

# Part Three

## Strategy Implementation, Control, and Innovation

The last section of this book examines what is often called the action phase of the strategic management process: implementation of the chosen strategy. Up to this point, three phases of that process have been covered—strategy formulation, analysis of alternative strategies, and strategic choice. Although important, these phases alone cannot ensure success.

To ensure success, the strategy must be translated into carefully implemented action. This means that

1. The strategy must be translated into guidelines for the daily activities of the firm's members.
2. The strategy and the firm must become one—that is, the strategy must be reflected in
  - a. The way the firm organizes its activities.
  - b. The key organization leaders.
  - c. The culture of the organization.
3. The company's managers must put into place "steering" controls that provide strategic control and the ability to adjust strategies, commitments, and objectives in response to ever-changing future conditions.
4. Increasingly, organizations must make a serious commitment to be innovative and must consider bringing the entrepreneurship process into their company to survive, grow, and prosper in a vastly more competitive and rapidly changing global business arena.

Chapter 10 explains how organizational action is successfully initiated in four interrelated steps:

1. Creation of clear *short-term objectives* and *action plans*.
2. Development of specific *functional tactics*, to include *outsourcing*, that create competitive advantage.
3. Empowerment of operating personnel through *policies* to guide decisions.
4. Implementation of effective *reward systems*.

Short-term objectives and action plans guide implementation by converting long-term objectives into short-term actions and targets. Functional tactics, whether done internally or outsourced to other partners, translate the business strategy into activities that build advantage. Policies empower operating personnel by defining guidelines for making decisions. Reward systems encourage effective results.

Today's competitive environment requires careful analysis in designing the organizational structure most suitable to build and sustain competitive advantage. Chapter 11 examines traditional organizational structures—their pros and cons. It looks at the pervasive trend toward outsourcing, along with outsourcing's pros and cons. It concludes with examination of the latest developments in creating ambidextrous, virtual, boundaryless organizations designed to adapt in a highly interconnected, lightning-speed, global business environment.

There can be no doubt that effective organizational leadership and the consistency of a strong organizational culture reinforcing norms and behaviors best suited to the organization's mission are two central ingredients in enabling successful execution of a firm's strategies and objectives. Chapter 12 examines leadership, the critical things good leaders do, and how to nurture effective operating managers as they become outstanding future organizational leaders. Chapter 12 then examines the organizational culture, how it is shaped, and creative ways of managing the strategy-culture relationship.

Because the firm's strategy is implemented in a changing environment, successful implementation requires strategic control—an ability to “steer” the firm through an extended future time period when premises, sudden events, internal implementation efforts, and general economic and societal developments will be sources of change not anticipated or predicted when the strategy was conceived and initiated. Chapter 13 examines how to set up strategic controls to deal with the important steering function during the implementation process. The chapter also examines operational control functions and the balanced scorecard approach to integrating strategic and operational control.

The overriding concerns in executing strategies and leading a company are survival, growth, and prosperity. In a global economy that allows everyone everywhere instant information and instant connectivity, change often occurs at lightning speed. Thus, leaders are increasingly encouraging their firms to embrace innovation and entrepreneurship as key ways to respond to such overwhelming uncertainty. Chapter 14 examines innovation in general, different types of innovation, and the best ways to bring more innovative activity into a firm. It examines the entrepreneurship process as another way to build innovative responsiveness and opportunity recognition into a firm, both in new-venture settings and in large business organizations.

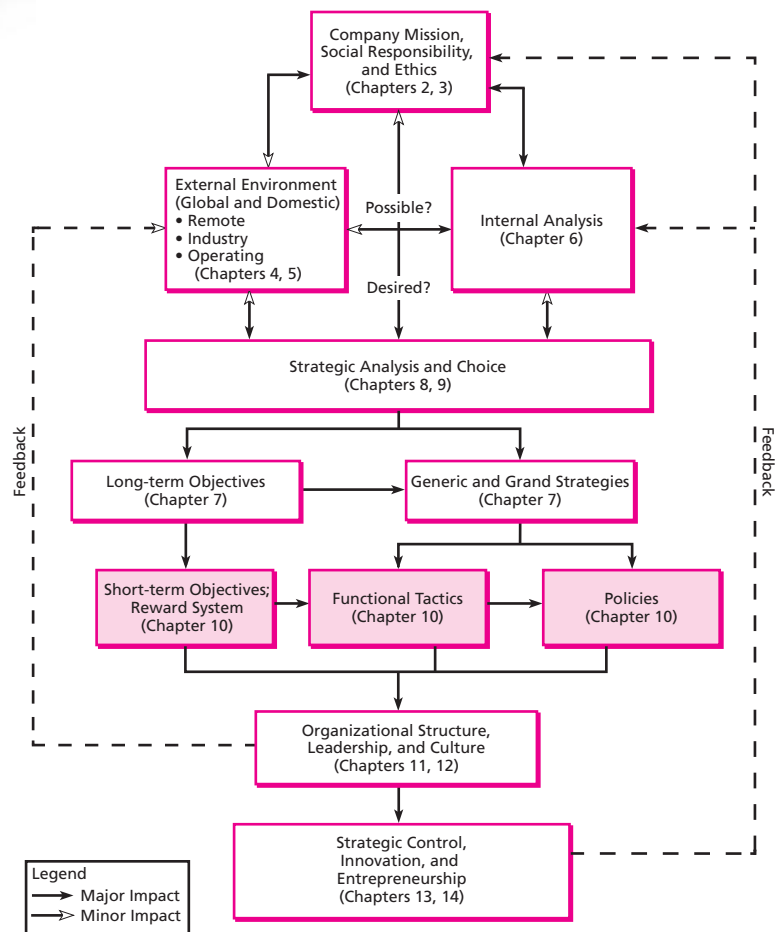
Implementation is “where the action is.” It is the arena that most students enter at the start of their business careers. It is the strategic phase in which staying close to the customer, achieving competitive advantage, and pursuing excellence become realities. These five chapters in Part Three will help you understand how this is done and how to prepare to take your place as a future leader of successful, innovative business organizations.

# Chapter Ten

## Implementation

**After reading and studying this chapter, you should be able to**

1. Understand how short-term objectives are used in strategy implementation.
2. Identify and apply the qualities of good short-term objectives to your own experiences.
3. Illustrate what is meant by functional tactics and understand how they are used in strategy implementation.
4. Gain a general sense of what outsourcing is and how it becomes a choice in functional tactics decisions for strategy implementation.
5. Understand what policies are and how to use policies to empower operating personnel in implementing business strategies and functional tactics.
6. Understand the use of financial reward in executive compensation.
7. Identify different types of executive compensation and when to use each in strategy implementation.



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Xerox and Hewlett-Packard faced difficult times as this decade began. For Xerox, bankruptcy was a real possibility given its \$14 billion debt and its serious problems with the U.S. Securities and Exchange Commission. Hewlett-Packard was falling behind in the computer business while living solely on profits from its printer division. Anne Mulcahy became Xerox CEO during this time. Carly Fiorina became HP's CEO. Five years later, Anne Mulcahy was celebrated for the success of her strategy at Xerox while Carly Fiorina was dismissed for the failure of the path she chose. Two legendary technology companies and two celebrated CEOs who shattered the "glass ceiling" in being selected to lead two legendary companies back to glory: why did one succeed and the other fail?

Analysts suggest that the "devil is in the detail." Fiorina's strategy was to acquire Compaq, build the size of HP's PC business, and use profits from HP's venerable printer business to sustain a reorganization of the combined companies. Mark Anderson, an investment analyst who has followed HP for more than 20 years, said this about Carly Fiorina's strategy:

I would say it stinks, but it isn't even a strategy. A few bullet points don't make a strategy. Such an approach lacks the technical and market understanding necessary to drive HP.<sup>1</sup>

In other words, Carly Fiorina's strategy was a glitzy combination of two large computer companies, but it was less clear exactly what key actions and tactics would bring about a reinvented, "new," profitable HP.

Anne Mulcahy took a different approach, in part reflecting her 28 years inside Xerox. She set about to "reinvent" Xerox as well, but made four functional tactics and their respective short-term objectives very clear building blocks for reinventing Xerox: (1) She prioritized aggressive cost cutting—30 percent—throughout the company to restore profitability. (2) She emphasized a productivity increase in each Xerox division. (3) She quickly settled Xerox's SEC litigation about its accounting practices, and she refinanced Xerox's massive debt. (4) She made a major point of continued heavy R&D funding even as every other part of Xerox suffered through severe cost cutting. This, she felt, sent a message of belief in Xerox's future. It clearly established her priorities.

Mulcahy's articulation of specific tactical efforts, and the short-term objectives they were intended to achieve, turned Xerox around in three short years. As she proudly pointed out:

Probably one of the hardest things was to continue investing in the future, in growth. One of the most controversial decisions we made was to continue our R&D investment. When you're drastically restructuring in other areas, that's a tough decision. It makes it harder for the other businesses to some extent. But it was important for the Xerox people to believe we were investing in the future. Now two-thirds of our revenue is coming from products and services introduced in the last two years.<sup>2</sup>

The reason Anne Mulcahy succeeded while Carly Fiorina did not, the focus of this chapter, involves translating strategic thought into organizational action. In the words of two well-worn phrases, they move from "planning their work" to "working their plan." Anne Mulcahy successfully made this shift at Xerox when she did these five things well:

1. Identify short-term objectives.
2. Initiate specific functional tactics.
3. Outsource nonessential functions.
4. Communicate policies that empower people in the organization.
5. Design effective rewards.

<sup>1</sup> "The Only HP Way Worth Trying," Viewpoint, *BusinessWeek*, March 9, 2005.

<sup>2</sup> "She Put the Bounce Back in Xerox," *BusinessWeek*, January 10, 2005.

Short-term objectives translate long-range aspirations into this year's targets for action. If well developed, these objectives provide clarity, a powerful motivator and facilitator of effective strategy implementation.

Functional tactics translate business strategy into daily activities people need to execute. Functional managers participate in the development of these tactics, and their participation, in turn, helps clarify what their units are expected to do in implementing the business's strategy.

Outsourcing nonessential functions normally performed in-house frees up resources and the time of key people to concentrate on leveraging the functions and activities critical to the core competitive advantages around which the firm's long range strategy is built.

Policies are empowerment tools that simplify decision making by empowering operating managers and their subordinates. Policies can empower the "doers" in an organization by reducing the time required to decide and act.

Rewards that align manager and employee priorities with organizational objectives and shareholder value provide very effective direction in strategy implementation.

## SHORT-TERM OBJECTIVES

### short-term objective

Measurable outcomes achievable or intended to be achieved in one year or less.

Chapter 7 described business strategies, grand strategies, and long-term objectives that are critically important in crafting a successful future. To make them become a reality, however, the people in an organization who actually "do the work" of the business need guidance in exactly what they need to do. Short-term objectives help do this. **Short-term objectives** are measurable outcomes achievable or intended to be achieved in one year or less. They are specific, usually quantitative, results operating managers set out to achieve in the immediate future.

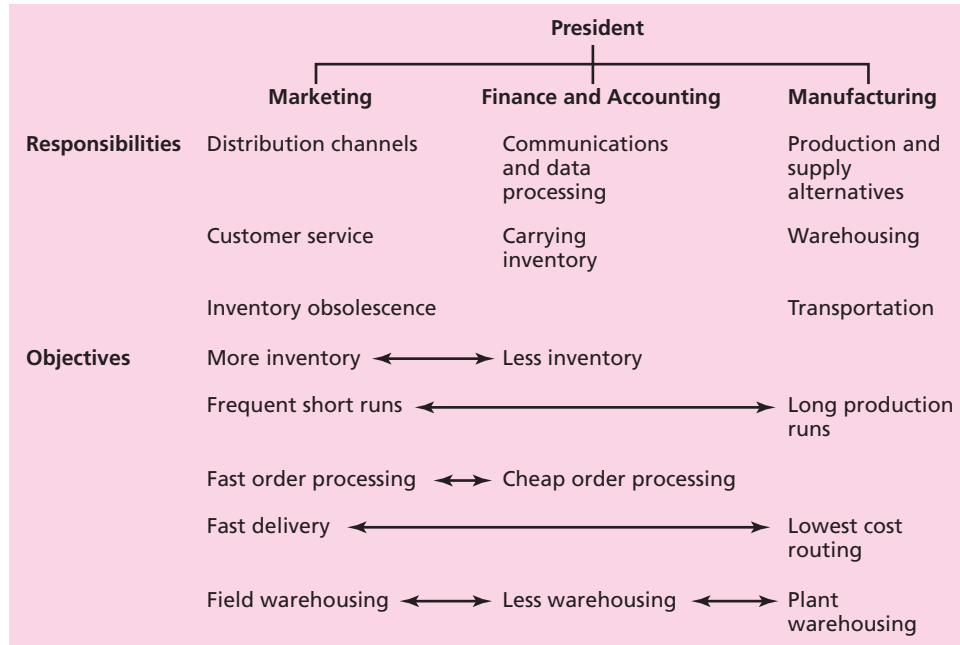
Short-term objectives help implement strategy in at least three ways:

1. Short-term objectives "operationalize" long-term objectives. If we commit to a 20 percent gain in revenue over five years, what is our specific target or objective in revenue during the current year, month, or week to indicate we are making appropriate progress?
2. Discussion about and agreement on short-term objectives help raise issues and potential conflicts within an organization that usually require coordination to avoid otherwise dysfunctional consequences. Exhibit 10.1 illustrates how objectives within marketing, manufacturing, and accounting units within the same firm can be very different even when created to pursue the same firm objective (e.g., increased sales, lower costs).
3. Finally, short-term objectives assist strategy implementation by identifying measurable outcomes of action plans or functional activities, which can be used to make feedback, correction, and evaluation more relevant and acceptable.

