Fundamentals of Strategic Management

CHAPTER 1

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Chapter Outline

What Is Strategic Management?

Intended and Realized Strategies

Scientific and Artistic Perspectives on Strategic Management

Influences on Strategic Management

Corporate Governance and Boards of Directors

Strategic Decisions

Artificial Intelligence

The Global Imperative

Learning Objectives

1. Identify the strategic management process and explain how it can be applied to an organization.
2. Describe the difference between intended and realized strategies.
3. Define the three primary contributing theoretical influences to the strategic management field.
4. Explain the corporate governance process.
5. Describe the difference between strategic and nonstrategic decisions.
6. Discuss how artificial intelligence affects strategic management.

What do WeWork, Rite Aid, Yellow Corp, and Bed, Bath & Beyond have in common? Each of these recognized companies filed for bankruptcy in 2023. Each firm failed for different reasons. WeWork's office-sharing model imploded when COVID-19 sent workers home, Rite Aid succumbed to stiff competition from CVS and Walgreens, Yellow Corp was not managed well, and Bed, Bath & Beyond struggled to compete with Amazon and other online retailers. Sometimes, bad luck plays a role.

Nonetheless, there are some fundamental strategic differences between most successful and unsuccessful firms. Successful companies typically plan, prepare, and execute more effectively than their rivals. Likewise, those with competent leaders capable of thinking strategically usually fare the best during difficult times. Strategy matters.

This book is about strategic management—developing a systematic, strategic perspective for managing an organization. The model presented herein employs the language of profit-seeking firms, such as *industries*, *corporate restructuring*, *production costs*, and *product differentiation*. The strategic principles presented in this book are not limited to manufacturers and service firms but can be applied to nonprofit organizations and government. Understanding and applying them can help make any organization more successful.

Strategic management is more important than ever. Today's business world is global, internet-driven, and obsessed with speed, and the challenges it creates for top managers are often complex, ambiguous, and unstructured. Add to this the constant allegations of top-management wrongdoings, increasing executive compensation, and global economic shocks like COVID-19, and it is easy to see why leaders are under tremendous pressure to respond to strategic problems quickly, decisively, and responsibly. Indeed, the need for effective strategic management has never been more pronounced.

This chapter introduces the notion of strategic management, highlights its importance, and presents a five-step process for strategically analyzing an organization. The remaining chapters expand on each step in the process, emphasizing their application to ongoing enterprises. These steps overlap in the real world, but each step is considered independently.

What Is Strategic Management?

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

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

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

Each organization exists for a purpose. Its **mission** is a broadly defined but enduring statement of purpose that identifies the scope of an organization's operations and its offerings to affected groups and entities. Most established organizations have developed a formal mission statement. Tesla's mission is "to accelerate the world's transition to sustainable energy." JetBlue seeks "to inspire humanity, both in the air and on the ground." Missions are discussed in more detail in Chapter 5.

Strategy refers to top management's plans to develop and sustain **competitive advantage**—a situation whereby a firm's successful strategies cannot be easily duplicated by competitors[1]—so that the organization's mission is fulfilled.[2] This definition starts with the notion that an organization has a plan, its managers understand how to achieve competitive advantage, and its members know the mission—why the company exists. Sometimes, these assumptions do not hold; many strategic problems emanate from ill-conceived strategies. Sometimes, managers disagree about an organization's competitive advantage, mission, or whether a strategic plan is even necessary.[3] Comments such as "We're too busy to focus on developing a strategy" or "I'm not exactly sure what my company is trying to accomplish" are too common in many organizations.

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

Strategic management is a broader term than *strategy*. It is a process that includes top management's analysis of the organization's environment before formulating a strategy, as well as the plan for implementation and control of the strategy. Put another way, the difference between a strategy and the strategic management process is that the latter includes considering what must be done before a strategy is formulated by assessing whether an implemented strategy was successful. The strategic management process can

