

The buddy system

The economy is a more alliance-based environment than it was 20 years ago. Organisations increasingly band together into multi-enterprise networks and these new collaborations require special skills to manage. CIMA's **Louise Ross** looks at research that shows how, instead of contracts and terms of engagement, trust and information sharing are the key factors for success.

Economists advise that there are three basic approaches for organisations to configure themselves to obtain resources they need – they can buy from the market, build the required capability, or form networks. Put simply, the options are buy, build or band together. The first two options are often referred to by economists as the “market” and “hierarchy” options for industrial organisation

but the last is the one which has become increasingly common since the late 1980s.

Banding together into networks, often referred to as “virtual organisations”, requires a specific kind of management to ensure the networks’ goals are reached. The ability to build and sustain long-term relationships with other members of the

network becomes critical, to reflect the evolution from transactional to collaborative relationships. Ideally, collaboration offers access to resources, capabilities or markets that participants can’t benefit from individually, but one can also argue that participants are giving up flexibility or independence by specialising and locking themselves into such relationships.



Specialisation, and the consequent dependence on the contribution of other members of the virtual organisation, requires a network built on trust. Trust that individual participants will balance their own self-interests against the interests of the network as a whole. Management has to both react to, and help create this environment of trust.

Motives for virtual organisations

There are several reasons why organisations might form alliances. McKinsey consultants Hagel and Singer argue that the traditional organisation has three elements – a customer relationship element, a product innovation element and an infrastructure business. Each element has a different driver:

- The customer relationship element is driven by economies of scope – extending the relationship with the

customer by offering the widest range of products and services;

- The product innovation element is driven by speed – achieving the fastest possible time to market to win market share before competition builds; and
- The infrastructure business is driven by economies of scale – to reduce fixed costs.

For any of these elements, ‘specialists’ might provide those processes more cost-effectively than the organisation could itself, and remove some of the tension which exists between these competing drivers. These specialists organise themselves into a virtual organisation, in a value chain formed around these core processes. New activities or members are added as customer needs evolve, and economies of scale, scope, specialisation and integration are exploited.

Benefits of such collaboration include sharing of costs; or the reduction of risk when entering new markets. Collaboration can be an effective response to a macro-economic climate of fierce competition, globalisation or rapid growth; or for industries whose competitive landscape is characterised by increasing R&D costs, and shortening technology life-cycles.

For example, in the electronics industry there is an increasingly short golden period after the introduction of a new product to earn profits before first the competition, then enhanced products arrive on the scene. Achieving the optimum level of inventory to avoid stock-outs during the golden period, or gluts when the consumer has moved on to the next generation product, requires a fast and efficient flow of products, parts, cash and information between all parties within the typically fragmented supply chains in this sector.