Short-term objectives are usually accompanied by action plans, which enhance these objectives in three ways. First, action plans usually identify functional tactics and activities that will be undertaken in the next week, month, or quarter as part of the business's effort to build competitive advantage. The important point here is *specificity*—what exactly is to be done. We will examine functional tactics in a subsequent section of this chapter. The second element of an action plan is a clear *time frame for completion*—when the effort will begin and when its results will be accomplished. A third element action plans contain is identification of *who is responsible* for each action in the plan. This accountability is very important to ensure action plans are acted upon.

Because of the particular importance of short-term objectives in strategy implementation, the next section addresses how to develop meaningful short-term objectives. Exhibit 10.2, Top Strategist, provides a *BusinessWeek* interview with Symantec CEO John Thompson about the nature and importance of short-term objectives to Symantec's success.

**EXHIBIT 10.1**  
Potential Conflicting  
Objectives and  
Priorities



**Qualities of Effective Short-Term Objectives**

**Measurable**

Short-term objectives are more consistent when they clearly state *what* is to be accomplished, *when* it will be accomplished, and *how* its accomplishment will be *measured*. Such objectives can be used to monitor both the effectiveness of each activity and the collective progress across several interrelated activities. Exhibit 10.3 illustrates several effective and ineffective short-term objectives. Measurable objectives make misunderstanding less likely among interdependent managers who must implement action plans. It is far easier to quantify the objectives of *line* units (e.g., production) than of certain *staff* areas (e.g., personnel). Difficulties in quantifying objectives often can be overcome by initially focusing on *measurable activity* and then identifying *measurable outcomes*.

**Priorities**

Although all annual objectives are important, some deserve priority because of a timing consideration or their particular impact on a strategy’s success. If such priorities are not established, conflicting assumptions about the relative importance of annual objectives may inhibit progress toward strategic effectiveness. Anne Mulcahy’s turnaround of Xerox described at the beginning of this chapter emphasized several important short-term objectives. But it was clear throughout Xerox that her highest priority in the first two years was to dramatically lower overhead and production costs so as to satisfy the difficult challenge of continuing to invest heavily in R&D while also restoring profitability.

Priorities are established in various ways. A simple ranking may be based on discussion and negotiation during the planning process. However, this does not necessarily communicate the real difference in the importance of objectives, so such terms as primary, top, and secondary may be used to indicate priority. Some firms assign weights (e.g., 0 to 100 percent) to establish and communicate the relative priority of objectives. Whatever the method, recognizing priorities is an important dimension in the implementation value of short-term objectives.

## Top Strategist

John Thompson, Chairman and CEO of Symantec

Exhibit  
10.2



John Thompson, Chairman  
and CEO of Symantec

"If you could only monitor five objectives to run/steer your business, what would they be and why?" is a question *BusinessWeek* posed to John Thompson, chairman and CEO of Symantec, a Cupertino (California)-based Internet security outfit that makes antivirus and firewall technology as it implemented a merger with Veritas

in 2005. Since Thompson joined Symantec as top exec, revenues have grown eightfold, from \$632 million to more than \$5.3 billion in 2007.

**Q:** So what would be your critical objectives, and why?

**A:** Let's define what objectives are: They are vectors for how you are performing now, but also indicators for how you will do in the future. Here are five critical objectives I use to manage Symantec. Our most critical objectives are customer satisfaction and market share.

### CUSTOMER SATISFACTION

We use an outside firm to poll customers on a continuous basis to determine their satisfaction with our products and services. This needs to be an anonymous relationship—a conversation between our pollster and our customers. Polling is done by product area: firewall, antivirus, services, and other product lines.

### MARKET SHARE

There are a couple of ways we look at this. We have our own views based on relevant markets. Then we use industry analysts such as Gartner, IDC, and Giga as benchmarks for annualized results on market share. On a quarterly basis, we look at our revenue performance and growth rates, and that of our competitors. We compare against actual realized growth rates, as compared to growth rates of relevant competitors in similar segments.

The purpose is to get trending data. That gives us a sense of market changes and market growth. We also use a blended (rating) of analyst companies in the same space. Each industry-analyst firm counts things a bit differently, based on its methodology. The numbers don't have to be spot on or Six Sigma precise.

### REVENUE GROWTH

You have to consider if revenue is growing at a rate equal to or greater than the market rate. If you look at the antivirus market, for example, industry analysts projected growth in the high teens while our enterprise antivirus sector grew at a rate of 32 percent. This indicates that we are gaining market share faster than the market growth rate for the industry.

We can then assess how we had planned to grow. Did we plan to grow at 32 percent or less—or more? You have to gauge your growth relative to the market for your product or service and your own internal expectations of your performance.

### EXPENSES

It is important to always plan for how much money will have to be spent to generate a certain level of revenue. This enables you to monitor funds flow in the company. Did I plan to spend \$10 or \$12, and what did I get for that expense in return? The purpose is to keep expenses in equilibrium to revenue generation.

### EARNINGS

Two keys to watch here—operating margins and earnings per share (EPS). A business running efficiently is improving its operating margins. If you are efficient in your operating margins, this should produce a strong EPS, which is a strong objective that Wall Street looks at all the time.

**Q:** What problems do tracking objectives solve for a corporation? How does maintaining objectives help you manage and steer the direction of the corporation?

**A:** I am a little old-fashioned—I don't believe you can manage what you don't measure. The importance of objectives becomes more important as the enterprise grows in size and scale. Objectives also serve as an indication for

(continued)

## Exhibit 10.2 cont.

the team about what you are paying attention to. If employees know you are measuring market growth and customer satisfaction, they will pay attention to those considerations and will behave based on indicators that you, as the leader, provide to the organization. Objectives helps the team focus on what's important for an organization.

**Q:** How should companies consider industry-specific objectives versus broad financial objectives: P/E [price to earnings] ratio, etc?

**A:** This is an issue for all of us. I am on the board of a utility company. The company has achieved modest single-digit revenue growth. They are quite proud of that, while I would be quite concerned if that were to be the growth rate for a software firm. For example: An important consideration may be what you are spending in R&D in comparison to your peer group. Or, for a software firm, what is the license revenue mix?

I couldn't care less about the performance of Symantec relative to that of a financial-services company. But I would care about the performance of Symantec in comparison with an enterprise software company or with another securities software firm. Whatever measures you choose should

give you the ability to measure your performance against like-industry companies.

**Q:** What do new managers need to keep in mind as they consider/reevaluate the use of objectives for their companies?

**A:** Live by the adage that you can't manage what you can't measure. The best objectives are simple to understand, simple to communicate, and relatively easy for everyone to get access to the data that represents the results. That makes your objectives an effective management tool. If you make your objectives difficult to gather, manage, or communicate, they won't be effective. Simplicity is key.

My experience has proven to me the importance of picking the few objectives that are the most critical for the running of the business. Stick with them—and communicate them to both internal and external audiences.

Sources: Reprinted with special permission from "Symantec's CEO Takes the Long View," *BusinessWeek*, February 28, 2007; Sarah Lacy, "Symantec's John Thompson: I Can't Wait to Compete," *BusinessWeek*, March 21, 2005; and Sarah Lacy, "A Revolution in John Thompson's Head," *BusinessWeek*, April 28, 2005. Copyright © 2007 The McGraw-Hill Companies.

### ***Cascading: From Long-Term Objectives to Short-Term Objectives***

The link between short-term and long-term objectives should resemble cascades through the firm from basic long-term objectives to specific short-term objectives in key operation areas. The cascading effect has the added advantage of providing a clear reference for communication and negotiation, which may be necessary to integrate and coordinate objectives and activities at the operating level.

3M's recent refocus on growth, particularly in international markets, provides a good example of cascading objectives. 3M's CEO, George Buckley, has had to aggressively seek to turn around the company's declining performance by accelerating sales growth while financing the growth internally by improving cash flow and profitability. Currently, 60 percent of 3M's sales come from outside the United States and Buckley expects that to rise to 75 percent in two years. At the same time, only 35 percent of their manufacturing and distribution facilities are located outside the United States. To achieve 3M's sales goals, and growth abroad, operating managers have set an objective of 18 new plants or major expansions online within the next two years, with 11 new plants being outside the United States and four of those in China alone. Managers of 3M's logistic chain have identified lowering the number of "days 3M products spend traveling through its supply lines" as a critical objective to increase cash flow, which in turn helps free up cash to build these new plants. Currently, a typical product might be extruded in Canada, machined in France, packaged



**EXHIBIT 10.3**  
Creating Measurable  
Objectives

Examples of Deficient Objectives	Examples of Objectives with Measurable Criteria for Performance
To improve morale in the division (plant, department, etc.)	To reduce turnover (absenteeism, number of rejects, etc.) among sales managers by 10 percent by January 1, 2008. <i>Assumption:</i> Morale is related to measurable outcomes (i.e., high and low morale are associated with different results).
To improve support of the sales effort	To reduce the time lapse between order data and delivery by 8 percent (two days) by June 1, 2008. To reduce the cost of goods produced by 6 percent to support a product price decrease of 2 percent by December 1, 2008. To increase the rate of before- or on-schedule delivery by 5 percent by June 1, 2008.
To improve the firm's image	To conduct a public opinion poll using random samples in the five largest U.S. metropolitan markets to determine average scores on 10 dimensions of corporate responsibility by May 15, 2008. To increase our score on those dimensions by an average of 7.5 percent by May 1, 2008.

in Mexico, and sold in Japan—tying up a sizable inventory around the world just sitting on boats, in trucks, and in warehouses—currently averaging 100 days. Supply chain managers have the objective of freeing up \$1 billion in working capital, and \$200 million in cost savings annually from a more efficient supply chain. Buckley will be monitoring working capital as a percent of sales which, as it declines, provides the needed internal cash flow to achieve the overall goal of international plant and facilities expansion.<sup>3</sup>

## FUNCTIONAL TACTICS THAT IMPLEMENT BUSINESS STRATEGIES

**functional tactics**  
Detailed statements of the “means” or activities that will be used by a company to achieve short-term objectives and establish competitive advantage.

**Functional tactics** are the key, routine activities that must be undertaken in each functional area—marketing, finance, production/operations, R&D, and human resource management—to provide the business’s products and services. In a sense, functional tactics translate thought (grand strategy) into action designed to accomplish specific short-term objectives. Every value chain activity in a company executes functional tactics that support the business’s strategy and help accomplish strategic objectives.

Exhibit 10.5 Strategy in Action, illustrates the difference between functional tactics and business strategy. It also shows that functional tactics are essential to implement business strategy. It explains the situation at California Pizza Kitchen, where consultants were brought in to identify specific tactical things employees needed to do or deal with to implement an overall business strategy to differentiate the growing pizza chain from many other restaurant competitors. The business strategy outlined the competitive posture of its operations in the restaurant industry. To increase the likelihood that these strategies would be successful, specific functional tactics were needed for the firm’s operating components. These functional tactics clarified the business strategy, giving specific,

<sup>3</sup> Brian Hindo, “3M Chief Plants a Money Tree,” *BusinessWeek Online*, June 11, 2007.

#### EXHIBIT 10.4 The Value-Added Benefit of Short- Term Objectives and Action Plans

Source: Reprinted with special permission from Brian Hindo, “3M Chief Plants a Money Tree,” *BusinessWeek Online*, June 11, 2007. Copyright © 2007 The McGraw-Hill Companies.

- They give operating personnel a better understanding of their role in the firm’s mission.
- The process of developing them becomes a forum for raising and resolving conflicts between strategic intent and operational reality.
- They provide a basis for developing budgets, schedules, trigger points, and other sources of strategic control.
- They can be powerful motivators, especially when connected to the reward system.

short-term guidance to operating managers and employees in the areas of marketing, operations, and finance.

### Differences between Business Strategies and Functional Tactics

Functional tactics are different from business or corporate strategies in three fundamental ways:

1. Time horizon.
2. Specificity.
3. Participants who develop them.

#### *Time Horizon*

Functional tactics identify activities to be undertaken “now” or in the immediate future. Business strategies focus on the firm’s posture three to five years out. Exhibit 10.6, *Strategy in Action*, shows functional tactics turnaround CEO Alan Mulally seeks to implement in five strategic areas of concern at Ford Motor Company.

The shorter time horizon of functional tactics is critical to the successful implementation of a business strategy for two reasons. First, it focuses the attention of functional managers on what needs to be done *now* to make the business strategy work. Second, it allows functional managers like those at 3M to adjust to changing current conditions.

#### *Specificity*

Functional tactics are more specific than business strategies. Business strategies provide general direction. Functional tactics identify the specific activities that are to be undertaken in each functional area and thus allow operating managers to work out *how* their unit is expected to pursue short-term objectives. Exhibit 10.5, *Strategy in Action*, illustrated the nature and value of specificity in functional tactics versus business strategy at California Pizza Kitchen.

Specificity in functional tactics contributes to successful implementation by

- Helping ensure that functional managers know what needs to be done and can focus on accomplishing results.
- Clarifying for top management how functional managers intend to accomplish the business strategy, which increases top management’s confidence in and sense of control over the business strategy.
- Facilitating coordination among operating units within the firm by clarifying areas of interdependence and potential conflict.