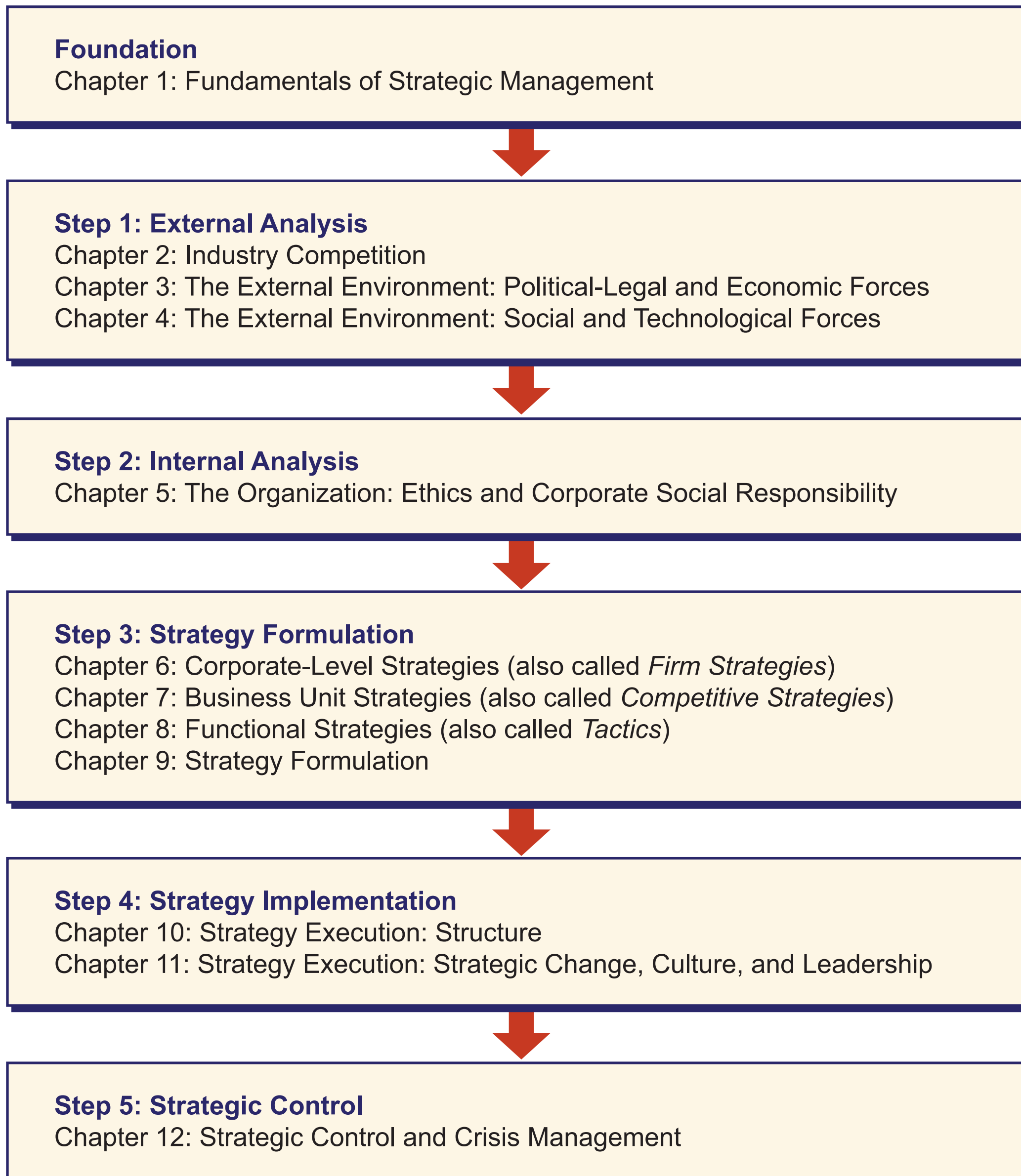

FIGURE 1-1
Organization of the Book

be summarized in five steps, each of which is discussed in greater detail in subsequent chapters of the book (see Figure 1-1)[4]:

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

The sequential order of the steps is logical. A thorough understanding of the organization and its environment is essential if the appropriate strategy is to be developed, implemented, and controlled. Arguably, step 2 could occur before step 1. However, the external environment is analyzed before the internal environment (see Figure 1-1) because internal goals, resources, and competencies are viewed *relative* to rivals and are understood within the context of the industry and the factors that drive it. For example, Hyatt's "World of Hyatt" loyalty program is only a company strength if it is better than similar programs offered by Marriott, Hilton, and other competitors. In this respect, a firm is understood within the context of its environment.

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

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

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

The second economic concept linked to strategic management is **subjective value**, the idea that a resource's value is determined by the individual or organization possessing it, not an objective measure that would be the same for all firms. For example, having a highly trained workforce with strong technical skills is of greater value to an organization that emphasizes technology in production than to one with a labor-intensive approach. Subjective value explains why one firm is willing to pay a premium (i.e., more than the value based on the current stock price) to acquire another firm; its managers believe the firm is more valuable as part of the acquiring firm. Indeed, marketplace transactions occur because two parties value the same product or service differently. The efficient market hypothesis explains why companies with similar resources tend to perform at similar levels, but subjective value explains why substantial performance variation can exist among comparable firms.

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

Inside organizations, strategies are being formulated, implemented, and controlled simultaneously while external and internal factors are continually reassessed. In addition, changes in one stage of the strategic management process will inevitably affect other stages. Firms typically modify their strategies during implementation as conditions change. Hence, because these steps are so tightly intertwined, *insiders* treat all the steps as a single integrated, ongoing process.[5]

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

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

An effective strategy is built on the organization's **business model**, the mechanism whereby the organization seeks to earn a profit by selling its goods or services. Although all firms seek to produce and sell a product or service at a price higher than its production and overhead costs, a business model is more detailed. For example, a magazine publisher might adopt a "subscription model," an "advertising model," or perhaps some combination of the two. Profits would be generated primarily from readers under the subscription model but from advertisers under the advertising model. Identifying a firm's business

model can become more complicated when intricate details are considered. Progressive firms often devise innovative business models that extract revenue—and ultimately, profits—from sources not identified by competitors.

Consider the *razor-and-blades* business model developed by Gillette. A company gives away or deeply discounts a product—the razor—while planning to profit from future sales of required replacement or complementary products—the blades. Customers willing to sign a two-year service contract might receive a "free" or deeply discounted cell phone. Computer printers are often sold below production cost, but customers must periodically replace the ink cartridges, high-margin items. This model is not foolproof, however. In a competitive marketplace, customers may purchase the required complementary products at lower prices from rivals not under pressure to recoup initial losses. Online companies like Harry's and Dollar Shave Club have challenged the razor-and-blades business model with a different, cheaper way to purchase shaving supplies. Aftermarket printer cartridges are often available from sellers on eBay at a fraction of the prices charged by manufacturers.

Successful business models can change over time, and many of the changes are internet-driven. For example, since the early 2000s, many authors have strayed from the traditional business model whereby book publishers offer contracts and pay 10–15% royalties. Leveraging advances in publishing software, social media, and a robust online retail book market, they have opted for a "self-publishing" model. Enterprising authors who publish their work also shoulder the initial risk but can net as much as a 70% return on e-book sales from companies like Amazon. More than 1 million books are self-published in the United States each year.

Consider the auto industry. Tesla sells its electric vehicles to consumers in the United States directly through the internet. Tesla does so out of necessity—the small carmaker lacks an extensive nationwide dealer network—and a desire to improve efficiency. Industry groups have attempted to block the move, arguing that carmakers should not be allowed to "bypass" franchised auto retailers. In some states, laws restricting direct sales have been in place for years to protect the territorial rights of local franchises. Tesla has no franchisees and has argued that such laws violate the company's right to choose how it sells its products.[6] Business models can also change rapidly. For example, until recently, most U.S. restaurants did not offer food delivery because it added a layer of complexity to their operations and seemed to conflict with the dine-in experience. Third-party delivery services challenged the prevailing logic by offering their services to multiple restaurants on a commission basis. The new approach gained widespread acceptance in the mid-2010s and grew substantially in 2019 when COVID-19 kept many customers at home. Growth waned when the pandemic subsided, creating a substantial challenge. Food delivery is an expensive business. After paying the restaurant and accounting for refunds, advertising, and promotion, an average $36 DoorDash order resulted in a loss of 90 cents. Margins are low, so delivery services must constantly improve efficiency and create economies of scale to generate profits. Nonetheless, companies like DoorDash, Uber Eats, and Grubhub have become household names, and many consumers still use food-delivery services postpandemic.[7]

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

Innovative business models can be found in retail, even in the Amazon era. David Schlessinger and Tom Vellios founded Five Below, Inc. in 2002. The retail chain grew from fewer than 200 stores following its initial public offering (IPO) in 2012 to over 1,500 in 2023, when traditional retailers were struggling amid pressure from online rivals. Five Below's business model differs from that of a typical dollar store and features a vast array of products priced at $5 or less, many of which are less expensive than on Amazon.

