strategy scholars have endorsed a *scientific perspective*, whereby strategic managers systematically assess the firm's external environment and evaluate the pros and cons of myriad alternatives before formulating strategy. The business environment is seen as largely objective, analyzable, and predictable. As such, strategic managers should follow an orderly process of environmental, competitive, and internal analysis, and build the organization's strategy accordingly.

According to the scientific perspective, strategic managers should be trained, highly skilled analytical thinkers capable of digesting data from a multitude of sources and rendering it into a desired direction for the firm. "Strategy scientists" tend to minimize the role of imagination and creativity in the strategy process, and are not generally receptive to alternatives that emerge from any process other than a comprehensive, analytical approach.

Others have a different view. According to the *artistic perspective* on strategy, the lack of environmental predictability and the fast pace of change render elaborate strategy planning as suspect at best. Instead, strategists should incorporate large doses of creativity and intuition in order to design a comprehensive strategy for the firm.[12] Henry Mintzberg's notion of a craftsman—encompassing individual skill, dedication, and perfection through mastery of detail—embodies the artistic model. The strategy artist senses the state of the organization, interprets its subtleties, and seeks to mold its strategy like a potter molds clay. The artist visualizes the outcomes associated with various alternatives and ultimately charts a course based on holistic thinking, intuition, and imagination.[13] "Strategy artists" may even view strategic planning exercises as time poorly spent and may not be as likely as those in the science school to make the effort necessary to maximize the value of a formal planning process.[14]

This text acknowledges the artistic perspective but emphasizes the science view. Creativity and innovation are important and encouraged, but are most likely to translate into organizational success when they occur as part of a comprehensive, systematic approach to strategic management. Nonetheless, the type of formal strategic planning proposed in this text is not without its critics. Some charge that such models are too complex, or that they apply only to businesses in highly certain environments.[15] Others emphasize that the stages in the process are so closely interrelated and that considering them as independent steps may be counterproductive. Still others, such as Mintzberg, argue that planning models stifle the creativity and imagination that is central to formulating an effective strategy.[16] Although these views have merit, the comprehensive, systematic model proposed herein is presented as a proper foundation for understanding the strategic management process. It does not, however, preclude the application of other approaches.

Theoretical Perspectives on Strategic Management

Strategic managers must understand the technical dimensions of their own organizations as well as the functional areas of business, such as marketing, production, finance, and human resources. Because strategic management is an interdisciplinary field, however, managers must also be familiar with contributions from related areas, such as economics, psychology, and sociology. The required breadth of knowledge contributes to the complexity of the field. Answers to strategic problems are often unclear and depend on one's perspective, but not every alternative is equally viable. A closer look at the strategic management discipline sheds light on this dilemma.

The roots of the strategic management field can be traced to the 1950s when the discipline was originally called "business policy." Today, strategic management is an eclectic field, drawing upon a variety of theoretical frameworks. Three prominent perspectives are summarized in Table 1-1. There are a number of other influences as well, but these three illustrate how competing viewpoints have coalesced into an overarching discipline.

industrial organization (IO) A view based in microeconomic theory that states that firm profitability is most closely associated with industry structure.

Industrial organization (IO), a branch of microeconomics, emphasizes the *influence of the industry environment* upon the firm. The central tenet of industrial organization theory is the notion that a firm must adapt to influences in its industry to survive and prosper; thus, its financial performance is primarily determined by the success of the industry in which it competes. Industries with favorable structures offer the greatest opportunity for firm profitability.[17] Following this perspective, it is more important for a firm to choose the correct industry within which to compete than to determine *how* to compete within a given industry. Recent research has supported the notion that industry factors tend to play a dominant role in the performance of most firms, except for those that are the notable industry leaders or losers.[18]

IO assumes that an organization's performance and ultimate survival depend on its ability to *adapt* to industry forces over which it has little or no control. According to IO, strategic managers should seek to understand the nature of the industry and formulate