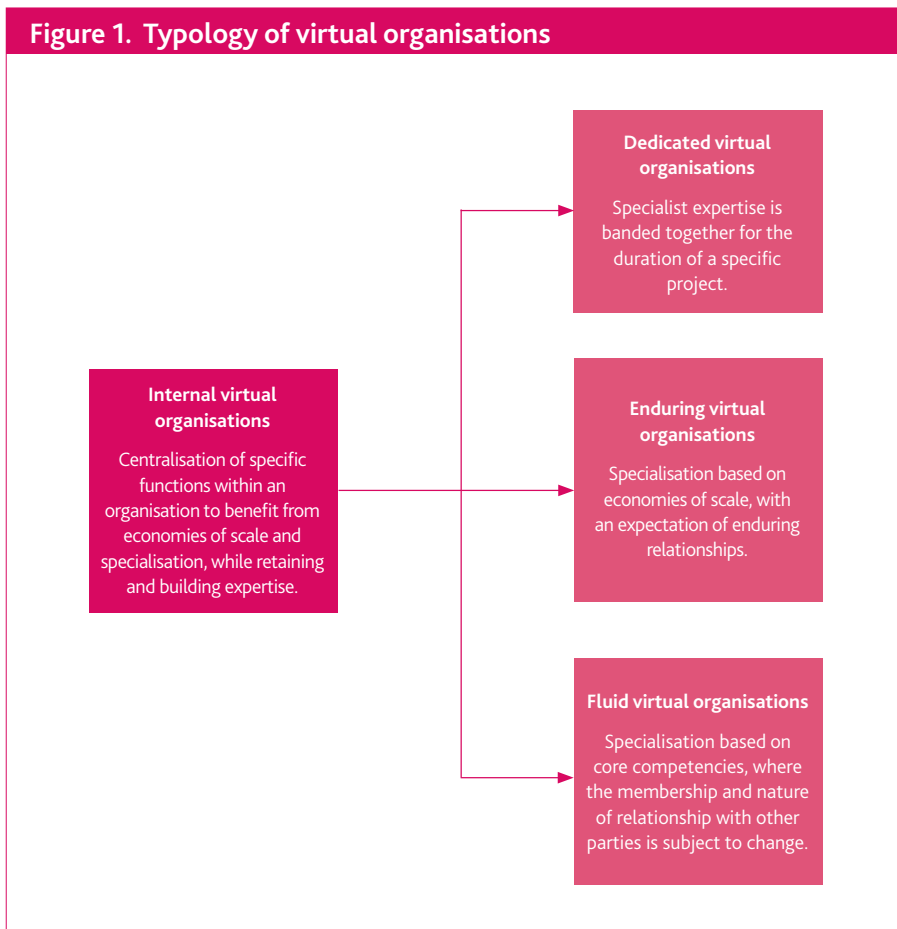
The desire to collaborate might also be prompted by a participant’s own circumstances, when it does not itself have the capabilities it needs to profit from its innovations. Those capabilities may relate to R&D, marketing, manufacturing, or after-sales. Some theorists argue that the alliance itself can be seen as a learning and development process, that the proximity and interactions between customers, suppliers, researchers and competitors stimulates innovation.

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Typology of virtual organisations (see box, left)

An example of an internal virtual organisation is the shared service centre. Functions such as accounting, HR, IT, Legal Services or Purchasing are centralised in one location, servicing divisions of the company as internal customers. The organisation retains accumulated expertise, but also benefits from economies of scale and specialisation. Shared Service Centres may evolve into selling their spare capacity to other organisations – for example, life insurance and pensions group Aegon has outsourced certain middle office processes to service provider LogicaCMG, and opened these up to third party customers.

Examples of enduring virtual organisations can be found within outsourcing in the automotive industry. To avoid expensive retooling, major car manufacturers outsource the manufacture of components





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such as exhaust systems, wheels, gearboxes, carbon-fibre components (bumpers/fenders) and acoustic components. In the US, if demand for any component is less than 200,000 pieces annually, it is deemed better for production to be outsourced.

An example of a dedicated virtual organisation is the consortium known as the Groningen Long Term Project (GLT). This relates to a huge gas field in the north Netherlands which has been in production since 1959 for Dutch oil and gas producer NAM. Significant renovation of well-head plant was required to ensure continued access to reserves.

NAM produced detailed specifications for various engineering, construction, instrumentation or supply activities, and invited firms to form their own consortia to tender for the entire project. Shortlisted applicants presented their competing solutions, which NAM evaluated against total cost of ownership, predicted reliability and technological strength. The winning consortia Stork GLT consequently formed itself a legal entity for the duration of the original contract (1996-2006); and benefited from a major follow-on contract for further renovation.

An example of a Fluid Virtual Organisation is Nike, described by Datamonitor as 'a designer, marketer and distributor of athletic footwear ..and accessories'. Nike directly manufactures only 6% of its products. It has different relationships with different partners (for example, with respect to the extent to which they collaborate on design).

Virtual organisations – simultaneously co-operative and self-interested

One characteristic of virtual organisations is that they manage to be simultaneously co-operative and opportunistic or self-interested – there is, after all, a commercial relationship at the core of most of these networks. Management is thus about the balance of self-interest with the interests of the network as a whole, about how issues are resolved in the absence of competitive and adversarial relationships, or those governed by the relatively simple demands of a single transaction.

Traditionally, relationships between entities, or between customer and supplier, are governed by contracts, property rights, and commercial law. But it is impossible to draft an entirely comprehensive contract to cover all contingencies, yet allow for flexibility, responsiveness and the exploitation of opportunities.

Trust in virtual organisations

There has been extensive research conducted by organisational psychologists and accounting academics, which concludes that trust is the key to successful collaborative relationships. Research also suggests that the level of trust, along with the degree of risk, is the main determinant of the structure of the network.