Its stores are relatively small—about 8,000 square feet—with shelving no higher than 5 feet. As Bradly Thomas, Key-Banc managing director of equity research, puts it, "No retailer is truly Amazon-proof, but [Five Below is] in a better position than most. You will save money if you shop at Five Below rather than on Amazon. Most retailers can't say that."[8]

Tru Kids, a new company created by the Toys "R" Us bankruptcy, controls the Toys "R" Us and Babies "R" Us brands going forward. Tru Kids opened two new Toys "R" Us stores in the United States in late 2019, but with a new business model. Unlike previous Toys "R" Us stores, the new ones were smaller (about 6,500 square feet) and included a playground environment. The business model changed as well. All toy sales at the new stores went directly to the manufacturers, which pay fees to Tru Kids as a middleman.[9] WHP Global acquired Toys "R" Us in 2021 and is leveraging the brand in the United Kingdom, India, and Mexico. In 2022, Toys "R" Us returned with 452 pop-up shows at Macy's stores throughout the United States. WHP continued U.S. expansion in 2024 with locations in airports on cruise ships.[10] WHP seeks to leverage the iconic brand with an updated business model in tune with postpandemic shopping patterns. However, the emergence of new internet-based business models has created some significant challenges. The business model for many lesser-known brands has shifted toward livestreaming of performances on YouNow and other apps. Much of the revenue is generated not through purchases but through virtual tips left by online fans.[11]

Amazon: Leveraging the Internet

Source: Skorzewiak/Shutterstock .com.

Many websites do not receive revenue directly from patrons but instead from advertisers based on traffic generated through the site. "Paying for clicks" has merits because advertisers are only required to compensate sites when prospective customers respond to an ad. However, tens of thousands of dubious websites have emerged in the last few years, each supported by "botnets," armies of hijacked computers working in unknown locations across the globe. The botnets create phony web traffic for advertisers, enabling the proprietors of these illegitimate sites to collect payments. The most sophisticated botnets appear to be authentic online consumers, pausing to view advertisements, clicking from site to site, watching videos, and even putting items in shopping carts. Hence, advertisers are paying for faux web traffic. Given the technological complexity and global nature of the problem, it is difficult to prosecute the perpetrators.[12] Hence, firms can benefit from innovative business models, but executing them can be more complicated than expected.

Business models can also include the concept of social entrepreneurship because profit is only one measure of company performance. Many entrepreneurs define success in part by examining the effects their products and services have on individuals or specific groups, such as the poor—the "bottom of the pyramid." TOMS donates a pair of shoes to the poor for each pair purchased, a pair of glasses for each pair of TOMS eyewear purchased, and a week of clean water for each bag of coffee purchased. From a social perspective, this business model can be judged on its profitability and its effects on alleviating poverty. From a marketing standpoint, this business model targets consumers who wish to purchase from firms with a social orientation. Consumers who want to "make a difference in the world" might be more inclined to buy TOMS shoes.

Although a successful strategy is built on the firm's business model, crafting one can be challenging. Factors typically associated with successful strategies include the following:

1. The organization's competitive environment is well understood.
2. Strengths and weaknesses are thoroughly and realistically assessed.

3. The strategy is consistent with the organization's mission and goals.
4. Plans for executing a strategy are designed with specificity before the strategy is implemented.
5. Possible future changes in a proposed strategy are evaluated before it is adopted.

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

Although some success factors are associated with the competitive environment in profit-seeking firms, strategic management is not limited to for-profit organizations. Top managers of any organization, regardless of profit or nonprofit status, must understand the organization's environment and capabilities and develop strategies to assist the enterprise in attaining its goals. Former Drexel University President Constantine Papadakis, for example, was widely considered a leading strategic thinker among top university executives. The innovative Greek immigrant promoted Drexel through aggressive marketing while campaigning for an all-digital library without books. In many respects, he managed the university in the same way that other executives manage profit-seeking enterprises. His annual salary was close to $1,000,000 in the years preceding his death in 2009, making him one of the highest-paid university presidents at the time.[13]

Intended and Realized Strategies

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

Henry Mintzberg introduced two terms to help clarify the shift that often occurs between strategy formulation and implementation. An **intended strategy** (i.e., what management planned initially) may be realized just as it was designed, in a modified form, or even in an entirely different way. The strategy that management intends is occasionally realized, but the intended strategy and the **realized strategy**—what management implements—usually differ.[14] Hence, the original strategy may be realized with desirable or undesirable results or modified as changes in the firm or the environment become known.

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

Realized strategy The strategy top management implements, which may differ significantly from the one originally intended.

Henry Mintzberg has contributed a lot to our current understanding of strategic thinking. His views often challenge conventional wisdom. Consider his 5 Ps for strategy at https://www.mindtools.com/a1snnzo/mintzbergs-5-ps-of-strategy.

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

Scientific and Artistic Perspectives on Strategic Management

There are two perspectives on the approach top executives should take to strategic management. Most strategy scholars have endorsed a *scientific perspective*, whereby strategic managers systematically assess the firm's external environment and evaluate the pros and cons of myriad alternatives before formulating a strategy. The business environment is seen as mostly objective, analyzable, and predictable. As such, strategic managers should

follow an orderly environmental, competitive, and internal analysis process and build the organization's strategy accordingly.

According to the scientific perspective, strategic managers should be trained, highly skilled analytical thinkers capable of digesting data from many sources and translating it into a coherent strategy for the firm. "Strategy scientists" tend to minimize the role of imagination and creativity in the strategy process. Many are not receptive to alternatives that do not emerge from a comprehensive, analytical approach.