#### *Participants*

Different people participate in strategy development at the functional and business levels. Business strategy is the responsibility of the general manager of a business unit. That manager typically delegates the development of functional tactics to subordinates charged with running the operating areas of the business. The manager of a business unit must

# Strategy in Action

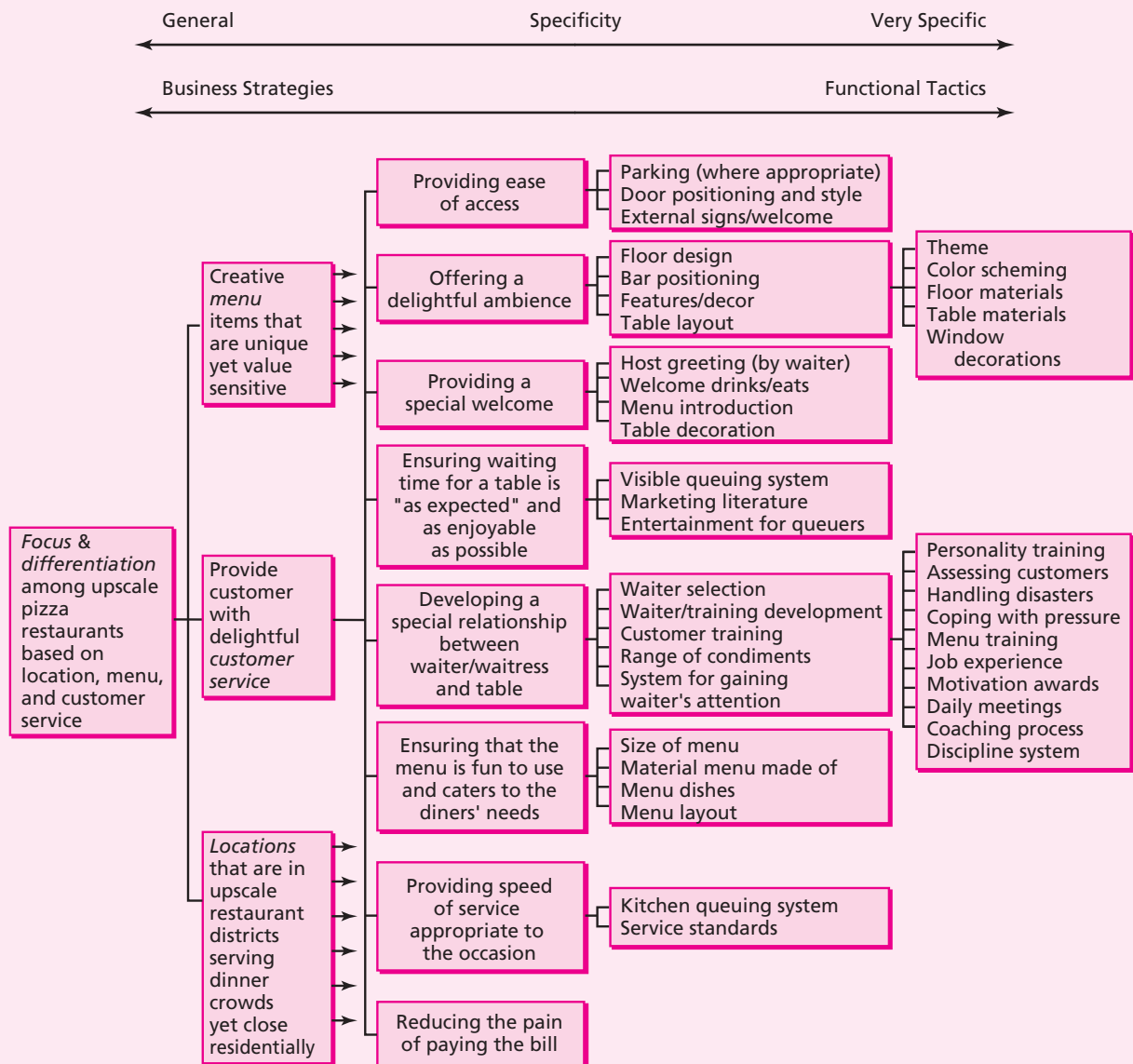
## Exhibit 10.5

### The Nature and Value of Specificity in Functional Tactics versus Business Strategy



A restaurant business was encountering problems. Although its management had agreed unanimously that it was committed to a business strategy to differentiate itself from other competitors based on concept and customer service rather than price, California Pizza Kitchen continued to encounter inconsistencies across different store locations in how well it did this. Consultants indicated that the customer experience varied greatly from store to store. The conclusion was that while the management understood the “busi-

ness strategy,” and the employees did too in general terms, the implementation was inadequate because of a lack of specificity in the functional tactics—what everyone should do every day in the restaurant—to make the vision a reality in terms of the customers’ dining experience. The following breakdown of part of their business strategy into specific functional tactics just in the area of customer service helps illustrate the value specificity in functional tactics brings to strategy implementation.



Sources: Adapted from Dennis Milton, "California Pizza Kitchen: Say Cheese!," *BusinessWeek*, July 15, 2003; and A. Campbell and K. Luchs, Eds., *Core Competency – Based Strategy* (London: Thompson, 1997).

## Strategy in Action

## Exhibit 10.6

### The Mulally Difference in Key Tactics to Save Ford Motor Company

BusinessWeek

How Things Are Changing at Ford Now That the New Boss Has Arrived

	Before	After
Organization	Regional fiefdoms. Every global market has had its own strategy and products.	Mulally wants to break down geographic hierarchies and create a single worldwide organization.
Division chief meetings	Held monthly. Lots of happy talk. Little information sharing.	Held weekly. Discussing problems is encouraged. Goal is to spot red flags early.
Product mix	Emphasis on trucks, SUVs, niche sports cars.	Focus is shifting to passenger cars and or crossovers.
Brand vision	To diversify away from ford brand. The company acquired dysfunctional luxury brands.	Strengthen the traditional blue oval Ford brand. Sell off or close poor-performing brands.
Promotions	Managers changed jobs frequently to develop their skills.	Executives stay in place, winning only promotions that are deserved.

Source: Reprinted with special permission from “The Mulally Difference,” *BusinessWeek*, June 7, 2007. Copyright © 2007 The McGraw-Hill Companies.

establish long-term objectives and a strategy that corporate management feels contributes to corporate-level goals. Similarly, key operating managers must establish short-term objectives and operating strategies that contribute to business-level goals. Just as business strategies and objectives are approved through negotiation between corporate managers and business managers, so, too, are short-term objectives and functional tactics approved through negotiation between business managers and operating managers.

Involving operating managers in the development of functional tactics improves their understanding of what must be done to achieve long-term objectives and, thus, contributes to successful implementation. It also helps ensure that functional tactics reflect the reality of the day-to-day operating situation. And perhaps most important, it can increase the commitment of operating managers to the strategies developed.

## OUTSOURCING FUNCTIONAL ACTIVITIES

A generation ago, it was conventional wisdom that a business has a better chance of success if it controls the doing of everything necessary to produce its products or services. Referring back to Chapter 6’s value chain approach, the “wise” manager would have sought to maintain control of virtually all the “primary” activities and the “support” activities associated with the firm’s work. Not any longer. Starting for most firms with the outsourcing of producing payroll each week, companies worldwide are embracing the idea that the best way to implement their strategies is to retain responsibility for executing some functions while seeking outside people and companies to do key support and key primary activities where they can do so more effectively and more inexpensively. **Outsourcing**, then, is acquiring an activity, service, or product necessary to provide a company’s products or services from “outside” the people or operations controlled by that acquiring company.

DuPont Co. has always run corporate training and development out of its Wilmington (Delaware) head office. But these days, Boston-based Forum Corp. handles it instead. In Somers, New York, PepsiCo Inc. employees, long used to receiving personal financial

### outsourcing

Obtaining work previously done by employees inside the companies from sources outside the company.

planning from their employer, now get that service from KPMG Peat Marwick. Denver's TeleTech Holdings Inc. is taking customer-service calls from AT&T customers and books seat reservations for Continental Airlines.

Wyck Hay's first entrepreneurial effort was a smashing success: The co-founder of herbal tea maker Celestial Seasonings helped sell the company to Kraft Foods for \$40 million in 1984. But Hay found managing 300 employees a headache. So when he launched Woodside (California)-based Kaboom Beverages a few years ago, he kept a decidedly small payroll: himself. In lieu of a workforce, Hay assembled a team of contractors to perform every task at his \$2 million business—from label design to manufacturing of his "power juice" drinks. Hay said outsourcing saves him at least 30 percent, while minimizing his daily distractions. "I don't know that I ever plan to hire any employees," he mused.<sup>4</sup>

Relentless cost cutting is the main force behind the trend. BellSouth Corp., which shed 13,200 employees over two years, outsourced about \$60 million in services to replace them. Companies are parceling out everything from mailroom management to customer service, from pieces of human resources departments to manufacturing and distribution. "We're at the beginning of an explosion," predicts Scott Hartz, managing partner of PricewaterhouseCoopers consulting group. "Many of the firms doing more outsourcing aren't troubled corporations trying to save a nickel. They are often the corporate leaders." All major corporations now outsource at least some services.<sup>5</sup> Exhibit 10.7 provides a summary of the increase in outsourcing.

It's hardly just rote work that's being outsourced—even such key functions as marketing are now up for bidding. "Some CEOs say they'd rather focus on operations and finance," says Dave Camp, the director of creative services at Bellevue (Washington)-based Outsource Marketing. The 12-person company originally provided basic marketing support to small clients. Today, it acts as the full marketing department for some clients.<sup>6</sup>

The hype over outsourcing's benefits, however, disguises numerous problems. General Electric Co. stubbed its toe when the introduction of a new washing machine was delayed by production problems at a contractor to whom it had farmed out key work. GE only lost three weeks as a result of the glitches, but it could have been worse. Southern Pacific Rail Corp. suffered through myriad computer breakdowns and delays after outsourcing its internal computer network to IBM.

The important point to recognize at this point is that functional activities long associated with doing the work of any business organization are increasingly subject to be outsourced if they can be done more cost effectively by other providers. So it becomes critical for managers implementing strategic plans to focus company activities on functions deemed central to the company's competitive advantage and to seek others outside the firm's structure to provide the functions that are necessary, but not within the scope of the firm's core competencies. And, increasingly, this decision considers every organizational activity fair game—even marketing, product design, innovation. We will explore this in greater detail in Chapter 11.

## EMPOWERING OPERATING PERSONNEL: THE ROLE OF POLICIES

Specific functional tactics provide guidance and initiate action implementing a business's strategy, but more is needed. Supervisors and personnel in the field have been charged in today's competitive environment with being responsible for customer value—for being

<sup>4</sup> Dean Foust, et al., "The Outsourcing Food Chain," *BusinessWeek Online*, March 11, 2004.

<sup>5</sup> Steven Goldman, "Dynamism as the Norm," *BusinessWeek Online*, April 18, 2005.

<sup>6</sup> Ibid.

**EXHIBIT 10.7**  
**Outsourcing Is**  
**Increasing**

Source: Estimated based on various articles in *BusinessWeek* on outsourcing.

ORDERING OUT...		
Companies That Say They Outsource Some Functional Activity		
	Yes	No
2008	98%	2%
2000	75	25
1995	52	48
1990	23	77
... FOR EVERYTHING		
Functional Activities Most Frequently Outsourced		
Payroll		75%
Manufacturing		72
Maintenance		68
Warehousing/transportation/distribution		62
Information technology		52
Travel		48
Temporary service		48
HR activities (varied)		40
Product design		35
R&D		25
Marketing		22

the “front line” of the company’s effort to truly meet customers’ needs. Meeting customer needs is a buzzword regularly cited as a key priority by most business organizations. Efforts to do so often fail because employees that are the real contact point between the business and its customers are not empowered to make decisions or act to fulfill customer needs. One solution has been to empower operating personnel by pushing down decision making to their level. General Electric allows appliance repair personnel to decide about warranty credits on the spot, a decision that used to take several days and multiple organizational levels. American Air Lines allows customer service personnel and their supervisors wide range in resolving customer ticket pricing decisions. Federal Express couriers make decisions and handle package routing information that involves five management levels in the U.S. Postal Service.

**empowerment**

The act of allowing an individual or team the right and flexibility to make decisions and initiate action.

**Empowerment** is the act of allowing an individual or team the right and flexibility to make decisions and initiate action. It is being expanded and widely advocated in many organizations today. Training, self-managed work groups, eliminating whole levels of management in organizations, and aggressive use of automation are some of the ways and ramifications of this fundamental change in the way business organizations function. At the heart of the effort is the need to ensure that decision making is consistent with the mission, strategy, and tactics of the business while at the same time allowing considerable latitude to operating personnel. One way operating managers do this is through the use of policies.

**policies**

Broad, precedent-setting decisions that guide or substitute for repetitive or time-sensitive managerial decision making.

**Policies** are directives designed to guide the thinking, decisions, and actions of managers and their subordinates in implementing a firm’s strategy. Sometimes called *standard operating procedures*, policies increase managerial effectiveness by standardizing many routine decisions and clarifying the discretion managers and subordinates can exercise in implementing functional tactics. Logically, policies should be derived from functional

## Strategy in Action

## Exhibit 10.8

### Selected Policies That Aid Strategy Implementation

3M Corporation has a *personnel policy*, called the *15 percent rule*, that allows virtually any employee to spend up to 15 percent of the workweek on anything that he or she wants to, as long as it's product related. (This policy supports 3M's corporate strategy of being a highly innovative manufacturer, with each division required to have a quarter of its annual sales come from products introduced within the past five years.)

