# Harvard Business Review

Click here to visit:
>| Harvard Business Online

| Current Issue | Customer Service | Subscriber Benefits | HBR Subscriber Alert

*Is Your Company Ready to Go?*

Measuring the Strategic Readiness of Intangible Assets
*Robert S. Kaplan and David P. Norton*

Get your HBR Subscriber Alert

> | **Click Here**

**The next issue of HBR online will post on the 1st of the month.**

**Now Available!** Exclusive New Benefit for HBR Subscribers: Online access to the past twelve issues of HBR! Simply select the issue you want to access from the drop down menu above.

## Features

Measuring the Strategic Readiness of Intangible Assets
*Robert S. Kaplan and David P. Norton*

Worse Than Enemies
*Kerry J. Sulkowicz*

Getting IT Right
*Charlie S. Feld and Donna B. Stoddard*

How to Have an Honest Conversation About Your Business Strategy
*Michael Beer and Russell A. Eisenstat*

Launching a World-Class Joint Venture
*James Bamford, David Ernst, and David G. Fubini*

**The HBR List**

>| The HBR List: Breakthrough Ideas for 2004

## Departments

**From the Editor**

>| For Strategy, the Readiness Is All
*Thomas A. Stewart*

**Forethought**

>| Books in Brief

**HBR Case Study**

>| Give My Regrets to Wall Street
*Mark L. Frigo and Joel Litman*

**Managing Yourself**

>| Success That Lasts
*Laura Nash and Howard Stevenson*

**Best Practice**

>| Turning Gadflies into Allies
*Michael Yaziji*

**Panel Discussion**

>| Opt Artists
*Don Moyer*

**Also in this Issue**

>| Letters to the Editor

>| Executive Summaries

>| Reprints and Subscriptions

>| About HBR

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

FEATURE ARTICLE

# Measuring the Strategic Readiness of Intangible Assets

**A real—and revolutionary—opportunity lies in studying and assessing how well prepared a company's people, systems, and culture are to carry out its strategy.**

***by Robert S. Kaplan and David P. Norton***

How valuable is a company culture that enables employees to understand and believe in their organization's mission, vision, and core values? What's the payoff from investing in a knowledge management system or in a new customer database? Is it more important to improve the skills of all employees or focus on those in just a few key positions?

Measuring the value of such intangible assets is the holy grail of accounting. Employees' skills, IT systems, and organizational cultures are worth far more to many companies than their tangible assets. Unlike financial and physical ones, intangible assets are hard for competitors to imitate, which makes them a powerful source of sustainable competitive advantage. If managers could find a way to estimate the value of their intangible assets, they could measure and manage their company's competitive position much more easily and accurately.

But that's simpler said than done. Unlike financial and physical assets, intangible assets are worth different things to different people. An oil well, for example, is almost as valuable to a retail firm as it is to an oil exploration corporation because either company could sell it swiftly if necessary. But a workforce with a strong sense of customer service and satisfaction is worth far more to the retailer than it would be to the oil company. Also, unlike tangible assets, intangible assets almost never create value by themselves. They need to be combined with other assets. Investments in IT, for example, have little value unless complemented with HR training and incentive programs. And, conversely, many HR training programs have little value unless complemented with modern technology tools. HR and IT investments must be integrated and aligned with corporate strategy if the organization is to realize their full potential. Indeed, when companies separate functions like HR and IT organizationally, they usually end up with competing silos of technical specialization. The HR department argues for increases in employee training, while the IT department lobbies for buying new hardware and software packages.

What's more, intangible assets seldom affect financial performance directly. Instead, they work indirectly through complex chains of cause and effect. Training employees in Total Quality Management and Six Sigma, for instance, should improve process quality. That improvement should then increase customer satisfaction and loyalty—and also create some excess resource capacity. But only if the company can transform that loyalty into improved sales and margins and eliminate or redeploy the excess resources will the investment in training pay off. By contrast, the impact of a new tangible asset is immediate: When a retailer develops a new site, it sees financial benefits from the sales in the newly opened outlet right away.

Although these characteristics make it impossible to value intangible assets on a freestanding basis, they also point the way to a new approach for quantifying how intangible assets add value to the company. By understanding the problems associated with valuing intangible assets, we learn that the measurement of the value they create is embedded in the context of the strategy the company is pursuing. Companies such as Dell, Wal-Mart, or McDonald's that are following a low-cost strategy derive value from Six Sigma and TQM training because their strategies are predicated on continuous process improvement. The strategy of offering customers integrated solutions (rather than discrete products) pursued by Goldman Sachs, IBM Consulting, and the like

>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague
>| Executive Summary

IN THIS ARTICLE

The Strategy Map
Human Capital Readiness at Consumer Bank
Seven Behaviors for Transformation

WRITTEN BY

**Robert S. Kaplan** (rkaplan@hbs.edu) is the Marvin Bower Professor of Leadership Development at Harvard Business School in Boston. **David P. Norton** (dnorton@bscol.com) is the founder and president of the Balanced Scorecard Collaborative (www.bscol.com) in Lincoln, Massachusetts. This article is based on their book *Strategy Maps: Converting Intangible Assets into Tangible Outcomes* (Harvard Business School Press, 2004).

>| *Harvard Business Review* OnPoint Edition

This article is enhanced with a summary of key points to help you quickly absorb and apply the concepts and a bibliography to guide further exploration.

>| *Harvard Business Review* OnPoint Collection

This article is also part of the specially priced OnPoint collection "Focusing Your Organization on Strategy—with the Balanced Scorecard, 2nd Edition" which includes four OnPoint articles with an overview comparing different perspectives on this topic.

requires employees good at establishing and maintaining long-term customer relationships. An organization cannot possibly assign a meaningful financial value to an intangible asset like "a motivated and prepared workforce" in a vacuum because value can be derived only in the context of the strategy. What the company *can* measure, however, is whether its workforce is properly trained and motivated to pursue a particular goal.

Viewed in this light, it becomes clear that measuring the value of intangible assets is really about estimating how closely aligned those assets are to the company's strategy. If the company has a sound strategy and if the intangible assets are aligned with that strategy, then the assets will create value for the organization. If the assets are not aligned with the strategy or if the strategy is flawed, then intangible assets will create little value, even if large amounts have been spent on them.

In the following pages, we will draw on the concepts and tools of the Balanced Scorecard to present a way to systematically measure the alignment of the company's human, information, and organization capital—what we call its *strategic readiness*—without which even the best strategy cannot succeed.

### Defining Strategic Readiness

In developing the Balanced Scorecard more than a decade ago, we identified, in its Learning and Growth Perspective, three categories of intangible assets essential for implementing any strategy:

• **Human Capital:** the skills, talent, and knowledge that a company's employees possess.

• **Information Capital:** the company's databases, information systems, networks, and technology infrastructure.

• **Organization Capital:** the company's culture, its leadership, how aligned its people are with its strategic goals, and employees' ability to share knowledge.

To link these intangible assets to a company's strategy and performance, we developed a tool called the "strategy map," which we first introduced in our previous article for *Harvard Business Review,* "Having Trouble with Your Strategy? Then Map It" (September–October 2000). As the exhibit "The Strategy Map" shows, intangible assets influence a company's performance by enhancing the internal processes most critical to creating value for customers and shareholders. Companies build their strategy maps from the top down, starting with their long-term financial goals and then determining the value proposition that will deliver the revenue growth specified in those goals, identifying the processes most critical to creating and delivering that value proposition, and, finally, determining the human, information, and organization capital the processes require.

The Strategy Map

This article focuses on the bottom—the foundation—of the map and will show how intangible assets actually determine the performance of the critical internal processes. Once that link has been established, it becomes easy to trace the steps back up the map to see exactly how intangible assets relate to the company's strategy and performance. That, in turn, makes it possible to align those assets with the strategy and measure their contribution to it. The degree to which the current set of assets does—or does not—contribute to the performance of the critical internal processes determines the strategic readiness of those assets and thus their value to the organization. The strategic readiness of each type of intangible asset can be thought of as follows:

**Human Capital (HC):** In the case of human capital, strategic readiness is measured by whether employees have the right kind and level of skills to perform the critical internal processes on the strategy map. The first step in estimating HC readiness is to identify the *strategic job families*—the positions in which employees with the right skills, talent, and knowledge have the biggest impact on enhancing the organization's critical internal processes. The next step is to pinpoint the set of specific competencies needed to perform each of those strategic jobs. The difference between the requirements needed to carry out these jobs effectively and the company's current capabilities represents a "competency gap" that measures the organization's HC readiness.

**Information Capital (IC):** The strategic readiness of information capital is a measure of how well the company's strategic IT portfolio of infrastructure and applications supports the critical internal processes. Infrastructure comprises hardware—such as

central servers and communication networks—and the managerial expertise—such as standards, disaster planning, and security—required to effectively deliver and use applications. Two categories of applications, in turn, are built on this infrastructure: *Transaction-processing applications,* such as an ERP system, automate the basic repetitive transactions of the enterprise. *Analytic applications* promote analysis, interpretation, and sharing of information and knowledge. Either type may or may not be a *transformational application*—one that changes the prevailing business model of the enterprise. Levi's uses a transformational application to tailor jeans to individual customers. Home Shopping Network uses a transformational application to measure the "profits per second" being generated by currently offered merchandise. Transformational applications have the most potential impact on strategic objectives and require the greatest degree of organization change to deliver their benefits.

**Organization Capital (OC):** Organization capital is perhaps the least understood of the intangible assets, and the task of measuring it is correspondingly difficult. But in looking at the strategic priorities that companies in our database of Balanced Scorecard implementations used for their organization capital objectives, we found a consistent picture. Successful companies had a *culture* in which people were deeply aware of and internalized the mission, vision, and core values needed to execute the company's strategy. These companies strove for excellent *leadership* at all levels, leadership that could mobilize the organization toward its strategy. They strove for a clear *alignment* between the organization's strategic objectives and individual, team, and departmental goals and incentives. Finally, these companies promoted *teamwork,* especially the sharing of strategic knowledge throughout the organization. Determining OC readiness, we concluded, would involve first identifying the changes in organization capital required by the new strategy—what we call the "organization change agenda"—and then separately identifying and measuring the state of readiness of the company's cultural, leadership, alignment, and teamwork objectives.

Strategic readiness is related to the concept of liquidity, which accountants use to classify financial and physical assets on a company's balance sheet. Accountants divide a firm's assets into various categories, such as cash, accounts receivable, inventory, property, plant and equipment, and long-term investments. These are ordered hierarchically according to the ease and speed with which they can be converted to cash—in other words, according to the degree of their liquidity. Accounts receivable is more liquid than inventory, and both accounts receivable and inventory are classified as short-term assets since they typically convert to cash within 12 months, faster than the cash recovery cycle from such illiquid assets as plant and equipment. Strategic readiness does much the same for intangible assets—the higher their state of readiness, the faster they contribute to generating cash.

**Human Capital Readiness**

All jobs are important to the organization; otherwise, people wouldn't be hired and paid to perform them. Organizations may require truck drivers, computer operators, production supervisors, materials handlers, and call center operators and should make it clear that contributions from all these employees can improve organizational performance. But we have found that some jobs have a much greater impact on strategy than others. Managers must identify and focus on the critical few that have the greatest impact on successful strategy implementation.

John Bronson, vice president of human resources at Williams-Sonoma, estimates that people in only five job families determine 80% of his company's strategic priorities. The executive team of a chemical company has identified eight job families critical to its strategy of offering customized innovative solutions. These job families employ, in aggregate, 100 individuals—less than 7% of the total workforce. Kimberlee Williams, vice president of human resources at Unicco, a large integrated facilities-services management company, says that three job families are key to its strategy: project managers, who oversee the operations in specific accounts; operations directors, who broaden the relationships within existing accounts; and business development executives, who help acquire new accounts. These three job families employ only 215 people, less than 4% of the workforce. By focusing human capital development activities on these critical few individuals, the chemical company, Unicco, and Williams-Sonoma can greatly leverage their human capital investments. It is sobering to think that strategic success in these three companies is determined by how well they develop competencies in less than 10% of their workforces.

Once a company identifies its strategic job families, it must define the requirements for these jobs in considerable detail, a task often referred to as "job profiling" or "competency profiling." A competency profile describes the knowledge, skills, and values

required by successful occupants in the job family. Often, HR managers will interview individuals who best understand the job requirements to develop a competency profile they can use to recruit, hire, train, and develop people for that position. To see how this might be done, consider Consumer Bank, a composite example distilled from our experiences in working with about a dozen retail banks.

Consumer Bank was migrating from its historic strategy of promoting individual products to one offering complete financial solutions and one-stop shopping to targeted customers. The map for this new strategy identified seven critical internal processes, one of which was "cross-sell the product line." Human resources and line executives then identified the financial planner as the job most important to the effective performance of this process. A planning workshop further identified four skills fundamental to the financial planner's job: solutions selling, relationship management, product-line knowledge, and professional certification. For each internal process on its strategy map, Consumer Bank replicated this approach, identifying the strategic job families and critical competencies each required. The results are summarized in the exhibit "Human Capital Readiness at Consumer Bank."

**Human Capital Readiness at Consumer Bank**

To take the next step—assessing the current capabilities and competencies of each of the employees in each strategic job family—companies can draw from a broad range of approaches. For example, employees can themselves assess how well their current capabilities fit the job requirements and then discuss those assessments with a mentor or career manager. Alternatively, an assessor can solicit 360-degree feedback on employees' performance from their supervisors, peers, and subordinates. From these assessments, employees get a clear understanding of their objectives, meaningful feedback on their current levels of skill and performance, and specific recommendations for future personal development.

Consumer Bank estimated that it needed 100 trained and skilled financial planners to execute the cross-selling process. But in assessing its recent targeted hiring, training, and development programs, the bank's HR group determined that only 40 of its financial planners had reached a high enough level of proficiency. The bank's human capital readiness for this piece of the strategy was, therefore, only 40%, as the exhibit shows. By replicating this analysis for all its strategic job families, the bank learned the state of its human capital readiness and thus whether the organization could move forward quickly with its new strategy.

### Information Capital Readiness

Executives must understand how to plan, set priorities for, and manage an information capital portfolio that supports their organization's strategy. As with human capital, the strategy map serves as a starting point for delineating a company's IC objectives. In the case of Consumer Bank, the chief information officer led an initiative to identify the specific information capital needs of each of the seven internal processes previously identified as critical to the bank's new value proposition.

For the customer management process "cross-sell the product line," the workshop team identified an application for customers to analyze and manage their portfolios by themselves (a customer portfolio self-management system) as a transformational application. The workshop team identified an analytical application for the same process (a customer profitability system) and a transaction-processing application (an integrated customer file). The internal process "understand customer segments" also needed a customer profitability system, as well as a separate customer feedback system to support market research. The process "shift to appropriate channel" required a strong foundation of transactional systems, including a packaged CRM software suite that included modules for lead management, order management, and sales force automation. For the operations process "provide rapid response," participants identified a transformational application (customer self-help) as well as an analytic application (a best-practice community knowledge management system) for sharing successful sales techniques among telemarketers. Finally, the "minimize problems" process required an analytical application (service quality analysis) to identify problems and two related transaction-level systems (one for incident tracking and another for problem management).

After defining its portfolio of IC applications, the project team identified several required components of IT infrastructure. Some applications needed a CRM transactions database. Others required that a Web-enabled infrastructure be integrated into the bank's overall Web site architecture. The team also learned about the need for an

internal R&D project to develop a new interactive voice-response technology. All together, the bank's planning process defined an information capital portfolio made up of 14 unique applications (some of which supported more than one internal process) and four IT infrastructure projects. (See the exhibit "Information Capital Readiness at Consumer Bank.")

## Information Capital Readiness at Consumer Bank

The first two rows of the information capital readiness report, like the human capital report, list the company's critical internal processes and its strategic job families. The remaining five rows specify the various items in the IC portfolio, assigning scores indicating how well developed each item is. In this example, Consumer Bank has the IC portfolio it needs to support innovation but is less able to support the jobs most critical to its customer management and operational excellence goals.

| | Operations Management | | Customer Management | | Innovation | |
|---|---|---|---|---|---|---|
| Strategic Processes | Minimize problems | Provide rapid response | Cross-sell the product line | Shift to appropriate channel | Understand customer segments | Develop new products |
| Strategic Job Families | Quality manager | Call center representative | Certified financial planner | Telemarketer | Consumer marketer | Joint venture manager |
| | Strategic Information Capital Portfolio | | | | | |
| Transformational Applications | | Customer self-help 4 | Customer portfolio self-management 4 | | | |
| Analytical Applications | Service quality analysis 2 | Best-practice community knowledge management system 3 | Customer profitability 3 | Best-practice community knowledge management system 2 | Customer profitability 3 | Best-practice community knowledge management system 2 |
| Transaction-Processing Applications | Incident tracking 6; Problem management 2 | Workforce scheduling 3; Problem management 2 | Integrated customer file 2 | CRM/lead management 6; CRM/order management 2; CRM/sales force automation 4 | Customer feedback 2 | Project management 2 |
| Technology Infrastructure | Web enabled 3; Computer telephony integration 4 | Computer telephony integration 4; Interactive voice response 3 | CRM packaged software 2; Web enabled 3 | Web enabled 3; Computer telephony integrated 4 | CRM packaged software 2 | |
| Combined Readiness Level | ✗ | ✗ | ? | ✗ | ✓ | ✓ |

**Ratings**

**1** OK

**2** Minor enhancements needed

**3** New development under way

**4** New development behind schedule

**5** Major enhancements required

**6** New application required

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

The team then turned to assessing the readiness of the bank's existing portfolio of IC infrastructure and applications, assigning a numerical indicator from 1 to 6 to each system. A score of 1 or 2 indicates that the system is already available and operating normally, perhaps needing only minor enhancements. A score of 3 or 4 indicates that the system has been identified and funded but is not yet installed or operational. In other words, current capability does not yet exist but development programs are under way to close the gap. A score of 5 or 6 signals that a new infrastructure or application is needed to support the strategy, but nothing has yet been done to create, fund, and deliver the capability. Managers responsible for the IC development programs provided the subjective judgments for this simple measurement system, and the CIO was responsible for assessing the integrity of the reported numbers. In the IC exhibit, we can also see that Consumer Bank aggregated the readiness measures of individual applications and infrastructure programs—designating them green, yellow, or red, based on the worst-case application in the category—to create a portfolio status report. With such a report,

managers can see the strategic readiness of the organization's information capital at a glance, easily pinpointing the areas in which more resources are needed. It is an excellent tool for monitoring a portfolio of information capital development programs.

Many sophisticated IT organizations already use more quantitative, objective assessments of their information capital portfolios than the subjective process we've just described for Consumer Bank. These organizations survey users to assess their satisfaction with each system. They perform financial analyses to determine the operating and maintenance costs of each application. Some conduct technical audits to assess the underlying quality of the code, ease of use, quality of documentation, and frequency of failure for each application. From this profile, an organization can build strategies for managing its portfolio of existing IC assets just as one would manage a collection of physical assets like machinery or a fleet of trucks. Applications with high levels of maintenance can be streamlined, for example, applications with high operating costs can be optimized, and applications with high levels of user dissatisfaction can be replaced. This more comprehensive approach can be effective for managing a portfolio of applications that are already operational.

**Organization Capital Readiness**

Success in performing the critical internal processes identified in an organization's strategy map invariably requires an organization to change in fundamental ways. Assessing OC readiness is essentially about assessing how well the company can mobilize and sustain the organization change agenda associated with its strategy. For instance, if the strategy involves focusing on the customer, the company needs to determine whether its existing culture is customer-centric, whether its leaders have the requisite skills to foster such a culture, whether employees are aware of the goal and are motivated to deliver exceptional customer service, and, finally, how well employees share with others their knowledge about the company's customers. Let's explore how companies can make these kinds of assessments for each of the four OC dimensions.

**Culture.** Of the four, culture is perhaps the most complex and difficult dimension to understand and describe because it encompasses a wider range of behavioral territory than the others. That's probably why "shaping the culture" is the most often-cited objective in the Learning and Growth section of our Balanced Scorecard database. Executives generally believe that changes in strategy require basic changes in the way business is conducted at all levels of the organization, which means, of course, that people will need to develop new attitudes and behaviors—in other words, change their culture.

Assessment of cultural readiness relies heavily on employee surveys. But in preparing surveys, companies need to distinguish clearly between the values that all employees share—the company's base culture—and the perceptions that employees have of their existing system—the climate. The concept of base culture has its roots in anthropology, which defines an organization's culture as the symbols, myths, and rituals embedded in the group consciousness (or subconscious). To describe a company's base culture, therefore, you have to uncover the organization's systems of shared meanings, assumptions, and values.

The concept of climate has its roots in social psychology and is determined by the way organizational influences—such as the incentive structure or the perceived warmth and support of superiors and peers—affect employees' motivation and behavior. The anthropological component reflects employees' shared attitudes and beliefs independent of the actual organizational infrastructure, while climate reflects their shared perception of existing organizational policies, practices, and procedures, both formal and informal.

Surveying perceptions of existing organizational policies and practices is a fairly straightforward task, but getting at the base culture requires a little more digging. Anthropologists usually rely on storytelling to identify shared beliefs and images, but that approach is inadequate for quantifying the alignment of culture to strategy. Organizational behavior scholars have developed measurement instruments, such as Charles O'Reilly and colleagues' Organizational Culture Profile, in which employees rank 54 value statements according to their perceived importance and relevance in the organization. Once ranked, an organization's culture can be described with a reasonable degree of reliability and validity. Then the organization can assess to what extent the existing culture is consistent with its strategy and what kinds of changes may be needed.

One caveat: Managers do need to be aware that some variations in culture are necessary and desirable in different operating units or functions. The culture of an R&D group, for example, should be different from the culture of a manufacturing unit; the

culture of an emergent business unit should be different from the culture of a mature one. Executives should strive for agreement throughout the organization about corporatewide values such as integrity, respect, treatment of colleagues, and commitment to customer satisfaction. But some value statements in the survey instrument should refer to the culture of specific operating units. So, for example, surveys of the employees in operations and service-delivery units would include statements about quality and continuous improvement, whereas the R&D department survey might include statements about creativity and innovation. For employees involved in customer acquisition, statements might relate to retention and growth or to a deep understanding of individual customers' preferences and needs.

**Leadership.** If companies change their strategies, people will have to do some things differently as well. It is the responsibility of leaders at all levels of the organization—from the CEO of a retail chain down to the local store managers—to help employees identify and understand the changes needed and to motivate and guide them toward the new ways of working.

In researching the best practices in our Balanced Scorecard database, we were able to identify seven generic types of behavioral changes that build organization capital, and each fell into one of two categories: changes that support the creation of value—such as increasing people's focus on the customer—and those required to carry out the company's strategy—such as increasing accountability. The sidebar "Seven Behaviors for Transformation" describes these behavioral changes in more detail.

Seven Behaviors for Transformation

To ensure that it gets the kind of leaders it needs, a company should draw up a *leadership competency model* for each of its leadership positions. This is a kind of job profile that defines the competencies a leader is expected to have to be effective in carrying out the company's strategy. For example, one manufacturing company, attempting to create teams to solve customers' problems, identified and defined three competencies essential for people in team leadership positions:

• **Customer Focus**—Outstanding leaders understand their customers. They place themselves in the customers' minds and spend time with them to understand their current and future needs.

• **Fostering Teamwork**—Outstanding leaders work collaboratively with their own teams and across organizational and geographic boundaries. They empower their teams to achieve excellence.

• **Open Communications**—Outstanding leaders tell the truth. They openly share information with peers, managers, and subordinates. They tell the whole story, not just how it looks from their position.

Often, organizations will measure leadership traits, such as those listed above, through employee surveys. A staff or external unit solicits information from subordinates, peers, and superiors about a leader's mastery of the critical skills. This personal feedback is used mainly for coaching and developing the leader, but the unit can also aggregate the detailed (and confidential) data from the individual reviews to create a status report on the readiness of key leadership competencies needed throughout the organization.

**Alignment.** An organization is aligned when all employees have a commonality of purpose, a shared vision, and an understanding of how their personal roles support the overall strategy. An aligned organization encourages behaviors such as innovation and risk taking because individuals' actions are directed toward achieving high-level objectives. Encouraging and empowering individual initiative in an unaligned organization leads to chaos, as the innovative risk takers pull the organization in contradictory directions.

Achieving alignment is a two-step process. First, managers communicate the high-level strategic objectives in ways that all employees can understand. This involves using a wide range of communication mechanisms: brochures, newsletters, town meetings, orientation and training programs, executive talks, company intranets, and bulletin boards. The goal of this step is to create intrinsic motivation, to inspire employees to internalize the organization's values and objectives so that they want to help the organization succeed. The next step uses extrinsic motivation. The organization has employees set explicit personal and team objectives aligned to the strategy and establishes incentives that reward employees when they meet personal, departmental, business unit, and corporate targets.

Measuring alignment readiness is relatively straightforward. Many survey instruments are already available for assessing how much employees know about and how well they understand high-level strategic objectives. It is also fairly easy to see whether or not individuals' personal objectives and the company's existing incentive schemes are consistent with the high-level strategy.

For example, a large property and casualty insurance company adopted a new strategy intended to reduce its underwriting losses by creating a tighter link between the underwriters, who decide whether to accept a new piece of business, and the claims agents, who deal with the consequences from poor underwriting decisions. Historically, these specialists lived in different parts of the organization, and their incentives were totally unrelated to each other, which clearly did little to foster cooperation between them or with the line business units they supported. To reflect the new strategy, the company changed to a team-based compensation system in which everyone's incentive pay was based on a common set of measures (their Balanced Scorecard). Underwriters and claims agents, who worked in service departments shared by the various business units, were now rewarded using the Balanced Scorecard measures related to the business units they supported. The company used a survey instrument to capture the employees' perceptions of the improved teamwork created by aligning the incentive systems.

**Teamwork and Knowledge Sharing.** There is no greater waste than a good idea used only once. Most organizations have to go through a cultural change to shift individuals from hoarding to sharing their local knowledge. No asset has greater potential for an organization than the collective knowledge possessed by all its employees. That's why many companies, hoping to generate, organize, develop, and distribute knowledge throughout the organization, have spent millions of dollars to purchase or create formal knowledge management systems.

The challenge in implementing such systems is motivating people to actually document their ideas and knowledge to make them available to others. Most organizations in our Balanced Scorecard database attempted to develop such motivation by selecting "teamwork" and "knowledge sharing" as strategic priorities in their Learning and Growth Perspective. Typical measures for these priorities included the number of best practice ideas the employees identified and used, the percentage of employees who transferred knowledge in a workout process, the number of people who actually used the knowledge management system, how often the system is used, the percentage of information in the knowledge management system that was updated, and how much was obsolete.

For knowledge sharing to matter, it must be aligned with the priorities of the strategy map. For example, one organization—a chemical company—created several best practice communities to complement the internal process objectives on its strategy map. The Improve Workplace Safety community consisted of the safety directors from every facility. They studied the best practices at the high-performing plants and created a best practice–sharing program. The company's output measure, "days away from work," dropped by 70%. In another example, a children's hospital was attempting to reduce costs without reducing the quality of patient care. Intensive discussions resulted in a top-ten list of best practices already being used somewhere in the hospital. The hospital then formed cross-functional medical practice teams of physicians, nurses, and administrators to implement as many of these procedures as they practically could. It measured success, the output of this knowledge-sharing process, by the "number of best practices utilized." The effective implementation of best practices over the next three years led to dramatic improvements in organizational outcomes: Readmission rates dropped by 50%, cost per case and length of stay each declined by 25%, and both customer satisfaction and quality of care increased. In these and many other examples in our case files, organizations enhanced their performance by aligning the teamwork and knowledge-sharing component of their organization capital with their strategy.

To get an overview of organizational readiness, companies can put the information they obtain from their various surveys and assessments together in a report like the one shown in "Organization Capital Readiness Report." In this exhibit, the leadership measure, drawn from the leadership competency model, displays the company's estimate, based on employee surveys, of the degree to which the company possesses the key attributes for leadership. At 92%, the company is above target on its leadership objective and can be considered strategically ready in terms of this dimension. The company's OC with respect to teamwork and knowledge sharing is also in good shape. But the firm is performing inadequately in alignment and in developing the right culture, and these problems are lowering its overall level of organization capital readiness.

## Organization Capital Readiness Report

The various measures for organization capital readiness should be put together in a readiness report, which shows, for all the components of organization capital, where the company needs to introduce changes to its behaviors and policies. The report shown here is a simplified version of one prepared by a company in our Balanced Scorecard database.

| Attribute | Strategic Objective | Strategic Measure | Target | Actual |
|---|---|---|---|---|
| Culture | Foster awareness and internalization of the mission, vision, and core values needed to execute the strategy | Customer-focused (customer survey; percentage who understand the organization's mission) | 80% | 68% ✗ |
| | | Other core values (employee change readiness survey) | 80% | 52% ✗ |
| Leadership | Develop leaders at all levels who can mobilize the organization toward its strategy | Leadership gap (percentage of key attributes in competency model rated above threshold) | 90% | 92% ✓ |
| Alignment | Align goals and incentives with the strategy at all levels of the organization | Strategic awareness (percentage of staff who can identify organization's strategic priorities) | 80% | 75% ✗ |
| | | Strategic alignment (percentage of staff whose objectives and incentives link to Balanced Scorecard) | 100% | 60% ✗ |
| Teamwork | Ensure that knowledge and staff assets that have strategic potential are shared | Sharing best practices (number of knowledge management system hits per employee) | 5.0 | 6.1 ✓ |

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

• • •

The intangible assets described in the Balanced Scorecard's Learning and Growth Perspective are the foundation of every organization's strategy, and the measures in this perspective are the ultimate lead indicators. Human capital becomes most valuable when it is concentrated in the relatively few strategic job families implementing the internal processes critical to the organization's strategy. Information capital creates the greatest value when it provides the requisite infrastructure and strategic applications that complement the human capital. Organizations introducing a new strategy must create a culture of corresponding values, a cadre of exceptional leaders who can lead the change agenda, and an informed workforce aligned to the strategy, working together, and sharing knowledge to help the strategy succeed.

Some managers shy away from measuring their intangible assets because these measures are usually "softer," or more subjective, than the financial measures they conventionally use to motivate and assess performance. The Balanced Scorecard movement has encouraged organizations to face the measurement challenge. Using the systematic approaches set out in this article, companies can now measure what they want, rather than wanting only what they can currently measure. Even if the measures are imprecise, the simple act of attempting to gauge the capabilities of employees, information systems, and organization capital communicates the importance of these drivers for value creation. In the course of our work, we have seen many companies find new ways to measure—and consequently new ways to enhance the value of—their intangible assets. The measurement and management of these assets played a prominent role in their transformation into successful, strategy-focused organizations.

Reprint Number R0402C | *Harvard Business Review* OnPoint edition 5887 | *Harvard Business Review* OnPoint collection 5933

>| Executive Summary
>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague



Copyright © 2004 Harvard Business School Publishing. All rights reserved.

# Customer Service

Our customer service agents will be happy to provide you with information on back issues, replace missing or damaged issues, or assist with any subscription transactions.

**U.S./Canada**
Phone: 800-274-3214
Fax: 303-604-7644
*Harvard Business Review*
P.O. Box 52623
Boulder, CO 80322-2623 USA
E-mail: hbursubs@neodata.com

**All Other Countries**
Phone: +44 185-843-8868
Fax: +44 185-846-8969
*Harvard Business Review* International Subscriber Services
Tower House, Sovereign Park
Lathkill Street
Market Harborough
Leicestershire LE16 9EF England
Web site: www.subscription.co.uk/help/harvard

**To subscribe online**, visit www.hbr.org

To order reprints of *Harvard Business Review* articles, use the reprint link (on the first page of each article), or visit www.harvardbusinessonline.org.

To request permission to quote or translate *Harvard Business Review* articles, e-mail custserv@hbsp.harvard.edu.

For *Harvard Business Review* advertising opportunities, visit our Web page at www.hbradsales.com.

To contact our editors, e-mail hbr_editorial@hbsp.harvard.edu.

The *Harvard Business Review* is published monthly.

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

# Subscriber Benefits

*Harvard Business Review* Subscriber Advantage (HBR Subscriber Advantage) is an exclusive loyalty rewards program for subscribers of the magazine and for Harvard Business School professors, staff, and alumni. As a main feature of the program, members are allowed Web access to the current issue of *Harvard Business Review*. In the future, members will also receive monthly HBR e-mail updates, enjoy incentives and savings on Harvard Business School Publishing products, and preview upcoming management-thought content (such as the first chapter of an upcoming book).

*Strategy & Innovation:* A Premiere Newsletter from Harvard Business School Publishing and Innosite

*Strategy & Innovation*, our new bimonthly newsletter, brings you essential commentary, research, and analysis from thought leaders like Clayton M. Christensen and other authorities on innovation. It explores the strategies, processes, and best practices that distinguish consistent innovation superstars from the also-rans and one-hit wonders. It does more than help you pick the winners—it gives you the insights that you need to build a robust innovation engine in your organization.

Let us send you a free trial issue so that you can read it for yourself, and we'll also send you a complimentary *Harvard Business Review* OnPoint Collection *Fluid Strategies*, just for giving *Strategy & Innovation* a try.

To order your free trial issue, click here.


PREMIERE ISSUE

Receive a FREE trial copy of *Strategy & Innovation*, featuring Clayton M. Christensen, AND a FREE HBR OnPoint Collection.

STRATEGY INNOVATION
Beyond the Innovator's Dilemma
HBR OnPoint
FREE HBR Articles


Copyright © 2004 Harvard Business School Publishing. All rights reserved.

BREAKTHROUGH IDEAS FOR 2004

February 2004
Online Version

# Harvard Business Review

*Is Your Company Ready to Go?*

Measuring the Strategic Readiness of Intangible Assets
*Robert S. Kaplan and David P. Norton*

Get your HBR Subscriber Alert

> | **Click Here**

**The next issue of HBR online will post on the 1st of the month.**

**Now Available!** Exclusive New Benefit for HBR Subscribers: Online access to the past twelve issues of HBR! Simply select the issue you want to access from the drop down menu above.

## FEATURES

Measuring the Strategic Readiness of Intangible Assets
*Robert S. Kaplan and David P. Norton*

Worse Than Enemies
*Kerry J. Sulkowicz*

Getting IT Right
*Charlie S. Feld and Donna B. Stoddard*

How to Have an Honest Conversation About Your Business Strategy
*Michael Beer and Russell A. Eisenstat*

Launching a World-Class Joint Venture
*James Bamford, David Ernst, and David G. Fubini*

**The HBR List**

>| The HBR List: Breakthrough Ideas for 2004

## DEPARTMENTS

**From the Editor**

>| For Strategy, the Readiness Is All
*Thomas A. Stewart*

**Forethought**

>| Books in Brief

**HBR Case Study**

>| Give My Regrets to Wall Street
*Mark L. Frigo and Joel Litman*

**Managing Yourself**

>| Success That Lasts
*Laura Nash and Howard Stevenson*

**Best Practice**

>| Turning Gadflies into Allies
*Michael Yaziji*

**Panel Discussion**

>| Opt Artists
*Don Moyer*

**Also in this Issue**

>| Letters to the Editor

>| Executive Summaries

>| Reprints and Subscriptions

>| About HBR

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague
>| Executive Summary

# Worse Than Enemies

## The CEO's Destructive Confidant

**CEOs nearly always need an intimate counselor. But unless leaders examine their own motives—and those of their confidants—these relationships will almost certainly be dangerous, and sometimes even catastrophic.**

***by Kerry J. Sulkowicz***

The CEO is often the most isolated and protected employee in the organization. No one gives him unfiltered information. Many people dissemble or conceal things from him. Few leaders, even veteran CEOs, can do the job without talking to someone about their experiences, which is why most develop a close relationship with a trusted colleague—a person with whom they feel free to share their thoughts and fears. Few leaders speak out about these relationships, perhaps because they don't like acknowledging their dependency on others. But in business and politics, most leaders rely on the advice and opinions of a trusted insider: a confidant.

The need for a close confidant is rooted in childhood. Every child wants to feel close to someone, to feel understood, cared for, and loved. While parents ordinarily satisfy such childhood yearnings, these needs are never completely satisfied. In adolescence, we typically resolve them by developing a best friend from among our peer group, and we usually pick individuals of the same sex. When we find ourselves in demanding situations later in life, we seek similar refuge with a fellow adult.

The most effective CEOs find confidants who complement their strengths and sharpen their effectiveness. Bill Gates uses Steve Ballmer in this way; Warren Buffett turns to vice chairman Charlie Munger. In the end, both the CEOs and their organizations benefit from these relationships.

Over the past eight years as a consultant to top management teams and as a psychoanalyst who treats company leaders in private practice, I have found that many CEO–confidant relationships function very well. These confidants serve their leaders and keep the CEOs' best interests at heart. They derive their gratification vicariously—through the help they provide, not for any personal gain—and are usually quite aware of the potential for abusing their access to the CEOs' innermost secrets.

Unfortunately, almost as many confidants end up hurting, undermining, or otherwise exploiting CEOs when they are at their most vulnerable. These confidants rarely make the headlines, but behind the scenes they do enormous damage to the CEO and to the organization. What's more, the leader is often the last one to know when and how the confidant relationship became toxic.

Dangerous confidants come in all shapes and sizes. They are sometimes intentionally scheming and deceitful. Like Rasputin, the crafty manipulator of the Russian imperial family, these overtly bad confidants have sociopathic personalities: They habitually lie and cheat to achieve their aims without any apparent constraints of conscience.

Take someone we'll call Sanford Anderson. (I have changed the names in our examples to protect the privacy of the individuals and companies depicted.) The CEO of a privately held real estate business in the Midwest, a company worth billions, Anderson fell victim to just such a confidant. Early in his career, Anderson's corporate attorney, Gregg Mayer, had saved the firm millions by deftly handling a discrimination lawsuit, which earned him Anderson's undying gratitude and respect. As the years passed, Anderson came to rely on Mayer's advice about everything from investment strategy, architecture and design, to personnel development.

IN THIS ARTICLE

Before It's Too Late

WRITTEN BY

**Kerry J. Sulkowicz**, a psychiatrist and psychoanalyst, is the founder of the Boswell Group and a senior fellow at Katzenbach Partners in New York. He advises and teaches senior business leaders and boards about the psychological aspects of management, governance, and corporate culture. He can be reached at kjs@boswellgroup.com.

Although Anderson was in most respects a highly effective CEO, he had never seriously contemplated the prospect of retiring. Anderson's worries about retirement took the form of denial of his own mortality. Instead of acknowledging his anxiety, he manifested it by plunging even more deeply into work, while ignoring his fatigue and gradual loss of passion. Consequently, he had never set in place an adequate succession plan. Given the toxic confidant that he was, Mayer used the lack of succession planning as an opportunity to advance his own interests. Mayer preyed on Anderson's anxieties about aging and retirement by fueling his fears about whom might want to wrest control of his business.

Rather than encourage Anderson to slow down after he was hospitalized for chest pain, Mayer egged Anderson on in a way calculated to make him more anxious and afraid. As Mayer put it to Anderson, "Now that you've almost had a heart attack, the people you're up against might try to give you a real heart attack by making you angry." Just as Mayer planned, his stoking of Anderson's fears paid off handsomely. When Anderson stepped down, he impulsively handed the reins of power to Mayer. Shocked by the announcement of the new CEO, several key members of the management team stormed out in protest. Unfortunately, without the skills of these key players, the company was soon in trouble, and Anderson's legacy was ruined.

Destructive confidants like Mayer are far more commonplace than we would like to believe. But even more common, and more insidious, are confidants who are convinced they are serving their CEOs well, people who can't see the havoc they wreak on the lives of leaders and their organizations. These confidants have blind spots about their own personalities and capabilities, and little awareness of the damage they can cause.

I have been able to identify three distinct types of destructive confidants over the course of my work. First are *reflectors,* people who mirror the CEO, constantly reassuring him that he is the "fairest CEO of them all." By contrast, the second type of destructive confidant, the *insulator,* buffers the CEO from the organization, preventing critical information from getting out and from getting in. Then, as we have just seen in the previous example, there is the *usurper,* the confidant who cunningly ingratiates himself with the CEO in a desperate bid for power. In the following pages, we'll explore how the CEO–confidant relationship plays out in each case and discuss ways in which CEOs can avoid these destructive relationships. As we shall see, the truth is that many leaders have only themselves to blame for the confidants they have.

Before It's Too Late

**Mirror, Mirror on the Wall**

CEOs are narcissistic—if they weren't, they wouldn't be leaders. Moreover, without that quality, they couldn't grow their business or provide the organization with the vision it needs. In my experience, CEOs with the best confidant relationships have a healthy dose of narcissism, and their confidants provide positive and negative feedback, they bolster CEOs' flagging spirits, and they encourage CEOs to achieve balance and creativity.

But some CEOs constantly need to be told wonderful things about themselves. Typically, these leaders are both grandiose and extremely vulnerable to slights, and they often have a hard time hearing bad news or facing harsh realities. They surround themselves with yes-men who are unwilling to tell them the truth; these leaders also tend to have failed marriages, trophy wives, or extramarital affairs with women who feed their egos. Some narcissistic CEOs, such as Richard Scrushy of HealthSouth or Dennis Kozlowski of Tyco, turn their organizations into elaborate monuments to themselves. Unfortunately, these leaders are also prone to selecting confidants who cater to their fragile self-esteem. These are the reflecting confidants.

The reflector intuitively knows how to make a narcissistic CEO feel good. Although all confidants may do this to some extent, reflectors are driven by their own neurotic need to please authority. That's usually because they've grown up with narcissistic parents who demanded that their children mirror them to an inappropriate extent. These kids feel that they exist to take care of their parents, rather than the reverse. For example, children with depressed mothers typically feel responsible for their mothers' happiness. In such an environment, a child's self-esteem becomes contingent on giving the parents what they want, rather than on developing an autonomous personality.

One confidant told me that the first thing he did each morning with his mother, a former actress, was to scrutinize her face to see if she was having a bad day. If she was, he used to take it as a signal that he needed to find some good news quick. As a confidant, he was equally terrified of angry outbursts on the part of his CEO. Like other reflectors,

this confidant was extremely sensitive to the limited range of emotion that a fragile CEO could tolerate, and he twisted himself into knots trying to avoid upsetting him.

In extreme forms, the CEO–confidant pair ends up creating its own distorted version of reality, what is known in the psychiatric literature as folie à deux—or shared madness. When shared madness develops and other key executives see how much the CEO values the reflector, some may try to become the CEO's reflectors themselves. This often leads to a polarization of employees: A small group of employees fiercely defends the CEO, while a larger group rebels against the leader and seeks out another senior executive who serves as its unofficial leader and the voice of reality.

**In extreme forms, the CEO–confidant pair ends up creating its own distorted version of reality, or shared madness.**

Consider what happened at Regal Software, a developer of video gaming technology. As a first-time CEO, Paul Rothberg almost instantly found himself at odds with the company's talented software developers, who resented his autocratic management style. Rothberg's unreasonable expectations of R&D eventually created a split between the organization's research and business arms. As the gulf widened, Rothberg found himself increasingly butting heads with most of Regal's employees, and so he began turning for interpersonal advice to Frank Jordan, a former headhunter turned executive coach.

Rothberg had installed Jordan in an office at Regal's headquarters, where he spent three mornings a week ostensibly to be available to coach all the senior executives. In reality, though, Rothberg was his only client. Rothberg would call Jordan twice a day; he also made frequent visits to his office at Regal. It soon became clear to other employees how much the embattled CEO depended on his new confidant. For his part, Jordan was seduced into believing that nothing was more important for him to do than to keep the CEO happy. He would listen intently to Rothberg's concerns and then color his own observations to match Rothberg's. To outsiders, they looked like coconspirators who spent endless hours huddled in conversation. Indeed, Jordan offered Rothberg constant reassurance that he was doing the right thing, when, in fact, Rothberg was gravely misguided.

Consciously or not, Rothberg and Jordan created a symbiotic relationship in which they relied almost entirely on each other's perceptions about what was happening at Regal. Rothberg had looked to Jordan to be his eyes and ears, but the more Jordan was drawn into his privileged role, the more unable he was to accurately understand the situation unfolding around him. Unfortunately, Jordan supplied flawed advice, such as encouraging Rothberg to attend more of his software developers' creative meetings, which only made him seem even more intrusive and controlling. At the same time, Jordan inadvertently bolstered Rothberg's fundamentally harsh and rigid personality by consistently praising the CEO's judgment rather than offering constructive criticism. A vicious circle ensued, fueling the polarization of employees into Rothberg loyalists or enemies.

Although it isn't always the case that shared madness between a CEO and his confidant leads to paranoia, these ingrained attitudes of mistrust and negativity are easily magnified under these circumstances. Rothberg's naïveté, for instance, was not the only cause of Regal's organizational tensions. Deeper down, the rift was fueled by companywide worries about the feasibility of Regal's developing technology. But Rothberg's misuse of his confidant brought organizational anxieties to a crisis point. Ultimately, as Rothberg's manipulations and deceptions continued to escalate, senior management felt betrayed, and Rothberg was ousted. For his part, Jordan had squandered his reputation as an independent expert. Lingering suspicions and resentments prevented him from functioning effectively as an outside consultant, and he, too, was eventually forced out.

### You Need Me, and Don't Forget It!

While the reflector inadvertently joins with the CEO in creating a shared, distorted view of reality, the insulator tries to serve as a mediator between an ill-suited CEO and his organization. CEOs who need insulators tend to be abrasive or abusive leaders. These arrogant leaders often deny the negative impact of their personality on those around them. They thoughtlessly push away their best people, make impulsive business decisions, alienate large constituencies within the company, and poison morale. These leaders quickly find themselves at odds with their subordinates, senior executives, and boards because of their lack of emotional intelligence. And whether they are quietly off-putting or openly hostile, these leaders rarely feel concerned about, or able to, change their interpersonal style.

To compensate, these abrasive CEOs seek insulators, people whom they believe can translate their poorly communicated ideas into language their organizations can understand. They need people willing to intercede when they make self-destructive moves. Like the mother of a child abused by his father, the insulator is constantly apologizing to the organization on the CEO's behalf: "He didn't mean it." The insulator is also much like the enabler—to borrow the language of Alcoholics Anonymous—who makes excuses for the alcoholic.

Insulators have some special characteristics. Many have passive personalities and need to be rescuers. Women in senior management positions are certainly not all insulators, but, for reasons that still have not been sufficiently researched, most insulators turn out to be women. And although they typically harbor no ambitions to be CEOs themselves, insulators crave control over both the leader and the organization. That contrasts with reflectors, who unconsciously try to control leaders by pleasing them. Thus, while insulators can be quite manipulative, they position their behavior to appear as though they are doing an altruistic service for their bosses and companies.

The insulator's false humility can be grating, but it is often difficult to see what is toxic about it. In the short run, insulators appear to be helpful, even essential, particularly to those who don't trust the CEO. The problem is that over time, insulators undermine the very authority of the leader they are seemingly trying to protect. Senior executives learn that to get anything substantive done, they must go through the insulating confidant, who quickly comes to be seen as the real power behind the throne. This arrangement has two problems. First, because the insulator's formal power inadequately reflects her influence, she is often largely unaccountable for her actions. Second and more crucial, insulators feed the CEO filtered information about the organization; as a result, the CEO becomes dangerously cut off from the grass roots.

Jay Stephens was a CEO whose personality cried out for an insulator. After a successful academic career in engineering, he was tapped to take over the research operations of Pantreon, a large energy company. Stephens had a reputation for being brilliant but impossible, and his vicious tirades and abrasive personality were legendary. After making several important discoveries that had saved the firm billions of dollars, Stephens became the dark-horse candidate for CEO. When the board chose him as the new leader, he quickly replaced the old head of HR with Louisa Attwood, a junior HR manager who had helped him when he first joined Pantreon.

It soon became clear to senior management that Attwood was also being promoted to the role of CEO confidant. Whenever he felt the urge, Stephens would call Attwood for lengthy conversations—sometimes in the middle of the night. Frequently, these talks were opportunities for Stephens to vent his frustrations and to disparage whomever he felt had disappointed or betrayed him. Attwood spent most of her time listening and some occasionally offering to intervene in these interpersonal conflicts. She also saw her interactions with Stephens as opportunities to solidify her increasingly powerful role in their relationship.

**Senior executives learn that to get anything substantive done, they must go through the insulating confidant, who quickly comes to be seen as the real power behind the throne.**

Attwood had a privileged relationship with Stephens in that she was the only member of the senior management team who escaped the CEO's attacks. In no small part, Attwood was chosen for this role because, as head of HR, she was out of the line of competition to succeed Stephens. But she was also chosen because of her intuitive ability to temper the CEO's personality. Attwood learned, over time, to filter virtually every significant corporate initiative or communication that came from Stephens. She edited all his memos, coached him on board presentations, and frequently stepped in to do damage control after Stephens had displayed his true colors. One of the inside jokes at Pantreon was that in her previous life, Attwood must have been a UN interpreter. Not that she was impartial. Senior executives who learned to manage Stephens by going through Attwood were dismayed when she injected her own perspectives into their communications.

During Stephens's tenure as CEO of Pantreon, the company's tradition of engineering innovation began a gradual but clear decline, and its marketing efforts also slowed. Sales fell flat. Not by accident, the boardroom became more fiercely contentious than ever, in part because of all the unspoken tension around Stephens's behavior and the unacknowledged efforts to manage around it. Several key executives left the organization out of frustration at having an insulated and unreachable CEO who forced

them to go through a third party.

Because of Stephens's relentless abrasiveness, Attwood continued to shield him from the organization—even managing to portray herself as a long-suffering martyr in the process. While Stephens never directly acknowledged his dependence on Attwood, he rewarded her with generous bonuses and option grants, which the rest of the management team resented deeply. When Stephens finally retired—after what many outside observers viewed as a mixed record at Pantreon's helm—Attwood sought early retirement and spent a year traveling, ostensibly to recover from her emotionally depleting role as a kind of container of toxic behavior. But from the organization's perspective, it was good riddance. The executives forced to depend on Attwood had come to deeply resent her power and her barely disguised need for control.

This all-too-common form of CEO–confidant relationship occurs in businesses of all types and sizes. It may be symptomatic of the ever-increasing complexity of modern corporate life, as well as of the inadequate screening of potential CEOs. Leaders who don't know how to express anger or criticism constructively, or who inadvertently make provocative, demeaning statements to their direct reports, probably need some insulation to preserve their role and stature. The challenge is preventing that insulation from suffocating CEOs and their top management team members.

**You and Me Against the World, Sucker**

Insulators and reflectors may lack the self-knowledge to serve the CEO well, but they are not unethical. The same cannot be said of our third confidant type, the usurper. Usurpers are dangerous not only to the CEO but also to the organization as a whole. They are sociopaths who should be shown the door as soon as possible. It's important, though, to do this in a way that saves face for the exploited CEO, who may, like Rasputin's czar, come crashing down along with his dangerous confidant.

Usurpers are deliberately scheming and ambitious. Whether at work or in their personal lives, usurpers only last long enough in relationships to get their needs met. When they feel that people are no longer gratifying their desires, usurpers will abruptly end the relationship. Usurpers clearly treat others badly, and they are frequently self-destructive as well. Not surprisingly, they often have long histories of impulsivity, as well as substance abuse or illegal behavior. And although women do act as usurpers, these extremes of behavior are more commonly associated with males. The majority of usurping confidants I have observed have been men.

Unlike the insulator, the successful usurper does not want to empower anyone else: He wants the power for himself. Quite often, the usurper actually aspires to be the CEO. One of the best literary examples of a usurper is Shakespeare's Iago, who masterfully manipulated Othello to kill Othello's own beloved Desdemona. As Shakespeare understood so well, leaders often fall prey to these wicked confidants because the usurper is usually a brilliant observer and, therefore, manipulator of the CEO's personality. Usurpers have an uncanny ability to find a leader's Achilles' heel and to exploit it ruthlessly. In clinical terms, usurpers show varying degrees of sociopathic behavior, which—while not commonplace—certainly occurs in business and in society at large. Of course, to make it up to an organization's highest levels, usurping confidants must also be talented, productive, and charismatic. When they are, their bad behavior can go unnoticed for quite a while, so long as they have their boss's protection.

**CEOs are just as complicit in the destructive relationship as the confidants. In many ways, they are more responsible because they're the ones who need the relationship most.**

Consider Chris Wolman and Tony Miller. Wolman had led a golden life. Blessed with good looks and a winning personality, he came from a tight-knit family that had all the right social connections. He prepped at Exeter before going on to Princeton and then to Harvard Business School, where he graduated as a Baker Scholar. After a decade in investment banking, Wolman decided to start his own hedge fund.

Miller, Wolman's B-school classmate, was also extremely bright, but his life had been much tougher than Wolman's. The child of an abusive father and an alcoholic mother, Miller grew up in the inner city and went to a local state college. Twice divorced, Miller was constantly struggling to compensate for his humble beginnings. Exposed from an early age to lying and stealing, he developed a spotty conscience. As a result, Miller had a lot of bravado and no shame. But he had a terrific head for numbers—which was a talent that Wolman was quick to recognize when he hired Miller to be his CFO as soon as

the position came open.

From the start, Miller made almost superhuman efforts to win Wolman over. He showered his boss with attention, all the while subverting others' efforts to gain it. When other executives tried to have a word with Wolman at a company retreat, for example, Miller was never more than a step away. But given his rare ability to manipulate people, Miller was also able to modulate his behavior in such a way that it did not immediately alienate his colleagues. Not surprisingly, when Wolman experienced a major success, it was Miller who threw the party. It was also Miller who made sure that there was plenty of cocaine available for those so inclined.

Although Miller unctuously insinuated himself into Wolman's kitchen cabinet, he was also intensely envious of his boss and sought constantly to find ways to use the CEO for his own gain. On several occasions, and without Wolman's direct knowledge, Miller made insider trades using information obtained from his boss. And while he pretended to Wolman's face to be one of his closest friends since their MBA days, Miller showed little regard for Wolman as a person. For example, Miller didn't go to the funeral of Wolman's father, who had been chronically ill. By then, Wolman was beginning to feel exploited by his toxic confidant, but his dependency on Miller led Wolman to rationalize his confidant's flaws (or inconsistencies). To question Miller at this point would have forced Wolman to question himself; unfortunately, he wasn't prepared to do so until his confidant's behavior became even more egregious.

If it's clear that Miller was benefiting from the relationship, it takes a little digging to understand what was in it for Wolman. In part, he enjoyed Miller's insouciance and envied his apparent freedom. All his life, Wolman had been deeply risk averse, but he derived immense vicarious pleasure from watching Miller gamble on everything from his personal finances to his social life, where he was a renowned womanizer and man-about-town. For his part, Miller repeatedly encouraged Wolman to open up about personal matters as he never had to his more conventional friends. As a result, Wolman increasingly began to feel that Miller was one of the few people with whom he could really talk. Of course, Miller was the most dangerous of all Wolman's intimates because he instilled in his boss a belief that everyone was out to get him. By consistently urging Wolman to question other people's motives, Miller also deflected attention from his own.

Miller lasted just two years at Wolman's company. Inevitably, the two men began to clash as Miller's bid for power became more and more blatant. When Wolman refused to step aside, Miller left abruptly to start his own firm. Within a few years, Miller was indicted for securities violations. Unfortunately, Wolman could only see in retrospect how seriously he had exposed himself.

**Becoming the Messenger**

Once people realize that the CEO and his confidant are harming the company, they have to face the greater challenge of doing something about it. Destructive confidants are usually not very receptive to criticism, even if they are aware that the relationship is problematic for the organization. And in the majority of cases, confidants are oblivious to how pathological the relationship has become. They may feel they have been acting in the CEO's best interests all along. For these reasons, toxic confidants should not be vilified or scapegoated. This will only serve to get their backs up.

Training and educating the confidant can help. Well-intentioned senior executives and others who find themselves in this role often have no training: They have to rely on intuition, high ethical standards, and good judgment. Yet the confidant's role involves maneuvering in the same murky waters that psychoanalysts generally navigate over the course of their daily work. Educating confidants about the inevitable storms would help prevent some of them from blowing off course. I train confidants by speaking with them about their detailed interactions with the CEO, helping them gain greater objectivity about the nature of the relationship and how the CEO is using them. Consultants trained in interpersonal dynamics—psychoanalysts, for instance—can serve as supervisors, or confidants, to the confidants.

But in my experience, training confidants has only limited value. I have never encountered a fully rehabilitated toxic confidant. The only sure way to avoid destructive CEO–confidant relationships is for the CEO to step back and dispassionately analyze the relationship and his role in it. As we've seen, CEOs are just as complicit in the destructive relationship as the confidants. In many ways, they are more responsible because they're the ones who need the relationship most. The trouble is, CEOs have a hard time with this kind of introspection. Think about it. We all find it difficult to step back from relationships and ask, "What did I do wrong?" It is particularly difficult for

CEOs because the business world frowns on admissions of personal weakness. Many leaders view introspection as dangerous to the goals of corporate leadership, in which the capacity to take decisive action is key.

To get a CEO to reevaluate his confidant, someone has to break the news to him that there are problems. Although senior managers are quite close to the action, and therefore subject to their own need to deny or distort these destructive relationships, they likely have more objectivity than the primary players. The messenger has to be someone the CEO trusts and respects, someone who can speak openly and directly to the leader without fear of retribution. This could be another executive who could describe to the CEO, both in personal and organizational terms, what has been observed.

Another option is for a senior board member or a small subcommittee of the board to take the lead. In some cases, an external coach or consultant can most easily deliver the message. If, however, the toxic confidant has also been a coach, the interpersonal dynamics can become complicated.

Whoever bears the bad news needs to do so with a generous spirit, because how the feedback is given will largely determine how well it is received. Most CEOs will find feedback couched in terms of consequences to the organization much more palatable than attacks on their personality or judgment. Of course, a certain amount of resistance is natural and predictable, and most CEOs will still find the discussion extremely uncomfortable. But the more enlightened ones will be able to use the information productively rather than dismiss it defensively. The CEO may even have a reasonable explanation, which could change the board's opinion.

The explanation may include information that sheds light on the dependency, such as expertise on the part of the confidant that makes him seem indispensable. At the very least, the CEO should think hard about the feedback and give serious consideration to making some difficult changes.

In the final analysis, resolving a toxic CEO–confidant relationship is much more difficult than getting rid of a bad adviser, because CEOs have a personal stake in their confidant. In many cases the link becomes so strong that a company may have to ditch the CEO along with the confidant. The sobering reality of destructive CEO–confidant relationships is that it takes two to tango: The worst confidants are drawn to the most unaware CEOs. Although it is tempting to believe that if you get rid of the bad confidant you will get rid of the problem, all too often the CEO will simply find another like-minded confidant. Only if the CEO can be brought to realize that he was stuck in a symbiotic relationship with his old confidant will he be likely to find a new and better one. But unless he can gain some understanding as to why he chose a toxic confidant in the first place, he will be doomed to repeat the same mistake.


>| Executive Summary

>| Purchase Reprint

>| Printable Version

>| E-mail a Colleague


Reprint Number R0402D



Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review
Click here to visit:
>| http://www.hbsp.org

FEATURE ARTICLE

# Worse Than Enemies

## The CEO's Destructive Confidant

**CEOs nearly always need an intimate counselor. But unless leaders examine their own motives—and those of their confidants—these relationships will almost certainly be dangerous, and sometimes even catastrophic.**

***by Kerry J. Sulkowicz***

**Kerry J. Sulkowicz**, a psychiatrist and psychoanalyst, is the founder of the Boswell Group and a senior fellow at Katzenbach Partners in New York. He advises and teaches senior business leaders and boards about the psychological aspects of management, governance, and corporate culture. He can be reached at kjs@boswellgroup.com.

The CEO is often the most isolated and protected employee in the organization. No one gives him unfiltered information. Many people dissemble or conceal things from him. Few leaders, even veteran CEOs, can do the job without talking to someone about their experiences, which is why most develop a close relationship with a trusted colleague—a person with whom they feel free to share their thoughts and fears. Few leaders speak out about these relationships, perhaps because they don't like acknowledging their dependency on others. But in business and politics, most leaders rely on the advice and opinions of a trusted insider: a confidant.

The need for a close confidant is rooted in childhood. Every child wants to feel close to someone, to feel understood, cared for, and loved. While parents ordinarily satisfy such childhood yearnings, these needs are never completely satisfied. In adolescence, we typically resolve them by developing a best friend from among our peer group, and we usually pick individuals of the same sex. When we find ourselves in demanding situations later in life, we seek similar refuge with a fellow adult.

The most effective CEOs find confidants who complement their strengths and sharpen their effectiveness. Bill Gates uses Steve Ballmer in this way; Warren Buffett turns to vice chairman Charlie Munger. In the end, both the CEOs and their organizations benefit from these relationships.

Over the past eight years as a consultant to top management teams and as a psychoanalyst who treats company leaders in private practice, I have found that many CEO–confidant relationships function very well. These confidants serve their leaders and keep the CEOs' best interests at heart. They derive their gratification vicariously—through the help they provide, not for any personal gain—and are usually quite aware of the potential for abusing their access to the CEOs' innermost secrets.

Unfortunately, almost as many confidants end up hurting, undermining, or otherwise exploiting CEOs when they are at their most vulnerable. These confidants rarely make

the headlines, but behind the scenes they do enormous damage to the CEO and to the organization. What's more, the leader is often the last one to know when and how the confidant relationship became toxic.

Dangerous confidants come in all shapes and sizes. They are sometimes intentionally scheming and deceitful. Like Rasputin, the crafty manipulator of the Russian imperial family, these overtly bad confidants have sociopathic personalities: They habitually lie and cheat to achieve their aims without any apparent constraints of conscience.

Take someone we'll call Sanford Anderson. (I have changed the names in our examples to protect the privacy of the individuals and companies depicted.) The CEO of a privately held real estate business in the Midwest, a company worth billions, Anderson fell victim to just such a confidant. Early in his career, Anderson's corporate attorney, Gregg Mayer, had saved the firm millions by deftly handling a discrimination lawsuit, which earned him Anderson's undying gratitude and respect. As the years passed, Anderson came to rely on Mayer's advice about everything from investment strategy, architecture and design, to personnel development.

Although Anderson was in most respects a highly effective CEO, he had never seriously contemplated the prospect of retiring. Anderson's worries about retirement took the form of denial of his own mortality. Instead of acknowledging his anxiety, he manifested it by plunging even more deeply into work, while ignoring his fatigue and gradual loss of passion. Consequently, he had never set in place an adequate succession plan. Given the toxic confidant that he was, Mayer used the lack of succession planning as an opportunity to advance his own interests. Mayer preyed on Anderson's anxieties about aging and retirement by fueling his fears about whom might want to wrest control of his business.

Rather than encourage Anderson to slow down after he was hospitalized for chest pain, Mayer egged Anderson on in a way calculated to make him more anxious and afraid. As Mayer put it to Anderson, "Now that you've almost had a heart attack, the people you're up against might try to give you a real heart attack by making you angry." Just as Mayer planned, his stoking of Anderson's fears paid off handsomely. When Anderson stepped down, he impulsively handed the reins of power to Mayer. Shocked by the announcement of the new CEO, several key members of the management team stormed out in protest. Unfortunately, without the skills of these key players, the company was soon in trouble, and Anderson's legacy was ruined.

Destructive confidants like Mayer are far more commonplace than we would like to believe. But even more common, and more insidious, are confidants who are convinced they are serving their CEOs well, people who can't see the havoc they wreak on the lives of leaders and their organizations. These confidants have blind spots about their own personalities and capabilities, and little awareness of the damage they can cause.

I have been able to identify three distinct types of destructive confidants over the course of my work. First are *reflectors,* people who mirror the CEO, constantly reassuring him that he is the "fairest CEO of them all." By contrast, the second type of destructive confidant, the *insulator,* buffers the CEO from the organization, preventing critical information from getting out and from getting in. Then, as we have just seen in the previous example, there is the *usurper,* the confidant who cunningly ingratiates himself with the CEO in a desperate bid for power. In the following pages, we'll explore how the CEO–confidant relationship plays out in each case and discuss ways in which CEOs can avoid these destructive relationships. As we shall see, the truth is that many leaders have only themselves to blame for the confidants they have.

**Before It's Too Late**
Sidebar **R0402D_A** (Located at the end of this article)

## Mirror, Mirror on the Wall

CEOs are narcissistic—if they weren't, they wouldn't be leaders. Moreover, without that quality, they couldn't grow their business or provide the organization with the vision it needs. In my experience, CEOs with the best confidant relationships have a healthy dose of narcissism, and their confidants provide positive and negative feedback, they bolster CEOs' flagging spirits, and they encourage CEOs to achieve balance and creativity.

But some CEOs constantly need to be told wonderful things about themselves. Typically, these leaders are both grandiose and extremely vulnerable to slights, and they often have a hard time hearing bad news or facing harsh realities. They surround themselves with yes-men who are unwilling to tell them the truth; these leaders also tend to have failed marriages, trophy wives, or extramarital affairs with women who feed their egos. Some narcissistic CEOs, such as Richard Scrushy of HealthSouth or Dennis Kozlowski of Tyco, turn their organizations into elaborate monuments to themselves. Unfortunately, these leaders are also prone to selecting confidants who cater to their fragile self-esteem. These are the reflecting confidants.

The reflector intuitively knows how to make a narcissistic CEO feel good. Although all confidants may do this to some extent, reflectors are driven by their own neurotic need to please authority. That's usually because they've grown up with narcissistic parents who demanded that their children mirror them to an inappropriate extent. These kids feel that they exist to take care of their parents, rather than the reverse. For example, children with depressed mothers typically feel responsible for their mothers' happiness. In such an environment, a child's self-esteem becomes contingent on giving the parents what they want, rather than on developing an autonomous personality.

One confidant told me that the first thing he did each morning with his mother, a former actress, was to scrutinize her face to see if she was having a bad day. If she was, he used to take it as a signal that he needed to find some good news quick. As a confidant, he was equally terrified of angry outbursts on the part of his CEO. Like other reflectors, this confidant was extremely sensitive to the limited range of emotion that a fragile CEO could tolerate, and he twisted himself into knots trying to avoid upsetting him.

In extreme forms, the CEO–confidant pair ends up creating its own distorted version of reality, what is known in the psychiatric literature as folie à deux—or shared madness. When shared madness develops and other key executives see how much the CEO values the reflector, some may try to become the CEO's reflectors themselves. This often leads to a polarization of employees: A small group of employees fiercely defends the CEO, while a larger group rebels against the leader and seeks out another senior executive who serves as its unofficial leader and the voice of reality.

**In extreme forms, the CEO–confidant pair ends up creating its own distorted version of reality, or shared madness.**

Consider what happened at Regal Software, a developer of video gaming technology. As a first-time CEO, Paul Rothberg almost instantly found himself at odds with the company's talented software developers, who resented his autocratic management style. Rothberg's unreasonable expectations of R&D eventually created a split between the organization's research and business arms. As the gulf widened, Rothberg found himself

increasingly butting heads with most of Regal's employees, and so he began turning for interpersonal advice to Frank Jordan, a former headhunter turned executive coach.

Rothberg had installed Jordan in an office at Regal's headquarters, where he spent three mornings a week ostensibly to be available to coach all the senior executives. In reality, though, Rothberg was his only client. Rothberg would call Jordan twice a day; he also made frequent visits to his office at Regal. It soon became clear to other employees how much the embattled CEO depended on his new confidant. For his part, Jordan was seduced into believing that nothing was more important for him to do than to keep the CEO happy. He would listen intently to Rothberg's concerns and then color his own observations to match Rothberg's. To outsiders, they looked like coconspirators who spent endless hours huddled in conversation. Indeed, Jordan offered Rothberg constant reassurance that he was doing the right thing, when, in fact, Rothberg was gravely misguided.

Consciously or not, Rothberg and Jordan created a symbiotic relationship in which they relied almost entirely on each other's perceptions about what was happening at Regal. Rothberg had looked to Jordan to be his eyes and ears, but the more Jordan was drawn into his privileged role, the more unable he was to accurately understand the situation unfolding around him. Unfortunately, Jordan supplied flawed advice, such as encouraging Rothberg to attend more of his software developers' creative meetings, which only made him seem even more intrusive and controlling. At the same time, Jordan inadvertently bolstered Rothberg's fundamentally harsh and rigid personality by consistently praising the CEO's judgment rather than offering constructive criticism. A vicious circle ensued, fueling the polarization of employees into Rothberg loyalists or enemies.

Although it isn't always the case that shared madness between a CEO and his confidant leads to paranoia, these ingrained attitudes of mistrust and negativity are easily magnified under these circumstances. Rothberg's naïveté, for instance, was not the only cause of Regal's organizational tensions. Deeper down, the rift was fueled by companywide worries about the feasibility of Regal's developing technology. But Rothberg's misuse of his confidant brought organizational anxieties to a crisis point. Ultimately, as Rothberg's manipulations and deceptions continued to escalate, senior management felt betrayed, and Rothberg was ousted. For his part, Jordan had squandered his reputation as an independent expert. Lingering suspicions and resentments prevented him from functioning effectively as an outside consultant, and he, too, was eventually forced out.

**You Need Me, and Don't Forget It!**

While the reflector inadvertently joins with the CEO in creating a shared, distorted view of reality, the insulator tries to serve as a mediator between an ill-suited CEO and his organization. CEOs who need insulators tend to be abrasive or abusive leaders. These arrogant leaders often deny the negative impact of their personality on those around them. They thoughtlessly push away their best people, make impulsive business decisions, alienate large constituencies within the company, and poison morale. These leaders quickly find themselves at odds with their subordinates, senior executives, and boards because of their lack of emotional intelligence. And whether they are quietly off-putting or openly hostile, these leaders rarely feel concerned about, or able to, change their interpersonal style.

To compensate, these abrasive CEOs seek insulators, people whom they believe can translate their poorly communicated ideas into language their organizations can understand. They need people willing to intercede when they make self-destructive moves. Like the mother of a child abused by his father, the insulator is constantly

apologizing to the organization on the CEO's behalf: "He didn't mean it." The insulator is also much like the enabler—to borrow the language of Alcoholics Anonymous—who makes excuses for the alcoholic.

Insulators have some special characteristics. Many have passive personalities and need to be rescuers. Women in senior management positions are certainly not all insulators, but, for reasons that still have not been sufficiently researched, most insulators turn out to be women. And although they typically harbor no ambitions to be CEOs themselves, insulators crave control over both the leader and the organization. That contrasts with reflectors, who unconsciously try to control leaders by pleasing them. Thus, while insulators can be quite manipulative, they position their behavior to appear as though they are doing an altruistic service for their bosses and companies.

The insulator's false humility can be grating, but it is often difficult to see what is toxic about it. In the short run, insulators appear to be helpful, even essential, particularly to those who don't trust the CEO. The problem is that over time, insulators undermine the very authority of the leader they are seemingly trying to protect. Senior executives learn that to get anything substantive done, they must go through the insulating confidant, who quickly comes to be seen as the real power behind the throne. This arrangement has two problems. First, because the insulator's formal power inadequately reflects her influence, she is often largely unaccountable for her actions. Second and more crucial, insulators feed the CEO filtered information about the organization; as a result, the CEO becomes dangerously cut off from the grass roots.

Jay Stephens was a CEO whose personality cried out for an insulator. After a successful academic career in engineering, he was tapped to take over the research operations of Pantreon, a large energy company. Stephens had a reputation for being brilliant but impossible, and his vicious tirades and abrasive personality were legendary. After making several important discoveries that had saved the firm billions of dollars, Stephens became the dark-horse candidate for CEO. When the board chose him as the new leader, he quickly replaced the old head of HR with Louisa Attwood, a junior HR manager who had helped him when he first joined Pantreon.