Others have a different view. According to the *artistic perspective* on strategy, the lack of environmental predictability and the fast pace of change render elaborate strategy planning as suspect at best. Instead, strategists should incorporate large doses of creativity and intuition to design a comprehensive strategy for the firm.[15] Henry Mintzberg's notion of a craftsperson—encompassing individual skill, dedication, and perfection through mastery of detail—embodies the artistic model. The strategy artist senses the state of the organization, interprets its subtleties, and seeks to mold its strategy like a potter molds clay. The artist visualizes the outcomes of various alternatives and ultimately charts a course based on holistic thinking, intuition, and imagination.[16] "Strategy artists" may even view strategic planning exercises as time poorly spent and may not be as likely as those in the science school to maximize the value of systematic planning.[17]

This book emphasizes the scientific view. Creativity and innovation are essential and encouraged but are most likely to translate into organizational success as part of a comprehensive, systematic approach to strategic management. Nonetheless, the type of formal strategic planning proposed in this text is not without its critics. Some contend that such models are too complicated or that they apply only to businesses in highly certain environments.[18] Mintzberg and others have argued that a traditional strategic planning approach is too stodgy and stifles the creativity and imagination central to formulating an effective strategy.[19]

These criticisms of traditional, "legacy" strategic planning have merit. Although the strategic management process is sequential, firms function in a fast-paced environment. **Strategic thinking**—applying the process and principles utilized in strategic planning sessions to ongoing strategic challenges—is also important. Effective strategic leaders are masters at both formal strategic planning and strategic thinking.

Strategic thinking The application of the process and principles utilized in strategic planning sessions to ongoing strategic challenges.

Influences on Strategic Management

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

The roots of the strategic management field can be traced to the 1950s, when the discipline was initially called "business policy." Today, strategic management is an eclectic field, drawing on various theoretical frameworks. Three prominent perspectives are summarized in Table 1-1 and discussed further in the text. There are many other influences, but these three illustrate how competing viewpoints have coalesced into an overarching discipline.

Industrial organization (IO), a branch of microeconomics, emphasizes the *influence of the industry environment* on the firm. The central tenet of IO theory is the notion that a firm must adapt to influences in its industry to survive and prosper; thus, its financial performance is driven primarily by the success of its industry. Industries with favorable structures offer the best opportunities for firm profitability.[20] Following this perspective, it is more important for a firm to choose the correct industry within which to compete than to determine *how* to compete within a given industry. Recent research has supported the notion that industry factors tend to play a dominant role in the performance of most firms, except for those that are notable industry leaders or losers.[21]

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

TABLE 1-1 Theoretical Perspectives on Firm Performance

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

IO assumes that an organization's performance and ultimate survival depend on its ability to *adapt* to industry forces over which it has little or no control. According to IO, strategic managers should seek to understand the nature of the industry and formulate strategies that feed off the industry's characteristics.[22] Because IO focuses on industry forces, strategies, resources, and competencies are assumed to be similar among competitors within a given industry. Suppose one firm deviates from the industry norm and implements a new, successful strategy. In that case, other firms will rapidly follow suit by purchasing the resources, competencies, or management talent that have made the leading firm so profitable. Hence, although the IO perspective emphasizes the industry's influence on individual firms, some companies can influence the strategies of their rivals and even modify the industry's structure.[23]

Perhaps the opposite of the IO perspective, **resource-based theory** views performance primarily as a function of a firm's ability to utilize its resources.[24] Although environmental opportunities and threats are important, a firm's unique resources allow it to develop a **distinctive competence**, distinguishing itself from its rivals and creating a competitive advantage. "Resources" include a firm's tangible and intangible assets, such as capital, equipment, employees, knowledge, and information.[25] An organization's resources are directly linked to its capabilities, which can create value and ultimately lead to profitability for the firm.[26] Resource-based theory focuses primarily on individual firms rather than on the competitive environment.

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

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

If resources are to be used for **sustained competitive advantage**—a firm's ability to enjoy strategic benefits over an extended time—those resources must be valuable, rare, not subject to perfect imitation, and without strategically relevant substitutes.[27] Valuable resources contribute significantly to the firm's effectiveness and efficiency. Only a few competitors possess rare resources, and imperfectly imitable resources cannot be fully duplicated by rivals. Resources with no strategically relevant substitutes enable the firm to operate in a manner that cannot be effectively imitated by others, thereby sustaining high performance.

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

According to the third perspective, **contingency theory**, the most profitable firms develop *beneficial fits* with their environments. In other words, a strategy is most likely to succeed when it is consistent with the organization's mission, competitive environment, and resources. Contingency theory represents a *middle ground* that views organizational performance as the joint outcome of environmental forces and the firm's strategic actions. Firms can become proactive by operating in environments where opportunities and threats match the firms' strengths and weaknesses.[28] If the industry environment deteriorates, a firm should consider departing and reallocating resources to other, more favorable markets.

Contingency theory A view that the most profitable firms are likely to be the ones that fit best with their environment.

Which perspective is most accurate? Each has intuitive appeal. Several prominent studies have attempted to unravel this quandary. Organization-specific effects account for about half of a firm's performance variation relative to its rivals, with the remainder split between industry effects and other factors. Hence, although the numbers vary across industries, individual firm performance is best understood from multiple perspectives. Luck can even play a role.[29]

Differences aside, each perspective has merit and has been incorporated into the strategic management process laid out in this text. The industrial organization view is prominent in the industry analysis phase, mainly in Michael Porter's "five forces" model. Resource-based theory is applied directly to the internal analysis phase and the effort to identify an organization's resources that could lead to sustained competitive advantage. Contingency theory is prominent in the strategic alternative-generation phase, where alternatives are developed to improve the organization's fit with its environment. Hence, multiple perspectives are critical to a holistic understanding of strategic management.[30]

Corporate Governance and Boards of Directors

Small businesses are often governed by one or several individuals well known to everyone in the organization. Ownership is usually *private* and may rest with a single person, a family, or several business partners. Because more resources are needed, many midsize and large organizations are *public*, with shares of stock available for purchase on exchanges such as the New York Stock Exchange. Shareholders in public organizations—the firm's owners—are represented by an elected board of directors legally authorized to monitor firm activities, as well as top managers' selection, evaluation, and compensation. Strategic decision-making in these firms is more complicated because the ownership is widely dispersed and often changes.

Corporate governance The board of directors, institutional investors, and large shareholders who monitor firm strategies to ensure managerial responsiveness.