Wendy's has a *purchasing policy* that gives local store managers the authority to buy fresh meat and produce locally, rather than from regionally designated or company-owned sources. (This policy supports Wendy's functional strategy of having fresh, unfrozen hamburgers daily.)

General Cinema has a *financial policy* that requires annual capital investment in movie theaters not to

exceed annual depreciation. (By seeing that capital investment is no greater than depreciation, this policy supports General Cinema's financial strategy of maximizing cash flow—in this case, all profit—to its growth areas. The policy also reinforces General Cinema's financial strategy of leasing as much as possible.)

Crown, Cork, and Seal Company has an *R&D policy* of not investing any financial or people resources in basic research. (This policy supports Crown, Cork, and Seal's functional strategy, which emphasizes customer services, not technical leadership.)

Bank of America has an *operating policy* that requires annual renewal of the financial statement of all personal borrowers. (This policy supports Bank of America's financial strategy, which seeks to maintain a loan-to-loss ratio below the industry norm.)

tactics (and, in some instances, from corporate or business strategies) with the key purpose of aiding strategy execution.<sup>7</sup> Exhibit 10.8, Strategy in Action, illustrates selected policies of several well-known firms.

### Creating Policies That Empower

Policies communicate guidelines to decisions. They are designed to control decisions while defining allowable discretion within which operational personnel can execute business activities. They do this in several ways:

1. *Policies establish indirect control over independent action* by clearly stating how things are to be done *now*. By defining discretion, policies in effect control decisions yet empower employees to conduct activities without direct intervention by top management.
2. *Policies promote uniform handling of similar activities*. This facilitates the coordination of work tasks and helps reduce friction arising from favoritism, discrimination, and the disparate handling of common functions—something that often hampers operating personnel.

<sup>7</sup> The term *policy* has various definitions in management literature. Some authors and practitioners equate policy with strategy. Others do this inadvertently by using "policy" as a synonym for company mission, purpose, or culture. Still other authors and practitioners differentiate policy in terms of "levels" associated, respectively, with purpose, mission, and strategy. "Our policy is to make a positive contribution to the communities and societies we live in" and "Our policy is not to diversify out of the hamburger business" are two examples of the breadth of what some call policies. This book defines *policy* much more narrowly as specific guides to managerial action and decisions in the implementation of strategy. This definition permits a sharper distinction between the formulation and implementation of functional strategies. And, of even greater importance, it focuses the tangible value of the policy concept where it can be most useful—as a key administrative tool to enhance effective implementation and execution of strategy.

3. *Policies ensure quicker decisions* by standardizing answers to previously answered questions that otherwise would recur and be pushed up the management hierarchy again and again—something that requires unnecessary levels of management between senior decision makers and field personnel.

4. *Policies institutionalize basic aspects of organization behavior.* This minimizes conflicting practices and establishes consistent patterns of action in attempts to make the strategy work—again, freeing operating personnel to act.

5. *Policies reduce uncertainty in repetitive and day-to-day decision making,* thereby providing a necessary foundation for coordinated, efficient efforts and freeing operating personnel to act.

6. *Policies counteract resistance to or rejection of chosen strategies by organization members.* When major strategic change is undertaken, unambiguous operating policies clarify what is expected and facilitate acceptance, particularly when operating managers participate in policy development.

7. *Policies offer predetermined answers to routine problems.* This greatly expedites dealing with both ordinary and extraordinary problems—with the former, by referring to these answers; with the latter, by giving operating personnel more time to cope with them.

8. *Policies afford managers a mechanism for avoiding hasty and ill-conceived decisions in changing operations.* Prevailing policy can always be used as a reason for not yielding to emotion-based, expedient, or temporarily valid arguments for altering procedures and practices.

Policies may be written and formal or unwritten and informal. Informal, unwritten policies are usually associated with a strategic need for competitive secrecy. Some policies of this kind, such as promotion from within, are widely known (or expected) by employees and implicitly sanctioned by management. Managers and employees often like the latitude granted by unwritten and informal policies. However, such policies may detract from the long-term success of a strategy. Formal, written policies have at least seven advantages:

1. They require managers to think through the policy's meaning, content, and intended use.
2. They reduce misunderstanding.
3. They make equitable and consistent treatment of problems more likely.
4. They ensure unalterable transmission of policies.
5. They communicate the authorization or sanction of policies more clearly.
6. They supply a convenient and authoritative reference.
7. They systematically enhance indirect control and organizationwide coordination of the key purposes of policies.

The strategic significance of policies can vary. At one extreme are such policies as travel reimbursement procedures, which are really work rules and may not have an obvious link to the implementation of a strategy. Exhibit 10.9, Strategy in Action, provides an interesting example of how the link between a simple policy and strategy implementation regarding customer service can have serious negative consequences when it is neither obvious to operating personnel nor well thought out by bank managers. At the other extreme are organizationwide policies that are virtually functional strategies, such as Wendy's requirement that every location invest 1 percent of its gross revenue in local advertising.



## Strategy in Action

## Exhibit 10.9

### Make Sure Policies Aren't Used to Drive Away Customers

Every year *Inc.* magazine sponsors a conference for the 500 fastest growing companies in the United States to share ideas, hear speakers, and network. A recent conference included a talk by Martha Rogers, co-author of *The One to One Future*. Here is an interesting anecdote about policies she used in her talk:

The story was about a distinguished-looking gentleman in blue jeans who walked into a bank and asked a teller to complete a transaction. The teller said she was sorry, but the person responsible was out for the day. The man would have to come

back. He then asked to have his parking receipt validated. Again, she said she was sorry, but under bank policy she could not validate a parking receipt unless the customer completed a transaction. The man pressed her. She did not waver. "That's our policy," she said.

So the man completed a transaction. He withdrew all \$1.5 million from his account. It turned out he was John Akers, then chairman of IBM.

The moral: Give employees information about the value of customers, not mindless policies.

Policies can be externally imposed or internally derived. Policies regarding equal employment practices are often developed in compliance with external (government) requirements, and policies regarding leasing or depreciation may be strongly influenced by current tax regulations.

Regardless of the origin, formality, and nature of policies, the key point to bear in mind is that they can play an important role in strategy implementation. Communicating specific policies will help overcome resistance to strategic change, empower people to act, and foster commitment to successful strategy implementation.

Policies empower people to act. Compensation, at least theoretically, rewards their action. The last decade has seen many firms realize that the link between compensation, particularly executive management compensation, and value-building strategic outcomes within their firms was uncertain. The recognition of this uncertainty has brought about increased recognition of the need to link management compensation with the successful implementation of strategies that build long-term shareholder value. The next section examines this development and major types of executive bonus compensation plans.

## BONUS COMPENSATION PLANS<sup>8</sup>

### Major Plan Types

Company shareholders typically believe that the goal of a bonus compensation plan is to motivate executives and key employees to achieve maximization of shareholder wealth. Because shareholders are both owners and investors of the firm, they desire a reasonable return on their investment. Because they are absentee landlords, shareholders expect their board of directors to ensure that the decision-making logic of their firm's executives to be concurrent with their own primary motivation.

However, the goal of shareholder wealth maximization is not the only goal that executives may pursue. Alternatively, executives may choose actions that increase their personal compensation, power, and control. Therefore, an executive compensation plan that contains

<sup>8</sup> We wish to thank Roy Hossler for his assistance on this section.

**EXHIBIT 10.10** Types of Executive Bonus Compensation

Bonus Type	Description	Rationale	Shortcomings
Stock option grants	Right to purchase stock in the future at a price set now. Compensation is determined by “spread” between option price and exercise price.	Provides incentive for executive to create wealth for shareholders as measured by increase in firm’s share price.	Movement in share price does not explain all dimensions of managerial performance.
Restricted stock plan	Shares given to executive who is prohibited from selling them for a specific time period. May also include performance restrictions.	Promotes longer executive tenure than other forms of compensation.	No downside risk to executive, who always profits unlike other shareholders.
Golden handcuffs	Bonus income deferred in a series of annual installments. Deferred amounts not yet paid are forfeited with executive resignation.	Offers an incentive for executive to remain with the firm.	May promote risk-averse decision making due to downside risk borne by executive.
Golden parachute	Executives have right to collect the bonus if they lose position due to takeover, firing, retirement, or resignation.	Offers an incentive for executive to remain with the firm.	Compensation is achieved whether or not wealth is created for shareholders. Rewards either success or failure.
Cash based on internal business performance using financial measures	Bonus compensation based on accounting performance measures such as return on equity.	Offsets the limitations of focusing on market-based measures of performance.	Weak correlation between earnings measures and shareholder wealth creation. Annual earnings do not capture future impact of current decisions.

a bonus component can be used to orient management’s decision making toward the owners’ goals. The success of bonus compensation as an incentive hinges on a proper match between an executive bonus plan and the firm’s strategic objectives. As one author has written, “Companies can succeed by clarifying their business vision or strategy and aligning company pay programs with its strategic direction.”<sup>9</sup> Exhibit 10.10 summarizes five types of executive compensation plans we will now explore in more detail.

**Stock Options**

A common measure of shareholder wealth creation is appreciation of company stock price. Therefore, a popular form of bonus compensation is stock options. Stock options have typically represented more than 50 percent of a chief executive officer’s average pay

<sup>9</sup> James E. Nelson, “Linking Compensation to Business Strategy,” *The Journal of Business Strategy* 19, no. 2 (1998), pp. 25–27.

**stock options**

The right, or “option,” to purchase company stock at a fixed price at some future date.

package.<sup>10</sup> **Stock options** provide the executive with the right to purchase company stock at a fixed price in the future. The precise amount of compensation is based on the difference, or “spread,” between the option’s initial price and its selling, or exercised, price. As a result, the executive receives a bonus only if the firm’s share price appreciates. If the share price drops below the option price, the options become worthless.

Stock options were the source of extraordinary wealth creation for executives, managers, and rank-and-file employees in the technology boom of the last decade. Behind using options as compensation incentives was the notion that they were essentially free. Although they dilute shareholders’ equity when they’re exercised, taking the cost of stock options as an expense against earnings was not required. That, in turn, helped keep earnings higher than actual costs to the company and its shareholders. The bear market and corporate scandals of the last few years brought increased scrutiny on the use of and accounting for stock options. Recent changes in SEC guidelines have encouraged expensing stock options to more accurately reflect company performance. The following table shows the effect expensing stocks options would have on the net earnings of Standard & Poor’s (S&P) 500 firms in recent years. “Stock options were a free resource, and because of that, they were used freely,” said BankOne CEO James Dimon, who voluntarily began to expense stock options in 2003. “But now,” he said, “when you have to expense options, you start to think, ‘Is it an effective cost? Is there a better way?’” The Financial Accounting Standards Board issued a new ruling in 2004 that required expensing of stock options beginning in 2006.<sup>11</sup>

**A Big Hit to Earnings**

If options had been expensed the past 10 years, earnings would have been whacked as their popularity grew as shown below:

**Options Expense as a Percent of Net Earnings for S&P 500 Companies**

1996	1998	2000	2002	2005
2%	5%	8%	23%	22%

Source: *The Analysis Accounting Observer*; R. G. Associates Inc.

Microsoft shocked the business world in 2003 by announcing it would discontinue stock options, eliminating a form of pay that made thousands of Microsoft employees millionaires and helped define the culture of the tech industry. Starting in September 2003, the company began paying its 54,000 employees with restricted stock, a move that will let employees make money even if the company’s share price declines. Like options, the restricted stock will vest gradually over a five-year period, and grants of restricted stock are counted as expenses and charged against earnings. Said CEO Steven Ballmer, “We asked: Is there a smarter way to compensate our people, a way that would make them feel even more excited about their financial deal at Microsoft and at the same time be something that was at least as good for the shareholders as today’s compensation package?” At the time of Ballmer’s announcement, more than 20,000 employees who had joined Microsoft in the past three years held millions of stock options that were “under water,” meaning the market value of Microsoft stock was far below the stock price of their stock options.

Restricted stock has the advantage of offering employees more certainty, even if there is less potential for a big win. It also means shareholders don’t have to worry about massive

<sup>10</sup> Louis Lavelle, Frederick Jespersen, and Spencer Ante, “Executive Pay,” *BusinessWeek*, April 21, 2003.

<sup>11</sup> U.S. GAAP (generally accepted accounting principles) required expensing of stock options using one of two acceptable valuation methods starting in the first fiscal year after June 15, 2005. ([www.wikipedia.org/wiki/employee\\_stock\\_options](http://www.wikipedia.org/wiki/employee_stock_options))

dilution after employees exercise big stock gains, as happened in the 1990s. Another advantage is that grants of restricted stock are much easier to value than options because restricted stock is equivalent to a stock transfer at the market price. That improves the transparency of corporate accounting.<sup>12</sup>

Research suggests that stock option plans lack the benefits of plans that include true stock ownership. Stock option plans provide unlimited upside potential for executives, but limited downside risk because executives incur only opportunity costs. Because of the tremendous advantages to the executive of stock price appreciation, there is an incentive for the executive to take undue risk. Thus, supporters of stock ownership plans argue that direct ownership instills a much stronger behavioral commitment, even when the stock price falls, because it binds executives to their firms more than do options.<sup>13</sup> Additionally, “Executive stock options may be an efficient means to induce management to undertake more risky projects.”<sup>14</sup>

Options may have been overused and indeed abused in the last two bull markets,<sup>15</sup> but evidence suggests that the smart use of options and other incentive compensation does boost performance. Companies that spread ownership throughout a large portion of their workforce deliver higher returns than similar companies with more concentrated ownership. If options seemed for a time to be the route that enriched CEOs, employees, and investors alike, it still appears they will be used, although with less emphasis than a mix of options, restricted stock, and cash bonuses. Whatever the exact mix, they are likely to be more closely tied to achieving specific operating goals. The next section examines restricted stock and cash bonuses in greater detail.