It soon became clear to senior management that Attwood was also being promoted to the role of CEO confidant. Whenever he felt the urge, Stephens would call Attwood for lengthy conversations—sometimes in the middle of the night. Frequently, these talks were opportunities for Stephens to vent his frustrations and to disparage whomever he felt had disappointed or betrayed him. Attwood spent most of her time listening and some occasionally offering to intervene in these interpersonal conflicts. She also saw her interactions with Stephens as opportunities to solidify her increasingly powerful role in their relationship.

**Senior executives learn that to get anything substantive done, they must go through the insulating confidant, who quickly comes to be seen as the real power behind the throne.**

Attwood had a privileged relationship with Stephens in that she was the only member of the senior management team who escaped the CEO's attacks. In no small part, Attwood was chosen for this role because, as head of HR, she was out of the line of competition to succeed Stephens. But she was also chosen because of her intuitive ability to temper the CEO's personality. Attwood learned, over time, to filter virtually every significant corporate initiative or communication that came from Stephens. She edited all his memos, coached him on board presentations, and frequently stepped in to do damage control after Stephens had displayed his true colors. One of the inside jokes at Pantreon

was that in her previous life, Attwood must have been a UN interpreter. Not that she was impartial. Senior executives who learned to manage Stephens by going through Attwood were dismayed when she injected her own perspectives into their communications.

During Stephens's tenure as CEO of Pantreon, the company's tradition of engineering innovation began a gradual but clear decline, and its marketing efforts also slowed. Sales fell flat. Not by accident, the boardroom became more fiercely contentious than ever, in part because of all the unspoken tension around Stephens's behavior and the unacknowledged efforts to manage around it. Several key executives left the organization out of frustration at having an insulated and unreachable CEO who forced them to go through a third party.

Because of Stephens's relentless abrasiveness, Attwood continued to shield him from the organization—even managing to portray herself as a long-suffering martyr in the process. While Stephens never directly acknowledged his dependence on Attwood, he rewarded her with generous bonuses and option grants, which the rest of the management team resented deeply. When Stephens finally retired—after what many outside observers viewed as a mixed record at Pantreon's helm—Attwood sought early retirement and spent a year traveling, ostensibly to recover from her emotionally depleting role as a kind of container of toxic behavior. But from the organization's perspective, it was good riddance. The executives forced to depend on Attwood had come to deeply resent her power and her barely disguised need for control.

This all-too-common form of CEO–confidant relationship occurs in businesses of all types and sizes. It may be symptomatic of the ever-increasing complexity of modern corporate life, as well as of the inadequate screening of potential CEOs. Leaders who don't know how to express anger or criticism constructively, or who inadvertently make provocative, demeaning statements to their direct reports, probably need some insulation to preserve their role and stature. The challenge is preventing that insulation from suffocating CEOs and their top management team members.

### You and Me Against the World, Sucker

Insulators and reflectors may lack the self-knowledge to serve the CEO well, but they are not unethical. The same cannot be said of our third confidant type, the usurper. Usurpers are dangerous not only to the CEO but also to the organization as a whole. They are sociopaths who should be shown the door as soon as possible. It's important, though, to do this in a way that saves face for the exploited CEO, who may, like Rasputin's czar, come crashing down along with his dangerous confidant.

Usurpers are deliberately scheming and ambitious. Whether at work or in their personal lives, usurpers only last long enough in relationships to get their needs met. When they feel that people are no longer gratifying their desires, usurpers will abruptly end the relationship. Usurpers clearly treat others badly, and they are frequently self-destructive as well. Not surprisingly, they often have long histories of impulsivity, as well as substance abuse or illegal behavior. And although women do act as usurpers, these extremes of behavior are more commonly associated with males. The majority of usurping confidants I have observed have been men.

Unlike the insulator, the successful usurper does not want to empower anyone else: He wants the power for himself. Quite often, the usurper actually aspires to be the CEO. One of the best literary examples of a usurper is Shakespeare's Iago, who masterfully manipulated Othello to kill Othello's own beloved Desdemona. As Shakespeare understood so well, leaders often fall prey to these wicked confidants because the usurper is usually a brilliant observer and, therefore, manipulator of the CEO's

personality. Usurpers have an uncanny ability to find a leader's Achilles' heel and to exploit it ruthlessly. In clinical terms, usurpers show varying degrees of sociopathic behavior, which—while not commonplace—certainly occurs in business and in society at large. Of course, to make it up to an organization's highest levels, usurping confidants must also be talented, productive, and charismatic. When they are, their bad behavior can go unnoticed for quite a while, so long as they have their boss's protection.

**CEOs are just as complicit in the destructive relationship as the confidants. In many ways, they are more responsible because they're the ones who need the relationship most.**

Consider Chris Wolman and Tony Miller. Wolman had led a golden life. Blessed with good looks and a winning personality, he came from a tight-knit family that had all the right social connections. He prepped at Exeter before going on to Princeton and then to Harvard Business School, where he graduated as a Baker Scholar. After a decade in investment banking, Wolman decided to start his own hedge fund.

Miller, Wolman's B-school classmate, was also extremely bright, but his life had been much tougher than Wolman's. The child of an abusive father and an alcoholic mother, Miller grew up in the inner city and went to a local state college. Twice divorced, Miller was constantly struggling to compensate for his humble beginnings. Exposed from an early age to lying and stealing, he developed a spotty conscience. As a result, Miller had a lot of bravado and no shame. But he had a terrific head for numbers—which was a talent that Wolman was quick to recognize when he hired Miller to be his CFO as soon as the position came open.

From the start, Miller made almost superhuman efforts to win Wolman over. He showered his boss with attention, all the while subverting others' efforts to gain it. When other executives tried to have a word with Wolman at a company retreat, for example, Miller was never more than a step away. But given his rare ability to manipulate people, Miller was also able to modulate his behavior in such a way that it did not immediately alienate his colleagues. Not surprisingly, when Wolman experienced a major success, it was Miller who threw the party. It was also Miller who made sure that there was plenty of cocaine available for those so inclined.

Although Miller unctuously insinuated himself into Wolman's kitchen cabinet, he was also intensely envious of his boss and sought constantly to find ways to use the CEO for his own gain. On several occasions, and without Wolman's direct knowledge, Miller made insider trades using information obtained from his boss. And while he pretended to Wolman's face to be one of his closest friends since their MBA days, Miller showed little regard for Wolman as a person. For example, Miller didn't go to the funeral of Wolman's father, who had been chronically ill. By then, Wolman was beginning to feel exploited by his toxic confidant, but his dependency on Miller led Wolman to rationalize his confidant's flaws (or inconsistencies). To question Miller at this point would have forced Wolman to question himself; unfortunately, he wasn't prepared to do so until his confidant's behavior became even more egregious.

If it's clear that Miller was benefiting from the relationship, it takes a little digging to understand what was in it for Wolman. In part, he enjoyed Miller's insouciance and envied his apparent freedom. All his life, Wolman had been deeply risk averse, but he derived immense vicarious pleasure from watching Miller gamble on everything from his personal finances to his social life, where he was a renowned womanizer and man-about-town. For his part, Miller repeatedly encouraged Wolman to open up about personal matters as he never had to his more conventional friends. As a result, Wolman

increasingly began to feel that Miller was one of the few people with whom he could really talk. Of course, Miller was the most dangerous of all Wolman's intimates because he instilled in his boss a belief that everyone was out to get him. By consistently urging Wolman to question other people's motives, Miller also deflected attention from his own.

Miller lasted just two years at Wolman's company. Inevitably, the two men began to clash as Miller's bid for power became more and more blatant. When Wolman refused to step aside, Miller left abruptly to start his own firm. Within a few years, Miller was indicted for securities violations. Unfortunately, Wolman could only see in retrospect how seriously he had exposed himself.

**Becoming the Messenger**

Once people realize that the CEO and his confidant are harming the company, they have to face the greater challenge of doing something about it. Destructive confidants are usually not very receptive to criticism, even if they are aware that the relationship is problematic for the organization. And in the majority of cases, confidants are oblivious to how pathological the relationship has become. They may feel they have been acting in the CEO's best interests all along. For these reasons, toxic confidants should not be vilified or scapegoated. This will only serve to get their backs up.

Training and educating the confidant can help. Well-intentioned senior executives and others who find themselves in this role often have no training: They have to rely on intuition, high ethical standards, and good judgment. Yet the confidant's role involves maneuvering in the same murky waters that psychoanalysts generally navigate over the course of their daily work. Educating confidants about the inevitable storms would help prevent some of them from blowing off course. I train confidants by speaking with them about their detailed interactions with the CEO, helping them gain greater objectivity about the nature of the relationship and how the CEO is using them. Consultants trained in interpersonal dynamics—psychoanalysts, for instance—can serve as supervisors, or confidants, to the confidants.

But in my experience, training confidants has only limited value. I have never encountered a fully rehabilitated toxic confidant. The only sure way to avoid destructive CEO–confidant relationships is for the CEO to step back and dispassionately analyze the relationship and his role in it. As we've seen, CEOs are just as complicit in the destructive relationship as the confidants. In many ways, they are more responsible because they're the ones who need the relationship most. The trouble is, CEOs have a hard time with this kind of introspection. Think about it. We all find it difficult to step back from relationships and ask, "What did I do wrong?" It is particularly difficult for CEOs because the business world frowns on admissions of personal weakness. Many leaders view introspection as dangerous to the goals of corporate leadership, in which the capacity to take decisive action is key.

To get a CEO to reevaluate his confidant, someone has to break the news to him that there are problems. Although senior managers are quite close to the action, and therefore subject to their own need to deny or distort these destructive relationships, they likely have more objectivity than the primary players. The messenger has to be someone the CEO trusts and respects, someone who can speak openly and directly to the leader without fear of retribution. This could be another executive who could describe to the CEO, both in personal and organizational terms, what has been observed.

Another option is for a senior board member or a small subcommittee of the board to take the lead. In some cases, an external coach or consultant can most easily deliver the message. If, however, the toxic confidant has also been a coach, the interpersonal

dynamics can become complicated.

Whoever bears the bad news needs to do so with a generous spirit, because how the feedback is given will largely determine how well it is received. Most CEOs will find feedback couched in terms of consequences to the organization much more palatable than attacks on their personality or judgment. Of course, a certain amount of resistance is natural and predictable, and most CEOs will still find the discussion extremely uncomfortable. But the more enlightened ones will be able to use the information productively rather than dismiss it defensively. The CEO may even have a reasonable explanation, which could change the board's opinion.

The explanation may include information that sheds light on the dependency, such as expertise on the part of the confidant that makes him seem indispensable. At the very least, the CEO should think hard about the feedback and give serious consideration to making some difficult changes.

In the final analysis, resolving a toxic CEO–confidant relationship is much more difficult than getting rid of a bad adviser, because CEOs have a personal stake in their confidant. In many cases the link becomes so strong that a company may have to ditch the CEO along with the confidant. The sobering reality of destructive CEO–confidant relationships is that it takes two to tango: The worst confidants are drawn to the most unaware CEOs. Although it is tempting to believe that if you get rid of the bad confidant you will get rid of the problem, all too often the CEO will simply find another like-minded confidant. Only if the CEO can be brought to realize that he was stuck in a symbiotic relationship with his old confidant will he be likely to find a new and better one. But unless he can gain some understanding as to why he chose a toxic confidant in the first place, he will be doomed to repeat the same mistake.

---

Reprint Number R0402D

## Before It's Too Late

Sidebar **R0402D_A**

Because of the unconscious factors that determine whom you choose as your confidant, you may often be the last one to know if yours is toxic. To find out if you are getting trapped in a poisonous relationship with a trusted adviser, look for these warning signs:

• **People complain that you're inaccessible.** Your own difficult personality may explain why you need a confidant, but choosing someone who distances you from your organization is a poor solution. Address head-on the issues that surround your interpersonal style.

• **You feel that no one but your confidant understands you.** While it's natural for a leader to have a few trusted advisers, a CEO who overvalues the opinions of a particular individual is in danger of getting into murky waters, maybe even of courting disaster. Overreliance on a single person suggests he has undue influence, which should raise a red flag. Seek out other people who "get" you.

• **Your confidant discourages you from seeking other counsel.** When your trusted adviser wants to make sure nobody else gets close to you, he may be trying to wrest power from you. Such confidants prey on your distrust and suspicion and are among the most insidious confidants of all. Show them the door quickly.

• **Your adviser starts to call the shots.** Confidants who tell you what to do are

behaving like they are the real power, and not necessarily just the power behind the throne. Svengali-like confidants are dangerous to you and your reputation. Find someone who can genuinely listen to you and can offer you constructive criticism.

• **Your confidant praises you to the heavens.** If your confidant lays it on thick and is afraid to tell you the unvarnished truth, you may already have trouble on your hands. Look around for someone who doesn't feel compelled to inflate your self-esteem.

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

# Executive Summaries

## The HBR List

**Breakthrough Ideas for 2004**

Reprint R0402A

>| Read Entire Article >| Purchase Reprint

HBR's editors searched for the best new ideas related to the practice of management and came up with a collection that is as diverse as it is provocative. The 2004 HBR List includes emergent concepts from biology, network science, management theory, and more. A few highlights:

**Richard Florida** wonders why U.S. society doesn't seem to be thinking about the flow of people as the key to America's advantage in the "creative age." **Diane L. Coutu** describes how the revolution in neurosciences will have a major impact on business. **Clayton M. Christensen** explains the law of conservation of attractive profits: When attractive profits disappear at one stage in the value chain because a product becomes commoditized, the opportunity to earn attractive profits with proprietary products usually emerges at an adjacent stage.

**Joel Kurtzman** asks where the "stupid money" is headed. **Robert Sutton** reports on the emergence of "no asshole"—excuse the crude language—rules. **Daniel H. Pink** explains why the master of fine arts is the new MBA. **Joseph Fuller** asks whether the useful life of the public company is over. **Herminia Ibarra** describes how companies can get the most out of managers returning from leadership-development programs. **Iqbal Quadir** suggests a radical fix for the third world's trade problems: Get the World Bank to lend to *rich* countries so that there are resources for retraining workers in dying industries.

**Clay Shirky** describes how technology will allow companies to get vast amounts of real-time data from social networks. **Thomas A. Stewart** shows how jokes constitute a trove of information about what's really going on in a company. And **Ray Kurzweil** makes the case that while high-tech stocks have seesawed, technology has marched steadily forward—and will continue to do so.

## HBR Case Study

**Give My Regrets to Wall Street**
*Mark L. Frigo and Joel Litman*

Reprint R0402B

>| Read Entire Article >| Purchase Reprint

It's been only four years since First Rangeway Consulting went public, but to CEO Kenneth Charles, it seems like a lifetime. In the grand old days of its IPO, the company couldn't grow fast enough to meet customer demand; top talent answered the siren call of its options; and the owners gleefully watched their wealth escalate along with the stock.

Post-bubble, First Rangeway's stock is down 80% from its peak value, potential hires are wary, and the company feels beleaguered by Sarbanes-Oxley and SEC requirements. In addition, Kenneth worries that pressure to make quarterly results is compromising his relationship with customers. And did we mention that he loathes analyst calls?

That said, First Rangeway's stock price is on the mend, and there are some extremely tempting opportunities on the horizon that will require a heap of capital. Rangeway's CFO speculates that these opportunities could mean as much as 30% growth over the next several years.

### February 2004

### Coming in March 2004

**Reclaim Your Job**
Sumantra Ghoshal and Heike Bruch

**It's Time to Retire Retirement**
Ken Dychtwald, Tamara Erickson, and Bob Morison

**Strategy as Ecology**
Marco Iansiti and Roy Levien

### ***Harvard Business Review*** OnPoint articles and collections

Many articles are available in ***Harvard Business Review*** **enhanced OnPoint editions**, which include a summary of key points to help you quickly absorb and apply the concepts, the full-text article, and a bibliography to guide further exploration.

Specially priced ***Harvard Business Review*** **OnPoint collections** include three OnPoint articles with an overview comparing different perspectives on a topic.

Should First Rangeway remain public or go private? What are the advantages and disadvantages of each alternative? Four experts weigh in on this fictional case study: Tom Copeland, the former chair of UCLA's finance department and managing director of corporate finance at Monitor Group; Chan Suh, the cofounder, CEO, and chairman of Agency.com; Ed Nusbaum, the CEO of Grant Thornton; and John J. Mulherin, the president and CEO of the Ziegler Companies.

## Features

**Measuring the Strategic Readiness of Intangible Assets**
*Robert S. Kaplan and David P. Norton*

Reprint R0402C; *Harvard Business Review* OnPoint edition 5887;
*Harvard Business Review* OnPoint collection 5933 "Focusing Your Organization on Strategy—with the Balanced Scorecard, 2nd Edition"

>|Read Entire Article >|Purchase Reprint >|Purchase *Harvard Business Review* OnPoint edition
>|Purchase *Harvard Business Review* OnPoint collection

Measuring the value of intangible assets such as company culture, knowledge management systems, and employees' skills is the holy grail of accounting. Executives know that these intangibles, being hard to imitate, are powerful sources of sustainable competitive advantage. If managers could measure them, they could manage the company's competitive position more easily and accurately.

In one sense, the challenge is impossible. Intangible assets are unlike financial and physical resources in that their value depends on how well they serve the organizations that own them. But while this prevents an independent valuation of intangible assets, it also points to an altogether different approach for assessing their worth.

In this article, the creators of the Balanced Scorecard draw on its tools and framework—in particular, a tool called the strategy map—to present a step-by-step way to determine "strategic readiness," which refers to the alignment of an organization's human, information, and organization capital with its strategy. In the method the authors describe, the firm identifies the processes most critical to creating and delivering its value proposition and determines the human, information, and organization capital the processes require.

Some managers shy away from measuring intangible assets because they seem so subjective. But by using the systematic approaches set out in this article, companies can now measure what they want, rather than wanting only what they can currently measure.

**Worse Than Enemies: The CEO's Destructive Confidant**
*Kerry J. Sulkowicz*

Reprint R0402D

>|Read Entire Article >|Purchase Reprint

The CEO is often the most isolated and protected employee in the organization. Few leaders, even veteran CEOs, can do the job without talking to someone about their experiences, which is why most develop a close relationship with a trusted colleague, a confidant to whom they can tell their thoughts and fears.

In his work with leaders, the author has found that many CEO–confidant relationships function very well. The confidants keep their leaders' best interests at heart. They derive their gratification vicariously, through the help they provide rather than through any personal gain, and they are usually quite aware that a person in their position can potentially abuse access to the CEO's innermost secrets.

Unfortunately, almost as many confidants will end up hurting, undermining, or otherwise exploiting CEOs when the executives are at their most vulnerable. These confidants rarely make the headlines, but behind the scenes they do enormous damage to the CEO and to the organization as a whole. What's more, the leader is often the last one to know when or how the confidant relationship became toxic.

The author has identified three types of destructive confidants. The *reflector* mirrors the CEO, constantly reassuring him that he is the "fairest CEO of them all." The *insulator* buffers the CEO from the organization, preventing critical information from getting in or out. And the *usurper* cunningly ingratiates himself with the CEO in a desperate bid for power. This article explores how the CEO–confidant relationship plays out with each type

of adviser and suggests ways CEOs can avoid these destructive relationships.

**Getting IT Right**
*Charlie S. Feld and Donna B. Stoddard*

Reprint R0402E; *Harvard Business Review* OnPoint edition 5905;
*Harvard Business Review* OnPoint collection 5895 "Making IT Matter"

>|Read Entire Article >|Purchase Reprint >|Purchase *Harvard Business Review* OnPoint edition
>|Purchase *Harvard Business Review* OnPoint collection

Modern information technology started four decades ago, yet in most major corporations, IT remains an expensive mess. This is partly because the relatively young and rapidly evolving practice of IT continues to be either grossly misunderstood or blindly ignored by top management. Senior managers know how to talk about finances because they all speak or understand the language of profit and loss and balance sheets. But when they allow themselves to be befuddled by IT discussions or bedazzled by three-letter acronyms, they shirk a critical responsibility.

In this article, the authors say a systematic approach to understanding and executing IT can and should be implemented, and it should be organized along three interconnected principles:

*A Long-Term IT Renewal Plan Linked to Corporate Strategy.* Such a plan focuses the entire IT group on the company's overarching goals during a multiyear period, makes appropriate investments directed toward cutting costs in the near term, and generates a detailed blueprint for long-term systems rejuvenation and value creation.

*A Simplified, Unifying Corporate Technology Platform.* Instead of relying on vertically oriented data silos that serve individual corporate units (HR, accounting, and so on), companies adopt a clean, horizontally oriented architecture designed to serve the whole organization.

*A Highly Functional, Performance-Oriented IT Organization.* Instead of functioning as if it were different from the rest of the firm or as a loose confederation of tribes, the IT department works as a team and operates according to corporate performance standards.

Getting IT right demands the same inspired leadership and superb execution that other parts of the business require. By sticking to the three central principles outlined in this article, companies can turn IT from a quagmire into a powerful weapon.

**How to Have an Honest Conversation About Your Business Strategy**
*Michael Beer and Russell A. Eisenstat*

Reprint R0402F; *Harvard Business Review* OnPoint edition 5925;
*Harvard Business Review* OnPoint collection 5917 "Honesty Is the Best Strategy"

>|Read Entire Article >|Purchase Reprint >|Purchase *Harvard Business Review* OnPoint edition
>|Purchase *Harvard Business Review* OnPoint collection

Too many organizations descend into underperformance because they can't confront the painful gap between their strategy and the reality of their capabilities, their behaviors, and their markets. That's because senior managers don't know how to engage in truthful conversations about the problems that threaten the business—and because lower-level managers are afraid to speak up. These factors lie behind many failures to implement strategy. Indeed, the dynamics in almost any organization are such that it's extremely difficult for senior people to hear the unfiltered truth from managers lower down.

Beer and Eisenstat present the methodology they've developed for getting the truth about an organization's problems (and the truth is always embedded within the organization) onto the table in a way that allows senior management to do something useful with it. By assembling a task force of the most effective managers to collect data about strategic and organizational problems, the senior team sends a clear message that it is serious about uncovering the truth. Task force members present their findings to the senior team in the form of a discussion. This conversation needs to move back and forth between advocacy and inquiry; it has to be about the issues that matter most; it has to be collective and public; it has to allow employees to be honest without risking their jobs; and it has to be structured. This direct feedback from a handful of their best people moves senior teams to make changes they otherwise might not have.

Senior teams that have engaged in this process have made dramatic changes in how their businesses are organized and managed—and in their bottom-line results. Success

that begins with honest conversations begets future conversations that further improve performance.

**Launching a World-Class Joint Venture**
*James Bamford, David Ernst, and David G. Fubini*

Reprint R0402G

>|Read Entire Article >|Purchase Reprint

More than 5,000 joint ventures, and many more contractual alliances, have been launched worldwide in the past five years. Companies are realizing that JVs and alliances can be lucrative vehicles for developing new products, moving into new markets, and increasing revenues. The problem is, the success rate for JVs and alliances is on a par with that for mergers and acquisitions—which is to say not very good.

The authors, all McKinsey consultants, argue that JV success remains elusive for most companies because they don't pay enough attention to launch planning and execution. Most companies are highly disciplined about integrating the companies they target through M&A, but they rarely commit sufficient resources to launching similarly sized joint ventures or alliances. As a result, the parent companies experience strategic conflicts, governance gridlock, and missed operational synergies. Often, they walk away from the deal.

The launch phase begins with the parent companies' signing of a memorandum of understanding and continues through the first 100 days of the JV or alliance's operation. During this period, it's critical for the parents to convene a team dedicated to exposing inherent tensions early. Specifically, the launch team must tackle four basic challenges. First, build and maintain strategic alignment across the separate corporate entities, each of which has its own goals, market pressures, and shareholders. Second, create a shared governance system for the two parent companies. Third, manage the economic interdependencies between the corporate parents and the JV. And fourth, build a cohesive, high-performing organization (the JV or alliance)—not a simple task, since most managers come from, will want to return to, and may even hold simultaneous positions in the parent companies. Using real-world examples, the authors offer their suggestions for meeting these challenges.

## Managing Yourself

**Success That Lasts**
*Laura Nash and Howard Stevenson*

Reprint R0402H

>|Read Entire Article >|Purchase Reprint

Pursuing success can feel like shooting in a landscape of moving targets: Every time you hit one, five more pop up from another direction. We are under constant pressure to do more, get more, be more. But is that really what success is all about?

Laura Nash and Howard Stevenson interviewed and surveyed hundreds of professionals to study the assumptions behind the idea of success. They then built a practical framework for a new way of thinking about success—a way that leads to personal and professional fulfillment instead of feelings of anxiety and stress.

The authors' research uncovered four irreducible components of success: happiness (feelings of pleasure or contentment about your life); achievement (accomplishments that compare favorably against similar goals others have strived for); significance (the sense that you've made a positive impact on people you care about); and legacy (a way to establish your values or accomplishments so as to help others find future success). Unless you hit on all four categories with regularity, any one win will fail to satisfy.

People who achieve lasting success, the authors learned, tend to rely on a kaleidoscope strategy to structure their aspirations and activities. This article explains how to build your own kaleidoscope framework. The process can help you determine which tasks you should undertake to fulfill the different components of success and uncover areas where there are holes. It can also help you make better choices about what you spend your time on and the level of energy you put into each activity.

According to Nash and Stevenson, successful people who experience real satisfaction achieve it through the deliberate imposition of limits. Cultivating your sense of "just enough" can help you set reachable goals, tally up more true wins, and enjoy lasting

success.

## Best Practice

**Turning Gadflies into Allies**
*Michael Yaziji*

Reprint R0402J

>|Read Entire Article >|Purchase Reprint

Multinational companies are the driving force behind globalization, but they are also the source of many of its most painful consequences, including currency crises, cross-border pollution, and overfishing. These problems remain unsolved because they are beyond the scope of individual governments; transnational organizations have also proved unequal to the task.

Nonprofit, nongovernmental organizations have leaped into the breach. To force policy changes, they have seized on all forms of modern persuasion to influence public sentiment toward global traders, manufacturers, and investors.

By partnering with NGOs instead of opposing them, companies can avoid costly conflict and can use NGOs' assets to gain competitive advantage. So far, however, most companies have proved ill equipped to deal with NGOs. Large companies know how to compete on the basis of product attributes and price. But NGO attacks focus on production methods and their spillover effects, which are often noneconomic. Similarly, NGOs are able to convert companies' standard competitive strengths—such as size and wide market awareness of their brands—into liabilities. That's because the wealthier and better known a company is, the juicier the target it makes. Emboldened by their successes, NGOs continue to take on new causes.

By partnering with NGOs instead of reflexively opposing them, companies could draw on NGOs' key strengths—legitimacy, awareness of social forces, distinct networks, and specialized technical expertise—which most companies could use more of. And with NGOs as allies and guides, companies should also be able to accelerate innovation, foresee shifts in demand, shape legislation affecting them, and, in effect, set technical and regulatory standards for their industries.



Copyright © 2004 Harvard Business School Publishing. All rights reserved.

# The HBR List

## Breakthrough Ideas for 2004

**From the fields of biology, neuroscience, economics, positive psychology, network science, marketing, management theory, and more—here are the emergent ideas that are changing the way business is done.**

There's nothing like a new idea to shake things up. Last fall, when we got to work rounding up 20 provocative new ideas in management, some people said it was too ambitious. It was a time of hunkering down, they said, not a time of imagining. Managers and those who study effective management were focused on the basics, the blocking and tackling of cost cutting and controllership. If anything, they claimed, we would discover a kind of anti-intellectualism out there.

They couldn't have been more wrong. When we put out the call for new ideas, we were inundated. Some of the best concepts seem to have sprung from the muck of the past few years. We have Rakesh Khurana plotting the redemption of management, Chris Meyer proposing a new model for ensuring security, and Bob Sutton imploring us not to tolerate bad people—even if they bring in good money. Other writers pick up on promising trends in technology, neuroscience, sociology, and psychology.

Taken together, these 20 ideas cover a lot of ground. Turn the page, and you'll see in no uncertain terms that far from lying fallow, the ground in the business world is as fertile as ever.

### 1. You Got a License to Run That Company?

*Rakesh Khurana*

Management today cannot properly be called a "profession." But given its dominance in American society, it must become one—and that means managers must serve a higher purpose than just maximizing shareholder returns.

### 2. No Monopoly on Creativity

*Richard Florida*

The power behind the U.S. economy is its "creative class"—scientists, artists, engineers, technologists, and designers, to name a few. The creative sector accounts for nearly half of American wage income, but the United States is suddenly in danger of losing its edge.

### 3. The Strategy Is the Structure

*Adrian Slywotzky and David Nadler*

Traditionally, strategy has dictated structure. But if you let strategy and organizational change evolve in parallel and influence each other, your company will have a better chance of keeping up with its markets.

### 4. Business on the Brain

*Diane L. Coutu*

Advances in drug development, genetic mapping, and neuroimaging technologies have shifted our attention from the mind to the brain. How will the new hard-science approach affect leadership, cooperation, and other dimensions of business?

**5. The Law of Conservation of Attractive Profits**

*Clayton M. Christensen*

When a product starts to become a commodity, a decommoditization process is often triggered somewhere else in the value chain. Managers might therefore be able to predict which activities will generate the most attractive profits in the future.

**6. The Force Behind Gigli**

*Joel Kurtzman*

Investors are always scrambling to find out where the "smart money" is going. It's also important, whether you're an investor or a business manager, to know where the stupid money is going.

**7. More Trouble Than They're Worth**

*Robert Sutton*

When it comes to hiring and promoting people, a simple but revolutionary idea is taking hold in the ranks of management: the "no asshole" rule. Organizations just shouldn't tolerate the fear and loathing these jerks leave in their wake.

**8. Finally, Market Research You Can Use**

*Duncan Simester*

Executives complain that their companies' investments in market research are rarely put to good use. Market researchers can make their work a lot more valuable by focusing on long-term field research and other methods that can lead directly to optimized profits for organizations.

**9. The MFA Is the New MBA**

*Daniel H. Pink*

Businesses have come to realize that the only way to differentiate their offerings is to make them beautiful and emotionally compelling—which explains why an arts degree is now such a hot credential in management. Meanwhile, MBA graduates are becoming this century's blue-collar workers: They entered a workforce that was full of promise only to see their jobs move overseas.

**10. Requiem for the Public Corporation**

*Joseph Fuller*

The public limited company is the world's most common corporate organization. But is the useful life of the public company—at least in the form we have known it for more than a century—over?

**11. Accentuate the Positive**

*Bronwyn Fryer*

Organizational psychologists have always focused on the problems that bring companies to their knees: managerial abuse, greed, distrust, poor morale, burnout, office politics, and so on. The new field of "positive organizational scholarship," created in the aftermath of the September 11, 2001, attacks, measures the values and processes that make some organizations inspiring places to work.

**12. Biological Block**

*Chris Meyer*

The immune system operates on some broad principles: ubiquitous detection capability, a sophisticated ability to discriminate friend from foe, and accumulated learning. These factors constitute an architecture for security that we can also use in society and business.

**13. How You Gonna Keep 'Em Down on the Farm After They've Seen Insead?**

*Herminia Ibarra*

Once your valued executive returns from an inspiring leadership program and plugs back into the old routine, there's a good chance you'll lose her—unless you've carefully managed the "takeoff" period before her departure and have a good plan for her "reentry."

**14. You Don't Have a Nanostrategy?**

*Gardiner Morse*

Nanotechnology products—dime-sized computers and ultralight textiles stronger than Kevlar—will certainly disrupt, transform, and create whole industries. If you don't already have a lookout watching for how and when this new field will become important for your business, it's time to get one.

**15. The Loan Ranger**

*Iqbal Quadir*

What is it that keeps rich countries' governments from living up to their rhetoric about free trade? Lobbyists for dying industries who wail about lost jobs. The World Bank should therefore lend to the *rich* countries so they can retrain those workers—and be free to pursue genuine free trade, which will benefit everyone.

**16. Cosmetic Psychopharmacology**

*Ellen Peebles*

Your employees now have access to medications—like Prozac—that not only alleviate depression but also alter personalities in ways that are good for business. Will ambitious managers be able to leave well enough alone?

**17. Watching the Patterns Emerge**

*Clay Shirky*

Managers manage what they can see, but until now they've never been able to "see" into the informal social networks that have always driven business. Better data and new research are finally giving companies a chance to leverage real people's interactions, for everything from trend spotting to identifying internal experts within a department.

**18. Laughter, the Best Consultant**

*Thomas A. Stewart*

You can learn a lot about a company by paying attention to its humor. Skits at sales conferences, wisecracks during meetings, jokes in e-mails: These constitute an extraordinary trove of information about what's really going on.

**19. Watch Your Back**

*Leigh Buchanan*

Fear of risk can cripple a company's ability to compete aggressively. But a new framework for enterprise risk management may finally convince businesses that they can systematically assess hazards on all fronts, without damping their managers' entrepreneurial zeal.

**20. IT Doesn't Scatter**

*Ray Kurzweil*

If you asked most people to describe the past decade of IT, they would call it boom and bust—a roller coaster ride. The reality is that despite the stock swings, the bursting bubbles, the scandals, and the countless other disappointments, technology has marched smoothly and relentlessly ahead.

• • •

**Breakthrough Ideas for 2004**

What's the best idea you've heard lately that's related to the practice of management? HBR's editors asked around, then put their heads together, and the result is the 2004 HBR List.

It's a compendium of new thinking as diverse as it is provocative. Perspectives from economics and sociology sit side by side with developments in brain science and urban planning. Notes of caution—even contrition—mix with calls to action. You'll find insights on how to formulate strategy, spur innovation, spot danger, manage risk, and get the highest performance from the people in your organization. There are new findings about large-scale trends and fresh thoughts on day-to-day decision making.

If there is a crosscurrent running through them, it is only this: that managers with open minds and access to new thinking can make a difference, to the competitiveness of their organizations and the well-being of the world. Since the beginning, HBR has sought to present not just ideas, but ideas with impact. With the 2004 List, we deliver a bumper crop of them. Consider them, debate them, let them inspire your own thinking. Then go and make an impact.

**1. You Got a License to Run That Company?**

Management, for a brief period in the last century, was well on its way to becoming a profession. But managers have been retreating from that goal for the past 60 years, and we have an unparalleled wave of corporate scandals in recent times to show for it.

What is a "profession"? In ordinary parlance, the term refers to an occupation that requires a high degree of technical skill and competence. A more traditional definition, however, also encompasses mastery of an abstract, systematic body of knowledge—and a primary orientation toward ethical service to society.

It was that comprehensive notion of professionalism that inspired the founders of the Wharton School of the University of Pennsylvania, the Tuck School at Dartmouth, and Harvard Business School—America's first business schools—in the early years of the twentieth century. They intended not only to standardize the production of managers for the nation's corporations but also to professionalize the occupation of management itself. If they had succeeded, managers might have come to play a role in the business-dominated society of the twentieth century analogous to the role of the clergy in preindustrial America.

However, the "professionalization" project lost steam after World War II. As the demand for trained managers exploded, the number of business programs rose and their content became diluted. By 1959, both the Ford Foundation and the Carnegie Corporation had issued highly critical reports on the state of American business schools, decrying their purely vocational curricula. Both called for more emphasis on the social and behavioral sciences and on the use of quantitative methods. Those directives, along with the funding provided by the two foundations, led to the recruitment of new faculty, many of whom were trained in economics. This saw the development of many of the economic theories that form the staple fare of MBA courses today. By the time concepts like agency theory and efficient-market theory found their way into the classroom in the 1980s, another fundamental shift was occurring: Managerial capitalism was giving way to a new system of investor capitalism. MBA students were taught that as managers, they were merely agents, bound by arm's-length contractual relationships to a single set of constituents: shareholders.

**An ethic of pure self-interest has replaced the professional ethics that business schools once tried to teach.**

What went unnoticed was that such a view of the manager's role and responsibilities was utterly incompatible with the traditional concept of professionalism. The postwar attempt to reform American business education had created unintended consequences. A Hobbesian ethic of pure self-interest, backed by the power of the highly abstract and systematic "science" of economics, replaced the professional ethics that the business schools had once tried to teach. That is particularly troublesome because business executives are unrivaled by any other group in their control over material and human resources and their dominance in American society. What's more, executives have succeeded in imposing their values, norms, and methods on older, more autonomous professions such as law and medicine.

It is time to reacquaint managers with the concept of professionalism. Along with that should come a fundamental reassessment of business education and how well it serves

society's interests. The American business school has become an institution that serves a very different purpose than was originally intended. That transformation has had a profound effect on American management's evolution toward its present condition, where it is ripe for reexamination.

***Rakesh Khurana*** *(rkhurana@hbs.edu) is an assistant professor at Harvard Business School in Boston. He is writing a book, scheduled to be published by Princeton University Press in 2005, on management as a profession.*

**2. No Monopoly on Creativity**

Creativity is a virtually limitless resource: Every human being has creative potential that can be turned to valuable ends. The number of people doing creative work—the scientists, engineers, technologists, artists, and designers and the various professionals in health care, finance, law, and other fields who make up the "creative class"—has increased vastly over the past century. In 1900, fewer than 10% of U.S. workers were doing creative work. In 1980, that figure was slightly more than 15%. But by 2000, the creative class included almost a third of the workforce. The creative sector accounts for nearly half of all wage and salary income in the United States—$1.7 trillion, as much as the manufacturing and service sectors combined. Imagine how much wealth could be generated if the creative capacities of the remaining two-thirds of the workforce were harnessed, too.

In the past year I've been hit by a harsh realization: The United States, while retaining an edge in this regard, is far from unbeatable. In fact, its position is more tenuous than commonly thought.

For most of human history, wealth came from a place's endowment of natural resources, like fertile soil or raw materials. But today, the key economic resource, creative people, is highly mobile. And it gravitates toward places with certain underlying conditions. To achieve growth, a region must have what I call the three Ts: technology, talent, and tolerance. So the Creativity Index that Kevin Stolarick and I created is based on three component scores, each a matter of objective counting. To determine, for example, if a place is likely to have a culture of tolerance, we look at the concentrations of gay, "bohemian," and foreign-born people and the degree of racial integration. The tolerance and openness implied by these concentrations form a critical element in a place's ability to attract different kinds of people and generate new ideas.

What's frightening is that, far from cultivating its creative advantage, our society at a national level seems determined to undercut it. Today in the United States, there is considerable concern over the outsourcing of software and information technology jobs to India and over China's rise as a manufacturing power. But the real threat to our competitiveness lies in new restrictions on research, scientific disclosure, immigration, and flows of people, because those limits are starting to affect our ability to attract creative and talented people from around the world. An eminent oceanographer in San Diego recently told me, "We can't hold a scientific meeting here because we can't get visas for people." No one seems to be thinking about the flow of people as the key to our advantage in the creative age.

The economic leaders of the future will not necessarily be emerging giants like India and China. They certainly won't be countries that focus on being cost-effective centers for manufacturing and basic business processing. Rather, they will be the countries that are able to attract creative people and come up with next-generation products and business processes as a result. With Irene Tinagli, a Carnegie Mellon University doctoral student, I recently compared 14 European and Scandinavian nations to the United States. Sweden, Finland, Denmark, and the Netherlands had Creativity Index scores that closely matched that of the United States, and Ireland is gaining quickly (see the exhibit "The Creativity Index"). Other research indicates that Canada, Australia, and New Zealand have built dynamic creative climates. Toronto and Vancouver, Canada, and Sydney and Melbourne in Australia compete very well with major U.S. regions like Chicago and Washington, DC.

## The Creativity Index

For a country or region to achieve growth, it must have the three Ts: technology, talent, and tolerance. The national and regional creativity indices are based on objective measures of those factors. (The scores for both rankings are on a scale of 0 to 1, but the two lists are not strictly comparable because of differences in the measures used to compile them.)

In the creative age, leads change abruptly: Austin, Texas, and Seattle have recently shot upward on the Creativity Index.

### ...for Nations

| | Rank | Score |
|---|---|---|
| 1. | Sweden | 0.81 |
| 2. | United States | 0.73 |
| 3. | Finland | 0.72 |
| 4. | Netherlands | 0.67 |
| 5. | Denmark | 0.58 |
| 6. | Germany | 0.57 |
| (7.) | Belgium | 0.52 (tie) |
| (7.) | United Kingdom | 0.52 (tie) |
| 9. | France | 0.46 |
| 10. | Austria | 0.39 |
| (11.) | Ireland | 0.37 (tie) |
| (11.) | Spain | 0.37 (tie) |
| 13. | Italy | 0.34 |
| 14. | Greece | 0.31 |
| 15. | Portugal | 0.19 |

Source: Richard Florida and Irene Tinagli, *Europe in the Creative Age*. Data are from various years within the period 1997–2000.

### ...for U.S. Regions

| | Rank | Score |
|---|---|---|
| 1. | Austin, Texas | 0.963 |
| 2. | San Francisco | 0.958 |
| 3. | Seattle | 0.955 |
| 4. | Burlington, Vermont | 0.942 |
| 5. | Boston | 0.934 |
| 6. | Raleigh–Durham–Chapel Hill, North Carolina | 0.932 |
| 7. | Portland, Oregon | 0.926 |
| 8. | Madison, Wisconsin | 0.918 |
| 9. | Boise, Idaho | 0.914 |
| 10. | Minneapolis | 0.900 |
| (11.) | Albuquerque, New Mexico | 0.897 (tie) |
| (11.) | Washington, DC | 0.897 (tie) |
| 13. | Sacramento, California | 0.895 |
| 14. | Denver | 0.876 |
| (15.) | Atlanta | 0.873 (tie) |
| (15.) | Corvallis, Oregon | 0.873 (tie) |

Source: Richard Florida, *The Rise of the Creative Class* (forthcoming edition); index compiled by Kevin Stolarick of Carnegie Mellon University. The data cover the years 1997–2001.

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

Leads in the creative age are very easily won and lost—Austin, Texas, and Seattle have recently shot up the Creativity Index while Pittsburgh and Cleveland have fallen. No one place has a preordained position at the top of the heap. Americans must wake up to the fact that economies are fluid and that creativity is an asset that must be constantly cultivated.

***Richard Florida*** *is the H. John Heinz III Professor of Regional Economic Development at the Heinz School of Public Policy and Management at Carnegie Mellon University in Pittsburgh. He is the author of* The Rise of the Creative Class *(Basic Books, 2002). He can be contacted at* ***florida@cmu.edu****.*

### 3. The Strategy Is the Structure

Traditionally, strategy dictated structure: You started by defining a strategic goal, then recast your organization to serve it. But for a host of reasons, including the ever decreasing half-life of strategic advantage, this sequential, compartmentalized process now seems obsolete.

Consider the experience of Air Liquide, the French producer of industrial gases, where a successful new strategy was actually driven in large part by the organization's changing structure. Air Liquide had found a way to produce gases in small plants on-site at customers' factories. In short order, growing numbers of Air Liquide staff were being stationed permanently at client sites—which put the staff in a position to notice ways in which their company could help customers improve operating efficiency, increase output quality, and reduce the capital requirements of various processes.

A companywide reorganization (instituted for unrelated reasons) gave these on-site teams greater autonomy, and suddenly they were able to act on the new opportunities. Often this involved taking on activities that had been managed by customers, such as handling hazardous materials, troubleshooting quality-control systems, and managing inventory. Today, these relatively high-margin services constitute about 25% of Air Liquide's revenues, compared to 7% in 1991, before the reorganization.

Without the reorganization, this potent new strategy—the antidote to the commoditization that was threatening Air Liquide's product lines—would not have emerged. The formerly centralized hierarchy would have hindered the field staff from making decisions or even accessing information about customers. When the seeds of this new growth opportunity sprouted in parts of the organization that were closest to the

customer, the entire organization was able to adapt and execute well because the preconditions, in the form of the new structure, were there to do so.

Although mismatches of organization and strategy are often obvious in hindsight, they are never obvious prospectively. Teams that are charged with developing new businesses typically make overoptimistic projections and downplay the difficulties of execution. Think of all the computer hardware and software firms that have pursued strategies to become complete IT solution providers. Most have failed; they simply do not have the skills, relationships, mind-set, and organizational structures required for a broad-based, “systems-agnostic” approach.

At the very least, this suggests that, if an organization is not prepared to execute strategy A, it’s better to choose strategy B, perhaps as an interim option. But we would go further to suggest that strategy and organizational change should happen in parallel and they should be allowed to influence each other. A new model, *concurrent enterprise design,* might be the best hope of enabling organizations to move at least as fast as their markets.

*__Adrian Slywotzky__ is a Boston-based managing director of Mercer Management Consulting. __David Nadler__ is the CEO and chairman of Mercer Delta Organizational Consulting and is based in New York.*

**4. Business on the Brain**

Psychoanalysis—the talking cure—was the most popular form of mental therapy for most of the twentieth century, for good reason. For a start, analysis seemed a far more humane treatment than its primitive alternatives such as lobotomy or early forms of electric shock. More dramatically, however, the horrors of Hitler’s Germany, where monsters like Josef Mengele conducted cruel experiments on Jews, homosexuals, Gypsies, and the mentally ill, outraged people and generated stiff resistance to any form of experimentation involving human beings.

But the 1960s turned the world on its head. Newly discovered medications made huge strides against debilitating illnesses such as manic depression and schizophrenia. The asylums emptied out, and mental illness finally came to be understood as largely a function of genetic inheritance and chemical imbalance. By the 1990s, scientists all over the world were united in the Human Genome Project, a massive effort to map all the human genes, making them accessible for study—and manipulation.

**MRI technology already helps researchers determine how potential customers respond to products and advertisements.**

Drugs and genes are not the only scientific changes that are turning our attention toward the brain and away from the mind. One of the greatest medical breakthroughs of the past few decades has been the development of powerful imaging tools such as MRI and PET scans, which have made it possible for scientists to “see” the brain in action. For instance, scientists can now map how different stimuli affect different parts of the brain, which gives them powerful information about what people think and feel and remember. For their contributions in inventing the MRI, American Paul C. Lauterburg and Briton Sir Peter Mansfield were awarded the 2003 Nobel Prize in medicine last October.

Inevitably, the revolution in the neurosciences will have a major impact on business. In marketing, for example, MRI technology already helps researchers determine how potential customers respond to products and advertisements. But the impact of the new changes in science doesn’t end there. Brain research will inevitably affect other business subjects, such as leadership and cooperation. The field of organizational behavior, for example, owes a great debt to the traditional social sciences of psychology and psychoanalysis. Many of the tools managers have grown up with—such as our theories of motivation and personality—are rooted in these social sciences. But the new “hard” sciences will inevitably bring new tools and solutions to challenge—and maybe even to replace—these old favorites. As Harvard Business School professor Nitin Nohria, coauthor with Paul R. Lawrence of *Driven: How Human Nature Shapes Our Choices,* puts it: “I think the social-science lemon has been squeezed dry. There may be some drops of juice left, but the fruit of the neurosciences has barely begun to be touched. Businesspeople are turning to them now because we see a much richer opportunity for ourselves in the future.”

*__Diane L. Coutu__ (dcoutu@hbsp.harvard.edu) is a senior editor at HBR.*

**5. The Law of Conservation of Attractive Profits**

In my recent book—and in an earlier HBR article—I explored a couple of linked ideas having to do with how profitability in a value chain shifts over time. Briefly (and way too simplistically as a result of space constraints here!), the thinking went something like this:

• Products are most profitable when they're still not "good enough" to satisfy consumers. This is because to make them performance competitive, engineers must use interdependent, proprietary architectures. Use of such architectures makes product differentiation straightforward, because each company pieces its parts together in a unique way.

• Once a product's performance *is* good enough, companies must change the way they compete. The innovations for which customers will pay premium prices become speed to market and the ability responsively and conveniently to give customers exactly what they need, when they need it. To compete in this way, companies are forced to employ modular architectures for products. Modularity causes the products to become undifferentiable and commoditized. Attractive profits don't evaporate, however...

• They move elsewhere in the value chain, often to subsystems from which the modular product is assembled. This is because it is improvements in the subsystems, rather than the modular product's architecture, that drive the assembler's ability to move upmarket toward more attractive profit margins. Hence, the subsystems become decommoditized and attractively profitable.

My sense is that these shifts are more than coincidental; I suspect that when most products start to become commoditized or modularized, this turn of events kick-starts a *decommoditization* process somewhere else in the value chain. As a general rule, one side of an interface in the value chain *must* be modular to allow the side that's not yet good enough to be optimized.

My friend Chris Rowen, CEO of Tensilica, suggested that we call this phenomenon the law of conservation of attractive profits. (He was playing off the law of conservation of energy, which states that energy cannot be created or destroyed, though it may be changed from one form to another.) Translated into managerial terms, the law goes something like this: When attractive profits disappear at one stage in the value chain because a product becomes modular and commoditized, the opportunity to earn attractive profits with proprietary products will usually emerge at an adjacent stage.

If that's the case (and I hasten to add that it's still a hypothesis), it suggests that there is a dynamic dimension to Michael Porter's five-forces framework. Because the hypothesis suggests that the location in the value chain where attractive profits can be earned shifts in a predictable way over time, companies that outsource activities that are not today's core competencies may well miss the boat. This "law" might help managers foresee which activities in the value chain will generate the most attractive profits in the future so that they can develop or acquire competencies where the most money will be.

**Companies outsourcing activities that are not today's core competencies may well miss the boat.**

***Clayton M. Christensen*** *is the Robert and Jane Cizik Professor of Business Administration at Harvard Business School. His most recent book is* The Innovator's Solution: Creating and Sustaining Successful Growth *(Harvard Business School Press, 2003). He can be reached at* cchristensen@hbs.edu.

**6. The Force Behind Gigli**

Investors are always scrambling to find out where the "smart money" is going. But it's also important, whether you're an investor or a business manager, to know where the stupid money is going.

It's a well-established phenomenon that's gone too long without a name: Companies, industries, and even whole sectors have a stupid-money problem when they are suddenly flooded with capital seeking irrational rates of return or with investors whose interests run contrary to those of a normally operating market. Sounds like a nice problem to have? It's not, because it prompts companies to alter their business models in ways that are not sustainable over the long haul.

> **“Stupid money” prompts companies to alter their business models in ways that are not sustainable.**

Think of the 1970s, when tens of billions of dollars of stupid money flowed from the OPEC countries to the money center banks in London and New York. From there it was lent to Argentina, Brazil, Mexico, Nigeria, Indonesia, and other developing countries for infrastructure projects such as power plants, bridges, and dams. But when this episode ended, tens of billions of stupid-money loans could not be repaid by the borrowers without help from the United States and other governments. More than one money center bank teetered on the brink of insolvency.

Or think of the 1980s, when billions of dollars of stupid money flowed into the U.S. real estate market via the savings and loan industry. Large spreads between the interest paid on deposits and that received on mortgages—as well as plentiful capital from the junk bond market—created incentives for S&Ls to shovel money out the door. Condominiums, country clubs, hotels, offices, and shopping centers with dubious economic value were built. Though some money was made by “flipping” these projects and from fees charged by developers and financial institutions, many billions were lost when the stupid money fled the scene. The savings and loan industry collapsed and with it much of the commercial real estate market. It took nearly a decade for the government to clean up the mess.

Right now, there’s at least one place where the stupid money is sloshing around like San Pellegrino: Hollywood. The problem there is that a large proportion of movies have been financed with money from European tax shelters—which create larger returns for their investors when a project loses money than when it makes money. According to industry estimates, Germany, the largest source of these funds, provided Hollywood with about $2.3 billion in tax shelter money in 2002, more than 20% of Hollywood’s overall investment budget.

A few industries have adapted to living with stupid money the way certain species of fish have adapted to living near deep-water sulfur chimneys. Hollywood is a perfect example. Rather than focusing on profits from movies, the industry has been prodded by loss-seeking capital into focusing on increasing costs. Studios make money from fees from independent producers based on a percentage of a project’s production, distribution, and marketing costs, rather than by relying exclusively on a film’s revenue. In the fee-based model that has evolved in Hollywood, profits are about as rare as an interview with Robert DeNiro.

What can managers do (short of taking the money and running) to survive the distorting effects of stupid money? For Hollywood, righting the business model would mean changing the way the studios go after their multiple streams of revenue. Rather than produce a handful of $200 million blockbuster movies each year, the studios might do better by focusing on making more, smaller-budget movies.

And where is the stupid money going next? Given its predilection for glamour, glitz, and new ideas, I’d say nanotechnology and the life sciences are ripe for an infestation. These are fields where we’re seeing not only federal funding but also feverish investment by people looking to get in on the next big thing. If it happens, we know how it will go. Stupid money will begin by running after the sector’s Seabiscuits and end up stalking its nags. The smart money will show up again only after the inevitable downturn, the shakeout, and the reform of the business models.

***Joel Kurtzman*** *(**Joel.A.Kurtzman@us.pwcglobal.com**) is the global lead partner for thought leadership and innovation at PricewaterhouseCoopers and president of the Tangible Group, based in Concord, Massachusetts. His latest book is* How the Markets Really Work *(Crown, 2002).*

### 7. More Trouble Than They’re Worth

There’s a simple practice that can make an organization better, but while many managers talk about it, few write it down. They enforce “no asshole” rules. I apologize for the crudeness of the term—you might prefer to call them tyrants, bullies, boors, cruel bastards, or destructive narcissists, and so do I, at times. Some behavioral scientists refer to them in terms of psychological abuse, which they define as “the sustained display of hostile verbal and nonverbal behaviors, excluding physical contact.” But all that cold precision masks the fear and loathing these jerks leave in their wake. Somehow, when I see a mean-spirited person damaging others, no other term seems quite right.

I first encountered an explicit rule against them about 15 years ago. It was during a faculty meeting of my academic department, and our chairman was leading a discussion about which candidate we should hire. A faculty member proposed that we hire a renowned researcher from another school, a suggestion that prompted another to remark, "I don't care if he won the Nobel Prize, I don't want any assholes ruining our group." From that moment on, it was completely legitimate for any of us to question a hiring decision on those grounds. And it made the department a better place.

Since then, I've heard of many organizations that use this rule. McDermott, Will & Emery, an international law firm with headquarters in Chicago, is (or at least was) known as a better place to work than other firms, and it has been quite profitable in recent years. A survey from Vault, a Web-based provider of career information, reports that McDermott has a time-honored no asshole rule, which holds that "you're not allowed to yell at your secretary or yell at each other"—although the survey also reports that the firm has been growing so fast lately that the rule is starting to fall by the wayside. Similarly, a Phoenix-based law firm provides this written guideline to summer associates: "At Snell & Wilmer, we also have a 'no jerk rule,' which means that your ability to get along with the other summer associates and our attorneys and staff factors into our ultimate assessment." And the president of a software firm told me a couple of months back, "I keep reminding everyone, 'Make sure we don't hire any assholes, we don't want to ruin the company.'"

All this might lead you to believe that this rule bears mainly on employee selection. It doesn't. It's a deeper statement about an organization's culture and what kind of person survives and thrives in it. All of us, including me, have that inner asshole waiting to get out. The difference is that some organizations allow people (especially "stars") to get away with abusing one person after another and even reward them for it. Others simply won't tolerate such behavior, no matter how powerful or profitable the jerk happens to be. I remember when my daughter switched schools a few years back. After a couple of months, she told me, "In our old school, when they said you had to be nice, they meant it. In my new school, they say it but don't really mean it."

**Some organizations allow "stars" to get away with abusing people. Others simply won't tolerate it.**

I acknowledge that there is a subjective element to this rule. Certainly, a person can look like, or even be, a sinner to one person and a saint to another. But I've found two useful tests. The first is: After talking to the alleged asshole, do people consistently feel oppressed and belittled by the person, and, especially, do they feel dramatically worse about themselves? The second is: Does the person consistently direct his or her venom at people seen as powerless and rarely, if ever, at people who are powerful? Indeed, the difference between the ways a person treats the powerless and the powerful is as good a measure of human character as I know.

I'll close with an odd twist: It might be even better if a company could implement a "one asshole" rule. Research on both deviance and norm violations shows that if one example of misbehavior is kept on display—and is seen to be rejected, shunned, and punished—everyone else is more conscientious about adhering to written and unwritten rules. I've never heard of a company that tried to hire a token asshole. But I've worked with a few organizations that accidentally hired and even promoted one or two, who then unwittingly showed everyone else what *not* to do. The problem is that people can hide their dark sides until they are hired, or even are promoted to partner or tenured professor. So by aiming to hire no assholes at all, you just might get the one or two you need.

***Robert Sutton*** *is a professor of management science and engineering at Stanford University's School of Engineering in California. He is also the author of* Weird Ideas That Work: 11½ Practices for Promoting, Managing, and Sustaining Innovation *(Free Press, 2002). He can be reached at* ***bobsut@stanford.edu****.*

### 8. Finally, Market Research You Can Use

Executives often complain that the findings generated by their companies' investments in market research are rarely put to use. The problem could be solved if marketers made their research more useful. How? By shifting their perspective in three important ways.

First, market researchers should aim beyond measurement to optimization. The marketing literature is full of sophisticated methods for measuring customer behavior, but managers have a bigger problem than tracking customers' buying patterns: They need to decide what action the firm should take to profit from that behavior. Deciding

which response will yield the best result is an optimization problem.

Many impressive tools and methods for optimization have been developed to solve engineering and manufacturing problems. For these methods to work with marketing problems, they must be modified. These modifications are being made, as optimization experts realize that marketing offers meaty, significant problems and access to large amounts of data. The earliest successes were in pricing, with the development of sophisticated yield-management systems in the airline and hotel industries. Other work involved the development of models to predict creditworthiness in the credit card industry. More recently, Internet retailers have begun to develop optimization systems to identify which products to show to different customers. Examples of current targets for optimization research include systems for determining who should receive direct-mail promotions and which products and prices to highlight in those promotions. In product development, optimization may help companies design product lines to satisfy customers with diverse needs.

A focus on optimization requires that managers choose a time frame over which to optimize. This brings me to the second shift in perspective: More studies should focus on the long term. Decisions on pricing, advertising, and other marketing matters often have lingering impacts on demand and profits, yet the vast majority of marketing studies limit attention to the immediate outcome. To understand how this can undermine good decision making,consider the findings of a few recent studies.

A publishing firm studying the impact of price promotions over two years discovered effects that were important for its pricing strategies: It found that if deep discounts were offered, established customers stocked up and then purchased less later on, whereas first-time customers tended to come back and purchase more often in subsequent periods. A study of 20,000 people who used a home furnishings catalog found that 10% discounts to customers who ordered out-of-stock items increased revenue in the short term but decreased the rate at which those customers ordered different items later. And other studies have concluded that moving from a short-term to a long-term focus on catalog mailings could increase profits for mail order companies by as much as 40%.

Clearly, market researchers must study such long-term effects if their findings are to guide optimal decision making. So why haven't they? In part, it's because of the difficulty of collecting data over time. But that hurdle is about to be lowered. New methods currently in development will make it possible to use historical data to reliably estimate long-run effects.

The third change market researchers should make is to start testing their theories in the field. What we usually see in the marketing literature is the results of experiments conducted on college students or analyses of historical data collected from public or proprietary sources. There has been a striking absence of field tests in which companies deliberately vary how they interact with customers engaged in real transactions and measure the responses.

But this, too, has been changing recently, as managers are increasingly collaborating with academics to conduct large-scale experiments involving actual customers. Examples include studies that vary the actions of a company's sales force, the pages shown to customers on a company's Web site, and the content of catalogs and other direct-mail promotions. Catalog companies are particularly well placed to test different marketing actions. For instance, they can easily conduct split-sample studies, in which different versions of a catalog are sent to large, random samples of customers. This type of research meets a high standard of rigor because it explicitly controls for alternative explanations due to intervening events or systematic differences between samples. It also yields findings that are easy to communicate. Even the least sophisticated practitioners can appreciate the conclusions when shown how profits differ across experimental conditions.

For all these reasons, the catalog industry has been the quickest to embrace field testing, but managers in other industries are beginning to catch on. Investment will be required in order to develop the infrastructure and expertise necessary to conduct field tests. Most companies will need to invest in measurement technologies to ensure that outcomes are measured correctly, and they will need to create a process for disseminating and institutionalizing the findings. But if they do manage to stage rigorous field experiments—and use the findings to optimize profits—they can rightfully claim to be treating marketing as a science.

***Duncan Simester*** *(simester@mit.edu) is an associate professor of management science at MIT's Sloan School of Management in Cambridge, Massachusetts.*

### 9. The MFA Is the New MBA

Getting admitted to Harvard Business School is a cinch. At least that's what several hundred people must have thought last year after they applied to the graduate program of the UCLA Department of Art—and didn't get in. While Harvard's MBA program admitted about 10% of its applicants, UCLA's fine arts graduate school admitted only 3%. Why? An arts degree is now perhaps the hottest credential in the world of business. Corporate recruiters have begun visiting the top arts grad schools—places such as the Rhode Island School of Design, the School of the Art Institute of Chicago, Michigan's Cranbrook Academy of Art—in search of talent. And this broadened approach has often come at the expense of more traditional business graduates. For instance, in 1993, 61% of McKinsey's hires had MBA degrees. Less than a decade later, it was down to 43%, because McKinsey says other disciplines are just as valuable in helping new hires perform well at the firm. With applications climbing and ever more arts grads occupying key corporate positions, the master of fine arts is becoming the new business degree.

**Corporate recruiters have begun visiting top arts grad schools. This approach has often come at the expense of traditional business graduates.**

The reasons are twofold—supply and demand. The supply of people with basic MBA skills is expanding and therefore driving down their value. Meanwhile, the demand for artistic aptitude is surging. In many ways, MBA graduates are becoming this century's blue-collar workers—people who entered a workforce that was full of promise only to see their jobs move overseas. For example, Lehman Brothers and Bear Stearns have begun to hire MBAs in India for financial analysis and other number-crunching work. Starting salaries: around $800 per month. A.T. Kearney estimates that in the next five years, U. S. financial services companies will transfer a half-million jobs to low-cost locales such as India—saving the industry some $30 billion but displacing 8% of their American workforce. As the *Economist* recently put it, the sorts of entry-level MBA tasks that "would once have been foisted on ambitious but inexperienced young recruits, working long hours to earn their spurs in Wall Street or the City of London, are, thanks to the miracle of fibre-optic cable, foisted on their lower-paid Indian counterparts."

At the same time, businesses are realizing that the only way to differentiate their goods and services in today's overstocked, materially abundant marketplace is to make their offerings transcendent—physically beautiful and emotionally compelling. Think iMac computers, Design Within Reach, and Target aisles full of Isaac Mizrahi women's wear and Michael Graves toilet brushes. Or just listen to auto industry legend Robert Lutz. When Lutz took over as chairman of General Motors North America, a journalist asked him how his approach would differ from his predecessor's. Here's what he said: "It's more right brain.... I see us as being in the art business. Art, entertainment, and mobile sculpture, which, coincidentally, also happens to provide transportation." General Motors—General Motors!—is in the art business. So, now, are we all.

***Daniel H. Pink*** *(dp@danpink.com) is the author of* Free Agent Nation *(Warner Business Books, 2001) and* A Whole New Mind *(forthcoming from Riverhead Books).*

### 10. Requiem for the Public Corporation

Over the last three years, executives, politicians, and shareholders in the United States have valiantly tried to fix the problems of the public limited company, the world's most common corporate organization. They have enacted more laws for companies to follow, set higher standards for the selection of board members, and insisted that audit firms comply with stringent new rules. Yet these post-Enron reforms beg one fundamental question: Is the useful life of the public company, at least in the form we have known it for more than a century, over?

I am not, of course, the first person to question the viability of the widely held company. Two decades ago, shareholders in the United States accused executives of being more interested in protecting their jobs than generating higher profits. The shareholders supported raids by takeover artists to dislodge incumbent CEOs, and they hoped the new managers would deliver higher returns. The shareholder revolt became so widespread that in 1989, Harvard Business School's Michael Jensen argued that new kinds of organizations might someday eclipse the public limited corporation.

Jensen, now a colleague of mine at Monitor, focused on agency problems, the conflicts that arise when the interests of managers and shareholders diverge. At the time he wrote, the struggle pitted shareholders and executives in a fight over low investor

returns and executive inertia. Now, the clash focuses on high executive compensation levels (at Tyco, for instance) and risky investments (by Enron, for example). Corporate America has responded by restructuring salary packages, increasing the transparency of financial reports, and strengthening the supervisory role of boards of directors. Have agency problems been resolved? Hardly. They can never be resolved, for the interests of managers and shareholders will always differ to a degree.

The problems go beyond those posed by agency. The costs of being a public company have risen steadily over the years, with new laws like Sarbanes-Oxley adding to overhead costs. At the same time, public companies have to deal with more lawsuits from aggressive lawyers. It is also getting hard to recruit and retain topflight talent for public companies as executives increasingly see the costs of being in the spotlight—in reputation damage and personal liability—outweighing the benefits.

Most problematic, the financial benefits of going public have eluded many companies. We've seen the emergence of two tiers of companies in the stock market. A few big companies such as GE with large markets for their shares do benefit from the liquidity that the stock market provides. However, a large number of small companies have struggled to gain investors' attention. Their stocks remain stagnant, followed by only a few second- and third-tier investment banks. That leaves these midcap companies in public purgatory. On the one hand, institutional investors do not buy their shares out of fear that they will find it impossible to escape a stock for which they have established a new market price. On the other, these companies cannot issue more shares in the primary market, due to the dilutive effects and the lack of investor interest. The sum of these forces explains why experts predicted a record number of firms would deregister in 2003, taking advantage of a legal loophole that allows American companies to remain public but not make financial disclosures.

So why do companies remain wedded to the notion of public ownership? Most companies choose to go public because it yields higher returns and greater liquidity. When it does not, they must reexamine their options. Although it is not clear what those might be, the time has come to rethink rather than reform the public corporation.

***Joseph Fuller*** *is the CEO of Monitor Group, a family of professional service firms based in Cambridge, Massachusetts. A longer version of this article appears in the winter 2004 edition of* Directors & Boards *(www.directorsandboards.com).*

**11. Accentuate the Positive**

Ever since organizational psychologists and management scholars began studying workplace behavior, they have focused on a long list of problems that can bring organizations to their knees: managerial abuse, greed, distrust, poor morale, burnout, office politics, and so on. This focus on the negative aspects of working life has made sense for two reasons. First, organizational scholarship is grounded in the field of psychology, which has perennially concentrated on mental illness and social pathology. Second, scholars since the time of Dante have generally found that the tortures of hell yield more interesting book material than do the blisses of heaven.

Thus it may come as a surprise to learn that companies where the focus is on amplifying positive attributes such as loyalty, resilience, trustworthiness, humility and compassion—rather than combating the negatives—perform better, financially and otherwise. A new field of inquiry called positive organizational scholarship (POS), spearheaded by organizational behavior and psychology researchers at the University of Michigan, the University of Pennsylvania, the University of British Columbia, and elsewhere, is shedding promising new light on the outcomes of various approaches to managing behavior in the workplace.

On the face of it, POS doesn't sound new. Ever since 1952, when Norman Vincent Peale published the self-help classic *The Power of Positive Thinking,* the benefits of an optimistic outlook have been touted ad nauseum. Additionally, authors such as Tom Peters and Jim Collins have long studied the leadership attributes that help companies excel. What makes POS different is its focus: Rather than zeroing in on the positive qualities of individuals, POS takes a rigorous look at the more widespread social constructs, values, and processes that make organizations great. And because it measures results, positive organizational scholarship goes beyond platitudinous talk about the virtues of being good. Southwest Airlines, for example, isn't the envy of the airline industry merely because it has a competitive cost structure or because founder Herb Kelleher, now retired, was a cool guy. The company is successful, these researchers contend, because it carefully protects and nurtures its employees. According to Kim Cameron, a professor of organizational behavior and human resource

management at the University of Michigan Business School who has studied "virtuous" firms, Southwest—despite its no-layoffs policy—was the only major airline to escape devastating long-term financial losses following the September 11, 2001, terrorist attacks. Southwest's overall passenger loads and stock price remained comparatively high.

Why is this field of study emerging now? The germ of POS was, in fact, planted on 9/11, when the media focused on the qualities of empathy, courage, and resilience in the workplace. In 2002, the debacles at Enron, WorldCom, and others renewed conversations about ethics and governance. Suddenly, scholars began to ask: How can companies foster honesty and trust at work? How do organizations that replenish workers' energy, build collective strength, and foster emotionally intelligent cultures operate? And how do these firms perform, both competitively and financially, over time?

**Some organizations manage to foster emotionally intelligent cultures. Scholars are beginning to ask: How do these firms operate?**

Positive organizational scholarship is inspiring researchers to look at work in a whole new light—and they are finding that employee happiness really does pay. It's beginning to look as if a positive workplace atmosphere is worth developing, and not merely for its own sake; it may be the foundation of true organizational success.

***Bronwyn Fryer*** *(bfryer@hbsp.harvard.edu) is a senior editor at HBR.*

**12. Biological Block**

On the Massachusetts Turnpike in Boston, a hundred-foot-long billboard asks: "Is your neighbor's gun locked?" The point, of course, is that everyone in the vicinity of a gun should be engaged in the task of containing the threat.

There's a bigger idea here, and it's cropping up all over the place—the immune system as an architecture for security. The vertebrate immune system, still far from well understood, operates on a few broad principles: a ubiquitous detection capability, a sophisticated ability to discriminate friend from foe, a diverse repertoire of defensive responses, the ability to recognize and deal with novel threats, and accumulated learning. These principles have already been built into "digital immune systems"—if you use Symantec's corporate antiviral product, you're soaking in it. Using technology developed at IBM's Watson Labs, this system protects computer networks by recognizing "malware" anywhere in the network, quarantining it, and sending it to an analysis center, where Symantec develops and deploys digital antibodies, not just on the infected computer but throughout the network—in as little as an hour. Then the network remembers the response, so the inoculation confers permanent immunity.

Three more signs: Mathematician Stephen Strogatz described the 2003 power grid meltdown that blacked out parts of eight states as "a massive allergic reaction" to a problem in the grid—that is, a kind of autoimmune failure of the network. Financial institutions are exploring whether fraud can be prevented by treating it as a detectable infection—T-men, not T cells. And a new discipline has been born: "Theoretical immunology" explicitly brings together the study of natural, "wet" immune systems and the development of mathematical models that can both improve our understanding of our own wetware and aid in the design of immune systems for other hosts under threat.

**Financial institutions are exploring whether fraud can be prevented by treating it as a detectable infection.**

Immune response is an idea whose time has come. We have new capabilities: Our biological understanding and our in silico simulation technology are growing. And we have newly pressing needs: The most urgent problem of our day—terrorism—requires an immune system, not a series of firewalls, for effective protection. Success will come when every cell of the body politic has the capability and the will to detect terror in the offing and the ability to trigger a lethal immune response. Are your neighbor's WMDs locked?

***Chris Meyer****'s most recent book (with Stan Davis) is* It's Alive: The Coming Convergence of Information, Biology, and Business *(Crown Business, 2003). He can be reached at chris.meyer@itsalivebook.com.*

**13. How You Gonna Keep 'Em Down on the Farm After They've Seen Insead?**

Companies that want to make serious investments in leadership development have numerous options. They can send their high-potential managers to programs offered through business schools like Harvard and Insead, to facilities like the Center for Creative Leadership, or to sessions designed by internal corporate training groups. But despite all the competition in the market, many companies aren't convinced they are getting their money's worth.

The problem may not be the programs. In fact, the personal learning catalyzed by a top-notch program can be tremendous. The problem, my research suggests, is what happens when a manager comes back to the day-to-day routine of the office. Having been inspired by exposure to new models and networks, he or she returns transformed, but to an organization that has not experienced a parallel makeover. The clash of expectations—the manager's and the company's—can be brutal. And so, paradoxically, the better the management development program, the more likely it may be to precipitate a valued employee's departure.

