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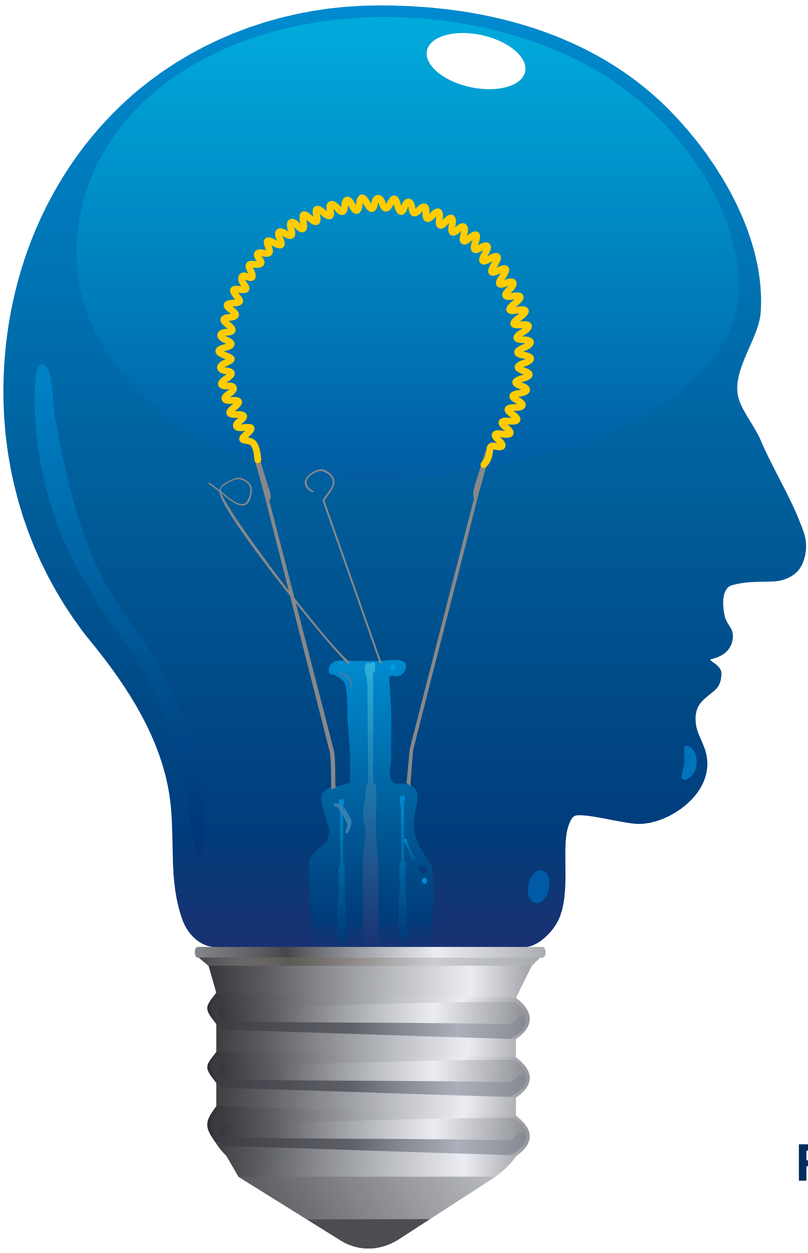

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Introduction

Welcome to the first issue of *RSM Insight.* We have created this publication in order to make easily accessible to business leaders the outstanding research of RSM faculty. In each issue we will provide a short, typically two-page, summary rewritten in business rather than academic language, of a few recent articles published by RSM faculty on topics that are particularly timely and relevant for senior executives. We would be very interested to receive any comments from you about the summaries, either directly to the authors or to me.

Best wishes,

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Nurturing good ideas

by Jan van den Ende and Bob Kijkuit

Managers know that simply generating lots of ideas doesn't necessarily produce good ones. What companies need are systems that nurture good ideas and cull bad ones—before they ever reach the decision maker's desk. Our research shows that tapping the input of many people early in the process can help ensure that the best ideas rise to the top.

It's not uncommon for companies' idea-generation activities to produce thousands of ideas. Reviewing all of them to find the best is resource intensive and doesn't guarantee high-quality results. After all, how seriously will reviewers consider idea number 532? Probably it will get only superficial attention, and it will be selected for development only if its usefulness is immediately apparent. This screening approach is likely to leave potential blockbuster ideas on the cutting-room floor.