Corporate governance refers to the board of directors, institutional investors (e.g., pension and retirement funds, mutual funds, banks, insurance companies, among other money managers), and large shareholders who monitor firm strategies to ensure effective management. Boards of directors and institutional investors—representatives of pension and retirement funds, mutual funds, and financial institutions—are generally the most influential in the governance systems. Because institutional investors own more than half of all shares of publicly traded firms, they tend to wield substantial influence.[31]

Boards of directors often include both inside (i.e., firm executives) and outside directors. Insiders bring company-specific knowledge to the board, whereas outsiders bring independence and an external perspective. Over the past several decades, the composition of the typical board has shifted from one controlled by insiders to one controlled by outsiders. This increased outside influence often allows board members to effectively oversee managerial decisions.[32] Moreover, when outsiders are added to insider-dominated boards, dismissal of the chief executive officer (CEO) is more likely when corporate performance declines, and outsiders are more likely to pressure for corporate restructuring.[33]

Many companies became concerned about potential conflicts of interest and the amount of time a board member who sits on multiple boards can spend with the affairs of each company. As a result, many companies have begun limiting the number of board memberships their members may hold. Most corporate board members at the largest 1,500 U.S. companies do not hold seats on other boards. Director salaries can range from less than $100,000 to over $300,000, depending on the firm's size, industry, and other factors.

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

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

Sarbanes-Oxley has been both hailed and criticized. *Forbes* explains the costs and benefits at *http://www.forbes.com/sites/hbsworkingknowledge/2014/03/10/the-costs-and-benefits-of-sarbanes-oxley/*.

Even with new disclosure regulations, however, it can be challenging to determine what top executives earn at public companies. Some analysts have noted positive changes among boards as a result of this legislation, in terms of both independence and expertise. In contrast, others contend that government regulations like Sarbanes-Oxley have merely added more costly paperwork.[34] A record number of public firms went private in the mid-2000s, primarily due to investor and management frustration with the legislation.

Evidence also suggests that many CEOs have become more reluctant to sit on publicly held company boards. Increased board member liability and policy changes that often restrict the number of outside boards a CEO may serve on have also contributed to this change.[35]

Boards of directors are responsible for monitoring activities in the organization, evaluating top management's strategic proposals, and establishing a broad strategic direction for the firm. As such, boards select and terminate the CEO, establish the compensation package, advise top management on strategic issues, and monitor managerial and company performance as representatives of the shareholders. Critics argue that board members do not always fulfill their legal roles.[36] One reason is that CEOs typically nominate individuals they believe will be supportive as board members. The generous compensation they often receive can also create a conflict of interest.[37]

When insiders control a board, a "rubber-stamp mentality" can develop, whereby directors do not aggressively challenge executive decisions as they should. This is particularly true when the CEO also serves as chair of the board, a phenomenon known as **CEO duality**.[38] Insider board members may be less willing to exert control when the CEO is also the chair of the board because they often control present rewards and future career prospects within the firm. In the absence of CEO duality, insiders may be more likely to contribute to board control, often in subtle and indirect ways so as not to document any opposition to the CEO. As Espen Eckbo, director of a corporate governance research center at Dartmouth College, put it, "The board hires, fires and sets the compensation for the CEO. It is probably the most important thing they do. For the CEO to be the chairman of the board is a bit odd." CEO duality has become less common in recent years, however. The percentage of S&P 500 companies with a separate CEO and chair increased from about 30% in 2005 to over 50% in 2021. CEO duality exists in only 15% of UK firms and is prohibited in Germany altogether.[39]

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

Activist shareholders can significantly influence a firm's operations. Target, for example, suffered the effects of the recession and experienced sluggish sales in the late 2000s and early 2010s. Investor activist William Ackman challenged Target to address the recession more aggressively. Ackman's Pershing Square Capital Management **hedge fund**—an investment fund open to only a few investors but permitted by regulators to undertake riskier and more speculative investments—is Target's sixth-largest shareholder and has actively supported dissident nominees for board slots. In response to Ackman, Target expanded its stores' fresh foods and other "recession-proof" offerings.[40]

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

Criticism notwithstanding, some board members have played useful stewardship roles. Many directors vigorously promote the best interests of the firm's shareholders and other stakeholders. Board members are often invaluable sources of environmental and competitive information.[41] By conscientiously carrying out their duties, directors can ensure that management remains focused on company performance.[42]

Governance can be strengthened in various ways. Some analysts have suggested that outside directors should be the only ones to evaluate the performance of top managers against the established mission and goals, that all outside board members should meet alone at least once annually, and that boards of directors should develop appropriate qualifications for board membership and communicate these qualifications to shareholders. For institutional shareholders, they recommend that institutions and other shareholders act as owners and not just investors,[43] that they not interfere with day-to-day managerial decisions, that they evaluate the performance of the board of directors regularly,[44] and that they should recognize that the prosperity of the firm benefits all shareholders.

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

Strategy at Work 1-1

The Growing Responsiveness of Corporate Boards[45]

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

Consider the case of Nell Minow, vice chair at Value Edge Advisors. Minow was formerly a principal of Lens, a $100 million investment firm that took positions in firms believed to be underperforming and then increased their value as an activist investor. Specifically, Minow scoured the market for companies with strong products, solid fundamentals, and relatively low share prices. She would then accumulate a substantial number of shares in the company, advise the CEO of her ownership position, and request a meeting with the CEO and the board to discuss changes that she believed could improve firm performance. Activist owners like Minow have signaled top executives and boards that investors need not be idle while the firms they own perform poorly.

Strategic Decisions

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

1. Strategic decisions have a broad impact on the organization. They involve input from and affect multiple functional areas. As a result, they require a multiple-perspective, integrated approach. Decisions that address only part of the organization are usually not considered strategic decisions.
2. Strategic decisions have a long-term and future-oriented view but are built on knowledge about the past and present. Scholars and managers do not always agree on what constitutes the "long term," but most agree that it can range from several years to more than a decade.
3. Strategic decisions seek to capitalize on favorable situations outside the organization. In general, this means taking advantage of opportunities that exist for the firm, but it also includes taking measures to minimize the effects of external threats.
4. Strategic decisions are nonrepetitive and may not resemble the past, even remotely. Because organizations and their environments are constantly changing, such decisions often lack precedence and require a fresh look at all options. When made, however, their influence cascades throughout the organization as department managers seek to make functional decisions that reflect the firm's broader direction.
5. Strategic decisions involve choices. Although making "win–win" strategic decisions may be possible, most require some trade-off between alternatives, at least in the short run. For example, raising salaries to retain a skilled workforce can increase wages, and adding product features or enhancing quality can increase the cost of production. However, such trade-offs may diminish in the long run because a more skilled, higher-paid workforce may be more productive than a typical workforce, and sales of a higher-quality product may increase, thereby raising sales and potentially profits. Decision-makers must understand these complex relationships across the business spectrum. Hence, strategic decisions should be based on a systematic, comprehensive analysis of internal attributes and factors external to the organization.