How can organizations—and individual managers—get the full value of leadership development? It's a question of emphasizing the "takeoff" and "reentry" phases of the experience. In preparation, for example, a manager should spend time with the boss and other key stakeholders, engaging in a dialogue about his or her strengths, weaknesses, and future trajectory. Having done so, the manager will be in a much better position, when he or she returns, to get a development assignment that will serve as a training ground for the new skills and approaches suggested in the program. It's amazing how few managers seize the opportunity (or excuse) that is created by an upcoming development program to initiate such a conversation with the boss. But whether they do or not, the boss should ensure that it happens.

Similarly, on reentry, managers must take the time to reprioritize goals and fine-tune their strategies. What should he or she aim to accomplish in the first week? The first month? Within six months? This reflection and planning should happen immediately after reentry—even if it means letting voice mails and e-mails pile up for yet another day. In a series of studies ranging from the introduction of new technologies to managers' approaches to taking on new roles, behavioral scientists have found a consistent "window of opportunity" effect: We have only a short time to make a real change after any break from routine. After that, things slip quickly into business as usual.

Finally, there is the question of how the individual should transfer his or her new knowledge to the rest of the team at the organization. I've seen many participants leave a program excited by their learning, having taken volumes of notes about what they plan to do differently, only to be bewildered when the people back home are not as quick to see the light. The key is to recognize that the power of the learning experience is not just intellectual. It's also emotional. While it's easiest to pass along the ideas and the readings, the manager must devise ways to share the experience more fully.

People often speak of executive programs as having been transformative. But the benefit shouldn't end there, at the event and within the individual. By thoughtfully managing a manager's takeoff and reentry, an organization can hope to be transformed by the experience as well.

***Herminia Ibarra*** *is the Insead Chaired Professor in Organizational Behavior at Insead in Fontainebleau, France. She is the author of* Working Identity: Unconventional Strategies for Reinventing Your Career *(Harvard Business School Press, 2003). She can be reached at* ***Herminia.Ibarra@insead.edu****.*

**14. You Don't Have a Nanostrategy?**

Lost in the hype about nanotechnology—somewhere between the threat of ooblecky nano-goo and the promise of cancer-curing microbots—lies the real story: Nanotechnologies will eventually disrupt, transform, and create whole industries. Mihail Roco, key architect of the robustly funded U.S. National Nanotechnology Initiative, estimates that by 2015, the global market for nanotech-based products will reach $1 trillion and employ 800,000 workers in the United States and 2 million worldwide. The question isn't *whether* your industry will be affected, but when and how.

Nanotech isn't a single field so much as a sprawling idea that cuts across disciplines, including engineering, physics, chemistry, biology, and materials science. The concept is that by manipulating matter at the molecular level, literally rearranging atoms and molecules, you can create new materials and products with extraordinary properties—fibers with 30 times the tensile strength of steel at a fraction of its weight, chemical detectors that can sense a single molecule, precision-guided smart drugs, and computer

memories 1,000 times denser than any we have today.

**Nanotech isn't a single field so much as a sprawling idea that cuts across disciplines, from physics to biology.**

Nathan Myrhvold, Microsoft's former CTO and now the managing director of Intellectual Ventures, a private entrepreneurial firm, cautions companies to keep this fantastical nanofuture in perspective. "Nanotechnology may give rise to the next industrial revolution—maybe—but most nanotech applications aren't going to sneak up on you. The first industrial revolution didn't sneak up on us either," he says. "The broad vision is right, but some of these applications may be 50 years off. So what you want to do is keep your ear to the ground." For some industries, nanotech's implications are near term and obvious. Any company with a major stake in IT ought to be actively involved in nanotech R&D and investment if it has the resources, as industry leaders IBM and HP are. The same is true for materials manufacturers. At the other end of the spectrum are companies in the service industries and elsewhere that will be nanotechnology's end users, the beneficiaries of dime-sized supercomputers and ultralight textiles stronger than Kevlar.

A company's responses to nanotechnology opportunities, of course, will depend on where it falls on this spectrum. The major players' aggressive strategy-development programs include scenario planning and intensive "boot camps" in which teams develop theoretical nanoproducts, says George Day, director of Wharton's emerging technologies management resource program. Other companies are retaining industry scouts and consulting firms with nanotech expertise and assembling internal "crow's nest" teams charged with tracking nanotech developments. Less aggressive surveillance strategies include tapping the resources of trade associations such as the New York–based NanoBusiness Alliance and inviting in various outside research scientists, customers, and suppliers with nanotech experience to discuss the technology's potential impact on business. At the very least, if you don't have a lookout now, get one. Have an insider shinny up to the crow's nest and take a look around. You might be surprised by what she sees on the horizon.

***Gardiner Morse*** *(gmorse@hbsp.harvard.edu) is a senior editor at HBR.*

### 15. The Loan Ranger

Why does widespread poverty persist in so many parts of the world? Because poor countries need trade and instead get aid. A simple, if surprising, change could fix the situation.

We all know that trade is what's needed to propel countries. When two countries engage in trade, both benefit. But rich countries discourage trade with poor countries in three major ways. First, they hold fast to the trading principle of reciprocity; that is, they offer another country a tariff reduction on a product in return for the same treatment on another item that they are hoping to sell to that country. Because the poor country's economy is vastly smaller, this "equal treatment" prevents it from bargaining for the reductions in trade barriers it needs to compete in rich countries. This is why, for instance, the United States puts a tariff on imports from Bangladesh that is nearly ten times higher than that on imports from France.

At the same time, rich countries spend, collectively, nearly $1 billion a day subsidizing the part of their economies where poor countries may have a real competitive advantage: agriculture. For most poor countries, a boost in agriculture would make a critical difference. Genuine economic development tends to be bottom-up; a surplus in agriculture produces the purchasing power and investment capital for manufactured goods, and surpluses in manufacturing similarly lead to more complex consumption and production.

Finally, rich countries use their leverage to promote free trade where they have an advantage. Instead of buying from poor countries, they're more interested in selling to them. It's a short-sighted strategy. When rich countries buy from poor countries, they not only bring costs down for their own consumers, they also raise purchasing power naturally in the poor countries—leading to larger markets for the rich countries' goods.

Instead, rich countries try to artificially boost poor countries' purchasing power by providing "aid"—to the tune of nearly $1 billion a week—through various bilateral channels and multilateral institutions. When aid is given to a poor country's government (and most aid does go to governments), it has the added effect of promoting statism—it

contributes to the centralization of power, whereas decentralization fosters democratization and economic growth. By taking pressure off that government to achieve greater tax revenues through economic growth, it allows the poor country to live with wrong policies and therefore contributes to worsening governance.

Solving the problem requires a fresh focus on the actual bottleneck. What is it that keeps rich countries' governments from living up to their rhetoric about free trade? Just this: a limited number of special interests that lobby aggressively on the part of dying industries. People who work in these sectors, we hear, will suffer; they will have to be retrained, rehabilitated. But that, we know, can be done—provided there is sufficient funding for related projects. And there, I would propose, is where institutions like the World Bank should be offering their aid. Let's start lending to the *rich* countries, so they can make their own people whole. Then they can pursue genuine free trade, benefiting both rich and poor economies. With good access to rich markets, poor economies would make substantial gains and earn access to capital and know-how naturally.

***Iqbal Quadir*** *(Iqbal_Quadir@harvard.edu) is the founder of GrameenPhone, which provides telephone access throughout Bangladesh, including to its rural poor. He lectures in public policy at Harvard's John F. Kennedy School of Government in Cambridge, Massachusetts.*

**16. Cosmetic Psychopharmacology**

Your employees now have access to medications—notably, SSRIs (selective serotonin reuptake inhibitors) like Prozac—that not only offer effective treatment for certain types of depression but also have the power to alter personality in ways that are good for business. In his 1993 best seller, *Listening to Prozac,* psychiatrist Peter Kramer told stories of patients who, when medicated, became "better than well"—showing, for example, greater assertiveness, better bargaining skills, and improved social competence. One patient, no longer depressed and already well regarded in her workplace, asked to have her dose increased so she'd have the confidence to request a promotion.

More recently, Brian Knutson of Stanford and his colleagues at the University of California–San Francisco Medical School's Langley Porter Psychiatric Institute looked at the short-term effects of SSRIs on people with no mood or personality disorders. Subjects were given a daily dose of either Paxil or a placebo and after a month were asked to perform a tricky negotiation. The people on Paxil performed best—perhaps because they were less hostile.

Now there's a tempting prospect. Getting ready to close a deal? Better drug up the team in advance. After all, you don't know what the other side is on. The potential for such use led Kramer to speculate about the role "cosmetic psychopharmacology" (a term he coined) could play in the world of business. After all, who wouldn't want to be better than well? Who wouldn't want to be less distractible, more optimistic, more socially adept? "I've certainly been asked," says Harvard psychiatrist Joe Glenmullen. "But that's the one thing I won't prescribe a drug for. I've heard stories of people who are in the office late at night, and they go to the Xerox room and are surprised to find people sharing their Prozac or Ritalin."

**Getting ready to close a deal? Better drug up the team in advance. After all, you don't know what the other side is on.**

Kramer says patients aren't beating down his door for pills they don't really need. At least not yet. To some extent, he attributes the restraint to a fear of side effects. A large number of Prozac users report sexual dysfunction, for example. For other medications like Zoloft and Celexa, users can become seriously ill if they go off too quickly or even if they miss a couple of doses. More difficult to pin down is the nagging fear that, just as cosmetic surgery can deprive a face of character, cosmetic use of these medications will level out temperament. Some antidepressant users have complained that the same drug that allows them to cope with the daily stresses of life robs them of their creative "edge."

But Kramer sees another reason for the restraint: an attitude described by the late Gerald Klerman as pharmacological Calvinism. "If you look at studies of medication, the rule is that people take less than their doctor prescribes. We just don't like taking medicine," Kramer says. For business, that may be a bigger problem than the danger that some people will pop pills they don't need. Studies have shown that lost work time due to depression costs companies a fortune, with estimates ranging from $31 billion to $44 billion per year in lost productivity in the U.S. alone. "At least half of depression goes untreated," says Brookline, Massachusetts, psychotherapist Joanna Volpe-

Vartanian. "People are worried about what their bosses will think, and they're afraid to use their employee assistance program or insurance benefits lest a record stay on a computer somewhere."

But that attitude may change as the image of psychopharmacology moves from problem fixer to advantage provider. Athletes have steroids. Fighter pilots have their "go pills." Will ambitious managers be able to leave well enough alone?

***Ellen Peebles*** *(epeebles@hbsp.harvard.edu) is a senior editor at HBR.*

**17. Watching the Patterns Emerge**

We've known for decades that informal social networks drive business—from employees at the watercooler to job seekers canvassing acquaintances to communities of practice. But it is much harder to map a network than to draw an org chart, and unlike org charts, social networks are self-altering. Knowing that networks are valuable doesn't help tell us how they are valuable or how to use them.

That is changing. Three big forces are at work: our understanding of the mechanics of social networks, within and between businesses; the growing cloud of data that surrounds our every transaction; and the speed at which we're able to react to those data.

**Better Models of Social Networks.** Stanley Milgram gave us the phrase "six degrees of separation" in a 1967 paper, but we didn't understand how the six-degrees phenomenon worked for another 30 years, until Duncan Watts and Steve Strogatz finally worked out the details, described in Watts's 2003 book, *Six Degrees.* This work, along with that of their peers, such as Albert-László Barabási of Notre Dame and Bernardo Huberman of HP, amounts to a revolution in our understanding of how social networks operate.

**Better Real-World Data.** Our lives are increasingly mediated by the Internet, from booking flights to making dates, and Web activities generate a cloud of metadata, the data that describe objects or transactions. One of the surprises with metadata is how little we need before we can start divining useful information. Amazon's book recommendations, Blogdex.net's lists of conversational trends on Web logs, Huberman's maps of social networks derived from e-mail traffic—all these things and many more come from the mining of simple metadata.

**Faster Reflexes.** We can now work with the data in real time. Until recently, all mapping of social networks was like photography. You'd take a snapshot of a group's relationships, develop it, and weeks or months later, you'd see how it came out. With better tools for mining social metadata, we can start to treat our social networks like mirrors, getting the information we need as we need it. Social networking sites like LinkedIn and Friendster let individuals figure out who is in their friend-of-a-friend networks, while software applications like Spoke and Visible Path map companies' social networks to help businesses figure out whom to tap when trying to pitch a product or close a sale.

In what Kevin Werbach has called the era of "postmodern knowledge management," it's becoming clear that viewing a company's knowledge as something separate from its employees is impossible. Our growing understanding of social networks may help us leverage real people's interactions, for everything from trend spotting by scouring public conversations to identifying internal experts within a department to ensuring that a merger actually results in cooperation among employees, not just a change in logo.

Social networks can't simply be strip-mined of their value, however. A social network is a living thing that is altered by use. There are reports that the value of networking for job possibilities is weakening, in part because so many employment experts have recommended this very strategy. Likewise, privacy concerns and employees' inclination to see their social networks as personal assets will lead to tension between management and rank-and-file workers about both the observation and use of social networks.

Many of the social networking tools being proposed today will fail, because the obvious ideas are technologically simple but socially unworkable. ("If we all dump our address books into one big database, everybody will know everybody!") As we get smarter about building social networking tools, however, we will take it for granted that our social networks have measurable value, as do other intangibles such as brand, and we will find ways to recognize it. Managers manage what they can see, and as they begin to see social networks, the long-term effect on the business landscape will be profound.

***Clay Shirky*** *(clay@shirky.com) is a consultant and teaches at New York University's graduate Interactive Telecommunications Program, where he works on the social and economic effects of Internet technologies. His writings are archived at www.shirky.com.*

**18. Laughter, the Best Consultant**

Long before—four full years before—the once-rocketing Enron imploded in midair, a group of employees in the company's international division got together for their annual powwow. As well as listening to presentations about past performance and exhortations to reach new heights, the Enronians entertained themselves by putting on skits, with a prize going to the team that staged the best show. In 1997, the theme was mental toughness.

That year Sherron Watkins, later famous as the woman whose letter to CEO Ken Lay warned him that accounting scandals could doom the company, was cast as the Wicked Witch of the West in a parody of *The Wizard of Oz*. In the skit, Dorothy needed to find the wizard to get a deal approved. Of the executives accompanying her, one had no brain, one had no heart, and the third, the Cowardly Lion, was padding contracts because he wasn't brave enough to get earnings on his own. As for the wizard, the man who could approve the deal, the man behind the curtain—well, it turned out he had no sophisticated computer models, no special financial acumen. He was a fake. And his name, he said when he was discovered, was Andy Fastow. You don't need a brain or a heart to succeed at Enron, the fictional Fastow declared; and to the corrupt Cowardly Lion, he said: "You're my kind of guy."

That was fiction. The real Andy Fastow was, of course, the man who soon became Enron's chief financial officer and, if the charges against him are accurate, the chief architect of a series of deceptive deals that hid Enron's deteriorating financial condition from the public. When the curtain was pulled back on the real Enron's real finances, the company collapsed. Most employees and almost all of the business world were taken totally by surprise. But it was all there in the skit. Just as it was there in the wisecrack that went around the office after the publication of Enron's 1997 annual report, whose cover showed a tropical forest with a large leaf smack in the middle. "The fig leaf," the wags called it.

There's a lesson here, or maybe it's a management tip: You can learn a lot about a company by paying attention to its humor. People tell jokes, often, as a way of revealing uncomfortable truths. Monarchs employed court jesters to cut through their courtiers' unctuous sycophancy, for example. These days, it's editorial cartoonists and late-night TV hosts who lampoon the powerful. The same impulses are at work in every corporation on earth. Skits at sales conferences, wisecracks in meetings, jokes in e-mails: These constitute an extraordinary trove of information about what's really going on.

***Thomas A. Stewart*** *(editors@hbsp.harvard.edu) is the editor of HBR. His most recent book is* The Wealth of Knowledge: Intellectual Capital and the Twenty-First Century Organization *(Doubleday, 2001).*

**19. Watch Your Back**

Cruising through the draft of a potentially influential new framework for enterprise risk management, I am reminded of the thousand natural (and unnatural) shocks that companies are heir to. Those risks include, but are nowhere near limited to, emerging competition and price movements; political agendas and new regulations; changes in demographics and work/life priorities; unexpected repair costs; quality deficiencies; utility or computer service downtime; and good old human frailty. Toss in fire, flood, and earthquake—as this document does—and you have a portrait of the organization as a quivering mass of vulnerabilities. And that's exactly the view you need to take to prevent or mitigate nasty surprises that wallop stock prices, sales, and reputations, according to the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which is publishing the framework in the first quarter of this year (the draft is available at www.coso.org).

COSO are the folks who brought us the internal control framework adopted by many public companies scrambling to comply with Sarbanes-Oxley. The organization's traditional purview is financial reporting; that it has now embraced risk in all its infinite variety speaks to the growing demand for a cross-company, senior-executive-led approach to enterprise risk management (ERM), which goes well beyond traditional risk management's focus on a limited number of threats within functional silos. ERM takes a portfolio approach that recognizes the variety and interdependence of organizational vulnerabilities. "Sarbanes-Oxley has directed attention to risk, but the Enrons were really

about accounting fraud," says John J. Flaherty, the chairman of COSO and retired chief auditor for PepsiCo. "We're focused more on risks that creep up on an organization and handicap it or put it out of business—where they never saw it coming."

Enterprise risk management is oldish hat in Britain, where the Turnbull Initiative of 1999 required public companies to regularly report on all significant exposures—ranging from IT to brand—as well as on the internal controls designed to minimize them. Today, UK companies perform comprehensive risk audits at least twice a year, and a few conduct them in real time, according to Richard Sharman, director of KPMG's enterprise risk management group in London. The majority of Britain's 100 largest companies employ a chief risk officer or director of risk management who is responsible for embedding risk awareness in the culture, change-management style.

Although most of Europe is similarly up to snuff, the United States lags by 18 months or so. A study by management consulting firm Tillinghast-Towers Perrin found that 11% of U.S. companies, mainly in the financial services, insurance, and utilities sectors, have full-fledged ERM programs. Sharman thinks the COSO framework may catalyze U.S. businesses to systematically bring all of their Achilles' heels to heel. In addition, the new Basel II Accord is prompting banks to develop best practices around risk, and those practices are migrating into other industries. "Some of your global organizations are starting to think along the lines of European organizations around risk," says Sharman. "It doesn't just mean buying insurance. It doesn't just mean financial control. It is a CEO issue. And it does affect the brand."

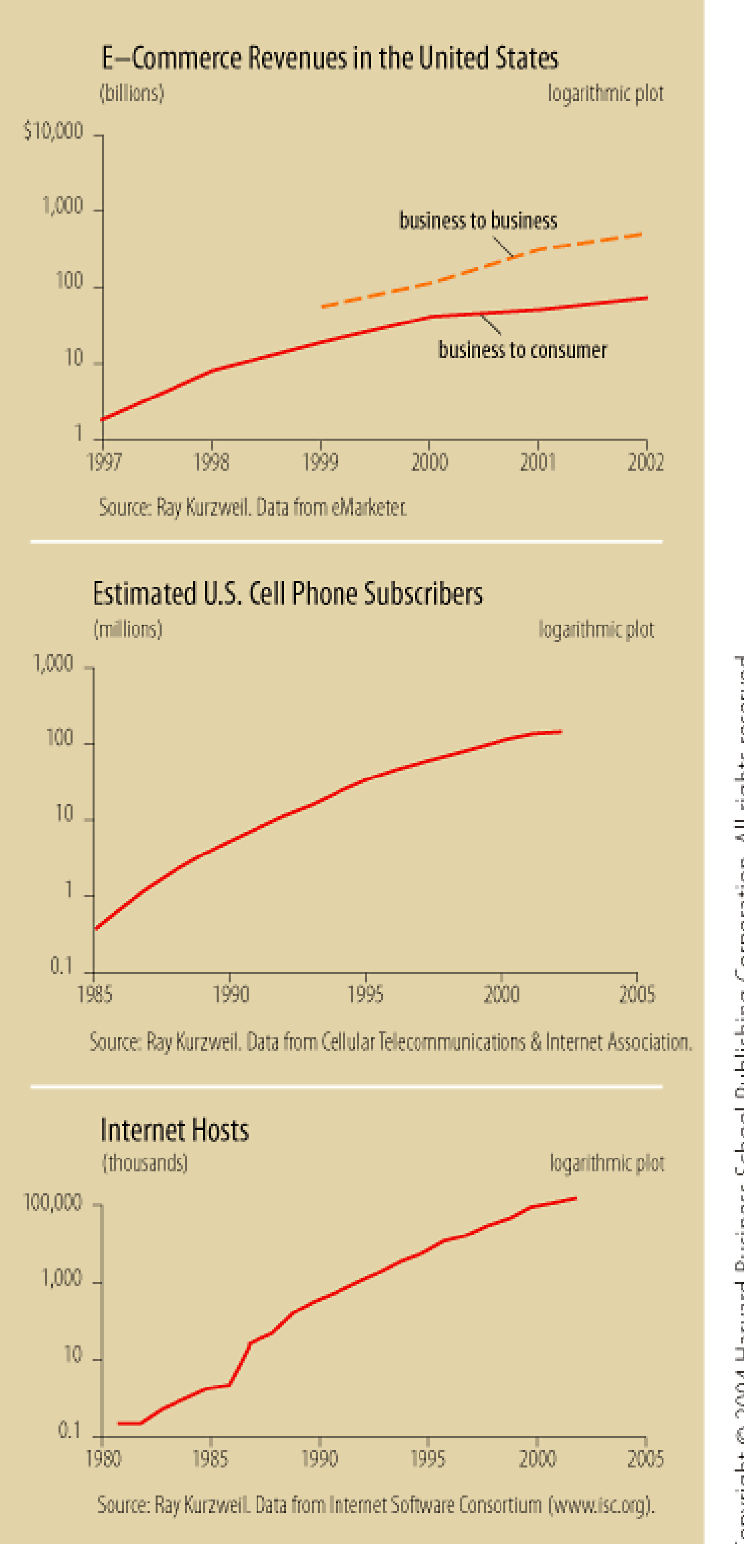
**A study found that only 11% of U.S. companies have full-fledged enterprise risk management programs.**

But ERM serves desire as well as fear; companies that adopt it for compliance purposes only are missing the larger point. Badly done, systemic risk assessment could put the brakes on aggressive behavior, but it need not result in what SEC Chairman William H. Donaldson described in a *Financial Times* interview as "a loss of risk-taking zeal." Rather, ERM should allow companies to make decisions with greater speed and confidence. "Having risk under control gives a company agility, flexibility," says Steven Hunt, a vice president of research at Forrester Research who specializes in security. "It's like driving a car: You can only go fast if you know you have good brakes."

***Leigh Buchanan*** *is a senior editor at HBR. She can be reached at* ***lbuchanan@hbsp.harvard.edu***.

**20. IT Doesn't Scatter**

Take a look at the accompanying charts. Have you ever seen trend lines so smooth? This has been the reality of information-based technologies. Yet if you asked most people to describe IT's past decade, they would call it boom and bust—a roller coaster ride.




Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

Let's look first at the business-to-consumer (B2C) and business-to-business (B2B) data. Actual B2C revenues grew smoothly from $1.8 billion in 1997 to $70 billion in 2002. B2B had similarly smooth growth from $56 billion in 1999 to $482 billion in 2002. We see the same trends in telecommunications, where the number of U.S. cell phone subscribers grew smoothly and exponentially from 340,000 in 1985 to 140 million in 2002. The number of Internet hosts rose from 213 in 1981 to 162 million in 2002.

The price-performance and capacity of the underlying technologies have grown even more rapidly than the market penetration. You could buy one transistor for a dollar in 1968 versus 10 million transistors for a dollar today. And unlike Gertrude Stein's roses, a transistor is not a transistor is not a transistor. As they've become smaller and less expensive, they've also become dramatically faster—by a factor of about 1,000 over the past 28 years. So the cost per transistor cycle has dropped regularly by half every 1.1 years.

The exponential growth of the power of information technologies (broadly defined) goes

>| Executive Summary
>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague

far beyond the well-known paradigm of the miniaturization of transistors on an integrated circuit described by Moore's Law. We see the same phenomenon in many other areas of technology that deal with or create information. For example, magnetic data storage has doubled in price-performance every 15 months over the past half-century. We see similar exponential growth in the price-performance and capacity of such diverse technologies as wired and wireless communications, DNA sequencing, and brain scanning.

So why have the capital markets been so volatile? First, because as much as IT has delivered, Wall Street expected even more. The perception was that the Internet and telecommunications technologies represented revolutions that would overturn the business models for many industries. That was and is correct—but these trends take time to develop. Second, there was a profound lack of communication within the investment community. This allowed, for example, massive overinvestment in certain areas (such as fiber), while other areas (such as the "last mile" of the communication infrastructure) were ignored. The result was more than $2 trillion of lost market capitalization.

**Why have the high-tech capital markets been so volatile? Because as much as IT has delivered, Wall Street expected even more.**

Regardless of whether your portfolio or mine suffers another setback, we'd do well to keep in mind that technology will continue to march ahead. If everyone involved with information technology—and these days, who isn't?—understood the trends underlying these technologies, the painful episodes of boom and bust in investment values might, at long last, begin to subside.

***Ray Kurzweil*** *(raymond@kurzweiltech.com) is an inventor and expert on artificial intelligence. His latest book is* The Age of Spiritual Machines: When Computers Exceed Human Intelligence *(Viking Press, 1999).*

---

Reprint Number R0402A



Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review

Click here to visit:
>| http://www.hbsp.org



# The HBR List

## Breakthrough Ideas for 2004

**From the fields of biology, neuroscience, economics, positive psychology, network science, marketing, management theory, and more—here are the emergent ideas that are changing the way business is done.**

There's nothing like a new idea to shake things up. Last fall, when we got to work rounding up 20 provocative new ideas in management, some people said it was too ambitious. It was a time of hunkering down, they said, not a time of imagining. Managers and those who study effective management were focused on the basics, the blocking and tackling of cost cutting and controllership. If anything, they claimed, we would discover a kind of anti-intellectualism out there.

They couldn't have been more wrong. When we put out the call for new ideas, we were inundated. Some of the best concepts seem to have sprung from the muck of the past few years. We have Rakesh Khurana plotting the redemption of management, Chris Meyer proposing a new model for ensuring security, and Bob Sutton imploring us not to tolerate bad people—even if they bring in good money. Other writers pick up on promising trends in technology, neuroscience, sociology, and psychology.

Taken together, these 20 ideas cover a lot of ground. Turn the page, and you'll see in no uncertain terms that far from lying fallow, the ground in the business world is as fertile as ever.

### 1. You Got a License to Run That Company?

*Rakesh Khurana*

Management today cannot properly be called a "profession." But given its dominance in American society, it must become one—and that means managers must serve a higher purpose than just maximizing shareholder returns.

### 2. No Monopoly on Creativity

*Richard Florida*

The power behind the U.S. economy is its "creative class"—scientists, artists, engineers, technologists, and designers, to name a few. The creative sector accounts for nearly half of American wage income, but the United States is suddenly in danger of losing its edge.

### 3. The Strategy Is the Structure

*Adrian Slywotzky and David Nadler*

Traditionally, strategy has dictated structure. But if you let strategy and organizational change evolve in parallel and influence each other, your company will have a better chance of keeping up with its markets.

**4. Business on the Brain**

*Diane L. Coutu*

Advances in drug development, genetic mapping, and neuroimaging technologies have shifted our attention from the mind to the brain. How will the new hard-science approach affect leadership, cooperation, and other dimensions of business?

**5. The Law of Conservation of Attractive Profits**

*Clayton M. Christensen*

When a product starts to become a commodity, a decommoditization process is often triggered somewhere else in the value chain. Managers might therefore be able to predict which activities will generate the most attractive profits in the future.

**6. The Force Behind Gigli**

*Joel Kurtzman*

Investors are always scrambling to find out where the “smart money” is going. It’s also important, whether you’re an investor or a business manager, to know where the stupid money is going.

**7. More Trouble Than They’re Worth**

*Robert Sutton*

When it comes to hiring and promoting people, a simple but revolutionary idea is taking hold in the ranks of management: the “no asshole” rule. Organizations just shouldn’t tolerate the fear and loathing these jerks leave in their wake.

**8. Finally, Market Research You Can Use**

*Duncan Simester*

Executives complain that their companies’ investments in market research are rarely put to good use. Market researchers can make their work a lot more valuable by focusing on long-term field research and other methods that can lead directly to optimized profits for organizations.

**9. The MFA Is the New MBA**

*Daniel H. Pink*

Businesses have come to realize that the only way to differentiate their offerings is to make them beautiful and emotionally compelling—which explains why an arts degree is now such a hot credential in management. Meanwhile, MBA graduates are becoming this century’s blue-collar workers: They entered a workforce that was full of promise only to see their jobs move overseas.

**10. Requiem for the Public Corporation**

*Joseph Fuller*

The public limited company is the world's most common corporate organization. But is the useful life of the public company—at least in the form we have known it for more than a century—over?

**11. Accentuate the Positive**

*Bronwyn Fryer*

Organizational psychologists have always focused on the problems that bring companies to their knees: managerial abuse, greed, distrust, poor morale, burnout, office politics, and so on. The new field of "positive organizational scholarship," created in the aftermath of the September 11, 2001, attacks, measures the values and processes that make some organizations inspiring places to work.

**12. Biological Block**

*Chris Meyer*

The immune system operates on some broad principles: ubiquitous detection capability, a sophisticated ability to discriminate friend from foe, and accumulated learning. These factors constitute an architecture for security that we can also use in society and business.

**13. How You Gonna Keep 'Em Down on the Farm After They've Seen Insead?**

*Herminia Ibarra*

Once your valued executive returns from an inspiring leadership program and plugs back into the old routine, there's a good chance you'll lose her—unless you've carefully managed the "takeoff" period before her departure and have a good plan for her "reentry."

**14. You Don't Have a Nanostrategy?**

*Gardiner Morse*

Nanotechnology products—dime-sized computers and ultralight textiles stronger than Kevlar—will certainly disrupt, transform, and create whole industries. If you don't already have a lookout watching for how and when this new field will become important for your business, it's time to get one.

**15. The Loan Ranger**

*Iqbal Quadir*

What is it that keeps rich countries' governments from living up to their rhetoric about free trade? Lobbyists for dying industries who wail about lost jobs. The World Bank should therefore lend to the *rich* countries so they can retrain those workers—and be free to pursue genuine free trade, which will benefit everyone.

**16. Cosmetic Psychopharmacology**

*Ellen Peebles*

Your employees now have access to medications—like Prozac—that not only alleviate

depression but also alter personalities in ways that are good for business. Will ambitious managers be able to leave well enough alone?

### 17. Watching the Patterns Emerge

*Clay Shirky*

Managers manage what they can see, but until now they've never been able to "see" into the informal social networks that have always driven business. Better data and new research are finally giving companies a chance to leverage real people's interactions, for everything from trend spotting to identifying internal experts within a department.

### 18. Laughter, the Best Consultant

*Thomas A. Stewart*

You can learn a lot about a company by paying attention to its humor. Skits at sales conferences, wisecracks during meetings, jokes in e-mails: These constitute an extraordinary trove of information about what's really going on.

### 19. Watch Your Back

*Leigh Buchanan*

Fear of risk can cripple a company's ability to compete aggressively. But a new framework for enterprise risk management may finally convince businesses that they can systematically assess hazards on all fronts, without damping their managers' entrepreneurial zeal.

### 20. IT Doesn't Scatter

*Ray Kurzweil*

If you asked most people to describe the past decade of IT, they would call it boom and bust—a roller coaster ride. The reality is that despite the stock swings, the bursting bubbles, the scandals, and the countless other disappointments, technology has marched smoothly and relentlessly ahead.

• • •

### Breakthrough Ideas for 2004

What's the best idea you've heard lately that's related to the practice of management? HBR's editors asked around, then put their heads together, and the result is the 2004 HBR List.

It's a compendium of new thinking as diverse as it is provocative. Perspectives from economics and sociology sit side by side with developments in brain science and urban planning. Notes of caution—even contrition—mix with calls to action. You'll find insights on how to formulate strategy, spur innovation, spot danger, manage risk, and get the highest performance from the people in your organization. There are new findings about large-scale trends and fresh thoughts on day-to-day decision making.

If there is a crosscurrent running through them, it is only this: that managers with open minds and access to new thinking can make a difference, to the competitiveness of their organizations and the well-being of the world. Since the beginning, HBR has sought to present not just ideas, but ideas with impact. With the 2004 List, we deliver a bumper

crop of them. Consider them, debate them, let them inspire your own thinking. Then go and make an impact.

### 1. You Got a License to Run That Company?

Management, for a brief period in the last century, was well on its way to becoming a profession. But managers have been retreating from that goal for the past 60 years, and we have an unparalleled wave of corporate scandals in recent times to show for it.

What is a "profession"? In ordinary parlance, the term refers to an occupation that requires a high degree of technical skill and competence. A more traditional definition, however, also encompasses mastery of an abstract, systematic body of knowledge—and a primary orientation toward ethical service to society.

It was that comprehensive notion of professionalism that inspired the founders of the Wharton School of the University of Pennsylvania, the Tuck School at Dartmouth, and Harvard Business School—America's first business schools—in the early years of the twentieth century. They intended not only to standardize the production of managers for the nation's corporations but also to professionalize the occupation of management itself. If they had succeeded, managers might have come to play a role in the business-dominated society of the twentieth century analogous to the role of the clergy in preindustrial America.

However, the "professionalization" project lost steam after World War II. As the demand for trained managers exploded, the number of business programs rose and their content became diluted. By 1959, both the Ford Foundation and the Carnegie Corporation had issued highly critical reports on the state of American business schools, decrying their purely vocational curricula. Both called for more emphasis on the social and behavioral sciences and on the use of quantitative methods. Those directives, along with the funding provided by the two foundations, led to the recruitment of new faculty, many of whom were trained in economics. This saw the development of many of the economic theories that form the staple fare of MBA courses today. By the time concepts like agency theory and efficient-market theory found their way into the classroom in the 1980s, another fundamental shift was occurring: Managerial capitalism was giving way to a new system of investor capitalism. MBA students were taught that as managers, they were merely agents, bound by arm's-length contractual relationships to a single set of constituents: shareholders.

**An ethic of pure self-interest has replaced the professional ethics that business schools once tried to teach.**

What went unnoticed was that such a view of the manager's role and responsibilities was utterly incompatible with the traditional concept of professionalism. The postwar attempt to reform American business education had created unintended consequences. A Hobbesian ethic of pure self-interest, backed by the power of the highly abstract and systematic "science" of economics, replaced the professional ethics that the business schools had once tried to teach. That is particularly troublesome because business executives are unrivaled by any other group in their control over material and human resources and their dominance in American society. What's more, executives have succeeded in imposing their values, norms, and methods on older, more autonomous professions such as law and medicine.

It is time to reacquaint managers with the concept of professionalism. Along with that should come a fundamental reassessment of business education and how well it serves

society's interests. The American business school has become an institution that serves a very different purpose than was originally intended. That transformation has had a profound effect on American management's evolution toward its present condition, where it is ripe for reexamination.

***Rakesh Khurana*** *(rkhurana@hbs.edu) is an assistant professor at Harvard Business School in Boston. He is writing a book, scheduled to be published by Princeton University Press in 2005, on management as a profession.*

**2. No Monopoly on Creativity**

Creativity is a virtually limitless resource: Every human being has creative potential that can be turned to valuable ends. The number of people doing creative work—the scientists, engineers, technologists, artists, and designers and the various professionals in health care, finance, law, and other fields who make up the "creative class"—has increased vastly over the past century. In 1900, fewer than 10% of U.S. workers were doing creative work. In 1980, that figure was slightly more than 15%. But by 2000, the creative class included almost a third of the workforce. The creative sector accounts for nearly half of all wage and salary income in the United States—$1.7 trillion, as much as the manufacturing and service sectors combined. Imagine how much wealth could be generated if the creative capacities of the remaining two-thirds of the workforce were harnessed, too.

In the past year I've been hit by a harsh realization: The United States, while retaining an edge in this regard, is far from unbeatable. In fact, its position is more tenuous than commonly thought.

For most of human history, wealth came from a place's endowment of natural resources, like fertile soil or raw materials. But today, the key economic resource, creative people, is highly mobile. And it gravitates toward places with certain underlying conditions. To achieve growth, a region must have what I call the three Ts: technology, talent, and tolerance. So the Creativity Index that Kevin Stolarick and I created is based on three component scores, each a matter of objective counting. To determine, for example, if a place is likely to have a culture of tolerance, we look at the concentrations of gay, "bohemian," and foreign-born people and the degree of racial integration. The tolerance and openness implied by these concentrations form a critical element in a place's ability to attract different kinds of people and generate new ideas.

What's frightening is that, far from cultivating its creative advantage, our society at a national level seems determined to undercut it. Today in the United States, there is considerable concern over the outsourcing of software and information technology jobs to India and over China's rise as a manufacturing power. But the real threat to our competitiveness lies in new restrictions on research, scientific disclosure, immigration, and flows of people, because those limits are starting to affect our ability to attract creative and talented people from around the world. An eminent oceanographer in San Diego recently told me, "We can't hold a scientific meeting here because we can't get visas for people." No one seems to be thinking about the flow of people as the key to our advantage in the creative age.

The economic leaders of the future will not necessarily be emerging giants like India and China. They certainly won't be countries that focus on being cost-effective centers for manufacturing and basic business processing. Rather, they will be the countries that are able to attract creative people and come up with next-generation products and business processes as a result. With Irene Tinagli, a Carnegie Mellon University doctoral student, I recently compared 14 European and Scandinavian nations to the United States. Sweden,

Finland, Denmark, and the Netherlands had Creativity Index scores that closely matched that of the United States, and Ireland is gaining quickly (see the exhibit "The Creativity Index"). Other research indicates that Canada, Australia, and New Zealand have built dynamic creative climates. Toronto and Vancouver, Canada, and Sydney and Melbourne in Australia compete very well with major U.S. regions like Chicago and Washington, DC.

## The Creativity Index

For a country or region to achieve growth, it must have the three Ts: technology, talent, and tolerance. The national and regional creativity indices are based on objective measures of those factors. (The scores for both rankings are on a scale of 0 to 1, but the two lists are not strictly comparable because of differences in the measures used to compile them.)

In the creative age, leads change abruptly: Austin, Texas, and Seattle have recently shot upward on the Creativity Index.

### ...for Nations

| | Rank | Score |
|---|---|---|
| 1. | Sweden | 0.81 |
| 2. | United States | 0.73 |
| 3. | Finland | 0.72 |
| 4. | Netherlands | 0.67 |
| 5. | Denmark | 0.58 |
| 6. | Germany | 0.57 |
| (7.) | Belgium | 0.52 (tie) |
| (7.) | United Kingdom | 0.52 (tie) |
| 9. | France | 0.46 |
| 10. | Austria | 0.39 |
| (11.) | Ireland | 0.37 (tie) |
| (11.) | Spain | 0.37 (tie) |
| 13. | Italy | 0.34 |
| 14. | Greece | 0.31 |
| 15. | Portugal | 0.19 |

Source: Richard Florida and Irene Tinagli, *Europe in the Creative Age*. Data are from various years within the period 1997–2000.

### ...for U.S. Regions

| | Rank | Score |
|---|---|---|
| 1. | Austin, Texas | 0.963 |
| 2. | San Francisco | 0.958 |
| 3. | Seattle | 0.955 |
| 4. | Burlington, Vermont | 0.942 |
| 5. | Boston | 0.934 |
| 6. | Raleigh–Durham–Chapel Hill, North Carolina | 0.932 |
| 7. | Portland, Oregon | 0.926 |
| 8. | Madison, Wisconsin | 0.918 |
| 9. | Boise, Idaho | 0.914 |
| 10. | Minneapolis | 0.900 |
| (11.) | Albuquerque, New Mexico | 0.897 (tie) |
| (11.) | Washington, DC | 0.897 (tie) |
| 13. | Sacramento, California | 0.895 |
| 14. | Denver | 0.876 |
| (15.) | Atlanta | 0.873 (tie) |
| (15.) | Corvallis, Oregon | 0.873 (tie) |

Source: Richard Florida, *The Rise of the Creative Class* (forthcoming edition); index compiled by Kevin Stolarick of Carnegie Mellon University. The data cover the years 1997–2001.

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

Leads in the creative age are very easily won and lost—Austin, Texas, and Seattle have recently shot up the Creativity Index while Pittsburgh and Cleveland have fallen. No one place has a preordained position at the top of the heap. Americans must wake up to the fact that economies are fluid and that creativity is an asset that must be constantly cultivated.

***Richard Florida*** *is the H. John Heinz III Professor of Regional Economic Development at the Heinz School of Public Policy and Management at Carnegie Mellon University in Pittsburgh. He is the author of* The Rise of the Creative Class *(Basic Books, 2002). He can be contacted at* ***florida@cmu.edu****.*

### 3. The Strategy Is the Structure

Traditionally, strategy dictated structure: You started by defining a strategic goal, then recast your organization to serve it. But for a host of reasons, including the ever decreasing half-life of strategic advantage, this sequential, compartmentalized process now seems obsolete.

Consider the experience of Air Liquide, the French producer of industrial gases, where a successful new strategy was actually driven in large part by the organization's changing structure. Air Liquide had found a way to produce gases in small plants on-site at customers' factories. In short order, growing numbers of Air Liquide staff were being stationed permanently at client sites—which put the staff in a position to notice ways in which their company could help customers improve operating efficiency, increase output quality, and reduce the capital requirements of various processes.

A companywide reorganization (instituted for unrelated reasons) gave these on-site teams greater autonomy, and suddenly they were able to act on the new opportunities. Often this involved taking on activities that had been managed by customers, such as handling hazardous materials, troubleshooting quality-control systems, and managing inventory. Today, these relatively high-margin services constitute about 25% of Air Liquide's revenues, compared to 7% in 1991, before the reorganization.

Without the reorganization, this potent new strategy—the antidote to the commoditization that was threatening Air Liquide's product lines—would not have emerged. The formerly centralized hierarchy would have hindered the field staff from making decisions or even accessing information about customers. When the seeds of this new growth opportunity sprouted in parts of the organization that were closest to the customer, the entire organization was able to adapt and execute well because the preconditions, in the form of the new structure, were there to do so.

Although mismatches of organization and strategy are often obvious in hindsight, they are never obvious prospectively. Teams that are charged with developing new businesses typically make overoptimistic projections and downplay the difficulties of execution. Think of all the computer hardware and software firms that have pursued strategies to become complete IT solution providers. Most have failed; they simply do not have the skills, relationships, mind-set, and organizational structures required for a broad-based, "systems-agnostic" approach.

At the very least, this suggests that, if an organization is not prepared to execute strategy A, it's better to choose strategy B, perhaps as an interim option. But we would go further to suggest that strategy and organizational change should happen in parallel and they should be allowed to influence each other. A new model, *concurrent enterprise design,* might be the best hope of enabling organizations to move at least as fast as their markets.

***Adrian Slywotzky*** *is a Boston-based managing director of Mercer Management Consulting.* ***David Nadler*** *is the CEO and chairman of Mercer Delta Organizational Consulting and is based in New York.*

### 4. Business on the Brain

Psychoanalysis—the talking cure—was the most popular form of mental therapy for most of the twentieth century, for good reason. For a start, analysis seemed a far more humane treatment than its primitive alternatives such as lobotomy or early forms of electric shock. More dramatically, however, the horrors of Hitler's Germany, where monsters like Josef Mengele conducted cruel experiments on Jews, homosexuals, Gypsies, and the mentally ill, outraged people and generated stiff resistance to any form of experimentation involving human beings.

But the 1960s turned the world on its head. Newly discovered medications made huge strides against debilitating illnesses such as manic depression and schizophrenia. The asylums emptied out, and mental illness finally came to be understood as largely a

function of genetic inheritance and chemical imbalance. By the 1990s, scientists all over the world were united in the Human Genome Project, a massive effort to map all the human genes, making them accessible for study—and manipulation.

**MRI technology already helps researchers determine how potential customers respond to products and advertisements.**

Drugs and genes are not the only scientific changes that are turning our attention toward the brain and away from the mind. One of the greatest medical breakthroughs of the past few decades has been the development of powerful imaging tools such as MRI and PET scans, which have made it possible for scientists to "see" the brain in action. For instance, scientists can now map how different stimuli affect different parts of the brain, which gives them powerful information about what people think and feel and remember. For their contributions in inventing the MRI, American Paul C. Lauterburg and Briton Sir Peter Mansfield were awarded the 2003 Nobel Prize in medicine last October.

Inevitably, the revolution in the neurosciences will have a major impact on business. In marketing, for example, MRI technology already helps researchers determine how potential customers respond to products and advertisements. But the impact of the new changes in science doesn't end there. Brain research will inevitably affect other business subjects, such as leadership and cooperation. The field of organizational behavior, for example, owes a great debt to the traditional social sciences of psychology and psychoanalysis. Many of the tools managers have grown up with—such as our theories of motivation and personality—are rooted in these social sciences. But the new "hard" sciences will inevitably bring new tools and solutions to challenge—and maybe even to replace—these old favorites. As Harvard Business School professor Nitin Nohria, coauthor with Paul R. Lawrence of *Driven: How Human Nature Shapes Our Choices,* puts it: "I think the social-science lemon has been squeezed dry. There may be some drops of juice left, but the fruit of the neurosciences has barely begun to be touched. Businesspeople are turning to them now because we see a much richer opportunity for ourselves in the future."

***Diane L. Coutu*** *(dcoutu@hbsp.harvard.edu) is a senior editor at HBR.*

### 5. The Law of Conservation of Attractive Profits

In my recent book—and in an earlier HBR article—I explored a couple of linked ideas having to do with how profitability in a value chain shifts over time. Briefly (and way too simplistically as a result of space constraints here!), the thinking went something like this:

• Products are most profitable when they're still not "good enough" to satisfy consumers. This is because to make them performance competitive, engineers must use interdependent, proprietary architectures. Use of such architectures makes product differentiation straightforward, because each company pieces its parts together in a unique way.

• Once a product's performance *is* good enough, companies must change the way they compete. The innovations for which customers will pay premium prices become speed to market and the ability responsively and conveniently to give customers exactly what they need, when they need it. To compete in this way, companies are forced to employ modular architectures for products. Modularity causes the products to become undifferentiable and commoditized. Attractive profits don't evaporate, however...

• They move elsewhere in the value chain, often to subsystems from which the modular product is assembled. This is because it is improvements in the subsystems, rather than the modular product's architecture, that drive the assembler's ability to move upmarket toward more attractive profit margins. Hence, the subsystems become decommoditized and attractively profitable.

My sense is that these shifts are more than coincidental; I suspect that when most products start to become commoditized or modularized, this turn of events kick-starts a *decommoditization* process somewhere else in the value chain. As a general rule, one side of an interface in the value chain *must* be modular to allow the side that's not yet good enough to be optimized.

My friend Chris Rowen, CEO of Tensilica, suggested that we call this phenomenon the law of conservation of attractive profits. (He was playing off the law of conservation of energy, which states that energy cannot be created or destroyed, though it may be changed from one form to another.) Translated into managerial terms, the law goes something like this: When attractive profits disappear at one stage in the value chain because a product becomes modular and commoditized, the opportunity to earn attractive profits with proprietary products will usually emerge at an adjacent stage.

If that's the case (and I hasten to add that it's still a hypothesis), it suggests that there is a dynamic dimension to Michael Porter's five-forces framework. Because the hypothesis suggests that the location in the value chain where attractive profits can be earned shifts in a predictable way over time, companies that outsource activities that are not today's core competencies may well miss the boat. This "law" might help managers foresee which activities in the value chain will generate the most attractive profits in the future so that they can develop or acquire competencies where the most money will be.

**Companies outsourcing activities that are not today's core competencies may well miss the boat.**

***Clayton M. Christensen*** *is the Robert and Jane Cizik Professor of Business Administration at Harvard Business School. His most recent book is* The Innovator's Solution: Creating and Sustaining Successful Growth *(Harvard Business School Press, 2003). He can be reached at* ***cchristensen@hbs.edu****.*

## 6. The Force Behind Gigli

Investors are always scrambling to find out where the "smart money" is going. But it's also important, whether you're an investor or a business manager, to know where the stupid money is going.

It's a well-established phenomenon that's gone too long without a name: Companies, industries, and even whole sectors have a stupid-money problem when they are suddenly flooded with capital seeking irrational rates of return or with investors whose interests run contrary to those of a normally operating market. Sounds like a nice problem to have? It's not, because it prompts companies to alter their business models in ways that are not sustainable over the long haul.

**"Stupid money" prompts companies to alter their business models in ways that are not sustainable.**

Think of the 1970s, when tens of billions of dollars of stupid money flowed from the OPEC countries to the money center banks in London and New York. From there it was lent to Argentina, Brazil, Mexico, Nigeria, Indonesia, and other developing countries for

infrastructure projects such as power plants, bridges, and dams. But when this episode ended, tens of billions of stupid-money loans could not be repaid by the borrowers without help from the United States and other governments. More than one money center bank teetered on the brink of insolvency.

Or think of the 1980s, when billions of dollars of stupid money flowed into the U.S. real estate market via the savings and loan industry. Large spreads between the interest paid on deposits and that received on mortgages—as well as plentiful capital from the junk bond market—created incentives for S&Ls to shovel money out the door. Condominiums, country clubs, hotels, offices, and shopping centers with dubious economic value were built. Though some money was made by “flipping” these projects and from fees charged by developers and financial institutions, many billions were lost when the stupid money fled the scene. The savings and loan industry collapsed and with it much of the commercial real estate market. It took nearly a decade for the government to clean up the mess.

Right now, there’s at least one place where the stupid money is sloshing around like San Pellegrino: Hollywood. The problem there is that a large proportion of movies have been financed with money from European tax shelters—which create larger returns for their investors when a project loses money than when it makes money. According to industry estimates, Germany, the largest source of these funds, provided Hollywood with about $2.3 billion in tax shelter money in 2002, more than 20% of Hollywood’s overall investment budget.

A few industries have adapted to living with stupid money the way certain species of fish have adapted to living near deep-water sulfur chimneys. Hollywood is a perfect example. Rather than focusing on profits from movies, the industry has been prodded by loss-seeking capital into focusing on increasing costs. Studios make money from fees from independent producers based on a percentage of a project’s production, distribution, and marketing costs, rather than by relying exclusively on a film’s revenue. In the fee-based model that has evolved in Hollywood, profits are about as rare as an interview with Robert DeNiro.

What can managers do (short of taking the money and running) to survive the distorting effects of stupid money? For Hollywood, righting the business model would mean changing the way the studios go after their multiple streams of revenue. Rather than produce a handful of $200 million blockbuster movies each year, the studios might do better by focusing on making more, smaller-budget movies.

And where is the stupid money going next? Given its predilection for glamour, glitz, and new ideas, I’d say nanotechnology and the life sciences are ripe for an infestation. These are fields where we’re seeing not only federal funding but also feverish investment by people looking to get in on the next big thing. If it happens, we know how it will go. Stupid money will begin by running after the sector’s Seabiscuits and end up stalking its nags. The smart money will show up again only after the inevitable downturn, the shakeout, and the reform of the business models.

***Joel Kurtzman*** *(Joel.A.Kurtzman@us.pwcglobal.com) is the global lead partner for thought leadership and innovation at PricewaterhouseCoopers and president of the Tangible Group, based in Concord, Massachusetts. His latest book is* How the Markets Really Work *(Crown, 2002).*

**7. More Trouble Than They’re Worth**

There’s a simple practice that can make an organization better, but while many managers talk about it, few write it down. They enforce “no asshole” rules. I apologize

for the crudeness of the term—you might prefer to call them tyrants, bullies, boors, cruel bastards, or destructive narcissists, and so do I, at times. Some behavioral scientists refer to them in terms of psychological abuse, which they define as "the sustained display of hostile verbal and nonverbal behaviors, excluding physical contact." But all that cold precision masks the fear and loathing these jerks leave in their wake. Somehow, when I see a mean-spirited person damaging others, no other term seems quite right.

I first encountered an explicit rule against them about 15 years ago. It was during a faculty meeting of my academic department, and our chairman was leading a discussion about which candidate we should hire. A faculty member proposed that we hire a renowned researcher from another school, a suggestion that prompted another to remark, "I don't care if he won the Nobel Prize, I don't want any assholes ruining our group." From that moment on, it was completely legitimate for any of us to question a hiring decision on those grounds. And it made the department a better place.

Since then, I've heard of many organizations that use this rule. McDermott, Will & Emery, an international law firm with headquarters in Chicago, is (or at least was) known as a better place to work than other firms, and it has been quite profitable in recent years. A survey from Vault, a Web-based provider of career information, reports that McDermott has a time-honored no asshole rule, which holds that "you're not allowed to yell at your secretary or yell at each other"—although the survey also reports that the firm has been growing so fast lately that the rule is starting to fall by the wayside. Similarly, a Phoenix-based law firm provides this written guideline to summer associates: "At Snell & Wilmer, we also have a 'no jerk rule,' which means that your ability to get along with the other summer associates and our attorneys and staff factors into our ultimate assessment." And the president of a software firm told me a couple of months back, "I keep reminding everyone, 'Make sure we don't hire any assholes, we don't want to ruin the company.'"

All this might lead you to believe that this rule bears mainly on employee selection. It doesn't. It's a deeper statement about an organization's culture and what kind of person survives and thrives in it. All of us, including me, have that inner asshole waiting to get out. The difference is that some organizations allow people (especially "stars") to get away with abusing one person after another and even reward them for it. Others simply won't tolerate such behavior, no matter how powerful or profitable the jerk happens to be. I remember when my daughter switched schools a few years back. After a couple of months, she told me, "In our old school, when they said you had to be nice, they meant it. In my new school, they say it but don't really mean it."

**Some organizations allow "stars" to get away with abusing people. Others simply won't tolerate it.**

I acknowledge that there is a subjective element to this rule. Certainly, a person can look like, or even be, a sinner to one person and a saint to another. But I've found two useful tests. The first is: After talking to the alleged asshole, do people consistently feel oppressed and belittled by the person, and, especially, do they feel dramatically worse about themselves? The second is: Does the person consistently direct his or her venom at people seen as powerless and rarely, if ever, at people who are powerful? Indeed, the difference between the ways a person treats the powerless and the powerful is as good a measure of human character as I know.

I'll close with an odd twist: It might be even better if a company could implement a "one asshole" rule. Research on both deviance and norm violations shows that if one example of misbehavior is kept on display—and is seen to be rejected, shunned, and punished—

everyone else is more conscientious about adhering to written and unwritten rules. I've never heard of a company that tried to hire a token asshole. But I've worked with a few organizations that accidentally hired and even promoted one or two, who then unwittingly showed everyone else what *not* to do. The problem is that people can hide their dark sides until they are hired, or even are promoted to partner or tenured professor. So by aiming to hire no assholes at all, you just might get the one or two you need.

***Robert Sutton*** *is a professor of management science and engineering at Stanford University's School of Engineering in California. He is also the author of* Weird Ideas That Work: 11½ Practices for Promoting, Managing, and Sustaining Innovation *(Free Press, 2002). He can be reached at* **bobsut@stanford.edu**.

### 8. Finally, Market Research You Can Use

Executives often complain that the findings generated by their companies' investments in market research are rarely put to use. The problem could be solved if marketers made their research more useful. How? By shifting their perspective in three important ways.

First, market researchers should aim beyond measurement to optimization. The marketing literature is full of sophisticated methods for measuring customer behavior, but managers have a bigger problem than tracking customers' buying patterns: They need to decide what action the firm should take to profit from that behavior. Deciding which response will yield the best result is an optimization problem.

Many impressive tools and methods for optimization have been developed to solve engineering and manufacturing problems. For these methods to work with marketing problems, they must be modified. These modifications are being made, as optimization experts realize that marketing offers meaty, significant problems and access to large amounts of data. The earliest successes were in pricing, with the development of sophisticated yield-management systems in the airline and hotel industries. Other work involved the development of models to predict creditworthiness in the credit card industry. More recently, Internet retailers have begun to develop optimization systems to identify which products to show to different customers. Examples of current targets for optimization research include systems for determining who should receive direct-mail promotions and which products and prices to highlight in those promotions. In product development, optimization may help companies design product lines to satisfy customers with diverse needs.

A focus on optimization requires that managers choose a time frame over which to optimize. This brings me to the second shift in perspective: More studies should focus on the long term. Decisions on pricing, advertising, and other marketing matters often have lingering impacts on demand and profits, yet the vast majority of marketing studies limit attention to the immediate outcome. To understand how this can undermine good decision making,consider the findings of a few recent studies.

A publishing firm studying the impact of price promotions over two years discovered effects that were important for its pricing strategies: It found that if deep discounts were offered, established customers stocked up and then purchased less later on, whereas first-time customers tended to come back and purchase more often in subsequent periods. A study of 20,000 people who used a home furnishings catalog found that 10% discounts to customers who ordered out-of-stock items increased revenue in the short term but decreased the rate at which those customers ordered different items later. And other studies have concluded that moving from a short-term to a long-term focus on catalog mailings could increase profits for mail order companies by as much as 40%.

Clearly, market researchers must study such long-term effects if their findings are to guide optimal decision making. So why haven't they? In part, it's because of the difficulty of collecting data over time. But that hurdle is about to be lowered. New methods currently in development will make it possible to use historical data to reliably estimate long-run effects.

The third change market researchers should make is to start testing their theories in the field. What we usually see in the marketing literature is the results of experiments conducted on college students or analyses of historical data collected from public or proprietary sources. There has been a striking absence of field tests in which companies deliberately vary how they interact with customers engaged in real transactions and measure the responses.

But this, too, has been changing recently, as managers are increasingly collaborating with academics to conduct large-scale experiments involving actual customers. Examples include studies that vary the actions of a company's sales force, the pages shown to customers on a company's Web site, and the content of catalogs and other direct-mail promotions. Catalog companies are particularly well placed to test different marketing actions. For instance, they can easily conduct split-sample studies, in which different versions of a catalog are sent to large, random samples of customers. This type of research meets a high standard of rigor because it explicitly controls for alternative explanations due to intervening events or systematic differences between samples. It also yields findings that are easy to communicate. Even the least sophisticated practitioners can appreciate the conclusions when shown how profits differ across experimental conditions.

For all these reasons, the catalog industry has been the quickest to embrace field testing, but managers in other industries are beginning to catch on. Investment will be required in order to develop the infrastructure and expertise necessary to conduct field tests. Most companies will need to invest in measurement technologies to ensure that outcomes are measured correctly, and they will need to create a process for disseminating and institutionalizing the findings. But if they do manage to stage rigorous field experiments—and use the findings to optimize profits—they can rightfully claim to be treating marketing as a science.

***Duncan Simester*** *(simester@mit.edu) is an associate professor of management science at MIT's Sloan School of Management in Cambridge, Massachusetts.*

## 9. The MFA Is the New MBA

Getting admitted to Harvard Business School is a cinch. At least that's what several hundred people must have thought last year after they applied to the graduate program of the UCLA Department of Art—and didn't get in. While Harvard's MBA program admitted about 10% of its applicants, UCLA's fine arts graduate school admitted only 3%. Why? An arts degree is now perhaps the hottest credential in the world of business. Corporate recruiters have begun visiting the top arts grad schools—places such as the Rhode Island School of Design, the School of the Art Institute of Chicago, Michigan's Cranbrook Academy of Art—in search of talent. And this broadened approach has often come at the expense of more traditional business graduates. For instance, in 1993, 61% of McKinsey's hires had MBA degrees. Less than a decade later, it was down to 43%, because McKinsey says other disciplines are just as valuable in helping new hires perform well at the firm. With applications climbing and ever more arts grads occupying key corporate positions, the master of fine arts is becoming the new business degree.

**Corporate recruiters have begun visiting top arts grad schools. This approach has often come at the expense of traditional business graduates.**

The reasons are twofold—supply and demand. The supply of people with basic MBA skills is expanding and therefore driving down their value. Meanwhile, the demand for artistic aptitude is surging. In many ways, MBA graduates are becoming this century's blue-collar workers—people who entered a workforce that was full of promise only to see their jobs move overseas. For example, Lehman Brothers and Bear Stearns have begun to hire MBAs in India for financial analysis and other number-crunching work. Starting salaries: around $800 per month. A.T. Kearney estimates that in the next five years, U. S. financial services companies will transfer a half-million jobs to low-cost locales such as India—saving the industry some $30 billion but displacing 8% of their American workforce. As the *Economist* recently put it, the sorts of entry-level MBA tasks that "would once have been foisted on ambitious but inexperienced young recruits, working long hours to earn their spurs in Wall Street or the City of London, are, thanks to the miracle of fibre-optic cable, foisted on their lower-paid Indian counterparts."

At the same time, businesses are realizing that the only way to differentiate their goods and services in today's overstocked, materially abundant marketplace is to make their offerings transcendent—physically beautiful and emotionally compelling. Think iMac computers, Design Within Reach, and Target aisles full of Isaac Mizrahi women's wear and Michael Graves toilet brushes. Or just listen to auto industry legend Robert Lutz. When Lutz took over as chairman of General Motors North America, a journalist asked him how his approach would differ from his predecessor's. Here's what he said: "It's more right brain.... I see us as being in the art business. Art, entertainment, and mobile sculpture, which, coincidentally, also happens to provide transportation." General Motors —General Motors!—is in the art business. So, now, are we all.

***Daniel H. Pink*** *(dp@danpink.com) is the author of* Free Agent Nation *(Warner Business Books, 2001) and* A Whole New Mind *(forthcoming from Riverhead Books).*

## 10. Requiem for the Public Corporation

Over the last three years, executives, politicians, and shareholders in the United States have valiantly tried to fix the problems of the public limited company, the world's most common corporate organization. They have enacted more laws for companies to follow, set higher standards for the selection of board members, and insisted that audit firms comply with stringent new rules. Yet these post-Enron reforms beg one fundamental question: Is the useful life of the public company, at least in the form we have known it for more than a century, over?

I am not, of course, the first person to question the viability of the widely held company. Two decades ago, shareholders in the United States accused executives of being more interested in protecting their jobs than generating higher profits. The shareholders supported raids by takeover artists to dislodge incumbent CEOs, and they hoped the new managers would deliver higher returns. The shareholder revolt became so widespread that in 1989, Harvard Business School's Michael Jensen argued that new kinds of organizations might someday eclipse the public limited corporation.

Jensen, now a colleague of mine at Monitor, focused on agency problems, the conflicts that arise when the interests of managers and shareholders diverge. At the time he wrote, the struggle pitted shareholders and executives in a fight over low investor returns and executive inertia. Now, the clash focuses on high executive compensation levels (at Tyco, for instance) and risky investments (by Enron, for example). Corporate

America has responded by restructuring salary packages, increasing the transparency of financial reports, and strengthening the supervisory role of boards of directors. Have agency problems been resolved? Hardly. They can never be resolved, for the interests of managers and shareholders will always differ to a degree.

The problems go beyond those posed by agency. The costs of being a public company have risen steadily over the years, with new laws like Sarbanes-Oxley adding to overhead costs. At the same time, public companies have to deal with more lawsuits from aggressive lawyers. It is also getting hard to recruit and retain topflight talent for public companies as executives increasingly see the costs of being in the spotlight—in reputation damage and personal liability—outweighing the benefits.

Most problematic, the financial benefits of going public have eluded many companies. We've seen the emergence of two tiers of companies in the stock market. A few big companies such as GE with large markets for their shares do benefit from the liquidity that the stock market provides. However, a large number of small companies have struggled to gain investors' attention. Their stocks remain stagnant, followed by only a few second- and third-tier investment banks. That leaves these midcap companies in public purgatory. On the one hand, institutional investors do not buy their shares out of fear that they will find it impossible to escape a stock for which they have established a new market price. On the other, these companies cannot issue more shares in the primary market, due to the dilutive effects and the lack of investor interest. The sum of these forces explains why experts predicted a record number of firms would deregister in 2003, taking advantage of a legal loophole that allows American companies to remain public but not make financial disclosures.

So why do companies remain wedded to the notion of public ownership? Most companies choose to go public because it yields higher returns and greater liquidity. When it does not, they must reexamine their options. Although it is not clear what those might be, the time has come to rethink rather than reform the public corporation.

***Joseph Fuller*** *is the CEO of Monitor Group, a family of professional service firms based in Cambridge, Massachusetts. A longer version of this article appears in the winter 2004 edition of* Directors & Boards *(www.directorsandboards.com).*

### 11. Accentuate the Positive

Ever since organizational psychologists and management scholars began studying workplace behavior, they have focused on a long list of problems that can bring organizations to their knees: managerial abuse, greed, distrust, poor morale, burnout, office politics, and so on. This focus on the negative aspects of working life has made sense for two reasons. First, organizational scholarship is grounded in the field of psychology, which has perennially concentrated on mental illness and social pathology. Second, scholars since the time of Dante have generally found that the tortures of hell yield more interesting book material than do the blisses of heaven.

Thus it may come as a surprise to learn that companies where the focus is on amplifying positive attributes such as loyalty, resilience, trustworthiness, humility and compassion—rather than combating the negatives—perform better, financially and otherwise. A new field of inquiry called positive organizational scholarship (POS), spearheaded by organizational behavior and psychology researchers at the University of Michigan, the University of Pennsylvania, the University of British Columbia, and elsewhere, is shedding promising new light on the outcomes of various approaches to managing behavior in the workplace.

On the face of it, POS doesn't sound new. Ever since 1952, when Norman Vincent Peale

published the self-help classic *The Power of Positive Thinking,* the benefits of an optimistic outlook have been touted ad nauseum. Additionally, authors such as Tom Peters and Jim Collins have long studied the leadership attributes that help companies excel. What makes POS different is its focus: Rather than zeroing in on the positive qualities of individuals, POS takes a rigorous look at the more widespread social constructs, values, and processes that make organizations great. And because it measures results, positive organizational scholarship goes beyond platitudinous talk about the virtues of being good. Southwest Airlines, for example, isn't the envy of the airline industry merely because it has a competitive cost structure or because founder Herb Kelleher, now retired, was a cool guy. The company is successful, these researchers contend, because it carefully protects and nurtures its employees. According to Kim Cameron, a professor of organizational behavior and human resource management at the University of Michigan Business School who has studied "virtuous" firms, Southwest—despite its no-layoffs policy—was the only major airline to escape devastating long-term financial losses following the September 11, 2001, terrorist attacks. Southwest's overall passenger loads and stock price remained comparatively high.

Why is this field of study emerging now? The germ of POS was, in fact, planted on 9/11, when the media focused on the qualities of empathy, courage, and resilience in the workplace. In 2002, the debacles at Enron, WorldCom, and others renewed conversations about ethics and governance. Suddenly, scholars began to ask: How can companies foster honesty and trust at work? How do organizations that replenish workers' energy, build collective strength, and foster emotionally intelligent cultures operate? And how do these firms perform, both competitively and financially, over time?

**Some organizations manage to foster emotionally intelligent cultures. Scholars are beginning to ask: How do these firms operate?**

Positive organizational scholarship is inspiring researchers to look at work in a whole new light—and they are finding that employee happiness really does pay. It's beginning to look as if a positive workplace atmosphere is worth developing, and not merely for its own sake; it may be the foundation of true organizational success.

***Bronwyn Fryer*** *(bfryer@hbsp.harvard.edu) is a senior editor at HBR.*

### 12. Biological Block

On the Massachusetts Turnpike in Boston, a hundred-foot-long billboard asks: "Is your neighbor's gun locked?" The point, of course, is that everyone in the vicinity of a gun should be engaged in the task of containing the threat.

There's a bigger idea here, and it's cropping up all over the place—the immune system as an architecture for security. The vertebrate immune system, still far from well understood, operates on a few broad principles: a ubiquitous detection capability, a sophisticated ability to discriminate friend from foe, a diverse repertoire of defensive responses, the ability to recognize and deal with novel threats, and accumulated learning. These principles have already been built into "digital immune systems"—if you use Symantec's corporate antiviral product, you're soaking in it. Using technology developed at IBM's Watson Labs, this system protects computer networks by recognizing "malware" anywhere in the network, quarantining it, and sending it to an analysis center, where Symantec develops and deploys digital antibodies, not just on the infected computer but throughout the network—in as little as an hour. Then the network remembers the response, so the inoculation confers permanent immunity.

Three more signs: Mathematician Stephen Strogatz described the 2003 power grid meltdown that blacked out parts of eight states as “a massive allergic reaction” to a problem in the grid—that is, a kind of autoimmune failure of the network. Financial institutions are exploring whether fraud can be prevented by treating it as a detectable infection—T-men, not T cells. And a new discipline has been born: “Theoretical immunology” explicitly brings together the study of natural, “wet” immune systems and the development of mathematical models that can both improve our understanding of our own wetware and aid in the design of immune systems for other hosts under threat.

**Financial institutions are exploring whether fraud can be prevented by treating it as a detectable infection.**

Immune response is an idea whose time has come. We have new capabilities: Our biological understanding and our in silico simulation technology are growing. And we have newly pressing needs: The most urgent problem of our day—terrorism—requires an immune system, not a series of firewalls, for effective protection. Success will come when every cell of the body politic has the capability and the will to detect terror in the offing and the ability to trigger a lethal immune response. Are your neighbor’s WMDs locked?

***Chris Meyer****’s most recent book (with Stan Davis) is* It’s Alive: The Coming Convergence of Information, Biology, and Business *(Crown Business, 2003). He can be reached at* chris.meyer@itsalivebook.com*.*

### 13. How You Gonna Keep ’Em Down on the Farm After They’ve Seen Insead?

Companies that want to make serious investments in leadership development have numerous options. They can send their high-potential managers to programs offered through business schools like Harvard and Insead, to facilities like the Center for Creative Leadership, or to sessions designed by internal corporate training groups. But despite all the competition in the market, many companies aren’t convinced they are getting their money’s worth.

The problem may not be the programs. In fact, the personal learning catalyzed by a top-notch program can be tremendous. The problem, my research suggests, is what happens when a manager comes back to the day-to-day routine of the office. Having been inspired by exposure to new models and networks, he or she returns transformed, but to an organization that has not experienced a parallel makeover. The clash of expectations—the manager’s and the company’s—can be brutal. And so, paradoxically, the better the management development program, the more likely it may be to precipitate a valued employee’s departure.

How can organizations—and individual managers—get the full value of leadership development? It’s a question of emphasizing the “takeoff” and “reentry” phases of the experience. In preparation, for example, a manager should spend time with the boss and other key stakeholders, engaging in a dialogue about his or her strengths, weaknesses, and future trajectory. Having done so, the manager will be in a much better position, when he or she returns, to get a development assignment that will serve as a training ground for the new skills and approaches suggested in the program. It’s amazing how few managers seize the opportunity (or excuse) that is created by an upcoming development program to initiate such a conversation with the boss. But whether they do or not, the boss should ensure that it happens.

Similarly, on reentry, managers must take the time to reprioritize goals and fine-tune

their strategies. What should he or she aim to accomplish in the first week? The first month? Within six months? This reflection and planning should happen immediately after reentry—even if it means letting voice mails and e-mails pile up for yet another day. In a series of studies ranging from the introduction of new technologies to managers' approaches to taking on new roles, behavioral scientists have found a consistent "window of opportunity" effect: We have only a short time to make a real change after any break from routine. After that, things slip quickly into business as usual.

Finally, there is the question of how the individual should transfer his or her new knowledge to the rest of the team at the organization. I've seen many participants leave a program excited by their learning, having taken volumes of notes about what they plan to do differently, only to be bewildered when the people back home are not as quick to see the light. The key is to recognize that the power of the learning experience is not just intellectual. It's also emotional. While it's easiest to pass along the ideas and the readings, the manager must devise ways to share the experience more fully.