### **Restricted Stock**

#### **restricted stock**

Stock given to an employee who is prohibited or “restricted” from selling the stock for a certain time period and not at all if they leave the company before that time period.

A **restricted stock** plan is designed to provide benefits of direct executive stock ownership. In a typical restricted stock plan, an executive is given a specific number of company stock shares. The executive is prohibited from selling the shares for a specified time period. Should the executive leave the firm voluntarily before the restricted period ends, the shares are forfeited. Therefore, restricted stock plans are a form of deferred compensation that promotes longer executive tenure than other types of plans.

In addition to being contingent on a vesting period, restricted stock plans may also require the achievement of predetermined performance goals. Price-vesting restricted stock plans tie vesting to the firm’s stock price in comparison to an index or to reaching a predetermined goal or annual growth rate. If the executive falls short on some of the restrictions, a certain amount of shares are forfeited. The design of these plans motivates the executive to increase shareholder wealth while promoting a long-term commitment to stay with the firm.

If the restricted stock plan lacks performance goal provisions, the executive needs only to remain employed with the firm over the vesting period to cash in on the stock. Performance provisions make sure executives are not compensated without achieving some

<sup>12</sup> Many argue that stock options are critical to start-up firms as a way to motivate and retain talented employees with the promise of getting rich should the new venture succeed. Among them appear to be FASB chairman Robert Herz, who favors sentiment to make special exceptions in the expensing of options in pre-IPO firms.

<sup>13</sup> Jeffrey Pfeffer, “Seven Practices of Successful Organizations,” *California Management Review*, Winter 1998.

<sup>14</sup> Richard A. DeFusco, Robert R. Johnson, and Thomas S. Zorn, “The Effect of Executive Stock Option Plans on Stockholders and Bondholders,” *Journal of Finance* 45, no. 2 (1990), pp. 617–35.

<sup>15</sup> Erik Lie and Randall A. Heron, “Does Backdating Explain the Stock Price Pattern Around Stock Option Grants,” *Journal of Financial Economics* 83, (2007) pp. 271–95. Lie and Heron found 30 percent of all U.S. publicly traded firms apparently manipulated (backdated) stock option grants to increase the payoff to executives receiving the grants. See the Chapter 10 Discussion Case Part II for more details.

level of shareholder wealth creation. Like stock options, restricted stock plans offer no downside risk to executives because the shares were initially gifted to the executive. Unlike options, the stock retains value tied to its market value once ownership is fully vested. Shareholders, on the other hand, do suffer a loss in personal wealth resulting from a share price drop.

### *Golden Handcuffs*

The rationale behind plans that defer compensation forms the basis for another type of executive compensation called golden handcuffs. **Golden handcuffs** refer to either a restricted stock plan, where the stock compensation is deferred until vesting time provisions are met, or to bonus income deferred in a series of annual installments. This type of plan may also involve compensating an executive a significant amount upon retirement or at some predetermined age. In most cases, compensation is forfeited if the executive voluntarily resigns or is discharged before certain time restrictions.

Many boards consider their executives' skills and talents to be their firm's most valuable assets. These "assets" create and sustain the professional relationships that generate revenue and control expenses for the firm. Research suggests that the departure of key executives is unsettling for companies and often disrupts long-range plans when new key executives adopt a different management strategy.<sup>16</sup> Thus, the golden handcuffs approach to executive compensation is more congruent with long-term strategies than short-term performance plans, which offer little staying-power incentive.

Firms may turn to golden handcuffs if they believe stability of management is critical to sustained growth. Jupiter Asset Management recently tied 10 fund managers to the firm with golden handcuffs. The compensation scheme calls for a cash payment in addition to base salaries if the managers remain at the firm for five years. In the first year of the plan, the firm's pretax profits more than doubled, and their assets under management increased 85 percent. The firm's chairman has also signed a new incentive deal that will keep him at Jupiter for four years.

Deferred compensation is worrisome to some executives. In cases where the compensation is payable when the executives are retired and no longer in control, as when the firm is acquired by another firm or a new management hierarchy is installed, the golden handcuff plans are considerably less attractive to executives.

Golden handcuffs may promote risk averseness in executive decision making due to the huge downside risk borne by executives. This risk averseness could lead to mediocre performance results from executives' decisions. When executives lose deferred compensation if the firm discharges them voluntarily or involuntarily, the executive is less likely to make bold and aggressive decisions. Rather, the executive will choose safe, conservative decisions.

### *Golden Parachutes*

**Golden parachutes** are a form of bonus compensation that guarantees a substantial cash payment to an executive if the executive quits, is fired, or simply retires. In addition, the golden parachute may also contain covenants that allow the executive to cash in on noninvested stock compensation.

The popularity of golden parachutes grew with the increased popularity of takeovers, which often led to the ouster of the acquired firm's top executives. In these cases, the golden parachutes encouraged executives to take an objective look at takeover offers. The executives could decide which move was in the best interests of the shareholders, having been personally protected in the event of a merger. The "parachute" helps soften the fall

#### **golden handcuffs**

A form of executive compensation where compensation is deferred (either a restricted stock plan or bonus income deferred in a series of annual installments).

#### **golden parachute**

A form of bonus compensation that guarantees a substantial cash payment if the executive quits, is fired, or simply retires.

<sup>16</sup> William E. Hall, Brian J. Lake, Charles T. Morse, and Charles T. Morse, Jr., "More Than Golden Handcuffs," *Journal of Accountancy* 184, no. 5 (1997), pp. 37–42.

of the ousted executive. It is “golden” because the size of the cash payment often varies from several to tens of millions of dollars.

AMP Incorporated, the world’s largest producer of electronic connectors, had golden parachutes for several executives. When Allied Signal proclaimed itself an unsolicited suitor for AMP, the action focused attention on the AMP parachutes for its three top executives. Robert Ripp became AMP’s chief executive officer during this time. If Allied Signal ousted him, he stood to receive a cash payment of three times the amount of his salary as well as his highest annual bonus from the previous three years. His salary at the time was \$600,000 and his previous year’s bonus was \$200,000. The cash payment to Ripp would therefore exceed \$2 million. Parachutes would also open for the former chief executive officer and the former chairman who were slated to officially retire a year later. They stood to receive their parachutes if they were ousted before their respective retirement dates with each parachute valued at more than \$1 million.

In addition to cash payments, these three executives’ parachutes also protect existing blocks of restricted stock grants and nonvested stock options. The restricted stock grants were scheduled to become available within three years. Should the takeover come to fruition, the executives would receive the total value of the restricted stock even if it was not yet vested. The stock options would also become available immediately. Some of the restricted stock was performance restricted. Under normal conditions this stock would not be available without the firm reaching certain performance levels. However, the golden parachutes allow the executives to receive double the value of the performance-restricted stock.

Golden parachutes are designed in part to anticipate hostile takeovers like this. In AMP’s case, Ripp’s position is to lead the firm’s board of directors in deciding if Allied Signal’s offer is in the long-term interests of shareholders. Because Ripp is compensated heavily whether AMP is taken over or not, the golden parachute has helped remove the temptation that Ripp could have of not acting in the best interests of shareholders.

By design, golden parachutes benefit top executives whether or not there is evidence that value is created for shareholders. In fact, research has suggested that since high-performing firms are rarely taken over, golden parachutes often compensate top executives for abysmal performance.<sup>17</sup> Recent stockholder reactions to excessive executive compensation regardless of company performance are seen in Exhibit 10.11, Strategy in Action.

### Cash

Executive bonus compensation plans that focus on accounting measures of performance are designed to offset the limitations of market-based measures of performance. This type of plan is most usually associated with the payment of periodic (quarterly or annual) cash bonuses. Market factors beyond the control of management, such as pending legislation, can keep a firm’s share price repressed even though a top executive is exceeding the performance expectations of the board. In this situation, a highly performing executive loses bonus compensation due to the undervalued stock. However, accounting measures of performance correct for this problem by tying executive bonuses to improvements in internally measured performance.

Traditional accounting measures, such as net income, earnings per share, return on equity, and return on assets, are used because they are easily understood, are familiar to senior management, and are already tracked by firm data systems.<sup>18</sup> Sears bases annual

<sup>17</sup> Graef S. Crystal, *In Search of Excess* (New York: W. W. Norton & Company, 1991).

<sup>18</sup> Francine C. McKenzie and Matthew D. Shilling, “Avoiding Performance Measurement Traps: Ensuring Effective Incentive Design and Implementation,” *Compensation and Benefits Review*, July–August 1998, pp. 57–65.

## Strategy in Action

## Exhibit 10.11

### Shareholder Reaction to Executive Compensation Plans

BusinessWeek

#### BACK-DATED OPTIONS

Iowa professor Erik Lie found that more than 30 percent of all U.S. public corporations—2,000 companies—routinely manipulated stock option accounting rules to increase executive pay.

#### FED-UP SHAREHOLDERS

Unions and public pension funds have racked up more than two dozen majority votes for shareholder resolutions opposing high executive pay.

#### GOLDEN PARACHUTES

At Alcoa, 65 percent of shareholders voted for a union resolution calling for stockholder approval of lavish executive severance packages. Similar proposals won majorities at Delta and Raytheon.

#### CUSHY RETIREMENT DEALS

A proposal at U.S. Bancorp seeking shareholder votes on special executive pension benefits passed by 52 percent. Labor pulled resolutions at GE, Coke, and Exelon after they agreed to reforms.

#### EXPENSING STOCK OPTIONS

Labor resolutions demanding that companies deduct option costs from earnings have garnered majorities at 15 companies, including Apple and Capital One.

Sources: Reprinted with special permission from “He’s Making Hay As CEOs Squirm,” *BusinessWeek*, January 15, 2007; and Amy Borrus, “Executive Pay: Labor Strikes Back,” *BusinessWeek*, May 26, 2003. Copyright © 2007 The McGraw-Hill Companies.

bonus payments on such performance criteria, given an executive’s business unit and level with the firm. The measures used by Sears include return on equity, revenue growth, net sales growth, and profit growth.

Critics argue that because of inherent flaws in accounting systems, basing compensation on these figures may not result in an accurate gauge of managerial performance. Return on equity estimates, for example, are skewed by inflation distortions and arbitrary cost allocations. Accounting measures are also subject to manipulation by firm personnel to artificially inflate key performance figures. Firm performance schemes, critics believe, need to be based on a financial measure that has a true link to shareholder value creation.<sup>19</sup> This issue led to the creation of the Balanced Scorecard, which emphasizes not only financial measures, but also such measures as new-product development, market share, and safety as discussed in Chapter 12.

### Matching Bonus Plans and Corporate Goals

Exhibit 10.12 provides a summary of the five types of executive bonus compensation plans. The figure includes a brief description, a rationale for implementation, and the identification of possible shortcomings for each of the compensation plans. Not only do compensation plans differ in the method through which compensation is rewarded to the executive, but they also provide the executive with different incentives.

Exhibit 10.12 matches a company’s strategic goal with the most likely compensation plan. On the vertical axis are common strategic goals. The horizontal axis lists the main compensation types that serve as incentives for executives to reach the firm’s goals. A rationale is provided to explain the logic behind the connection between the firm’s goal and the suggested method of executive compensation.

Researchers emphasize that fundamental to these relationships is the importance of incorporating the level of strategic risk of the firm into the design of the executive’s

<sup>19</sup> William Franklin, “Making the Fat Cats Earn Their Cream,” *Accountancy*, July 1998, pp. 38–39.

**EXHIBIT 10.12 Compensation Plan Selection Matrix**

Strategic Goal	Type of Bonus Compensation					Rationale
	Cash	Golden Handcuffs	Golden Parachutes	Restricted Stock Plans	Stock Options	
Achieve corporate turnaround					X	Executive profits only if turnaround is successful in returning wealth to shareholders.
Create and support growth opportunities					X	Risk associated with growth strategies warrants the use of this high-reward incentive.
Defend against unfriendly takeover			X			Parachute helps takeover remove temptation for executive to evaluate takeover based on personal benefits.
Evaluate suitors objectively			X			Parachute compensates executive if job is lost due to a merger favorable to the firm.
Globalize operations					X	Risk of expanding overseas requires a plan that compensates only for achieved success.
Grow share price incrementally	X					Accounting measures can identify periodic performance benchmarks.
Improve operational efficiency	X					Accounting measures represent observable and agreed-upon measures of performance.
Increase assets under management				X		Executive profits proportionally as asset growth leads to long-term growth in share price.
Reduce executive turnover		X				Handcuffs provide executive tenure incentive.
Restructure organization					X	Risk associated with major change in firm's assets warrants the use of this high-reward incentive.
Streamline operations				X		Rewards long-term focus on efficiency and cost control.

compensation plan. Incorporating an appropriate level of executive risk can create a desired behavioral change commensurate with the risk level of strategies shareholders and their firms want.<sup>20</sup> To help motivate an executive to pursue goals of a certain risk-return level, the compensation plan can quantify that risk-return level and reward the executive accordingly.