The ongoing Walmart–Amazon battle illustrates the strategic choice imperative. As the world's largest traditional retailer, Walmart is invested heavily in brick-and-mortar stores. Online behemoth Amazon has no stores but has invested in over 185 fulfillment centers worldwide, each stocked with inventory. Walmart *chose* a traditional retail model, whereas Amazon *chose* an online model. Although both companies have been successful, they struggle to compete *directly* because each has different strengths. Lacking a sophisticated online distribution center, Walmart promotes the shipment of merchandise to local stores for customer pickup. Walmart attempts to utilize its inventory system to fulfill online orders, but doing this has been challenging. Amazon has avoided the brick-and-mortar option altogether.[46]

Because of these distinctions, strategic decision-making is typically reserved for the chief executive and members of the **top-management team**. The CEO is ultimately responsible (and generally *held responsible*) for the organization's strategic management but rarely acts alone. Except in the smallest companies, the CEO relies on a *team* of top-level executives—including members of the board of directors, vice presidents, and even various line and staff managers in some instances—all of whom play instrumental strategic roles. Strategic decisions improve dramatically when more than one capable executive participates in the process.[47]

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

The team size on which the top executive relies for strategic input and support can vary across firms. Companies organized around functions such as marketing and production generally involve the heads of the functional departments in strategic decisions. The degree of involvement of top and middle managers in the strategic management process also depends on the personal philosophy of the CEO.[48] Some chief executives are known for making quick decisions, whereas others are known for involving top managers and others in the process.

Large organizations often employ outside consultants to assist in strategic planning. Doing so can help guide managers through the process, but firm members should drive the strategy because they (should) know more than outsiders about their firms and industries. Consultants can complement the insight of top managers but can never replace it.

Top-Management Team

The CEO leads the top-management team, but others play important roles.

Source: G-Stock Studio/Shutterstock.com.

Input to strategic decisions, however, need not be limited to members of the top-management team. On the contrary, obtaining information from others throughout the organization, either directly or indirectly, can be beneficial. Most strategic decisions result from the streams of inputs, decisions, and actions of many people. The top-management team might create the context for strategic decisions by establishing rules and procedures and influencing the informal means through which the organization accomplishes activities. Strategic decisions do not necessarily start with top-management action, however, but can "bubble up" from a series of lower-level decisions throughout the firm. For example, an employee in a company's research and development (R&D) department may learn about a new product or production process idea at a trade show. The employee may relate the idea to a manager, who, in turn, may modify it and pass it up the line. Eventually, a different version of the idea may be discussed with the organization's marketing and production managers and later presented to top management. Ultimately, the CEO will decide whether to incorporate the idea into the ongoing strategic planning process. This example illustrates the indirect involvement of individuals throughout the organization in the strategic management process. Top management is ultimately responsible for the final decision, but its decision is based on a culmination of the ideas, creativity, information, and analyses of others.[49]

Although participation can be healthy, most firms place significant limits on the amount of input and control that their managers have in strategic decisions. There are a few exceptions, however. Ternary Software has fewer than 25 employees, but all must agree before a strategic decision can be implemented. Such democracy is easier to implement in smaller organizations, but even large companies like Google have taken steps to create an egalitarian culture for decision-making.[50]

Global Business

International considerations are an integral part of business today.

Source: Ferbies/Shutterstock.com.

Decisions made in informal settings are often confirmed in corporate boardrooms. A formal, systematic decision-making process is often applied to affirm what top executives already see as the appropriate course of action. A danger associated with this approach is that it tends to jump straight to a proposed solution without considering how a decision should be made. Although there are no guarantees, top-management teams that circumvent a logical decision-making approach are more susceptible to mistakes. For example, when a systematic cost-benefit analysis is not employed, leaders may confuse the actual costs of a decision with sunk costs—those already expended—a common error that distorts decision-making and can lead to an escalation of commitment to a failed strategy.[51]

Artificial Intelligence

Artificial intelligence (AI) is the ability of a computer or robot to perform tasks commonly done by humans. It is difficult to understate the effects of AI on strategic management. It is changing how businesses run their operations, make decisions, and communicate with customers. Integrating AI with strategies at all levels is essential. For example:

1. AI promotes competitive advantage through innovation. Self-driving cars, individualized health care, and smart home appliances have the power to both expand and collapse markets. AI may drastically cut costs by automating processes, enhancing operational effectiveness, and minimizing errors, enabling organizations to offer competitive pricing while preserving profitability. AI offers thorough market analysis to help firms comprehend rivals, consumer behavior, and new trends, which helps them develop more successful marketing plans. Hence, personalized marketing initiatives are more effective at reaching potential clients because they are

highly targeted. Businesses may improve conversion rates by using AI to customize their marketing campaigns to customer preferences.