People often speak of executive programs as having been transformative. But the benefit shouldn't end there, at the event and within the individual. By thoughtfully managing a manager's takeoff and reentry, an organization can hope to be transformed by the experience as well.

***Herminia Ibarra*** *is the Insead Chaired Professor in Organizational Behavior at Insead in Fontainebleau, France. She is the author of* Working Identity: Unconventional Strategies for Reinventing Your Career *(Harvard Business School Press, 2003). She can be reached at* **Herminia.Ibarra@insead.edu**.

### 14. You Don't Have a Nanostrategy?

Lost in the hype about nanotechnology—somewhere between the threat of ooblecky nano-goo and the promise of cancer-curing microbots—lies the real story: Nanotechnologies will eventually disrupt, transform, and create whole industries. Mihail Roco, key architect of the robustly funded U.S. National Nanotechnology Initiative, estimates that by 2015, the global market for nanotech-based products will reach $1 trillion and employ 800,000 workers in the United States and 2 million worldwide. The question isn't *whether* your industry will be affected, but when and how.

Nanotech isn't a single field so much as a sprawling idea that cuts across disciplines, including engineering, physics, chemistry, biology, and materials science. The concept is that by manipulating matter at the molecular level, literally rearranging atoms and molecules, you can create new materials and products with extraordinary properties—fibers with 30 times the tensile strength of steel at a fraction of its weight, chemical detectors that can sense a single molecule, precision-guided smart drugs, and computer memories 1,000 times denser than any we have today.

**Nanotech isn't a single field so much as a sprawling idea that cuts across disciplines, from physics to biology.**

Nathan Myrhvold, Microsoft's former CTO and now the managing director of Intellectual Ventures, a private entrepreneurial firm, cautions companies to keep this fantastical nanofuture in perspective. "Nanotechnology may give rise to the next industrial revolution—maybe—but most nanotech applications aren't going to sneak up on you. The first industrial revolution didn't sneak up on us either," he says. "The broad vision is right, but some of these applications may be 50 years off. So what you want to do is keep your ear to the ground." For some industries, nanotech's implications are near term

and obvious. Any company with a major stake in IT ought to be actively involved in nanotech R&D and investment if it has the resources, as industry leaders IBM and HP are. The same is true for materials manufacturers. At the other end of the spectrum are companies in the service industries and elsewhere that will be nanotechnology's end users, the beneficiaries of dime-sized supercomputers and ultralight textiles stronger than Kevlar.

A company's responses to nanotechnology opportunities, of course, will depend on where it falls on this spectrum. The major players' aggressive strategy-development programs include scenario planning and intensive "boot camps" in which teams develop theoretical nanoproducts, says George Day, director of Wharton's emerging technologies management resource program. Other companies are retaining industry scouts and consulting firms with nanotech expertise and assembling internal "crow's nest" teams charged with tracking nanotech developments. Less aggressive surveillance strategies include tapping the resources of trade associations such as the New York–based NanoBusiness Alliance and inviting in various outside research scientists, customers, and suppliers with nanotech experience to discuss the technology's potential impact on business. At the very least, if you don't have a lookout now, get one. Have an insider shinny up to the crow's nest and take a look around. You might be surprised by what she sees on the horizon.

***Gardiner Morse*** *(gmorse@hbsp.harvard.edu) is a senior editor at HBR.*

### 15. The Loan Ranger

Why does widespread poverty persist in so many parts of the world? Because poor countries need trade and instead get aid. A simple, if surprising, change could fix the situation.

We all know that trade is what's needed to propel countries. When two countries engage in trade, both benefit. But rich countries discourage trade with poor countries in three major ways. First, they hold fast to the trading principle of reciprocity; that is, they offer another country a tariff reduction on a product in return for the same treatment on another item that they are hoping to sell to that country. Because the poor country's economy is vastly smaller, this "equal treatment" prevents it from bargaining for the reductions in trade barriers it needs to compete in rich countries. This is why, for instance, the United States puts a tariff on imports from Bangladesh that is nearly ten times higher than that on imports from France.

At the same time, rich countries spend, collectively, nearly $1 billion a day subsidizing the part of their economies where poor countries may have a real competitive advantage: agriculture. For most poor countries, a boost in agriculture would make a critical difference. Genuine economic development tends to be bottom-up; a surplus in agriculture produces the purchasing power and investment capital for manufactured goods, and surpluses in manufacturing similarly lead to more complex consumption and production.

Finally, rich countries use their leverage to promote free trade where they have an advantage. Instead of buying from poor countries, they're more interested in selling to them. It's a short-sighted strategy. When rich countries buy from poor countries, they not only bring costs down for their own consumers, they also raise purchasing power naturally in the poor countries—leading to larger markets for the rich countries' goods.

Instead, rich countries try to artificially boost poor countries' purchasing power by providing "aid"—to the tune of nearly $1 billion a week—through various bilateral channels and multilateral institutions. When aid is given to a poor country's government

(and most aid does go to governments), it has the added effect of promoting statism—it contributes to the centralization of power, whereas decentralization fosters democratization and economic growth. By taking pressure off that government to achieve greater tax revenues through economic growth, it allows the poor country to live with wrong policies and therefore contributes to worsening governance.

Solving the problem requires a fresh focus on the actual bottleneck. What is it that keeps rich countries' governments from living up to their rhetoric about free trade? Just this: a limited number of special interests that lobby aggressively on the part of dying industries. People who work in these sectors, we hear, will suffer; they will have to be retrained, rehabilitated. But that, we know, can be done—provided there is sufficient funding for related projects. And there, I would propose, is where institutions like the World Bank should be offering their aid. Let's start lending to the *rich* countries, so they can make their own people whole. Then they can pursue genuine free trade, benefiting both rich and poor economies. With good access to rich markets, poor economies would make substantial gains and earn access to capital and know-how naturally.

***Iqbal Quadir*** *(Iqbal_Quadir@harvard.edu) is the founder of GrameenPhone, which provides telephone access throughout Bangladesh, including to its rural poor. He lectures in public policy at Harvard's John F. Kennedy School of Government in Cambridge, Massachusetts.*

## 16. Cosmetic Psychopharmacology

Your employees now have access to medications—notably, SSRIs (selective serotonin reuptake inhibitors) like Prozac—that not only offer effective treatment for certain types of depression but also have the power to alter personality in ways that are good for business. In his 1993 best seller, *Listening to Prozac,* psychiatrist Peter Kramer told stories of patients who, when medicated, became "better than well"—showing, for example, greater assertiveness, better bargaining skills, and improved social competence. One patient, no longer depressed and already well regarded in her workplace, asked to have her dose increased so she'd have the confidence to request a promotion.

More recently, Brian Knutson of Stanford and his colleagues at the University of California–San Francisco Medical School's Langley Porter Psychiatric Institute looked at the short-term effects of SSRIs on people with no mood or personality disorders. Subjects were given a daily dose of either Paxil or a placebo and after a month were asked to perform a tricky negotiation. The people on Paxil performed best—perhaps because they were less hostile.

Now there's a tempting prospect. Getting ready to close a deal? Better drug up the team in advance. After all, you don't know what the other side is on. The potential for such use led Kramer to speculate about the role "cosmetic psychopharmacology" (a term he coined) could play in the world of business. After all, who wouldn't want to be better than well? Who wouldn't want to be less distractible, more optimistic, more socially adept? "I've certainly been asked," says Harvard psychiatrist Joe Glenmullen. "But that's the one thing I won't prescribe a drug for. I've heard stories of people who are in the office late at night, and they go to the Xerox room and are surprised to find people sharing their Prozac or Ritalin."

**Getting ready to close a deal? Better drug up the team in advance. After all, you don't know what the other side is on.**

Kramer says patients aren't beating down his door for pills they don't really need. At

least not yet. To some extent, he attributes the restraint to a fear of side effects. A large number of Prozac users report sexual dysfunction, for example. For other medications like Zoloft and Celexa, users can become seriously ill if they go off too quickly or even if they miss a couple of doses. More difficult to pin down is the nagging fear that, just as cosmetic surgery can deprive a face of character, cosmetic use of these medications will level out temperament. Some antidepressant users have complained that the same drug that allows them to cope with the daily stresses of life robs them of their creative "edge."

But Kramer sees another reason for the restraint: an attitude described by the late Gerald Klerman as pharmacological Calvinism. "If you look at studies of medication, the rule is that people take less than their doctor prescribes. We just don't like taking medicine," Kramer says. For business, that may be a bigger problem than the danger that some people will pop pills they don't need. Studies have shown that lost work time due to depression costs companies a fortune, with estimates ranging from $31 billion to $44 billion per year in lost productivity in the U.S. alone. "At least half of depression goes untreated," says Brookline, Massachusetts, psychotherapist Joanna Volpe-Vartanian. "People are worried about what their bosses will think, and they're afraid to use their employee assistance program or insurance benefits lest a record stay on a computer somewhere."

But that attitude may change as the image of psychopharmacology moves from problem fixer to advantage provider. Athletes have steroids. Fighter pilots have their "go pills." Will ambitious managers be able to leave well enough alone?

***Ellen Peebles*** *(epeebles@hbsp.harvard.edu) is a senior editor at HBR.*

### 17. Watching the Patterns Emerge

We've known for decades that informal social networks drive business—from employees at the watercooler to job seekers canvassing acquaintances to communities of practice. But it is much harder to map a network than to draw an org chart, and unlike org charts, social networks are self-altering. Knowing that networks are valuable doesn't help tell us how they are valuable or how to use them.

That is changing. Three big forces are at work: our understanding of the mechanics of social networks, within and between businesses; the growing cloud of data that surrounds our every transaction; and the speed at which we're able to react to those data.

**Better Models of Social Networks.** Stanley Milgram gave us the phrase "six degrees of separation" in a 1967 paper, but we didn't understand how the six-degrees phenomenon worked for another 30 years, until Duncan Watts and Steve Strogatz finally worked out the details, described in Watts's 2003 book, *Six Degrees.* This work, along with that of their peers, such as Albert-László Barabási of Notre Dame and Bernardo Huberman of HP, amounts to a revolution in our understanding of how social networks operate.

**Better Real-World Data.** Our lives are increasingly mediated by the Internet, from booking flights to making dates, and Web activities generate a cloud of metadata, the data that describe objects or transactions. One of the surprises with metadata is how little we need before we can start divining useful information. Amazon's book recommendations, Blogdex.net's lists of conversational trends on Web logs, Huberman's maps of social networks derived from e-mail traffic—all these things and many more come from the mining of simple metadata.

**Faster Reflexes.** We can now work with the data in real time. Until recently, all

mapping of social networks was like photography. You'd take a snapshot of a group's relationships, develop it, and weeks or months later, you'd see how it came out. With better tools for mining social metadata, we can start to treat our social networks like mirrors, getting the information we need as we need it. Social networking sites like LinkedIn and Friendster let individuals figure out who is in their friend-of-a-friend networks, while software applications like Spoke and Visible Path map companies' social networks to help businesses figure out whom to tap when trying to pitch a product or close a sale.

In what Kevin Werbach has called the era of "postmodern knowledge management," it's becoming clear that viewing a company's knowledge as something separate from its employees is impossible. Our growing understanding of social networks may help us leverage real people's interactions, for everything from trend spotting by scouring public conversations to identifying internal experts within a department to ensuring that a merger actually results in cooperation among employees, not just a change in logo.

Social networks can't simply be strip-mined of their value, however. A social network is a living thing that is altered by use. There are reports that the value of networking for job possibilities is weakening, in part because so many employment experts have recommended this very strategy. Likewise, privacy concerns and employees' inclination to see their social networks as personal assets will lead to tension between management and rank-and-file workers about both the observation and use of social networks.

Many of the social networking tools being proposed today will fail, because the obvious ideas are technologically simple but socially unworkable. ("If we all dump our address books into one big database, everybody will know everybody!") As we get smarter about building social networking tools, however, we will take it for granted that our social networks have measurable value, as do other intangibles such as brand, and we will find ways to recognize it. Managers manage what they can see, and as they begin to see social networks, the long-term effect on the business landscape will be profound.

***Clay Shirky*** *(clay@shirky.com) is a consultant and teaches at New York University's graduate Interactive Telecommunications Program, where he works on the social and economic effects of Internet technologies. His writings are archived at www.shirky.com.*

### 18. Laughter, the Best Consultant

Long before—four full years before—the once-rocketing Enron imploded in midair, a group of employees in the company's international division got together for their annual powwow. As well as listening to presentations about past performance and exhortations to reach new heights, the Enronians entertained themselves by putting on skits, with a prize going to the team that staged the best show. In 1997, the theme was mental toughness.

That year Sherron Watkins, later famous as the woman whose letter to CEO Ken Lay warned him that accounting scandals could doom the company, was cast as the Wicked Witch of the West in a parody of *The Wizard of Oz*. In the skit, Dorothy needed to find the wizard to get a deal approved. Of the executives accompanying her, one had no brain, one had no heart, and the third, the Cowardly Lion, was padding contracts because he wasn't brave enough to get earnings on his own. As for the wizard, the man who could approve the deal, the man behind the curtain—well, it turned out he had no sophisticated computer models, no special financial acumen. He was a fake. And his name, he said when he was discovered, was Andy Fastow. You don't need a brain or a heart to succeed at Enron, the fictional Fastow declared; and to the corrupt Cowardly Lion, he said: "You're my kind of guy."

That was fiction. The real Andy Fastow was, of course, the man who soon became Enron's chief financial officer and, if the charges against him are accurate, the chief architect of a series of deceptive deals that hid Enron's deteriorating financial condition from the public. When the curtain was pulled back on the real Enron's real finances, the company collapsed. Most employees and almost all of the business world were taken totally by surprise. But it was all there in the skit. Just as it was there in the wisecrack that went around the office after the publication of Enron's 1997 annual report, whose cover showed a tropical forest with a large leaf smack in the middle. "The fig leaf," the wags called it.

There's a lesson here, or maybe it's a management tip: You can learn a lot about a company by paying attention to its humor. People tell jokes, often, as a way of revealing uncomfortable truths. Monarchs employed court jesters to cut through their courtiers' unctuous sycophancy, for example. These days, it's editorial cartoonists and late-night TV hosts who lampoon the powerful. The same impulses are at work in every corporation on earth. Skits at sales conferences, wisecracks in meetings, jokes in e-mails: These constitute an extraordinary trove of information about what's really going on.

***Thomas A. Stewart*** *(editors@hbsp.harvard.edu) is the editor of HBR. His most recent book is* The Wealth of Knowledge: Intellectual Capital and the Twenty-First Century Organization *(Doubleday, 2001).*

### 19. Watch Your Back

Cruising through the draft of a potentially influential new framework for enterprise risk management, I am reminded of the thousand natural (and unnatural) shocks that companies are heir to. Those risks include, but are nowhere near limited to, emerging competition and price movements; political agendas and new regulations; changes in demographics and work/life priorities; unexpected repair costs; quality deficiencies; utility or computer service downtime; and good old human frailty. Toss in fire, flood, and earthquake—as this document does—and you have a portrait of the organization as a quivering mass of vulnerabilities. And that's exactly the view you need to take to prevent or mitigate nasty surprises that wallop stock prices, sales, and reputations, according to the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which is publishing the framework in the first quarter of this year (the draft is available at www.coso.org).

COSO are the folks who brought us the internal control framework adopted by many public companies scrambling to comply with Sarbanes-Oxley. The organization's traditional purview is financial reporting; that it has now embraced risk in all its infinite variety speaks to the growing demand for a cross-company, senior-executive-led approach to enterprise risk management (ERM), which goes well beyond traditional risk management's focus on a limited number of threats within functional silos. ERM takes a portfolio approach that recognizes the variety and interdependence of organizational vulnerabilities. "Sarbanes-Oxley has directed attention to risk, but the Enrons were really about accounting fraud," says John J. Flaherty, the chairman of COSO and retired chief auditor for PepsiCo. "We're focused more on risks that creep up on an organization and handicap it or put it out of business—where they never saw it coming."

Enterprise risk management is oldish hat in Britain, where the Turnbull Initiative of 1999 required public companies to regularly report on all significant exposures—ranging from IT to brand—as well as on the internal controls designed to minimize them. Today, UK companies perform comprehensive risk audits at least twice a year, and a few conduct them in real time, according to Richard Sharman, director of KPMG's enterprise risk

management group in London. The majority of Britain's 100 largest companies employ a chief risk officer or director of risk management who is responsible for embedding risk awareness in the culture, change-management style.

Although most of Europe is similarly up to snuff, the United States lags by 18 months or so. A study by management consulting firm Tillinghast-Towers Perrin found that 11% of U.S. companies, mainly in the financial services, insurance, and utilities sectors, have full-fledged ERM programs. Sharman thinks the COSO framework may catalyze U.S. businesses to systematically bring all of their Achilles' heels to heel. In addition, the new Basel II Accord is prompting banks to develop best practices around risk, and those practices are migrating into other industries. "Some of your global organizations are starting to think along the lines of European organizations around risk," says Sharman. "It doesn't just mean buying insurance. It doesn't just mean financial control. It is a CEO issue. And it does affect the brand."

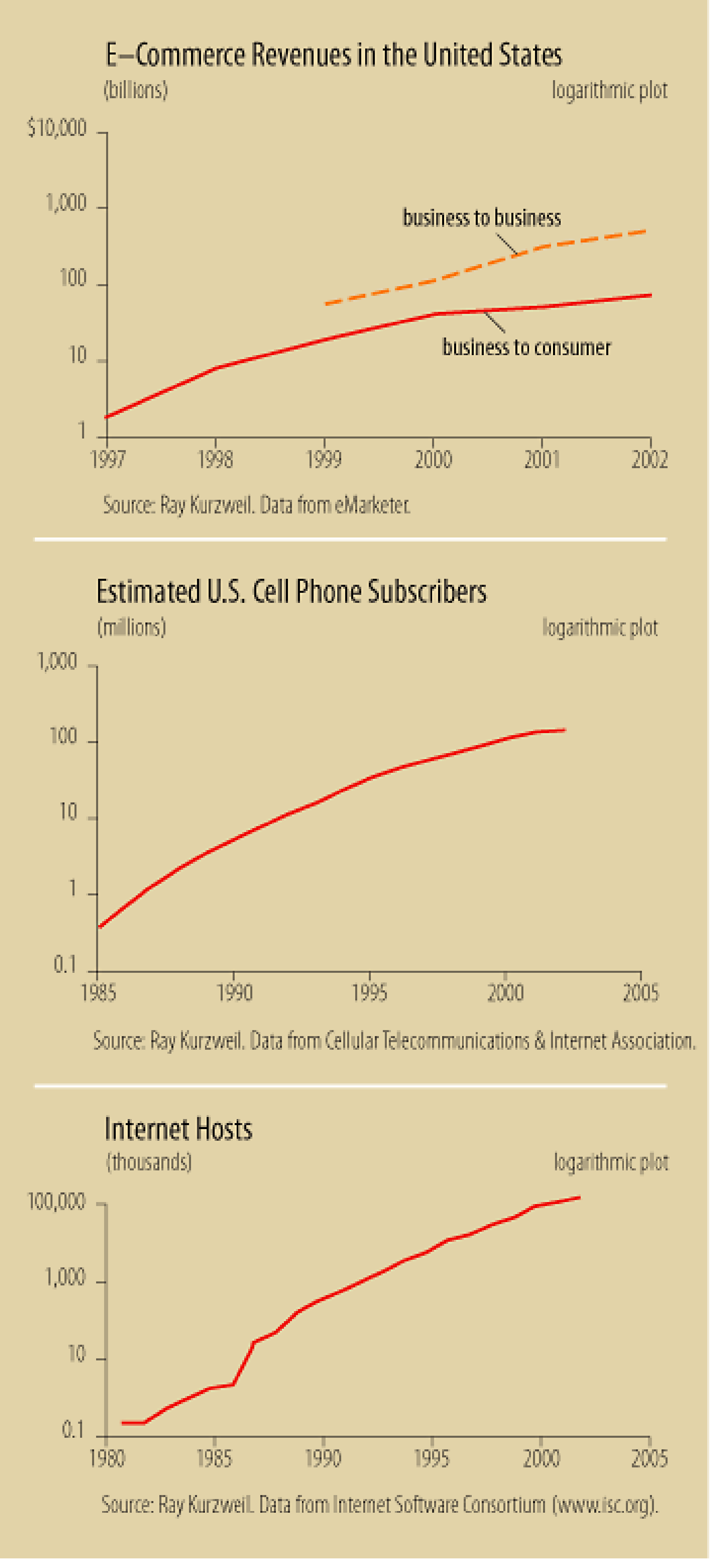
**A study found that only 11% of U.S. companies have full-fledged enterprise risk management programs.**

But ERM serves desire as well as fear; companies that adopt it for compliance purposes only are missing the larger point. Badly done, systemic risk assessment could put the brakes on aggressive behavior, but it need not result in what SEC Chairman William H. Donaldson described in a *Financial Times* interview as "a loss of risk-taking zeal." Rather, ERM should allow companies to make decisions with greater speed and confidence. "Having risk under control gives a company agility, flexibility," says Steven Hunt, a vice president of research at Forrester Research who specializes in security. "It's like driving a car: You can only go fast if you know you have good brakes."

***Leigh Buchanan*** *is a senior editor at HBR. She can be reached at* ***lbuchanan@hbsp.harvard.edu****.*

### 20. IT Doesn't Scatter

Take a look at the accompanying charts. Have you ever seen trend lines so smooth? This has been the reality of information-based technologies. Yet if you asked most people to describe IT's past decade, they would call it boom and bust—a roller coaster ride.




Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

Let's look first at the business-to-consumer (B2C) and business-to-business (B2B) data.

Actual B2C revenues grew smoothly from $1.8 billion in 1997 to $70 billion in 2002. B2B had similarly smooth growth from $56 billion in 1999 to $482 billion in 2002. We see the same trends in telecommunications, where the number of U.S. cell phone subscribers grew smoothly and exponentially from 340,000 in 1985 to 140 million in 2002. The number of Internet hosts rose from 213 in 1981 to 162 million in 2002.

The price-performance and capacity of the underlying technologies have grown even more rapidly than the market penetration. You could buy one transistor for a dollar in 1968 versus 10 million transistors for a dollar today. And unlike Gertrude Stein's roses, a transistor is not a transistor is not a transistor. As they've become smaller and less expensive, they've also become dramatically faster—by a factor of about 1,000 over the past 28 years. So the cost per transistor cycle has dropped regularly by half every 1.1 years.

The exponential growth of the power of information technologies (broadly defined) goes far beyond the well-known paradigm of the miniaturization of transistors on an integrated circuit described by Moore's Law. We see the same phenomenon in many other areas of technology that deal with or create information. For example, magnetic data storage has doubled in price-performance every 15 months over the past half-century. We see similar exponential growth in the price-performance and capacity of such diverse technologies as wired and wireless communications, DNA sequencing, and brain scanning.

So why have the capital markets been so volatile? First, because as much as IT has delivered, Wall Street expected even more. The perception was that the Internet and telecommunications technologies represented revolutions that would overturn the business models for many industries. That was and is correct—but these trends take time to develop. Second, there was a profound lack of communication within the investment community. This allowed, for example, massive overinvestment in certain areas (such as fiber), while other areas (such as the "last mile" of the communication infrastructure) were ignored. The result was more than $2 trillion of lost market capitalization.

**Why have the high-tech capital markets been so volatile? Because as much as IT has delivered, Wall Street expected even more.**

Regardless of whether your portfolio or mine suffers another setback, we'd do well to keep in mind that technology will continue to march ahead. If everyone involved with information technology—and these days, who isn't?—understood the trends underlying these technologies, the painful episodes of boom and bust in investment values might, at long last, begin to subside.

***Ray Kurzweil*** *(raymond@kurzweiltech.com) is an inventor and expert on artificial intelligence. His latest book is* The Age of Spiritual Machines: When Computers Exceed Human Intelligence *(Viking Press, 1999).*

Reprint Number R0402A

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

# Give My Regrets to Wall Street

**Increased public scrutiny, decreased stock-option appeal, and the relentless expectations of Wall Street are taking their toll on a once high-flying consultancy. Is going private the way out?**

***by Mark L. Frigo and Joel Litman***

Kenneth Charles and Matthew Phair sat on opposite sides of the conference room table, scratching away on their legal pads. As one voice after another leaked from the starfish-shaped phone, Matthew, the CFO of First Rangeway Consulting, took copious notes. Kenneth, the CEO, energetically doodled animals, as he often did when alone or with close associates. "During a conference call, no one can tell that you're drawing a dog," he liked to say, beaming approval on those who got the joke.

Doodling helped Ken focus, and his pen skittered across the paper as he listened to Victoria Michaels, a top-ranked sell-side analyst covering professional services stocks. Victoria was commending First Rangeway for its cost-control work and consequent increase in earnings. "But revenues are still flat quarter over quarter," she went on in a clipped voice that just missed being an English accent. "When and from where do you see revenue growth, and at what levels?"

"You know, Victoria, we've been holding client projects steady over the past year," Ken replied. "But proposal activity and engagement types point to an uptick next quarter, when corporate spending for our services should really kick in."

"We've already seen signs that we'll easily reach the targets we mentioned earlier," added Matt, jotting a number in the margin and drawing a box around it. "To reiterate, we stated a 10% quarter-over-quarter increase beginning next quarter."

The next question, from Kevin Danville of LRL Investments, was tougher. "Could you comment on how fruitful the business process outsourcing space might be over and above traditional consulting revenues?" Kevin asked, as Matt etched "BPO" into his paper, followed by three question marks.

Ken racked his brain for a response that would sound both encouraging and noncommittal. Not finding one, he settled for noncommittal. "We are investigating multiple revenue streams as we have in the past," he said, "and are prepared to move into those that complement our consulting work. However," he added, cringing inwardly at the necessarily oblique language, "it would be premature at this point to make any specific announcement."

That answer wasn't what the analysts wanted to hear, he knew. Although Ken had been a partner at First Rangeway since 1997—two years before the 2,800-employee consultancy's IPO and subsequent market triumph—he had been CEO for less than a year, and the quarterly analyst calls still made him sweat. On the day he accepted the top job, his wife, Cara, had presented him with a plaque that read simply, "All Things to All People," and for months it held pride of place on his office wall. Lately, however, the words seemed more like a command than a pleasantry, and Ken had banished the plaque to the nether regions of a desk drawer.

Thirty question-filled minutes later, the call operator finally rang down the curtain. Ken capped his pen and leaned back, puffing out his cheeks in relief. Matt tapped the on/off button on the speakerphone to make sure they were clear. The reassuring hum of a dial tone filled the air.

"Have I ever mentioned how much I love analyst calls?" said Ken, as Matt gathered his papers into a neat stack. "Because if I did, I was lying. How do you think my BPO response went over?"

>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague
>| Executive Summary

WRITTEN BY

**Mark L. Frigo** (mfrigo@depaul.edu) is the Eichenbaum Foundation Distinguished Professor of Strategy and Leadership and the director of the Center for Strategy, Execution, and Valuation at DePaul University's Kellstadt Graduate School of Business in Chicago.
**Joel Litman** (joel.litman@csfb.com) is a director with CSFB HOLT at Credit Suisse First Boston and Clinical Professor of Business Strategy in the Kellstadt MBA Program.

Matt shrugged. "Kevin didn't mention Locklin-Ladd Associates by name, but you know that's who he meant. They've been all over outsourcing, and they've hired some top guns to make it happen. There's money there, Ken. It could easily mean 30% growth for us for several years. Plus, Mark and Amy and some other partners have serious experience in that area."

"It would also mean a ton of up-front capital," replied the CEO. "But yes, it's worth considering." Certainly the prospect was tantalizing, and Ken couldn't deny feeling that residual dream-big itch, which, without access to heaps of money, the company was unlikely to scratch. None of the new markets First Rangeway was contemplating were frivolous; all represented directions in which its customers were heading. Five years ago, pursuing such opportunities would have been a no-brainer. But after the market's fall, it was definitely a brainer. For that reason and others, Ken was no longer convinced that public status remained a compelling proposition. "Of course," he mused out loud, "the whole equation changes if we..."

**"We are profitable. Proposal interest is up. The economy is up, and we're in a great position to take advantage of that. Without the IPO, we wouldn't have had these gains."**

"If we go private," concluded Matt. "It's item number one at the next management team meeting—and the big item at the board meeting." Leaning across the table, he tore the top sheet off Ken's pad and eyeballed it. "Nice giraffe," he commented, tossing the paper back toward the CEO.

### A Troubling Exchange

An hour later in the lobby, Ken stopped by the reception desk to order a cab and snitch a handful of Hershey's Miniatures from the cut-glass jar. "I thought you were on a diet?" said Lindsey Carruthers, coming up behind him. One of First Rangeway's rising stars, Lindsey was also Ken's self-appointed conscience. The CEO raised his hands in mock surrender and put back the candy. The two walked out together through the big glass double doors.

"I'm glad I ran into you," said Ken, scanning the street for his taxi. "I'm off to your alma mater in Boston to do a presentation at the B-school—trying to rustle up some top-notch MBAs. You've done a lot of recruiting there, right? What will they throw at me?"

Lindsey thought for a moment. "Well, they're still interested in First Rangeway, definitely," she said. "But I had lunch with a couple potential recruits last week, and they were concerned about the stock price. I'm not surprised, because we're so option- and stock-based, but they asked questions about the stock's potential I really couldn't answer. Want me to come with?"

"No, you just enjoy your lunch," said Ken, as his cab pulled up. Through the window, he watched Lindsey walk toward the corner salad bar. She was one of his best people and would probably make partner soon. In its glory years, First Rangeway had recruited a lot of great people from her school, many attracted by those very stock options that were giving this crop of MBAs the willies.

And why shouldn't options make them uncomfortable, Ken thought. First Rangeway's price was more than 80% off its highs, and volatile to boot. With the precipitous drop in global business, they'd downsized dramatically, laying people off, freezing hires. But things were looking up now. It was time to refocus on the people—on finding new blood to drive the business and hanging on to those partners who had made it successful so far.

Unfortunately, they would have to divert some of those new hires toward activities that would do nothing to build the company. Before that morning's analyst call, Matt had laid out the resources First Rangeway needed to stay up to snuff with Sarbanes-Oxley, SEC filings, and other cost-of-being-public requirements. The business was becoming more complicated: Innovative revenue and gain-sharing agreements with clients had made financial reporting a mare's nest. Matt estimated they'd need 12 more people, including in-house attorneys, audit staff, and dedicated systems folk to upgrade software for internal controls. He had ballparked the total at over a million dollars annually.

Cutting corners wasn't an option, Ken knew. Anything remotely questionable about their reporting could hinder a potential rebound in stock price or—worst of worst-case

scenarios—land him and Matt in jail for willfully certifying bad financial statements. "Neither of us wants to sign off on those filings unless they're 100% kosher," Matt had reminded him. "And by the way, we could also use two or three more bodies in investor relations."

The cab lurched, and a wave of nausea seized the CEO. Car sickness, nerves, or an empty stomach? Ken unwrapped the single chocolate bar he had secreted in one of his pockets and popped it into his mouth.

**Too Bullish to Bear?**

The presentation to the MBAs went swimmingly. Ken was justifiably proud of his oratory skills: The ability to motivate people was one factor in his professional rise. So inspirational was the CEO's description of his company's starry future that he was tempted to run out and apply for a job at First Rangeway himself.

Crossing the quad afterward, Ken noticed a tall woman in head-to-toe Brooks Brothers striding ahead of him. He quickened his pace and a moment later fell in beside Nancy Westview. Nancy was a prominent business personality, adored by the press, and had more pies than she had fingers to put in them. She was on campus that day guest lecturing at an entrepreneurship seminar. "I went in with six pages of notes and came out with 600 pages worth of business plans," she told Ken, waving a thick folder. "My favorite so far is an exercise service for small pets."

But small talk was a very small part of Nancy's conversational repertoire. One of First Rangeway's original investors (she still held a sizable position) and a member of its board, she soon switched to a subject of vital interest to the shareholders—and, most particularly, to Nancy Westview. "I know there's been a lot of talk recently about going private," she said, stepping neatly off the path to avoid a young professor on a Segway, "and I think it would be a mistake. The major indexes are all up for the year, and our stock is up twice that. The economy looks as if it's gaining steam, and I don't want it leaving the station without us."

Ken listened patiently as Nancy launched into a tutorial on the state of technology consulting. As expected, it was a study in upsides. Nancy's estimates of potential revenues from outsourcing slightly exceeded Matt's, and she knew from her prodigious networking that some of First Rangeway's competitors were entering other promising areas. There was also talk of industry consolidation: Nancy named three potential acquisitions that she deemed "tasty."

"There is no way we can talk about going private without taking these things into account—serious account," said Nancy, as they emerged from the grassy enclave onto a revving-up-for-rush-hour street. "I want to know what we're doing about these opportunities. The board meeting is Wednesday. I expect to hear answers."

"And answers you will have, Nancy," promised Ken, the first words he'd been able to get out in almost ten minutes. "Matt and I are still in research mode, but a direction is becoming clear." The last bit wasn't true, but Nancy, he knew, had a hate-hate relationship with ambiguity. Anxious to avoid a further monologue, he handed her into the first cab that pulled up, declining her offer to share the ride. As Ken raised his hand to hail another taxi, a bus rolled by, belching exhaust at him.

**Public Enemy Number One**

Ken arrived at his club at ten minutes past seven and hurried to the restaurant. The floor-to-ceiling windows were awash with night, and waiters slipped unobtrusively from table to table, lighting candles. Greg O'Keefe was already seated in their usual spot. Ken dropped into his chair and brushed away the leather-bound menu being proffered by a waiter. "Flame-grilled rib eye, black-and-blue. No potatoes. No bread. Glass of the house red."

"Atkins, Ken?" asked Greg, raising an eyebrow.

"Ten pounds so far," replied Ken, not mentioning that two of those ten had recently made a reappearance. "And how about you?" he asked, noticing the tautness of his former colleague's jacket across his increasingly barrel-like chest. "Evidence of life in the slow lane?"

"Nothing slow about it," said Greg. "I've got plenty of consulting work, and, seeing as I'm a bred-in-the-bone consultant, that tends to make me happy. Can you say the same?"

“Of course,” replied Ken, slightly annoyed. “First Rangeway is still a consulting firm through and through.”

“Oh yes?” said Greg. “And a consulting firm through and through needs access to all that capital why? Consulting is a cash-based business, old friend. The math is simple: If 200 partners generate $200 million in profits, they each make a million dollars. All being public does is dilute that.”

Ken sighed, wondering how they had managed to get off on this track so early in the evening. They’d been having the same argument for three years, beginning on the day Greg resigned from First Rangeway in the second wave of partner defections after the business downturn. Ken had bought into the former CEO’s ambitious vision. But Greg saw only what was lost: an unwavering focus on consulting.

Greg had launched into his by-now familiar interpretation of events. “Because we were so fantastic at what we did, we were able to pull off a successful IPO, which gave us lots of money to spend on things other than what we did and were fantastic at. It’s a catch-22 or a perfect storm or a tipping point…I can never remember which. I’m not arguing there isn’t value in floating a small percentage of stock and gaining liquidity. But after that, what’s the use?” he continued as the waiter placed a couple of green salads in front of them. He paused to fork some arugula into his mouth. “Private may not be sexy, but these days public isn’t anything to get hot and bothered about either. The privately owned consulting model has been working for decades. Decades from now, it will still be working.”

Ken scooped his croutons onto a spoon and deposited them onto his bread plate. “Look, Greg, do I really need to state the obvious here? We are profitable. Proposal interest is up. The economy is up, and we’re in a great position to take advantage of that. Without the IPO, we wouldn’t have had these gains. And if we go private now, we’ll miss out on a lot of opportunities that the board—that the board and I—see in the coming year.” He paused, realizing he was repeating some of the same rah-rah rhetoric he’d used on the MBA candidates a few hours earlier. “Anyway, you know the door is always open if you want to come back,” he said more gently.

“Well, Ken, if anyone can make it work, it’s you,” said Greg, conciliatorily. “Personally, I think First Rangeway’s gonna do great things. But it’s going to have to do them without me.” He smiled. “Unless of course, you change your mind about the private thing. Are you going to eat those croutons?”

**P.O.’d**

Closing the door of his den to stifle the sound of the Cartoon Network marathon unfolding in the next room, Ken sat at his desk and switched on the PC. He had an hour before the Saturday routine of soccer games and birthday parties kicked in, and about 100 e-mails to plow through. One from his brother in Maine. One from Amazon announcing that a recent order was on its way.

The third e-mail was from Tracy Durham, president of Bardwell Incorporated, and a longtime client of Ken’s. The previous year, Bardwell had initiated a multimillion-dollar engagement, and the e-mail bore glad tidings of its progress. Tracy reported that she was pleased with the Rangeway partner running the project. The team of employees from both companies had proven innovative and collaborative, its results solid. “I do, however, have one issue I’d like to discuss,” the e-mail concluded. “Call me when you can.”

Ken checked the date and time stamp: 10/11/03 08:32 am. Tracy was hard at it on a Saturday morning; it wouldn’t hurt to let her know Ken was hard at it, too. Anyway, Ken couldn’t enjoy the day knowing there was some problem out there preparing to bite. He had Tracy’s cell number and had been instructed to use it any time. Ken picked up the telephone.

Two rings. “Hello?”

“Hey, Tracy, I hope it’s OK to call you on a weekend…”

“Not a problem, Ken. I guess you saw my e-mail. As I said, things in general are going well. But some of our people have complained that some of your people are pushing them too hard to reach certain milestones on the programming project before end of quarter.”

Unconsciously, Ken picked up a pad and began doodling. Bardwell's compensation and culture, Tracy was explaining, simply weren't designed to accommodate 75-hour-plus workweeks. And the lead partner—whose energy and expertise she had praised in the e-mail—had been a little too aggressive about collecting on a bill ("and I let him know it, too," said Tracy, sounding peeved.) "I don't object to wrapping things up quickly," she continued. "But all of the pressure makes us wonder, Whose quarter are we trying to make: Bardwell's or Rangeway's?

"Making a quarter can't help a firm as much as losing a client could hurt it," Tracy said. "Right now this is not a huge thing." She paused, waited a beat. "Let's just make sure it doesn't become one."

Ken's pen was leaking, leaving moist blotches all over the page. This wasn't the first time a project team had been pressured in the name of quarterly revenue targets. And clients weren't the only ones hurting: His own employees were complaining of burnout as well. "I promise I'll speak to the engagement partner personally," he said hastily. "You've known me a long time, Tracy. You know we'll do right by you."

**This wasn't the first time that clients had been pressured in the name of quarterly revenue targets. And Ken's own employees were complaining of burnout as well.**

As Ken hung up, a chorus of voices summoned him into the living room to join the search for cleats.

**Time to Yield?**

On Monday morning, Ken's conversation with the lead partner on the Bardwell engagement went as well as could be expected. ("Did I really use the word 'unseemly'?" he asked himself later.) By 11 am, the CEO had moved on to other things. Specifically, he was back in the conference room with Matt, the speakerphone between them. Only this time, it was channeling the voice of investment banker Charlie Gremley.

"Going private is a pretty straightforward process," Charlie was explaining, "but that doesn't mean it's easy. If you plan to raise capital from financial sponsors, we can help you do that. If you're looking to raise the capital yourselves, we can help there, too. We'll start running valuation models now if you like. Needless to say, we're talking about something in excess of a couple of hundred million dollars."

As the investment banker spoke, Ken speculated on just how much money the partners could or would raise if they went this route. After First Rangeway's IPO, the owners' net worth skyrocketed, and many had sold some piece of their ownership. But others held on as paper gains gave way to paper losses. Then Charlie started to enumerate the people they'd need to steer the deal, and Ken pictured attorneys and accountants swarming over the company's headquarters like ants on a dropped popsicle. Talk about a distraction from the business...and the *cost*...

"There's something extremely *Alice Through the Looking Glass* about all this," remarked Matt as he switched off the phone. "I recall sitting right here five years ago listening to Charlie walk us through the IPO. Remember how helpful he was?"

"What I remember is how *encouraging* he was," replied Ken, with a touch of sourness. "Did I mention how much I love investment bankers? Because if I did..."

"Yes, I know, then you were lying," finished Matt.

**Private Aye, or Nay**

The management team meeting convened with the introduction of a tray of bagels and jugs of fresh-squeezed juice. It was 7:30, Tuesday morning. Ken gazed around the executive boardroom: The company's brightest and most seasoned players gazed back at him. "So," said the CEO, "may I direct your attention to the elephant in the room?"

Ken had ambitious goals for this meeting. Facing one of the most important decisions they would ever make, the team members couldn't simply react to current market conditions or focus on their own careers and wealth. Rather, he needed them to step into the ring for a little out-of-the-boxing. They had to consider the issue from many different perspectives.

The CEO nodded toward Laura Leadbetter, a senior partner sipping a tall cup of

Starbucks's strongest. "Laura, if a client of our own strategy consulting group were wrestling with this issue, how might we advise them?"

As a 20-year veteran of business, Laura had facilitated more executive retreats than she could throw a creativity consultant at. Still, she mulled over the question a while before responding. "We all know there are big-money implications to either direction," she said finally. "We want to do what is financially best for the business as a whole and, yes, for us individually. But—forgive me if I get a little Business Strategy 101 here—wealth comes through *fulfilling client needs.* So if I were advising a business, that's what I would say: First, define your clients' needs, and then align your genuine assets and business strategy, including capital structure, accordingly."

That was the right answer, and Ken smiled his approbation. Customer focus had always been the CEO's mantra. The team could paint this picture any number of ways, but First Rangeway's clients had to provide the frame. Confident, now, that the discussion would proceed toward the best possible conclusion, Ken threw out this challenge:

"Being a publicly traded company affects us in almost everything we do. We have to consider not only what kind of business this can be, but also what it *should* be. What we are discussing now, and what I will present to the board tomorrow, is no less than the future of First Rangeway. Let's talk."

---

### HBR Case Commentary

## Should First Rangeway remain public or go private?

**Four commentators offer expert advice.**

**Chan Suh** is cofounder, CEO, and chairman of Agency.com, an interactive marketing and technology company headquartered in New York. Agency.com went public in 1999 and private in 2001. Suh can be reached at **chan@agency.com**.

Ken may not want to hear this, but I see no compelling financial reasons why First Rangeway should go private. The business opportunities before it are attractive. The company is profitable, and its cash flow appears healthy. (When my company, Agency.com, went private, the most important factor in my decision was the cash flow beyond 24 months.) So long as First Rangeway can remain profitable and keep customers happy, it should do just fine as a public company in the long term.

Going private, by contrast, could be hugely disruptive. The biggest challenge lies not with lawyers and accountants but rather with Ken's own people. In a service company, as I'm sure Ken must know, people are *everything*. First Rangeway has been attracting top talent with a heavy reliance on the lure of options. If those options disappear because the company goes private, how will management induce those folks to stay? Options weren't a disproportionate part of compensation at Agency.com, but we still had to come up with a bonus program to retain our key staff. And even then we lost a few, including our CFO. It's not a question of loyalty. Those people signed on for one thing, and they ended up with something else.

**If First Rangeway stays public, I'm not sure Ken is its best possible CEO. If you don't enjoy running a public company, then you shouldn't be doing it.**

But if First Rangeway stays public, I'm not sure Ken is its best possible CEO. If you don't enjoy running a public company, then you shouldn't be doing it. Ken should have known the realities going in: the emphasis on short-term results, the scrutiny. With every quarter comes that call of reckoning, and even when your results are bad or the questions are difficult, you have to enjoy at least the challenge of answering those questions. I actually did enjoy it, as well as the tremendous discipline required to meet expectations about reporting and performance.

As a public-company CEO, you've also got to be extremely straightforward. The analysts didn't like the way Ken hedged on his response about business process outsourcing, and I don't blame them. He should have just said, "Yes, we've thought about it. No, we haven't made any decisions yet." There's a large difference between *being* a public-company CEO and *playing* a public-company CEO. The former tells the hard truths and takes his lumps; the latter spins everything, like a politician. I think Ken is still *playing* a public-company CEO. He's ambivalent about communicating with the shareholder base, and that's a huge part of his job.

To be fair, he also seems to regret all the time he's spending away from his customers. Public companies have two sets of masters—shareholders and customers—and their CEOs must tend to both. When Agency.com was public, I spent about 40% of my time on shareholder-related matters; now that's down to 10%, which is great. If First Rangeway is having trouble focusing on customers because its people are fixated on the stock market, then that might be a reason to privatize. That's another people issue peculiar to service companies: When your sellable goods expire every hour, you can't afford to have your people distracted from the client work.

If Ken insists on taking the company private, the first thing he has to do is start kissing some deep-pocketed frogs. And he must keep in mind that, whether he gets the money from existing partners or from new sources, those investors may be with him for a long time. And they won't restrict their phone calls to once a quarter. Or even to business hours.

So, my recommendation stands. Ken, keep the company public, and learn to love the job. It can be very rewarding.

---

**Ed Nusbaum** is the chief executive officer of Grant Thornton, a global accounting firm focused on midsize private companies and mid-cap public companies. He is also a member of the Financial Accounting Standards Board Advisory Council. He can be reached at Edward.Nusbaum@Gt.com.

---

**In considering whether or not to stay public, Ken should worry not only about attracting the new talent he needs to drive the business but also about retaining the talent he already has.**

Going private is an attractive scenario for First Rangeway, assuming that it is able to raise the necessary cash. (Charlie Gremley, the investment banker, sounds optimistic on that score.) A number of factors support that judgment.

As Ken has clearly discovered, it is easier to manage important decisions when you are not under public scrutiny. Private companies worry about profits, of course, but the pressure surrounding quarterly reporting is obviously hurting First Rangeway's customers. It has also begun to take its toll on employees, who are working long hours and complaining about burnout. The analyst calls are creating stress for management and are proving a distraction from the company's core business.

In addition, the impact of new legislation and reporting requirements on a company of this size is enormous. I would estimate that it costs First Rangeway somewhere between $250,000 and $1 million a year to remain public.

The stock price for a relatively small technology consulting firm such as First Rangeway is also likely to be very volatile in the future, and that may cause major financial and business disruptions. It's not surprising that many of Ken's best people were lured to First Rangeway by stock options. Options, as we know, are great when employees think their value is going to rise. But if it doesn't, they are likely to become discouraged. In considering whether or not to stay public, Ken should worry not only about attracting the new talent he needs to drive the business but also about retaining the talent he already has.

Finally, the leadership team doesn't seem to be chomping at the bit over the prospect of mergers or acquisitions, so First Rangeway is under little pressure to use its stock as currency.

If First Rangeway does decide to privatize, however, it will need to feel secure about its profits as it goes forward. The company is going to have to raise a couple hundred million dollars in financing—presumably in debt financing—and that will have an interest cost. If the company's profits exceed that interest cost, then the difference will flow directly to First Rangeway's partners or private equity holders. But if there are no profits, or if cash flow is not sufficient to make the principal and the interest payments, it will put a tremendous burden on the company. Analysts can and do get angry over poor performance, and Ken is understandably concerned about that. But private debt holders can put you out of business.

The final deciding factor in this scenario is First Rangeway's board. I believe that the board will support a privatization strategy if such a strategy makes sense from both an

economic and a business standpoint. Its members have a fiduciary responsibility to do what is in the best interests of the shareholders, and Ken can make a strong case that, because of the volatility of the market and the industry, it is in the shareholders' best interests to be bought out. If Ken is convincing on that point, even Nancy Westview, the board member who strongly advocates that First Rangeway remain public (and whose opinions may not be representative of those of the other members), will be unable to effectively object to the company pursuing a privatization strategy.

First Rangeway Consulting could undoubtedly continue to operate as a public company, and Ken and Matt still need to run some economic models and draw up their own list of pros and cons before making any critical decisions. But if I were in their shoes, I would soon begin the push toward going private.

---

**John J. Mulherin** is the president and chief executive officer of the Ziegler Companies, a boutique investment-banking firm serving the not-for-profit sectors of senior living, hospitals, education, and churches. The company is based in Milwaukee. Mulherin can be reached at jmulherin@ziegler.com.

---

**What might work for First Rangeway is to remain public but list on the Pink Sheets, a primarily over-the-counter mechanism for trading companies that are not on the major exchanges.**

My business, the Ziegler Companies, traded for ten years on the American Exchange, and we would still be trading there today if it weren't for the passage of Sarbanes-Oxley. Yes, the system needs real reform with teeth in it. But one size does not fit all, and micro-caps are suffering disproportionately.

First Rangeway's CFO, Matt, put a $1 million price tag on complying with new and existing regulations, and he didn't even address the high level of distraction Sarbanes-Oxley foments. Had Ziegler remained on the Amex under Sarbanes, we would have had to recreate our audit committee practices and charter. These mandates would also have meant adding numerous meetings and committees, as well as implementing some costly financial-risk and compliance processes that overlap with our existing and more-efficient processes.

Our start-up costs for compliance are estimated at $700,000; we believe that ongoing costs would have run $400,000 annually. Taken together, that's 20% to 25% of our bottom line for 2003. It sounds as though First Rangeway would be similarly hit.

What Ziegler ultimately chose to do—and what might work for First Rangeway as well—is to remain public but list on the Pink Sheets, a primarily over-the-counter mechanism for trading companies that are not on the major exchanges. Long considered the refuge of penny stocks and fallen angels, the Pink Sheets, which is electronic and Internet-accessible, has lately attracted a growing number of reputable firms and strong performers. As many as five to ten companies a week are signing on specifically to avoid the costs imposed by Sarbanes-Oxley. However, many people are unaware of the service's improvements and remain suspicious of its reputation, so Ken may have difficulty persuading his board that the Pink Sheets is an option.

But the first question that Ken faces isn't whether the Pink Sheets is a better venue for staying public than First Rangeway's current exchange. Rather, it is, who are First Rangeway's shareholders, and what is the company really doing for them?

The CEO offers little insight into how he intends to build shareholder value, and that may be because he doesn't have much in that way to offer. First Rangeway, after all, is a consultancy. That means its revenues are largely nonrecurring, and it has neither significant tangible assets such as inventory, nor intellectual property such as patents. At its core, the company is comprised of a group of people laboring together for their mutual benefit. Is there really a compelling reason for a company with this business model to be public at all? Some members of my executive team argued the very same thing about Ziegler when we were debating its privatization last fall.

I would also question whether privatization is the most important issue for debate. During my tenure at Ziegler, I have spent less time mulling over our capital structure than our business strategy. Is our strategy working? If not, how do we fix it? Do we close existing businesses? Start new ones? Redirect our resources? Improve our marketing? Ken appears to be focusing most of his attention on the public-private quandary instead of on those issues most likely to build sustainable value for

shareholders.

If Ken believes that First Rangeway is truly creating value, then by all means it should remain public (but consider listing on the Pink Sheets in order to escape the excessive burdens of Sarbanes-Oxley). If he can't make that argument—and I suspect he can't—then privatizing is the better choice.

---

**Tom Copeland**, formerly the chair of the finance department at UCLA, is the managing director of corporate finance at the Monitor Group, a management consulting firm based in Cambridge, Massachusetts. He is coauthor of *Real Options: A Practitioner's Guide* (Texere, 2001). He can be reached at **Tom_Copeland@monitor.com**.

---

A consulting firm functions best as a partnership because it depends on creative solutions to high-level problems. Because information is inalienable (once shared it cannot be returned to its owner) and because new ideas must be quickly disseminated, a flat structure based on trust works best. From an organizational standpoint, therefore, First Rangeway's IPO did the company no favors. It also caused significant increases in agency costs (monitoring, public reporting, performance expectations, and incentive structure) that may have driven a wedge between the public shareholders who own but do not manage the firm and the remaining post-IPO partners who manage but do not own it.

First Rangeway's IPO most likely transferred wealth from junior to senior partners, who owned a disproportionately large percentage of the firm. In addition, by creating a new class of outside owners, the IPO raised agency costs in three ways. First, the outsiders need to monitor management: First Rangeway spends $1 million annually on SEC compliance and related charges. Actual opportunity costs will be a significant multiple of that. Second, senior partners' incentive to push harder evaporates because they have essentially cashed out. Third, the remaining partners' incentive declines substantially because they now keep only a fraction of the fruit of their efforts. Things would have been different had the IPO money been reinvested in growth, but that didn't seem to happen.

The $200 million of profit would have been paid out as additional bonuses when the firm was a partnership. Senior partners created a wealth transfer and initiated agency costs by selling the claim on the stream of profits to outside owners. Post-IPO, it must have become harder to attract and retain top talent because the percentage of the total pie allotted to the partnership declined, as did the size of the pie.

While debating what First Rangeway's status should be in 2004, Ken and Matt should understand what might have been done differently in 1999. Back then, the senior partners should have sold their shares to the junior partners rather than to the public. The firm's charter should have separated ownership from control within the ranks of the partnership to solve a classic intergenerational problem: transfer of ownership. This can be facilitated by separating voting rights from stock ownership. When junior consultants are elected to partnership, they must buy shares from senior partners, who are required to sell. Over time, the number of shares owned by individual partners increases, then declines as retirement approaches. The number of votes, meanwhile, increases with seniority. Thus, control rests with senior partners, but their economic incentive to sell the firm to outsiders diminishes to zero as they prepare to retire. Capital for growth should be raised primarily via borrowing.

If First Rangeway's remaining partners can eliminate the agency problems created by the IPO, then the firm's value after privatization will exceed the buyback price. Monitoring costs will disappear, and internal incentives will improve. If the partners cannot resolve those issues, then the public-private dilemma will continue to haunt them. With a second IPO likely, the agency cost would remain and privatization would create little or no value.

**If First Rangeway's remaining partners can eliminate the agency problems created by the IPO, then the firm's value after privatization will exceed the buyback price.**

The remaining partners must decide whether it is easier to exceed expectations as a publicly held company or as a partnership. Will increased incentives improve consultants' performance? I believe so. The partners must also be sure that they can improve current expectations of the key value drivers: growth and operating margins. If they have to borrow to finance the buyback, they may have a debt burden for years to come.

---

>| Executive Summary
>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague

Reprint Number R0402B

*HBR's cases, which are fictional, present common managerial dilemmas and offer concrete solutions from experts.*



Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review
Click here to visit:
>| http://www.hbsp.org

HBR CASE STUDY

# Give My Regrets to Wall Street

**Increased public scrutiny, decreased stock-option appeal, and the relentless expectations of Wall Street are taking their toll on a once high-flying consultancy. Is going private the way out?**

***by Mark L. Frigo and Joel Litman***

**Mark L. Frigo** (mfrigo@depaul.edu) is the Eichenbaum Foundation Distinguished Professor of Strategy and Leadership and the director of the Center for Strategy, Execution, and Valuation at DePaul University's Kellstadt Graduate School of Business in Chicago. **Joel Litman** (joel.litman@csfb.com) is a director with CSFB HOLT at Credit Suisse First Boston and Clinical Professor of Business Strategy in the Kellstadt MBA Program.

Kenneth Charles and Matthew Phair sat on opposite sides of the conference room table, scratching away on their legal pads. As one voice after another leaked from the starfish-shaped phone, Matthew, the CFO of First Rangeway Consulting, took copious notes. Kenneth, the CEO, energetically doodled animals, as he often did when alone or with close associates. "During a conference call, no one can tell that you're drawing a dog," he liked to say, beaming approval on those who got the joke.

Doodling helped Ken focus, and his pen skittered across the paper as he listened to Victoria Michaels, a top-ranked sell-side analyst covering professional services stocks. Victoria was commending First Rangeway for its cost-control work and consequent increase in earnings. "But revenues are still flat quarter over quarter," she went on in a clipped voice that just missed being an English accent. "When and from where do you see revenue growth, and at what levels?"

"You know, Victoria, we've been holding client projects steady over the past year," Ken replied. "But proposal activity and engagement types point to an uptick next quarter, when corporate spending for our services should really kick in."

"We've already seen signs that we'll easily reach the targets we mentioned earlier," added Matt, jotting a number in the margin and drawing a box around it. "To reiterate, we stated a 10% quarter-over-quarter increase beginning next quarter."

The next question, from Kevin Danville of LRL Investments, was tougher. "Could you comment on how fruitful the business process outsourcing space might be over and above traditional consulting revenues?" Kevin asked, as Matt etched "BPO" into his paper, followed by three question marks.

Ken racked his brain for a response that would sound both encouraging and noncommittal. Not finding one, he settled for noncommittal. "We are investigating multiple revenue streams as we have in the past," he said, "and are prepared to move into those that complement our consulting work. However," he added, cringing inwardly at the necessarily oblique language, "it would be premature at this point to make any

specific announcement."

That answer wasn't what the analysts wanted to hear, he knew. Although Ken had been a partner at First Rangeway since 1997—two years before the 2,800-employee consultancy's IPO and subsequent market triumph—he had been CEO for less than a year, and the quarterly analyst calls still made him sweat. On the day he accepted the top job, his wife, Cara, had presented him with a plaque that read simply, "All Things to All People," and for months it held pride of place on his office wall. Lately, however, the words seemed more like a command than a pleasantry, and Ken had banished the plaque to the nether regions of a desk drawer.

Thirty question-filled minutes later, the call operator finally rang down the curtain. Ken capped his pen and leaned back, puffing out his cheeks in relief. Matt tapped the on/off button on the speakerphone to make sure they were clear. The reassuring hum of a dial tone filled the air.

"Have I ever mentioned how much I love analyst calls?" said Ken, as Matt gathered his papers into a neat stack. "Because if I did, I was lying. How do you think my BPO response went over?"

Matt shrugged. "Kevin didn't mention Locklin-Ladd Associates by name, but you know that's who he meant. They've been all over outsourcing, and they've hired some top guns to make it happen. There's money there, Ken. It could easily mean 30% growth for us for several years. Plus, Mark and Amy and some other partners have serious experience in that area."

"It would also mean a ton of up-front capital," replied the CEO. "But yes, it's worth considering." Certainly the prospect was tantalizing, and Ken couldn't deny feeling that residual dream-big itch, which, without access to heaps of money, the company was unlikely to scratch. None of the new markets First Rangeway was contemplating were frivolous; all represented directions in which its customers were heading. Five years ago, pursuing such opportunities would have been a no-brainer. But after the market's fall, it was definitely a brainer. For that reason and others, Ken was no longer convinced that public status remained a compelling proposition. "Of course," he mused out loud, "the whole equation changes if we..."

**"We are profitable. Proposal interest is up. The economy is up, and we're in a great position to take advantage of that. Without the IPO, we wouldn't have had these gains."**

"If we go private," concluded Matt. "It's item number one at the next management team meeting—and the big item at the board meeting." Leaning across the table, he tore the top sheet off Ken's pad and eyeballed it. "Nice giraffe," he commented, tossing the paper back toward the CEO.

### A Troubling Exchange

An hour later in the lobby, Ken stopped by the reception desk to order a cab and snitch a handful of Hershey's Miniatures from the cut-glass jar. "I thought you were on a diet?" said Lindsey Carruthers, coming up behind him. One of First Rangeway's rising stars, Lindsey was also Ken's self-appointed conscience. The CEO raised his hands in mock surrender and put back the candy. The two walked out together through the big glass double doors.

“I’m glad I ran into you,” said Ken, scanning the street for his taxi. “I’m off to your alma mater in Boston to do a presentation at the B-school—trying to rustle up some top-notch MBAs. You’ve done a lot of recruiting there, right? What will they throw at me?”

Lindsey thought for a moment. “Well, they’re still interested in First Rangeway, definitely,” she said. “But I had lunch with a couple potential recruits last week, and they were concerned about the stock price. I’m not surprised, because we’re so option- and stock-based, but they asked questions about the stock’s potential I really couldn’t answer. Want me to come with?”

“No, you just enjoy your lunch,” said Ken, as his cab pulled up. Through the window, he watched Lindsey walk toward the corner salad bar. She was one of his best people and would probably make partner soon. In its glory years, First Rangeway had recruited a lot of great people from her school, many attracted by those very stock options that were giving this crop of MBAs the willies.

And why shouldn’t options make them uncomfortable, Ken thought. First Rangeway’s price was more than 80% off its highs, and volatile to boot. With the precipitous drop in global business, they’d downsized dramatically, laying people off, freezing hires. But things were looking up now. It was time to refocus on the people—on finding new blood to drive the business and hanging on to those partners who had made it successful so far.

Unfortunately, they would have to divert some of those new hires toward activities that would do nothing to build the company. Before that morning’s analyst call, Matt had laid out the resources First Rangeway needed to stay up to snuff with Sarbanes-Oxley, SEC filings, and other cost-of-being-public requirements. The business was becoming more complicated: Innovative revenue and gain-sharing agreements with clients had made financial reporting a mare’s nest. Matt estimated they’d need 12 more people, including in-house attorneys, audit staff, and dedicated systems folk to upgrade software for internal controls. He had ballparked the total at over a million dollars annually.

Cutting corners wasn’t an option, Ken knew. Anything remotely questionable about their reporting could hinder a potential rebound in stock price or—worst of worst-case scenarios—land him and Matt in jail for willfully certifying bad financial statements. “Neither of us wants to sign off on those filings unless they’re 100% kosher,” Matt had reminded him. “And by the way, we could also use two or three more bodies in investor relations.”

The cab lurched, and a wave of nausea seized the CEO. Car sickness, nerves, or an empty stomach? Ken unwrapped the single chocolate bar he had secreted in one of his pockets and popped it into his mouth.

### Too Bullish to Bear?

The presentation to the MBAs went swimmingly. Ken was justifiably proud of his oratory skills: The ability to motivate people was one factor in his professional rise. So inspirational was the CEO’s description of his company’s starry future that he was tempted to run out and apply for a job at First Rangeway himself.

Crossing the quad afterward, Ken noticed a tall woman in head-to-toe Brooks Brothers striding ahead of him. He quickened his pace and a moment later fell in beside Nancy Westview. Nancy was a prominent business personality, adored by the press, and had more pies than she had fingers to put in them. She was on campus that day guest lecturing at an entrepreneurship seminar. “I went in with six pages of notes and came out with 600 pages worth of business plans,” she told Ken, waving a thick folder. “My

favorite so far is an exercise service for small pets."

But small talk was a very small part of Nancy's conversational repertoire. One of First Rangeway's original investors (she still held a sizable position) and a member of its board, she soon switched to a subject of vital interest to the shareholders—and, most particularly, to Nancy Westview. "I know there's been a lot of talk recently about going private," she said, stepping neatly off the path to avoid a young professor on a Segway, "and I think it would be a mistake. The major indexes are all up for the year, and our stock is up twice that. The economy looks as if it's gaining steam, and I don't want it leaving the station without us."

Ken listened patiently as Nancy launched into a tutorial on the state of technology consulting. As expected, it was a study in upsides. Nancy's estimates of potential revenues from outsourcing slightly exceeded Matt's, and she knew from her prodigious networking that some of First Rangeway's competitors were entering other promising areas. There was also talk of industry consolidation: Nancy named three potential acquisitions that she deemed "tasty."

"There is no way we can talk about going private without taking these things into account—serious account," said Nancy, as they emerged from the grassy enclave onto a revving-up-for-rush-hour street. "I want to know what we're doing about these opportunities. The board meeting is Wednesday. I expect to hear answers."

"And answers you will have, Nancy," promised Ken, the first words he'd been able to get out in almost ten minutes. "Matt and I are still in research mode, but a direction is becoming clear." The last bit wasn't true, but Nancy, he knew, had a hate-hate relationship with ambiguity. Anxious to avoid a further monologue, he handed her into the first cab that pulled up, declining her offer to share the ride. As Ken raised his hand to hail another taxi, a bus rolled by, belching exhaust at him.

**Public Enemy Number One**

Ken arrived at his club at ten minutes past seven and hurried to the restaurant. The floor-to-ceiling windows were awash with night, and waiters slipped unobtrusively from table to table, lighting candles. Greg O'Keefe was already seated in their usual spot. Ken dropped into his chair and brushed away the leather-bound menu being proffered by a waiter. "Flame-grilled rib eye, black-and-blue. No potatoes. No bread. Glass of the house red."

"Atkins, Ken?" asked Greg, raising an eyebrow.

"Ten pounds so far," replied Ken, not mentioning that two of those ten had recently made a reappearance. "And how about you?" he asked, noticing the tautness of his former colleague's jacket across his increasingly barrel-like chest. "Evidence of life in the slow lane?"

"Nothing slow about it," said Greg. "I've got plenty of consulting work, and, seeing as I'm a bred-in-the-bone consultant, that tends to make me happy. Can you say the same?"

"Of course," replied Ken, slightly annoyed. "First Rangeway is still a consulting firm through and through."

"Oh yes?" said Greg. "And a consulting firm through and through needs access to all that capital why? Consulting is a cash-based business, old friend. The math is simple: If 200 partners generate $200 million in profits, they each make a million dollars. All being

public does is dilute that."

Ken sighed, wondering how they had managed to get off on this track so early in the evening. They'd been having the same argument for three years, beginning on the day Greg resigned from First Rangeway in the second wave of partner defections after the business downturn. Ken had bought into the former CEO's ambitious vision. But Greg saw only what was lost: an unwavering focus on consulting.

Greg had launched into his by-now familiar interpretation of events. "Because we were so fantastic at what we did, we were able to pull off a successful IPO, which gave us lots of money to spend on things other than what we did and were fantastic at. It's a catch-22 or a perfect storm or a tipping point...I can never remember which. I'm not arguing there isn't value in floating a small percentage of stock and gaining liquidity. But after that, what's the use?" he continued as the waiter placed a couple of green salads in front of them. He paused to fork some arugula into his mouth. "Private may not be sexy, but these days public isn't anything to get hot and bothered about either. The privately owned consulting model has been working for decades. Decades from now, it will still be working."

Ken scooped his croutons onto a spoon and deposited them onto his bread plate. "Look, Greg, do I really need to state the obvious here? We are profitable. Proposal interest is up. The economy is up, and we're in a great position to take advantage of that. Without the IPO, we wouldn't have had these gains. And if we go private now, we'll miss out on a lot of opportunities that the board—that the board and I—see in the coming year." He paused, realizing he was repeating some of the same rah-rah rhetoric he'd used on the MBA candidates a few hours earlier. "Anyway, you know the door is always open if you want to come back," he said more gently.

"Well, Ken, if anyone can make it work, it's you," said Greg, conciliatorily. "Personally, I think First Rangeway's gonna do great things. But it's going to have to do them without me." He smiled. "Unless of course, you change your mind about the private thing. Are you going to eat those croutons?"

**P.O.'d**

Closing the door of his den to stifle the sound of the Cartoon Network marathon unfolding in the next room, Ken sat at his desk and switched on the PC. He had an hour before the Saturday routine of soccer games and birthday parties kicked in, and about 100 e-mails to plow through. One from his brother in Maine. One from Amazon announcing that a recent order was on its way.

The third e-mail was from Tracy Durham, president of Bardwell Incorporated, and a longtime client of Ken's. The previous year, Bardwell had initiated a multimillion-dollar engagement, and the e-mail bore glad tidings of its progress. Tracy reported that she was pleased with the Rangeway partner running the project. The team of employees from both companies had proven innovative and collaborative, its results solid. "I do, however, have one issue I'd like to discuss," the e-mail concluded. "Call me when you can."

Ken checked the date and time stamp: 10/11/03 08:32 am. Tracy was hard at it on a Saturday morning; it wouldn't hurt to let her know Ken was hard at it, too. Anyway, Ken couldn't enjoy the day knowing there was some problem out there preparing to bite. He had Tracy's cell number and had been instructed to use it any time. Ken picked up the telephone.

Two rings. "Hello?"

“Hey, Tracy, I hope it’s OK to call you on a weekend...”

“Not a problem, Ken. I guess you saw my e-mail. As I said, things in general are going well. But some of our people have complained that some of your people are pushing them too hard to reach certain milestones on the programming project before end of quarter.”

Unconsciously, Ken picked up a pad and began doodling. Bardwell’s compensation and culture, Tracy was explaining, simply weren’t designed to accommodate 75-hour-plus workweeks. And the lead partner—whose energy and expertise she had praised in the e-mail—had been a little too aggressive about collecting on a bill (“and I let him know it, too,” said Tracy, sounding peeved.) “I don’t object to wrapping things up quickly,” she continued. “But all of the pressure makes us wonder, Whose quarter are we trying to make: Bardwell’s or Rangeway’s?

“Making a quarter can’t help a firm as much as losing a client could hurt it,” Tracy said. “Right now this is not a huge thing.” She paused, waited a beat. “Let’s just make sure it doesn’t become one.”

Ken’s pen was leaking, leaving moist blotches all over the page. This wasn’t the first time a project team had been pressured in the name of quarterly revenue targets. And clients weren’t the only ones hurting: His own employees were complaining of burnout as well. “I promise I’ll speak to the engagement partner personally,” he said hastily. “You’ve known me a long time, Tracy. You know we’ll do right by you.”

**This wasn’t the first time that clients had been pressured in the name of quarterly revenue targets. And Ken’s own employees were complaining of burnout as well.**

As Ken hung up, a chorus of voices summoned him into the living room to join the search for cleats.

**Time to Yield?**

On Monday morning, Ken’s conversation with the lead partner on the Bardwell engagement went as well as could be expected. (“Did I really use the word ‘unseemly’?” he asked himself later.) By 11 am, the CEO had moved on to other things. Specifically, he was back in the conference room with Matt, the speakerphone between them. Only this time, it was channeling the voice of investment banker Charlie Gremley.

“Going private is a pretty straightforward process,” Charlie was explaining, “but that doesn’t mean it’s easy. If you plan to raise capital from financial sponsors, we can help you do that. If you’re looking to raise the capital yourselves, we can help there, too. We’ll start running valuation models now if you like. Needless to say, we’re talking about something in excess of a couple of hundred million dollars.”

As the investment banker spoke, Ken speculated on just how much money the partners could or would raise if they went this route. After First Rangeway’s IPO, the owners’ net worth skyrocketed, and many had sold some piece of their ownership. But others held on as paper gains gave way to paper losses. Then Charlie started to enumerate the people they’d need to steer the deal, and Ken pictured attorneys and accountants swarming over the company’s headquarters like ants on a dropped popsicle. Talk about a distraction from the business...and the *cost*...

"There's something extremely *Alice Through the Looking Glass* about all this," remarked Matt as he switched off the phone. "I recall sitting right here five years ago listening to Charlie walk us through the IPO. Remember how helpful he was?"

"What I remember is how *encouraging* he was," replied Ken, with a touch of sourness. "Did I mention how much I love investment bankers? Because if I did..."

"Yes, I know, then you were lying," finished Matt.

**Private Aye, or Nay**

The management team meeting convened with the introduction of a tray of bagels and jugs of fresh-squeezed juice. It was 7:30, Tuesday morning. Ken gazed around the executive boardroom: The company's brightest and most seasoned players gazed back at him. "So," said the CEO, "may I direct your attention to the elephant in the room?"

Ken had ambitious goals for this meeting. Facing one of the most important decisions they would ever make, the team members couldn't simply react to current market conditions or focus on their own careers and wealth. Rather, he needed them to step into the ring for a little out-of-the-boxing. They had to consider the issue from many different perspectives.

The CEO nodded toward Laura Leadbetter, a senior partner sipping a tall cup of Starbucks's strongest. "Laura, if a client of our own strategy consulting group were wrestling with this issue, how might we advise them?"

As a 20-year veteran of business, Laura had facilitated more executive retreats than she could throw a creativity consultant at. Still, she mulled over the question a while before responding. "We all know there are big-money implications to either direction," she said finally. "We want to do what is financially best for the business as a whole and, yes, for us individually. But—forgive me if I get a little Business Strategy 101 here—wealth comes through *fulfilling client needs*. So if I were advising a business, that's what I would say: First, define your clients' needs, and then align your genuine assets and business strategy, including capital structure, accordingly."