<sup>20</sup> Lavelle, Jespersen, and Ante, "Executive Pay."



The links we show between bonus compensation plans and strategic goals were derived from the results of prior research. The basic principle underlying Exhibit 10.12 is that different types of bonus compensation plans are intended to accomplish different purposes; one element may serve to attract and retain executives; another may serve as an incentive to encourage behavior that accomplishes firm goals.<sup>21</sup> Although every strategy option has probably been linked to each compensation plan at some time, experience shows that there may be scenarios where a plan type best fits a strategy option. Exhibit 10.12 attempts to display the “best matches.”

Once the firm has identified strategic goals that will best serve shareholders’ interests, an executive bonus compensation plan can be structured in such a way as to provide the executive with an incentive to work toward achieving these goals.

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## Summary

The first concern in the implementation of business strategy is to translate that strategy into action throughout the organization. This chapter discussed five considerations for accomplishing this.

Short-term objectives are derived from long-term objectives, which are then translated into current actions and targets. They differ from long-term objectives in time frame, specificity, and measurement. To be effective in strategy implementation, they must be integrated and coordinated. They also must be consistent, measurable, and prioritized.

Functional tactics are derived from the business strategy. They identify the specific, immediate actions that must be taken in key functional areas to implement the business strategy.

Outsourcing of selected functional activities has become a central tactical agenda for virtually every business firm in today’s global economy. Can we get that activity done more effectively—and more inexpensively—outside our company? This question has become a regular one managers ask as they seek to make their business strategies work.

Employee empowerment through policies provides another means for guiding behavior, decisions, and actions at the firm’s operating levels in a manner consistent with its business and functional strategies. Policies empower operating personnel to make decisions and take action quickly.

Compensation rewards action and results. Once the firm has identified strategic objectives that will best serve stockholder interests, there are five bonus compensation plans that can be structured to provide the executive with an incentive to work toward achieving those goals.

Objectives, functional tactics, policies, and compensation represent only the start of the strategy implementation. The strategy must be institutionalized—it must permeate the firm. The next chapter examines this phase of strategy implementation.

<sup>21</sup> Nelson, “Linking Compensation to Business Strategy.”

## Key Terms

empowerment, *p. 314*  
functional tactics, *p. 309*  
golden handcuffs, *p. 321*

golden parachute, *p. 321*  
outsourcing, *p. 312*  
policies, *p. 314*

restricted stock, *p. 320*  
short-term objective, *p. 305*  
stock options, *p. 319*

## Questions for Discussion

1. How does the concept “translate thought into action” bear on the relationship between business strategy and operating strategy? Between long-term and short-term objectives?
2. How do functional tactics differ from corporate and business strategies?
3. What key concerns must functional tactics address in marketing? finance? production/operations management? personnel?
4. What is “outsourcing?” Why has it become a key element in shaping functional tactics within most business firms today?
5. How do policies aid strategy implementation? Illustrate your answer.
6. Use Exhibits 10.9 and 10.11 to explain five executive bonus compensation plans.
7. Illustrate a policy, an objective, and a functional tactic in your personal career strategy.
8. Why are short-term objectives needed when long-term objectives are already available?

## Chapter 10 Discussion Case 1

BusinessWeek

### A Better Look at the Boss’s Pay



Since 1993, CEO pay has increased faster than the cost of gasoline, Ivy League tuition, residential real estate prices, and a whole lot else. Your boss may have an inflated ego, but it’s probably not nearly as inflated as his paycheck. In 1993, chief executives’ salaries averaged \$2.6 million, and by 2005 they had skyrocketed to \$10.5 million—a 304 percent increase over 12 years.

- 1 No topic inflames the passions of business leaders and shareholders like executive pay. Companies and compensation consultants argue that, in a free market, they’d be foolish not to pay the going rate for top talent. Investors demand that compensation be tied to performance and complain loudly when pay rises while share prices don’t.
- 2 The perennial battle is about to reach a new level of contentiousness. The proxy season, just getting started, will be the first under new Securities and Exchange Commission reporting rules that force companies to disclose more about executive pay than ever before—from the hundreds of millions some executives stand to gain in severance, pensions, and deferred pay, to any perk worth more than \$10,000. Golden parachutes and sybaritic benefits such as club memberships and personal use of company jets won’t score many

points against a backdrop of the options-backdating scandal and increasingly empowered activist investors.

Thanks to recent blowups like that at Home Depot, 3 shareholder-rights groups hold a distinct advantage in the public-relations war. Former Chief Executive Robert L. Nardelli walked away from Home Depot Inc. in early January with a \$210 million severance package, shocking shareholders unhappy with the company’s flagging stock. And the timing couldn’t have been worse for companies nervously preparing to reveal their own pay practices. “Home Depot is a preview of things to come,” says Michael S. Melbinger, a compensation lawyer with Winston & Strawn in Chicago. “It’s the perfect example of the rich payout that would have been buried before, but which everyone now must disclose.”

Governance advocates and politicians gain even more 4 public support when they point out that in 2005 the average CEO in the Standard & Poor’s 500-stock index took home 369 times the pay of the average worker, up from 28 times the average in 1970. The counterargument, that the ratio is down from the 514 multiple in 2000, doesn’t get much traction.

## THE LITTLE THINGS

Some boards have been looking hard at executive contracts 5 and even tried to renegotiate them. Such minor perks as the personal driver and financial planning services are often on the table. But most boards plan to do little more.

In many cases, they can’t. Almost all CEOs have contracts 6 guaranteeing their big payouts. And the fear of angering a CEO over a pay issue has made directors reluctant to push harder. “No one wants to be responsible for seeing the CEO walk,” says Jannice L. Koors, a managing director of pay consultants Pearl Meyer & Partners. In a survey of 110 companies

at year-end, Mercer Human Resource Consulting found that 70 percent planned only minimal changes to their executive compensation programs as a result of the new SEC rules; just 15 percent said the impact would be more substantial. Cutbacks in executives' packages are "just not terribly widespread," says Mark A. Borges, a former SEC official who is a principal at Mercer. Chicago lawyer Melbinger, who has sat in on recent board meetings, echoes Borges' view: "Yes, there's pressure to get rid of these deals, but I have not seen a single situation where an executive was willing to give one up."

- 7 To avoid provoking shareholders, companies are most commonly shifting pay out of categories that raise questions. Late last year aerospace giant Lockheed Martin Corp. said it would stop paying for a car and driver as well as club dues for CEO Robert J. Stevens. Instead, it hiked his \$1.48 million salary \$40,000. A spokesman says ending perks was in the company's best interests.
- 8 Some items, however, are too large to move or obscure. The biggest fights are likely to be over multimillion-dollar deferred pay and retirement accounts, as well as guaranteed payments for executives who are fired or who leave when the company is acquired. Such items have been focal points of recent firestorms, from the Nardelli flap to the \$82 million pension Pfizer Inc. paid outgoing CEO Hank McKinnell last year.
- 9 The surprise this proxy season, predicts Shekhar Purohit, a principal of pay consultants James F. Reda & Associates, will be just how common, and lucrative, these severance packages are. Typically they include a payment of three times salary and bonus, immediate vesting of options and restricted stock awards, and, in many cases, payment of taxes owed. Purohit says dozens of executives could have payouts of \$100 million or more.
- 10 Revelations of extra-sweet deferred-compensation deals are sure to raise eyebrows, too. Such plans usually allow executives to sock away money tax-free, often with a company match—much like 401(k) accounts, only with no limit on the contributions. And some companies guarantee better-than-market interest for executives. American Express Co. gave CEO Kenneth I. Chenault \$1.1 million in above-market returns on his deferred compensation account in 2005. The company won't divulge the rate it gave that year, but in 2006 it paid 13 percent on executives' deferred balances. In late January, AmEx said it would continue to pay 13 percent to 16 percent on money they set aside between 1994 and 2004 if the company meets or beats financial targets, and will pay 9 percent to 11 percent on money deferred after 2005. A spokesman says the plan is consistent with industry practice.

## RICH RETIREES

- 11 Pension plans will likely draw attention, too. Whereas regular workers typically retire on one-half to two-thirds of their average salary in their last three to five years, some CEOs get far more. Pfizer's deal with McKinnell was unusually

rich: in calculating his final pay, Pfizer counted not only salary and bonus, but stock awards that vested through 2004. That notched his annual pension up from roughly \$3.5 million to \$6.6 million. The company says it stopped including new stock awards in pension calculations in 2001, but earlier grants were grandfathered in. Huge bonuses issued just before retirement can also pump up pensions. "It's the gift that keeps on giving," says Kevin J. Murphy, a professor at the University of Southern California's Marshall School of Business.

Governance activists are already targeting such practices. 12 The United Brotherhood of Carpenters has identified 14 companies, including AT&T and Johnson & Johnson, where it believes the inclusion of large incentive bonuses in pension calculations has led to excessive benefits. So far, the union can claim one small victory. In January, American Express also announced further limits on retirement benefits. Rather than basing them on total salary and bonus—which for Chenault were \$1.1 million and \$6 million, respectively, in 2005—earnings used in calculating retirement will be capped at twice the annual salary. The AmEx spokesman says the changes, long in the works, stem from the shift away from traditional defined benefit pensions to 401(k)-type defined contribution plans.

As for the smaller perks, companies maintain that some 13 are born of legitimate need. For example, many argue that use of a company jet even for personal flights is a must in the post-9/11 era. Ditto home alarm systems and other security measures. The practice isn't universal. Intel Corp. and Goldman Sachs & Co. both forbid personal use of company jets.

Even so, in a study of 2005 proxies filed by the 100 largest 14 U.S. companies, compensation research firm Equilar Inc. found that the median value of personal travel on corporate jets rose 21.7 percent, to \$109,000, while execs got roughly \$37,000 to safeguard themselves, up 69 percent. The numbers for individuals can fly much higher. United Technologies Corp. chief George David ran up a \$581,396 tab for "personal use of the corporate aircraft for security reasons," according to SEC filings. The company declined to comment. FedEx Corp. gave CEO Frederick W. Smith \$833,000 in jet use and security services on top of his \$1.3 million salary in fiscal 2006. FedEx, which requires the CEO to use the jet for all travel, says an independent security consultant determined the need for the benefits.

Still, jet travel irks some. Richard C. Breeden, a former 15 SEC chairman who runs a hedge fund, criticized restaurant chain Applebee's International Inc. over the issue. He found that, over a 10-month period, Applebee's jet made 29 trips to Galveston, Texas, where Lloyd Hill, who stepped down as CEO in September but remains chairman, has a beach house. A spokeswoman for Applebee's, which said on February 13 it will explore a sale, says its plane policy is disclosed.

One thing is clear: it is increasingly tough for boards to 16 keep everyone happy. Retired General Hugh Shelton, the former chairman of the U.S. Joint Chiefs of Staff who heads

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the compensation committee of software maker Red Hat Inc., says boards are focused more on finding the right balance between shareholder demands to link pay to performance and the company's need to ensure good executives have the right incentives. "You try to be fair, and give appropriate rewards for performance," he says. But ultimately, "you

compensate them so that they're not desperate to go to work for someone else."

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## Discussion Case 2

BusinessWeek

## He's Making Hay as CEOs Squirm: Erik Lie Uncovered Widespread Backdating of Stock Options. Now He's Reaping Rewards

- 17** Erik Lie loves academic life. The University of Iowa associate finance professor is free to research whatever topic intrigues him, and his \$160,000-plus income goes a nice long way in Iowa City. Summers off means that Lie (rhymes with "key"), his wife, and two kids can travel back to his parents' vacation home in Norway. During the rest of the year, he's free to take off after class for a run or some cross-country skiing. "Life as a professor is good," says the lanky 38-year-old.
- 18** It's particularly good now that Lie's research is having a major impact on Corporate America. His mid-2005 research first suggested that hundreds of companies may have routinely manipulated stock-option accounting rules to sweeten top executives' paydays. A later study done with his research partner, Indiana University associate professor Randall Heron, puts the number at 2,000, or 29 percent of all public corporations. Five executives face criminal indictments for such alleged backdating, more than 100 companies face civil charges and shareholder suits, and hundreds more are neck-deep in comprehensive investigations of their books to try to make sure the Feds don't add them to the list.
- 19** The scandal is creating a financial windfall for Lie. He and Heron have created a limited partnership now that the initial crush of calls from reporters has given way to people willing to actually pay for their insights. Lie says he has earned around \$100,000 from hedge funds and other investors, who pay him to handicap whether a company's options irregularities are harmless paperwork errors or the kinds of fraud that lead to CEO ousters and big civil penalties. He'll probably draw \$400 an hour or more doing consulting work for law firms, and still more as an expert witness. He's now a senior adviser at the Brattle Group, a consultancy in Washington. All told, Lie figures he could make \$250,000 before the options scandal fades from memory.
- 20** Lie may be underestimating his prospects. An elite business professor can make tens of thousands for a one-day consulting gig. Notre Dame University professor Paul H. Schultz, who in the mid-1990s discovered that NASDAQ market makers were skimming pennies from investors on stock trades, says he earned \$250,000 over three years, charging \$250 an hour to work with plaintiffs' attorneys. "But Erik can do quite a bit better, if he wants to," Schultz says. "There are more lawsuits, and he should be charging a higher rate."

