mann also found that focused cable firms (i.e., firms with no diversification into other lines of business) were less likely to buy out their competitors than diversified companies.

Most interesting of all, however, was the finding that, compared to more focused firms, diversified companies were the least likely to stand still during turbulent times. In fact, Eisenmann found that diversified firms tended to either gobble up cable assets or to be gobbled up themselves (i.e., to exit the cable TV business). In other words, diversified firms were more likely to take things to extremes (i.e., to take much more or much less risk) than focused firms. On top of that, CEO equity ownership had a role to play. Eisenmann discovered that CEOs who owned a smaller slice of diversified firms were even less likely to stand still than CEOs who owned bigger slices.

Needless to say, these are complex results. And as Eisenmann noted, they underscore the need for more research to increase our understanding about why these results might have occurred in the first place.

But beyond this, what lessons does Eisenmann's study provide? Among other things, it suggests that CEOs with a larger ownership stake in their firms find it easier to ignore how the stock market reacts to their decisions. In short, they're less likely to change course when their stock price declines. Of course, industry liquidity played a major role in cable industry diversification decisions. Eisenmann noted that banks were more than willing to finance horizontal acquisitions in the cable industry. This allowed CEOs who were also firm owners to retain control of equity. So different lending policies might have led to different results. In short, Eisenmann's findings may not hold across industries.

Eisenmann does a wonderful job of identifying factors that may drive the risk-taking behavior of CEOs. Two concerns, however, should be raised. First, Eisenmann sidesteps the question of whether the risks that CEOs take are actually beneficial for shareholders or not. Ultimately, we need to know whether the factors driving the behavior of CEOs lead them to play it safer or take more chances than shareholders actually prefer.

Second, Eisenmann doesn't provide a specific roadmap for better aligning CEO thinking with shareholder interests. Of course, in the past year or so, a major shift in attitudes has taken place. Before that, many of us automatically assumed that awarding stock options was the best way to align CEO and shareholder interests. No longer. Enron, Worldcom, and Conseco all relied heavily on stock options. And look what happened.

Nevertheless, Eisenmann does us a great service by clarifying what influences CEOs to take or not take risks. Identifying such factors is an important first step and should help shareholders better understand how their CEOs are likely to act. In other words, examining the level of CEO ownership and company diversification may ultimately help shareholders make better investment decisions. Finally, Eisenmann's study serves as another call to arms to identify solutions to the governance issue. And as firms continue to get bigger, fewer executives will be able to call the company their own.

Source: Eisenmann, T. R. 2002. The effects of CEO equity ownership and firm diversification on risk taking. *Strategic Management Journal*, 23(6): 513–534.

Strong Corporate Cultures and Firm Performance: Are There Tradeoffs?

Adam Zuckerman, International Survey Research

Does your company have a strong culture? In other words, does widespread understanding and agreement exist among employees about what behaviors are important and what attitudes are appropriate? Or is there little consensus around such issues? The answer definitely matters. Researchers have found that companies with the strongest cultures—where values and norms are widely shared and strongly held—tend to outperform their peers. Indeed companies with strong cultures tend to enjoy better returns on investment, higher net income growth, and bigger increases in share price than firms with weaker cultures.

Research cultures tend to outperform their peers.

It's easy to understand the performance-enhancing effects of a strong culture. When values are clear and broadly accepted, internal controls and coordination are more effective. Consequently, the alignment between goals and behavior is greatly enhanced. Any actions contrary to behavioral norms can be easily identified and quickly corrected. Moreover, less time is wasted in deciding what actions to take or how to coordinate actions across groups. All of this should greatly improve execution around established routines and processes, thereby improving firm performance.

But are any other benefits associated with strong corporate cultures? And what about limitations?

Can certain business conditions blunt the positive impact of strong cultures? A recent study by Jesper B. Sorensen from the Massachusetts Institute of Technology examined these questions. Sorensen reasoned that in addition to achieving higher performance, companies with stronger cultures should also have more reliable (i.e., less variable) performance. Having such performance is important for several reasons. Reliable performance helps planning and decision-making. Likewise, stakeholders such as suppliers, employees, and investors clearly prefer reliable performance. And they have good reason to do so. Companies with highly variable performance and, in particular, highly variable cash flow tend to invest less in worthwhile projects, placing them at a competitive disadvantage. Likewise, such firms tend to have less of a following among analysts, lower bond ratings, and higher weighted average costs of capital than firms with more reliable performance.