That was the right answer, and Ken smiled his approbation. Customer focus had always been the CEO's mantra. The team could paint this picture any number of ways, but First Rangeway's clients had to provide the frame. Confident, now, that the discussion would proceed toward the best possible conclusion, Ken threw out this challenge:

"Being a publicly traded company affects us in almost everything we do. We have to consider not only what kind of business this can be, but also what it *should* be. What we are discussing now, and what I will present to the board tomorrow, is no less than the future of First Rangeway. Let's talk."

---

### HBR Case Commentary

## Should First Rangeway remain public or go private?

**Four commentators offer expert advice.**

---

**Chan Suh** is cofounder, CEO, and chairman of Agency.com, an interactive marketing and technology company headquartered in New York. Agency.com went public in 1999 and private in 2001. Suh can be reached at **chan@agency.com**.

Ken may not want to hear this, but I see no compelling financial reasons why First Rangeway should go private. The business opportunities before it are attractive. The company is profitable, and its cash flow appears healthy. (When my company, Agency.com, went private, the most important factor in my decision was the cash flow beyond 24 months.) So long as First Rangeway can remain profitable and keep customers happy, it should do just fine as a public company in the long term.

Going private, by contrast, could be hugely disruptive. The biggest challenge lies not with lawyers and accountants but rather with Ken's own people. In a service company, as I'm sure Ken must know, people are *everything*. First Rangeway has been attracting top talent with a heavy reliance on the lure of options. If those options disappear because the company goes private, how will management induce those folks to stay? Options weren't a disproportionate part of compensation at Agency.com, but we still had to come up with a bonus program to retain our key staff. And even then we lost a few, including our CFO. It's not a question of loyalty. Those people signed on for one thing, and they ended up with something else.

**If First Rangeway stays public, I'm not sure Ken is its best possible CEO. If you don't enjoy running a public company, then you shouldn't be doing it.**

But if First Rangeway stays public, I'm not sure Ken is its best possible CEO. If you don't enjoy running a public company, then you shouldn't be doing it. Ken should have known the realities going in: the emphasis on short-term results, the scrutiny. With every quarter comes that call of reckoning, and even when your results are bad or the questions are difficult, you have to enjoy at least the challenge of answering those questions. I actually did enjoy it, as well as the tremendous discipline required to meet expectations about reporting and performance.

As a public-company CEO, you've also got to be extremely straightforward. The analysts didn't like the way Ken hedged on his response about business process outsourcing, and I don't blame them. He should have just said, "Yes, we've thought about it. No, we haven't made any decisions yet." There's a large difference between *being* a public-company CEO and *playing* a public-company CEO. The former tells the hard truths and takes his lumps; the latter spins everything, like a politician. I think Ken is still *playing* a public-company CEO. He's ambivalent about communicating with the shareholder base, and that's a huge part of his job.

To be fair, he also seems to regret all the time he's spending away from his customers. Public companies have two sets of masters—shareholders and customers—and their CEOs must tend to both. When Agency.com was public, I spent about 40% of my time on shareholder-related matters; now that's down to 10%, which is great. If First Rangeway is having trouble focusing on customers because its people are fixated on the stock market, then that might be a reason to privatize. That's another people issue peculiar to service companies: When your sellable goods expire every hour, you can't afford to have your people distracted from the client work.

If Ken insists on taking the company private, the first thing he has to do is start kissing some deep-pocketed frogs. And he must keep in mind that, whether he gets the money from existing partners or from new sources, those investors may be with him for a long time. And they won't restrict their phone calls to once a quarter. Or even to business

hours.

So, my recommendation stands. Ken, keep the company public, and learn to love the job. It can be very rewarding.

---

**Ed Nusbaum** is the chief executive officer of Grant Thornton, a global accounting firm focused on midsize private companies and mid-cap public companies. He is also a member of the Financial Accounting Standards Board Advisory Council. He can be reached at **Edward.Nusbaum@Gt.com**.

---

**In considering whether or not to stay public, Ken should worry not only about attracting the new talent he needs to drive the business but also about retaining the talent he already has.**

Going private is an attractive scenario for First Rangeway, assuming that it is able to raise the necessary cash. (Charlie Gremley, the investment banker, sounds optimistic on that score.) A number of factors support that judgment.

As Ken has clearly discovered, it is easier to manage important decisions when you are not under public scrutiny. Private companies worry about profits, of course, but the pressure surrounding quarterly reporting is obviously hurting First Rangeway's customers. It has also begun to take its toll on employees, who are working long hours and complaining about burnout. The analyst calls are creating stress for management and are proving a distraction from the company's core business.

In addition, the impact of new legislation and reporting requirements on a company of this size is enormous. I would estimate that it costs First Rangeway somewhere between $250,000 and $1 million a year to remain public.

The stock price for a relatively small technology consulting firm such as First Rangeway is also likely to be very volatile in the future, and that may cause major financial and business disruptions. It's not surprising that many of Ken's best people were lured to First Rangeway by stock options. Options, as we know, are great when employees think their value is going to rise. But if it doesn't, they are likely to become discouraged. In considering whether or not to stay public, Ken should worry not only about attracting the new talent he needs to drive the business but also about retaining the talent he already has.

Finally, the leadership team doesn't seem to be chomping at the bit over the prospect of mergers or acquisitions, so First Rangeway is under little pressure to use its stock as currency.

If First Rangeway does decide to privatize, however, it will need to feel secure about its profits as it goes forward. The company is going to have to raise a couple hundred million dollars in financing—presumably in debt financing—and that will have an interest cost. If the company's profits exceed that interest cost, then the difference will flow directly to First Rangeway's partners or private equity holders. But if there are no profits, or if cash flow is not sufficient to make the principal and the interest payments, it will put a tremendous burden on the company. Analysts can and do get angry over poor performance, and Ken is understandably concerned about that. But private debt holders can put you out of business.

The final deciding factor in this scenario is First Rangeway's board. I believe that the

board will support a privatization strategy if such a strategy makes sense from both an economic and a business standpoint. Its members have a fiduciary responsibility to do what is in the best interests of the shareholders, and Ken can make a strong case that, because of the volatility of the market and the industry, it is in the shareholders' best interests to be bought out. If Ken is convincing on that point, even Nancy Westview, the board member who strongly advocates that First Rangeway remain public (and whose opinions may not be representative of those of the other members), will be unable to effectively object to the company pursuing a privatization strategy.

First Rangeway Consulting could undoubtedly continue to operate as a public company, and Ken and Matt still need to run some economic models and draw up their own list of pros and cons before making any critical decisions. But if I were in their shoes, I would soon begin the push toward going private.

---

**John J. Mulherin** is the president and chief executive officer of the Ziegler Companies, a boutique investment-banking firm serving the not-for-profit sectors of senior living, hospitals, education, and churches. The company is based in Milwaukee. Mulherin can be reached at **jmulherin@ziegler.com**.

---

**What might work for First Rangeway is to remain public but list on the Pink Sheets, a primarily over-the-counter mechanism for trading companies that are not on the major exchanges.**

My business, the Ziegler Companies, traded for ten years on the American Exchange, and we would still be trading there today if it weren't for the passage of Sarbanes-Oxley. Yes, the system needs real reform with teeth in it. But one size does not fit all, and micro-caps are suffering disproportionately.

First Rangeway's CFO, Matt, put a $1 million price tag on complying with new and existing regulations, and he didn't even address the high level of distraction Sarbanes-Oxley foments. Had Ziegler remained on the Amex under Sarbanes, we would have had to recreate our audit committee practices and charter. These mandates would also have meant adding numerous meetings and committees, as well as implementing some costly financial-risk and compliance processes that overlap with our existing and more-efficient processes.

Our start-up costs for compliance are estimated at $700,000; we believe that ongoing costs would have run $400,000 annually. Taken together, that's 20% to 25% of our bottom line for 2003. It sounds as though First Rangeway would be similarly hit.

What Ziegler ultimately chose to do—and what might work for First Rangeway as well—is to remain public but list on the Pink Sheets, a primarily over-the-counter mechanism for trading companies that are not on the major exchanges. Long considered the refuge of penny stocks and fallen angels, the Pink Sheets, which is electronic and Internet-accessible, has lately attracted a growing number of reputable firms and strong performers. As many as five to ten companies a week are signing on specifically to avoid the costs imposed by Sarbanes-Oxley. However, many people are unaware of the service's improvements and remain suspicious of its reputation, so Ken may have difficulty persuading his board that the Pink Sheets is an option.

But the first question that Ken faces isn't whether the Pink Sheets is a better venue for staying public than First Rangeway's current exchange. Rather, it is, who are First Rangeway's shareholders, and what is the company really doing for them?

The CEO offers little insight into how he intends to build shareholder value, and that may be because he doesn't have much in that way to offer. First Rangeway, after all, is a consultancy. That means its revenues are largely nonrecurring, and it has neither significant tangible assets such as inventory, nor intellectual property such as patents. At its core, the company is comprised of a group of people laboring together for their mutual benefit. Is there really a compelling reason for a company with this business model to be public at all? Some members of my executive team argued the very same thing about Ziegler when we were debating its privatization last fall.

I would also question whether privatization is the most important issue for debate. During my tenure at Ziegler, I have spent less time mulling over our capital structure than our business strategy. Is our strategy working? If not, how do we fix it? Do we close existing businesses? Start new ones? Redirect our resources? Improve our marketing? Ken appears to be focusing most of his attention on the public-private quandary instead of on those issues most likely to build sustainable value for shareholders.

If Ken believes that First Rangeway is truly creating value, then by all means it should remain public (but consider listing on the Pink Sheets in order to escape the excessive burdens of Sarbanes-Oxley). If he can't make that argument—and I suspect he can't—then privatizing is the better choice.

---

**Tom Copeland**, formerly the chair of the finance department at UCLA, is the managing director of corporate finance at the Monitor Group, a management consulting firm based in Cambridge, Massachusetts. He is coauthor of *Real Options: A Practitioner's Guide* (Texere, 2001). He can be reached at **Tom_Copeland@monitor.com**.

---

A consulting firm functions best as a partnership because it depends on creative solutions to high-level problems. Because information is inalienable (once shared it cannot be returned to its owner) and because new ideas must be quickly disseminated, a flat structure based on trust works best. From an organizational standpoint, therefore, First Rangeway's IPO did the company no favors. It also caused significant increases in agency costs (monitoring, public reporting, performance expectations, and incentive structure) that may have driven a wedge between the public shareholders who own but do not manage the firm and the remaining post-IPO partners who manage but do not own it.

First Rangeway's IPO most likely transferred wealth from junior to senior partners, who owned a disproportionately large percentage of the firm. In addition, by creating a new class of outside owners, the IPO raised agency costs in three ways. First, the outsiders need to monitor management: First Rangeway spends $1 million annually on SEC compliance and related charges. Actual opportunity costs will be a significant multiple of that. Second, senior partners' incentive to push harder evaporates because they have essentially cashed out. Third, the remaining partners' incentive declines substantially because they now keep only a fraction of the fruit of their efforts. Things would have been different had the IPO money been reinvested in growth, but that didn't seem to happen.

The $200 million of profit would have been paid out as additional bonuses when the firm was a partnership. Senior partners created a wealth transfer and initiated agency costs by selling the claim on the stream of profits to outside owners. Post-IPO, it must have become harder to attract and retain top talent because the percentage of the total pie allotted to the partnership declined, as did the size of the pie.

While debating what First Rangeway's status should be in 2004, Ken and Matt should understand what might have been done differently in 1999. Back then, the senior partners should have sold their shares to the junior partners rather than to the public. The firm's charter should have separated ownership from control within the ranks of the partnership to solve a classic intergenerational problem: transfer of ownership. This can be facilitated by separating voting rights from stock ownership. When junior consultants are elected to partnership, they must buy shares from senior partners, who are required to sell. Over time, the number of shares owned by individual partners increases, then declines as retirement approaches. The number of votes, meanwhile, increases with seniority. Thus, control rests with senior partners, but their economic incentive to sell the firm to outsiders diminishes to zero as they prepare to retire. Capital for growth should be raised primarily via borrowing.

If First Rangeway's remaining partners can eliminate the agency problems created by the IPO, then the firm's value after privatization will exceed the buyback price. Monitoring costs will disappear, and internal incentives will improve. If the partners cannot resolve those issues, then the public-private dilemma will continue to haunt them. With a second IPO likely, the agency cost would remain and privatization would create little or no value.

**If First Rangeway's remaining partners can eliminate the agency problems created by the IPO, then the firm's value after privatization will exceed the buyback price.**

The remaining partners must decide whether it is easier to exceed expectations as a publicly held company or as a partnership. Will increased incentives improve consultants' performance? I believe so. The partners must also be sure that they can improve current expectations of the key value drivers: growth and operating margins. If they have to borrow to finance the buyback, they may have a debt burden for years to come.

---

Reprint Number R0402B

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

# Executive Summaries

## The HBR List

**Breakthrough Ideas for 2004**

Reprint R0402A

HBR's editors searched for the best new ideas related to the practice of management and came up with a collection that is as diverse as it is provocative. The 2004 HBR List includes emergent concepts from biology, network science, management theory, and more. A few highlights:

**Richard Florida** wonders why U.S. society doesn't seem to be thinking about the flow of people as the key to America's advantage in the "creative age." **Diane L. Coutu** describes how the revolution in neurosciences will have a major impact on business. **Clayton M. Christensen** explains the law of conservation of attractive profits: When attractive profits disappear at one stage in the value chain because a product becomes commoditized, the opportunity to earn attractive profits with proprietary products usually emerges at an adjacent stage.

**Joel Kurtzman** asks where the "stupid money" is headed. **Robert Sutton** reports on the emergence of "no asshole"—excuse the crude language—rules. **Daniel H. Pink** explains why the master of fine arts is the new MBA. **Joseph Fuller** asks whether the useful life of the public company is over. **Herminia Ibarra** describes how companies can get the most out of managers returning from leadership-development programs. **Iqbal Quadir** suggests a radical fix for the third world's trade problems: Get the World Bank to lend to *rich* countries so that there are resources for retraining workers in dying industries.

**Clay Shirky** describes how technology will allow companies to get vast amounts of real-time data from social networks. **Thomas A. Stewart** shows how jokes constitute a trove of information about what's really going on in a company. And **Ray Kurzweil** makes the case that while high-tech stocks have seesawed, technology has marched steadily forward—and will continue to do so.

## HBR Case Study

**Give My Regrets to Wall Street**
*Mark L. Frigo and Joel Litman*

Reprint R0402B

It's been only four years since First Rangeway Consulting went public, but to CEO Kenneth Charles, it seems like a lifetime. In the grand old days of its IPO, the company couldn't grow fast enough to meet customer demand; top talent answered the siren call of its options; and the owners gleefully watched their wealth escalate along with the stock.

Post-bubble, First Rangeway's stock is down 80% from its peak value, potential hires are wary, and the company feels beleaguered by Sarbanes-Oxley and SEC requirements. In addition, Kenneth worries that pressure to make quarterly results is compromising his relationship with customers. And did we mention that he loathes analyst calls?

That said, First Rangeway's stock price is on the mend, and there are some extremely tempting opportunities on the horizon that will require a heap of capital. Rangeway's CFO speculates that these opportunities could mean as much as 30% growth over the next several years.

Should First Rangeway remain public or go private? What are the advantages and disadvantages of each alternative? Four experts weigh in on this fictional case study: Tom Copeland, the former chair of UCLA's finance department and managing director of corporate finance at Monitor Group; Chan Suh, the cofounder, CEO, and chairman of Agency.com; Ed Nusbaum, the CEO of Grant Thornton; and John J. Mulherin, the president and CEO of the Ziegler Companies.

## Features

#### Measuring the Strategic Readiness of Intangible Assets

*Robert S. Kaplan and David P. Norton*

Reprint R0402C; *Harvard Business Review* OnPoint edition 5887;
*Harvard Business Review* OnPoint collection 5933 "Focusing Your Organization on Strategy—with the Balanced Scorecard, 2nd Edition"

Measuring the value of intangible assets such as company culture, knowledge management systems, and employees' skills is the holy grail of accounting. Executives know that these intangibles, being hard to imitate, are powerful sources of sustainable competitive advantage. If managers could measure them, they could manage the company's competitive position more easily and accurately.

In one sense, the challenge is impossible. Intangible assets are unlike financial and physical resources in that their value depends on how well they serve the organizations that own them. But while this prevents an independent valuation of intangible assets, it also points to an altogether different approach for assessing their worth.

In this article, the creators of the Balanced Scorecard draw on its tools and framework—in particular, a tool called the strategy map—to present a step-by-step way to determine "strategic readiness," which refers to the alignment of an organization's human, information, and organization capital with its strategy. In the method the authors describe, the firm identifies the processes most critical to creating and delivering its value proposition and determines the human, information, and organization capital the processes require.

Some managers shy away from measuring intangible assets because they seem so subjective. But by using the systematic approaches set out in this article, companies can now measure what they want, rather than wanting only what they can currently measure.

**Worse Than Enemies: The CEO's Destructive Confidant**
*Kerry J. Sulkowicz*

Reprint R0402D

The CEO is often the most isolated and protected employee in the organization. Few leaders, even veteran CEOs, can do the job without talking to someone about their experiences, which is why most develop a close relationship with a trusted colleague, a confidant to whom they can tell their thoughts and fears.

In his work with leaders, the author has found that many CEO–confidant relationships function very well. The confidants keep their leaders' best interests at heart. They derive their gratification vicariously, through the help they provide rather than through any personal gain, and they are usually quite aware that a person in their position can potentially abuse access to the CEO's innermost secrets.

Unfortunately, almost as many confidants will end up hurting, undermining, or otherwise exploiting CEOs when the executives are at their most vulnerable. These confidants rarely make the headlines, but behind the scenes they do enormous damage to the CEO and to the organization as a whole. What's more, the leader is often the last one to know when or how the confidant relationship became toxic.

The author has identified three types of destructive confidants. The *reflector* mirrors the CEO, constantly reassuring him that he is the "fairest CEO of them all." The *insulator* buffers the CEO from the organization, preventing critical information from getting in or out. And the *usurper* cunningly ingratiates himself with the CEO in a desperate bid for power. This article explores how the CEO–confidant relationship plays out with each type of adviser and suggests ways CEOs can avoid these destructive relationships.

**Getting IT Right**
*Charlie S. Feld and Donna B. Stoddard*

Reprint R0402E; *Harvard Business Review* OnPoint edition 5905;
*Harvard Business Review* OnPoint collection 5895 "Making IT Matter"

Modern information technology started four decades ago, yet in most major corporations, IT remains an expensive mess. This is partly because the relatively young and rapidly evolving practice of IT continues to be either grossly misunderstood or blindly ignored by top management. Senior managers know how to talk about finances because they all speak or understand the language of profit and loss and balance sheets. But when they allow themselves to be befuddled by IT discussions or bedazzled by three-letter acronyms, they shirk a critical responsibility.

In this article, the authors say a systematic approach to understanding and executing IT can and should be implemented, and it should be organized along three interconnected principles:

*A Long-Term IT Renewal Plan Linked to Corporate Strategy.* Such a plan focuses the entire IT group on the company's overarching goals during a multiyear period, makes appropriate investments directed toward cutting costs in the near term, and generates a detailed blueprint for long-term systems rejuvenation and value creation.

*A Simplified, Unifying Corporate Technology Platform.* Instead of relying on vertically oriented data silos that serve individual corporate units (HR, accounting, and so on), companies adopt a clean, horizontally oriented architecture designed to serve the whole

organization.

*A Highly Functional, Performance-Oriented IT Organization.* Instead of functioning as if it were different from the rest of the firm or as a loose confederation of tribes, the IT department works as a team and operates according to corporate performance standards.

Getting IT right demands the same inspired leadership and superb execution that other parts of the business require. By sticking to the three central principles outlined in this article, companies can turn IT from a quagmire into a powerful weapon.

**How to Have an Honest Conversation About Your Business Strategy**
*Michael Beer and Russell A. Eisenstat*

Reprint R0402F; *Harvard Business Review* OnPoint edition 5925;
*Harvard Business Review* OnPoint collection 5917 “Honesty Is the Best Strategy”

Too many organizations descend into underperformance because they can’t confront the painful gap between their strategy and the reality of their capabilities, their behaviors, and their markets. That’s because senior managers don’t know how to engage in truthful conversations about the problems that threaten the business—and because lower-level managers are afraid to speak up. These factors lie behind many failures to implement strategy. Indeed, the dynamics in almost any organization are such that it’s extremely difficult for senior people to hear the unfiltered truth from managers lower down.

Beer and Eisenstat present the methodology they’ve developed for getting the truth about an organization’s problems (and the truth is always embedded within the organization) onto the table in a way that allows senior management to do something useful with it. By assembling a task force of the most effective managers to collect data about strategic and organizational problems, the senior team sends a clear message that it is serious about uncovering the truth. Task force members present their findings to the senior team in the form of a discussion. This conversation needs to move back and forth between advocacy and inquiry; it has to be about the issues that matter most; it has to be collective and public; it has to allow employees to be honest without risking their jobs; and it has to be structured. This direct feedback from a handful of their best people moves senior teams to make changes they otherwise might not have.

Senior teams that have engaged in this process have made dramatic changes in how their businesses are organized and managed—and in their bottom-line results. Success that begins with honest conversations begets future conversations that further improve performance.

**Launching a World-Class Joint Venture**
*James Bamford, David Ernst, and David G. Fubini*

Reprint R0402G

More than 5,000 joint ventures, and many more contractual alliances, have been launched worldwide in the past five years. Companies are realizing that JVs and alliances can be lucrative vehicles for developing new products, moving into new markets, and increasing revenues. The problem is, the success rate for JVs and alliances is on a par with that for mergers and acquisitions—which is to say not very good.

The authors, all McKinsey consultants, argue that JV success remains elusive for most companies because they don't pay enough attention to launch planning and execution. Most companies are highly disciplined about integrating the companies they target through M&A, but they rarely commit sufficient resources to launching similarly sized joint ventures or alliances. As a result, the parent companies experience strategic conflicts, governance gridlock, and missed operational synergies. Often, they walk away from the deal.

The launch phase begins with the parent companies' signing of a memorandum of understanding and continues through the first 100 days of the JV or alliance's operation. During this period, it's critical for the parents to convene a team dedicated to exposing inherent tensions early. Specifically, the launch team must tackle four basic challenges. First, build and maintain strategic alignment across the separate corporate entities, each of which has its own goals, market pressures, and shareholders. Second, create a shared governance system for the two parent companies. Third, manage the economic interdependencies between the corporate parents and the JV. And fourth, build a cohesive, high-performing organization (the JV or alliance)—not a simple task, since most managers come from, will want to return to, and may even hold simultaneous positions in the parent companies. Using real-world examples, the authors offer their suggestions for meeting these challenges.

## Managing Yourself

**Success That Lasts**
*Laura Nash and Howard Stevenson*

Reprint R0402H

Pursuing success can feel like shooting in a landscape of moving targets: Every time you hit one, five more pop up from another direction. We are under constant pressure to do more, get more, be more. But is that really what success is all about?

Laura Nash and Howard Stevenson interviewed and surveyed hundreds of professionals to study the assumptions behind the idea of success. They then built a practical framework for a new way of thinking about success—a way that leads to personal and professional fulfillment instead of feelings of anxiety and stress.

The authors' research uncovered four irreducible components of success: happiness (feelings of pleasure or contentment about your life); achievement (accomplishments that compare favorably against similar goals others have strived for); significance (the sense that you've made a positive impact on people you care about); and legacy (a way to establish your values or accomplishments so as to help others find future success). Unless you hit on all four categories with regularity, any one win will fail to satisfy.

People who achieve lasting success, the authors learned, tend to rely on a kaleidoscope strategy to structure their aspirations and activities. This article explains how to build your own kaleidoscope framework. The process can help you determine which tasks you should undertake to fulfill the different components of success and uncover areas where there are holes. It can also help you make better choices about what you spend your

time on and the level of energy you put into each activity.

According to Nash and Stevenson, successful people who experience real satisfaction achieve it through the deliberate imposition of limits. Cultivating your sense of "just enough" can help you set reachable goals, tally up more true wins, and enjoy lasting success.

## Best Practice

**Turning Gadflies into Allies**
*Michael Yaziji*

Reprint R0402J

Multinational companies are the driving force behind globalization, but they are also the source of many of its most painful consequences, including currency crises, cross-border pollution, and overfishing. These problems remain unsolved because they are beyond the scope of individual governments; transnational organizations have also proved unequal to the task.

Nonprofit, nongovernmental organizations have leaped into the breach. To force policy changes, they have seized on all forms of modern persuasion to influence public sentiment toward global traders, manufacturers, and investors.

By partnering with NGOs instead of opposing them, companies can avoid costly conflict and can use NGOs' assets to gain competitive advantage. So far, however, most companies have proved ill equipped to deal with NGOs. Large companies know how to compete on the basis of product attributes and price. But NGO attacks focus on production methods and their spillover effects, which are often noneconomic. Similarly, NGOs are able to convert companies' standard competitive strengths—such as size and wide market awareness of their brands—into liabilities. That's because the wealthier and better known a company is, the juicier the target it makes. Emboldened by their successes, NGOs continue to take on new causes.

By partnering with NGOs instead of reflexively opposing them, companies could draw on NGOs' key strengths—legitimacy, awareness of social forces, distinct networks, and specialized technical expertise—which most companies could use more of. And with NGOs as allies and guides, companies should also be able to accelerate innovation, foresee shifts in demand, shape legislation affecting them, and, in effect, set technical and regulatory standards for their industries.

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

Worse Than Enemies

# Before It's Too Late

## Five Signs of a Dangerous Confidant Relationship

Because of the unconscious factors that determine whom you choose as your confidant, you may often be the last one to know if yours is toxic. To find out if you are getting trapped in a poisonous relationship with a trusted adviser, look for these warning signs:

• **People complain that you're inaccessible.** Your own difficult personality may explain why you need a confidant, but choosing someone who distances you from your organization is a poor solution. Address head-on the issues that surround your interpersonal style.

• **You feel that no one but your confidant understands you.** While it's natural for a leader to have a few trusted advisers, a CEO who overvalues the opinions of a particular individual is in danger of getting into murky waters, maybe even of courting disaster. Overreliance on a single person suggests he has undue influence, which should raise a red flag. Seek out other people who "get" you.

• **Your confidant discourages you from seeking other counsel.** When your trusted adviser wants to make sure nobody else gets close to you, he may be trying to wrest power from you. Such confidants prey on your distrust and suspicion and are among the most insidious confidants of all. Show them the door quickly.

• **Your adviser starts to call the shots.** Confidants who tell you what to do are behaving like they are the real power, and not necessarily just the power behind the throne. Svengali-like confidants are dangerous to you and your reputation. Find someone who can genuinely listen to you and can offer you constructive criticism.

• **Your confidant praises you to the heavens.** If your confidant lays it on thick and is afraid to tell you the unvarnished truth, you may already have trouble on your hands. Look around for someone who doesn't feel compelled to inflate your self-esteem.

< Back to Article

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

FEATURE ARTICLE

# Getting IT Right

**It's been 40 years since the advent of modern IT, yet few companies do it well. If you stick to three central principles, you can turn IT from a costly mess into a powerful weapon.**

***by Charlie S. Feld and Donna B. Stoddard***

Of all the members of the executive committee, the CIO is the least understood—mostly because his profession is still so young. Over the centuries, the fields of manufacturing, finance, sales, marketing, and engineering have evolved into a set of commonly understood practices, with established vocabularies and operating principles comprehended by every member of the senior team. By contrast, the field of information technology—born only 40 years ago with the advent of the IBM 360 in 1964—is prepubescent.

This generation gap means that, in most organizations, the corporate parent—caught in the linguistic chasm between tech-speak and business-speak—has no idea what its youngest child is up to. Management too often shrugs its shoulders, hands the kid a fat allowance, and looks the other way. Later on, the company finds it's paid an outrageous price for the latest technological fad. Instead of addressing the problem, many companies just kick the kid out of the house.

The result in many major corporations is that IT is an expensive mess. Orders are lost. Customers call help desks that aren't helpful. Tracking systems don't track. Indeed, the average business fritters away 20% of its corporate IT budget on purchases that fail to achieve their objectives, according to Gartner Research. This adds up to approximately $500 billion wasted worldwide.

Such waste—most egregious in industries like transportation, insurance, telecommunications, banking, and manufacturing—is a direct result of the fact that IT has so far operated without the constructive involvement of the senior management team, despite the best intentions of CIOs. Over the years, IT departments have enthusiastically fulfilled requests by different corporate functions. In the process, companies have created and populated dozens of legacy information systems, each consisting of millions of lines of code, that do not talk to one another. As the data from discrete functions collect in separate databases, more and more resources are required merely to keep the systems functioning properly.

**There is no longer any reason why nontechnical executives should allow themselves to be befuddled by IT discussions or bedazzled by three-letter acronyms.**

While the Y2K crisis impelled many companies to clean up the worst of their legacy systems, most organizations merely did spring cleaning, ignoring the fact that their technological houses badly needed structural repair. Despite advances in technology, most companies continue to struggle with 35-year-old, costly, and rigid information archeology; a cynical executive board; a discouraged IT organization; and throngs of increasingly frustrated customers. Add the confusion of mergers and acquisitions and a long march of poorly implemented "solutions" (ERP, CRM, data warehouses, portals, mobile computing, dashboards, and outsourcing), and you end up with chaos. How can this situation possibly be set right?

Making IT work has little to do with technology itself. Just because a builder can acquire a handsome set of hammers, nails, and planks doesn't mean he can erect a quality house at reasonable cost. Making IT work demands the same things that other parts of the business do—inspired leadership, superb execution, motivated people, and the thoughtful attention and high expectations of senior management.

>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague
>| Executive Summary

WRITTEN BY

**Charlie S. Feld** (Charlie.feld@feldgroup.com) is chairman of the Feld Group, an IT operations firm in Irving, Texas. **Donna B. Stoddard** (dstoddard@babson.edu) is an associate professor who chairs the Information Technology Management Division at Babson College in Babson Park, Massachusetts.

>| *Harvard Business Review* OnPoint Edition

This article is enhanced with a summary of key points to help you quickly absorb and apply the concepts and a bibliography to guide further exploration.

>| *Harvard Business Review* OnPoint Collection

This article is also part of the specially priced OnPoint collection "Making IT Matter" which includes three OnPoint articles with an overview comparing different perspectives on this topic.

IT success also requires common understanding. Senior managers know how to talk about finances, because they all speak or understand the language and can agree on a common set of metrics (profit and loss, balance sheets, return on assets, and so on). They can do the same with most elements of operations, customer service, and marketing. So why not with IT? There is no longer any reason why nontechnical executives should allow themselves to be befuddled by IT discussions or bedazzled by three-letter acronyms. And there is no reason that technologists cannot learn to speak the language of business and become perfectly good leaders.

We believe that there are three interdependent, interrelated, and universally applicable principles for executing IT effectively and that it is top management's responsibility to understand and help apply them. The three principles are:

**A Long-Term IT Renewal Plan Linked to Corporate Strategy.** Revamping IT is like renewing a major urban area while people are living there. The effort requires a plan that keeps the entire IT group focused on the company's overarching goals during a multiyear period, makes appropriate investments directed toward near-term cost reduction, and generates a detailed blueprint for long-term systems rejuvenation and value creation.

**A Simplified, Unifying Corporate Technology Platform.** Such a platform replaces a wide variety of vertically oriented data silos that serve individual corporate units (HR, accounting, and so on) with a clean, horizontally oriented architecture designed to serve the company as a whole. This is similar to selecting standard-sized pipes and connectors for a city plan.

**A Highly Functional, Performance-Oriented IT Organization.** Instead of being treated as if it were different from the rest of the firm or as a loose confederation of tribes, the IT department works as a team and operates according to corporate performance standards.

Like interlocking gears, these principles work together and must be consistently applied. If they mesh well, each reinforces the others. If one is disengaged or turns in the wrong direction, the whole machine starts working against itself or grinds to a halt.

As a CIO, Charlie Feld has successfully applied these principles to rejuvenate IT at a number of *Fortune* 100 companies—first at Frito-Lay, then during his career as CIO at corporations such as Delta Air Lines and Burlington Northern and Santa Fe Railroads. What follows is a composite of his experiences, which illustrate the three principles in context.

### Gear 1: A Long-Term IT Plan

Because the rate of technological change is so rapid, and the job tenure of CIOs generally brief, most people see IT through the narrow lens of short-term, silver-bullet solutions. Heaven knows, vendors want you to believe that their important new technologies will blow away what has come before. You can't blame a salesperson for trying to sell, or CIOs for having a queasy buy-or-lose feeling, but this attitude is precisely the opposite of the one companies should be taking. We would argue that because the winds of change buffet IT more than any other area of the organization, IT benefits most from a long-term, disciplined, strategic view, and a square focus on achieving the company's most fundamental goals.

For example, Frito-Lay's strategic goal has always been to make, move, and sell tasty, fresh snack foods as rapidly and efficiently as possible. That goal hasn't changed since the 1930s, when founder Herman Lay ran his business from his Atlanta kitchen and delivery truck. He bought and cooked the potatoes. He delivered the chips to stores. He collected the money and knew all his customers. He balanced the books and did his own quality assurance. Herman Lay knew how to conduct the perfect "sense and respond" e-business before such a thing ever existed, for he held real-time customer, accounting, and inventory information all in one place—his head.

After years of spectacular growth, the company grew more and more distracted from this simple business model. By the early 1980s, the company's sales force had swelled to 10,000, and information grew harder and harder to manage. The company's old batch-based data processing systems were all driven by paper forms that took 12 weeks to print and distribute to the sales force. All sales transactions were recorded by hand; reams of disparate data were transferred to the company's mainframe computers. Much was lost in the process of setting up a dozen different functional organizations and a variety of databases, none of which communicated with each other.

This modus operandi made it impossible to change prices quickly or develop new regional promotions, streamline production, or improve inventory management. It was as if Herman Lay's company had suffered a spinal cord injury, with the brain and the body no longer connected. At the same time, the company was seeing the rise of strong regional competitors. The leaders realized that if trends continued as they were, its overall revenues would fall significantly by the early 1990s.

Mike Jordan, who took over as CEO of Frito-Lay in 1983, decided to tackle the problem. He reconstructed the company as a hybrid organization that was neither totally centralized nor decentralized. His goal was to teach the company to "walk and chew gum at the same time," as he put it, by separating out the company's two competitive advantages: the purchasing, production, and distribution leverages of a national powerhouse, and the local resources that gave the company regional speed and agility. All this led to an organizational design that kept purchasing, manufacturing, distribution, systems, accounting, and R&D as the centralized platform, leaving the decentralized sales and marketing organizations to launch their store-by-store and street-by-street offensives.

Having identified the company's strategy, Jordan then developed a long-term IT renewal (as opposed to a "rip and replace") plan. An executive committee—comprised of the CEO, CFO, CIO, and two executive vice presidents—outlined a shift from paper to a risky, emerging handheld technology for the salespeople on the street, as well as a transformation from batch accounting to online operational systems. The goal was to digitally reconnect the company's nervous system. Equipped with the cool new handhelds, the sales force would be able to manage price, inventory, and customer changes in real time and connect to the supply pipeline. The handheld computers would also establish a technological "beachhead"—one sufficiently important to keep the business's attention and achieve fast operating results.

Paying for all this, of course, would not be easy. The journey would take from 1984 to 1988, at a huge cost (at the time): $40 million for the handhelds and about $100 million for the databases and core systems. Some on the executive committee balked, arguing that efficiencies gained by the technology would be lost by salespeople working fewer hours. But the company had no choice but to revitalize its regional sales, and though the systems overhaul would be costly, staying put would be even costlier.

To fund the new computers, Jordan set up a long-term, ongoing funding mechanism designed to keep IT spending both predictable and fairly stable from year to year. To get things rolling, each sales region had to commit to a reduction in selling expenses from 22 cents on the dollar to 21 cents within a year of the handhelds' installation. The savings would be achieved by increasing sales at constant cost, reducing costs, or a combination of the two.

The scheme worked: With the new system in place, the company saved between 30,000 to 50,000 hours of paperwork per week. By 1988, savings resulting from better control over sales data came to more than $40 million per year—savings that in turn funded the renewal of the core data systems. Frito-Lay was able to cut the number of its distribution centers, reduce stale product by 50%, and increase its domestic revenues from $3 billion in 1986 to $4.2 billion by 1989. Today, Frito-Lay continues to be the dominant player in the snack-food industry.

Frito-Lay's technology story received a lot of press at the time, mostly because the handheld technology was sexy. But notice what the story was really about: It was about executing Herman Lay's original, real-time business experience—feeling the money jingling in the pocket and seeing the inventory in the truck.

### Gear 2: A Unifying Platform

Most IT organizations are amazingly complex and have individual initiatives that are like independent countries, each with its own business applications, technologies, culture, data definitions, and orientation. Project costs soar because individual teams are isolated rather than harnessed together, and few teams reuse each other's components—a condition exacerbated by a plethora of consultants and competitive technologies. And when a company is running hundreds of heterogeneous hardware and software systems, costs run rampant.

Consider the cost of such complexity at Delta Air Lines. In 1997, Delta's fleet consisted of 600 airplanes and a rainbow of models, ranging from 727s, 737s, 757s, to 767s, from MD 80s and 90s to L1011s. (By contrast, Southwest Airlines operates only one kind of airplane.) Each plane carried different instrumentation from different eras; as a result,

the company needed to train pilots and crew members to operate the different models. Keeping track of aircraft, people, parts inventory, qualified mechanics, handling equipment, and catering carts all added to the structural cost of the airline. Delta's new CEO, Leo Mullin, and his executive team understood that if they reduced the number of plane types they operated, they could lower annual costs by hundreds of millions of dollars.

What the executives didn't understand was that they had an even worse problem in their IT organization. The company was running more than 30 major IT platforms, with 60 million lines of code, none of which were integrated with each other. Each platform required approximately 100 IT support specialists to keep the systems up and running. That arrangement cost the company about $700 million per year in capital and operating expenses. The problem within IT made the air fleet look like a model of simplicity. Running the airline was nearly impossible. Gate changes by the tower systems were not received in time by the people who needed them: the crews, caterers, reservation agents, ticket counter agents, mechanics, baggage handlers, and customers. The gate-change data were locked inside individual and often conflicting systems.

Once it understood the root cause of complexity, Delta's executive team agreed to a long-term simplification project. Delta launched an effort to build an IT organization that spoke a common language, operated against a simple and well-understood set of principles, and created an architecture that included a common set of databases. Everyone in the IT organization focused on a consistent set of methods, technologies, and management disciplines.

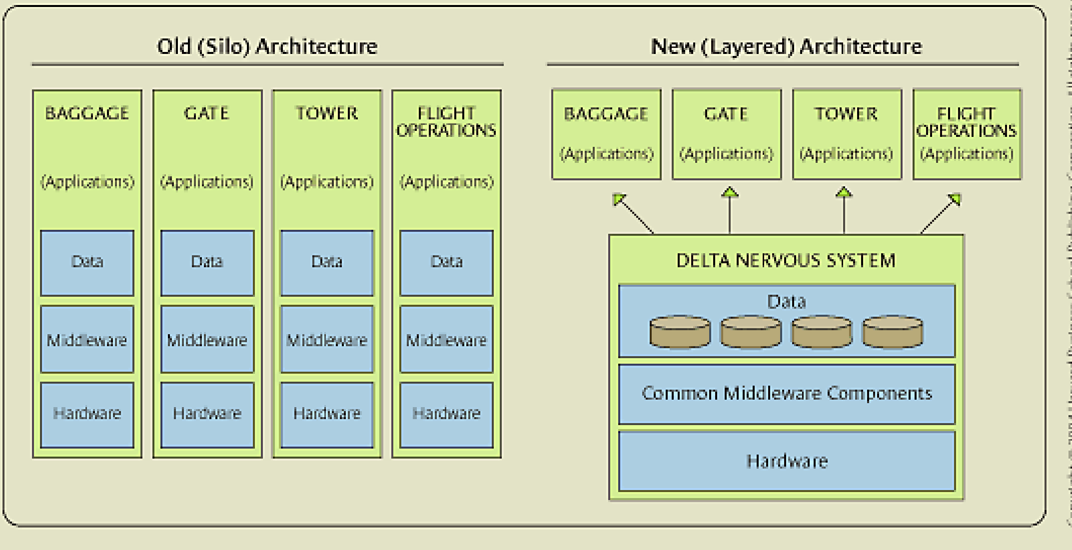
From 1998 to 2003, Delta refocused its formerly decentralized IT investments of $200 million to $300 million annually on a unified IT architecture called the Delta Nervous System, which cut inefficiencies out of virtually every area of its operation. Like Frito-Lay's system, Delta reconnected the electronic brain (IT) to the physical body (operations) by linking the customer, flight, schedule, and employee databases that keep track of everything from reservations to ticketing to check-in and baggage handling to crew operations.

The foundation of the Delta Nervous System was a comprehensive and aggressive simplification effort within the IT architecture to keep the number of moving parts to a minimum. To rebuild and simplify its IT systems, Delta took a radically different tack. Rebuilding the systems from scratch would have been extremely costly—plus the company had an airline to run. Instead, Delta built a new set of software, or middleware, that connected a common infrastructure with every application. The middleware within the Delta Nervous System sat on top of the old transaction systems and carried critical operational data from one application to the other. If a gate changed, the middleware pushed the news to the other systems that needed to know about the change (catering, crew, gate agent, baggage tracking, and so on). With this middleware in place, Delta could then go back and upgrade or replace older systems where necessary, without disrupting the IT system as a whole. (For a visual of the Delta Nervous System, see the exhibit "The Silo-Based Organization Versus the Layered Organization.")

## The Silo-Based Organization Versus the Layered Organization

Delta's IT architecture was once made up of a series of silos. Different parts of the company used different applications and disconnected databases, leading to redundancy, increased costs, and overall organizational dysfunction.

To rebuild and simplify its IT systems, Delta introduced a common layer of middleware that connected the company's electronic brain (IT) to its physical body (operations). Sitting on top of the old transaction systems, the middleware carried key operational data from one application to another: Customer, flight, schedule, and employee databases were connected to reservations, ticketing, check-in, baggage handling, and crew operations. Delta could then upgrade or replace older systems where necessary, without disrupting the underlying IT system.




Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

The middleware layer within the Delta Nervous System proved essential to leveraging technology innovation at Delta. It allowed the company to add new technology in a simpler and less risky manner over time. Most companies go through the agonizing work of rewriting their systems as technology changes. Delta, however, did the opposite. For example, Delta disconnected the manual systems that fed the operations control center (OCC) and reconnected them to the Delta Nervous System. This effectively rejuvenated the OCC without resorting to radical surgery or replacement. The OCC became a vibrant, fully functioning participant in the Delta Nervous System at a fraction of the cost.

The design of Delta's nervous system also formed the road map and contract between IT teams, providing guidance on how data would be stored, where the data would come from, how many copies the company would keep, as well as rules for calculating and interpreting the data. For example, all systems (operations control center, tower, gate, passenger, and crew) could now agree on the same meaning for a "flight arrival."

Since Delta revamped its information architecture, the company has reduced its IT costs by 30%. And despite the downturn in the airline industry, Delta has committed to a cost savings and revenue enhancement of $2 billion by the end of 2005, while increasing its service levels. Just as important, Delta has learned that discipline and simplicity in its approach to technology management lead to both speed and efficiency.

In doing the hot, sweaty work of simplifying its systems and aligning IT with the company's overarching business goals, Delta's senior managers also learned to trust their instincts. They learned that the same business skills that allowed them to see what was wrong with the company's fleet of aircraft could also guide them in managing Delta's armada of technology platforms.

**Gear 3: A High-Performance IT Culture**

There's no reason why most companies can't develop a long-term IT road map tied to corporate goals. There's also no reason that given sufficient discipline and resources, most can't develop a unifying IT platform. But without a high-performance IT organization in place—one that looks very different from those found in most companies —a messy IT business will persist.

For years, corporations have treated IT people differently—a holdover from "glass house" data processing culture of 30 years ago. Treating IT as if it were a separate corporate

entity sets up a vicious cycle. Allowed to work in their own tribes, IT folks feel less affiliation with the company than they do with their own projects. Like the soldiers building the bridge on the River Kwai, they grow so isolated that they forget what the war is about.

By contrast, the people in a high-performance IT organization don't feel different from other corporate citizens; in fact, they are business-savvy leaders in their own right. They operate according to the same corporate values as everyone else and are measured by the same tough performance standards.

The story of the 1995 merger of Burlington Northern and Santa Fe Railroads offers a case in point. The two railroads had two very distinct cultures, performance characteristics, and leadership styles. Burlington Northern's culture was kind, collaborative, and soft on accountability. Santa Fe's culture was tough and strictly hierarchical. Thrown together into a single, 1,500-person organization, these two talented but antagonistic teams were told by CEO Rob Krebs that they had 24 months to complete a seamless merger of their separate IT systems. The goal was to develop the largest integrated, real-time rail information system in the world—one that would allow the new company to control traffic and cargo across 33,500 miles of track that covered 28 states and two Canadian provinces. From a technology standpoint, it was a challenge of immense proportions.

But once again, the issue wasn't technology; it was about establishing a new and cohesive culture, with a clear-cut set of rules and a solid performance-management and feedback system. How, the leaders asked, would people react to the deadline pressure, and how would the teams work together to accomplish a Herculean mission? How would the overhaul of systems get done? How would talent be developed?

First on the agenda was the establishment of an accountable IT leadership team. An IT organization that has clear guidance, a shared mission, and high expectations can focus the developers and engineers around the work and correct performance problems. To do so, the IT managers must be hands-on people who are deeply involved in overseeing projects and teams. In setting up a leader-led organization, BNSF established three simple levels of hierarchy: the CIO, vice presidents, and directors.

Once the new leadership structure was in place, BNSF set the performance and bonus targets for expected leadership behavior—the same ones that applied across the company as a whole. These targets had three components: delivering results, leadership competencies, and the "new BNSF" cultural behaviors. A top-performing leader had to deliver on all three of these targets. None of the IT staff members had ever been evaluated in such a clear way before, and they responded extremely well to expectations and feedback.

Part of the secret of getting people out of the old way and into the new is to establish a rhythm—that is, to control the flow, timing, and pace of the work. Setting a calendar and adhering to it is, in most cases, the most visible means of signaling the transformation of the IT culture and new set of processes. At BNSF, quarterly updates, staff meetings, directors' councils, project reviews, technical reviews, and IT board meetings all helped give the new team a sense of normality and routine—especially important for people who are undergoing a reorganization. The meetings helped transform the formerly frustrating and messy IT cultures. Instead of accepting disorganization and lack of participation as a given, people showed up on time and generally became more efficient in their jobs.

The new organization and performance system was time-consuming to put in place, of course. Most of the leaders grumbled about these demands and the intense time pressure of the work. This was especially true for those who never had to manage under a clear set of expectations. But over time, and especially with the early success of the project, healthy work patterns began to emerge, and a new culture was born. Within a few months, BNSF's newly merged IT group became a high-performance organization—so much so that it beat the 24-month target by three months. The reorganization, combined with the savings realized from streamlining processes and facilities, allowed BNSF to achieve roughly $500 million worth of cost savings that it had committed to the Interstate Commerce Commission to obtain merger approval. Without the performance gear at high torque, BNSF could not have attained its corporate goals.

**All Systems Go**

Once these three gears are aligned and locked together, IT organizations and systems tend to deliver results rapidly—in many cases within six months. Yet despite the obvious benefits of these gears, some businesspeople may ask themselves, "Do we really have to do all of this ourselves? Can't we simply outsource to firms that already know how to do

>| Executive Summary
>| Purchase Reprint

this stuff? And wouldn't outsourcing be a cheaper alternative in the long run?"

The answer to all these questions is yes and no. Over time, fewer and fewer CIOs will run their own networks and data centers, and much development may be augmented by partners. However, the "gears" become even more critical when you bring outsourcing and offshoring into the picture, because management complexity rises. You can't abdicate the leadership and vision for these critical functions. And when you have a number of long-term contracts with various suppliers, the long-term plan must be extremely well articulated (Gear 1). When you work with a number of vendors that have their own tools and methodologies, it's critical to orchestrate an overarching common framework under which everyone can work productively (Gear 2). It's also much easier to build a high-performance culture when you own the human resources (Gear 3). In operating a multi-company workforce, it takes extraordinary leadership to create the esprit de corp required for high performance.

• • •

Without question, the next decade will require much more professional and sophisticated IT leadership than ever before. Fortunately, companies are learning fast. As we progress through the next decade, IT will mature from adolescence to adulthood, and much more speedily than any profession ever has. As the technology matures and improves, so will the skills, processes, and principles on which effective IT is based. And here's the bonus: Once organizations get IT right, they will get much more for far less.

Reprint Number R0402E | *Harvard Business Review* OnPoint edition 5905 | *Harvard Business Review* OnPoint collection 5895





Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review

Click here to visit:
>| http://www.hbsp.org

FEATURE ARTICLE

# Getting IT Right

**It's been 40 years since the advent of modern IT, yet few companies do it well. If you stick to three central principles, you can turn IT from a costly mess into a powerful weapon.**

***by Charlie S. Feld and Donna B. Stoddard***

**Charlie S. Feld** (Charlie.feld@feldgroup.com) is chairman of the Feld Group, an IT operations firm in Irving, Texas. **Donna B. Stoddard** (dstoddard@babson.edu) is an associate professor who chairs the Information Technology Management Division at Babson College in Babson Park, Massachusetts.

Of all the members of the executive committee, the CIO is the least understood—mostly because his profession is still so young. Over the centuries, the fields of manufacturing, finance, sales, marketing, and engineering have evolved into a set of commonly understood practices, with established vocabularies and operating principles comprehended by every member of the senior team. By contrast, the field of information technology—born only 40 years ago with the advent of the IBM 360 in 1964—is prepubescent.

This generation gap means that, in most organizations, the corporate parent—caught in the linguistic chasm between tech-speak and business-speak—has no idea what its youngest child is up to. Management too often shrugs its shoulders, hands the kid a fat allowance, and looks the other way. Later on, the company finds it's paid an outrageous price for the latest technological fad. Instead of addressing the problem, many companies just kick the kid out of the house.

The result in many major corporations is that IT is an expensive mess. Orders are lost. Customers call help desks that aren't helpful. Tracking systems don't track. Indeed, the average business fritters away 20% of its corporate IT budget on purchases that fail to achieve their objectives, according to Gartner Research. This adds up to approximately $500 billion wasted worldwide.

Such waste—most egregious in industries like transportation, insurance, telecommunications, banking, and manufacturing—is a direct result of the fact that IT has so far operated without the constructive involvement of the senior management team, despite the best intentions of CIOs. Over the years, IT departments have enthusiastically fulfilled requests by different corporate functions. In the process, companies have created and populated dozens of legacy information systems, each consisting of millions of lines of code, that do not talk to one another. As the data from discrete functions collect in separate databases, more and more resources are required merely to keep the systems functioning properly.

**There is no longer any reason why nontechnical executives should allow themselves to be befuddled by IT discussions or bedazzled by three-letter acronyms.**

While the Y2K crisis impelled many companies to clean up the worst of their legacy systems, most organizations merely did spring cleaning, ignoring the fact that their technological houses badly needed structural repair. Despite advances in technology, most companies continue to struggle with 35-year-old, costly, and rigid information archeology; a cynical executive board; a discouraged IT organization; and throngs of increasingly frustrated customers. Add the confusion of mergers and acquisitions and a long march of poorly implemented “solutions” (ERP, CRM, data warehouses, portals, mobile computing, dashboards, and outsourcing), and you end up with chaos. How can this situation possibly be set right?

Making IT work has little to do with technology itself. Just because a builder can acquire a handsome set of hammers, nails, and planks doesn’t mean he can erect a quality house at reasonable cost. Making IT work demands the same things that other parts of the business do—inspired leadership, superb execution, motivated people, and the thoughtful attention and high expectations of senior management.

IT success also requires common understanding. Senior managers know how to talk about finances, because they all speak or understand the language and can agree on a common set of metrics (profit and loss, balance sheets, return on assets, and so on). They can do the same with most elements of operations, customer service, and marketing. So why not with IT? There is no longer any reason why nontechnical executives should allow themselves to be befuddled by IT discussions or bedazzled by three-letter acronyms. And there is no reason that technologists cannot learn to speak the language of business and become perfectly good leaders.

We believe that there are three interdependent, interrelated, and universally applicable principles for executing IT effectively and that it is top management’s responsibility to understand and help apply them. The three principles are:

**A Long-Term IT Renewal Plan Linked to Corporate Strategy.** Revamping IT is like renewing a major urban area while people are living there. The effort requires a plan that keeps the entire IT group focused on the company’s overarching goals during a multiyear period, makes appropriate investments directed toward near-term cost reduction, and generates a detailed blueprint for long-term systems rejuvenation and value creation.

**A Simplified, Unifying Corporate Technology Platform.** Such a platform replaces a wide variety of vertically oriented data silos that serve individual corporate units (HR, accounting, and so on) with a clean, horizontally oriented architecture designed to serve the company as a whole. This is similar to selecting standard-sized pipes and connectors for a city plan.

**A Highly Functional, Performance-Oriented IT Organization.** Instead of being treated as if it were different from the rest of the firm or as a loose confederation of tribes, the IT department works as a team and operates according to corporate performance standards.

Like interlocking gears, these principles work together and must be consistently applied. If they mesh well, each reinforces the others. If one is disengaged or turns in the wrong direction, the whole machine starts working against itself or grinds to a halt.

As a CIO, Charlie Feld has successfully applied these principles to rejuvenate IT at a number of *Fortune* 100 companies—first at Frito-Lay, then during his career as CIO at corporations such as Delta Air Lines and Burlington Northern and Santa Fe Railroads. What follows is a composite of his experiences, which illustrate the three principles in context.

### Gear 1: A Long-Term IT Plan

Because the rate of technological change is so rapid, and the job tenure of CIOs generally brief, most people see IT through the narrow lens of short-term, silver-bullet solutions. Heaven knows, vendors want you to believe that their important new technologies will blow away what has come before. You can't blame a salesperson for trying to sell, or CIOs for having a queasy buy-or-lose feeling, but this attitude is precisely the opposite of the one companies should be taking. We would argue that because the winds of change buffet IT more than any other area of the organization, IT benefits most from a long-term, disciplined, strategic view, and a square focus on achieving the company's most fundamental goals.

For example, Frito-Lay's strategic goal has always been to make, move, and sell tasty, fresh snack foods as rapidly and efficiently as possible. That goal hasn't changed since the 1930s, when founder Herman Lay ran his business from his Atlanta kitchen and delivery truck. He bought and cooked the potatoes. He delivered the chips to stores. He collected the money and knew all his customers. He balanced the books and did his own quality assurance. Herman Lay knew how to conduct the perfect "sense and respond" e-business before such a thing ever existed, for he held real-time customer, accounting, and inventory information all in one place—his head.

After years of spectacular growth, the company grew more and more distracted from this simple business model. By the early 1980s, the company's sales force had swelled to 10,000, and information grew harder and harder to manage. The company's old batch-based data processing systems were all driven by paper forms that took 12 weeks to print and distribute to the sales force. All sales transactions were recorded by hand; reams of disparate data were transferred to the company's mainframe computers. Much was lost in the process of setting up a dozen different functional organizations and a variety of databases, none of which communicated with each other.

This modus operandi made it impossible to change prices quickly or develop new regional promotions, streamline production, or improve inventory management. It was as if Herman Lay's company had suffered a spinal cord injury, with the brain and the body no longer connected. At the same time, the company was seeing the rise of strong regional competitors. The leaders realized that if trends continued as they were, its overall revenues would fall significantly by the early 1990s.

Mike Jordan, who took over as CEO of Frito-Lay in 1983, decided to tackle the problem. He reconstructed the company as a hybrid organization that was neither totally centralized nor decentralized. His goal was to teach the company to "walk and chew gum at the same time," as he put it, by separating out the company's two competitive advantages: the purchasing, production, and distribution leverages of a national powerhouse, and the local resources that gave the company regional speed and agility. All this led to an organizational design that kept purchasing, manufacturing, distribution, systems, accounting, and R&D as the centralized platform, leaving the decentralized sales and marketing organizations to launch their store-by-store and street-by-street offensives.

Having identified the company's strategy, Jordan then developed a long-term IT renewal (as opposed to a "rip and replace") plan. An executive committee—comprised of the

CEO, CFO, CIO, and two executive vice presidents—outlined a shift from paper to a risky, emerging handheld technology for the salespeople on the street, as well as a transformation from batch accounting to online operational systems. The goal was to digitally reconnect the company's nervous system. Equipped with the cool new handhelds, the sales force would be able to manage price, inventory, and customer changes in real time and connect to the supply pipeline. The handheld computers would also establish a technological "beachhead"—one sufficiently important to keep the business's attention and achieve fast operating results.

Paying for all this, of course, would not be easy. The journey would take from 1984 to 1988, at a huge cost (at the time): $40 million for the handhelds and about $100 million for the databases and core systems. Some on the executive committee balked, arguing that efficiencies gained by the technology would be lost by salespeople working fewer hours. But the company had no choice but to revitalize its regional sales, and though the systems overhaul would be costly, staying put would be even costlier.

To fund the new computers, Jordan set up a long-term, ongoing funding mechanism designed to keep IT spending both predictable and fairly stable from year to year. To get things rolling, each sales region had to commit to a reduction in selling expenses from 22 cents on the dollar to 21 cents within a year of the handhelds' installation. The savings would be achieved by increasing sales at constant cost, reducing costs, or a combination of the two.

The scheme worked: With the new system in place, the company saved between 30,000 to 50,000 hours of paperwork per week. By 1988, savings resulting from better control over sales data came to more than $40 million per year—savings that in turn funded the renewal of the core data systems. Frito-Lay was able to cut the number of its distribution centers, reduce stale product by 50%, and increase its domestic revenues from $3 billion in 1986 to $4.2 billion by 1989. Today, Frito-Lay continues to be the dominant player in the snack-food industry.

Frito-Lay's technology story received a lot of press at the time, mostly because the handheld technology was sexy. But notice what the story was really about: It was about executing Herman Lay's original, real-time business experience—feeling the money jingling in the pocket and seeing the inventory in the truck.

**Gear 2: A Unifying Platform**

Most IT organizations are amazingly complex and have individual initiatives that are like independent countries, each with its own business applications, technologies, culture, data definitions, and orientation. Project costs soar because individual teams are isolated rather than harnessed together, and few teams reuse each other's components—a condition exacerbated by a plethora of consultants and competitive technologies. And when a company is running hundreds of heterogeneous hardware and software systems, costs run rampant.

Consider the cost of such complexity at Delta Air Lines. In 1997, Delta's fleet consisted of 600 airplanes and a rainbow of models, ranging from 727s, 737s, 757s, to 767s, from MD 80s and 90s to L1011s. (By contrast, Southwest Airlines operates only one kind of airplane.) Each plane carried different instrumentation from different eras; as a result, the company needed to train pilots and crew members to operate the different models. Keeping track of aircraft, people, parts inventory, qualified mechanics, handling equipment, and catering carts all added to the structural cost of the airline. Delta's new CEO, Leo Mullin, and his executive team understood that if they reduced the number of plane types they operated, they could lower annual costs by hundreds of millions of

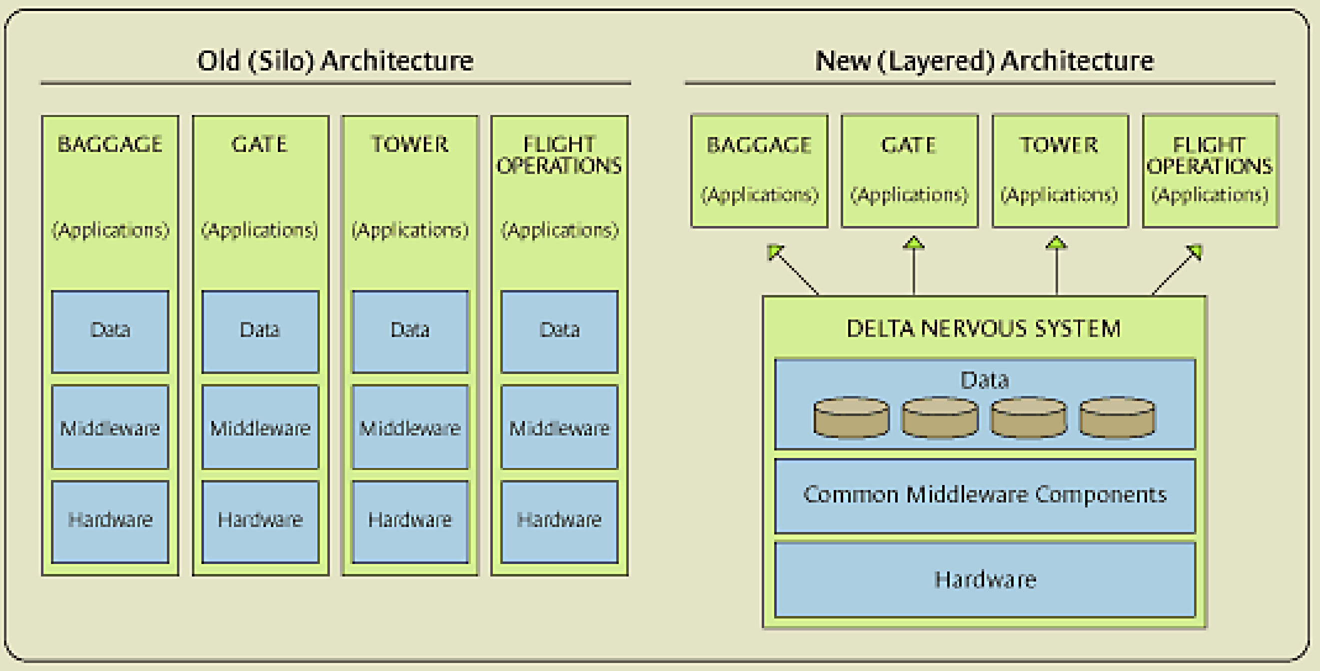
dollars.

What the executives didn't understand was that they had an even worse problem in their IT organization. The company was running more than 30 major IT platforms, with 60 million lines of code, none of which were integrated with each other. Each platform required approximately 100 IT support specialists to keep the systems up and running. That arrangement cost the company about $700 million per year in capital and operating expenses. The problem within IT made the air fleet look like a model of simplicity. Running the airline was nearly impossible. Gate changes by the tower systems were not received in time by the people who needed them: the crews, caterers, reservation agents, ticket counter agents, mechanics, baggage handlers, and customers. The gate-change data were locked inside individual and often conflicting systems.

Once it understood the root cause of complexity, Delta's executive team agreed to a long-term simplification project. Delta launched an effort to build an IT organization that spoke a common language, operated against a simple and well-understood set of principles, and created an architecture that included a common set of databases. Everyone in the IT organization focused on a consistent set of methods, technologies, and management disciplines.

From 1998 to 2003, Delta refocused its formerly decentralized IT investments of $200 million to $300 million annually on a unified IT architecture called the Delta Nervous System, which cut inefficiencies out of virtually every area of its operation. Like Frito-Lay's system, Delta reconnected the electronic brain (IT) to the physical body (operations) by linking the customer, flight, schedule, and employee databases that keep track of everything from reservations to ticketing to check-in and baggage handling to crew operations.

The foundation of the Delta Nervous System was a comprehensive and aggressive simplification effort within the IT architecture to keep the number of moving parts to a minimum. To rebuild and simplify its IT systems, Delta took a radically different tack. Rebuilding the systems from scratch would have been extremely costly—plus the company had an airline to run. Instead, Delta built a new set of software, or middleware, that connected a common infrastructure with every application. The middleware within the Delta Nervous System sat on top of the old transaction systems and carried critical operational data from one application to the other. If a gate changed, the middleware pushed the news to the other systems that needed to know about the change (catering, crew, gate agent, baggage tracking, and so on). With this middleware in place, Delta could then go back and upgrade or replace older systems where necessary, without disrupting the IT system as a whole. (For a visual of the Delta Nervous System, see the exhibit "The Silo-Based Organization Versus the Layered Organization.")




The middleware layer within the Delta Nervous System proved essential to leveraging technology innovation at Delta. It allowed the company to add new technology in a simpler and less risky manner over time. Most companies go through the agonizing work of rewriting their systems as technology changes. Delta, however, did the opposite. For example, Delta disconnected the manual systems that fed the operations control center (OCC) and reconnected them to the Delta Nervous System. This effectively rejuvenated the OCC without resorting to radical surgery or replacement. The OCC became a vibrant, fully functioning participant in the Delta Nervous System at a fraction of the cost.

The design of Delta's nervous system also formed the road map and contract between IT teams, providing guidance on how data would be stored, where the data would come from, how many copies the company would keep, as well as rules for calculating and interpreting the data. For example, all systems (operations control center, tower, gate, passenger, and crew) could now agree on the same meaning for a "flight arrival."

Since Delta revamped its information architecture, the company has reduced its IT costs by 30%. And despite the downturn in the airline industry, Delta has committed to a cost savings and revenue enhancement of $2 billion by the end of 2005, while increasing its service levels. Just as important, Delta has learned that discipline and simplicity in its approach to technology management lead to both speed and efficiency.

In doing the hot, sweaty work of simplifying its systems and aligning IT with the

company's overarching business goals, Delta's senior managers also learned to trust their instincts. They learned that the same business skills that allowed them to see what was wrong with the company's fleet of aircraft could also guide them in managing Delta's armada of technology platforms.

**Gear 3: A High-Performance IT Culture**

There's no reason why most companies can't develop a long-term IT road map tied to corporate goals. There's also no reason that given sufficient discipline and resources, most can't develop a unifying IT platform. But without a high-performance IT organization in place—one that looks very different from those found in most companies—a messy IT business will persist.

For years, corporations have treated IT people differently—a holdover from "glass house" data processing culture of 30 years ago. Treating IT as if it were a separate corporate entity sets up a vicious cycle. Allowed to work in their own tribes, IT folks feel less affiliation with the company than they do with their own projects. Like the soldiers building the bridge on the River Kwai, they grow so isolated that they forget what the war is about.

By contrast, the people in a high-performance IT organization don't feel different from other corporate citizens; in fact, they are business-savvy leaders in their own right. They operate according to the same corporate values as everyone else and are measured by the same tough performance standards.

The story of the 1995 merger of Burlington Northern and Santa Fe Railroads offers a case in point. The two railroads had two very distinct cultures, performance characteristics, and leadership styles. Burlington Northern's culture was kind, collaborative, and soft on accountability. Santa Fe's culture was tough and strictly hierarchical. Thrown together into a single, 1,500-person organization, these two talented but antagonistic teams were told by CEO Rob Krebs that they had 24 months to complete a seamless merger of their separate IT systems. The goal was to develop the largest integrated, real-time rail information system in the world—one that would allow the new company to control traffic and cargo across 33,500 miles of track that covered 28 states and two Canadian provinces. From a technology standpoint, it was a challenge of immense proportions.

But once again, the issue wasn't technology; it was about establishing a new and cohesive culture, with a clear-cut set of rules and a solid performance-management and feedback system. How, the leaders asked, would people react to the deadline pressure, and how would the teams work together to accomplish a Herculean mission? How would the overhaul of systems get done? How would talent be developed?

First on the agenda was the establishment of an accountable IT leadership team. An IT organization that has clear guidance, a shared mission, and high expectations can focus the developers and engineers around the work and correct performance problems. To do so, the IT managers must be hands-on people who are deeply involved in overseeing projects and teams. In setting up a leader-led organization, BNSF established three simple levels of hierarchy: the CIO, vice presidents, and directors.

Once the new leadership structure was in place, BNSF set the performance and bonus targets for expected leadership behavior—the same ones that applied across the company as a whole. These targets had three components: delivering results, leadership competencies, and the "new BNSF" cultural behaviors. A top-performing leader had to deliver on all three of these targets. None of the IT staff members had ever been evaluated in such a clear way before, and they responded extremely well to expectations

and feedback.

Part of the secret of getting people out of the old way and into the new is to establish a rhythm—that is, to control the flow, timing, and pace of the work. Setting a calendar and adhering to it is, in most cases, the most visible means of signaling the transformation of the IT culture and new set of processes. At BNSF, quarterly updates, staff meetings, directors' councils, project reviews, technical reviews, and IT board meetings all helped give the new team a sense of normality and routine—especially important for people who are undergoing a reorganization. The meetings helped transform the formerly frustrating and messy IT cultures. Instead of accepting disorganization and lack of participation as a given, people showed up on time and generally became more efficient in their jobs.

The new organization and performance system was time-consuming to put in place, of course. Most of the leaders grumbled about these demands and the intense time pressure of the work. This was especially true for those who never had to manage under a clear set of expectations. But over time, and especially with the early success of the project, healthy work patterns began to emerge, and a new culture was born. Within a few months, BNSF's newly merged IT group became a high-performance organization—so much so that it beat the 24-month target by three months. The reorganization, combined with the savings realized from streamlining processes and facilities, allowed BNSF to achieve roughly $500 million worth of cost savings that it had committed to the Interstate Commerce Commission to obtain merger approval. Without the performance gear at high torque, BNSF could not have attained its corporate goals.

### All Systems Go

Once these three gears are aligned and locked together, IT organizations and systems tend to deliver results rapidly—in many cases within six months. Yet despite the obvious benefits of these gears, some businesspeople may ask themselves, "Do we really have to do all of this ourselves? Can't we simply outsource to firms that already know how to do this stuff? And wouldn't outsourcing be a cheaper alternative in the long run?"

The answer to all these questions is yes and no. Over time, fewer and fewer CIOs will run their own networks and data centers, and much development may be augmented by partners. However, the "gears" become even more critical when you bring outsourcing and offshoring into the picture, because management complexity rises. You can't abdicate the leadership and vision for these critical functions. And when you have a number of long-term contracts with various suppliers, the long-term plan must be extremely well articulated (Gear 1). When you work with a number of vendors that have their own tools and methodologies, it's critical to orchestrate an overarching common framework under which everyone can work productively (Gear 2). It's also much easier to build a high-performance culture when you own the human resources (Gear 3). In operating a multi-company workforce, it takes extraordinary leadership to create the esprit de corp required for high performance.

• • •

Without question, the next decade will require much more professional and sophisticated IT leadership than ever before. Fortunately, companies are learning fast. As we progress through the next decade, IT will mature from adolescence to adulthood, and much more speedily than any profession ever has. As the technology matures and improves, so will the skills, processes, and principles on which effective IT is based. And here's the bonus: Once organizations get IT right, they will get much more for far less.

Reprint Number R0402E | HBR OnPoint edition 5905 | HBR OnPoint collection 5895

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

FEATURE ARTICLE

# How to Have an Honest Conversation About Your Business Strategy

**Every organization faces challenges in executing its strategy. Great companies know how to work through them.**

***by Michael Beer and Russell A. Eisenstat***

Despite widespread rhetoric about the need for organizational agility, an astonishing number of businesses stay stuck in neutral when they need to implement a new strategy.

Consider the situation that Lynne Camp faced in July 2000. Camp, the vice president and general manager of Agilent Technologies' Systems Generation and Delivery Unit (SGDU), was charged with creating a single global company from a set of fragmented businesses in Asia, Europe, and the United States. To gain control over product decisions being made by the regional teams she had inherited, Camp and her senior team had originally adopted a functional organization structure. This enabled them to exit many marginal, local businesses and focus on the opportunities that were most promising from a global perspective. It also allowed them to introduce more efficient shared processes.