TABLE 1-1 Theoretical Perspectives on Firm Performance

Theoretical Perspective	Primary Influence on Firm Performance	How Perspective Is Applied to the Case Analysis
Industrial organization (IO) theory	Structure of the industry	Industry analysis portion of the external environment
Resource-based theory	Firm's unique combination of strategic resources	Analysis of internal strengths and weaknesses
Contingency theory	Fit between the firm and its external environment	SWOT (strengths, weaknesses, opportunities, and threats) analysis and SW/OT matrix

strategies that feed off the industry's characteristics.[19] Because IO focuses on industry forces, strategies, resources, and competencies are assumed to be fairly similar among competitors within a given industry. If one firm deviates from the industry norm and implements a new, successful strategy, other firms will rapidly mimic the higher-performing firm by purchasing the resources, competencies, or management talent that have made the leading firm so profitable. Hence, although the IO perspective emphasizes the industry's influence on individual firms, it is also possible for firms to influence the strategy of rivals, and in some cases even modify the structure of the industry.[20]

resource-based theory The perspective that views performance primarily as a function of a firm's ability to utilize its resources.

distinctive competence Unique resources, skills, and capabilities that enable a firm to distinguish itself from its competitors and create competitive advantage.

sustained competitive advantage A firm's ability to enjoy strategic benefits over an extended period of time.

Perhaps the opposite of the IO perspective, **resource-based theory** views performance primarily as a function of a firm's ability to utilize its resources.[21] Although environmental opportunities and threats are important, a firm's unique resources comprise the key variables that allow it to develop a **distinctive competence**, enabling the firm to distinguish itself from its rivals and create competitive advantage. "Resources" include all of a firm's tangible and intangible assets, such as capital, equipment, employees, knowledge, and information.[22] An organization's resources are directly linked to its capabilities, which can create value and ultimately lead to profitability for the firm.[23] Resource-based theory focuses primarily on individual firms rather than on the competitive environment.

If resources are to be used for **sustained competitive advantage**—a firm's ability to enjoy strategic benefits over an extended period of time—those resources must be valuable, rare, not subject to perfect imitation, and without strategically relevant substitutes.[24] Valuable resources are those that contribute significantly to the firm's effectiveness and efficiency. Rare resources are possessed by only a few competitors, and imperfectly imitable resources cannot be fully duplicated by rivals. Resources that have no strategically relevant substitutes enable the firm to operate in a manner that cannot be effectively imitated by others, and thereby sustain high performance.

contingency theory The view that the most profitable firms are likely to be the ones that develop the best fit with their environment.

According to the third perspective, **contingency theory**, the most profitable firms develop *beneficial fits* with their environments. In other words, a strategy is most likely to be successful when it is consistent with the organization's mission, its competitive environment, and its resources. Contingency theory represents a *middle ground* perspective that views organizational performance as the joint outcome of environmental forces and the firm's strategic actions. Firms can become proactive by choosing to operate in environments where opportunities and threats match the firms' strengths and weaknesses.[25] Should the industry environment change in a way that is unfavorable to the firm, its top managers should consider leaving that industry and reallocating its resources to other, more favorable industries.

Which perspective is most accurate? Each has its own intuitive appeal. Several prominent studies have attempted to unravel this quandary. Overall, organization-specific effects account for about half of a firm's performance variation relative to its rivals, with the remainder split between industry effects and other factors. Hence, while the numbers vary across industries, individual firm performance is best understood from multiple perspectives. Luck can even play a role.[26]

Differences aside, each perspective has merit and has been incorporated into the strategic management process laid out in this text. The industrial organization view is seen in the industry analysis phase, most directly in Michael Porter's "five forces" model. Resource-based theory is applied directly to the internal analysis phase and the effort to identify an organization's resources that could lead to sustained competitive advantage. Contingency theory is seen in the strategic alternative generation phase, where alternatives are developed to improve the organization's fit with its environment. Hence, multiple perspectives are critical to a holistic understanding of strategic management.[27]

Corporate Governance and Boards of Directors

Small businesses are often governed by one or several individuals well known to everyone in the organization. Ownership is often *privately held* and may rest with a single person, a family, or a few business partners. Because more resources are needed, many mid-size and large organizations are *publicly held*, with shares of stock available for purchase

on exchanges such as the New York Stock Exchange. Shareholders in public organizations—the owners of the firm—are represented by an elected board of directors legally authorized to monitor firm activities, as well as the selection, evaluation, and compensation of top managers. Strategic decision-making in these firms is more complex because the ownership is widely dispersed and often changes frequently.