## LUCKY TIMING?

Rarely has an academic had such an outside, real-time impact on **21** the business world. Academics had long known that companies tended to grant options with remarkable acuity—just before big rises that gave those options immediate value, at least on paper. But Lie and Heron were first to suggest that this could only have happened with the help of hindsight. That's because those favorable trading patterns appeared only in cases where companies had delayed their options paperwork for months, giving them the ability to look back and cherry-pick the most lucrative grant dates. That's a violation of federal law—and of many corporate options plans—if not properly disclosed.

Lie helped make sure the scandal exploded, notifying the **22** Securities and Exchange Commission of his work and showing *The Wall Street Journal* how to interpret a particular company's options records, although he insists he never identified companies himself. He's clearly proud of his work's resonance but insists the attendant financial opportunities are a low priority. He limits his consulting time, he says, to less than one day a week. "I did not start this line of research for the money, and I am still not in this for the money," Lie says.

Now he's turning away many opportunities, he says— **23** particularly from plaintiffs' lawyers who would like to tailor his findings to suit their cases. But he is helping "less pushy" plaintiffs' attorneys prepare potential cases against three dozen companies, diving into details of specific transactions. Indeed, he says he'll probably take the stand as an expert witness in some high-profile cases. He won't name any names, in part because it's too early to know which companies will settle rather than make it into court, but does say that he "may become involved in litigations" against Apple Computer.

Lie is also open to working with defendants facing **24** options-related allegations, although none have taken him up on the offer. "People tend to think I'm against all companies," he says, "but I think some of the companies identified in the media are innocent"—perhaps a dozen or so of the 200 companies that have announced options irregularities. He says some guiltless CEOs are likely to lose their jobs simply because they were at the helm when mistakes were made by others. Still, "it's one of those necessary evils; a small price

to pay to get more transparency into the system. How much is good governance worth to the economy? I don't know, but it's billions and billions."

- 25 Lie grew up the son of left-leaning parents in southern Norway. His father, Rolf, a retired construction engineer, thinks Lie is imbued with the economic egalitarianism they taught him. "Erik doesn't like that people have gotten money they didn't deserve," says the elder Lie. The son briefly considered a career in law but later caught the academic bug while doing a finance research project at the University of Oregon.

## SERENDIPITY

- 26 When he began researching stock options as a young professor in 2002, it wasn't to find a scandal. "Shareholders were giving executives options so they'd work harder to change corporate behavior," he says. "I just wanted to see how it manifested itself"—say, by companies repurchasing more shares. Even after Lie began to suspect backdating, it took a while for anyone to listen. An initial paper in 2004 was slammed by a reviewer who said that Lie was "overreaching" and that his conclusions "made little economic sense." After Sarbanes-Oxley regulations were imposed, however, all option grants had to be reported to the SEC within two days. By comparing the new grants with pre-Sarbanes-Oxley grants, Lie and Heron were able to document a disappearance of the windfall obtained by execs at companies that had taken months to file in the past.

Defense lawyers dismiss Lie's analysis because it doesn't consider legitimate explanations for how options may have been granted at low stock prices. For example, CEOs during the boom routinely granted options on days when their stocks were down because of unfounded rumors. That way, they could provide some extra incentive to employees before cranking up their investor relations efforts to refute the rumor. "His analysis is simplistic," says Richard Marmaro of Skadden, Arps, Slate, Meagher & Flom, who is representing indicted former Brocade Communications Systems CEO Greg Reyes. "There are people whose job it is to grant options, who are expert in understanding what they perceived to be low prices."

Lie says he's going into this next phase of the scandal with his eyes wide open, expecting to have his motives criticized, and ready for persuasive arguments about why a specific company, board, or executive did nothing wrong. He figures that the bulk of backdaters have yet to be identified, and that just 10 percent will ever be punished in any way. "I don't anticipate I'll be able to create something of this magnitude again," he says. "But it's not necessary for me that there is a consequence for every single firm. My research has already helped curb this behavior. That's the most important thing."

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## Discussion Case 3

BusinessWeek

### Google Gives Employees Another Option: *The Search Giant's Innovative Program Offers Workers Another Way to Realize the Value of Their Stock Options*

- 29 In a bid to breathe new life into scandal-tainted stock options, Google plans to give employees a novel method of cashing in their options starting next April. The search giant will let employees sell their vested stock options, which give the holder the right to reap the difference between the initial price and the current price, to selected financial institutions in an auction marketplace it's setting up with Morgan Stanley.
- 30 The program is a unique stab at unlocking for employees the underlying value of these securities that have been a favored method of luring and keeping employees, particularly among technology companies. In the past year or so, as rules requiring the expensing of stock options kicked in, employers have been cutting back on the number of options they grant, or doling out new incentives such as restricted stock, in a bid to avoid a hit to reported profits.
- 31 That has some observers worrying about the possible demise of a classic performance incentive tool. While options continue to be granted by many companies, some 30 percent

have cut back their options grants, and 25 percent of employees who once received options and other equity awards now do not, according to the National Center for Employee Ownership, a nonprofit research group in Oakland, California. And for those getting grants, the value of their options is about a third lower than it used to be.

## HOW IT WORKS

Under Google's Transferable Stock Option program, employees could sell their stock options on the semi-private marketplace much the way public options are sold today. That would let employees potentially reap more than if they merely exercised and then sold the securities. Say an employee holds an option with a strike price of \$400, meaning it can be purchased for \$400 and then resold at a higher price. If Google's stock is trading at \$500, an investor might pay \$150 for that option, betting that the stock will rise well past \$500 during

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the life of the option. The employee selling the option could net an immediate \$150. An employee exercising and then selling the same option would net only \$100, the difference between the strike price and the current price.

- 33 The impetus for the new approach is Google's volatile stock, which can change substantially in the space of a month or even days. Google's stock has been on a long if volatile rise since the company's initial public offering in 2004 at \$85 a share. Just since September 1, 2006, the shares have risen 27 percent, to \$481.78 on December 12, after rising above \$500 in November.
- 34 As a result, many recent and incoming employees may feel the options don't have much value, given how high Google's stock already is. Moreover, an employee who joins one week ultimately may end up having very different compensation than another hired a few weeks later. That difference can raise pay equity issues and potentially reduce the incentive for employees to stick around. "This goes a long way toward solving recruiting and retention issues," says Dave Rolefson, Google's equity and executive compensation manager.

### "VERY INNOVATIVE"

- 35 If Google's plan works—an open question at this point—other companies once again might find options an attractive offering for hiring and keeping talent. "I think it's a very good idea," says James Glassman, resident fellow at the American Enterprise Institute, who was briefed on the plan. "It achieves Google's goal of making the value of options more apparent to people who get them."
- 36 There could also be some unpredictable consequences to the plan. Investors buying these options no doubt will want to hedge their bets, possibly through a short sale—a bet that Google's stock will fall. That's not usually something companies like to see. But Google believes the overall impact of the program on the company will be positive. Former Securities and Exchange Commission chairman Arthur Levitt, now a senior advisor to the Carlyle Group, says he's not sure what all the implications will be. "But on balance, it's a very innovative program," he says.
- 37 The plan is only for employees, not executives, who Google says are already adequately compensated. So on its face the plan doesn't address some of the recent problems surrounding stock options, including manipulation of the date on which the securities are granted, so-called backdating, that have landed companies other than Google in legal hot water. But it does offer a different—and possibly more accurate—way to value stock options, an area of great debate even now, nearly a year after options were required to be logged as expenses on a company's books.

## NO BENEFIT TO THE BOTTOM LINE

Google's program isn't aimed at minimizing the impact to its bottom line, however. Indeed, the company expects to incur a larger expense on its books as the plan rolls out. That's because the fair market value of the options will be greater under the new plan than the current one. The reason: the options, which are estimated to have a four-year average life before employees exercise them, will convert to two-year options when they're sold to investors. So their expected life will be essentially extended by two years—making them more valuable because investors will have two more years for Google's stock potentially to rise, and thus more of an impact on Google's bottom line.

If Google's stock doesn't rise, or even falls, the options may well still have value, because investors may assume that over a two-year period the stock has a good chance to rise again. So employees may be able to sell even underwater options—those whose strike price is higher than the current stock price—and reap gains. "Underwater options lose their value as retention tools," notes Levitt. Even under Google's new plan, however, if its stock price drops well below options' strike prices, investors may not want to pay for them, and the options will still be worthless.

Google said it's not implementing the new plan because it's having problems attracting and retaining employees—at least not yet. "We're not having any problem recruiting people to work at Google," says Rolefson. "Attrition rates are very low." The idea, in an increasingly competitive business, is to keep it that way.

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## DISCUSSION QUESTIONS

1. What has been the compensation of CEOs relative to their "line" workers the past few years?
2. Do you think it is deserved? Why?
3. Do executives and related compensation/incentives appear key to effective implementation, or unrelated?
4. Regarding Case 2, does it seem reasonable for executives and employees to "backdate" stock option grants so that their grants are priced at the lowest daily stock price within a two- to four-month time period? Why?
5. Regarding Case 3, does it appear Google has found a way to add liquidity and simplicity to employee stock options designed to reward effective implementation and performance? Why?

## Chapter 10 Appendix

### Functional Tactics

#### FUNCTIONAL TACTICS THAT IMPLEMENT BUSINESS STRATEGIES

Functional tactics are the key, routine activities that must be undertaken in each functional area—marketing, finance, production/operations, R&D, and human resource management—to provide the business’s products and services. In a sense, functional tactics translate thought (grand strategy) into action designed to accomplish specific short-term objectives. Every value chain activity in a company executes functional tactics that support the business’s strategy and help accomplish strategic objectives.

The next several sections will highlight key tactics around which managers can build competitive advantage and add value in each of the various functional areas.

#### FUNCTIONAL TACTICS IN PRODUCTION/OPERATIONS

##### Basic Issues

Production/operations management (POM) is the core function of any organization. That function converts inputs (raw materials, supplies, machines, and people) into value-enhanced output. The POM function is most easily associated

with manufacturing firms, but it also applies to all other types of businesses (e.g., service and retail firms). POM tactics must guide decisions regarding (1) the basic nature of the firm’s POM system, seeking an optimum balance between investment input and production/operations output, and (2) location, facilities design, and process planning on a short-term basis. Exhibit 10.A1 highlights key decision areas in which the POM tactics should provide guidance to functional personnel.

POM facility and equipment tactics involve decisions regarding plant location, size, equipment replacement, and facilities utilization that should be consistent with grand strategy and other operating strategies. In the mobile home industry, for example, the facilities and equipment tactic of Winnebago was to locate one large centralized, highly integrated production center (in Iowa) near its raw materials. On the other extreme, Fleetwood Inc., a California-based competitor, located dispersed, decentralized production facilities near markets and emphasized maximum equipment life and less-integrated, labor-intensive production processes. Both firms are leaders in the mobile home industry, but have taken very different tactical approaches.

The interplay between computers and rapid technological advancement has made flexible manufacturing systems (FMS) a major consideration for today’s POM tacticians. FMS allows managers to automatically and rapidly shift production systems to retool for different products or other steps

#### EXHIBIT 10.A1 Key Functional Tactics in POM

Functional Tactic	Typical Questions That the Functional Tactic Should Answer
Facilities and equipment	How centralized should the facilities be? (One big facility or several small facilities?) How integrated should the separate processes be? To what extent should further mechanization or automation be pursued? Should size and capacity be oriented toward peak or normal operating levels?
Sourcing	How many sources are needed? How should suppliers be selected, and how should relationships with suppliers be managed over time? What level of forward buying (hedging) is appropriate?
Operations planning and control	Should work be scheduled to order or to stock? What level of inventory is appropriate? How should inventory be used, controlled, and replenished? What are the key foci for control efforts (quality, labor cost, downtime, product use, other)? Should maintenance efforts be oriented to prevention or to breakdown? What emphasis should be placed on job specialization? Plant safety? The use of standards?

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in a manufacturing process. Changes that previously took hours or days can be done in minutes. The result is decreased labor cost, greater efficiency, and increased quality associated with computer-based precision.

Sourcing has become an increasingly important component in the POM area. Many companies now accord sourcing a separate status like any other functional area. Sourcing tactics provide guidelines about questions such as, Are the cost advantages of using only a few suppliers outweighed by the risk of overdependence? What criteria (e.g., payment requirements) should be used in selecting vendors? Which vendors can provide “just-in-time” inventory, and how can the business provide it to our customers? How can operations be supported by the volume and delivery requirements of purchases?

POM planning and control tactics involve approaches to the management of ongoing production operations and are intended to match production/operations resources with longer-range, overall demand. These tactical decisions usually determine whether production/operations will be demand oriented, inventory oriented, or outsourcing oriented to seek a balance between the two extremes. Tactics in this component also address how issues such as maintenance, safety, and work organization are handled. Quality control procedures are yet another focus of tactical priorities in this area.

Just-in-time (JIT) delivery, outsourcing, and statistical process control (SPC) have become prominent aspects of the way today’s POM managers create tactics that build greater value and quality in their POM system. JIT delivery was initially a way to coordinate with suppliers to reduce inventory carrying costs of items needed to make products. It also became a quality control tactic because smaller inventories made quality checking easier on smaller, frequent deliveries. It has become an important aspect of supplier-customer relationships in today’s best businesses.