Some firms, however, are taking steps to systematically improve the quality of ideas before they're submitted for review. They're encouraging employees to first discuss ideas with their colleagues to gain insights about their technical and market feasibility or how they fit with company objectives, which will either enhance the ideas' value or lead to their early and appropriate demise.

"People who tapped colleagues outside their departments were more successful; discussing an idea with them increased its chances of adoption, whereas discussions with colleagues from the same department didn't".

Consider how this works at Unilever, where we followed the development of ideas at the company's food labs in a 14-month study. Employees there usually discussed an idea with colleagues and, based on their feedback, made changes in the idea before submitting it. People who tapped colleagues outside their departments were more successful; discussing an idea with them increased its chances of adoption, whereas discussions with colleagues from the same department didn't.

Interestingly, communication with friends or trusted colleagues appeared to aid adoption, probably because their input tended to be richer and offered more constructive and critical feedback, leading to more substantial changes to the idea itself. What's more, the greater the number of perspectives an employee got, the higher his idea's chances of being adopted were.

Other firms take a similar tack. At the biotechnology research company KeyGene, management advises employees to discuss ideas with others before submitting them to a review committee. In IBM's ThinkPlace program, "catalysts" create networks of people around ideas. Employees post ideas on an intranet site; catalysts select promising ones and invite comment or support from people in their network. Eventually, they ask one or more network members, not necessarily the idea originator, to present the concept to a line manager or an internal innovation fund.

This approach to idea development offers a clear payoff in efficiency and in the quality of ideas. But it has another benefit as well: It enhances motivation by improving the odds of success and reducing the chance that an employee will invest unduly in an idea that's likely to fail. ■

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Superstition undermines alliances

by Koen Heimeriks

Many studies conclude that the more alliances a company forms, the better it becomes at them. That makes intuitive sense—but it's not always true.

My own study of nearly 200 firms, which collectively had formed more than 3,400 alliances, found that on average the results of firms with the most experience were worse than those of firms with only moderate experience, as gauged by the percentage of alliances that achieved their goals.

Previous research has suggested that firms with a lot of experience can become overconfident of their skills and be misled by "superstitious learning"—learning based on unsupported notions about cause and effect. Often these firms have sophisticated, centralized alliance functions that codify and enforce standard practices. But if some of those practices draw on superstitious ideas about what specific actions account for good or bad outcomes, firms can perpetuate suboptimal practices, inhibit learning, and undermine alliance performance.

What, then, determines whether a firm that actively pursues alliances will perform well? My findings suggest that it is the nature of the firm's alliance mechanisms. The greater its alliance experience, the more likely it is to have institutionalizing mechanisms, which formalize decision making and enforce standardized practices such as protocols for selecting partners. But what those mechanisms offer in efficiency they lack in flexibility, particularly when it comes to learning from successes and mistakes that are clearly associated with specific actions. That's where integrating mechanisms can offer insight. They encourage employees to share experiences from previous alliances and engage in group problem solving, nurturing a collaborative mind-set and willingness to improvise. This fosters experimentation and allows companies to adapt practices to new contexts—processes that promote truly effective practices and continual improvement.

Most of the companies I studied use both institutionalizing and integrating mechanisms. How they balanced the two seemed to be a key to success. The highly experienced firms, which relied predominantly on institutionalizing mechanisms, achieved an alliance success rate of 50%, somewhat below average for the entire database. These mechanisms do not seem to improve competence but, rather, mirror confidence. Firms that, in contrast, extensively used integrating mechanisms realized an alliance success rate of 71% on average.

Managers often talk about how they tolerate productive mistakes—errors employees and the company learn from. In the case of alliances, my research suggests, mere tolerance is probably not enough. Managers should create mechanisms that encourage thoughtful trial-and-error approaches and deliberate lesson sharing. ■

"What, then, determines whether a firm that actively pursues alliances will perform well?"

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Avoiding reputation damage in financial restatements

by Fred H. M. Gertsen, Cees B. M. van Riel and Guido Berens

If your company is forced to issue a financial restatement, how can the right managerial behaviour help to minimise the damage to corporate reputation?

Do we trust our public companies to always behave honourably and above board, when it comes to presenting their figures? The answer is debatable. First Enron, then Worldcom, and thereafter a succession of other high-profile accounting scandals have generated negative headlines in the international press and taken their toll on investor confidence and public trust.

In most countries, corporate governance and accounting requirements have become more stringent post-Enron. Demands for greater transparency mean that companies are legally obliged to issue financial restatements if their accounts differ from those previously presented, for example in annual reports.