Despite these strengths of the new structure, problems began to emerge. The functional departments didn't give the new businesses the attention they needed. The staffs of the regional field organizations were in a funk; they thought their customer perspective was being overlooked. Conflict between the functions, the businesses, and the field organizations was growing. The senior team was slow to make decisions, and no one took responsibility for the performance of the developing businesses.

Camp surveyed the problems and concluded that the best way to increase accountability and speed up decision making—and thus to support the strategy of focusing on a few promising businesses—was to switch to a matrix structure. Members of the senior team strongly disagreed. A matrix would not work, they thought, and besides, they were too overloaded to undertake another major reorganization. Camp could have imposed her solution unilaterally, but she knew that if she did, she'd undermine the senior team's commitment, which was critical to making this complex global structure work. She needed to find a different way out of the impasse.

As Camp searched for an approach that would jump-start change at SGDU, she began to suspect (correctly) that people throughout the unit were talking about its strategy—and she further suspected that plenty of managers a couple of layers down had insights that she needed to hear. But these conversations took place behind closed doors, for the most part. And private conversations, by their nature, can't mobilize an organization to address the gaps between its business strategy and the structure, capabilities, and market realities it faces.

In our experience, the challenge Lynne Camp faced—SGDU's collective inability to talk openly about its problems—is common. This lack of openness lies behind many failures to implement strategy. We've become convinced that the most powerful way for leaders to realign their organization is to publicly confront the unvarnished truth about the barriers blocking strategy implementation. Typically, this involves looking closely at the roles and decision rights of various parts of the business, as well as changing the behavior of people at all levels. Public, organizationwide conversations about such fundamental issues are difficult and likely to be painful. But pain contributes to a species' survival by triggering learning and adaptation; it can have the same effect on organizations. Businesses and the people inside them don't learn to change unless they have the courage to confront difficult truths.

Because most initiatives fail to uncover the truth, they lead to only superficial change.

>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague
>| Executive Summary

WRITTEN BY

**Michael Beer** is the Cahners-Rabb Professor of Business Administration Emeritus at Harvard Business School and the chairman of the Center for Organizational Fitness in Boston. **Russell A. Eisenstat** is the president of the Center for Organizational Fitness.

>| *Harvard Business Review* OnPoint Edition

This article is enhanced with a summary of key points to help you quickly absorb and apply the concepts and a bibliography to guide further exploration.

>| *Harvard Business Review* OnPoint Collection

This article is also part of the specially priced OnPoint collection "Honesty Is the Best Strategy" which includes three OnPoint articles with an overview comparing different perspectives on this topic.

Employee surveys, 360-degree feedback, interviews by external consultants, and even relatively honest one-to-one conversations between a key manager and the CEO (remember the courageous discussion Sherron Watkins had with Kenneth Lay at Enron) typically do not move the organization forward. They do not convince employees that management wants to know the truth and is ready to act. Quite the reverse—all too often, these methods lead to cynicism, and cynicism is the enemy of commitment to change. In one highly regarded company we studied, a task force of respected managers rebelled when asked by senior management to conduct and analyze a worldwide employee survey. They refused to get involved in yet another hopeless exercise. Meanwhile, senior managers fully believed that they had acted on past feedback.

We believe that organizationwide conversations are essential, so about 15 years ago we launched a research program to develop a process that leaders could use to engage their people in an honest conversation. The "strategic fitness process" was designed in partnership with senior executives to enhance their capacity to implement strategy quickly and effectively. It does so by fitting the organization to the strategy and increasing fitness, the capacity of the organization to learn and change. Since then, this process has been used in more than 150 businesses in the retail, hospitality, high technology, banking, and pharmaceutical industries.

**Crafting a Conversation that Matters**

After more than a decade of implementing the process and researching its consequences, we have identified several overriding lessons that we believe are relevant in any organizationwide conversation, whether or not leaders use our particular process. To wit:

**A conversation about strategy needs to move back and forth between advocacy and inquiry.** Most failures in organizations start when top management advocates a new direction and begins to develop programs for change without finding out what influential people in other parts of the organization think of the new focus. They thereby set themselves up to be blindsided by concerns that emerge much later. A smaller number of well-intentioned top managers make the opposite mistake. They do not advocate at all. Instead, in the name of participation and involvement, they depend entirely on inquiry—assembling a large group of managers and asking them to define a direction. The result is often widespread frustration. Managers and employees look to leaders to articulate a point of view about where the business is going, a point of view to which they can respond. Leaders need to advocate, then inquire, and repeat as needed.

**The conversation has to be about the issues that matter most.** To energize the organization, the conversation must be focused on the most important issues facing the organization—the company's strengths and the obstacles to performance. It's all too easy for senior managers to become swamped in the operational details of managing a business. What gets crowded out are tough and honest conversations about the fundamental issues that will determine long-term success. Do we have a distinctive business strategy that key managers believe in? Do we have the capabilities to execute that strategy? Is our leadership effective?

**The conversation has to be collective and public.** Successfully realigning an organization with a new strategic direction almost always requires simultaneously changing the worldview and the behaviors of a whole set of interdependent players—the CEO, the senior leadership team, and managers down the line. This won't happen without a collective, public conversation. By "collective" we mean that several levels of management across important functions and value-chain activities have to be engaged. By "public" we mean that senior managers need to keep everyone three to four levels below them informed about what has been learned, as well as what changes are planned.

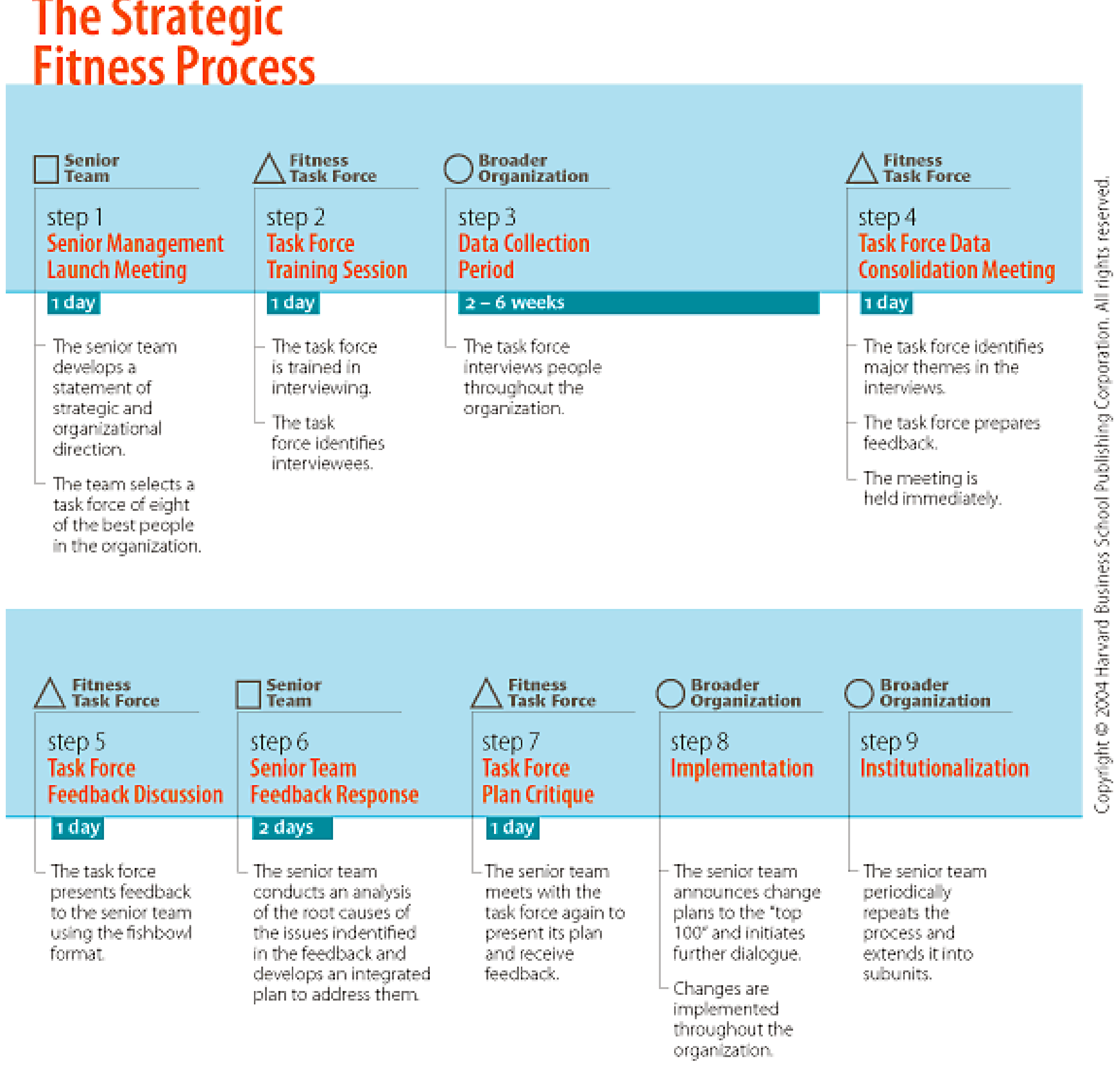
**The conversation has to allow employees to be honest without risking their jobs.** In most of the companies we've studied, managers talked about strategic problems with one or two people they trusted but pulled their punches in more public settings. In Agilent's SGDU division, for example, everyone knew about the tensions between the regional entities and the functional departments. Everyone was aware that the senior team wasn't managing effectively, and many managers doubted Camp's ability to lead the organization out of the morass. But none of these issues was discussed publicly, for two reasons. First, managers feared that being honest would hurt their careers or even endanger their jobs. Second, they were afraid that Camp and her senior team would feel so hurt and defensive that the conversation would not lead to change and might even set back the organization.

**The conversation has to be structured.** When people hear "honest," they tend to think "spontaneous." But public conversations in organizations are rarely spontaneous, as Lou Gerstner found out when he took charge at IBM in 1993, because the stakes are so high. Gerstner describes a strategic meeting at which managers sat at a large conference table with scores of assistants behind them, all listening to a PowerPoint presentation and engaging in little or no discussion. He was so frustrated by the lack of real dialogue that he turned off the overhead projector, with what he calls "the click heard around the world." Gerstner learned, as we have in our work, that the "free-for-all of problem solving" so essential for high performance "does not work so easily in a large, hierarchically based organization." Paradoxically, to achieve honesty and full engagement in these organizations, you need to structure the conversation carefully.[1]

**When people hear "honest," they tend to think "spontaneous." But public conversations in organizations are rarely spontaneous.**

### Driving Change, One Step at a Time

In the pages that follow, we'll outline the process we've developed to support productive, organizationwide conversations about barriers to performance (summarized in the exhibit "The Strategic Fitness Process"). We'll focus on important points to remember as this conversation unfolds. These points—and the principles underlying them—hold true in any setting where top management truly wants strategic change.



Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

**Start the conversation with the leadership team.** Businesses are designed with a built-in directional gyroscope—the senior team. These individuals oversee the parts of the organization that need to work together to implement business strategy. Yet our consistent finding in many companies is that these built-in gyroscopes are broken. The senior management teams are not doing the fundamental work that their organizations

expect of them—setting direction, resolving conflicting views about priorities, and creating the context and culture that will enable the firm to deliver results. In an extraordinary number of companies, unclear strategy and conflicting priorities obstruct performance. The cause, as perceived by people at lower levels as well as by members of the senior team, is an ineffective senior team. When these teams meet they tend to review results, focus on specific problems, or discuss administrative matters. They do not dig into or resolve fundamental strategic issues. All of this was true at SGDU. During senior team meetings people tended to interrupt one another, ignore one another's comments, and engage in a lot of side conversations. As a result, the group had difficulty achieving consensus and making timely decisions, particularly about the politically charged issues of strategy and organization design.

The responsibility for building an aligned organization cannot be delegated. The senior managers must work together to define the business strategy as well as the capabilities and values essential for long-term success.

We start the strategic fitness process with a one-day meeting. The senior management team develops the strategy and drafts a statement about organizational direction that will later be used as the basis of the inquiry into the organization's strategic alignment. To promote an honest dialogue that uncovers differences among members of the senior management team, we ask each member to prepare individual answers to six simple but profoundly important questions:

• What are the company's objectives and aspirations?

• What are the market threats and opportunities?

• What is the value proposition you are delivering?

• What are the most critical things the business must do to deliver on the value proposition and create or sustain competitive advantage?

• Which organizational capabilities are needed to implement the strategy?

• Which values should guide the organization?

At SGDU, the senior team's answers to these questions and their efforts to create a direction statement revealed to them that they were trying to straddle two very different strategies. The first was a reactive strategy—grow sales quickly by responding to immediate customer needs using existing technology. The second was a proactive, R&D-driven strategy of building distinctive, technology-based solutions platforms that competitors could not easily replicate. In creating the statement of direction, the senior team for the first time clearly committed itself to a technology-based platform strategy.

**Draft your best managers to collect data and engage the organization in a conversation.** The two conventional approaches to collecting data about strategic and organizational problems are to survey thousands of employees anonymously or to ask outsiders (consultants or HR specialists) to conduct interviews. The assumption is that only anonymous surveys and outsiders can elicit objective, truthful information. The problem is that out of a desire for objective data, the senior team is distancing itself from the people who have seen and experienced problems. That distance makes it possible for executives to underestimate or even deny problems and to delay action. In many companies we have studied, the senior team had massive amounts of survey data but had taken little action as a result of anything it had learned.

When a senior team appoints a task force of up to eight of its best managers to interview pivotal people in all parts of the organization, the team sends a clear message that it is serious about uncovering the truth and making changes. To ensure that the task force is seen as representing the interests of the entire organization, the senior team collectively selects its members. If anyone on the senior team expresses a concern about a proposed individual, that individual's name is stricken from the list.

Lynne Camp and her senior team, like many other senior teams, hesitated to appoint their *best* managers because these were also the *busiest* managers. We have learned the hard way, however, that if you do not appoint your most effective managers, the task force's feedback will have less credibility with the senior team and with the larger organization. It becomes all too easy for the senior team to discount or explain away painful truths.

Even if a credible task force is appointed, skepticism in the larger organization is likely to linger. Managers are apt to remember previous information-collecting efforts that yielded

few tangible results. The firm can allay this skepticism by having the task force, rather than the senior team, select the 100 or so people who are to be interviewed. This helps to assure the organization that the task force members—not senior management—control this piece of the process. The interviewees should be a representative sample of people, including managers, from the areas most responsible for implementing the strategy. The number of interviews can almost always be kept to 100 or less, regardless of whether the strategy being assessed is for a worldwide *Fortune* 50 corporation or a small start-up. Data collection focuses on company strengths and barriers to the implementation of strategy, not employee satisfaction and morale. Thus, the interviews can be limited to those in pivotal roles along the value chain.

Readers may wonder whether a task force handpicked by top management will confront the senior team with the truth. The answer, emphatically, is yes. Provided that certain safeguards are in place (we will describe these in a moment) and that task force members believe the leadership team is prepared to make changes, the task force quickly becomes a cohesive group, even when it is made up of people from warring factions of the organization. Moreover, task force members come to feel a deep obligation to those they have interviewed. Many see the assignment as a once-in-a-lifetime opportunity to make things better—and they don't shy away from confronting the brutal facts. As one task force member at SGDU put it, "People had spilled their guts to me in the interviews, and I owed it to them to really see this through."

**To uncover the truth, protect the people in the conversation.** In most organizations, lower-level managers are afraid to talk openly about problems that may be blocking effectiveness and performance. We've found that several approaches help to mitigate that fear.

First, and most important, the confidentiality of interviews must be safeguarded. Task force members report back general themes that come up in multiple conversations, not comments that can be attributed to any one individual. In addition, task force members interview people outside their own parts of the organization, making it less likely that they have an ax to grind or that the interviewees will feel intimidated.

The task force members have their own fears to deal with, of course. In going out to the organization on behalf of the senior management team, they risk their own reputations. As one task force member at SGDU pointed out, "We're going to put our careers on the line assuming the top team is going to follow through. If we do the interviews and nothing happens, then we'll look stupid." In addition, they are fully aware of the political costs of speaking uncomfortable truths. Many task forces, especially in organizations that have a history of top-down management, are anxious about these risks (although our research shows that a disproportionate number of task force members are later promoted). In one instance, it took three hours to assure an anxious task force that its members had not been given a career-limiting opportunity. More than one task force has begun its report with a plea not to "shoot the messenger"; one created buttons saying this, and members wore them into the meeting with the senior team.

The top manager must clarify his or her expectations for openness if these fears are to be addressed. Camp told the task force at the launch meeting, "I want the truth; nothing should be sugarcoated.... We have confidence in you, and we are counting on you to help us identify and address the real issues." In addition, what makes it possible for the task force members to speak the truth is that they are acting as representatives of the 100 people they have interviewed. We've also found that it helps if task force members can think of themselves as researchers with a job to do. They remind management of this reporter role by citing the number of people they interviewed and the general area in the company where they collected information (without, of course, revealing individual sources).

**Distill the conversation to the issues that matter.** The conversation between task force members and the people they interview is kept focused but open-ended. Interviewees are asked simply, "What are the strengths to build on and the barriers to address in implementing this strategy?" Task force members find that respondents are eager to discuss strategic issues because this is, in many cases, their first chance to talk to management honestly about the overall health and direction of the company. Task force members report long, emotional interviews. Employees who are not scheduled to be interviewed sometimes line up outside conference room doors, hoping for the chance to speak.

The task force's job is to extract from its hundreds of hours of rich and emotionally charged discussions the critical issues that matter most. This is done through a series of screens. At the end of each interview, the subject is asked to summarize the two or

three most business-critical issues to be shared with senior management. Each task force member then reviews all of his or her interview notes and selects the three or four most commonly mentioned barriers to implementing business strategy, as well as the major organizational strengths that need to be preserved. When the task force members come together, they collate these themes. The most important ones form the basis for the presentation to the senior management team.

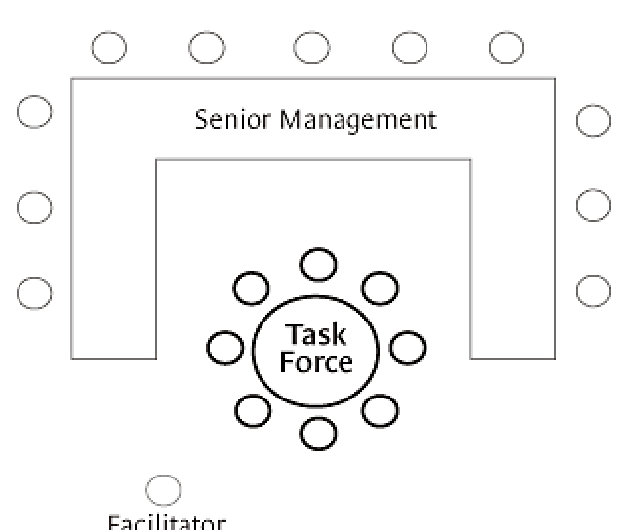
The task force is careful to illustrate the themes with descriptions of specific events or projects; these rich stories provide the top team with an in-depth view of how the organization really functions. The stories resemble well-researched case studies. We have found that these descriptions are vital to convincing senior management that the data are real and valid. Senior managers also respond powerfully to quotes from (unnamed) interviewees, which tend to bring home the employees' deep commitment as well as their frustration.

**Enable truth to speak to power.** The task force's presentation to senior management is always a charged meeting. This stage, perhaps more than any other, needs to be carefully managed. When we first developed this process, the task force would use slides. But we quickly learned that the task force had great difficulty agreeing on a few words that would convey their rich findings. We also found that—for all the safeguards we thought were in place—task force members were apprehensive about their individual parts of the presentation. They felt exposed and vulnerable because they could be individually identified with some portion of the bad news.

We now suggest that task force members present their findings in the form of a discussion. Task force members sit around a table in the middle of a room—in what we call a fishbowl—while the members of the senior team sit at tables around the outside of the fishbowl, observing and taking notes. For each of the major themes, the task force members discuss the range of perspectives that emerged from their interviews and the questions that the themes raise. They do not recommend solutions, and they don't deliver a written report of any kind; the depth of the senior team's understanding and insight is far greater when the executives actively listen and take notes.

## Fishbowl Discussion

Task force members are usually nervous about reporting their findings to the senior management team. It helps if they sit at a table in the middle of the room, while the members of the senior team sit at tables around the outside, observing and taking notes. The task force simply discusses the issues it identified—it doesn't recommend solutions, and it doesn't deliver a written report.




Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

Certain ground rules are set at the beginning of these meetings to enable senior managers to hear what's being said and to protect the task force members. Senior managers are not allowed to interrupt or challenge the task force; instead, at the end of each theme discussion, they are allowed to ask questions for clarification. They're also encouraged, as they listen, to recognize that "perceptions are facts" in shaping behavior and determining effectiveness of strategy implementation.

In every process we've observed, the task force was able to speak the truth with a level of openness and richness that went well beyond the initial expectations of the managers involved. One senior manager described the task force as "operating much like a professional consulting firm, except unlike consultants, they were a part of the organization and knew it inside and out. I think they worked so well together because they believed in what they were doing."

This is not to say that the task force feedback sessions are easy or painless. After all, senior management members are learning about the business consequences of their own actions. At SGDU, Lynne Camp learned that she was perceived as an authentic leader whom people liked and trusted, but that she was letting down the organization by not moving more quickly to resolve the four major organizational problems facing the business:

• *Slow decision making:* "Our functional organization is killing speed."

• *Lack of business focus:* "Lynne and her staff don't know the business well enough to ask the right questions."

• *Lack of accountability:* "Everyone reports to a function; no one is accountable."

• *Leadership ineffectiveness:* "Management has no track record in taking action. This is the last chance for Lynne and her staff to get it right."

The power of direct feedback from eight of their best people moves senior teams to effect changes they have otherwise been reluctant to make. This happened at SGDU. As Camp explained to the task force: "You lit a fire under us. Thank you for the unvarnished truth.... I take your feedback very seriously; it is my performance appraisal.... If the organization is going to change, I must change."

Camp pledged to do whatever it took to address the issues raised; she even offered to resign if it turned out that she was not the right person to lead SGDU, as did the rest of the senior team. This act of leadership courage was not especially unusual. A collective and truthful conversation, our experience shows, enhances everyone's willingness to put the organization and its objectives ahead of self-interest. This is its power.

**Diagnose the organization and develop a plan for change.** None of us would feel comfortable agreeing to a recommendation for surgery before a full diagnosis had been made. Yet upon hearing about problems in their organization, managers often move too quickly to institute major changes without undertaking a rigorous diagnosis of root causes. Why? Time pressures prevent reflection and in-depth diagnosis. Managers also lack an analytical framework for diagnosing the situation. One senior team created a 49-item action list, one for each problem it had perceived. This enabled the general manager to avoid confronting the underlying issues, which included his own focus on short-term productivity improvements at the expense of longer-term investments, an ineffective senior management team unable to bridge functional silos, and his own top-down style.

To overcome such problems, we have concluded that the senior team should convene for a full three-day meeting at which feedback, diagnosis, and action planning occur. Such a meeting creates the discipline that a senior team needs to go beyond symptoms to root causes.

On the first day, the task force gives its feedback, and the senior team gets an overnight assignment: to identify the organization's core strengths and weaknesses as they relate to its strategic objectives. The task force is done for now, but the senior team continues to meet for two more days. Using its overnight assignment, the team diagnoses the organization, deciding as a group what the company's strengths and weaknesses are, which weaknesses will materially undermine achievement of strategic goals, and which organizational levers—for example, organization structure, corporate culture, management processes, human resource policies, the leadership team—are causing the weaknesses. On the final day, the senior team makes decisions about organizational

changes and other priority actions.

At SGDU, Camp and her team wrestled with the fundamental but politically sensitive question of whether the functional departments, geographic entities, or businesses were going to drive the company. The team collectively agreed to move to a product-based rather than a geography-based business unit structure in which the geographic teams and functional departments played a supporting rather than a driving role. The businesses themselves would be responsible for R&D, product planning, marketing, and delivery. According to Camp, "We agreed to have the whole organization in place in six weeks. There was a real passion to demonstrate results [because of] the candid feedback and because we hadn't historically done that." Although Camp had favored a matrix organization, she was persuaded by her team's fact-based discussion of the task force's candid report that an organization built around several accountable product-based business units would be the best approach. The senior team had converged quickly on the new organizational design even though many of its members were functional managers who would lose power in the new structure.

**Stress test the plan.** Once the senior team has developed its plan, it meets again with the task force to present what it has heard, its diagnosis, and its action plan. This is a critical step in reinforcing the senior team's accountability to the organization.

To ensure that it's able to provide honest and thoughtful feedback, the task force takes time to deliberate alone before responding to the proposed plan. As a result of this review, the final meeting between the two groups is sometimes more contentious than it otherwise would have been—and it's more productive as well. One task force (not SGDU's) informed the CEO and his senior team that they had not fully addressed the need to streamline an overlayered divisional structure; a change in the structure would reduce the authority of a particularly influential member of the senior team. When the task force put this issue on the table, the CEO and the top team changed the plan. The revised plan had much greater credibility within the organization, and the task force was able to move beyond its initial role as a group of objective "reporters" and become a committed partner in the implementation of the plan. At SGDU, the task force gave useful feedback to the senior team about how to best communicate and implement the senior team's plans; in general, they were positive about what the senior team had proposed.

**More than one task force has begun its report with a plea not to "shoot the messenger."**

### The Bottom Line: Better Business Performance

Senior teams that have engaged in this process have been able to make dramatic changes in how their businesses were organized and managed—and in their firms' bottom-line performance. One Hewlett-Packard division improved profitability ninefold over a seven-year period; managers and employees engaged in a conversation each year using the strategic fitness process. Senior corporate executives reported that the division's senior team had transformed the division from the worst to one of the best in the sector. Ten country organizations in Merck's Latin American region were transformed when senior vice president Grey Warner, who headed the region, introduced this process at the country level. In just three years, these top-down organizations had developed customer-focused, more participative cultures in which employees at lower levels felt empowered to contribute. Substantial improvements in financial performance accompanied these changes. At Mattel Canada, the process uncovered conflicts between sales and operations and helped the company move from last to first in profitability among Mattel's international subsidiaries.

Six weeks after Lynne Camp and her team tested their plan with the task force, SGDU was operating as a decentralized, business-focused, accountable organization. The speed of SGDU's transformation is not uncommon; rapid transformations of this sort are possible because senior management teams are made to feel accountable to the organization.

Just as important, success that begins with honest conversations begets future conversations that further improve performance. The first time is, of course, the hardest. Once everyone has had a chance to see that real change does emerge out of initially painful truth telling, the organization gets better at having an honest collective conversation. The managers whose leadership actions were questioned the first time are typically seen as leading more effectively if they embraced the process and responded to feedback. Lynne Camp's stock went up dramatically because she courageously acknowledged her role in the organization's problems and responded by changing the

organization and how she managed. By enabling a complicated organizational truth to emerge, senior managers reduce cynicism, increase trust, and develop selfless commitment. As a result, they create a mandate for change that even the most entrenched and resistant power centers cannot resist.

Surprisingly few corporate leaders make a serious attempt to engage their organizations in honest conversations about the strategic and organizational issues they face. As a consequence, they forfeit the benefits of transparency achieved by the leaders of the organizations discussed in this article. We believe that in the twenty-first century, organizations will have to institutionalize a means for having honest conversations if they want to endure. Adopting the principles we have outlined here is a critical first step in creating the kind of frank public dialogue needed to build the collective commitment that drives rapid change, improved performance, and organizational vitality.

>| Executive Summary
>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague

---

1. Louis V. Gerstner, Jr., *Who Said Elephants Can't Dance? Inside IBM's Historic Turnaround* (HarperBusiness, 2002).

---

Reprint Number R0402F | *Harvard Business Review* OnPoint edition 5925 | *Harvard Business Review* OnPoint collection 5917

| Current Issue | Customer Service | Subscriber Benefits | HBR Subscriber Alert

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review

Click here to visit:
>| http://www.hbsp.org

FEATURE ARTICLE

# How to Have an Honest Conversation About Your Business Strategy

**Every organization faces challenges in executing its strategy. Great companies know how to work through them.**

***by Michael Beer and Russell A. Eisenstat***

**Michael Beer** is the Cahners-Rabb Professor of Business Administration Emeritus at Harvard Business School and the chairman of the Center for Organizational Fitness in Boston. **Russell A. Eisenstat** is the president of the Center for Organizational Fitness.

Despite widespread rhetoric about the need for organizational agility, an astonishing number of businesses stay stuck in neutral when they need to implement a new strategy.

Consider the situation that Lynne Camp faced in July 2000. Camp, the vice president and general manager of Agilent Technologies' Systems Generation and Delivery Unit (SGDU), was charged with creating a single global company from a set of fragmented businesses in Asia, Europe, and the United States. To gain control over product decisions being made by the regional teams she had inherited, Camp and her senior team had originally adopted a functional organization structure. This enabled them to exit many marginal, local businesses and focus on the opportunities that were most promising from a global perspective. It also allowed them to introduce more efficient shared processes.

Despite these strengths of the new structure, problems began to emerge. The functional departments didn't give the new businesses the attention they needed. The staffs of the regional field organizations were in a funk; they thought their customer perspective was being overlooked. Conflict between the functions, the businesses, and the field organizations was growing. The senior team was slow to make decisions, and no one took responsibility for the performance of the developing businesses.

Camp surveyed the problems and concluded that the best way to increase accountability and speed up decision making—and thus to support the strategy of focusing on a few promising businesses—was to switch to a matrix structure. Members of the senior team strongly disagreed. A matrix would not work, they thought, and besides, they were too overloaded to undertake another major reorganization. Camp could have imposed her solution unilaterally, but she knew that if she did, she'd undermine the senior team's commitment, which was critical to making this complex global structure work. She needed to find a different way out of the impasse.

As Camp searched for an approach that would jump-start change at SGDU, she began to suspect (correctly) that people throughout the unit were talking about its strategy—and she further suspected that plenty of managers a couple of layers down had insights that she needed to hear. But these conversations took place behind closed doors, for the

most part. And private conversations, by their nature, can't mobilize an organization to address the gaps between its business strategy and the structure, capabilities, and market realities it faces.

In our experience, the challenge Lynne Camp faced—SGDU's collective inability to talk openly about its problems—is common. This lack of openness lies behind many failures to implement strategy. We've become convinced that the most powerful way for leaders to realign their organization is to publicly confront the unvarnished truth about the barriers blocking strategy implementation. Typically, this involves looking closely at the roles and decision rights of various parts of the business, as well as changing the behavior of people at all levels. Public, organizationwide conversations about such fundamental issues are difficult and likely to be painful. But pain contributes to a species' survival by triggering learning and adaptation; it can have the same effect on organizations. Businesses and the people inside them don't learn to change unless they have the courage to confront difficult truths.

Because most initiatives fail to uncover the truth, they lead to only superficial change. Employee surveys, 360-degree feedback, interviews by external consultants, and even relatively honest one-to-one conversations between a key manager and the CEO (remember the courageous discussion Sherron Watkins had with Kenneth Lay at Enron) typically do not move the organization forward. They do not convince employees that management wants to know the truth and is ready to act. Quite the reverse—all too often, these methods lead to cynicism, and cynicism is the enemy of commitment to change. In one highly regarded company we studied, a task force of respected managers rebelled when asked by senior management to conduct and analyze a worldwide employee survey. They refused to get involved in yet another hopeless exercise. Meanwhile, senior managers fully believed that they had acted on past feedback.

We believe that organizationwide conversations are essential, so about 15 years ago we launched a research program to develop a process that leaders could use to engage their people in an honest conversation. The "strategic fitness process" was designed in partnership with senior executives to enhance their capacity to implement strategy quickly and effectively. It does so by fitting the organization to the strategy and increasing fitness, the capacity of the organization to learn and change. Since then, this process has been used in more than 150 businesses in the retail, hospitality, high technology, banking, and pharmaceutical industries.

## Crafting a Conversation that Matters

After more than a decade of implementing the process and researching its consequences, we have identified several overriding lessons that we believe are relevant in any organizationwide conversation, whether or not leaders use our particular process. To wit:

**A conversation about strategy needs to move back and forth between advocacy and inquiry.** Most failures in organizations start when top management advocates a new direction and begins to develop programs for change without finding out what influential people in other parts of the organization think of the new focus. They thereby set themselves up to be blindsided by concerns that emerge much later. A smaller number of well-intentioned top managers make the opposite mistake. They do not advocate at all. Instead, in the name of participation and involvement, they depend entirely on inquiry—assembling a large group of managers and asking them to define a direction. The result is often widespread frustration. Managers and employees look to leaders to articulate a point of view about where the business is going, a point of view to which they can respond. Leaders need to advocate, then inquire, and repeat as needed.

**The conversation has to be about the issues that matter most.** To energize the organization, the conversation must be focused on the most important issues facing the organization—the company's strengths and the obstacles to performance. It's all too easy for senior managers to become swamped in the operational details of managing a business. What gets crowded out are tough and honest conversations about the fundamental issues that will determine long-term success. Do we have a distinctive business strategy that key managers believe in? Do we have the capabilities to execute that strategy? Is our leadership effective?

**The conversation has to be collective and public.** Successfully realigning an organization with a new strategic direction almost always requires simultaneously changing the worldview and the behaviors of a whole set of interdependent players—the CEO, the senior leadership team, and managers down the line. This won't happen without a collective, public conversation. By "collective" we mean that several levels of management across important functions and value-chain activities have to be engaged. By "public" we mean that senior managers need to keep everyone three to four levels below them informed about what has been learned, as well as what changes are planned.

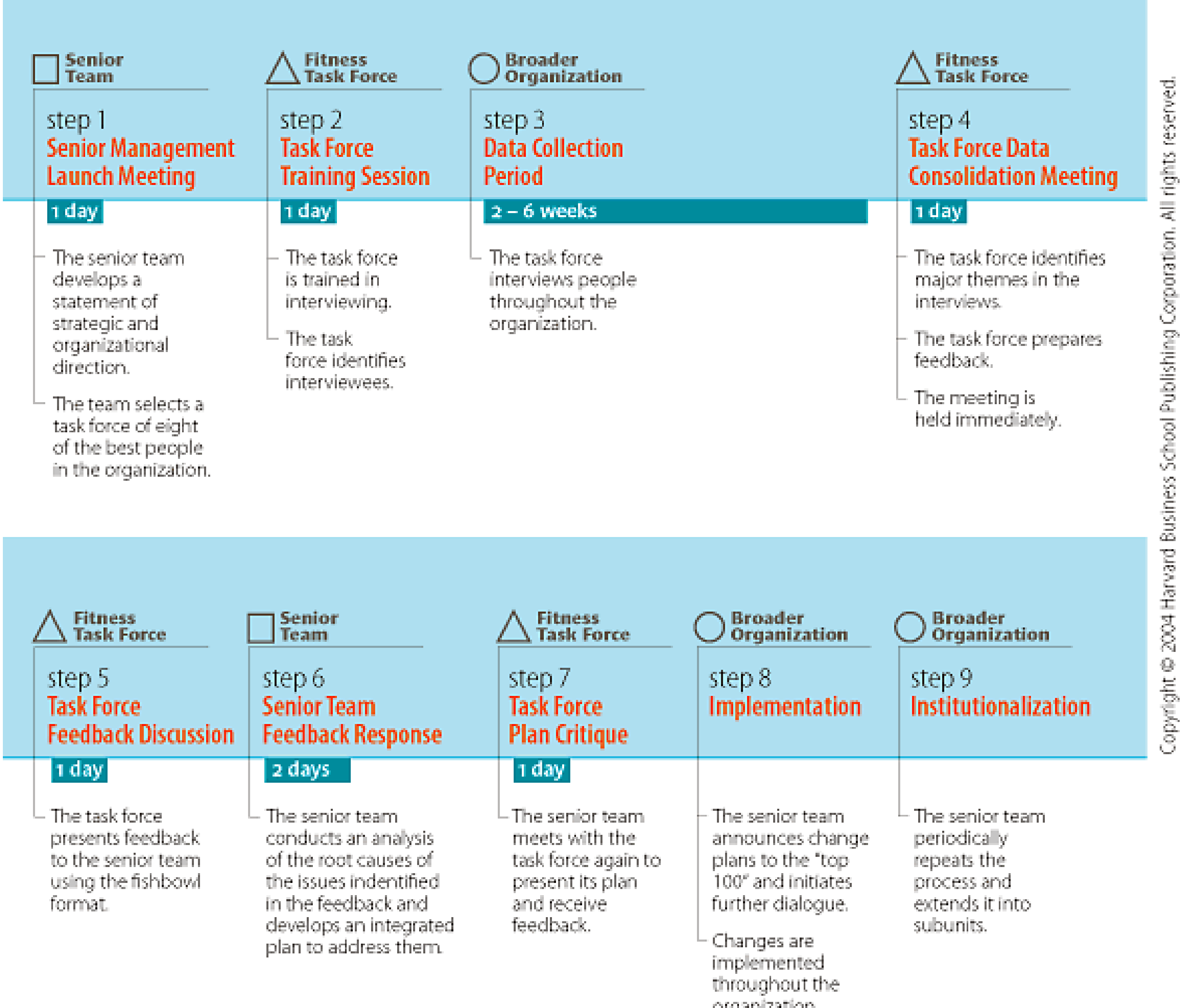
**The conversation has to allow employees to be honest without risking their jobs.** In most of the companies we've studied, managers talked about strategic problems with one or two people they trusted but pulled their punches in more public settings. In Agilent's SGDU division, for example, everyone knew about the tensions between the regional entities and the functional departments. Everyone was aware that the senior team wasn't managing effectively, and many managers doubted Camp's ability to lead the organization out of the morass. But none of these issues was discussed publicly, for two reasons. First, managers feared that being honest would hurt their careers or even endanger their jobs. Second, they were afraid that Camp and her senior team would feel so hurt and defensive that the conversation would not lead to change and might even set back the organization.

**The conversation has to be structured.** When people hear "honest," they tend to think "spontaneous." But public conversations in organizations are rarely spontaneous, as Lou Gerstner found out when he took charge at IBM in 1993, because the stakes are so high. Gerstner describes a strategic meeting at which managers sat at a large conference table with scores of assistants behind them, all listening to a PowerPoint presentation and engaging in little or no discussion. He was so frustrated by the lack of real dialogue that he turned off the overhead projector, with what he calls "the click heard around the world." Gerstner learned, as we have in our work, that the "free-for-all of problem solving" so essential for high performance "does not work so easily in a large, hierarchically based organization." Paradoxically, to achieve honesty and full engagement in these organizations, you need to structure the conversation carefully.[1]

**When people hear "honest," they tend to think "spontaneous." But public conversations in organizations are rarely spontaneous.**

## Driving Change, One Step at a Time

In the pages that follow, we'll outline the process we've developed to support productive, organizationwide conversations about barriers to performance (summarized in the exhibit "The Strategic Fitness Process"). We'll focus on important points to remember as this conversation unfolds. These points—and the principles underlying them—hold true in any setting where top management truly wants strategic change.




**Start the conversation with the leadership team.** Businesses are designed with a built-in directional gyroscope—the senior team. These individuals oversee the parts of the organization that need to work together to implement business strategy. Yet our consistent finding in many companies is that these built-in gyroscopes are broken. The senior management teams are not doing the fundamental work that their organizations expect of them—setting direction, resolving conflicting views about priorities, and creating the context and culture that will enable the firm to deliver results. In an extraordinary number of companies, unclear strategy and conflicting priorities obstruct performance. The cause, as perceived by people at lower levels as well as by members of the senior team, is an ineffective senior team. When these teams meet they tend to review results, focus on specific problems, or discuss administrative matters. They do not dig into or resolve fundamental strategic issues. All of this was true at SGDU. During senior team meetings people tended to interrupt one another, ignore one another's comments, and engage in a lot of side conversations. As a result, the group had difficulty

achieving consensus and making timely decisions, particularly about the politically charged issues of strategy and organization design.

The responsibility for building an aligned organization cannot be delegated. The senior managers must work together to define the business strategy as well as the capabilities and values essential for long-term success.

We start the strategic fitness process with a one-day meeting. The senior management team develops the strategy and drafts a statement about organizational direction that will later be used as the basis of the inquiry into the organization's strategic alignment. To promote an honest dialogue that uncovers differences among members of the senior management team, we ask each member to prepare individual answers to six simple but profoundly important questions:

• What are the company's objectives and aspirations?

• What are the market threats and opportunities?

• What is the value proposition you are delivering?

• What are the most critical things the business must do to deliver on the value proposition and create or sustain competitive advantage?

• Which organizational capabilities are needed to implement the strategy?

• Which values should guide the organization?

At SGDU, the senior team's answers to these questions and their efforts to create a direction statement revealed to them that they were trying to straddle two very different strategies. The first was a reactive strategy—grow sales quickly by responding to immediate customer needs using existing technology. The second was a proactive, R&D-driven strategy of building distinctive, technology-based solutions platforms that competitors could not easily replicate. In creating the statement of direction, the senior team for the first time clearly committed itself to a technology-based platform strategy.

**Draft your best managers to collect data and engage the organization in a conversation.** The two conventional approaches to collecting data about strategic and organizational problems are to survey thousands of employees anonymously or to ask outsiders (consultants or HR specialists) to conduct interviews. The assumption is that only anonymous surveys and outsiders can elicit objective, truthful information. The problem is that out of a desire for objective data, the senior team is distancing itself from the people who have seen and experienced problems. That distance makes it possible for executives to underestimate or even deny problems and to delay action. In many companies we have studied, the senior team had massive amounts of survey data but had taken little action as a result of anything it had learned.

When a senior team appoints a task force of up to eight of its best managers to interview pivotal people in all parts of the organization, the team sends a clear message that it is serious about uncovering the truth and making changes. To ensure that the task force is seen as representing the interests of the entire organization, the senior team collectively selects its members. If anyone on the senior team expresses a concern about a proposed individual, that individual's name is stricken from the list.

Lynne Camp and her senior team, like many other senior teams, hesitated to appoint their *best* managers because these were also the *busiest* managers. We have learned the hard way, however, that if you do not appoint your most effective managers, the

task force's feedback will have less credibility with the senior team and with the larger organization. It becomes all too easy for the senior team to discount or explain away painful truths.

Even if a credible task force is appointed, skepticism in the larger organization is likely to linger. Managers are apt to remember previous information-collecting efforts that yielded few tangible results. The firm can allay this skepticism by having the task force, rather than the senior team, select the 100 or so people who are to be interviewed. This helps to assure the organization that the task force members—not senior management—control this piece of the process. The interviewees should be a representative sample of people, including managers, from the areas most responsible for implementing the strategy. The number of interviews can almost always be kept to 100 or less, regardless of whether the strategy being assessed is for a worldwide *Fortune* 50 corporation or a small start-up. Data collection focuses on company strengths and barriers to the implementation of strategy, not employee satisfaction and morale. Thus, the interviews can be limited to those in pivotal roles along the value chain.

Readers may wonder whether a task force handpicked by top management will confront the senior team with the truth. The answer, emphatically, is yes. Provided that certain safeguards are in place (we will describe these in a moment) and that task force members believe the leadership team is prepared to make changes, the task force quickly becomes a cohesive group, even when it is made up of people from warring factions of the organization. Moreover, task force members come to feel a deep obligation to those they have interviewed. Many see the assignment as a once-in-a-lifetime opportunity to make things better—and they don't shy away from confronting the brutal facts. As one task force member at SGDU put it, "People had spilled their guts to me in the interviews, and I owed it to them to really see this through."

**To uncover the truth, protect the people in the conversation.** In most organizations, lower-level managers are afraid to talk openly about problems that may be blocking effectiveness and performance. We've found that several approaches help to mitigate that fear.

First, and most important, the confidentiality of interviews must be safeguarded. Task force members report back general themes that come up in multiple conversations, not comments that can be attributed to any one individual. In addition, task force members interview people outside their own parts of the organization, making it less likely that they have an ax to grind or that the interviewees will feel intimidated.

The task force members have their own fears to deal with, of course. In going out to the organization on behalf of the senior management team, they risk their own reputations. As one task force member at SGDU pointed out, "We're going to put our careers on the line assuming the top team is going to follow through. If we do the interviews and nothing happens, then we'll look stupid." In addition, they are fully aware of the political costs of speaking uncomfortable truths. Many task forces, especially in organizations that have a history of top-down management, are anxious about these risks (although our research shows that a disproportionate number of task force members are later promoted). In one instance, it took three hours to assure an anxious task force that its members had not been given a career-limiting opportunity. More than one task force has begun its report with a plea not to "shoot the messenger"; one created buttons saying this, and members wore them into the meeting with the senior team.

The top manager must clarify his or her expectations for openness if these fears are to be addressed. Camp told the task force at the launch meeting, "I want the truth; nothing should be sugarcoated.... We have confidence in you, and we are counting on you to help

us identify and address the real issues." In addition, what makes it possible for the task force members to speak the truth is that they are acting as representatives of the 100 people they have interviewed. We've also found that it helps if task force members can think of themselves as researchers with a job to do. They remind management of this reporter role by citing the number of people they interviewed and the general area in the company where they collected information (without, of course, revealing individual sources).

**Distill the conversation to the issues that matter.** The conversation between task force members and the people they interview is kept focused but open-ended. Interviewees are asked simply, "What are the strengths to build on and the barriers to address in implementing this strategy?" Task force members find that respondents are eager to discuss strategic issues because this is, in many cases, their first chance to talk to management honestly about the overall health and direction of the company. Task force members report long, emotional interviews. Employees who are not scheduled to be interviewed sometimes line up outside conference room doors, hoping for the chance to speak.

The task force's job is to extract from its hundreds of hours of rich and emotionally charged discussions the critical issues that matter most. This is done through a series of screens. At the end of each interview, the subject is asked to summarize the two or three most business-critical issues to be shared with senior management. Each task force member then reviews all of his or her interview notes and selects the three or four most commonly mentioned barriers to implementing business strategy, as well as the major organizational strengths that need to be preserved. When the task force members come together, they collate these themes. The most important ones form the basis for the presentation to the senior management team.

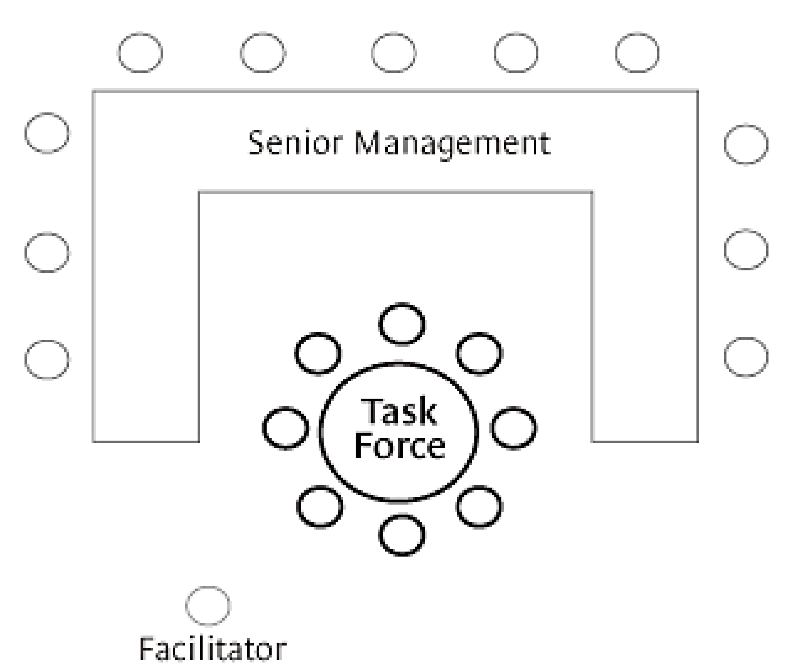
The task force is careful to illustrate the themes with descriptions of specific events or projects; these rich stories provide the top team with an in-depth view of how the organization really functions. The stories resemble well-researched case studies. We have found that these descriptions are vital to convincing senior management that the data are real and valid. Senior managers also respond powerfully to quotes from (unnamed) interviewees, which tend to bring home the employees' deep commitment as well as their frustration.

**Enable truth to speak to power.** The task force's presentation to senior management is always a charged meeting. This stage, perhaps more than any other, needs to be carefully managed. When we first developed this process, the task force would use slides. But we quickly learned that the task force had great difficulty agreeing on a few words that would convey their rich findings. We also found that—for all the safeguards we thought were in place—task force members were apprehensive about their individual parts of the presentation. They felt exposed and vulnerable because they could be individually identified with some portion of the bad news.

We now suggest that task force members present their findings in the form of a discussion. Task force members sit around a table in the middle of a room—in what we call a fishbowl—while the members of the senior team sit at tables around the outside of the fishbowl, observing and taking notes. For each of the major themes, the task force members discuss the range of perspectives that emerged from their interviews and the questions that the themes raise. They do not recommend solutions, and they don't deliver a written report of any kind; the depth of the senior team's understanding and insight is far greater when the executives actively listen and take notes.

## Fishbowl Discussion

Task force members are usually nervous about reporting their findings to the senior management team. It helps if they sit at a table in the middle of the room, while the members of the senior team sit at tables around the outside, observing and taking notes. The task force simply discusses the issues it identified—it doesn't recommend solutions, and it doesn't deliver a written report.




Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

Certain ground rules are set at the beginning of these meetings to enable senior managers to hear what's being said and to protect the task force members. Senior managers are not allowed to interrupt or challenge the task force; instead, at the end of each theme discussion, they are allowed to ask questions for clarification. They're also encouraged, as they listen, to recognize that "perceptions are facts" in shaping behavior and determining effectiveness of strategy implementation.

In every process we've observed, the task force was able to speak the truth with a level of openness and richness that went well beyond the initial expectations of the managers involved. One senior manager described the task force as "operating much like a professional consulting firm, except unlike consultants, they were a part of the organization and knew it inside and out. I think they worked so well together because they believed in what they were doing."

This is not to say that the task force feedback sessions are easy or painless. After all, senior management members are learning about the business consequences of their own

actions. At SGDU, Lynne Camp learned that she was perceived as an authentic leader whom people liked and trusted, but that she was letting down the organization by not moving more quickly to resolve the four major organizational problems facing the business:

• *Slow decision making:* "Our functional organization is killing speed."

• *Lack of business focus:* "Lynne and her staff don't know the business well enough to ask the right questions."

• *Lack of accountability:* "Everyone reports to a function; no one is accountable."

• *Leadership ineffectiveness:* "Management has no track record in taking action. This is the last chance for Lynne and her staff to get it right."

The power of direct feedback from eight of their best people moves senior teams to effect changes they have otherwise been reluctant to make. This happened at SGDU. As Camp explained to the task force: "You lit a fire under us. Thank you for the unvarnished truth.... I take your feedback very seriously; it is my performance appraisal.... If the organization is going to change, I must change."

Camp pledged to do whatever it took to address the issues raised; she even offered to resign if it turned out that she was not the right person to lead SGDU, as did the rest of the senior team. This act of leadership courage was not especially unusual. A collective and truthful conversation, our experience shows, enhances everyone's willingness to put the organization and its objectives ahead of self-interest. This is its power.

**Diagnose the organization and develop a plan for change.** None of us would feel comfortable agreeing to a recommendation for surgery before a full diagnosis had been made. Yet upon hearing about problems in their organization, managers often move too quickly to institute major changes without undertaking a rigorous diagnosis of root causes. Why? Time pressures prevent reflection and in-depth diagnosis. Managers also lack an analytical framework for diagnosing the situation. One senior team created a 49-item action list, one for each problem it had perceived. This enabled the general manager to avoid confronting the underlying issues, which included his own focus on short-term productivity improvements at the expense of longer-term investments, an ineffective senior management team unable to bridge functional silos, and his own top-down style.

To overcome such problems, we have concluded that the senior team should convene for a full three-day meeting at which feedback, diagnosis, and action planning occur. Such a meeting creates the discipline that a senior team needs to go beyond symptoms to root causes.

On the first day, the task force gives its feedback, and the senior team gets an overnight assignment: to identify the organization's core strengths and weaknesses as they relate to its strategic objectives. The task force is done for now, but the senior team continues to meet for two more days. Using its overnight assignment, the team diagnoses the organization, deciding as a group what the company's strengths and weaknesses are, which weaknesses will materially undermine achievement of strategic goals, and which organizational levers—for example, organization structure, corporate culture, management processes, human resource policies, the leadership team—are causing the weaknesses. On the final day, the senior team makes decisions about organizational changes and other priority actions.

At SGDU, Camp and her team wrestled with the fundamental but politically sensitive

question of whether the functional departments, geographic entities, or businesses were going to drive the company. The team collectively agreed to move to a product-based rather than a geography-based business unit structure in which the geographic teams and functional departments played a supporting rather than a driving role. The businesses themselves would be responsible for R&D, product planning, marketing, and delivery. According to Camp, "We agreed to have the whole organization in place in six weeks. There was a real passion to demonstrate results [because of] the candid feedback and because we hadn't historically done that." Although Camp had favored a matrix organization, she was persuaded by her team's fact-based discussion of the task force's candid report that an organization built around several accountable product-based business units would be the best approach. The senior team had converged quickly on the new organizational design even though many of its members were functional managers who would lose power in the new structure.

**Stress test the plan.** Once the senior team has developed its plan, it meets again with the task force to present what it has heard, its diagnosis, and its action plan. This is a critical step in reinforcing the senior team's accountability to the organization.

To ensure that it's able to provide honest and thoughtful feedback, the task force takes time to deliberate alone before responding to the proposed plan. As a result of this review, the final meeting between the two groups is sometimes more contentious than it otherwise would have been—and it's more productive as well. One task force (not SGDU's) informed the CEO and his senior team that they had not fully addressed the need to streamline an overlayered divisional structure; a change in the structure would reduce the authority of a particularly influential member of the senior team. When the task force put this issue on the table, the CEO and the top team changed the plan. The revised plan had much greater credibility within the organization, and the task force was able to move beyond its initial role as a group of objective "reporters" and become a committed partner in the implementation of the plan. At SGDU, the task force gave useful feedback to the senior team about how to best communicate and implement the senior team's plans; in general, they were positive about what the senior team had proposed.

**More than one task force has begun its report with a plea not to "shoot the messenger."**

### The Bottom Line: Better Business Performance

Senior teams that have engaged in this process have been able to make dramatic changes in how their businesses were organized and managed—and in their firms' bottom-line performance. One Hewlett-Packard division improved profitability ninefold over a seven-year period; managers and employees engaged in a conversation each year using the strategic fitness process. Senior corporate executives reported that the division's senior team had transformed the division from the worst to one of the best in the sector. Ten country organizations in Merck's Latin American region were transformed when senior vice president Grey Warner, who headed the region, introduced this process at the country level. In just three years, these top-down organizations had developed customer-focused, more participative cultures in which employees at lower levels felt empowered to contribute. Substantial improvements in financial performance accompanied these changes. At Mattel Canada, the process uncovered conflicts between sales and operations and helped the company move from last to first in profitability among Mattel's international subsidiaries.

Six weeks after Lynne Camp and her team tested their plan with the task force, SGDU was operating as a decentralized, business-focused, accountable organization. The speed

of SGDU’s transformation is not uncommon; rapid transformations of this sort are possible because senior management teams are made to feel accountable to the organization.

Just as important, success that begins with honest conversations begets future conversations that further improve performance. The first time is, of course, the hardest. Once everyone has had a chance to see that real change does emerge out of initially painful truth telling, the organization gets better at having an honest collective conversation. The managers whose leadership actions were questioned the first time are typically seen as leading more effectively if they embraced the process and responded to feedback. Lynne Camp’s stock went up dramatically because she courageously acknowledged her role in the organization’s problems and responded by changing the organization and how she managed. By enabling a complicated organizational truth to emerge, senior managers reduce cynicism, increase trust, and develop selfless commitment. As a result, they create a mandate for change that even the most entrenched and resistant power centers cannot resist.

Surprisingly few corporate leaders make a serious attempt to engage their organizations in honest conversations about the strategic and organizational issues they face. As a consequence, they forfeit the benefits of transparency achieved by the leaders of the organizations discussed in this article. We believe that in the twenty-first century, organizations will have to institutionalize a means for having honest conversations if they want to endure. Adopting the principles we have outlined here is a critical first step in creating the kind of frank public dialogue needed to build the collective commitment that drives rapid change, improved performance, and organizational vitality.

---

1. Louis V. Gerstner, Jr., *Who Said Elephants Can’t Dance? Inside IBM’s Historic Turnaround* (HarperBusiness, 2002).

---

Reprint Number R0402F | HBR OnPoint edition 5925 | HBR OnPoint collection 5917

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

FEATURE ARTICLE

# Launching a World-Class Joint Venture

**JVs and alliances can deliver more shareholder value than M&As can, but getting them off the ground can trip you up in unpredictable ways.**

***by James Bamford, David Ernst, and David G. Fubini***

More than 5,000 joint ventures, and many more contractual alliances, have been launched worldwide in the past five years. The largest 100 JVs currently represent more than $350 billion in combined annual revenues. So it's become clear to many companies that alliances—both equity JVs (where the partners contribute resources to create a new company) and contractual alliances (where the partners collaborate without creating a new company)—can be ideal for managing risk in uncertain markets, sharing the cost of large-scale capital investments, and injecting newfound entrepreneurial spirit into maturing businesses.

What's less clear to these companies is how to overcome the many challenges inherent in implementing joint ventures and alliances. In 1991, we assessed the performance of 49 joint ventures and alliances and found that only 51% were "successful"—that is, each partner had achieved returns greater than the cost of capital. A decade later, in 2001, we assessed the outcomes of more than 2,000 alliance announcements—and the success rate still hovered at just 53%, despite studies that have highlighted the well-known reasons for JV failure: wrong strategies, incompatible partners, inequitable or unrealistic deals, and weak management.

Our most recent research, on which this article is based, confirms that the challenge continues. Why is JV success so elusive? We believe it's because many companies overlook a critical piece of any alliance or JV effort—the launch planning and execution. Although most companies are highly disciplined about integrating acquisitions, they rarely commit sufficient resources to launching similarly sized joint ventures or alliances. Mistakes made during the launch phase often erode up to half the potential value creation of a venture. The launch phase—beginning with the signing of a memorandum of understanding and continuing through the first 100 days of operation—is usually not managed closely enough. This lack of attention can result in strategic conflicts between the allied companies, governance gridlock, and missed operational synergies. As one executive told us, "If we could improve our skills in one area, it would not be in deal making or ongoing management but in the launch phase. That's where the rubber meets the road."

**Weak controls can cost the parent companies money and can expose them to unexpected risks.**

### JV Challenges

When an organization brings an acquired company into the fold, only one corporation exists after the deal, allowing for unilateral decision making. By contrast, after two companies agree to an alliance, there are still multiple parties (two parent companies, and, in many cases, a new company) dealing with disparate interests. This creates a unique set of challenges. (For an overview of the challenges companies face in launching JVs and alliances, see the exhibit "Clearing the Hurdles.")

>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague
>| Executive Summary

IN THIS ARTICLE

When Is a JV Worth the Trouble?
About the Research

WRITTEN BY

**James Bamford** is a consultant in McKinsey & Company's Washington, DC, office and a coauthor of *Mastering Alliance Strategy* (Wiley, 2003). **David Ernst** is a partner in McKinsey's Washington office and a leader of its corporate finance and strategy practice. He is a coauthor of *Collaborating to Compete* (Wiley, 1993). **David G. Fubini** is a senior partner in McKinsey's Boston office and leads its global organization and postmerger management practices.

## Clearing the Hurdles

M&As are notoriously difficult to manage, but JVs and alliances bring their own set of challenges, outlined here. To overcome each of the four challenges – and at every stage of the JV's development and launch – companies need to assign dedicated project management teams.

| | Strategy | Governance | Economics | Organization |
|---|---|---|---|---|
| **JV Challenges** | • Parent companies may hold different strategic interests, which may affect the nature and degree of integration. | • Parents share control of the JV, which complicates decision making.<br>• Parents have separate reporting systems, processes, and metrics. | • Parents provide ongoing services, staffing, and resources to the JV, which affects venture economics. Transfer pricing may become an issue.<br>• The JV's performance is less transparent compared with that of the parents' wholly owned businesses. | • Parents must manage cultural differences, as well as conflicting incentives and career paths. |
| **Keys to Successful Launch** | • Align the parents' interests around the JV's objectives up front.<br>• Specify first-year goals for the JV. | • Apply loose-tight governance.<br>• Create clear protocols for decision making. | • Specify the services parents will provide, and establish fair transfer-pricing schemes.<br>• Establish good risk- and performance-management systems for the JV. | • Secure commitments from key staff – especially from parent company employees.<br>• Create a compelling value proposition for JV employees. |

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

The first challenge is building and maintaining *strategic alignment* across the separate corporate entities, each of which has its own goals, market pressures, and shareholders. If these individual interests are not addressed during the launch phase, conflicts will develop in crucial strategic areas. For instance, should the JV's products or services target high-end or mass-market consumers? Should the venture's reinvestment goals emphasize revenue growth or cash flow? Such conflicts can delay the venture's development and can set the stage for costly compromises down the road. JV and alliance partners try to anticipate areas of potential misalignment during the negotiation phase—but many conflicts of interest surface only when the partners dig deep into operational details and start to run the business.

The second challenge is to create a *governance* system that promotes shared decision-making and oversight between the two parent companies. Even though a joint venture isn't necessarily a marriage for life, governance problems can quickly trigger termination of the deal. Weak controls can cost the parent companies money and can expose them to unexpected risks. The secret to effective governance is balance: providing enough oversight to protect important assets without stifling entrepreneurship.

The third challenge that most joint ventures—and virtually all nonequity alliances—face is managing the *economic interdependencies* between the corporate parents and the JV. To avoid duplicating costs, most alliances are structured so that the parents continually provide financial capital, human skills, material resources, and marketing and other services. The parent companies generally do outline the broad extent of the economic interdependencies during the negotiation phase—but they often don't quantify the specific resources and finances that should be flowing to and from each partner until the launch phase. Consider what Starbucks and PepsiCo did. In 1994, the companies formed their successful North American Coffee Partnership, a JV with more than 90% of the U.S. ready-to-drink coffee business. The venture was set up with fewer than a dozen full-time professionals, who have capitalized on the parent companies' capabilities. Starbucks contributes services such as coffee purchasing and roasting, creation of beverage concentrates, and quality assurance. PepsiCo provides distribution of the JV products to grocery, convenience, and mass-market stores. The two companies jointly manage marketing and product development. And they agreed during the launch phase on specific ground rules for compensating each parent fairly for its contributions.

The fourth challenge is building the *organization*—a cohesive, high-performing JV or alliance—when most managers come from, will want to return to, and may even hold simultaneous positions in the parent companies. Many venture CEOs lament that alliances are treated as dumping grounds for underperforming executives, rather than as magnets for high-potential managers. Most companies that complete a merger dedicate a full-time team of their best leaders to integrate the target company. By contrast, many JV launch teams comprise a handful of part-time managers who are learning as they go. According to a board member of one successful multibillion-dollar JV, "We agreed to

virtually every decision—picking the IT systems, selecting staff at every level—prior to closing the deal." If organizations underinvest in launch project management, they can jeopardize the long-term health of their ventures.

Some guidelines for launch planning and execution apply to all JVs and alliances. The parents should appoint a launch leader (sometimes, but not always, the JV CEO) and identify deal champions. The latter are typically senior executives from each parent company who are known and respected across the organization and have a strong interest in the success of the joint venture. The parents should also assemble a dedicated and experienced transition team immediately upon signing the memorandum of understanding. This team is responsible for getting the business up and running. Its tasks include developing a detailed business plan, creating the 100-day road map that orchestrates the activities of all work groups, and intervening when the launch process veers off track.

Other requirements of launch planning vary based on the nature of the venture. There are basically four types of joint ventures: In the *consolidation JV,* the value of the alliance comes from a deep combination of existing businesses. In the *skills-transfer JV,* the value comes from the transfer of some critical skills from one partner to the joint venture—and sometimes to the other partner. In the *coordination JV,* the value comes from leveraging the complementary capabilities of both partners. And in the *new-business JV,* the value comes from combining existing capabilities, not businesses, to create new growth. The transition team should focus on maximizing operational synergies in the first two cases, and it should focus on understanding new or expanded market opportunities in the latter two.

Once the right launch team is in place and a time line has been set, the real work begins. Successful JVs tackle each of the challenges outlined previously. They preempt failure by exposing inherent tensions early in the process. They move quickly from general road maps to detailed, practical planning. They clarify strategy and governance, and they put in place the right incentives and processes to secure top talent and critical resources from the parents.

When Is a JV Worth the Trouble?

**Resolving Strategic Conflicts Up Front**

It is common for companies to assume that the JV's strategy has already been defined during deal making and that the launch phase, therefore, is simply the time to implement a shared strategic vision. In our experience, it is virtually impossible to get into enough detail during the deal-making phase to surface and resolve all the strategic differences between the corporate parents.

Consider the following examples. Two large pharmaceutical companies formed a venture to expand the market for a specific class of drugs. Each partner contributed complementary patent-protected medicines within the drug class and regional marketing strengths to the JV. Yet once the JV was up and running, one parent wanted to promote its higher-margin, lower-volume products, while the other parent wanted to expand its market share for its products through aggressive pricing. The companies had failed to address this fundamental misalignment early in the process, and the venture struggled through two years of friction and weak sales before one partner ultimately bought the other out. In another consolidation JV between two global chemical companies, it was clear early on that one partner was more willing to invest in the venture than the other one was. The companies had different targets for return on capital and different perceptions of the long-term strategic benefits associated with the venture. The CEO of this joint venture was caught in the cross fire, lacking agreement from the parent companies about how and where the JV would compete and what level of investment was appropriate. In both cases, the companies had failed to discover strategic conflicts early enough in the launch process, when the partners might have been more amenable to negotiation. To root out these conflicts, companies should do the following:

**Develop a VC-quality business plan.** Prior to closing the deal, the launch team, working with future management, needs to develop a detailed business plan. It should meet the same standards of rigor, detail, and logic that a venture capitalist would demand. To start with, the management team (the CEO, CFO, and COO) should meet off-site for two or three days with members of the JV board and the deal champions from both parent companies. The group should define exactly how and where the JV will compete, project how the JV might expand beyond its initial scope, set financial targets, plan capital expenditures, and create a blueprint for the organization. This work is then translated into a detailed business plan. It all sounds straightforward, but these

meetings are often contentious precisely because they reveal gaps in strategic alignment.

The launch team, working with the JV board, also needs to draw up performance contracts that make key JV managers accountable for the success of the venture. The partners should clarify the resources, personnel, and behaviors required for the JV's success so confusion about these matters won't hamstring the people charged with running the venture day to day. Consider the following example: Four electric power companies interviewed for a CEO to run their proposed joint venture. One candidate was offered the position but took his time in deciding whether to accept. Before committing to the venture, he interviewed each board member to understand the parents' objectives, revised the JV business plan, and proposed six specific objectives for the first nine months of his tenure as CEO. He then insisted on the collective endorsement of the JV board as a precondition to accepting the job, and he negotiated a compensation agreement that linked his bonus to these objectives. He also negotiated an employment contract that empowered him to make key operating decisions and choose executives. As he later explained, "In joint ventures, especially with many partners, there is a tendency for the partners to each make back-channel requests of the CEO and to try to influence the alliance through people they put into the JV. I was not going to put up with that. I needed all the partners to agree on the venture's overall priorities and hold me responsible for executing against them."

**Successful alliances pay a lot of attention to communication—not just during the launch phase, but throughout the life of the venture.**

**Act quickly to manage inevitable setbacks.** A detailed business plan and supporting performance contracts are important, but they can't prevent unpleasant surprises once the venture is launched. For instance, Starbucks and PepsiCo were forced to rethink the direction of their joint venture after the first product it introduced, a carbonated coffee drink, received mixed results in early tests with customers. "We had a great partner, a leveraged organizational model, but no product," one Starbucks executive recalled. The partners ultimately redefined the JV's product, drawing on the lessons they learned from those initial market tests.

Successful alliances pay a lot of attention to communication—not just during the launch phase, but throughout the life of the venture. For instance, senior management at TRW Koyo Steering Systems, a JV manufacturer of automotive components, followed a policy of "equal communications" with each of the parent companies (TRW Automotive and Koyo Seiko). When Arvind Korde, CEO of the JV, needed to communicate facts or issues to one parent, he always copied the other parent, thereby promoting openness and trust. And Korde and his team were quick to react to problems. One year into the venture, the JV was on the verge of securing its first customer, which exposed the parent companies' difference of opinion around pricing. TRW, which was focused on profitability more than growth, argued for higher margins and prices. Koyo Seiko sought to build market share and maximize the scale of its global relationship with key Asian customers. "This was a real turning point for the JV," Korde recalls. "Despite our early success, I wasn't sure we would make it out of there alive." Korde called an off-site meeting of his management team in which they experienced what he calls a "coming to Jesus" moment. In that session, the management team crafted a new vision for the JV and a constructive approach for resolving the conflict.

### Achieving Loose-Tight Governance

Besides managing the parents' goals and expectations, the launch team needs to focus on building an effective governance system for the JV or alliance. An appropriate structure should allow the JV management team to make timely decisions while providing the parents with sufficient oversight to protect their assets.

During the deal phase, most companies focus on the composition of the board, the parent companies' veto rights, and the conditions for termination of the venture. But effective ongoing governance requires more than contractual agreements. Without the right launch planning, the typical JV contract is a recipe for disaster because every major decision is subject to board approval, which requires the agreement of both partners. The default process for resolving disputes is often, "Talk some more." This usually results in strategic deadlock between the parent companies, followed by erosion of the synergy created by the deal and, often, termination of the venture. The launch phase is the time to go beyond the lines and boxes and address how decisions will be made and disputes resolved. To find the right balance between giving the JV enough autonomy and

granting the parents enough control, companies should do the following:

**Apply rigorous risk management and performance tracking.** Some companies grant the venture management team so much autonomy that it borders on negligence. This was the case in a billion-dollar industrial JV that combined similar business units to increase scale and reduce operating costs. During the launch phase, the partners failed to create adequate oversight mechanisms. Three years into the alliance, the U.S. partner was dismayed to discover that the JV had incurred a $400 million debt without ever having gone through either parent's capital-budgeting process. In a second JV at the same company, one parent found that the venture was delivering an annual 3% return on invested capital, a figure well below its targeted rate of 14%. The JV was not part of the standard corporate-planning and strategy review forums and was never subject to the same level of scrutiny as the wholly owned businesses.

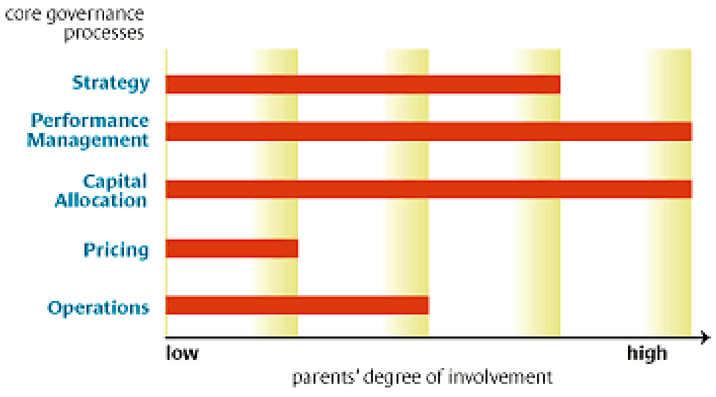
In the wake of Sarbanes-Oxley, companies have increased their attention to transparency, risk management, disclosure, and performance management in their wholly owned businesses. But our research shows that companies don't evaluate the performance of their JVs as diligently as they do their wholly owned businesses with equivalent assets. That's a mistake; parents need to treat their ventures and their wholly owned units similarly. This means, for large joint ventures, putting in place an audit process like the ones used at the best public companies, including an active audit committee and external auditors focused solely on the venture's economics. It means building a strong finance organization inside the JV to make sure that the board and venture management have the critical information they need to do their jobs. And sometimes it means including the JV in at least one parent's annual or semiannual corporate review, thereby ensuring transparency.