Sorensen also sought to pinpoint any critical limitations inherent in firms with strong cultures. He theorized that although performance should be more reliable in such firms, this positive impact of a strong culture could vanish during periods of industry volatility. Sorensen reasoned that when industry volatility is low to moderate, a company's underlying assumptions and basic procedures remain fundamentally sound. As a result, maintaining reliable performance requires only high levels of communication and coordination, along with occasional incremental adjustments to basic procedures. In short, the key to success in a relatively stable environment is using the right procedures at the right time in the right sequences. And this, Sorensen argued, is the context in which strong corporate cultures should excel, given their high level of behavior control and coordination.

The key to success in a relatively stable environment is using the right procedures at the right time in the right sequences.

But once industry volatility becomes substantial, maintaining reliable performance requires more than just incremental adjustments to existing procedures. Instead, a volatile business climate often demands that firms develop entirely new procedures and embrace an exploration mentality to survive, if not thrive. Sorensen surmised that firms with strong cultures would have a harder time undertaking these types of activities precisely because of the qualities that helped them excel during calmer periods. When current norms and values are widely shared and strongly held, employees are highly committed to the current "worldview." This makes them less likely to seek out fundamentally new alternatives to existing procedures or even recognize the need for radical change in the first place. Moreover, dissenting employees whose beliefs do contradict the company's dominant perspective are less likely to remain, much less be listened to. Of course, these are the very employees most likely to facilitate change by introducing new ideas and novel approaches. This underscores what some have described as the dual nature of strong corporate cultures. In essence, being clear about who and what you are makes it tougher to morph into something else.

To examine these issues, Sorensen re-analyzed data collected in the late 1980s as part of some earlier investigations. The data set included information on over 150 large, publicly traded companies representing 19 distinct industries. To assess corporate performance and performance reliability, Sorensen relied on two commonly used measures: yearly return on invested capital (ROI), and yearly operating cash flow. Both measures were examined over a six-year period. Sorensen used the volatility of stock prices in an industry (relative to the broader market) as an indicator of industry volatility. When industries have to adapt in the face of wrenching change, investor uncertainty typically results, bringing with it wider stock price swings among firms in those industries.

To measure corporate culture, top executives from each participating company filled out a survey assessing firms in the sample that were in their respective industries. For each firm, executives were asked about the extent to which: 1) company managers commonly spoke of their firm's way of doing things, 2) company values were clearly stated and serious efforts were made to have managers follow them, and 3) long-standing policies and procedures were used beyond those implemented by the current CEO. Responses to these items were averaged across executives to create a "strength of culture" score for each firm. This approach to assessing cultural strength—one based on brief evaluations by external observers—is a limitation inherent in Sorensen's study.

Nevertheless, Sorensen's results were consistent with his predictions. Using advanced modeling techniques, he found that firms with strong cultures had better and more reliable financial performance over the 6-year period examined than firms with weaker cultures. However, as industry volatility increased, the "reliability advantage" of firms with stronger cultures decreased and eventually became nonexistent. This outcome is consistent with the idea that having a consensus about company goals and values provides the biggest benefit when environments are stable. Although the characteristics present in firms with strong cultures mean that they can efficiently exploit their established competencies, new competencies and procedures may be needed when the environment becomes highly volatile. And that's when firms with strong cultures may find it difficult to adapt.

Having a consensus about company goals and values provides the biggest benefit when environments are stable.

Taken together, these results prompt two questions. First, what is the relative value of having the ability to exploit established routines versus having the ability to explore new options and creatively adapt to a changing environment? And second, can these two sets of abilities really co-exist in one organization?

Regarding the first question, Sorensen suggests that exploitation outweighs exploration. Sorensen argues that the general tendency of firms with strong cultures to perform better (and more reliably) over time than firms with weaker cultures implies that exploitation is more valuable. In other words, exploitation helps firms with strong cultures be successful enough during stable times to weather more volatile periods.

On the second question, Sorensen doesn't say how firms can hold on to the benefits associated with a strong culture without losing the ability to explore and adapt in the face of volatility. Indeed, he cautions against drawing a tempting conclusion—that if a strong culture is built around the value of exploration, then it will permit maximum exploitation as well. Sorensen argues that the benefits associated with strong cultures accrue precisely because exploitation of established routines is valued more than exploration.

Whether strong cultures can both exploit and explore successfully over the long haul remains an intriguing question for future research. For instance, can companies somehow rebalance their emphasis on exploitation versus exploration to match shifts in industry volatility? Does it make sense for firms to try to strengthen their culture during quiet times and weaken it during periods of intense change? If so, how? Overall, Sorensen's study does us a great service by empirically demonstrating that stronger corporate cultures generally produce better and more reliable performance. At the same time, however, his results show that the positive impact of a strong culture dissipates as volatility rises. In doing so, Sorensen has underscored the need for more research and given corporations yet another reason to look in the mirror.

Source: Sorensen, J. B. The strength of corporate culture and the reliability of firm performance. 2002. *Administrative Science Quarterly*, 47(1): 70–91.