Market and press reactions to such revisions are, predictably, negative, and most who have issued financial restatements have faced serious problems – substantial financial losses and falls in share price, replacement of their full Board of Directors, and, in the worst cases, even bankruptcy.

Yet not all restatements need have such devastating effects, argue researchers from RSM. Findings from their major study of financial restatement cases, involving leading US and European companies, suggest that companies can manage such crises judiciously so as to minimise or limit the damage to reputation and future financial performance.

The research team – Fred Gertsen of PriceWaterhouseCoopers, and Professors Cees van Riel and Guido Berens of RSM's Centre for Corporate Communication – saw opportunities for generating better understanding not only of what triggers the need for financial restatements and determines their severity but, more critically, how to handle them most effectively, should the need arise.

The goal of our research was to define such guidelines, by providing insight into the managerial behaviours that can influence the damage done ▶

Avoiding reputation damage in financial restatements (continued)

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by a restatement," says Van Riel.

Part of the initial problem, he explains, was that onlookers making judgements often did not discriminate sufficiently between different levels of financial restatement and their implications. "The first thing we did was to look at what categories of financial restatements actually exist, and what distinctions could be made between them.

"We came up with four types, based on two important criteria. Firstly the degrees to which people perceive distortion, ie, what is the potential impact of the financial restatement on the organisation's future performance. Secondly, the perceived degree of malicious intent. Are the management knowingly and purposely supplying distorted financial figures for their own gain?"

"Company executives rounding on one another or shifting the blame leaves analysts questioning whether corporate governance is still in control."

Many financial restatements fall into the category the team dubbed 'white lies': little distortion and little or no malicious intent, perhaps stemming from human accounting errors. "At worst, we had what we called 'black magic fraud': grave cases, like Enron, with enormous financial implications and a clear and corrupt intent. In between we had two other categories: 'grey accounting hocus-pocus' (low on malicious intent but high on distortion) and 'purple delusion' (low on distortion but high on malicious intent)."

To cover all four categories, they examined financial restatements in 14 companies, both US and European. The restatements occurred in different industries, countries and periods, but all had featured prominently in the international financial press. Well-known North American names included Goodyear, Nortel, Cablevision and the Federal Home Loan Mortgage Corporate (the US's largest mortgage provider, known as Freddie Mac, which hit the headlines again in the summer of 2008). The four European firms included were Shell, Ahold, Adecco and the Italian food company Parmalat.

By studying a wealth of company annual reports, corporate websites, official press releases as well as external press coverage and transcripts of all the analyst question sessions, Van Riel and colleagues were able to track just how the companies both communicated with the outside world – and responded to the surrounding speculation and enquiries – through the whole period of each financial restatement crisis.

The managerial challenges

This detailed analysis revealed some key managerial issues arising from financial restatement. None are necessarily disastrous in themselves but they are difficult to manage as they often occur in combination, intensifying the pressure.

The very fact of being investigated, whether by the Justice Department or other regulatory bodies, casts suspicion on, and potentially discredits, senior management who are often already implicated. As companies take remedial action, heads start to roll. When new management arrives, actions and decisions from the past are subject to minute scrutiny and hindsight also comes into play – further discrediting the judgement of past managers.

In what the team called the 'tip-of-the-iceberg effect', a complete loss of confidence can be triggered by a detail of negligible financial import. The spotlight then turns on the company's other accounting and disclosure practices, perhaps revealing further irregularities and errors – and hitting market value once again. "What the organisation tends to do first is to ask for new external accountants," says Van Riel. "They look not only at the specific elements where the financial restatement is focused, but do the whole thing again. And they come in with a totally different mindset from the original 'house' external accountants. They really dig deep and want to find dirt."

The need for financial restatement can also lead to paralysis in corporate communications. Perhaps through fear or lack of experience, some companies instinctively adopt a defensive communication strategy, or worse still, fail to communicate altogether.

Comprehension gaps are also evident, particularly a failure to appreciate internally how the market and analysts will interpret and respond to company statements. Clear distinctions were necessary between restatements required because of accounting 'irregularities' – implying intent – and those resulting from simpler human accounting 'errors', yet observers without professional accounting training (as is generally true within the market) cannot distinguish sufficiently between the two. From the company's standpoint, differentiating between 'good' and 'bad' restatement situations in a nuanced way that will allow outsiders to assess accurately the severity of the situation requires considerable force of argument and the right accounting rhetoric – and management's capacity to do this well and at the appropriate time is critical.