Corporate governance refers to the board of directors, institutional investors (e.g., pension and retirement funds, mutual funds, banks, insurance companies, among other money managers), and large shareholders known as **blockholders** who monitor firm strategies to ensure effective management. Boards of directors and institutional investors—representatives of pension and retirement funds, mutual funds, and financial institutions—are generally the most influential in the governance systems. Because institutional investors own more than half of all shares of publicly traded firms, they tend to wield substantial influence. Blockholders tend to hold less than 20 percent of the shares, so their influence is proportionally less than that of institutional investors.[28]

corporate governance The board of directors, institutional investors, and blockholders who monitor firm strategies to ensure managerial responsiveness.

blockholders Large shareholders who monitor firm strategies to ensure effective management.

Boards of directors often include both inside (i.e., firm executives) and outside directors. Insiders bring company-specific knowledge to the board, whereas outsiders bring independence and an external perspective. Over the past several decades, the composition of the typical board has shifted from one controlled by insiders to one controlled by outsiders. This increase in outside influence often allows board members to oversee managerial decisions more effectively.[29] Moreover, when additional outsiders are added to insider-dominated boards, dismissal of the chief executive officer (CEO) is more likely when corporate performance declines[30] and outsiders are more likely to pressure for corporate restructuring.[31]

Many companies became concerned about both potential conflicts of interest and the amount of time a board member who sits on multiple boards can spend with the affairs of each company. As a result, many companies have begun to limit the number of board memberships their own board members may hold. Approximately two-thirds of corporate board members at the largest 1,500 U.S. companies do not hold seats on other boards. The average director's direct compensation ranged from $90,775 at firms with revenues between $50 and $500 million to $228,058 at the 200 largest firms in the Standard & Poors 500 based on revenue.[32]

The **Sarbanes-Oxley Act** passed in 2002 requires firms to include more independent directors on their boards and to make disclosures on internal controls, ethics codes, and the composition of their audit committees on annual reports. The act requires that both the CEO and the chief financial officer (CFO) certify every report that contains company financial statements. It restricts membership of the firm's audit committee—the formal group charged with reporting oversight—to outsiders (i.e., board members who are not managers). Sarbanes-Oxley also prohibits firms from extending personal loans to board members or executives.

Sarbanes-Oxley Act Legislation passed in 2002 that created more-detailed reporting requirements for boards and executives in public U.S. companies and accounting firms.

Even with new disclosure regulations, however, it can be difficult to determine precisely what top executives earn at public companies. A number of analysts have noted positive changes among boards as a result of this legislation in terms of both independence and expertise, while others contend that government regulations like Sarbanes-Oxley have merely added more costly paperwork.[33] A record number of public firms went private in the mid-2000s, primarily due to investor and management frustration with the legislation. Evidence also suggests that many CEOs have become more reluctant to sit on boards of publicly held companies. Increased liability on the part of board members and recent policy changes that often restrict the number of outside boards on which a CEO may serve have also contributed to this change.[34]

Sarbanes-Oxley has been both hailed and criticized since its passage in 2002. Its costs and benefits are explained in *Forbes* at *www.forbes.com/sites/hbsworkingknowledge/2014/03/10/the-costs-and-benefits-of-sarbanes-oxley/*.

Boards of directors are responsible for monitoring activities in the organization, evaluating top management's strategic proposals, and establishing the broad strategic direction for the firm. As such, boards select and terminate the CEO, establishing his or her compensation package, advising top management on strategic issues, and monitoring managerial and company performance as representatives of the shareholders. Critics charge that board members do not always fulfill their legal roles.[35] One reason is that they are nominated by a CEO who expects support in return. The generous compensation they often receive can create a conflict of interest as well.[36]

When insiders control a board, a "rubber stamp" mentality can develop, whereby directors do not aggressively challenge executive decisions as they should. This is particularly true when the CEO also serves as chair of the board, a phenomenon known as **CEO duality**.[37] Insider board members may be less willing to exert control when the CEO is also the chair of the board because present rewards and future career prospects within the firm are largely determined by the CEO. In the absence of CEO duality, however, insiders may be more likely to contribute to board control, often in subtle and indirect ways so as not to document any opposition to the decisions of the CEO. For example, the insiders may ostensibly present both sides of various issues, while carefully framing the alternatives in favor of one that may be in opposition to the wishes of the CEO.