A trusting relationship is one in which participants:

- Share information – **openness**
- Establish clear rules – **understanding of the other parties' needs**
- Avoid surprises – **reliability**
- Deliver what is promised – **competence**
- Demonstrate commitment – **reciprocity**
- Care for the welfare of the other parties even if this is just in the self-interest of continuity of supply – **mutuality**

Although trust has to be demonstrably present in all the interactions and contacts between members of the network, these behaviours originate at the top level, being so rooted in the ethical culture of the organisation. And top level agreement is integral to the creation of ethical relationships, ones that establish an equitable basis on which surpluses are shared.

Involvement of other parties:**8.4%**

in strategic planning

13.9%

in the budgeting processes

more than

20%

in information exchange

Benefits of trust

Trust between network participants increases their commitment to long-term relationships. This commitment is demonstrated by offering long-term contracts, and undertaking not to use multiple suppliers. This will give other participants the confidence to think longer term about their investments in infrastructure or training.

Trust reduces the costs of governance, which in turn will reduce transaction costs. And trust facilitates the sharing of information which is essential to the performance of networks, and the provision of this information is the responsibility of the management accountant.

New roles for the management accountant

As well as new demands on management, virtual organisations make new demands on management accountants, requiring strategic management accounting and management accounting that extends beyond the traditional boundaries of the organisation.

Recent CIMA sponsored research undertaken by Ariela Caglio and Angelo Ditillo into the management accountant's role in networked organisations indicated the prevalence of the following collaborative management accounting practices:

Other studies have identified interorganisational performance measurement, investment appraisal, activity-based costing (ABC), and open-book accounting. Given the importance of sharing financial information to both the success of the network, and the role of the management accountant, I'll conclude by looking at a specific collaborative cost management technique, interorganisational cost management.

Interorganisational cost management (IOCM)

Coad and Scapens discuss several examples where collaborative networks have exploited the significant economic advantages of interorganisational cost management (IOCM). They characterise IOCM as a cost management technique that should not be overlooked when evaluating make-or-buy decisions, between the 'market' (buy) and 'hierarchy' (manufacture) solutions. In both the latter options, Coad and Scapens advise that costs tend to be underestimated, because the transaction costs of sourcing, evaluating, and monitoring suppliers tend to be ignored; as do the non-production costs of manufacture, such as the creation of internal information and monitoring systems, budgets and planning. IOCM requires the company to recognise such transaction costs, both internal and external.

The cases Coad and Scapens discuss include Sainsbury's, which rolled out IOCM to its

smaller suppliers after successfully using it to improve supply chain performance with 24 of its major suppliers, and Nissan, which used IOCM to support just-in-time (JIT) initiatives with its seat supplier, encouraging it to invest in JIT technology, and undertake collaborative value engineering and co-operative target cost management.

IOCM focuses not just on 'cost' but the 'cost to use'. That is, it considers not just cost/price, but quality, lead times, on-time delivery, and other aspects that users might value such as customisation. It is helpful therefore for suppliers to familiarise themselves with their customers' processes and strategic plans, to have contact between the two organisations involving technical people who are interested in product specifications which affect manufacturing decisions, marketing people who can discuss differentiation, and purchasing people who might provide the focus on costs and terms of trade.

Such dedication to relationship building is not dependent on both parties being connected by a network relationship, of course, but this would facilitate it.

Conclusion

Virtual organisations require new management skills, less about managing resources and more about orchestrating relationships and managing the interfaces within networks. Research into successful and unsuccessful collaborative relationships demonstrates that the keys to success are trust and information sharing. Trust is essential to achieve the necessary balance between each organisation's self-interest, and the mutual interests of the network.

The creation and maintenance of trust emanates from the very top of the participating organisations, as it is senior management who set the ethical tone of their own organisation, and hence their culture and behaviour as a partner in any collaborative effort. It also shapes any participants expectations of others' behaviour and their confidence to create long-term relationships.

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Information sharing, important in itself for the success of the virtual organisation because it supports collaborative strategic tools such as Value Chain Analysis, is also an important building block to create and maintain trusting and committed relationships. ■

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Previously, Ross was a senior auditor at the National Audit Office.