Communication can also be hampered by mixed messages going out when the management, auditors and other gatekeepers are not 'aligned' – that is, where they have not reached a common view on how to handle the situation and especially how/what to communicate to the outside world. ▶

The research team identified four distinctions between categories of financial restatement and labelled them:

- **'White Lies'**
- **'Black Magic Fraud'**
- **'Grey Accounting Hocus-pocus'**
- **'Purple Delusion'**

Avoiding reputation damage in financial restatements (continued)

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Top tips for managing financial restatements

So how can companies limit the damage? Addressing five key things can help, says Van Riel. These were areas where differences can really show – where they are handled well (as in the case of Freddie Mac), the benefits are very clearly apparent.

• Confirm the nature of the problem

Giving statements that confirm the nature of the problem and volunteering explanations to analysts or the media noticeably improves the understanding of these stakeholders. That is critical in limiting distortion, because where there is insufficient understanding negative speculation can circulate. "This fits with what we know from research about consumer inference-making," says Van Riel, "namely that people tend to lower their evaluation of a product when they have insufficient information about it."

But, he adds, the research also showed that in these situations executives tend to answer questions in a relatively straightforward way. "Few saw questions as an opportunity to explain issues raised in greater detail or used a question as an opening to persuade the markets that correct strategic decisions have been taken."

• Take the blame

Company executives rounding on one another or shifting the blame from the company to third parties leaves analysts questioning whether corporate governance is still in control. This can make the situation seem worse, and can also be damaging to executives' perceived trustworthiness. Rarely did companies assume the blame directly for the underlying problems – understandable, as this might leave them more open to litigation.

But, as other research has suggested, blame-taking is essential in restoring trust: "When managers avoid blame for something that is clearly their responsibility, this is likely to erode public trust even further. If accepting the blame helps to restore trust where 'honest' mistakes are concerned, does this necessarily hold good where lapses of ethics are concerned, where malicious intent is clearly involved?" This is a difficult area, concedes Van Riel, as the research evidence from elsewhere suggests not.

• Communicate openly

Open communication is important, right from the outset. The scope of disclosure, ie, how much the company does or does not say, is critical because investors and others in the market will regard it as a proxy for the seriousness of the accounting issues. Providing more details leads them to assume the problems are less widespread, and so again decreases the perceived level of distortion.

Being upfront about how the restatement may affect business operations or financing is seen as a 'constructive factor' in the dialogue between companies and analysts. Most of the companies studied, however, gave general statements, intended to reassure, rather than precise details.

"The cases we analysed provide evidence that precise command of accounting language as a quality of financial leadership has been dismissed in favour of 'governance credos' and sound business performance litany."

Another key mismatch is that while markets expect chief executives to explain technical details and demonstrate their grasp of technical accounting issues, CEOs fight shy of this, leaving such discussions to their chief financial officers. "It was one of the most striking findings," says Van Riel, and "also one of the most difficult to address. It's very hard to say to people at the top of the organisation, your knowledge of finance is just too limited. How do you handle that? How do you tell a CEO that he doesn't understand enough of the financial elements?"

Yet, the researchers argue, with systems now requiring greater scrutiny of procedures and wider public access to information, the need for a detailed awareness of financial procedures has intensified. Both CFO and CEO must bear responsibility for financial sign-off to regulators. Insufficient technical knowledge of accounting will no longer be acceptable in mitigation of any reporting irregularities.

• Take corporate governance measures

Demonstrating not only your commitment to corporate governance but also your ability to take appropriate measures is vital. Where companies do this, stock and bond prices improve accordingly, because those measures lessen fears that the company will act with malicious intent in future.

Wherever fraud or intent was suspected, boards and CEOs took great pains to assure analysts and the media that appropriate action had been taken. "In some cases we saw how remedial actions – often those which were regulatory – had been taken under time pressure. Members of senior management were sacrificed for the cause, but without any public justification of what that cause actually was," says Van Riel.

As a result, some companies scored relatively highly on governance actions but far less well on communicating openly about the problem.

• Act in compliance with the rules

The cases showed that adhering closely to policies and regulations after the need for a restatement helps to rebuild trust, presumably because the market again becomes more confident that there will not be further instances of malicious intent.

Van Riel is adamant that while financial restatements will still be tough to weather, taking the right attitude from the start can make an enormous difference. "Stubborn behaviour is really not helpful," he says. "What we have seen is that the way to solve a problem like this is first and foremost to be open from the beginning. Taking the blame because you were responsible, and that's your role. You have to show that you really are being responsible; that you care about the corporate governance measures, and that you are truly acting in compliance with these regulations. Those who did this – as Freddie Mac did – really benefited." ■

"Demonstrating not only your commitment to corporate governance but also your ability to take appropriate measures is vital."