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

Activist shareholders can significantly influence a firm's operations. Target, for example, suffered the effects of the recession and experienced sluggish sales in the late 2000s and early 2010s. Investor activist William Ackman challenged Target to address the recession more aggressively. Ackman's Pershing Square Capital Management **hedge fund**—an investment fund open to only a small number of investors but permitted by regulators to undertake riskier and more speculative investments—is Target's sixth largest shareholder and has actively supported dissident nominees for board slots. In response to Ackman, Target expanded its fresh foods and other "recession-proof" offerings in many of its stores.[38]

hedge fund An investment fund open to only a small number of investors but permitted by regulators to undertake riskier and more speculative investments.

Pressure on directors to acknowledge shareholder concerns has continued well into the 2010s. The major source of pressure in recent years has come from institutional investors, owners of large chunks of most publicly traded companies via retirement or mutual funds. By virtue of the size of their investments, they wield considerable power and are more willing to use it than ever before (see Strategy at Work 1-1). Some challenge companies they believe are underperforming, while others seek to institute social change by influencing product and human resource policies in companies like Walmart and McDonald's.

Criticism notwithstanding, some board members have played effective stewardship roles. Many directors vigorously promote the best interests of the firm's shareholders and other stakeholders. Board members are often invaluable sources of environmental and competitive information.[39] By conscientiously carrying out their duties, directors can ensure that management remains focused on company performance.[40]

A number of recommendations have been made on how to promote an effective governance system. For example, it has been suggested that outside directors be the only ones to evaluate the performance of top managers against established mission and goals, that all outside board members should meet alone at least once annually, and that boards of directors should establish appropriate qualifications for board membership and communicate these qualifications to shareholders. For institutional shareholders, it is recommended that institutions and other shareholders act as owners and not just investors,[41] that they not interfere with day-to-day managerial decisions, that they evaluate the performance of the board of directors regularly,[42] and that they should recognize that the prosperity of the firm benefits all shareholders.

Strategic Decisions

How does one think and act strategically, and who makes the strategic decisions? The answers to these questions vary across firms and may also be influenced by ownership and other issues related to corporate governance. It is also important to distinguish between strategic decisions and common management decisions. In general, strategic decisions are marked by five key distinctions:

1. Strategic decisions have a wide impact on the organization. They involve input from and affect multiple functional areas. As a result, they require a multi-perspective, integrated approach. Decisions that address only part of the organization—perhaps a single functional area—are usually not considered to be strategic decisions.
2. Strategic decisions are long term and future oriented, but are built on knowledge about the past and present. Scholars and managers do not always agree on what constitutes the "long term," but most agree that it can range anywhere from several years in duration to more than a decade.

Strategy at Work 1-1

The Growing Responsiveness of Corporate Boards[43]

There is an adage on Wall Street: "If you don't like the stock, sell it." Over the past decade, however, a number of dismayed investors have decided to challenge the board instead. Many corporate boards have historically functioned as rubber stamps for top executives. Nonetheless, the directors of many prominent corporations have become increasingly responsible to shareholder interests, thanks in part to the increased influence of institutional shareholders. These large investment firms control substantial numbers of shares in widely held firms and have the clout necessary to pressure board members for change when needed.

Consider the case of Nell Minow. A principal at activist money-management firm Lens Inc., Minow searches for companies with strong products and underlying values that appear to be underperforming. After identifying a target, Minow purchases a substantial number of shares in the company and then advises the CEO of her ownership position. She requests a meeting with the CEO and/or the board to discuss changes that could improve the performance of the firm. Activist owners like Minow have sent a message to both top executives and boards that poor performance is not unlikely to go unchallenged.

However, a number of analysts and executives believe that further change to the system is needed. According to David Leighton, former chairman of the board at Nabisco Brands, Ltd., companies should seek out more independent and qualified board members who will consider the strategic direction of the firm more aggressively.