2. Insights from AI can improve decision-making. As data proliferate, businesses want AI to analyze enormous data sets quickly and effectively and spot patterns, trends, and correlations that people might overlook. AI also makes it possible to analyze data in real-time, assisting organizations in making quick decisions based on the most recent facts, which is essential in fields where prompt decisions are necessary. Predictive analytics, which uses previous data to forecast future patterns and results, enables organizations to foresee changes in the market, changing consumer preferences, and potential dangers. AI algorithms can speed up experimentation procedures, assisting companies in improving goods and services in response to customer input.
3. AI can enhance operational effectiveness, transforming supply chain management and processes. Software bots driven by AI and robotic process automation (RPA) can quickly and accurately carry out repetitive, rule-based operations, enabling employees to concentrate on more innovative and strategic duties thanks to the reduction of human error. AI algorithms optimize the whole supply chain, from the procurement of materials to the delivery of goods to clients, resulting in lower costs, shorter lead times, and higher customer satisfaction. AI-driven technologies for demand forecasting and inventory management assist companies in having the proper amount of goods on hand while minimizing stockouts and the associated costs. AI analyzes sensor data in manufacturing and logistics to forecast when machines or vehicles need maintenance, avoiding expensive failures and maximizing the use of resources.
4. AI facilitates more effective customer engagement. Businesses can now provide their clients with more efficient and tailored services thanks to AI technologies. Chatbots and virtual assistants are accessible around the clock to respond to consumer questions and deliver information. AI-driven natural-language processing (NLP) enables companies to comprehend better and respond to client feedback, reviews, and social media comments, opening the door to real-time client interaction and service enhancement. Engaging customers can enhance brand loyalty. AI can also enhance personalization and promote mass customization by using client data to produce individualized recommendations and experiences. E-commerce companies employ AI to provide product recommendations based on a user's browsing and purchase history. AI can also foresee potential problems or client requirements. By examining previous data, businesses may offer proactive solutions and increase client loyalty and retention.
5. AI is essential to risk management, assisting organizations in identifying and reducing potential threats. AI supports scenario planning by examining various factors and projecting possible outcomes, assisting companies in preparing for a range of possibilities. By monitoring and analyzing data for potential infractions or breaches, AI can assist firms in remaining compliant with industry regulations. AI systems can identify fraudulent activity in real-time by examining transaction data and user behavior, a crucial concern for financial institutions and e-commerce companies. AI-enhanced cybersecurity solutions can also detect threats and respond more quickly than conventional techniques, safeguarding sensitive data and ensuring company continuity.
6. AI helps organizations manage human resources. AI-driven systems that evaluate résumés and applications can find the best applicants, perform preliminary interviews, and even conduct the interviews themselves, saving time and money during the hiring process. AI-powered learning platforms can tailor training materials and tests so that workers are exposed to the information most likely to improve their abilities. By examining numerous data points, AI can deliver more

objective performance evaluations, assisting organizations in making knowledgeable judgments about promotions, bonuses, and training opportunities. AI can also track employee well-being through sentiment analysis, assisting companies in proactively addressing problems like burnout or unhappiness.

The Global Imperative

Most business organizations buy, sell, or trade across borders, whether they have a physical presence in other countries or sell a significant amount of imported merchandise. Although firms typically concentrate on serving local or domestic markets before expanding internationally, many must interact with entities in other nations to survive. For example, virtually all of Japan's industries would halt if imports of raw materials from other nations ceased because the nation is small and isolated, and its natural resources are quite limited. In larger countries like the United States, manufacturers typically utilize components from abroad in their production processes, and most retailers sell products that were produced abroad. Hence, strategic management is a global undertaking, underscored by the widespread impacts of tariffs associated with the China–U.S. trade dispute in the late 2010s and early 2020s. Examples related to concepts, industries, and firms throughout the world are included in each chapter.

Comparative advantage The idea that certain products may be produced more cheaply or at a higher quality in specific countries as a result of advantages in labor costs or technology.

The high degree of global interconnectedness common in many enterprises today emanates from the economic concept of **comparative advantage**, the idea that certain products may be produced more cheaply or at a higher quality in specific countries as a result of advantages in labor costs or technology. For this reason, many manufacturers in the United States and other developed nations have shifted their production to Asia and other parts of the world. However, for several reasons, firms do not always engage in production only in areas where they are most efficient. For example, the cost of transporting raw materials or goods from one nation to another can exceed the potential cost savings. Political turmoil or trade restrictions can also create a barrier.

Even if one nation enjoys an absolute advantage over another in most areas, the weaker nation must participate in some forms of business to maintain economic viability and employ its citizens. Firms in these nations tend to produce in areas with the lowest absolute advantage. Put another way, even when firms in less developed countries lack a comparative advantage, they tend to operate in locales where their inefficiencies are less pronounced. In contrast, their counterparts in developed nations concentrate on more vital industries. All nations benefit economically from such an arrangement.

A nation's comparative advantage can erode over time. Chinese manufacturers enjoyed some of the lowest global labor rates for unskilled or semiskilled production in the 2000s. Worker skills and production quality increased in the rapidly developing nation, making Chinese labor more expensive, well ahead of countries like India, Pakistan, Indonesia, Cambodia, Vietnam, and Bangladesh.[52]

Comparative advantage is a national concept. The fact that a given nation possesses certain forms of comparative advantage can influence the strategic actions of companies within that nation, but it is only one consideration. Global involvement may also provide

Case Analysis 1-1

Step 1: Introduction of the Organization

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

It is also essential to identify the current business model. Doing so is simple for some companies (Ford, for example, hopes to sell cars and offer consumer financing at a profit) but complicated for others, where revenue streams and competitive advantage are more challenging to identify.

advantages to a firm not directly related to costs. For political reasons, a firm often needs to establish operations in other countries, primarily if a substantial proportion of sales is derived abroad. Doing so can also provide managers with a critical understanding of local markets. For example, Ford operates plants in Western Europe, where manufacturing has helped its engineers design windshield wipers for cars engaged in high-speed driving on the German autobahns.[53]

Summary

1. **Identify the strategic management process and explain how it can be applied to an organization.**

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

2. **Describe the difference between intended and realized strategies.**

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

3. **Define the three primary contributing theoretical influences to the strategic management field.**

   IO theory, resource-based theory, and contingency theory have influenced the strategic management field. IO focuses on how industry factors influence firm performance, whereas the resource-based view underscores the importance of each organization's unique set of resources and capabilities. Contingency theory emphasizes the fit between internal and external factors. Although these theories are based on widely varied assumptions about what leads to high performance, each has merit and contributes to an overall understanding of the field.

4. **Explain the corporate governance process.**

   Corporate governance includes boards of directors, institutional investors, and other groups that can influence the broad direction of a firm. Boards are responsible for managing the overall direction of the firm, but daily oversight is relegated to the CEO and the top-management team.

5. **Describe the difference between strategic and nonstrategic decisions.**

   Top executives focus on strategic decisions because they have broad, long-term impacts on the firm. Making strategic decisions can be challenging because such decisions are nonrepetitive and involve important trade-offs. In its final form, a strategic decision emerges from the inputs, decisions, and actions of the entire top-management team.