**Streamline decision making.** Of course, some corporate parents go too far and implement governance systems that stifle entrepreneurship and create dysfunctional bureaucracy. During the launch of a $4 billion natural resource JV, the parent companies created a large board with subcommittees intended to be heavily involved in—but not accountable for—the day-to-day operations of the venture. All major decisions required multiple subcommittee and board meetings, interspersed with additional fact-finding efforts by the JV management team. Since each subcommittee met only four times per year, the time it took for the JV to make a decision became a distinct competitive disadvantage. As a result, profitability declined, frictions among the parent companies and the venture's management escalated, and the parents had to completely restructure the JV's governance approach.

Companies can avoid this governance trap by implementing a loose-tight governance model. (See the exhibit "The Loose-Tight Approach.") In this approach, the partners identify the venture's most important governance processes (for instance, setting strategy, allocating resources, or determining pricing) and then designate the appropriate degree of parental involvement for each. As a general rule, parent companies operating through a JV board should play an active role in the three governance areas critical to driving financial performance and protecting shareholder interest: capital allocation, risk management, and performance management. The parents should generally limit their interventions in more operational processes—such as staffing, pricing, and product development—where the JV needs independence to ensure competitiveness and market responsiveness.

## The Loose-Tight Approach

To find the right balance between maintaining enough control over their joint ventures and giving the ventures enough autonomy, parent companies should apply a loose-tight governance model, identifying the most important governance processes in the JV and formally designating what their degree of involvement will be in those areas. As the chart below suggests, it's most important for parents to be actively involved in areas that are critical to protecting shareholder interests – for instance, in managing performance and in allocating capital.




Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

Once a high-level governance road map is in place, the launch team needs to translate it into practical decision-making processes that are consistent with the parent companies' formal and informal governance and influence structures. There are many ways to do this, but one effective approach is to map out each governance process, showing how information and decisions flow through the JV and parent companies. For example, a request for capital could originate within the JV's manufacturing organization and be formally submitted to the board for approval. But the way the process might work in practice is for board members to survey the CFOs at each parent company to make certain that the proposal meets their individual capital-expenditure requirements and then convene an informal discussion with one or both parent CEOs to make sure they're aligned. By mapping out both formal and informal decision-making processes, you can reduce the time and effort it will take to approve major initiatives.

**The launch team needs to challenge—and limit wherever possible—the interdependencies between the parents and the JV.**

### Managing the Interdependencies

For practical reasons, most JVs depend on their parents to provide ongoing access to capital, people, intellectual property, raw materials, and customers. Both tangible and intangible contributions from the parents determine their actual return on investment. But much damage can be done if the details of those contributions aren't worked out during launch. For instance, if transfer prices (the internal fees that one group charges another for a resource or a service) are not set appropriately, Parent A, who provides a resource to the joint venture, has an opportunity to supplement its returns "off the books" of the JV. When Partner B sees this happening, it uses the information to justify holding back its committed contributions, creating a loop of partner suspicion and distrust.

Winning JVs start to address economic interdependencies as soon as an agreement looks likely in order to avoid launch delays and the loss of millions of dollars in potential synergies. They make sure that the launch team contains appropriate expertise and authority to resolve important economic issues. Specifically, successful ventures do the following:

**Dedicate resources to resolve interdependencies up front.** The process of sorting out who will provide what to the joint venture is time-consuming for everyone involved. In one high-tech consolidation JV, the partners spent 10,000 man-hours over four

months determining precisely which services and resources each parent would provide the JV and constructing service-level agreements that specified transfer pricing, access rights, and other critical terms of the deal. The work can't be postponed just because it is contentious and resource intensive. According to one JV executive we spoke with, "Shared services are often a critical part of determining total venture economics and how the value is distributed between the partners." In the high-tech consolidation JV, the partners formed a small transition services team that identified the economic interdependencies across the 20 launch teams. This group established criteria for determining which services the JV would purchase from the parents. It then documented the shared resources and services and collaborated with the purchasing and finance teams to price each shared service.

**Challenge and limit interdependencies.** One of the most valuable tasks of the launch team is to challenge—and limit wherever possible—the number of interdependencies between the parents and the JV. Working teams in the high-tech consolidation JV initially generated a list of more than 1,000 dependencies upon one parent—that parent was slated to provide administrative services, component purchases, and shared research facilities, among a slew of other resources. Recognizing that a heavy load could create unmanageable complexity down the road for the parent company, the launch leaders challenged virtually every line item on the list. Eventually, they whittled it down to just 300 services that the parent would provide the venture in the first year and less than ten services in the second year and beyond.

Once a list of shared services is finalized, the launch team must develop transparent and honest methodologies for calculating transfer pricing. This is critical for maintaining trust down the road. A 50-50 telecom joint venture depended on one parent for 90 different shared services. Two years into the JV, a strategic review revealed that this partner was allocating its corporate overhead and other nonshared costs to the JV, thereby creating significant profits for itself while hampering the venture's ability to set competitive prices and make a profit. The partners did renegotiate transfer pricing, but the distrust that was created continues to plague the venture.

**Parent companies need to move outside their comfort zones when devising an organizational structure for their JVs.**

To avoid this situation, the launch team should agree at the outset on the methods for allocating costs, specifying which operating costs should be included (for instance, customer billing or maintenance) and the basis upon which to allocate each shared cost (for instance, per subscriber, per region, per dollar of revenue). The launch team should also establish a way to benchmark the parents' internal pricing and quality of service against those of outside vendors and suppliers. And the launch team should specify a path for resolving contentious economic issues.

Finally, the JV should be linked to the corporate review and planning cycle of at least one of the parents, reducing the odds that important economic issues will fall between the cracks and require 11th-hour intervention.

### Building the Organization

Parent companies may need to move outside their comfort zones when devising an organizational structure for their JVs, adopting a staffing model, and designing incentive plans. There is a tendency in many JVs that combine existing organizations to select a familiar organizational model—either a regional one, if the parents are contributing assets from different regions, or a product-division structure, if each parent is contributing different products. This simple approach allows each parent to protect its turf and minimize organizational disruption—but it also dilutes the potential effectiveness of the new organization. If the parents try to preserve the status quo, they risk reducing the synergies between them. And let's not forget that companies are often attracted to the JV structure precisely because of their need for a new model and mind-set to compete in a new business. The creation of a joint venture is an opportunity to unfreeze the organization. Beyond the issue of formal structure, a successful JV launch requires taking the following approaches to staffing and incentives.

**Choose your organizational model carefully.** There are three basic organizational models for joint ventures: independent, dependent, and interdependent. The independent model, pursued by companies such as Carlson Wagonlit Travel and Marathon Ashland Petroleum, lets companies create new and often more entrepreneurial cultures. The independent JV typically has an entirely separate reporting structure from the parents, its own facilities, and the freedom to source from external as well as

internal suppliers. This model allows venture management to have greater focus and unity of purpose, but it also requires the venture to establish and maintain separate HR systems. This can make it harder to recruit potential managers who would prefer the wider career opportunities offered by the parent companies.

Some companies go to the opposite extreme and create dependent JVs. This type of JV operates as a business unit of one parent and uses that parent company's incentive systems and HR policies. BP and Mobil used this approach when creating two JVs in their downstream European oil businesses: The refining venture operated as a BP business, while the lubricants venture operated as a Mobil business. The advantages here are opposite those of the independent JV. There is no need to create a separate HR system for the venture, and the managing parent ensures that the venture's high performers get equal access to promotion opportunities within the wholly owned businesses. But the dependent model limits the JV's ability to share people and skills with the nonoperating partner and gives that partner less influence in the JV.

The third model, the interdependent JV, is tough to execute but is by far the most commonly implemented structure. Members of the management team maintain links to their original corporate parent. They remain on the same compensation plans, anticipate future career moves back to the parent, and sometimes have dotted-line-reporting relationships to an executive in their parent organization. The interdependent model protects career paths and offers maximum flexibility, but it can be complex to manage and can perpetuate divided loyalties.

In one billion-dollar global media JV, the management team remained culturally divided into U.S. and German camps two years after the venture's formation. This interdependent JV was operating in a mature sector, and the partners had agreed to rotate the senior positions between them every three years—which created a questionable career path for those deciding to stay at the JV. To make matters worse, the venture was functioning at a significant talent disadvantage. Those managers who performed well were repatriated back to the parents, while those with mediocre performance remained at the venture. This JV was further bedeviled by unclear reporting relationships. For example, a senior-ranking German manager in the JV routinely communicated privately with a senior board member from the German parent (who was his former boss). As a result, the JV CEO had to treat his second in command as a board liaison rather than a direct report, making it difficult to hold his feet to the fire on performance issues.

Unfortunately, this is not an isolated case. Many JVs are held back because they offer the wrong incentives and are unclear about accountability. And the problems are not limited to the senior management team; they spread throughout the venture, even back to the support staffers who remain with the parent organizations.

The disadvantages of the interdependent model can be mitigated if the JV CEO is empowered to write performance reviews and to make all hiring and firing decisions; if all parties agree up front on performance criteria; if a minimum tour of duty is established within the venture, typically three years; and if the parents aren't allowed to poach from the venture until that tour of duty is up.

**Make people want to join the team.** Regardless of the organizational model, the launch team must create a compelling value proposition that makes good people want to join the team. For start-ups, the excitement of building something from the ground up is often sufficient to attract motivated players. In difficult turnaround situations, the compensation upside might be essential (lower base pay but higher bonus or stock options than in the parent companies).

Personal considerations cannot be underestimated. Everyone wants to work for a motivational leader, and selecting a CEO who inspires loyalty is the best way to build a strong new business. This is especially important in interdependent JVs, where personal loyalty to the JV CEO can help unite the management team and overcome the employees' natural affiliations to one parent or the other. The physical proximity of key members of the JV management team is also important for accelerating team building.

The value in creating a strong management team and a motivated staff is obvious. It's equally important to get the staff inside the parent companies on your side. Two groups are worth special attention. The first is the handful of parent company managers who possess distinctive skills that need to be transferred to the joint venture, such as R&D, product marketing, or manufacturing process design. The second is the broader set of employees performing day-to-day work for the JV, who continue to reside in a parent company.

**Obtain commitments from parent company staff.** Top-performing companies recognize that skills are transferred by people, not by processes or contracts. Failure to acknowledge this can be costly. For instance, a global consumer goods company held a 50% stake in a partner in a developing country; the resulting JV was looking to the global partner to transfer some of its operating and marketing expertise into the developing-country partner's underperforming beverage business. The JV requested from the global partner two or three people highly skilled in emerging-market branding and marketing. The parent offered very limited support from its developing-country gurus; instead, it sent a marketing executive who had spent most of his career in North America. Lacking access to crucial skills, the JV couldn't prop up the declining brand and failed to capture half of the expected synergies, or around $450 million.

Getting sufficient time and attention from a few topflight people is often critical to a JV's success. Managers at the parent companies often assume that these individuals will contribute their magic to the venture regardless of formal allocations or incentives. To be certain that these valuable players do inject their crucial know-how, the JV launch team needs to identify them right away and create mechanisms to involve them heavily in the first six to 18 months of operations. For example, the CEO of a successful U.S.–Japanese JV spent two weeks during the first month of the venture in Japan finding local managers who truly understood what it would take to build a world-class manufacturing line in the United States. He then persuaded the managers to come to the States for up to a year, where they could have a direct, immediate impact on the layout and operations of the new plant.

Once the skill holders are identified, successful companies create formal contracts for them that define their levels of commitment to the JV (usually 50% or more of their time to ensure focus and accountability) and the metrics by which their performance will be evaluated and rewarded. The launch team also needs to create incentives for parent company employees who spend less than half their time on the JV—for instance, sales reps, administrative staff, and others—so that they are motivated to provide strong support.

For example, two software companies recently created a JV to combine the field sales capabilities of both parent companies. The JV's products would be sold through the venture itself, as well as through both parents. To rally disparate salespeople around this goal, the sales and marketing launch teams focused on developing rules of engagement for all three sales groups (product pricing and positioning, and the management of joint accounts); defining incentives for all the salespeople; and developing mechanisms for building and transferring product knowledge among the sales forces—a critical issue, since the JV would be developing and manufacturing the products.

• • •

Launching a world-class joint venture is complex and demanding. Research shows that it can, in fact, be more resource intensive than postmerger integration or internal business start-ups. Best-in-class companies manage to do it well, sometimes over and over again. They execute the classic launch tasks (organization building and project management) well. They also maintain an intense focus on issues like strategy, deal economics, and governance that most companies assume have been discussed and resolved up front. When executives understand the unique demands of joint ventures, and invest in early planning, the rewards can be enormous. As one manager summed it up: "If you get launch right, the rest almost takes care of itself."

About the Research

Reprint Number R0402G

>| Executive Summary
>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague

| Current Issue | Customer Service | Subscriber Benefits | HBR Subscriber Alert

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review

Click here to visit:
>| http://www.hbsp.org

FEATURE ARTICLE

# Launching a World-Class Joint Venture

**JVs and alliances can deliver more shareholder value than M&As can, but getting them off the ground can trip you up in unpredictable ways.**

***by James Bamford, David Ernst, and David G. Fubini***

**James Bamford** is a consultant in McKinsey & Company's Washington, DC, office and a coauthor of *Mastering Alliance Strategy* (Wiley, 2003). **David Ernst** is a partner in McKinsey's Washington office and a leader of its corporate finance and strategy practice. He is a coauthor of *Collaborating to Compete* (Wiley, 1993). **David G. Fubini** is a senior partner in McKinsey's Boston office and leads its global organization and postmerger management practices.

More than 5,000 joint ventures, and many more contractual alliances, have been launched worldwide in the past five years. The largest 100 JVs currently represent more than $350 billion in combined annual revenues. So it's become clear to many companies that alliances—both equity JVs (where the partners contribute resources to create a new company) and contractual alliances (where the partners collaborate without creating a new company)—can be ideal for managing risk in uncertain markets, sharing the cost of large-scale capital investments, and injecting newfound entrepreneurial spirit into maturing businesses.

What's less clear to these companies is how to overcome the many challenges inherent in implementing joint ventures and alliances. In 1991, we assessed the performance of 49 joint ventures and alliances and found that only 51% were "successful"—that is, each partner had achieved returns greater than the cost of capital. A decade later, in 2001, we assessed the outcomes of more than 2,000 alliance announcements—and the success rate still hovered at just 53%, despite studies that have highlighted the well-known reasons for JV failure: wrong strategies, incompatible partners, inequitable or unrealistic deals, and weak management.

Our most recent research, on which this article is based, confirms that the challenge continues. Why is JV success so elusive? We believe it's because many companies overlook a critical piece of any alliance or JV effort—the launch planning and execution. Although most companies are highly disciplined about integrating acquisitions, they rarely commit sufficient resources to launching similarly sized joint ventures or alliances. Mistakes made during the launch phase often erode up to half the potential value creation of a venture. The launch phase—beginning with the signing of a memorandum of understanding and continuing through the first 100 days of operation—is usually not managed closely enough. This lack of attention can result in strategic conflicts between the allied companies, governance gridlock, and missed operational synergies. As one executive told us, "If we could improve our skills in one area, it would not be in deal making or ongoing management but in the launch phase. That's where the rubber meets the road."

**Weak controls can cost the parent companies money and can expose them to unexpected risks.**

### JV Challenges

When an organization brings an acquired company into the fold, only one corporation exists after the deal, allowing for unilateral decision making. By contrast, after two companies agree to an alliance, there are still multiple parties (two parent companies, and, in many cases, a new company) dealing with disparate interests. This creates a unique set of challenges. (For an overview of the challenges companies face in launching JVs and alliances, see the exhibit "Clearing the Hurdles.")

## Clearing the Hurdles

M&As are notoriously difficult to manage, but JVs and alliances bring their own set of challenges, outlined here. To overcome each of the four challenges—and at every stage of the JV's development and launch—companies need to assign dedicated project management teams.

| | Strategy | Governance | Economics | Organization |
|---|---|---|---|---|
| **JV Challenges** | • Parent companies may hold different strategic interests, which may affect the nature and degree of integration. | • Parents share control of the JV, which complicates decision making.<br>• Parents have separate reporting systems, processes, and metrics. | • Parents provide ongoing services, staffing, and resources to the JV, which affects venture economics. Transfer pricing may become an issue.<br>• The JV's performance is less transparent compared with that of the parents' wholly owned businesses. | • Parents must manage cultural differences, as well as conflicting incentives and career paths. |
| **Keys to Successful Launch** | • Align the parents' interests around the JV's objectives up front.<br>• Specify first-year goals for the JV. | • Apply loose-tight governance.<br>• Create clear protocols for decision making. | • Specify the services parents will provide, and establish fair transfer-pricing schemes.<br>• Establish good risk- and performance-management systems for the JV. | • Secure commitments from key staff – especially from parent company employees.<br>• Create a compelling value proposition for JV employees. |

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

The first challenge is building and maintaining *strategic alignment* across the separate corporate entities, each of which has its own goals, market pressures, and shareholders. If these individual interests are not addressed during the launch phase, conflicts will develop in crucial strategic areas. For instance, should the JV's products or services target high-end or mass-market consumers? Should the venture's reinvestment goals emphasize revenue growth or cash flow? Such conflicts can delay the venture's development and can set the stage for costly compromises down the road. JV and alliance partners try to anticipate areas of potential misalignment during the negotiation phase—but many conflicts of interest surface only when the partners dig deep into operational details and start to run the business.

The second challenge is to create a *governance* system that promotes shared decision-making and oversight between the two parent companies. Even though a joint venture isn't necessarily a marriage for life, governance problems can quickly trigger termination of the deal. Weak controls can cost the parent companies money and can expose them to unexpected risks. The secret to effective governance is balance: providing enough

oversight to protect important assets without stifling entrepreneurship.

The third challenge that most joint ventures—and virtually all nonequity alliances—face is managing the *economic interdependencies* between the corporate parents and the JV. To avoid duplicating costs, most alliances are structured so that the parents continually provide financial capital, human skills, material resources, and marketing and other services. The parent companies generally do outline the broad extent of the economic interdependencies during the negotiation phase—but they often don't quantify the specific resources and finances that should be flowing to and from each partner until the launch phase. Consider what Starbucks and PepsiCo did. In 1994, the companies formed their successful North American Coffee Partnership, a JV with more than 90% of the U.S. ready-to-drink coffee business. The venture was set up with fewer than a dozen full-time professionals, who have capitalized on the parent companies' capabilities. Starbucks contributes services such as coffee purchasing and roasting, creation of beverage concentrates, and quality assurance. PepsiCo provides distribution of the JV products to grocery, convenience, and mass-market stores. The two companies jointly manage marketing and product development. And they agreed during the launch phase on specific ground rules for compensating each parent fairly for its contributions.

The fourth challenge is building the *organization*—a cohesive, high-performing JV or alliance—when most managers come from, will want to return to, and may even hold simultaneous positions in the parent companies. Many venture CEOs lament that alliances are treated as dumping grounds for underperforming executives, rather than as magnets for high-potential managers. Most companies that complete a merger dedicate a full-time team of their best leaders to integrate the target company. By contrast, many JV launch teams comprise a handful of part-time managers who are learning as they go. According to a board member of one successful multibillion-dollar JV, "We agreed to virtually every decision—picking the IT systems, selecting staff at every level—prior to closing the deal." If organizations underinvest in launch project management, they can jeopardize the long-term health of their ventures.

Some guidelines for launch planning and execution apply to all JVs and alliances. The parents should appoint a launch leader (sometimes, but not always, the JV CEO) and identify deal champions. The latter are typically senior executives from each parent company who are known and respected across the organization and have a strong interest in the success of the joint venture. The parents should also assemble a dedicated and experienced transition team immediately upon signing the memorandum of understanding. This team is responsible for getting the business up and running. Its tasks include developing a detailed business plan, creating the 100-day road map that orchestrates the activities of all work groups, and intervening when the launch process veers off track.

Other requirements of launch planning vary based on the nature of the venture. There are basically four types of joint ventures: In the *consolidation JV,* the value of the alliance comes from a deep combination of existing businesses. In the *skills-transfer JV,* the value comes from the transfer of some critical skills from one partner to the joint venture—and sometimes to the other partner. In the *coordination JV,* the value comes from leveraging the complementary capabilities of both partners. And in the *new-business JV,* the value comes from combining existing capabilities, not businesses, to create new growth. The transition team should focus on maximizing operational synergies in the first two cases, and it should focus on understanding new or expanded market opportunities in the latter two.

Once the right launch team is in place and a time line has been set, the real work begins. Successful JVs tackle each of the challenges outlined previously. They preempt

failure by exposing inherent tensions early in the process. They move quickly from general road maps to detailed, practical planning. They clarify strategy and governance, and they put in place the right incentives and processes to secure top talent and critical resources from the parents.

---

**When Is a JV Worth the Trouble?**

Sidebar **R0402G_A** (Located at the end of this article)

---

## Resolving Strategic Conflicts Up Front

It is common for companies to assume that the JV's strategy has already been defined during deal making and that the launch phase, therefore, is simply the time to implement a shared strategic vision. In our experience, it is virtually impossible to get into enough detail during the deal-making phase to surface and resolve all the strategic differences between the corporate parents.

Consider the following examples. Two large pharmaceutical companies formed a venture to expand the market for a specific class of drugs. Each partner contributed complementary patent-protected medicines within the drug class and regional marketing strengths to the JV. Yet once the JV was up and running, one parent wanted to promote its higher-margin, lower-volume products, while the other parent wanted to expand its market share for its products through aggressive pricing. The companies had failed to address this fundamental misalignment early in the process, and the venture struggled through two years of friction and weak sales before one partner ultimately bought the other out. In another consolidation JV between two global chemical companies, it was clear early on that one partner was more willing to invest in the venture than the other one was. The companies had different targets for return on capital and different perceptions of the long-term strategic benefits associated with the venture. The CEO of this joint venture was caught in the cross fire, lacking agreement from the parent companies about how and where the JV would compete and what level of investment was appropriate. In both cases, the companies had failed to discover strategic conflicts early enough in the launch process, when the partners might have been more amenable to negotiation. To root out these conflicts, companies should do the following:

**Develop a VC-quality business plan.** Prior to closing the deal, the launch team, working with future management, needs to develop a detailed business plan. It should meet the same standards of rigor, detail, and logic that a venture capitalist would demand. To start with, the management team (the CEO, CFO, and COO) should meet off-site for two or three days with members of the JV board and the deal champions from both parent companies. The group should define exactly how and where the JV will compete, project how the JV might expand beyond its initial scope, set financial targets, plan capital expenditures, and create a blueprint for the organization. This work is then translated into a detailed business plan. It all sounds straightforward, but these meetings are often contentious precisely because they reveal gaps in strategic alignment.

The launch team, working with the JV board, also needs to draw up performance contracts that make key JV managers accountable for the success of the venture. The partners should clarify the resources, personnel, and behaviors required for the JV's success so confusion about these matters won't hamstring the people charged with running the venture day to day. Consider the following example: Four electric power companies interviewed for a CEO to run their proposed joint venture. One candidate was offered the position but took his time in deciding whether to accept. Before committing to the venture, he interviewed each board member to understand the parents'

objectives, revised the JV business plan, and proposed six specific objectives for the first nine months of his tenure as CEO. He then insisted on the collective endorsement of the JV board as a precondition to accepting the job, and he negotiated a compensation agreement that linked his bonus to these objectives. He also negotiated an employment contract that empowered him to make key operating decisions and choose executives. As he later explained, “In joint ventures, especially with many partners, there is a tendency for the partners to each make back-channel requests of the CEO and to try to influence the alliance through people they put into the JV. I was not going to put up with that. I needed all the partners to agree on the venture’s overall priorities and hold me responsible for executing against them.”

**Successful alliances pay a lot of attention to communication—not just during the launch phase, but throughout the life of the venture.**

**Act quickly to manage inevitable setbacks.** A detailed business plan and supporting performance contracts are important, but they can’t prevent unpleasant surprises once the venture is launched. For instance, Starbucks and PepsiCo were forced to rethink the direction of their joint venture after the first product it introduced, a carbonated coffee drink, received mixed results in early tests with customers. “We had a great partner, a leveraged organizational model, but no product,” one Starbucks executive recalled. The partners ultimately redefined the JV’s product, drawing on the lessons they learned from those initial market tests.

Successful alliances pay a lot of attention to communication—not just during the launch phase, but throughout the life of the venture. For instance, senior management at TRW Koyo Steering Systems, a JV manufacturer of automotive components, followed a policy of “equal communications” with each of the parent companies (TRW Automotive and Koyo Seiko). When Arvind Korde, CEO of the JV, needed to communicate facts or issues to one parent, he always copied the other parent, thereby promoting openness and trust. And Korde and his team were quick to react to problems. One year into the venture, the JV was on the verge of securing its first customer, which exposed the parent companies’ difference of opinion around pricing. TRW, which was focused on profitability more than growth, argued for higher margins and prices. Koyo Seiko sought to build market share and maximize the scale of its global relationship with key Asian customers. “This was a real turning point for the JV,” Korde recalls. “Despite our early success, I wasn’t sure we would make it out of there alive.” Korde called an off-site meeting of his management team in which they experienced what he calls a “coming to Jesus” moment. In that session, the management team crafted a new vision for the JV and a constructive approach for resolving the conflict.

### Achieving Loose-Tight Governance

Besides managing the parents’ goals and expectations, the launch team needs to focus on building an effective governance system for the JV or alliance. An appropriate structure should allow the JV management team to make timely decisions while providing the parents with sufficient oversight to protect their assets.

During the deal phase, most companies focus on the composition of the board, the parent companies’ veto rights, and the conditions for termination of the venture. But effective ongoing governance requires more than contractual agreements. Without the right launch planning, the typical JV contract is a recipe for disaster because every major decision is subject to board approval, which requires the agreement of both partners. The default process for resolving disputes is often, “Talk some more.” This usually results in strategic deadlock between the parent companies, followed by erosion of the

synergy created by the deal and, often, termination of the venture. The launch phase is the time to go beyond the lines and boxes and address how decisions will be made and disputes resolved. To find the right balance between giving the JV enough autonomy and granting the parents enough control, companies should do the following:

**Apply rigorous risk management and performance tracking.** Some companies grant the venture management team so much autonomy that it borders on negligence. This was the case in a billion-dollar industrial JV that combined similar business units to increase scale and reduce operating costs. During the launch phase, the partners failed to create adequate oversight mechanisms. Three years into the alliance, the U.S. partner was dismayed to discover that the JV had incurred a $400 million debt without ever having gone through either parent's capital-budgeting process. In a second JV at the same company, one parent found that the venture was delivering an annual 3% return on invested capital, a figure well below its targeted rate of 14%. The JV was not part of the standard corporate-planning and strategy review forums and was never subject to the same level of scrutiny as the wholly owned businesses.

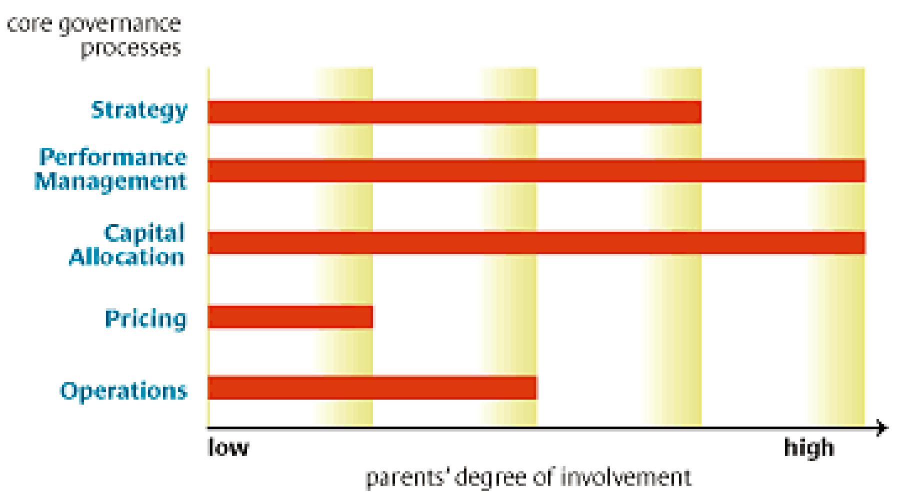
In the wake of Sarbanes-Oxley, companies have increased their attention to transparency, risk management, disclosure, and performance management in their wholly owned businesses. But our research shows that companies don't evaluate the performance of their JVs as diligently as they do their wholly owned businesses with equivalent assets. That's a mistake; parents need to treat their ventures and their wholly owned units similarly. This means, for large joint ventures, putting in place an audit process like the ones used at the best public companies, including an active audit committee and external auditors focused solely on the venture's economics. It means building a strong finance organization inside the JV to make sure that the board and venture management have the critical information they need to do their jobs. And sometimes it means including the JV in at least one parent's annual or semiannual corporate review, thereby ensuring transparency.

**Streamline decision making.** Of course, some corporate parents go too far and implement governance systems that stifle entrepreneurship and create dysfunctional bureaucracy. During the launch of a $4 billion natural resource JV, the parent companies created a large board with subcommittees intended to be heavily involved in—but not accountable for—the day-to-day operations of the venture. All major decisions required multiple subcommittee and board meetings, interspersed with additional fact-finding efforts by the JV management team. Since each subcommittee met only four times per year, the time it took for the JV to make a decision became a distinct competitive disadvantage. As a result, profitability declined, frictions among the parent companies and the venture's management escalated, and the parents had to completely restructure the JV's governance approach.

Companies can avoid this governance trap by implementing a loose-tight governance model. (See the exhibit "The Loose-Tight Approach.") In this approach, the partners identify the venture's most important governance processes (for instance, setting strategy, allocating resources, or determining pricing) and then designate the appropriate degree of parental involvement for each. As a general rule, parent companies operating through a JV board should play an active role in the three governance areas critical to driving financial performance and protecting shareholder interest: capital allocation, risk management, and performance management. The parents should generally limit their interventions in more operational processes—such as staffing, pricing, and product development—where the JV needs independence to ensure competitiveness and market responsiveness.

## The Loose-Tight Approach

To find the right balance between maintaining enough control over their joint ventures and giving the ventures enough autonomy, parent companies should apply a loose-tight governance model, identifying the most important governance processes in the JV and formally designating what their degree of involvement will be in those areas. As the chart below suggests, it's most important for parents to be actively involved in areas that are critical to protecting shareholder interests – for instance, in managing performance and in allocating capital.




Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

Once a high-level governance road map is in place, the launch team needs to translate it into practical decision-making processes that are consistent with the parent companies' formal and informal governance and influence structures. There are many ways to do this, but one effective approach is to map out each governance process, showing how information and decisions flow through the JV and parent companies. For example, a request for capital could originate within the JV's manufacturing organization and be formally submitted to the board for approval. But the way the process might work in practice is for board members to survey the CFOs at each parent company to make certain that the proposal meets their individual capital-expenditure requirements and then convene an informal discussion with one or both parent CEOs to make sure they're aligned. By mapping out both formal and informal decision-making processes, you can reduce the time and effort it will take to approve major initiatives.

**The launch team needs to challenge—and limit wherever possible—the interdependencies between the parents and the JV.**

### Managing the Interdependencies

For practical reasons, most JVs depend on their parents to provide ongoing access to capital, people, intellectual property, raw materials, and customers. Both tangible and intangible contributions from the parents determine their actual return on investment. But much damage can be done if the details of those contributions aren't worked out during launch. For instance, if transfer prices (the internal fees that one group charges

another for a resource or a service) are not set appropriately, Parent A, who provides a resource to the joint venture, has an opportunity to supplement its returns "off the books" of the JV. When Partner B sees this happening, it uses the information to justify holding back its committed contributions, creating a loop of partner suspicion and distrust.

Winning JVs start to address economic interdependencies as soon as an agreement looks likely in order to avoid launch delays and the loss of millions of dollars in potential synergies. They make sure that the launch team contains appropriate expertise and authority to resolve important economic issues. Specifically, successful ventures do the following:

**Dedicate resources to resolve interdependencies up front.** The process of sorting out who will provide what to the joint venture is time-consuming for everyone involved. In one high-tech consolidation JV, the partners spent 10,000 man-hours over four months determining precisely which services and resources each parent would provide the JV and constructing service-level agreements that specified transfer pricing, access rights, and other critical terms of the deal. The work can't be postponed just because it is contentious and resource intensive. According to one JV executive we spoke with, "Shared services are often a critical part of determining total venture economics and how the value is distributed between the partners." In the high-tech consolidation JV, the partners formed a small transition services team that identified the economic interdependencies across the 20 launch teams. This group established criteria for determining which services the JV would purchase from the parents. It then documented the shared resources and services and collaborated with the purchasing and finance teams to price each shared service.

**Challenge and limit interdependencies.** One of the most valuable tasks of the launch team is to challenge—and limit wherever possible—the number of interdependencies between the parents and the JV. Working teams in the high-tech consolidation JV initially generated a list of more than 1,000 dependencies upon one parent—that parent was slated to provide administrative services, component purchases, and shared research facilities, among a slew of other resources. Recognizing that a heavy load could create unmanageable complexity down the road for the parent company, the launch leaders challenged virtually every line item on the list. Eventually, they whittled it down to just 300 services that the parent would provide the venture in the first year and less than ten services in the second year and beyond.

Once a list of shared services is finalized, the launch team must develop transparent and honest methodologies for calculating transfer pricing. This is critical for maintaining trust down the road. A 50-50 telecom joint venture depended on one parent for 90 different shared services. Two years into the JV, a strategic review revealed that this partner was allocating its corporate overhead and other nonshared costs to the JV, thereby creating significant profits for itself while hampering the venture's ability to set competitive prices and make a profit. The partners did renegotiate transfer pricing, but the distrust that was created continues to plague the venture.

**Parent companies need to move outside their comfort zones when devising an organizational structure for their JVs.**

To avoid this situation, the launch team should agree at the outset on the methods for allocating costs, specifying which operating costs should be included (for instance, customer billing or maintenance) and the basis upon which to allocate each shared cost (for instance, per subscriber, per region, per dollar of revenue). The launch team should

also establish a way to benchmark the parents' internal pricing and quality of service against those of outside vendors and suppliers. And the launch team should specify a path for resolving contentious economic issues.

Finally, the JV should be linked to the corporate review and planning cycle of at least one of the parents, reducing the odds that important economic issues will fall between the cracks and require 11th-hour intervention.

### Building the Organization

Parent companies may need to move outside their comfort zones when devising an organizational structure for their JVs, adopting a staffing model, and designing incentive plans. There is a tendency in many JVs that combine existing organizations to select a familiar organizational model—either a regional one, if the parents are contributing assets from different regions, or a product-division structure, if each parent is contributing different products. This simple approach allows each parent to protect its turf and minimize organizational disruption—but it also dilutes the potential effectiveness of the new organization. If the parents try to preserve the status quo, they risk reducing the synergies between them. And let's not forget that companies are often attracted to the JV structure precisely because of their need for a new model and mind-set to compete in a new business. The creation of a joint venture is an opportunity to unfreeze the organization. Beyond the issue of formal structure, a successful JV launch requires taking the following approaches to staffing and incentives.

**Choose your organizational model carefully.** There are three basic organizational models for joint ventures: independent, dependent, and interdependent. The independent model, pursued by companies such as Carlson Wagonlit Travel and Marathon Ashland Petroleum, lets companies create new and often more entrepreneurial cultures. The independent JV typically has an entirely separate reporting structure from the parents, its own facilities, and the freedom to source from external as well as internal suppliers. This model allows venture management to have greater focus and unity of purpose, but it also requires the venture to establish and maintain separate HR systems. This can make it harder to recruit potential managers who would prefer the wider career opportunities offered by the parent companies.

Some companies go to the opposite extreme and create dependent JVs. This type of JV operates as a business unit of one parent and uses that parent company's incentive systems and HR policies. BP and Mobil used this approach when creating two JVs in their downstream European oil businesses: The refining venture operated as a BP business, while the lubricants venture operated as a Mobil business. The advantages here are opposite those of the independent JV. There is no need to create a separate HR system for the venture, and the managing parent ensures that the venture's high performers get equal access to promotion opportunities within the wholly owned businesses. But the dependent model limits the JV's ability to share people and skills with the nonoperating partner and gives that partner less influence in the JV.

The third model, the interdependent JV, is tough to execute but is by far the most commonly implemented structure. Members of the management team maintain links to their original corporate parent. They remain on the same compensation plans, anticipate future career moves back to the parent, and sometimes have dotted-line-reporting relationships to an executive in their parent organization. The interdependent model protects career paths and offers maximum flexibility, but it can be complex to manage and can perpetuate divided loyalties.

In one billion-dollar global media JV, the management team remained culturally divided

into U.S. and German camps two years after the venture's formation. This interdependent JV was operating in a mature sector, and the partners had agreed to rotate the senior positions between them every three years—which created a questionable career path for those deciding to stay at the JV. To make matters worse, the venture was functioning at a significant talent disadvantage. Those managers who performed well were repatriated back to the parents, while those with mediocre performance remained at the venture. This JV was further bedeviled by unclear reporting relationships. For example, a senior-ranking German manager in the JV routinely communicated privately with a senior board member from the German parent (who was his former boss). As a result, the JV CEO had to treat his second in command as a board liaison rather than a direct report, making it difficult to hold his feet to the fire on performance issues.

Unfortunately, this is not an isolated case. Many JVs are held back because they offer the wrong incentives and are unclear about accountability. And the problems are not limited to the senior management team; they spread throughout the venture, even back to the support staffers who remain with the parent organizations.

The disadvantages of the interdependent model can be mitigated if the JV CEO is empowered to write performance reviews and to make all hiring and firing decisions; if all parties agree up front on performance criteria; if a minimum tour of duty is established within the venture, typically three years; and if the parents aren't allowed to poach from the venture until that tour of duty is up.

**Make people want to join the team.** Regardless of the organizational model, the launch team must create a compelling value proposition that makes good people want to join the team. For start-ups, the excitement of building something from the ground up is often sufficient to attract motivated players. In difficult turnaround situations, the compensation upside might be essential (lower base pay but higher bonus or stock options than in the parent companies).

Personal considerations cannot be underestimated. Everyone wants to work for a motivational leader, and selecting a CEO who inspires loyalty is the best way to build a strong new business. This is especially important in interdependent JVs, where personal loyalty to the JV CEO can help unite the management team and overcome the employees' natural affiliations to one parent or the other. The physical proximity of key members of the JV management team is also important for accelerating team building.

The value in creating a strong management team and a motivated staff is obvious. It's equally important to get the staff inside the parent companies on your side. Two groups are worth special attention. The first is the handful of parent company managers who possess distinctive skills that need to be transferred to the joint venture, such as R&D, product marketing, or manufacturing process design. The second is the broader set of employees performing day-to-day work for the JV, who continue to reside in a parent company.

**Obtain commitments from parent company staff.** Top-performing companies recognize that skills are transferred by people, not by processes or contracts. Failure to acknowledge this can be costly. For instance, a global consumer goods company held a 50% stake in a partner in a developing country; the resulting JV was looking to the global partner to transfer some of its operating and marketing expertise into the developing-country partner's underperforming beverage business. The JV requested from the global partner two or three people highly skilled in emerging-market branding and marketing. The parent offered very limited support from its developing-country gurus; instead, it sent a marketing executive who had spent most of his career in North

America. Lacking access to crucial skills, the JV couldn't prop up the declining brand and failed to capture half of the expected synergies, or around $450 million.

Getting sufficient time and attention from a few topflight people is often critical to a JV's success. Managers at the parent companies often assume that these individuals will contribute their magic to the venture regardless of formal allocations or incentives. To be certain that these valuable players do inject their crucial know-how, the JV launch team needs to identify them right away and create mechanisms to involve them heavily in the first six to 18 months of operations. For example, the CEO of a successful U.S.–Japanese JV spent two weeks during the first month of the venture in Japan finding local managers who truly understood what it would take to build a world-class manufacturing line in the United States. He then persuaded the managers to come to the States for up to a year, where they could have a direct, immediate impact on the layout and operations of the new plant.

Once the skill holders are identified, successful companies create formal contracts for them that define their levels of commitment to the JV (usually 50% or more of their time to ensure focus and accountability) and the metrics by which their performance will be evaluated and rewarded. The launch team also needs to create incentives for parent company employees who spend less than half their time on the JV—for instance, sales reps, administrative staff, and others—so that they are motivated to provide strong support.

For example, two software companies recently created a JV to combine the field sales capabilities of both parent companies. The JV's products would be sold through the venture itself, as well as through both parents. To rally disparate salespeople around this goal, the sales and marketing launch teams focused on developing rules of engagement for all three sales groups (product pricing and positioning, and the management of joint accounts); defining incentives for all the salespeople; and developing mechanisms for building and transferring product knowledge among the sales forces—a critical issue, since the JV would be developing and manufacturing the products.

• • •

Launching a world-class joint venture is complex and demanding. Research shows that it can, in fact, be more resource intensive than postmerger integration or internal business start-ups. Best-in-class companies manage to do it well, sometimes over and over again. They execute the classic launch tasks (organization building and project management) well. They also maintain an intense focus on issues like strategy, deal economics, and governance that most companies assume have been discussed and resolved up front. When executives understand the unique demands of joint ventures, and invest in early planning, the rewards can be enormous. As one manager summed it up: "If you get launch right, the rest almost takes care of itself."

---

**About the Research**
Sidebar **R0402G_B** (Located at the end of this article)

---

Reprint Number R0402G

## When Is a JV Worth the Trouble?

Sidebar **R0402G_A**

Some managers avoid or overlook the JV option because they aren't sure at what point the advantages outweigh the complexities. Yet some companies have developed a core competency in alliances and pursue JVs over and over again with good results.

Judicious use of JVs starts with a careful evaluation of the business opportunity at hand. First, consider your dedicated internal resources. If you don't have the required skills and experience in house—and there is not enough time to develop these capabilities from scratch—an external vehicle (a JV, a contractual alliance, or mergers and acquisitions) might be a good option.

In general, the further removed a new business opportunity is from a company's core competencies and existing businesses, the more likely the company is to consider an alliance instead of an acquisition or organic growth. Alliances tend to have higher success rates than M&As when the objective is to enter a new region, product area, or customer segment or to develop entirely new capabilities. Alliances have lower success rates when control is important—for instance, when the goal is consolidation of operations or improved performance.

Many companies assume the fastest way to gain scale with new products or capabilities is to buy or merge with another company. But anyone who's gone down the M&A evaluation path knows the barriers and risks. Mergers and acquisitions often require that the buyer pay a premium of 20% to 50% over the current stock price of the targeted company. But experience and research show that most acquirers never recover that premium. By contrast, a joint venture typically involves no premium.

An unwilling M&A target or partner can also be a barrier. If two companies are comparable in size, and one party is unwilling (or unable, perhaps by local law) to participate in a merger, a joint venture may be an attractive alternative for capturing specific capabilities from another company. And let's not forget that integrating an acquired company takes lots of time and resources. It can tie up managers for years while the core business goes unattended. The process is particularly risky when a company has no experience—or a poor track record—with integrating acquisitions. Again, a joint venture or contractual alliance, which can allow a more tailored deal, may be a safer alternative.

Equity JVs make the most sense when value will be gained by integrating assets or capabilities, or when the size of the prize warrants the effort of setting up a separate company with its own culture and P&L. Contractual alliances can be a good alternative when the relevant assets or capabilities cannot be carved out of the parent companies (for instance, a sales force or a brand) and when value creation is driven by improved coordination and learning, not resource integration.

## About the Research

Sidebar **R0402G_B**

To better understand the challenges of JV launch, we and our colleagues in McKinsey's postmerger management and alliances practices interviewed 50 executives who were directly involved in the launch of 25 joint ventures across the globe. (The interviews took place in 2002 and 2003.) The ventures represented assets or revenues in excess of $300 million, involved some degree of operational integration, and covered a range of industries: automotive, consumer products, electronics, energy, financial services, pharmaceuticals, and telecommunications, among others. The companies were based in the United States, Europe, Asia, and emerging markets. Most of these JVs were two to five years of age—old enough to have a track record of performance but young enough for executives to remember launch details.

Over the past decade, we've interviewed more than 500 executives about their alliances and have advised more than 1,000 companies on alliance strategy, structuring, launch planning, and restructuring. We also have conducted several studies (in 1991 and 2001) of alliance success rates and the factors associated with success and failure.

Our definition of an alliance covers a broad range of collaborations involving shared risk, rewards, and control. These include equity joint ventures where a separate company is created; contractual alliances (with or without equity stakes), such as exclusive marketing or distribution arrangements; and joint marketing agreements. While this article focuses primarily on joint ventures, many of the findings apply equally to deep contractual alliances.

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

Launching a World-Class Joint Venture

# When Is a JV Worth the Trouble?

Some managers avoid or overlook the JV option because they aren't sure at what point the advantages outweigh the complexities. Yet some companies have developed a core competency in alliances and pursue JVs over and over again with good results.

Judicious use of JVs starts with a careful evaluation of the business opportunity at hand. First, consider your dedicated internal resources. If you don't have the required skills and experience in house—and there is not enough time to develop these capabilities from scratch—an external vehicle (a JV, a contractual alliance, or mergers and acquisitions) might be a good option.

In general, the further removed a new business opportunity is from a company's core competencies and existing businesses, the more likely the company is to consider an alliance instead of an acquisition or organic growth. Alliances tend to have higher success rates than M&As when the objective is to enter a new region, product area, or customer segment or to develop entirely new capabilities. Alliances have lower success rates when control is important—for instance, when the goal is consolidation of operations or improved performance.

Many companies assume the fastest way to gain scale with new products or capabilities is to buy or merge with another company. But anyone who's gone down the M&A evaluation path knows the barriers and risks. Mergers and acquisitions often require that the buyer pay a premium of 20% to 50% over the current stock price of the targeted company. But experience and research show that most acquirers never recover that premium. By contrast, a joint venture typically involves no premium.

An unwilling M&A target or partner can also be a barrier. If two companies are comparable in size, and one party is unwilling (or unable, perhaps by local law) to participate in a merger, a joint venture may be an attractive alternative for capturing specific capabilities from another company. And let's not forget that integrating an acquired company takes lots of time and resources. It can tie up managers for years while the core business goes unattended. The process is particularly risky when a company has no experience—or a poor track record—with integrating acquisitions. Again, a joint venture or contractual alliance, which can allow a more tailored deal, may be a safer alternative.

Equity JVs make the most sense when value will be gained by integrating assets or capabilities, or when the size of the prize warrants the effort of setting up a separate company with its own culture and P&L. Contractual alliances can be a good alternative when the relevant assets or capabilities cannot be carved out of the parent companies (for instance, a sales force or a brand) and when value creation is driven by improved coordination and learning, not resource integration.

< Back to Article

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

## Launching a World-Class Joint Venture

# About the Research

To better understand the challenges of JV launch, we and our colleagues in McKinsey's postmerger management and alliances practices interviewed 50 executives who were directly involved in the launch of 25 joint ventures across the globe. (The interviews took place in 2002 and 2003.) The ventures represented assets or revenues in excess of $300 million, involved some degree of operational integration, and covered a range of industries: automotive, consumer products, electronics, energy, financial services, pharmaceuticals, and telecommunications, among others. The companies were based in the United States, Europe, Asia, and emerging markets. Most of these JVs were two to five years of age—old enough to have a track record of performance but young enough for executives to remember launch details.

Over the past decade, we've interviewed more than 500 executives about their alliances and have advised more than 1,000 companies on alliance strategy, structuring, launch planning, and restructuring. We also have conducted several studies (in 1991 and 2001) of alliance success rates and the factors associated with success and failure.

Our definition of an alliance covers a broad range of collaborations involving shared risk, rewards, and control. These include equity joint ventures where a separate company is created; contractual alliances (with or without equity stakes), such as exclusive marketing or distribution arrangements; and joint marketing agreements. While this article focuses primarily on joint ventures, many of the findings apply equally to deep contractual alliances.

< Back to Article

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

MANAGING YOURSELF

# Success That Lasts

**Single-minded ambition is a great way to achieve some goals—but is that really success? New research reveals surprisingly practical ways to find professional and personal fulfillment.**

***by Laura Nash and Howard Stevenson***

**A 55-year-old, highly successful venture capitalist** *is thinking about his next investment. He's not certain he has the energy to start another seven-year round of intense financing and consulting activity. "I just can't imagine enjoying that pace again, and frankly, it's time I paid attention to my family. But I'd really feel a loser if I didn't play the game as hard as everyone else. I guess I should retire."*

**The president of a $1 billion division** *of a consumer products company discovers that manufacturing and distribution bugs will delay the scheduled rollout of a new product line. Retailers are eager for the product, pressures on share price are intense, and the president's bonus is tied to the rollout's success. If he goes ahead, the product is sure to be on top—but only temporarily. The costs down the road from disappointed consumers and time invested in having to fix mistakes will clearly hurt the bottom line. What is success under these circumstances?*

**A fast-track 32-year-old software engineer** *with a second degree in sacred music feels that something is missing in her career strategy. She wants the lifestyle of a well-paid manager, but software doesn't feel as socially significant as playing the organ for a congregation. And she someday wants a house and a family. "Why can't I find the career path that will get me all of these things?" she wonders. "Are they really so unreasonable?"*

>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague
>| Executive Summary

IN THIS ARTICLE

The Kaleidoscope Strategy for Businesses

WRITTEN BY

**Laura Nash** (lnash@justenoughsuccess.com) is a senior research fellow and **Howard Stevenson** (hstevenson@justenoughsuccess.com) is the Sarofim-Rock Professor of Business Administration at Harvard Business School in Boston. They are the authors of *Just Enough: Tools for Creating Success in Your Work and Life* (John Wiley & Sons, 2004), from which this article is adapted.

Different as these examples may be, these individuals have a similar problem: They all need a comprehensive framework for thinking about success. And they're far from alone.

Survey after survey shows a high degree of job dissatisfaction and burnout among the general working population, even among those with plenty of options. In the collective soul-searching prompted by September 11, 2001, many high achievers revisited their notion of success. The wave of corporate scandals that followed soon after only made the questions more acute. Even the most dedicated employees wondered aloud whether they would ever recommend their own careers and companies to their children.

Pursuing success is like shooting at a series of moving targets. Every time you hit one, five more pop up from another direction. Just when we've achieved one goal, we feel pressure to work harder to earn more money, exert more effort, possess more toys. Standards and examples of "making it" constantly shift, while a fast-paced world of technological and social change constantly poses new obstacles to overcome.

During the past decade, traditional career paths suddenly became pointless. Professionals found themselves overworked and undersatisfied in the boom, then overworked and competitively vulnerable in the bust. And far too many businesses discovered they were using the wrong measures to gauge success, winning big in the 1990s only to lose big for their shareholders and employees at the turn of the millennium. The climb to success can feel like an Escher drawing of a staircase that goes nowhere.

In the face of such instability, many people assume success requires a winner-takes-all approach. They believe that success depends on putting all your energy into achieving one goal, be it a single-minded focus on your job or a commitment to being the best soccer mom in your community. But no matter how noble, one goal can't satisfy all of a person's complex needs and desires, as the examples at the beginning of the article demonstrate. The same holds true for the goals of a business.

Fortunately, success doesn't have to be seen as a one-dimensional tug-of-war between achievement and happiness. If developed in the right way, your ideals of the good life for yourself and society can become powerful—and manageable—factors of success. We studied hundreds of high achievers who realize lasting success, make a positive difference, and enjoy the process. And we learned that some of the most successful people have gotten where they are precisely because they have a greater understanding of what success is really about and the versatility to make good on their ideals. In this article, we'll introduce a practical framework that will help you see success in these same

terms. But first, a closer examination of how we arrived at this model.

### What Is Enduring Success?

Our research took a fresh look at the assumptions behind success. We were interested in real, enduring success—where getting what you want has rewards that are sustainable for you and those you care about. This type of attainment delivers a sense of legitimacy and importance; its satisfactions endure far beyond the momentary rewards of a bonus or a new position. Lasting success is emotionally renewing, not anxiety provoking.

Unlike an equation for a successful market strategy, no one person or company can fully embody lasting success for others. Everyone (and every business) has a unique vision of real success, and that notion changes over time. A family-oriented person would hardly call the absentee life of a top executive a success but might find travel and adventure just the ticket after the kids grow up. A born investment banker would hardly regard mixing cement as a successful career, whereas a construction worker who just completed an extraordinary bridge might point to the structure with pride for the rest of his or her life. No one, however, has unreserved success, not even the most obvious winner. Recognizing how important it is for each person to understand and develop his or her unique definition of success over time, we chose not to report on one or two well-known examples of success as the perfect model to follow.

Nonetheless, for the purposes of research, we posited five common characteristics of individuals who by most standards had achieved enduring success: high achievement, multiple goals, the ability to experience pleasure, the ability to create positive relationships, and a value on accomplishments that endure.

We held more than 60 interviews with successful professionals, surveyed 90 top executives attending Harvard Business School management programs, and informally observed high achievers with whom we live and work. We conducted more than a dozen model-testing sessions with between 50 and 110 executives in each. Most of these groups were drawn from HBS graduates or current members of the Young Presidents' Organization. We also reviewed the problems that the general population has reported about success, using sources that ranged from media reports to conversations with friends, students, and colleagues. We talked to people from all different walks of life, at every level of the economy, both in and out of business careers. Some of them were stay-at-home parents who had once worked full time; others were at the pinnacle of their careers.

### The Complexity of Success

Success involves more than a heart-pounding race to the finish line. Our research uncovered four irreducible components of enduring success: happiness (feelings of pleasure or contentment about your life); achievement (accomplishments that compare favorably against similar goals others have strived for); significance (the sense that you've made a positive impact on people you care about); and legacy (a way to establish your values or accomplishments so as to help others find future success).

These four categories form the basic structure of what people try to gain through the pursuit and enjoyment of success. Take away any one component, and it no longer feels like "real" success. If you were wildly wealthy because you had mastered a certain business problem but couldn't experience pleasure, for instance, would you consider yourself successful? If building your power base kept you from being there for others, would your success feel morally right? If you left your career to be a full-time parent, would you have enough of an outlet for your talents? Just as a steady diet of the same four foods would hardly be satisfying over the long term, the four components of success cannot be satisfied by the presence of a single flavor in each category. That is why you cannot neatly categorize the realms of your life, assigning happiness to self, achievement to work, significance to family, legacy to community.

Unless you hit on all four categories with regularity, any one win will fail to satisfy. You'll experience what we call the "wince factor": You know you're doing what is right, but it still feels like a loss. You're preoccupied with thoughts of the other things you could be doing or getting. Your achievements and pleasures fade almost as soon as they occur. By contrast, success that encompasses all four kinds of accomplishment is enriching; it endures. You can create this synergy within a single event, but you can also create it through a juxtaposition of activities. Taking time out in the middle of a high-stress period or stopping to give back to the community while in the midst of pursuing your most self-advancing goals are good examples of this.

If you think about what constitutes a moment of lasting satisfaction in your own life—maybe it's your daily practice of a musical instrument—it may be surprisingly trivial in comparison with your major commitments at work or at home. The activity draws force from accomplishing something distinctive in each of the four categories over time. The musical instrument provides release and pleasure (happiness), it is a challenge to master and build on (achievement), and it becomes even more fulfilling when you join a band that competes with other bands or play concerts at hospitals (significance). Those who also turn these "lesser" vocations into legacies that build the same opportunity for the next generation—say, through getting involved in recruiting and training younger musicians—will find an even deeper sense of success from so-called hobbies.

Anyone who takes the four elements of success seriously soon realizes how complicated it can be to touch on all four with regularity. As you scale up your goals, the four-part mix becomes more difficult to achieve. Each factor has a different set of characteristics. Satisfying different needs, they draw on distinctive emotional drives and prioritize self and others in different ways. That's why people who tell you that happiness, achievement, and significance will come automatically if you simply do the work you love are misguided. Regardless of how much you care about your job, you will still feel conflicting desires—between work and home, between working forever on a problem and taking a break from it, between going for more market share today and investing in the company's needs for tomorrow. The skills you use to compete are totally different from those you employ in moments of enjoyment. You can be there for a friend, and you can care about a customer, but these acts (in the significance category) can't be substituted for the kind of thinking and prioritization that is necessary to structure favorable financial terms for your own firm (in the achievement category).

**People who tell you that happiness, achievement, and significance will come automatically if you simply do the work you love are misguided.**

Understanding the distinctive features of the four areas of success can help you articulate what you are seeking in a certain activity. You can then create a diagnostic for determining how to achieve the most appropriate goal. You may be expecting too many categories to be fulfilled without incorporating the right resources and perspectives, or you may be falling prey to a mismatch.

Matching your expectations to the right category is a critical skill for achieving sustainable success. If you expect happiness to come primarily from competition (an achievement skill), you'll probably turn into someone neither you nor those around you can tolerate—and wonder why success has made you so lonely. People who report having trouble defining the right goals for themselves or for their companies are often caught in such mismatches. For instance, a self-described family-friendly company might hold critical staff meetings over late dinners or during extended weekend retreats.

The act of categorizing in and of itself can help you take more decisive action and channel the right emotions and perspectives to the task at hand. You can stop measuring a job only by how happy it makes you or calculating a business success only in terms of your ability to achieve mastery over something. Instead, you'll see how one task fits into a larger context. By the same token, you'll be able to anticipate what kind

of emotional capital you'll need to bring to a task. If you try to bring feelings of happiness or contentment to your achievement goals, you'll stunt your performance from the start. If you don't put achievement in its place, however, you'll trap yourself in a workaholic restlessness.

Those in our research who achieved satisfying, enduring, multidimensional success consciously went after victories in all four categories without losing touch with their values and special talents. They seemed to understand intuitively the paradox we uncovered at the heart of enduring success: To get to more wins on the various important measures that make up your notion of the good life, success has to rest on a paradigm of limitation in any one activity for the sake of the whole. Or, as we call it, "on the reasoned pursuit of just enough."

This principle flies in the face of the popular opinion that success is all about breaking through limitations, that it's about having more, being more, doing more. Our research shows that the high-powered people who experienced real satisfaction achieved it through the deliberate imposition of limits. They all shared a versatile talent that we call "switching and linking": They were able to focus intensely on one task until it gave them a particular sense of satisfaction, then put it down and jump to the next category with a feeling of accomplishment and renewed energy. This versatile refocusing could occur within the same activity (say, when you base your product strategy on accomplishing your profit goal *and* on caring for the customer), or it can involve switching attention between two realms (taking a break from work to joke with a friend).

The people in our research who were particularly skilled at sifting through the moving targets and going after only those that would produce lasting rewards shared two characteristics. First, they viewed success as a broad and dynamic experience of accomplishment, one that factored in all four categories. They didn't attribute their success to one single event or even one single realm of life. Second, their concrete examples of what counted as "real" success included accomplishments of wildly varying magnitude. They weren't setting maximum goals for themselves in each category; rather, they set some at a small scale and some at a scale that demanded sustained effort. The baseline for these individuals wasn't the amount of activity or number of rewards in any one category, but the securing of a proportionate mix of all four. Anyone can learn to do this; you just need to have a larger framework in which to understand the dynamics of the four categories.

## The Kaleidoscope Strategy

We compare an effective success strategy to a kaleidoscope—that simple mechanical

device with a lens, mirror, and a long tube housing separate chambers. Each chamber holds pieces of glass that constantly shift as the tube is moved. Although the chambers are separate, the eye sees one unique picture made up of the various chambers. Mirrors reflect the entire set of glass chips and enhance the complexity of the pattern. The beauty of that pattern comes from the variety and symmetry of the design. Although the patterns in a kaleidoscope are inherently unstable, changed by your own movements or by outside forces, the pieces provide ongoing satisfaction as they take their places within new patterns.

Now imagine a slightly different kind of kaleidoscope, one that is your own vision of a successful life. This kaleidoscope also has four chambers—happiness, achievement, significance, and legacy—and you can add brilliant glass pieces (goals sought and fulfilled) over a lifetime, making your unique pattern richer and richer. In this metaphor, success is about choice, movement, pattern, and a structure that holds all the separate activities together. And, just like a kaleidoscope, you have to hold this pattern up to the light. By regularly assessing the picture you are creating in all four chambers, you can quickly spot "holes"—places you feel require more attention—in your activities and be assured that you are justified in interrupting other work to attend to them. The rest of the chips will be enough for the moment, but not enough for the rest of your life.

Through our research, we discovered that the people who achieve enduring success rely on a kaleidoscope strategy to structure their aspirations. Not only do they continually create new chips in each of the four categories, but they also choose their actions so that the whole picture will display a pleasing proportionality. Feeling deep satisfaction in each category strengthens these achievers' ability to turn away from one category when another needs attention. It allows them to say, "I don't need to work away at this particular thing until I'm satiated and hate the very sight of it. This is just enough." They recognize the importance of setting their own standards for "enough" and not falling prey to the lure of the infinite "more."

This is exactly the kind of thinking you see in good leaders: They anticipate what will be needed in all four dimensions of success despite pressures to deliver to the maximum in one. This is what the subjects in the three examples at the beginning of this article were lacking. They had no framework in which to identify and sort multiple desires so that they could go after their conflicting goals sequentially in a proportionate mix.

The burned-out venture capitalist needs to understand that scaling back his achievement goals is part of a larger picture of expansion in the other categories, rather than a paralyzing prospect of loss and "doing nothing." This kaleidoscope view will allow him space to cultivate the emotional relationships he craves with his family. That doesn't

mean he should give up all forms of achievement; he simply needs to readjust the level of energy he puts into that category. Doing so will require more creative thought and versatility than he's exhibiting now.

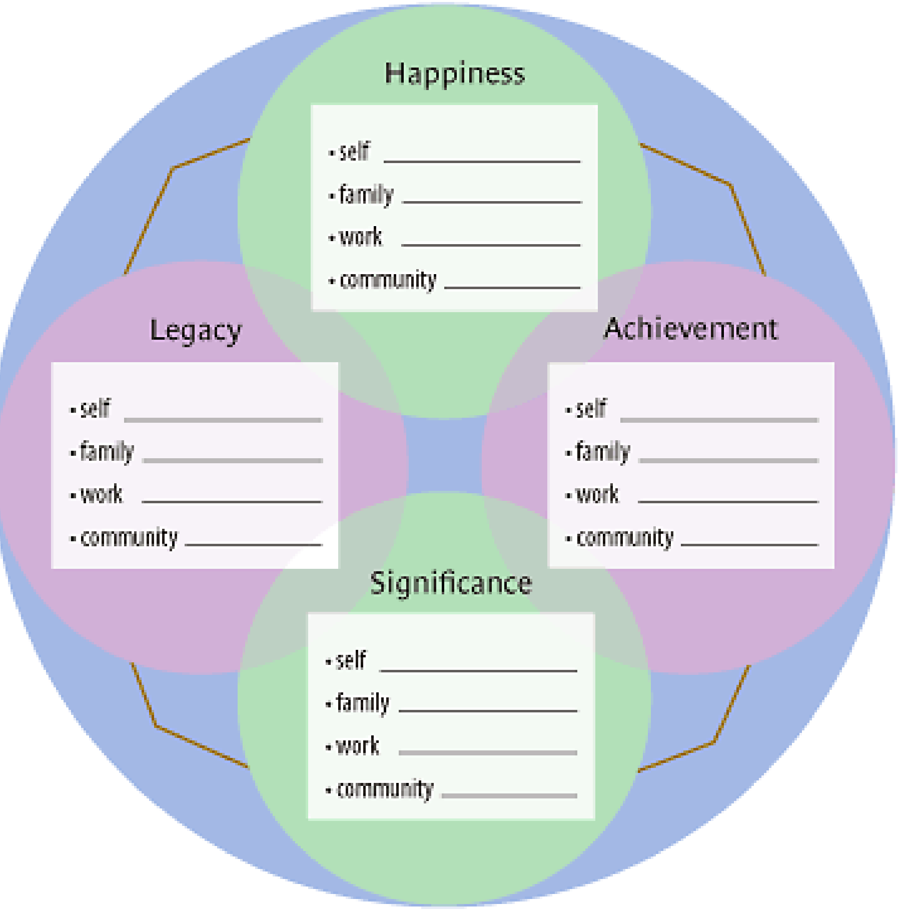
The executive overseeing the problematic product rollout was framing his dilemma in terms of short-term versus long-term achievement. He would do better to reframe his challenge in terms of legacy: What kind of platform would he be creating for the success of this product and that of future managers in the company if he decided to release incomplete products? Thinking about the problem from this perspective helped him clarify his priorities. Instead of feeling that he had to make a trade-off in a negative sense, he could take a positive view of what needed the most attention and what was worth sacrificing for. In the end, he delayed rolling out the new product line—and not only were the retailers delighted with the final results, but the product division, in crafting the solution, discovered a new way to coordinate and leverage its technological capabilities across three countries.

The software engineer torn between computers and church music needed to shrink or redirect her goals in some activities and develop them in others. When she tried the kaleidoscope strategy, she quickly saw that church music registered high in her significance category but would always be a limited outlet for achievement. She had neither the skill nor the opportunity to become a star musician. Software had more potential for significance than she had previously thought. She needed to learn how to change her job in ways that emphasized the social value she was creating in the products she worked on and the help she provided to others. She began to see benefits in framing church music primarily as an exercise in significance rather than in achievement, with all its competitive and financial associations. But to fill both chambers, she'd need to restructure her job commitments in order to minimize travel and commit to choir practice. When she looked at the whole picture of goals she could satisfy through the sum of these activities, scaling back suddenly seemed more positive. The pieces were enough. And, she recognized, taking this path would require continued growth on her part—something she had forgotten she valued and which she now had the confidence to pursue strategically. Enduring success required enduring commitment.

### Building Your Own Kaleidoscope

To create your own kaleidoscope, start by sketching out your framework. Take a piece of paper and draw four intersecting circles. Label them happiness, achievement, significance, and legacy. In each circle, list self, family, work, and community. This will enable you to do a full inventory of the mix and determine how each piece falls in the context of each major domain of your life. (See the exhibit "My Personal Kaleidoscope.")

# My Personal Kaleidoscope




Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

The people who achieved enduring success in our research used a kaleidoscope strategy to structure their aspirations. Not only did they continually add new activities to each of the four categories, but they also focused on creating a well-balanced big picture. If you take a minute to map an inventory of your successes so far, you'll quickly discover which areas need more attention.

**Success is about choice, movement, pattern, and a structure that holds all the separate activities together.**

Next, quickly jot down examples of your successes or great satisfactions. You don't have to come up with one for every item in every circle—this is just a quick sketch of your beliefs about yourself, not the full picture. Don't spend time worrying about whether you should put a particular target next to a particular item. Just work with your first impulses.

Take your college degree as an example. You may feel that graduating from college was a major achievement, a benchmark in your overall career plans and something you will value for your whole life. Your degree represents a mastery of skills. You had to compete successfully to get there and get the grades. You felt satisfaction when you were successful. So you would write "college" in your achievement chamber, next to the word "work."

But what if college represented other things for you? Significance in your family life, for example, because your parents or spouse really valued what you were doing? In that case, you might also put college in your significance chamber, next to "family."

The point is not to compulsively divide your life into little circles and lists. Rather, it is to help you assess the various types of satisfactions you have already experienced and see what they add up to. The answer is often more surprising or richer than you may have suspected.

Depending on your age, you might even want to fill out framework profiles for several periods in your life. Did you want the same things at 40 as you did at 20? Will you want the same things at 60? At 85? Could you ever fully abandon one of the categories and still feel that you were a success? (This is the trap that many retirees and those who downscale their careers to become full-time parents fall into.)

Now, metaphorically speaking, you can hold your kaleidoscope up to the light. Look at it objectively, and ask yourself:

1. How integrated is your profile? Are some of the domains empty? Are others too full? Is each realm of your identity—self, family, work, community—a depository of only one satisfaction, or is there a broader basis for success in each of these areas?

2. How varied is your profile? Where are most of your greatest successes and satisfactions so far? Where are the holes? The obsessions? Are the chambers and realms evolving or repeating the same things over and over?

3. What have you learned about what you actually do? Where is your time going? How does it speak to what you really want from success? Research into success has shown that one of the biggest causes of failure is an overreliance on one's greatest strengths. Are you favoring what you do best and neglecting your need for fulfillment in all four categories?

Here's how the kaleidoscope strategy helped John, the owner of a large real estate company, find enduring success. John was having trouble deciding what to do with his business. After a blowout with his teenage child and a series of relentless, debilitating headaches, he decided he had to cut back on his work. He had already bought a plane—against his family's wishes—and he had increased his time for himself, but he was still suffering. "I know I should sell part of this business for the sake of my happiness," he said, "but I just can't do it."

We suggested he try putting this sale in another category, one that seemed rather empty. Why not think about the sale as an active engagement in legacy rather than as a platform for happiness? The pieces fit. Legacy is about building on your achievements and values to help others succeed after you're gone. John remembered a young manager who had left the firm, someone who knew John's values and was quite accomplished in his own right. This person would probably welcome the chance to head the new spin-off, and he'd be likely to extend the kind of business John had spent his life building. The buyers would need such a person, and John would be comfortable doing business with them.

After seeing the situation from a different perspective, John was more decisive about the sale and had a richer platform of concrete goals around which to structure the transaction: the terms in which legacy would be fulfilled, the new time frame for his own enjoyment of life, a revitalizing and more realistic set of achievement goals, and a sense of providing the space to be there for his daughter and wife without giving up all the challenges of the real estate business.

Identifying where his activities were located in the kaleidoscope gave John immediate insight into what he was seeking and getting from his efforts—as well as what was lacking. In channeling your efforts effectively toward what you really seek from success, it's critical to test your profile against your idealized view of yourself. What do you want your profile of accomplishments in each of the four categories to look like tomorrow? Next month? Over your lifetime?

**The Kaleidoscope Strategy for Businesses**

## Getting to "Just Enough"

If you pay attention to the four categories and their relation to one another, you can enrich the potential for any activity to satisfy you on numerous dimensions, whether at work, in your leisure time, or in some other aspect of your life. The high achievers in our study were able to accomplish great things for themselves and others by recognizing they had multiple goals that were critical to their idea of real success and by being fully committed to whatever activity they were engaged in. By switching and linking, they limited their attention to one task, and when other needs pressed, they were able to make lightning fast changes of focus and emotional energy. Instead of feeling cheated because they couldn't get it all, they were renewed by following the cycle of attention to each category.

**"Just enough" is the antidote to society's addiction to the infinite "more."**

How do you know when it's time to stop your work in one category and switch your attention to another? That's where the concept of "just enough" becomes critical. Conventional interpretations of "enough" don't capture its full potential. People tend to use the term to express dissatisfaction, as in, "That's it! I've had enough!" or as a code for mediocrity or passivity, as in, "If I'm just happy every day, that's enough." We mean something else by enough, closer to its root definition: occurring in sufficient quantity or quality to satisfy demands or needs. If you have a firm idea of the big picture in your kaleidoscope of success, it becomes easier to determine and appreciate "enough" in any one activity. Without losing your energy for high aspirations, you set reachable goals. "Just enough" is the antidote to society's addiction to the infinite "more." Seen in that light, it becomes a vehicle for actively making choices that allow you to do and get more, not less, through achieving satisfaction in more areas of your life.