3. Strategic decisions seek to capitalize on favorable situations outside the organization. In general, this means taking advantage of opportunities that exist for the firm, but it also includes taking measures to minimize the effects of external threats as well.
4. Strategic decisions are nonrepetitive and may not remotely resemble situations addressed in the past. Because organizations and their environments are constantly changing, such decisions often lack precedence and require a fresh look at all of the options. When made, however, their influence cascades throughout the organization as department managers seek to make functional decisions in ways that reflect the broader direction of the firm.
5. Strategic decisions involve choices. Although making "win-win" strategic decisions may be possible, most involve some degree of trade-off between alternatives, at least in the short run. For example, raising salaries to retain a skilled workforce can increase wages, and adding product features or enhancing quality can increase the cost of production. However, such trade-offs may diminish in the long run, as a more skilled, higher paid workforce may be more productive than a typical workforce, and sales of a higher quality product may increase, thereby raising sales and potentially profits. Decision-makers must understand these complex relationships across the business spectrum. Hence, strategic decisions should be based on a systematic, comprehensive analysis of internal attributes and factors external to the organization.

The ongoing Walmart-Amazon.com battle illustrates the strategic choice imperative. As the world's largest retailer, Walmart is heavily invested in brick-and-mortar stores. Online behemoth Amazon.com has no stores, but has invested in over 135 warehouses stocked with inventory. Walmart *chose* a traditional retail model, whereas Amazon.com *chose* an online model. Both companies have been successful, but both struggle to compete *directly* with each other. Lacking the sophisticated online distribution center, Walmart promotes shipment of merchandise to local stores for customer pick-up. Walmart attempts to utilize its own inventory system to fulfill online orders, but doing this has been a challenge. Amazon.com has avoided the brick-and-mortar option altogether.[44]

Because of these distinctions, strategic decision-making is generally reserved for the top executive and members of his or her **top management team**. The chief executive is the individual ultimately responsible (and generally *held responsible*) for the organization's strategic management, but he or she rarely acts alone. Except in the smallest

top management team
A team of top-level executives—headed by the CEO—all of whom play instrumental roles in the strategic management process.

companies, he or she relies on a *team* of top-level executives—including members of the board of directors, vice presidents, and even various line and staff managers in some instances—all of whom play instrumental roles in strategically managing the firm. Generally speaking, the quality of strategic decisions improves dramatically when more than one capable executive participates in the process.[45]

The size of the team on which the top executive relies for strategic input and support can vary across firms. Companies organized around functions such as marketing and production generally involve the heads of the functional departments in strategic decisions. Very large organizations often employ corporate-level strategic-planning staffs and outside consultants to assist top executives in the process. The degree of involvement of top and middle managers in the strategic management process also depends on the personal philosophy of the CEO.[46] Some chief executives are known for making quick decisions, whereas others have a reputation for involving a large number of top managers and others in the process.

Input to strategic decisions, however, need not be limited to members of the top management team. To the contrary, obtaining input from others throughout the organization, either directly or indirectly, can be quite beneficial. In fact, most strategic decisions result from the streams of inputs, decisions, and actions of many people. The top management team might create the context for strategic decisions by establishing rules and procedures, and by influencing the informal means through which things are accomplished in the organization. Strategic decisions do not necessary start with top management action, however, but instead can "bubble up" from a series of lower level decisions throughout the firm. For example, an employee in a company's research and development department may attend a trade show where a new product or production process idea that seems relevant to the company is discussed. The employee may relate the idea to his or her manager, who, in turn, may modify and pass it along to his or her manager. Eventually, a version of the idea may be discussed with the organization's marketing and production managers, and later presented to top management. Ultimately, the CEO will decide whether or not to incorporate the idea into the ongoing strategic planning process. This example illustrates the indirect involvement of individuals throughout the organization in the strategic management process. Top management is ultimately responsible for the final decision, but its

Top Management Team

The CEO leads the top management team, but others in the organization play important roles.
Source: OPOLJA/Shutterstock.com.

decision is based on a culmination of the ideas, creativity, information, and analyses of others[47] (See Strategy at Work 1-1).