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Measure for measure: new ways of looking at the long-term performance of firms

by George S. Yip, Timothy M. Devinney and Gerry Johnson

The need for sustainable long-term performance is an expectation driving the actions of those at the top of organisations. Yet there are few illusions about just how difficult that is to achieve – nor is it easy to determine precisely what should be measured and how.

The difficulties managers face in sustaining long-term performance arise not just from a competitive environment that naturally flattens out a firm's performance. There are also inherent problems in accounting for the multidimensional character of performance as it is commonly understood and measured. We need to understand what it means to perform, and to find robust and consistent ways of measuring that.

Senior managers typically face three particular challenges in measuring performance:

• how to balance short-term and long-term performance
• how to deal with different measures of performance which may throw up conflicting results
• how to find the right peer comparators

Such issues were very much in our minds when deciding on a new approach for our recent study, which examined the financial performance of 215 of the UK's largest public companies, across 38 industries, from 1984 to 2003. What was striking was that only 13% of those firms achieved consistently superior performance when compared with their British and international industry peers.

Some of our qualifiers – such as BP, Cadbury Schweppes or Tesco – would have been named by the most casual observer. Others are far less well-known niche players, such as the Scottish soft drinks manufacturer AG Barr (producers of Irn-Bru) and Bespak, producer of medical devices for drug delivery.

The method we chose was frontier analysis, an input-output efficiency measurement technique more commonly used in economics and operations research. It has, however, proved valuable in evaluating the performance of organisations with no direct profit imperative, such as hospitals, and those with multiple inputs and outputs.

Frontier analysis undoubtedly offers real potential for companies looking to improve their strategic management. And it could prove equally useful for investment analysts, board directors, policy makers and others interested in how companies are performing.

It involves quite complex statistical processes, but essentially it is a sophisticated form of benchmarking. It focuses not on absolute measures of performance but on actual extremes of performance for the industry on any given measure. This enables you to define a frontier for each type of industry/peer group, against which you can then plot the relative performance of firms.

Plotting annual deviation to show how far a company is from the frontier each year provides a graphic picture of performance over an entire period, and makes it easier to pinpoint periods of superior or inferior performance. Even more importantly, it can reveal clearly how performance tracks over time

relative to a defined maximum set by selected peers.

The logic is that a firm is being benchmarked not just against other firms' performance in a given year but against any firm's performance in any given year.

The beauty of the frontier approach is that it can accommodate any number and mixture of measures and still allow companies to be ranked against each other, even where they excel on different criteria. In this sense, frontier analysis

"Frontier analysis undoubtedly offers real potential for companies looking to improve their strategic management."

can compare apples with oranges!

The mix of measures used should not only reflect the various interests of different corporate stakeholders but also be relevant to the strategic ▸

Measure for measure: new ways of looking at the long-term performance of firms (continued)

by George S. Yip, Timothy M. Devinney and Gerry Johnson

decisions being made by managers, and to what top managers can influence. The criteria will almost certainly differ for different firms, depending on their age and operating environment. What is vital is that the measures should be sufficiently broad and diverse – choosing ones that are too similar will yield less useful information about any ranking order.

For our UK study, for example, we selected five performance measures: profit margin, return on shareholders funds, return on total assets, return on capital employed, and cash flow to operating revenues. All represent precisely the type of information used by investors, managers and key stakeholders to assess how well a firm is performing.

Selecting the right comparators to include both domestic and international peers requires careful thought, but the technique offers valuable flexibility for companies operating in multiple sectors. While frontier analysis does not eliminate the problem of company diversity it reduces its effect by allowing different companies to, in effect, select their own dimensions of performance. So, for example, both Cadbury-Schweppes and Unilever qualified in the food category, despite having quite different product mixes.

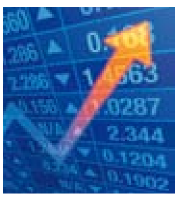
“What is vital is that the measures should be sufficiently broad and diverse...”

Where a company has sufficiently diverse businesses to require analysis in more than one industry, the exercise can be repeated placing the company in different sectors.

If a different answer emerges – for example, if the same company shows up as a long-term superior performer when compared to peers in one industry but not in another – that is a valuable finding, which the company might use to consider rebalancing its portfolio of businesses towards those sectors in which it qualifies as a long-term superior performer and away from those in which it does not.

You could also use this technique alongside business portfolio analysis to evaluate whether a company is in the right mix of industries.

Getting the right view of performance can make a huge difference in getting the right performance. ■



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