6. **Discuss how artificial intelligence affects strategic management.**

   AI is changing how organizations create and execute strategies. If employed correctly, AI can foster innovation, improve decision-making, enhance operations, engage customers more effectively, promote better risk assessment, and help organizations manage their human resources.

Key Terms

Business model, p. 4
CEO duality, p. 11
Comparative advantage, p. 16
Contingency theory, p. 9
Corporate governance, p. 10
Distinctive competence, p. 9
Efficient market hypothesis, p. 4
Hedge fund, p. 11
Industrial organization (IO), p. 8
Intended strategy, p. 7
Mission, p. 2
Realized strategy, p. 7
Resource-based theory, p. 9
Sarbanes-Oxley Act, p. 10
Strategic management, p. 2
Strategic thinking, p. 8
Strategy, p. 2
Subjective value, p. 4
Sustained competitive advantage, p. 9
Top-management team, p. 13

Review Questions & Exercises

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

Practice Quiz

True or False

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

Multiple Choice

7. Strategies are formulated in the strategic management stage that occurs immediately after
   A. the assessment of internal strengths and weaknesses.
   B. implementation of the strategy.
   C. control of the strategy.
   D. none of the above
8. The strategy originally planned by top management is called the
   A. grand strategy.
   B. realized strategy.
   C. emergent strategy.
   D. none of the above
9. The notion that successful firms tend to be the ones that adapt to influences in their industries is based on
   A. IO theory.
   B. resource-based theory.
   C. contingency theory.
   D. none of the above
10. The notion of distinctive competence is consistent with
    A. industrial organization theory.
    B. resource-based theory.
    C. contingency theory.
    D. none of the above
11. To contribute to sustained competitive advantage, firm resources should be
    A. valuable and rare.
    B. not subject to perfect imitation.
    C. without strategically relevant substitutes.
    D. all of the above
12. Which of the following is *not* a characteristic of strategic decisions?
    A. They are long-term in nature.
    B. They involve choices.
    C. They involve trade-offs.
    D. All of the above are characteristics of strategic decisions.

Answers can be found in the end-of-book Answers section.

Case 1: Costco

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

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

Later in 1993, Price Club merged with Costco Wholesale. During the 1990s, the firm expanded its international interests, launching outlets in Great Britain, Japan, and South Korea. Price Club changed its corporate name to Costco Companies in 1997 and again to Costco Wholesale in 1999. Costco developed rapidly under CEO Jim Sinegal's leadership. Sinegal was succeeded by Chief Operating Officer (COO) Craig Jelinek in 2012.

Today, Costco is the largest wholesale club operator in the United States, operating 591 membership warehouses—each amassing about $178 million in sales—and serving about 128 million members. Most of its outlets are in the United States and Canada, but additional stores can be found in Mexico, Japan, Australia, South Korea, Taiwan, Puerto Rico, and the United Kingdom. Membership costs about $50 annually and is available to businesses and individuals.

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

Costco's success can be attributed to its ability to minimize costs by negotiating fiercely with suppliers. The company does not require its members to pay more than 14% above the firm's cost for goods.

Case Challenges

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

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Capstone 101: Overview

Many strategic management courses include participation in a competitive business simulation like Capsim's Capstone. A simulation is a great way to learn more about business competition. Capstone provides an attractive balance of simplicity and complexity. Whether you are a traditional undergraduate without management experience or a seasoned business veteran pursuing a graduate degree, it can be an enjoyable learning experience, even if you play the game more than once. The Capstone 101 sections at the end of each chapter apply textbook concepts to Capstone.

Participation in a simulation can be an individual assignment, but students are usually divided into teams to make marketing, production, finance, and other decisions for a virtual company. Student companies often compete in a single industry, although your course might include multiple industries with computer-run companies to balance the number of firms. Capstone includes eight rounds, each representing a year in the life of the company. After each round, students get results in the *Capstone Courier* before they make decisions for the next round.

Strategy simulations like Capstone cannot reproduce everything in the real world, so some limitations exist. Students make decisions for the entire simulated year at one time and cannot modify them until the following round. Simulations make assumptions about interest rates, changes in demand between rounds, and other factors that affect company performance. The decision options are limited to manage complexity, which means they cannot consider the softer side of various decisions. For example, an increase in an advertising budget will affect the demand for products without regard to the content of a particular ad.

Perhaps you plan to seek advice on Capstone from other students who have already experienced it, blogs posted by students at other colleges, or online videos posted by individuals who claim to know how to "master" the game. Sage advice is always helpful, but every industry is different. It is impossible to "game the system" and master a sophisticated simulation like Capstone with a few tricks. If you take shortcuts, you might learn the hard way.

Nonetheless, Capstone reinforces critical strategic management concepts very well. It allows students to operate virtual companies over simulated time without losing real money and reinforces the relationships among R&D, marketing, production, and finance. Ignoring them will hurt your company. For example, offering attractive products is essential but does not guarantee success. Buyers will not know your products exist without marketing campaigns. They might not purchase them if prices are too high, but you might not cover your expenses if prices are too low. Your company must produce enough products to meet demand, but too much can raise inventory costs. You must also obtain sufficient capital each round. Your company will receive an emergency loan at an exorbitant interest rate if you run out of cash. Hence, an otherwise effective strategy can quickly go awry if you ignore one of the functional areas. A chain is only as strong as its weakest link, which is undoubtedly true with Capstone.

You must understand precisely how Capstone works at the outset. Invest the necessary time to understand the specifics associated with all the competitive decisions you will make, the support provided to assist you in making them, and the metrics for evaluating the performance of your virtual company. Profitability and market share are important, but courses grade Capstone in part on a balanced scorecard (BSC; see Chapter 12) that evaluates your team's management in various areas. Identifying a strategy for your company before you start is also a must. Figuring out the details as you go is a recipe for disaster because recovering from substantial losses in the first few rounds is challenging.

The results of each round are not guaranteed; having a reasonable strategy and making "good decisions" could still result in a financial loss or a decline in market share. There are no guarantees in the business world, and this reality can raise anxiety during the game. Nonetheless, if you make responsible decisions in Capstone, your company will be competitive. Capstone can be fun and a great learning experience if you do your homework.

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