While participation can be healthy, most firms place significant limits of the say that their managers have in strategic decisions. There are a few exceptions, however. At Ternary Software, for example, all of its thirteen employees must agree before a strategic decision can be implemented. Such democracy is easier to implement in larger organizations, but even large companies like Google have taken steps to create an egalitarian culture for decision-making.[48]

The corporate boardroom is often a place where decisions that have already been made in a less formal setting are confirmed. A formal, systematic decision-making process is often applied as a means of confirming what top executives already see as the appropriate course of action. A danger associated with this type of approach is that it tends to jump straight to a proposed solution without considering how a decision should be made. Although there are no guarantees, top management teams that circumvent a logical decision-making approach are more susceptible to mistakes. For example, when a systematic cost-benefit analysis is not employed, leaders may confuse actual costs of a decision with sunk costs—those already expended—a common error that distorts decision-making and can lead to an escalation of commitment to a failed strategy.[49]

The Global Imperative

Most business organizations buy, sell, or trade across borders, whether they have a physical presence in other countries or sell a significant amount of imported merchandise. Although firms typically concentrate on serving local or domestic markets before expanding internationally, many must interact with entities in other nations as a means of survival. For example, virtually all of Japan's industries would grind to a halt if imports of raw materials from other nations ceased because Japan is small and isolated, and its natural resources are quite limited. In larger nations like the United States, manufacturers typically utilize components from abroad in their production processes, while most retailers sell products that were produced abroad. Hence, strategic management is—by definition—a global undertaking. For this reason, examples related to concepts, industries, and firms throughout the world are integrated into each of the chapters.

Global Business

International considerations are an integral part of business today.
Source: Ferbies/Shutterstock.com.

Case Analysis 1-1

Step 1: Introduction of the Organization

The first step in analyzing a firm is to develop familiarity with the organization. Analyzing an ongoing enterprise begins with a general introduction and understanding of the firm. When was the organization founded, why, and by whom? Is any unusual history associated with the organization? Is it privately or publicly held? What is the company's mission? Has the mission changed since its inception?

It is also important at this point to identify the business model currently employed. In other words, what does the company do, specifically, to generate profit? Identifying the business model is simple for some companies (Ford, for example, hopes to sell cars and offer consumer financing at a profit) but may be complicated for others where revenue streams and competitive advantage are more difficult to identify.

comparative advantage
The idea that certain products may be produced more cheaply or at a higher quality in particular countries, due to advantages in labor costs or technology.

The high degree of global interconnectedness common in many enterprises today emanates from the economic concept of **comparative advantage**, the idea that certain products may be produced more cheaply or at a higher quality in particular countries due to advantages in labor costs or technology. For this reason, many manufacturers in the United States and other developed nations have shifted their production to Asia and other parts of the world. Firms do not always engage in production only in areas where they are most efficient for several reasons, however. The cost of transporting raw materials or goods from one nation to another can exceed the potential cost savings. Political turmoil or trade restrictions can also create a barrier. Moreover, even if one nation enjoys an absolute advantage over another in most areas, the weaker nation must participate in some forms of business to maintain economic viability and employ its citizens. Firms in these nations tend to produce in areas where the absolute advantage is lowest. Put another way, even when firms in less-developed nations lack a comparative advantage, they tend to produce in areas where their inefficiencies are less pronounced, while their counterparts in developed nations concentrate on industries that are more vital. All nations benefit economically from such an arrangement.

The notion of comparative advantage is fluent, as nations enjoying a form of comparative advantage at one period may not enjoy it in future period. Chinese manufacturers enjoyed some of the lowest global labor rates for unskilled or semi-skilled production in the 2000s. Worker skills and production quality has increased in the rapidly developing nation, making Chinese labor the third most expensive in Asia in 2011, well ahead of nations like India, Pakistan, Indonesia, Cambodia, and Viet Nam.[50]

Of course, comparative advantage is a national concept. The fact that a given nation possesses certain forms of comparative advantage can influence the strategic actions of companies within that nation, but it is only one consideration. Moreover, while comparative advantage is a key consideration for international operations, it is not the only one. Global involvement may also provide advantages to a firm not directly related to costs. For political reasons, a firm often needs to establish operations in other countries, especially if a substantial proportion of sales is derived abroad. Doing so can also provide managers with a critical understanding of local markets. For example, Ford operates a number of plants in Western Europe, where manufacturing has helped Ford's engineers design windshield wipers for cars engaged in high-speed driving on the German autobahns.[51]

Summary

Top managers face more complex strategic challenges today than ever before. Strategic management involves analysis of an organization's external and internal environments, formulation and implementation of its strategic plan, and strategic control. These steps in the process are interrelated and typically done simultaneously in many firms.