Outsourcing, or the use of a source other than internal capacity to accomplish some task or process, has become a major operational tactic in today’s downsizing-oriented firms. Outsourcing is based on the notion that strategies should be built around the core competencies that add the most value in the value chain and that functions or activities that add little value or that cannot be done cost effectively should be done outside the firm—outsourced. When done well, the firm gains a supplier that provides superior quality at lower cost than it could provide itself. JIT and outsourcing have increased the strategic importance of the purchasing function. Outsourcing must include intense quality control by the buyer. ValuJet’s tragic 1996 crash in the Everglades was caused by poor quality control over its outsourced maintenance providers.

The Internet and e-commerce have begun to revolutionize functional tactics in operations and marketing. How we sell, where we make things, how we logistically coordinate what we do—all of these basic business functions and questions have new perspectives and ways of being addressed because of the technological effect of the globally emerging ways we link together electronically, quickly, and accurately.

## FUNCTIONAL TACTICS IN MARKETING

The role of the marketing function is to achieve the firm’s objectives by bringing about the profitable sale of the business’s products/services in target markets. Marketing tactics should guide sales and marketing managers in determining who will sell what, where, to whom, in what quantity, and how. Marketing tactics at a minimum should address four fundamental areas: products, price, place, and promotion. Exhibit 10.A2 highlights typical questions marketing tactics should address.

In addition to the basic issues raised in Exhibit 10.A2, marketing tactics today must guide managers addressing the effect of the communication revolution and the increased diversity among market niches worldwide. The Internet and the accelerating blend of computers and telecommunications has facilitated instantaneous access to several places around the world. A producer of plastic kayaks in Easley, South Carolina, receives orders from somewhere in the world about every 30 minutes over the Internet without any traditional distribution structure or global advertising. It fills the order within five days without any transportation capability. Speed linked to the ability to communicate instantaneously is causing marketing tacticians to radically rethink what they need to do to remain competitive and maximize value.

Diversity has accelerated because of communication technology, logistical capability worldwide, and advancements in flexible manufacturing systems. The diversity that has resulted is a virtual explosion of market niches—adaptations of products to serve hundreds of distinct and diverse customer segments that would previously have been served with more mass-market, generic products or services. Where firms used to rely on volume associated with mass markets to lower costs, they now encounter smaller niche players carving out subsegments they can serve more timely *and* more cost effectively. These new, smaller players lack the bureaucracy and committee approach that burdens the larger firms. They make decisions, outsource, incorporate product modifications, and make other agile adjustments to niche market needs before their larger competitors get through the first phase of committee-based decision making.

## FUNCTIONAL TACTICS IN ACCOUNTING AND FINANCE

While most functional tactics guide implementation in the immediate future, the time frame for functional tactics in the area of finance varies because these tactics direct the use of financial resources in support of the business strategy, long-term goals, and annual objectives. Financial tactics with longer time perspectives guide financial managers in long-term capital investment, debt financing, dividend allocation, and leveraging. Financial tactics designed to manage working



**EXHIBIT 10.A2 Key Functional Tactics in Marketing**

Functional Tactic	Typical Questions That the Functional Tactic Should Answer
Product (or service)	Which products do we emphasize? Which products/services contribute most to profitability? What product/service image do we seek to project? What consumer needs does the product/service seek to meet? What changes should be influencing our customer orientation?
Price	Are we competing primarily on price? Can we offer discounts on other pricing modifications? Are our pricing policies standard nationally, or is there regional control? What price segments are we targeting (high, medium, low, and so on)? What is the gross profit margin? Do we emphasize cost/demand or competition-oriented pricing?
Place	What level of market coverage is necessary? Are there priority geographic areas? What are the key channels of distribution? What are the channel objectives, structure, and management? Should the marketing managers change their degree of reliance on distributors, sales reps, and direct selling? What sales organization do we want? Is the salesforce organized around territory, market, or product?
Promotion	What are the key promotion priorities and approaches? Which advertising/communication priorities and approaches are linked to different products, markets, and territories? Which media would be most consistent with the total marketing strategy?

**EXHIBIT 10.A3 Key Functional Tactics in Finance and Accounting**

Functional Tactic	Typical Questions That the Functional Tactics Should Answer
Capital acquisition	What is an acceptable cost of capital? What is the desired proportion of short- and long-term debt? Preferred and common equity? What balance is desired between internal and external funding? What risk and ownership restrictions are appropriate? What level and forms of leasing should be used?
Capital allocation	What are the priorities for capital allocation projects? On what basis should the final selection of projects be made? What level of capital allocation can be made by operating managers without higher approval?
Dividend and working capital management	What portion of earnings should be paid out as dividends? How important is dividend stability? Are things other than cash appropriate as dividends? What are the cash flow requirements? The minimum and maximum cash balances? How liberal/conservative should the credit policies be? What limits, payment terms, and collection procedures are necessary? What payment timing and procedure should be followed?

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capital and short-term assets have a more immediate focus. Exhibit 10.A3 highlights some key questions that financial tactics must answer.

Accounting managers have seen their need to contribute value increasingly scrutinized. Traditional expectations centered around financial accounting; reporting requirements from bank and SEC entities and tax law compliance remain areas in which actions are dictated by outside governance. Managerial accounting, where managers are responsible for keeping records of costs and the use of funds within their company, has taken on increased strategic significance in the last decade. This change has

involved two tactical areas: (1) how to account for costs of creating and providing their business’s products and services and (2) valuing the business, particularly among publicly traded companies.

Managerial cost accounting has traditionally provided information for managers using cost categories like those shown on the left side of the following table. However, value chain advocates have been increasingly successful getting managers to seek activity-based cost accounting information like that shown on the right side. In so doing, accounting is becoming a more critical, relevant source of information that truly benefits strategic management.

Traditional Cost Accounting in a Purchasing Department		Activity-Based Cost Accounting in the Same Purchasing Department	
Wages and salaries	\$350,000	Evaluate supplier capabilities	\$135,750
Employee benefits	115,000	Process purchase orders	82,100
Supplies	6,500	Expedite supplier deliveries	23,500
Travel	2,400	Expedite internal processing	15,840
Depreciation	17,000	Check quality of items purchased	94,300
Other fixed charges	124,000	Check incoming deliveries against purchase orders	48,450
Miscellaneous operating expenses	25,250	Resolve problems	110,000
	<u>\$640,150</u>	Internal administration	130,210
			<u>\$640,150</u>

Source: From Terence P. Pare, “A New Tool for Managing Costs,” *Fortune*, June 14, 1993, pp. 124–29. Copyright, © 1993, Time, Inc. All rights reserved.

## FUNCTIONAL TACTICS IN RESEARCH AND DEVELOPMENT

With the increasing rate of technological change in most competitive industries, research and development has assumed a key strategic role in many firms. In the technology-intensive computer and pharmaceutical industries, for example, firms typically spend between 4 and 6 percent, respectively, of their sales dollars on R&D. In other industries, such as the hotel/motel and construction industries, R&D spending is less than 1 percent of sales. Thus, functional R&D tactics may be more critical instruments of the business strategy in some industries than in others.

Exhibit 10.A4 illustrates the types of questions addressed by R&D tactics. First, R&D tactics should clarify whether basic research or product development research will be emphasized. Several major oil companies now have solar energy subsidiaries in which basic research is emphasized, while the smaller oil companies emphasize product development research.

The choice of emphasis between basic research and product development also involves the time horizon for R&D efforts. Should these efforts be focused on the near term or

the long term? The solar energy subsidiaries of the major oil companies have long-term perspectives, while the smaller oil companies focus on creating products now in order to establish a competitive niche in the growing solar industry.

R&D tactics also involve organization of the R&D function. For example, should R&D work be conducted solely within the firm, or should portions of that work be contracted out? A closely related issue is whether R&D should be centralized or decentralized. What emphasis should be placed on process R&D versus product R&D?

Decisions on all of these questions are influenced by the firm’s R&D posture, which can be offensive or defensive, or both. If that posture is offensive, as is true for small high-technology firms, the firm will emphasize technological innovation and new-product development as the basis for its future success. This orientation entails high risks (and high payoffs) and demands considerable technological skill, forecasting expertise, and the ability to quickly transform innovations into commercial products.

A defensive R&D posture emphasizes product modification and the ability to copy or acquire new technology. Converse Shoes is a good example of a firm with such an R&D posture. Faced with the massive R&D budgets of Nike and Reebok, Converse placed R&D emphasis on

**EXHIBIT 10.A4 Key Functional Tactics in R&D**

R&D Decision Area	Typical Questions That the Functional Tactics Should Answer
Basic research versus product and process development	To what extent should innovation and breakthrough research be emphasized? In relation to the emphasis on product development, refinement, and modification? What critical operating processes need R&D attention? What new projects are necessary to support growth?
Time horizon	Is the emphasis short term or long term? Which orientation best supports the business strategy? The marketing and production strategy?
Organizational fit	Should R&D be done in-house or contracted out? Should R&D be centralized or decentralized? What should be the relationship between the R&D units and product managers? Marketing managers? Production managers?
Basic R&D posture	Should the firm maintain an offensive posture, seeking to lead innovation in its industry? Should the firm adopt a defensive posture, responding to the innovations of its competitors?

**EXHIBIT 10.A5 Key Functional Tactics in HRM**

Functional Tactic	Typical Questions That HRM Tactics Should Answer
Recruitment, selection, and orientation	What key human resources are needed to support the chosen strategy? How do we recruit these human resources? How sophisticated should our selection process be? How should we introduce new employees to the organization?
Career development and training	What are our future human resource needs? How can we prepare our people to meet these needs? How can we help our people develop?
Compensation	What levels of pay are appropriate for the tasks we require? How can we motivate and retain good people? How should we interpret our payment, incentive, benefit, and seniority policies?
Evaluation, discipline, and control	How often should we evaluate our people? Formally or informally? What disciplinary steps should we take to deal with poor performance or inappropriate behavior? In what ways should we “control” individual and group performance?
Labor relations and equal opportunity requirements	How can we maximize labor-management cooperation? How do our personnel practices affect women/minorities? Should we have hiring policies?

bolstering the product life cycle of its prime products (particularly canvas shoes).

Large companies with some degree of technological leadership often use a combination of offensive and defensive R&D strategy. GE in the electrical industry, IBM in the computer industry, and Du Pont in the chemical industry all have a defensive R&D posture for currently available products *and* an offensive R&D posture in basic, long-term research.

**FUNCTIONAL TACTICS IN HUMAN RESOURCE MANAGEMENT**

The strategic importance of human resource management (HRM) tactics received widespread endorsement in the 1990s. HRM tactics aid long-term success in the development of managerial talent and competent employees, the creation of systems to manage compensation or regulatory concerns, and guiding the effective

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utilization of human resources to achieve both the firm’s short-term objectives and employees’ satisfaction and development. HRM tactics are helpful in the areas shown in Exhibit 10.A5. The recruitment, selection, and orientation should establish the basic parameters for bringing new people into a firm and adapting them to “the way things are done” in the firm. The career development and training component should guide the action that personnel take to meet the future human resources needs of the overall business strategy. Merrill Lynch, a major brokerage firm whose long-term corporate strategy is to become a diversified financial service institution, has moved into such areas as investment banking, consumer credit, and venture capital. In support of its long-term objectives, it has incorporated extensive early-career training and ongoing career development programs to meet its expanding need for personnel with multiple competencies. Larger organizations need HRM tactics that guide decisions regarding labor relations; Equal Employment Opportunity Commission requirements; and employee compensation, discipline, and control.

Current trends in HRM parallel the reorientation of managerial accounting by looking at their cost structure anew. HRM’s “paradigm shift” involves looking at people expense as an investment in human capital. This involves looking at the business’s value chain and the “value” of human resource components along the various links in that chain. One of the results of this shift in perspective has been the downsizing and outsourcing phenomena of the last quarter century. While this has been traumatic for millions of employees in companies worldwide, its underlying basis involves an effort to examine the use of “human capital” to create value in ways that maximize the human contribution. This scrutiny continues to challenge the HRM area to include recent major trends to outsource some or all HRM activities not regarded as part of a firm’s core competence. The emerging implications for human resource management tactics may be a value-oriented perspective on the role of human resources in a business’s value chain as suggested here:

Traditional HRM Ideas	Emerging HRM Ideas
Emphasis solely on physical skills	Emphasis on total contribution to the firm
Expectation of predictable, repetitious behavior	Expectation of innovative and creative behavior
Comfort with stability and conformity	Tolerance of ambiguity and change
Avoidance of responsibility and decision making	Accepting responsibility for making decisions
Training covering only specific tasks	Open-ended commitment; broad continuous development
Emphasis placed on outcomes and results	Emphasis placed on processes and means
High concern for quantity and throughput	High concern for total customer value
Concern for individual efficiency	Concern for overall effectiveness
Functional and subfunctional specialization	Cross-functional integration
Labor force seen as unnecessary expense	Labor force seen as critical investment
Workforce is management’s adversary	Management and workforce are partners

Source: From A. Miller and G. Dess, *Strategic Management*, 2002, p. 400. Copyright © 2002 The McGraw-Hill Companies, Inc. Reprinted with permission.

To summarize, functional tactics reflect how each major activity of a firm contributes to the implementation of the business strategy. The specificity of functional tactics and the involvement of operating managers in their development

help ensure understanding of and commitment to the chosen strategy. A related step in implementation is the development of policies that empower operating managers and their subordinates to make decisions and to act autonomously.