A firm's intended strategy often requires modification before it has been fully implemented due to changes in environmental and/or organizational conditions. Because these changes are often difficult to predict, substantial changes in the environment may transform an organization's realized strategy into one that is quite different from its intended strategy.

The strategic management field has been influenced by such perspectives as industrial organization theory, resource-based theory, and contingency theory. Although they are based on widely varied assumptions about what leads to high performance, each of these perspectives has merit and contributes to an overall understanding of the field.

Strategy formulation is typically a global undertaking and is the direct responsibility of the CEO, but he or she relies on a team of other individuals as well, including the board of directors, vice presidents, and other various managers. In its final form, a strategic decision is crafted from the streams of inputs, decisions, and actions of the entire top management team.

Key Terms

blockholders
business model
CEO duality
comparative advantage
competitive advantage
contingency theory
corporate governance
distinctive competence
efficient market hypothesis
hedge fund
industrial organization (IO)
intended strategy
mission
realized strategy
resource-based theory
Sarbanes-Oxley Act
strategic management
strategy
subjective value
sustained competitive advantage
top management team

Review Questions and Exercises

1. Is it necessary that the five steps in the strategic management process be performed sequentially? Why or why not?
2. What is the difference between an intended strategy and a realized strategy? Why is this distinction important?
3. How have outside perspectives influenced the development of the strategic management field?
4. Does the CEO *alone* make the strategic decisions for an organization? Explain.

Chapter 1 Practice Quiz

True or False

1. A strategy seeks to develop and sustain competitive advantage.
2. Strategic management refers to formulating successful strategies for an organization.
3. Each step in the strategic management process is independent so that changes in one step will not substantially affect other steps.
4. The intended strategy and the realized strategy can never be the same.
5. Whereas industrial organization theory emphasizes the influence of industry factors of firm performance, resource-based theory emphasizes the role of firm factors.
6. Strategic decisions are made solely by and are ultimately the responsibility of the chief executive alone.

Multiple Choice

7. Strategies are formulated in the strategic management stage that occurs immediately after
   A. the assessment of internal strengths and weaknesses.
   B. implementation of the strategy.
   C. control of the strategy.
   D. none of the above
8. The strategy originally planned by top management is called the
   A. grand strategy.
   B. realized strategy.
   C. emergent strategy.
   D. none of the above

9. The notion that successful firms tend to be the ones that adapt to influences in their industries is based on
   A. industrial organization theory.
   B. resource-based theory.
   C. contingency theory.
   D. none of the above

10. The notion of distinctive competence is consistent with
   A. industrial organization theory.
   B. resource-based theory.
   C. contingency theory.
   D. none of the above

11. In order to contribute to sustained competitive advantage, firm resources should be
   A. valuable and rare.
   B. not subject to perfect imitation.
   C. without strategically relevant resources.
   D. all of the above

12. Which of the following is not a characteristic of strategic decisions?
   A. They are long-term in nature.
   B. They involve choices.
   C. They do not involve trade-offs.
   D. All of the above are characteristics of strategic decisions.

Case 1: Costco

The first Price Club Warehouse was opened in San Diego in 1975 by Sol Price, Robert Price (Sol's son), Rick Libenson, and Giles Bateman. The firm originally sought to sell merchandise in volume at deep discounts only to small businesses, but later expanded the concept to include government, utility, and hospital employees. By 1980, the company had four stores in Arizona and California and went public.

During the 1980s, the company expanded to the eastern United States and Canada. In 1988, Price Club acquired grocery distributor A. M. Lewis and launched Price Club Furnishings. In the early 1990s, however, competition intensified from Sam's Club and Pace. In 1992 and 1993, Price Club's joint venture with retailer Controladora Comercial Mexicana led to the opening of two Price Clubs in Mexico City.

Later in 1993, Price Club merged with Costco Wholesale. During the 1990s, the firm expanded its international interests, launching outlets in Great Britain, Japan, and South Korea. Price Club changed its corporate name to Costco Companies in 1997 and again to Costco Wholesale in 1999.

Today, Costco is the largest wholesale club operator in the United States, operating 672 membership warehouses—each amassing about $150 million in sales—and serving about 65 million members. Most of its outlets are located in the United States and Canada, but additional stores can be found in Mexico, Japan, Australia, South Korea, Taiwan, Puerto Rico, and the United Kingdom. Membership costs about $50 per year and is available to businesses and individuals.

Costco's business model emphasizes rock-bottom prices on a limited selection of mostly name-brand products in a wide range of merchandise categories. A typical outlet carries about 4,000 products, ranging from alcoholic beverages and appliances to fresh food, pharmaceuticals, and tires. Costco also offers its members insurance, financial, and travel services. Its subsidiary, Costco Wholesale Industries, is an operating manufacturing business in food packaging, meat processing, and jewelry to support the retail efforts.

Much of Costco's success can be attributed to its ability to minimize costs by negotiating fiercely with suppliers. The company never requires its members to pay more than 14 percent above the firm's cost for goods.

Jim Sinegal stepped down as CEO in 2012 and was succeeded by COO Craig Jelinek.

Case Challenges

1. How does Costco differ from other warehouse clubs like Sam's Club?
2. Does Costco compete with nonmembership retailers, such as Walmart and Target? Why or why not?
3. Can Costco compete successfully on a large scale outside of the United States and Canada? Why or why not?

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Simulation 101: Overview

Many strategic management courses include *Capstone* or another competitive business simulation as part of the required activities. Each simulation is different, but they share certain commonalities.

While participation in a simulation can be an individual assignment, students are usually divided into teams to make marketing, production, finance, and other decisions for a virtual company. Student companies often compete in a single industry, although multiple industries or computer-run companies might be added to balance the number of firms. A typical game might include eight rounds, each round representing a quarter or a year in the life of the company. Students are provided with results on their companies and industry after each round so they can make decisions for the next round accordingly.

There are a few obvious limitations of strategy simulations. They include only a representative set of decisions that a business would make, and these must cover a fixed period of time and cannot be changed until a round is completed. Simulations make assumptions about interest rates, changes in demand from one round to the next, and other factors that affect company performance. Moreover, they cannot consider the softer side of various decisions. For example, an increase in an advertising budget will affect demand for products without regard to the content of a particular ad. Some students will seek help on the simulation from other students who took the same course in a past term, from blogs posted by students at other colleges, or from online videos posted by individuals who claim to know how to master the game. Good advice is always helpful, but *it is not possible to "game the system" and master a sophisticated simulation with a few tricks*. Take shortcuts, and you will likely learn this the hard way.

While it is important to recognize these limitations, a simulation can reinforce key strategic management concepts. It allows students to operate virtual companies over an extended period of time without the risk of losing real money. Well-designed simulations also do an excellent job of reinforcing the interrelationships among functional areas of business. Overlooking these links can be a formula for disaster. For example, it is important to offer attractive products, but this does not guarantee success. Buyers will not know your products exist without marketing campaigns. They might not purchase them if prices are too high, and your company might not cover its expenses if prices are too low. Your company must produce enough products to meet demand, but producing too many can raise inventory costs. You must also obtain sufficient capital through borrowing, issuing stock, or some other means, or the simulation will punish your firm by providing an emergency loan at an exorbitant interest rate or restricting your firm's activities. Hence, an otherwise effective strategy can easily go awry if you ignore one of the functional areas. A chain is only as strong as its weakest link, and this is certainly true in this instance.

Each chapter in this book contains a *Simulation 101* section that connects content in the chapter with some of the issues you will encounter in a typical strategy simulation. It is critical that you understand exactly how the game works at the outset. Invest the necessary time to understand the specifics associated with all of the competitive decisions you will make, the support provided to assist you in making these decisions, and how the performance of your virtual company will be evaluated. Profitability and market share are important, but most simulations provide a balanced scorecard that also evaluates your team's management with regard to other factors, such as inventory management, cash flow, and human resources. Identifying a strategy for your company before you start is also a must. *Figuring out the details as you go is a recipe for disaster because recovering from losses in the first few rounds can be very difficult*.

Keep in mind that the results of each round are not guaranteed; having a reasonable strategy and making "good decisions" could still result in a financial loss or market share decline. This is a reality of the business world, and it can raise anxiety during the simulation experience. Nonetheless, competing in a simulation can be a lot of fun and a great learning experience if you do your homework.

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