Reprint Number R0402H





Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review
Click here to visit:
>| http://www.hbsp.org

MANAGING YOURSELF

# Success That Lasts

**Single-minded ambition is a great way to achieve some goals—but is that really success? New research reveals surprisingly practical ways to find professional and personal fulfillment.**

***by Laura Nash and Howard Stevenson***

**Laura Nash** (lnash@justenoughsuccess.com) is a senior research fellow and **Howard Stevenson** (hstevenson@justenoughsuccess.com) is the Sarofim-Rock Professor of Business Administration at Harvard Business School in Boston. They are the authors of *Just Enough: Tools for Creating Success in Your Work and Life* (John Wiley & Sons, 2004), from which this article is adapted.

**A 55-year-old, highly successful venture capitalist** *is thinking about his next investment. He's not certain he has the energy to start another seven-year round of intense financing and consulting activity. "I just can't imagine enjoying that pace again, and frankly, it's time I paid attention to my family. But I'd really feel a loser if I didn't play the game as hard as everyone else. I guess I should retire."*

**The president of a $1 billion division** *of a consumer products company discovers that manufacturing and distribution bugs will delay the scheduled rollout of a new product line. Retailers are eager for the product, pressures on share price are intense, and the president's bonus is tied to the rollout's success. If he goes ahead, the product is sure to be on top—but only temporarily. The costs down the road from disappointed consumers and time invested in having to fix mistakes will clearly hurt the bottom line. What is success under these circumstances?*

**A fast-track 32-year-old software engineer** *with a second degree in sacred music feels that something is missing in her career strategy. She wants the lifestyle of a well-paid manager, but software doesn't feel as socially significant as playing the organ for a congregation. And she someday wants a house and a family. "Why can't I find the career path that will get me all of these things?" she wonders. "Are they really so unreasonable?"*

Different as these examples may be, these individuals have a similar problem: They all need a comprehensive framework for thinking about success. And they're far from alone.

Survey after survey shows a high degree of job dissatisfaction and burnout among the general working population, even among those with plenty of options. In the collective soul-searching prompted by September 11, 2001, many high achievers revisited their notion of success. The wave of corporate scandals that followed soon after only made the questions more acute. Even the most dedicated employees wondered aloud whether they would ever recommend their own careers and companies to their children.

Pursuing success is like shooting at a series of moving targets. Every time you hit one, five more pop up from another direction. Just when we've achieved one goal, we feel

pressure to work harder to earn more money, exert more effort, possess more toys. Standards and examples of "making it" constantly shift, while a fast-paced world of technological and social change constantly poses new obstacles to overcome.

During the past decade, traditional career paths suddenly became pointless. Professionals found themselves overworked and undersatisfied in the boom, then overworked and competitively vulnerable in the bust. And far too many businesses discovered they were using the wrong measures to gauge success, winning big in the 1990s only to lose big for their shareholders and employees at the turn of the millennium. The climb to success can feel like an Escher drawing of a staircase that goes nowhere.

In the face of such instability, many people assume success requires a winner-takes-all approach. They believe that success depends on putting all your energy into achieving one goal, be it a single-minded focus on your job or a commitment to being the best soccer mom in your community. But no matter how noble, one goal can't satisfy all of a person's complex needs and desires, as the examples at the beginning of the article demonstrate. The same holds true for the goals of a business.

Fortunately, success doesn't have to be seen as a one-dimensional tug-of-war between achievement and happiness. If developed in the right way, your ideals of the good life for yourself and society can become powerful—and manageable—factors of success. We studied hundreds of high achievers who realize lasting success, make a positive difference, and enjoy the process. And we learned that some of the most successful people have gotten where they are precisely because they have a greater understanding of what success is really about and the versatility to make good on their ideals. In this article, we'll introduce a practical framework that will help you see success in these same terms. But first, a closer examination of how we arrived at this model.

**What Is Enduring Success?**

Our research took a fresh look at the assumptions behind success. We were interested in real, enduring success—where getting what you want has rewards that are sustainable for you and those you care about. This type of attainment delivers a sense of legitimacy and importance; its satisfactions endure far beyond the momentary rewards of a bonus or a new position. Lasting success is emotionally renewing, not anxiety provoking.

Unlike an equation for a successful market strategy, no one person or company can fully embody lasting success for others. Everyone (and every business) has a unique vision of real success, and that notion changes over time. A family-oriented person would hardly call the absentee life of a top executive a success but might find travel and adventure just the ticket after the kids grow up. A born investment banker would hardly regard mixing cement as a successful career, whereas a construction worker who just completed an extraordinary bridge might point to the structure with pride for the rest of his or her life. No one, however, has unreserved success, not even the most obvious winner. Recognizing how important it is for each person to understand and develop his or her unique definition of success over time, we chose not to report on one or two well-known examples of success as the perfect model to follow.

Nonetheless, for the purposes of research, we posited five common characteristics of individuals who by most standards had achieved enduring success: high achievement, multiple goals, the ability to experience pleasure, the ability to create positive relationships, and a value on accomplishments that endure.

We held more than 60 interviews with successful professionals, surveyed 90 top executives attending Harvard Business School management programs, and informally

observed high achievers with whom we live and work. We conducted more than a dozen model-testing sessions with between 50 and 110 executives in each. Most of these groups were drawn from HBS graduates or current members of the Young Presidents' Organization. We also reviewed the problems that the general population has reported about success, using sources that ranged from media reports to conversations with friends, students, and colleagues. We talked to people from all different walks of life, at every level of the economy, both in and out of business careers. Some of them were stay-at-home parents who had once worked full time; others were at the pinnacle of their careers.

**The Complexity of Success**

Success involves more than a heart-pounding race to the finish line. Our research uncovered four irreducible components of enduring success: happiness (feelings of pleasure or contentment about your life); achievement (accomplishments that compare favorably against similar goals others have strived for); significance (the sense that you've made a positive impact on people you care about); and legacy (a way to establish your values or accomplishments so as to help others find future success).

These four categories form the basic structure of what people try to gain through the pursuit and enjoyment of success. Take away any one component, and it no longer feels like "real" success. If you were wildly wealthy because you had mastered a certain business problem but couldn't experience pleasure, for instance, would you consider yourself successful? If building your power base kept you from being there for others, would your success feel morally right? If you left your career to be a full-time parent, would you have enough of an outlet for your talents? Just as a steady diet of the same four foods would hardly be satisfying over the long term, the four components of success cannot be satisfied by the presence of a single flavor in each category. That is why you cannot neatly categorize the realms of your life, assigning happiness to self, achievement to work, significance to family, legacy to community.

Unless you hit on all four categories with regularity, any one win will fail to satisfy. You'll experience what we call the "wince factor": You know you're doing what is right, but it still feels like a loss. You're preoccupied with thoughts of the other things you could be doing or getting. Your achievements and pleasures fade almost as soon as they occur. By contrast, success that encompasses all four kinds of accomplishment is enriching; it endures. You can create this synergy within a single event, but you can also create it through a juxtaposition of activities. Taking time out in the middle of a high-stress period or stopping to give back to the community while in the midst of pursuing your most self-advancing goals are good examples of this.

If you think about what constitutes a moment of lasting satisfaction in your own life—maybe it's your daily practice of a musical instrument—it may be surprisingly trivial in comparison with your major commitments at work or at home. The activity draws force from accomplishing something distinctive in each of the four categories over time. The musical instrument provides release and pleasure (happiness), it is a challenge to master and build on (achievement), and it becomes even more fulfilling when you join a band that competes with other bands or play concerts at hospitals (significance). Those who also turn these "lesser" vocations into legacies that build the same opportunity for the next generation—say, through getting involved in recruiting and training younger musicians—will find an even deeper sense of success from so-called hobbies.

Anyone who takes the four elements of success seriously soon realizes how complicated it can be to touch on all four with regularity. As you scale up your goals, the four-part mix becomes more difficult to achieve. Each factor has a different set of characteristics.

Satisfying different needs, they draw on distinctive emotional drives and prioritize self and others in different ways. That's why people who tell you that happiness, achievement, and significance will come automatically if you simply do the work you love are misguided. Regardless of how much you care about your job, you will still feel conflicting desires—between work and home, between working forever on a problem and taking a break from it, between going for more market share today and investing in the company's needs for tomorrow. The skills you use to compete are totally different from those you employ in moments of enjoyment. You can be there for a friend, and you can care about a customer, but these acts (in the significance category) can't be substituted for the kind of thinking and prioritization that is necessary to structure favorable financial terms for your own firm (in the achievement category).

**People who tell you that happiness, achievement, and significance will come automatically if you simply do the work you love are misguided.**

Understanding the distinctive features of the four areas of success can help you articulate what you are seeking in a certain activity. You can then create a diagnostic for determining how to achieve the most appropriate goal. You may be expecting too many categories to be fulfilled without incorporating the right resources and perspectives, or you may be falling prey to a mismatch.

Matching your expectations to the right category is a critical skill for achieving sustainable success. If you expect happiness to come primarily from competition (an achievement skill), you'll probably turn into someone neither you nor those around you can tolerate—and wonder why success has made you so lonely. People who report having trouble defining the right goals for themselves or for their companies are often caught in such mismatches. For instance, a self-described family-friendly company might hold critical staff meetings over late dinners or during extended weekend retreats.

The act of categorizing in and of itself can help you take more decisive action and channel the right emotions and perspectives to the task at hand. You can stop measuring a job only by how happy it makes you or calculating a business success only in terms of your ability to achieve mastery over something. Instead, you'll see how one task fits into a larger context. By the same token, you'll be able to anticipate what kind of emotional capital you'll need to bring to a task. If you try to bring feelings of happiness or contentment to your achievement goals, you'll stunt your performance from the start. If you don't put achievement in its place, however, you'll trap yourself in a workaholic restlessness.

Those in our research who achieved satisfying, enduring, multidimensional success consciously went after victories in all four categories without losing touch with their values and special talents. They seemed to understand intuitively the paradox we uncovered at the heart of enduring success: To get to more wins on the various important measures that make up your notion of the good life, success has to rest on a paradigm of limitation in any one activity for the sake of the whole. Or, as we call it, "on the reasoned pursuit of just enough."

This principle flies in the face of the popular opinion that success is all about breaking through limitations, that it's about having more, being more, doing more. Our research shows that the high-powered people who experienced real satisfaction achieved it through the deliberate imposition of limits. They all shared a versatile talent that we call "switching and linking": They were able to focus intensely on one task until it gave them a particular sense of satisfaction, then put it down and jump to the next category with a feeling of accomplishment and renewed energy. This versatile refocusing could occur

within the same activity (say, when you base your product strategy on accomplishing your profit goal *and* on caring for the customer), or it can involve switching attention between two realms (taking a break from work to joke with a friend).

The people in our research who were particularly skilled at sifting through the moving targets and going after only those that would produce lasting rewards shared two characteristics. First, they viewed success as a broad and dynamic experience of accomplishment, one that factored in all four categories. They didn't attribute their success to one single event or even one single realm of life. Second, their concrete examples of what counted as "real" success included accomplishments of wildly varying magnitude. They weren't setting maximum goals for themselves in each category; rather, they set some at a small scale and some at a scale that demanded sustained effort. The baseline for these individuals wasn't the amount of activity or number of rewards in any one category, but the securing of a proportionate mix of all four. Anyone can learn to do this; you just need to have a larger framework in which to understand the dynamics of the four categories.

**The Kaleidoscope Strategy**

We compare an effective success strategy to a kaleidoscope—that simple mechanical device with a lens, mirror, and a long tube housing separate chambers. Each chamber holds pieces of glass that constantly shift as the tube is moved. Although the chambers are separate, the eye sees one unique picture made up of the various chambers. Mirrors reflect the entire set of glass chips and enhance the complexity of the pattern. The beauty of that pattern comes from the variety and symmetry of the design. Although the patterns in a kaleidoscope are inherently unstable, changed by your own movements or by outside forces, the pieces provide ongoing satisfaction as they take their places within new patterns.

Now imagine a slightly different kind of kaleidoscope, one that is your own vision of a successful life. This kaleidoscope also has four chambers—happiness, achievement, significance, and legacy—and you can add brilliant glass pieces (goals sought and fulfilled) over a lifetime, making your unique pattern richer and richer. In this metaphor, success is about choice, movement, pattern, and a structure that holds all the separate activities together. And, just like a kaleidoscope, you have to hold this pattern up to the light. By regularly assessing the picture you are creating in all four chambers, you can quickly spot "holes"—places you feel require more attention—in your activities and be assured that you are justified in interrupting other work to attend to them. The rest of the chips will be enough for the moment, but not enough for the rest of your life.

Through our research, we discovered that the people who achieve enduring success rely on a kaleidoscope strategy to structure their aspirations. Not only do they continually create new chips in each of the four categories, but they also choose their actions so that the whole picture will display a pleasing proportionality. Feeling deep satisfaction in each category strengthens these achievers' ability to turn away from one category when another needs attention. It allows them to say, "I don't need to work away at this particular thing until I'm satiated and hate the very sight of it. This is just enough." They recognize the importance of setting their own standards for "enough" and not falling prey to the lure of the infinite "more."

This is exactly the kind of thinking you see in good leaders: They anticipate what will be needed in all four dimensions of success despite pressures to deliver to the maximum in one. This is what the subjects in the three examples at the beginning of this article were lacking. They had no framework in which to identify and sort multiple desires so that they could go after their conflicting goals sequentially in a proportionate mix.

The burned-out venture capitalist needs to understand that scaling back his achievement goals is part of a larger picture of expansion in the other categories, rather than a paralyzing prospect of loss and "doing nothing." This kaleidoscope view will allow him space to cultivate the emotional relationships he craves with his family. That doesn't mean he should give up all forms of achievement; he simply needs to readjust the level of energy he puts into that category. Doing so will require more creative thought and versatility than he's exhibiting now.

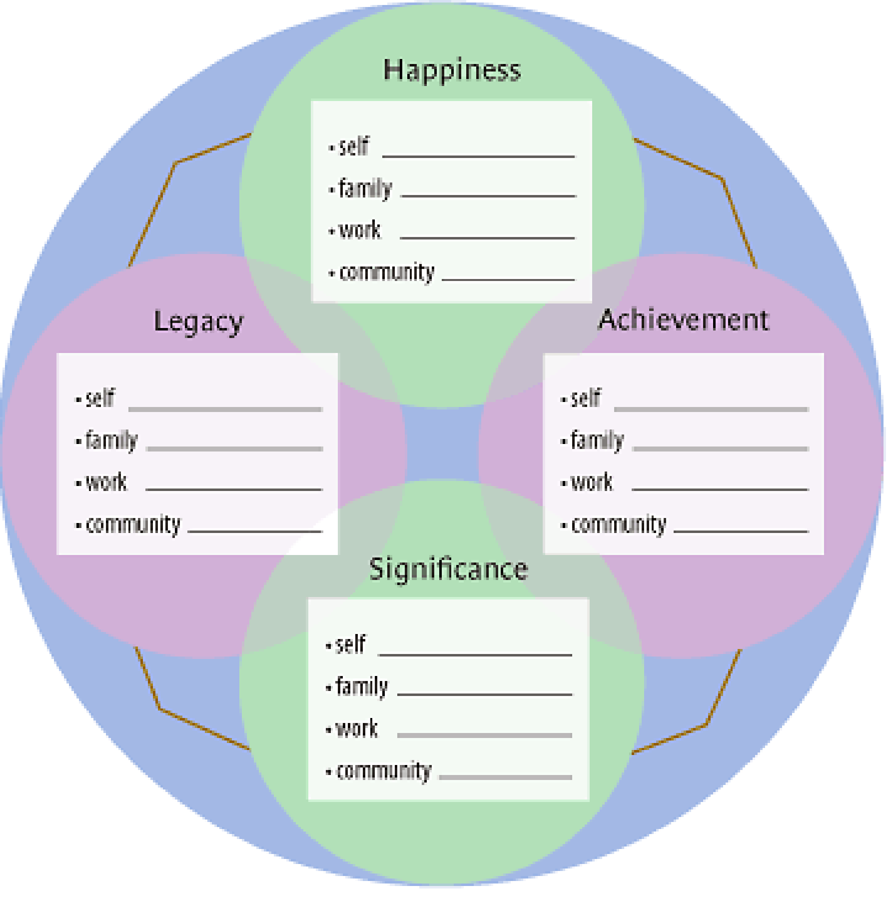
The executive overseeing the problematic product rollout was framing his dilemma in terms of short-term versus long-term achievement. He would do better to reframe his challenge in terms of legacy: What kind of platform would he be creating for the success of this product and that of future managers in the company if he decided to release incomplete products? Thinking about the problem from this perspective helped him clarify his priorities. Instead of feeling that he had to make a trade-off in a negative sense, he could take a positive view of what needed the most attention and what was worth sacrificing for. In the end, he delayed rolling out the new product line—and not only were the retailers delighted with the final results, but the product division, in crafting the solution, discovered a new way to coordinate and leverage its technological capabilities across three countries.

The software engineer torn between computers and church music needed to shrink or redirect her goals in some activities and develop them in others. When she tried the kaleidoscope strategy, she quickly saw that church music registered high in her significance category but would always be a limited outlet for achievement. She had neither the skill nor the opportunity to become a star musician. Software had more potential for significance than she had previously thought. She needed to learn how to change her job in ways that emphasized the social value she was creating in the products she worked on and the help she provided to others. She began to see benefits in framing church music primarily as an exercise in significance rather than in achievement, with all its competitive and financial associations. But to fill both chambers, she'd need to restructure her job commitments in order to minimize travel and commit to choir practice. When she looked at the whole picture of goals she could satisfy through the sum of these activities, scaling back suddenly seemed more positive. The pieces were enough. And, she recognized, taking this path would require continued growth on her part—something she had forgotten she valued and which she now had the confidence to pursue strategically. Enduring success required enduring commitment.

### Building Your Own Kaleidoscope

To create your own kaleidoscope, start by sketching out your framework. Take a piece of paper and draw four intersecting circles. Label them happiness, achievement, significance, and legacy. In each circle, list self, family, work, and community. This will enable you to do a full inventory of the mix and determine how each piece falls in the context of each major domain of your life. (See the exhibit "My Personal Kaleidoscope.")

## My Personal Kaleidoscope




The people who achieved enduring success in our research used a kaleidoscope strategy to structure their aspirations. Not only did they continually add new activities to each of the four categories, but they also focused on creating a well-balanced big picture. If you take a minute to map an inventory of your successes so far, you'll quickly discover which areas need more attention.

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

**Success is about choice, movement, pattern, and a structure that holds all the separate activities together.**

Next, quickly jot down examples of your successes or great satisfactions. You don’t have to come up with one for every item in every circle—this is just a quick sketch of your beliefs about yourself, not the full picture. Don’t spend time worrying about whether you should put a particular target next to a particular item. Just work with your first impulses.

Take your college degree as an example. You may feel that graduating from college was a major achievement, a benchmark in your overall career plans and something you will value for your whole life. Your degree represents a mastery of skills. You had to compete successfully to get there and get the grades. You felt satisfaction when you were successful. So you would write “college” in your achievement chamber, next to the word “work.”

But what if college represented other things for you? Significance in your family life, for

example, because your parents or spouse really valued what you were doing? In that case, you might also put college in your significance chamber, next to "family."

The point is not to compulsively divide your life into little circles and lists. Rather, it is to help you assess the various types of satisfactions you have already experienced and see what they add up to. The answer is often more surprising or richer than you may have suspected.

Depending on your age, you might even want to fill out framework profiles for several periods in your life. Did you want the same things at 40 as you did at 20? Will you want the same things at 60? At 85? Could you ever fully abandon one of the categories and still feel that you were a success? (This is the trap that many retirees and those who downscale their careers to become full-time parents fall into.)

Now, metaphorically speaking, you can hold your kaleidoscope up to the light. Look at it objectively, and ask yourself:

1. How integrated is your profile? Are some of the domains empty? Are others too full? Is each realm of your identity—self, family, work, community—a depository of only one satisfaction, or is there a broader basis for success in each of these areas?

2. How varied is your profile? Where are most of your greatest successes and satisfactions so far? Where are the holes? The obsessions? Are the chambers and realms evolving or repeating the same things over and over?

3. What have you learned about what you actually do? Where is your time going? How does it speak to what you really want from success? Research into success has shown that one of the biggest causes of failure is an overreliance on one's greatest strengths. Are you favoring what you do best and neglecting your need for fulfillment in all four categories?

Here's how the kaleidoscope strategy helped John, the owner of a large real estate company, find enduring success. John was having trouble deciding what to do with his business. After a blowout with his teenage child and a series of relentless, debilitating headaches, he decided he had to cut back on his work. He had already bought a plane—against his family's wishes—and he had increased his time for himself, but he was still suffering. "I know I should sell part of this business for the sake of my happiness," he said, "but I just can't do it."

We suggested he try putting this sale in another category, one that seemed rather empty. Why not think about the sale as an active engagement in legacy rather than as a platform for happiness? The pieces fit. Legacy is about building on your achievements and values to help others succeed after you're gone. John remembered a young manager who had left the firm, someone who knew John's values and was quite accomplished in his own right. This person would probably welcome the chance to head the new spin-off, and he'd be likely to extend the kind of business John had spent his life building. The buyers would need such a person, and John would be comfortable doing business with them.

After seeing the situation from a different perspective, John was more decisive about the sale and had a richer platform of concrete goals around which to structure the transaction: the terms in which legacy would be fulfilled, the new time frame for his own enjoyment of life, a revitalizing and more realistic set of achievement goals, and a sense of providing the space to be there for his daughter and wife without giving up all the challenges of the real estate business.

Identifying where his activities were located in the kaleidoscope gave John immediate insight into what he was seeking and getting from his efforts—as well as what was lacking. In channeling your efforts effectively toward what you really seek from success, it's critical to test your profile against your idealized view of yourself. What do you want your profile of accomplishments in each of the four categories to look like tomorrow? Next month? Over your lifetime?

**The Kaleidoscope Strategy for Businesses**
Sidebar **R0402H_A** (Located at the end of this article)

## Getting to "Just Enough"

If you pay attention to the four categories and their relation to one another, you can enrich the potential for any activity to satisfy you on numerous dimensions, whether at work, in your leisure time, or in some other aspect of your life. The high achievers in our study were able to accomplish great things for themselves and others by recognizing they had multiple goals that were critical to their idea of real success and by being fully committed to whatever activity they were engaged in. By switching and linking, they limited their attention to one task, and when other needs pressed, they were able to make lightning fast changes of focus and emotional energy. Instead of feeling cheated because they couldn't get it all, they were renewed by following the cycle of attention to each category.

**"Just enough" is the antidote to society's addiction to the infinite "more."**

How do you know when it's time to stop your work in one category and switch your attention to another? That's where the concept of "just enough" becomes critical. Conventional interpretations of "enough" don't capture its full potential. People tend to use the term to express dissatisfaction, as in, "That's it! I've had enough!" or as a code for mediocrity or passivity, as in, "If I'm just happy every day, that's enough." We mean something else by enough, closer to its root definition: occurring in sufficient quantity or quality to satisfy demands or needs. If you have a firm idea of the big picture in your kaleidoscope of success, it becomes easier to determine and appreciate "enough" in any one activity. Without losing your energy for high aspirations, you set reachable goals. "Just enough" is the antidote to society's addiction to the infinite "more." Seen in that light, it becomes a vehicle for actively making choices that allow you to do and get more, not less, through achieving satisfaction in more areas of your life.

Reprint Number R0402H

## The Kaleidoscope Strategy for Businesses

Sidebar **R0402H_A**

What makes for the enduring success of a company? In our view, businesses prosper when they enable individuals and society to achieve all four categories of enduring success: happiness, achievement, significance, and legacy. After all, could any company survive if everyone were miserable in their job? Happiness in an organization is essential, and it grows in cultures of trust and respect. And what company succeeds without solving problems and executing better than its competitors? Innovation and results are classic forms of business achievement. What great business doesn't add value for its customers, its shareholders, and its community? Providing such useful services is clearly significant. Of course, no business could thrive for long without active attention to its legacy. In fact, classic examples of enduring success—Johnson & Johnson's careful handling of the Tylenol-tampering episode or the development of an open-access standardized domain assignment system for the Internet by Jon Postel and others—illustrate wins in all four categories of the kaleidoscope.

Many of today's weak business ethics and performance problems can be traced to a failure to adopt the skills of enduring success. The favored candidate for "running things" is often the achievement-driven maximizer, but too often, that approach runs the business (and the leader) into the ground. This neglect creates costly success pathologies such as greed, lack of loyalty or commitment, burnout, insensitivity, and the demoralization of knowing that your work isn't making a positive contribution to society.

To create a platform for enduring success in your organization, it's important to discuss the features of all four segments of success in a collective kaleidoscope exercise. Companies that take responsibility for teaching their employees to pursue the four categories of success and to develop their "switching and linking" skills—their ability to shift focus quickly from one task to another—will create the conditions for commitment, happiness, satisfaction, and continuity in their organizations.

To determine how well your business is performing in the four categories of success, consider the following tests:

**Happiness.** Does your corporate culture allow employees to let down their guard and enjoy the moment—both individually and collectively?

**Achievement.** Are your financial victories the reward for genuine mastery of important new problems or a numbers game with no real results?

**Significance.** Does your product or service create real value for others?

**Legacy.** Are you preparing the organization for the next generation of success by investing in people, innovation, customer needs, and systems?

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

## Success That Lasts

# The Kaleidoscope Strategy for Businesses

What makes for the enduring success of a company? In our view, businesses prosper when they enable individuals and society to achieve all four categories of enduring success: happiness, achievement, significance, and legacy. After all, could any company survive if everyone were miserable in their job? Happiness in an organization is essential, and it grows in cultures of trust and respect. And what company succeeds without solving problems and executing better than its competitors? Innovation and results are classic forms of business achievement. What great business doesn't add value for its customers, its shareholders, and its community? Providing such useful services is clearly significant. Of course, no business could thrive for long without active attention to its legacy. In fact, classic examples of enduring success—Johnson & Johnson's careful handling of the Tylenol-tampering episode or the development of an open-access standardized domain assignment system for the Internet by Jon Postel and others—illustrate wins in all four categories of the kaleidoscope.

Many of today's weak business ethics and performance problems can be traced to a failure to adopt the skills of enduring success. The favored candidate for "running things" is often the achievement-driven maximizer, but too often, that approach runs the business (and the leader) into the ground. This neglect creates costly success pathologies such as greed, lack of loyalty or commitment, burnout, insensitivity, and the demoralization of knowing that your work isn't making a positive contribution to society.

To create a platform for enduring success in your organization, it's important to discuss the features of all four segments of success in a collective kaleidoscope exercise. Companies that take responsibility for teaching their employees to pursue the four categories of success and to develop their "switching and linking" skills—their ability to shift focus quickly from one task to another—will create the conditions for commitment, happiness, satisfaction, and continuity in their organizations.

To determine how well your business is performing in the four categories of success, consider the following tests:

**Happiness.** Does your corporate culture allow employees to let down their guard and enjoy the moment—both individually and collectively?

**Achievement.** Are your financial victories the reward for genuine mastery of important new problems or a numbers game with no real results?

**Significance.** Does your product or service create real value for others?

**Legacy.** Are you preparing the organization for the next generation of success by investing in people, innovation, customer needs, and systems?

< Back to Article

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

BEST PRACTICE

# Turning Gadflies into Allies

**Companies view nongovernmental organizations as pests, or worse. But joining them can be more productive than swatting them, and just might give your company an edge.**

***by Michael Yaziji***

Multinational companies are the driving force behind globalization, but they are also the source of many of its most painful consequences, including currency crises, cross-border pollution, and overfishing. These remain unsolved due to two kinds of failures. For one, such issues are, by their nature, beyond the scope of individual governments to avoid or resolve. For the other, transnational organizations, such as the World Bank, the International Monetary Fund, and the World Trade Organization, have proved unequal to the task.

Into the breach have leaped not-for-profit, nongovernmental organizations (NGOs) of concerned citizens. Realizing that news of cross-border problems can also cross borders, NGOs have sponsored angry protests in Seattle, Davos, Göteborg, and Genoa. While these are perhaps the best-publicized demonstrations of nongovernmental organizations' activism, they are hardly the only ones. NGOs have seized on all forms of modern persuasion—from advertising to boycotts and even sabotage—in order to influence public sentiment toward global traders, manufacturers, and investors. The NGOs hope that they can effect policy changes in this way.

In many NGOs' view, companies that incorporate offshore to avoid taxes or that send jobs overseas demonstrate a lack of allegiance to their country of origin. At the same time, by failing to bring with them the labor and human rights standards prevailing in the developed world, these companies appear unconcerned with the welfare of the countries where they do business. Yet their economic power frustrates official efforts to control their activities.

Such views can harden into a purely oppositional stance. Guy Taylor, a spokesperson for London-based Globalize Resistance, says his organization has as its aim a world free of corporations and that it would welcome their destruction. Yet while an anticorporate backlash continues to grow, many influential NGOs are increasingly composed of serious-minded, educated professionals who pursue a more moderate agenda. While NGOs may not forswear tough public campaigns against companies they think are acting selfishly or shortsightedly, lately they have become more willing to enter into negotiations with them.

NGOs like these have the skills, resources, insights, and depths of popular support that make it unwise for companies to confront them head-on. For example, in 2001, NGOs obliged Aventis to spend more than $500 million on buying back genetically modified Starlink corn from growers, ultimately leading it to spin off its agricultural business. NGOs have also virtually closed the EU market to the agricultural biotech industry. And in the face of a public relations disaster that nongovernmental organizations such as Doctors Without Borders and Oxfam International incited, GlaxoSmithKline, Merck, Bristol-Myers Squibb, Roche, and other pharmaceutical companies withdrew a lawsuit challenging a South African law that undercut patent enforcement of their AIDS drugs.

Those companies might have avoided such outcomes by partnering with NGOs instead of flatly opposing them. Doing so would have offered the companies the chance not only to avoid costly conflict but also to use NGOs' assets to gain competitive advantage. I've found evidence of NGOs' receptiveness to such an approach in case studies, archival data, and in-depth interviews with executives from Greenpeace, the World Wildlife Fund, the Marine Stewardship Council, and other NGOs. I've also spoken with frontline managers and the CEOs of companies such as Shell, ExxonMobil, and Monsanto, who

>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague
>| Executive Summary

IN THIS ARTICLE

Your business is at risk if...

WRITTEN BY

**Michael Yaziji** is a PhD candidate at Insead, in Fontainebleau, France, and is the founder of its Business and Society Forum. He is a former lecturer in philosophy and ethics at the University of California, Santa Barbara.

attested both to the costs of being attacked by NGOs and to the challenges and benefits of partnering with them.

So far, however, most companies have proved ill equipped to deal with NGOs. One reason is that NGO attacks pose very different challenges from those mounted by business competitors. Large companies know how to compete on the basis of product attributes and price. But NGO attacks focus on production methods and their spillover, often noneconomic effects. Similarly, NGOs are able to convert into liabilities companies' standard competitive strengths such as size and wide market awareness of their brands. That's because the wealthier and better known a company is, the juicier the target it makes. (See the box that lays out businesses at risk.)

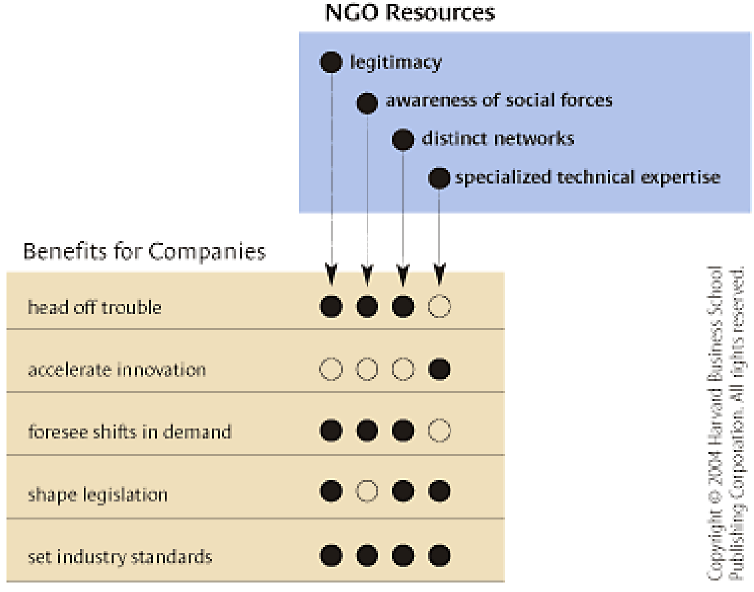
Your business is at risk if...

NGOs have developed special, often Internet-enabled, capabilities for turning the tables in these ways. For one thing, NGOs are ferocious networkers. It is not out of the ordinary for an NGO in, say, Bangalore to share information and coordinate strategies with counterparts in Boston and Budapest. One favorite NGO strategy is "swarming"—an attack on a single corporation by a host of small, modestly funded advocacy groups. Corporations like to think of themselves as operating on "Internet time," but NGOs are much nimbler. Issue-centered global coalitions of hundreds of NGOs can materialize and mobilize within days.

Emboldened by their successes, NGOs continue to take on, or form around, new causes. The number of NGOs with global concerns has quadrupled this past decade, a fact partly reflected in the twentyfold increase over the last ten years in mentions of NGOs generally in the *Wall Street Journal* and the *Financial Times*. To such advocacy groups and independent watchdog organizations, simple compliance with all applicable laws is not the end of a corporation's responsibilities—if the laws themselves are insufficiently protective. To NGOs' way of thinking, they have a permanent mandate to fill the regulatory vacuum. In the face of such numbers and expectations, companies would be well advised to look for common ground.

**Strengths Worth Coveting**

Nongovernmental organizations have four strengths that corporations would be well served to heed. They are legitimacy, awareness of social forces, distinct networks, and specialized technical expertise. The public bestows the first, and the second is a function of the NGOs' mission. The latter two refer to competences that NGOs have developed by venturing where corporations usually don't go.




**Legitimacy.** According to a poll conducted by the Edelman public relations firm, both Americans and Europeans said they found NGO spokespeople more credible than either a company's CEO or PR representative. Some fraction of the public, especially in Europe,

sees NGOs as dedicated first and foremost to serving an aspect of the general social welfare. While many companies produce direct benefits to society—those in the pharmaceutical and food industries being obvious examples—the public interprets those benefits as by-products of the companies' profit motive rather than as the direct result of their desire to feed or care for their fellow human beings.

Suspicion of companies' motives can become so entrenched that the soundest solutions aren't given a fair hearing. The fate of Shell Oil's Brent Spar storage and tanker offloading system is one such example. After conducting a thorough analysis of what to do with the platform, Shell concluded that towing it into the deep water of the North Atlantic and then sinking it was the best alternative from an environmental standpoint. (It would also be £40 million cheaper than dismantling the platform on land.) Outraged by the plan, Greenpeace organized a boycott of Shell products in the UK and sent protesters to occupy the facility. Ultimately, Shell succumbed to public pressure and hauled the rig ashore for dismantling. Greenpeace subsequently admitted that it had overstated the amount of oil residues in the tank and thus the harmful environmental effects of scuttling.

**Awareness of Social Forces.** Companies live and die by the markets they compete in; NGOs, by the ebb and flow of people's concerns about the safety and fairness of conditions worldwide. Although the gulf between the two arenas is large, businesses can learn much from NGOs' attunement to and influence on shifts in common beliefs and mores that in turn shape consumer demand. For example, in the early 1970s, years before organizations such as People for the Ethical Treatment of Animals were organizing boycotts of fur apparel, and guerrillas from the Animal Liberation Front were infiltrating mink farms to free the animals caged there, groups such as Animal Rights International had highlighted industrial conditions afflicting animals generally. If fur, cosmetics, poultry, and fast-food companies had noted the public's first stirrings of humane concern, they could have modified their practices and avoided the ensuing bad publicity and economic harm.

**Distinct Networks.** Most companies' networks primarily consist of organizations that would belong among Michael Porter's five forces model of buyers, suppliers, rival firms, new entrants, and substitute producers. NGOs' networks, by contrast, mostly consist of other NGOs, as well as donors, regulators, legislators, and public-interest lobbyists. These networks are often quite extensive and dense, since many NGOs are small, lack resources, and must form coalitions to be effective. Partnering with NGOs is an excellent way to gain access to the information circulating within their networks.

**Specialized Technical Expertise.** NGO members are often thought of as young, unsophisticated malcontents. In reality, the more established NGOs are filled with lawyers, policy analysts, and scientists. Half the employees of the largest, most influential environmental NGOs have master's or law degrees, and 10% to 20% have doctorates. Many of them possess knowledge that the companies being targeted lack. The NGOs may know about a new technology that is superior only in its environmental impact and therefore escaped businesses' attention. Or they may have noticed a judicial ruling in an out-of-the-way jurisdiction that may one day set a standard of conduct nationwide. Out of fear that their own research into ways of mitigating harm might establish liability, companies are sometimes willfully ignorant of developments that NGOs are aggressively pursuing.

**No More No-Go**

There are five primary benefits to partnering with NGOs:

**Head off trouble.** Although NGOs are known for engineering confrontations, the more established of these increasingly recognize that negotiating directly with companies is more efficient than putting on a negative campaign in hopes that the public will then pressure government officials or the companies themselves to correct the situation they've created. From the companies' standpoint as well, the involvement of motivated experts in place of committed adversaries makes negotiation a more promising alternative.

As soon as the first signs of disagreement with a project proposal are in evidence—whether it be a letter to the editor, a petition, or a picket line—the company under scrutiny should invite the critics in for a discussion. Even better, companies should learn the concerns of the NGOs that follow their industry and sound them out while a potentially controversial project is still on the drawing board.

Such is the method currently employed by Shell, which regularly brings together interested groups such as the World Wildlife Fund, Amnesty International, and local

NGOs at the initial stages of project planning and evaluation. As one senior Shell executive stated, "[Brent Spar] led us to a new approach in which we try to prevent crises through open dialogue. The discussions aren't always easy, but there is a reasonable amount of mutual trust and understanding between us now." An added benefit, according to the executive, is that the company now has an open channel of communication with the NGOs that attacked it in earlier controversies. If consultations occur regularly instead of during times of crisis, confrontation is less likely.

Consultations should include all interested parties, all gathered around the same table. That way, the party urging an NGO to soften its demands may not be the company itself but a fellow NGO. After all, different NGOs represent different interests. Some groups focus on human rights, some on the protection of endangered species, some on community concerns. When a large-scale project produces diverse results, certain NGOs can end up favoring it and others opposing it. For instance, a factory being planned might bring jobs to the local population but acid rain to the adjoining state. Two NGOs could assess the hazards and benefits differently, even though their networks overlap.

Private negotiation is preferable to public demonstrations, especially when it concerns projects that have not yet been made public. The two have trouble coexisting, since public posturing by either party can erode the trust and candor that are essential for progress to occur in private.

If a company's reputation turns out to be bad enough, most NGOs will refuse to negotiate with it for fear they will lose their bona fides. Some may be willing but will keep quiet about it. One environmental NGO I know well has a partnership with a global fast-food corporation. The NGO provides it with technical guidance on reducing waste. Many environmentalists think its standard practices place it beyond the pale, so the NGO does not talk about the partnership. As a senior executive of the NGO tells it, "We think this partnership is a good thing. It accords with our mission. But not all of our supporters would be thrilled at the association. We don't lie about it, but it just isn't an activity that we advertise."

Companies with decent records that acquire a reputation for approachability will raise their standing among responsible NGOs generally. And such companies will obtain valuable exposure to NGOs' concerns and ways of thinking.

**Accelerate innovation.** In the absence of a dire competitive threat, most companies are content to make incremental improvements to their processes or products. By focusing on the wider effects of companies' practices rather than on their costs or profitability, NGOs are able to demand more of an enterprise than it sometimes demands of itself. The result can be radical solutions that improve some aspect of society or the environment while also increasing competitiveness.

The creation of a market for liquefied petroleum gas (LPG) refrigerators occurred in just this way. In response to the Montreal Protocol's call for eliminating ozone-destroying chlorofluorocarbons by 1996, the chemical industry encouraged appliance makers to replace them with hydrochlorofluorocarbons (HCFCs), greenhouse gases with less ozone-destroying potential. DuPont and ICI, the specialty product and paint developer, invested more than $500 million in research into HCFCs and facilities for manufacturing them.

But in 1991, Greenpeace convinced DKK Scharfenstein, an appliance manufacturer in eastern Germany, to develop a refrigerator based on LPG. (It didn't hurt the company's receptiveness that it was on the verge of bankruptcy and that LPG is far less expensive than standard refrigerants.) The environmentally conscious German consumer market embraced DKK Scharfenstein's refrigerators containing the new technology. By 1994, Bosch and Liebherr, two of Germany's largest appliance makers, had moved almost exclusively to LPG-based refrigerators. Today, refrigerators with LPG technology dominate the markets in many European countries.

**Foresee shifts in demand.** NGOs often lead social movements. They detect latent but burgeoning concern about an issue, which they then amplify. New norms and values emerge that will, eventually, influence consumers' tastes. Ultimately, they can endanger entire industries. For example, the nuclear energy and genetically modified food industries have become embattled and shrunken at least in part because of NGO-sponsored campaigns highlighting the dangers they pose. Such movements can also direct consumers to substitutes that become the basis of new growth industries.

Take the $10 billion organic foods business, which has been enjoying annual growth rates of 20% to 30% for the past decade. By the time Monsanto and other companies began introducing genetically modified foods to the European market in hopes of

launching their own kind of growth industry, a public already traumatized by mad cow disease had become acutely conscious of the safety and purity of the food it ate. Then NGOs such as Friends of the Earth and Greenpeace publicized the dangers of cross-pollination and the threat to butterflies and other insects.

Flush with their success in the United States (where, for example, half the soybean crop is genetically modified), the companies producing genetically modified foods failed to take the true measure of Europeans' resistance. Within just a few years, government regulation and public distaste had driven genetically modified foods off Europe's store shelves. By consulting with NGOs, producers of these foods could have avoided investing in a market that was simply not interested and saved themselves billions of dollars.

NGOs are good at sensing shifts in taste and values. They should be, since they are usually born during one of those shifts and depend for their survival on keeping up with them. (The rise and fall of an NGO's funding tends to reflect the extent of the public's alarm about the sorts of issues that an NGO addresses.) But NGOs don't simply respond to those shifts. In a positive feedback loop, they help redirect and control them. By staying close to groups that are expert at following and shaping public opinion, companies get a leg up, either in their product development or their marketing.

**Shape legislation.** Through its tax policies, regulation of competition, grants of patent protection, and promulgation of labor and environmental standards, to name just some of its powers, government is perhaps the greatest nonmarket force shaping industry. NGOs have access to like-minded legislators and regulators that even the best-connected corporate lobbyists may not know well. Often, NGOs hear of behind-the-scenes maneuvering or legislative initiatives brewing long before they reach the committee level. And they are sometimes willing to report these to companies they trust. The result is usually better-informed legislation.

Some NGOs are formidable lobbying organizations in their own right. As a World Wildlife Fund executive in Brussels explained to me, "When I speak with EU lawmakers, I can reasonably claim to be speaking on behalf of 5 million fee-paying members. Politicians listen." Thus, by working with NGOs, companies can have a greater impact on future legislation than they would if they were speaking strictly on behalf of their own economic interests and in opposition to what may be society's well-being. An appreciation of the other side's perspective permits the brokering of interests that often precedes the writing of new law. Both companies and NGOs know that they can gain far greater influence by bringing an opponent into their coalition than by adding yet one more industry member or supporter.

**Set industry standards.** Cooperating with NGOs gives companies a chance not only to avoid various kinds of trouble but also to reshape their industry, sometimes for their own benefit. They can do this by establishing new technology standards, as DKK Scharfenstein happened to do when it developed its new kind of refrigerator. These technology standards then become the basis of new labor or environmental standards, which are enforced either by government mandate or market preference.

Unilever pursued this strategy in its groundbreaking partnership with the World Wildlife Fund. The two organizations joined forces to deal with a serious decline in fisheries around the world. Both knew that voluntary restraint on the part of some fleets would have no effect on the number of fish caught, since the other fleets would increase their catches accordingly—a classic problem of the commons. Yet all of them would suffer economically as the size of their catches shrank or their voyages ranged farther and lasted longer. The two organizations got together in 1996 to develop precise standards for responsible and sustainable fishing practices. Since its founding in 1999, the Marine Stewardship Council has accredited more than 100 companies, in 20 countries, that adhere to its standards. Accreditation gives those companies the right to put the MSC logo on their products.

In collaboration with NGOs, industries ranging from coffee production to clothing manufacturing to forestry have established similar certification programs. Aside from protecting the natural resources on which participating businesses depend, the programs have in effect created categories of sought-after products defined by the label they carry. Environmentally minded consumers, for instance, will prefer a can of tuna labeled "dolphin free" over one simply labeled "light tuna.''

A reputation for advancing the common good is not the only benefit that accrues to first movers. By setting demanding standards, they present their competitors with a dilemma: Either invest large amounts of capital in meeting those standards or face condemnation for refusing to do so. And for would-be attackers outside the market in

question, standards can serve as barriers to entry.

If you dominate your market, you might want to set a technical standard that your less well-capitalized competitors would have to struggle to afford, or that applies to an area in which they would prefer not to compete. If you don't dominate your market but deploy a technology that is safer or cleaner than your rivals', you may want to work at getting that technology adopted as the new regulatory standard. NGOs should be willing to assist you in this.

Being a first mover allows you to generate standards that are rational, practicable, and uniform. When markets fall into line behind such standards, they reduce the danger that more than one jurisdiction or regulatory body, each with its own idiosyncratic notions, will step in. In the United States in particular, where the 50 states as well as the federal government often exercise regulatory oversight, compliance can be difficult and expensive when a single industry standard does not prevail.

A caveat is in order. Credible NGOs will often insist on higher standards of behavior than a firm left to its own devices would choose. In short, an NGO endorsement may not come cheaply.

• • •

It's good business to make social and environmental concerns a key part of decision making. But it's not always possible. Bill Ford, CEO of Ford Motor, once said, "Transparency, stakeholder engagement, and accountability...will be the regulatory tools of the twenty-first century.'' He later had to concede that his company's commitment to helping cut greenhouse gases "will be tempered by our near-term business realities.''

Even when partnerships with NGOs are possible, they carry their own risks. First, if your company interacts with NGOs, it is likely providing them (and, by extension, your competitors and regulators) with sensitive information. Knowledge of R&D projects, strategic plans, and internal audits may help NGOs be better partners, but it might also make them dangerous ones. Just as companies have disclosure policies for joint ventures, they should have strict guidelines for partnerships with NGOs.

Second, partnering with NGOs, and advertising it, can draw stricter scrutiny from the public, the press, regulators, and so on than your company formerly received. A lapse that earlier would not have been noteworthy will suddenly call into question your company's sincerity, making further cooperation with NGOs difficult. Worse, cynics are likely to accuse your company of being interested exclusively in image building. CorpWatch, a corporate watchdog, gives out so-called Greenwash Awards to corporations that "put more money, time, and energy into slick PR campaigns aimed at promoting their eco-friendly images than they do in actually protecting the environment."

In short, an overriding interest in good public relations can have the perverse result of actually damaging your company's reputation.

Partnering with an NGO requires nothing less than a change in mentality. In my experience, otherwise highly competent executives find themselves at sea when they venture into the sociopolitical realm, which operates according to its own set of rules. Ask an executive his ultimate responsibility, and he will probably say, "Maximize shareholder return." NGOs—with fundamentally different assumptions about the free market and the role of corporations in society—will see that answer as the problem. And they will act accordingly.

Just as most progressive NGOs take into consideration companies' economic realities when they work to formulate their goals, companies must incorporate an understanding of NGOs' values and concerns into their ordinary cost-benefit calculations. If they do, they will be better prepared when NGOs, invited or not, arrive on their doorstep.


>| Executive Summary
>| Purchase Reprint
>| Printable Version
>| E-mail a Colleague


Reprint Number R0402J



Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review
Click here to visit:
>| http://www.hbsp.org

BEST PRACTICE

# Turning Gadflies into Allies

**Companies view nongovernmental organizations as pests, or worse. But joining them can be more productive than swatting them, and just might give your company an edge.**

***by Michael Yaziji***

**Michael Yaziji** is a PhD candidate at Insead, in Fontainebleau, France, and is the founder of its Business and Society Forum. He is a former lecturer in philosophy and ethics at the University of California, Santa Barbara.

Multinational companies are the driving force behind globalization, but they are also the source of many of its most painful consequences, including currency crises, cross-border pollution, and overfishing. These remain unsolved due to two kinds of failures. For one, such issues are, by their nature, beyond the scope of individual governments to avoid or resolve. For the other, transnational organizations, such as the World Bank, the International Monetary Fund, and the World Trade Organization, have proved unequal to the task.

Into the breach have leaped not-for-profit, nongovernmental organizations (NGOs) of concerned citizens. Realizing that news of cross-border problems can also cross borders, NGOs have sponsored angry protests in Seattle, Davos, Göteborg, and Genoa. While these are perhaps the best-publicized demonstrations of nongovernmental organizations' activism, they are hardly the only ones. NGOs have seized on all forms of modern persuasion—from advertising to boycotts and even sabotage—in order to influence public sentiment toward global traders, manufacturers, and investors. The NGOs hope that they can effect policy changes in this way.

In many NGOs' view, companies that incorporate offshore to avoid taxes or that send jobs overseas demonstrate a lack of allegiance to their country of origin. At the same time, by failing to bring with them the labor and human rights standards prevailing in the developed world, these companies appear unconcerned with the welfare of the countries where they do business. Yet their economic power frustrates official efforts to control their activities.

Such views can harden into a purely oppositional stance. Guy Taylor, a spokesperson for London-based Globalize Resistance, says his organization has as its aim a world free of corporations and that it would welcome their destruction. Yet while an anticorporate backlash continues to grow, many influential NGOs are increasingly composed of serious-minded, educated professionals who pursue a more moderate agenda. While NGOs may not forswear tough public campaigns against companies they think are acting selfishly or shortsightedly, lately they have become more willing to enter into negotiations with them.

NGOs like these have the skills, resources, insights, and depths of popular support that make it unwise for companies to confront them head-on. For example, in 2001, NGOs obliged Aventis to spend more than $500 million on buying back genetically modified Starlink corn from growers, ultimately leading it to spin off its agricultural business. NGOs have also virtually closed the EU market to the agricultural biotech industry. And in the face of a public relations disaster that nongovernmental organizations such as Doctors Without Borders and Oxfam International incited, GlaxoSmithKline, Merck, Bristol-Myers Squibb, Roche, and other pharmaceutical companies withdrew a lawsuit challenging a South African law that undercut patent enforcement of their AIDS drugs.

Those companies might have avoided such outcomes by partnering with NGOs instead of flatly opposing them. Doing so would have offered the companies the chance not only to avoid costly conflict but also to use NGOs' assets to gain competitive advantage. I've found evidence of NGOs' receptiveness to such an approach in case studies, archival data, and in-depth interviews with executives from Greenpeace, the World Wildlife Fund, the Marine Stewardship Council, and other NGOs. I've also spoken with frontline managers and the CEOs of companies such as Shell, ExxonMobil, and Monsanto, who attested both to the costs of being attacked by NGOs and to the challenges and benefits of partnering with them.

So far, however, most companies have proved ill equipped to deal with NGOs. One reason is that NGO attacks pose very different challenges from those mounted by business competitors. Large companies know how to compete on the basis of product attributes and price. But NGO attacks focus on production methods and their spillover, often noneconomic effects. Similarly, NGOs are able to convert into liabilities companies' standard competitive strengths such as size and wide market awareness of their brands. That's because the wealthier and better known a company is, the juicier the target it makes. (See the box that lays out businesses at risk.)

---

**Your business is at risk if...**

Sidebar **R0402J_A** (Located at the end of this article)

---

NGOs have developed special, often Internet-enabled, capabilities for turning the tables in these ways. For one thing, NGOs are ferocious networkers. It is not out of the ordinary for an NGO in, say, Bangalore to share information and coordinate strategies with counterparts in Boston and Budapest. One favorite NGO strategy is "swarming"—an attack on a single corporation by a host of small, modestly funded advocacy groups. Corporations like to think of themselves as operating on "Internet time," but NGOs are much nimbler. Issue-centered global coalitions of hundreds of NGOs can materialize and mobilize within days.

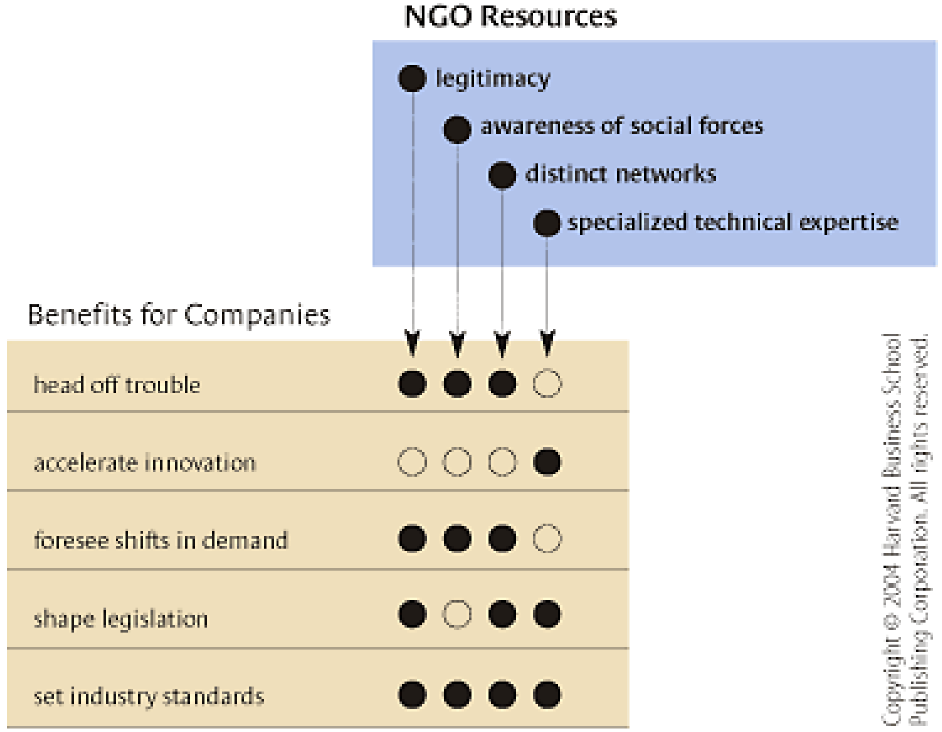
Emboldened by their successes, NGOs continue to take on, or form around, new causes. The number of NGOs with global concerns has quadrupled this past decade, a fact partly reflected in the twentyfold increase over the last ten years in mentions of NGOs generally in the *Wall Street Journal* and the *Financial Times*. To such advocacy groups and independent watchdog organizations, simple compliance with all applicable laws is not the end of a corporation's responsibilities—if the laws themselves are insufficiently protective. To NGOs' way of thinking, they have a permanent mandate to fill the regulatory vacuum. In the face of such numbers and expectations, companies would be well advised to look for common ground.

### Strengths Worth Coveting

Nongovernmental organizations have four strengths that corporations would be well

served to heed. They are legitimacy, awareness of social forces, distinct networks, and specialized technical expertise. The public bestows the first, and the second is a function of the NGOs' mission. The latter two refer to competences that NGOs have developed by venturing where corporations usually don't go.

The four NGO resources that companies can use to gain competitive advantage




**Legitimacy.** According to a poll conducted by the Edelman public relations firm, both Americans and Europeans said they found NGO spokespeople more credible than either a company's CEO or PR representative. Some fraction of the public, especially in Europe, sees NGOs as dedicated first and foremost to serving an aspect of the general social welfare. While many companies produce direct benefits to society—those in the pharmaceutical and food industries being obvious examples—the public interprets those benefits as by-products of the companies' profit motive rather than as the direct result of their desire to feed or care for their fellow human beings.

Suspicion of companies' motives can become so entrenched that the soundest solutions aren't given a fair hearing. The fate of Shell Oil's Brent Spar storage and tanker offloading system is one such example. After conducting a thorough analysis of what to do with the platform, Shell concluded that towing it into the deep water of the North Atlantic and then sinking it was the best alternative from an environmental standpoint. (It would also be £40 million cheaper than dismantling the platform on land.) Outraged by the plan, Greenpeace organized a boycott of Shell products in the UK and sent protesters to occupy the facility. Ultimately, Shell succumbed to public pressure and hauled the rig ashore for dismantling. Greenpeace subsequently admitted that it had overstated the amount of oil residues in the tank and thus the harmful environmental effects of scuttling.

**Awareness of Social Forces.** Companies live and die by the markets they compete in; NGOs, by the ebb and flow of people's concerns about the safety and fairness of conditions worldwide. Although the gulf between the two arenas is large, businesses can

learn much from NGOs' attunement to and influence on shifts in common beliefs and mores that in turn shape consumer demand. For example, in the early 1970s, years before organizations such as People for the Ethical Treatment of Animals were organizing boycotts of fur apparel, and guerrillas from the Animal Liberation Front were infiltrating mink farms to free the animals caged there, groups such as Animal Rights International had highlighted industrial conditions afflicting animals generally. If fur, cosmetics, poultry, and fast-food companies had noted the public's first stirrings of humane concern, they could have modified their practices and avoided the ensuing bad publicity and economic harm.

**Distinct Networks.** Most companies' networks primarily consist of organizations that would belong among Michael Porter's five forces model of buyers, suppliers, rival firms, new entrants, and substitute producers. NGOs' networks, by contrast, mostly consist of other NGOs, as well as donors, regulators, legislators, and public-interest lobbyists. These networks are often quite extensive and dense, since many NGOs are small, lack resources, and must form coalitions to be effective. Partnering with NGOs is an excellent way to gain access to the information circulating within their networks.

**Specialized Technical Expertise.** NGO members are often thought of as young, unsophisticated malcontents. In reality, the more established NGOs are filled with lawyers, policy analysts, and scientists. Half the employees of the largest, most influential environmental NGOs have master's or law degrees, and 10% to 20% have doctorates. Many of them possess knowledge that the companies being targeted lack. The NGOs may know about a new technology that is superior only in its environmental impact and therefore escaped businesses' attention. Or they may have noticed a judicial ruling in an out-of-the-way jurisdiction that may one day set a standard of conduct nationwide. Out of fear that their own research into ways of mitigating harm might establish liability, companies are sometimes willfully ignorant of developments that NGOs are aggressively pursuing.

**No More No-Go**

There are five primary benefits to partnering with NGOs:

**Head off trouble.** Although NGOs are known for engineering confrontations, the more established of these increasingly recognize that negotiating directly with companies is more efficient than putting on a negative campaign in hopes that the public will then pressure government officials or the companies themselves to correct the situation they've created. From the companies' standpoint as well, the involvement of motivated experts in place of committed adversaries makes negotiation a more promising alternative.

As soon as the first signs of disagreement with a project proposal are in evidence—whether it be a letter to the editor, a petition, or a picket line—the company under scrutiny should invite the critics in for a discussion. Even better, companies should learn the concerns of the NGOs that follow their industry and sound them out while a potentially controversial project is still on the drawing board.

Such is the method currently employed by Shell, which regularly brings together interested groups such as the World Wildlife Fund, Amnesty International, and local NGOs at the initial stages of project planning and evaluation. As one senior Shell executive stated, "[Brent Spar] led us to a new approach in which we try to prevent crises through open dialogue. The discussions aren't always easy, but there is a reasonable amount of mutual trust and understanding between us now." An added benefit, according to the executive, is that the company now has an open channel of communication with the NGOs that attacked it in earlier controversies. If consultations

occur regularly instead of during times of crisis, confrontation is less likely.

Consultations should include all interested parties, all gathered around the same table. That way, the party urging an NGO to soften its demands may not be the company itself but a fellow NGO. After all, different NGOs represent different interests. Some groups focus on human rights, some on the protection of endangered species, some on community concerns. When a large-scale project produces diverse results, certain NGOs can end up favoring it and others opposing it. For instance, a factory being planned might bring jobs to the local population but acid rain to the adjoining state. Two NGOs could assess the hazards and benefits differently, even though their networks overlap.

Private negotiation is preferable to public demonstrations, especially when it concerns projects that have not yet been made public. The two have trouble coexisting, since public posturing by either party can erode the trust and candor that are essential for progress to occur in private.

If a company's reputation turns out to be bad enough, most NGOs will refuse to negotiate with it for fear they will lose their bona fides. Some may be willing but will keep quiet about it. One environmental NGO I know well has a partnership with a global fast-food corporation. The NGO provides it with technical guidance on reducing waste. Many environmentalists think its standard practices place it beyond the pale, so the NGO does not talk about the partnership. As a senior executive of the NGO tells it, "We think this partnership is a good thing. It accords with our mission. But not all of our supporters would be thrilled at the association. We don't lie about it, but it just isn't an activity that we advertise."

Companies with decent records that acquire a reputation for approachability will raise their standing among responsible NGOs generally. And such companies will obtain valuable exposure to NGOs' concerns and ways of thinking.

**Accelerate innovation.** In the absence of a dire competitive threat, most companies are content to make incremental improvements to their processes or products. By focusing on the wider effects of companies' practices rather than on their costs or profitability, NGOs are able to demand more of an enterprise than it sometimes demands of itself. The result can be radical solutions that improve some aspect of society or the environment while also increasing competitiveness.

The creation of a market for liquefied petroleum gas (LPG) refrigerators occurred in just this way. In response to the Montreal Protocol's call for eliminating ozone-destroying chlorofluorocarbons by 1996, the chemical industry encouraged appliance makers to replace them with hydrochlorofluorocarbons (HCFCs), greenhouse gases with less ozone-destroying potential. DuPont and ICI, the specialty product and paint developer, invested more than $500 million in research into HCFCs and facilities for manufacturing them.

But in 1991, Greenpeace convinced DKK Scharfenstein, an appliance manufacturer in eastern Germany, to develop a refrigerator based on LPG. (It didn't hurt the company's receptiveness that it was on the verge of bankruptcy and that LPG is far less expensive than standard refrigerants.) The environmentally conscious German consumer market embraced DKK Scharfenstein's refrigerators containing the new technology. By 1994, Bosch and Liebherr, two of Germany's largest appliance makers, had moved almost exclusively to LPG-based refrigerators. Today, refrigerators with LPG technology dominate the markets in many European countries.

**Foresee shifts in demand.** NGOs often lead social movements. They detect latent but burgeoning concern about an issue, which they then amplify. New norms and values emerge that will, eventually, influence consumers' tastes. Ultimately, they can endanger

entire industries. For example, the nuclear energy and genetically modified food industries have become embattled and shrunken at least in part because of NGO-sponsored campaigns highlighting the dangers they pose. Such movements can also direct consumers to substitutes that become the basis of new growth industries.

Take the $10 billion organic foods business, which has been enjoying annual growth rates of 20% to 30% for the past decade. By the time Monsanto and other companies began introducing genetically modified foods to the European market in hopes of launching their own kind of growth industry, a public already traumatized by mad cow disease had become acutely conscious of the safety and purity of the food it ate. Then NGOs such as Friends of the Earth and Greenpeace publicized the dangers of cross-pollination and the threat to butterflies and other insects.

Flush with their success in the United States (where, for example, half the soybean crop is genetically modified), the companies producing genetically modified foods failed to take the true measure of Europeans' resistance. Within just a few years, government regulation and public distaste had driven genetically modified foods off Europe's store shelves. By consulting with NGOs, producers of these foods could have avoided investing in a market that was simply not interested and saved themselves billions of dollars.

NGOs are good at sensing shifts in taste and values. They should be, since they are usually born during one of those shifts and depend for their survival on keeping up with them. (The rise and fall of an NGO's funding tends to reflect the extent of the public's alarm about the sorts of issues that an NGO addresses.) But NGOs don't simply respond to those shifts. In a positive feedback loop, they help redirect and control them. By staying close to groups that are expert at following and shaping public opinion, companies get a leg up, either in their product development or their marketing.

**Shape legislation.** Through its tax policies, regulation of competition, grants of patent protection, and promulgation of labor and environmental standards, to name just some of its powers, government is perhaps the greatest nonmarket force shaping industry. NGOs have access to like-minded legislators and regulators that even the best-connected corporate lobbyists may not know well. Often, NGOs hear of behind-the-scenes maneuvering or legislative initiatives brewing long before they reach the committee level. And they are sometimes willing to report these to companies they trust. The result is usually better-informed legislation.

Some NGOs are formidable lobbying organizations in their own right. As a World Wildlife Fund executive in Brussels explained to me, "When I speak with EU lawmakers, I can reasonably claim to be speaking on behalf of 5 million fee-paying members. Politicians listen." Thus, by working with NGOs, companies can have a greater impact on future legislation than they would if they were speaking strictly on behalf of their own economic interests and in opposition to what may be society's well-being. An appreciation of the other side's perspective permits the brokering of interests that often precedes the writing of new law. Both companies and NGOs know that they can gain far greater influence by bringing an opponent into their coalition than by adding yet one more industry member or supporter.

**Set industry standards.** Cooperating with NGOs gives companies a chance not only to avoid various kinds of trouble but also to reshape their industry, sometimes for their own benefit. They can do this by establishing new technology standards, as DKK Scharfenstein happened to do when it developed its new kind of refrigerator. These technology standards then become the basis of new labor or environmental standards, which are enforced either by government mandate or market preference.

Unilever pursued this strategy in its groundbreaking partnership with the World Wildlife Fund. The two organizations joined forces to deal with a serious decline in fisheries around the world. Both knew that voluntary restraint on the part of some fleets would have no effect on the number of fish caught, since the other fleets would increase their catches accordingly—a classic problem of the commons. Yet all of them would suffer economically as the size of their catches shrank or their voyages ranged farther and lasted longer. The two organizations got together in 1996 to develop precise standards for responsible and sustainable fishing practices. Since its founding in 1999, the Marine Stewardship Council has accredited more than 100 companies, in 20 countries, that adhere to its standards. Accreditation gives those companies the right to put the MSC logo on their products.

In collaboration with NGOs, industries ranging from coffee production to clothing manufacturing to forestry have established similar certification programs. Aside from protecting the natural resources on which participating businesses depend, the programs have in effect created categories of sought-after products defined by the label they carry. Environmentally minded consumers, for instance, will prefer a can of tuna labeled "dolphin free" over one simply labeled "light tuna."

A reputation for advancing the common good is not the only benefit that accrues to first movers. By setting demanding standards, they present their competitors with a dilemma: Either invest large amounts of capital in meeting those standards or face condemnation for refusing to do so. And for would-be attackers outside the market in question, standards can serve as barriers to entry.

If you dominate your market, you might want to set a technical standard that your less well-capitalized competitors would have to struggle to afford, or that applies to an area in which they would prefer not to compete. If you don't dominate your market but deploy a technology that is safer or cleaner than your rivals', you may want to work at getting that technology adopted as the new regulatory standard. NGOs should be willing to assist you in this.

Being a first mover allows you to generate standards that are rational, practicable, and uniform. When markets fall into line behind such standards, they reduce the danger that more than one jurisdiction or regulatory body, each with its own idiosyncratic notions, will step in. In the United States in particular, where the 50 states as well as the federal government often exercise regulatory oversight, compliance can be difficult and expensive when a single industry standard does not prevail.

A caveat is in order. Credible NGOs will often insist on higher standards of behavior than a firm left to its own devices would choose. In short, an NGO endorsement may not come cheaply.

• • •

It's good business to make social and environmental concerns a key part of decision making. But it's not always possible. Bill Ford, CEO of Ford Motor, once said, "Transparency, stakeholder engagement, and accountability...will be the regulatory tools of the twenty-first century." He later had to concede that his company's commitment to helping cut greenhouse gases "will be tempered by our near-term business realities."

Even when partnerships with NGOs are possible, they carry their own risks. First, if your company interacts with NGOs, it is likely providing them (and, by extension, your competitors and regulators) with sensitive information. Knowledge of R&D projects, strategic plans, and internal audits may help NGOs be better partners, but it might also

make them dangerous ones. Just as companies have disclosure policies for joint ventures, they should have strict guidelines for partnerships with NGOs.

Second, partnering with NGOs, and advertising it, can draw stricter scrutiny from the public, the press, regulators, and so on than your company formerly received. A lapse that earlier would not have been noteworthy will suddenly call into question your company's sincerity, making further cooperation with NGOs difficult. Worse, cynics are likely to accuse your company of being interested exclusively in image building. CorpWatch, a corporate watchdog, gives out so-called Greenwash Awards to corporations that "put more money, time, and energy into slick PR campaigns aimed at promoting their eco-friendly images than they do in actually protecting the environment."

In short, an overriding interest in good public relations can have the perverse result of actually damaging your company's reputation.

Partnering with an NGO requires nothing less than a change in mentality. In my experience, otherwise highly competent executives find themselves at sea when they venture into the sociopolitical realm, which operates according to its own set of rules. Ask an executive his ultimate responsibility, and he will probably say, "Maximize shareholder return." NGOs—with fundamentally different assumptions about the free market and the role of corporations in society—will see that answer as the problem. And they will act accordingly.

Just as most progressive NGOs take into consideration companies' economic realities when they work to formulate their goals, companies must incorporate an understanding of NGOs' values and concerns into their ordinary cost-benefit calculations. If they do, they will be better prepared when NGOs, invited or not, arrive on their doorstep.

---

Reprint Number R0402J

---

## Your business is at risk if...

Sidebar **R0402J_A**

**offers lifesaving or life-threatening products**

(such as pharmaceuticals, arms)

**confronts changing social mores**

(such as fashion, alcohol, tobacco)

**produces significant spillover effects**

(such as mining, heavy manufacturing, waste management)

**enjoys high brand awareness**

(such as clothing, food and beverage, automotive)

**is based on new technologies**

(such as genetic engineering, personal-data collection)

**does business in different regions with differing ethical or social norms**

(such as textiles and clothing, oil and gas, forestry)

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

## Turning Gadflies into Allies

# Your business is at risk if it:

**offers lifesaving or life-threatening products**

(such as pharmaceuticals, arms)

**confronts changing social mores**

(such as fashion, alcohol, tobacco)

**produces significant spillover effects**

(such as mining, heavy manufacturing, waste management)

**enjoys high brand awareness**

(such as clothing, food and beverage, automotive)

**is based on new technologies**

(such as genetic engineering, personal-data collection)

**does business in different regions with differing ethical or social norms**

(such as textiles and clothing, oil and gas, forestry)

< Back to Article

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

WRITTEN BY

Thomas A. Stewart

# For Strategy, the Readiness Is All

***by Thomas A. Stewart***

I met Bob Kaplan in 1990. By then, he was already familiar to HBR readers; his first article for us, "Yesterday's Accounting Undermines Production," appeared in 1984 and won the McKinsey Award that year. The argument in that article—and in Bob's 1987 book *Relevance Lost: The Rise and Fall of Management Accounting,* coauthored with H. Thomas Johnson—was that the numbers companies collected were increasingly irrelevant to the needs, strategies, and real performance of business. At the time, I was investigating the nature and value of intellectual capital, and Bob's work was profoundly pertinent. In a subsequent article in *Fortune,* I wrote, "Intellectual capital can be as ephemeral as the holy grail."

A similar phrase appears in "Measuring the Strategic Readiness of Intangible Assets," the major new article by Kaplan and David Norton in this issue of HBR: "Measuring the value of...intangible assets is the holy grail of accounting." The authors don't claim to have found it; grails aren't to be found on this earth, except in Wagner and in Indiana Jones movies. But Kaplan and Norton have done the next best thing—or maybe something even better than that. They argue that companies should not try to put an overall value on assets like human capital. Instead, companies should first articulate their strategy, then rate their intangibles according to how well those assets are aligned with the strategy. A financial services company, for example, might decide that its strategy is to sell more different services to each customer. If that's the goal, then the company needs a set of intangibles to reach it—a certain number of people skilled in cross-selling, information systems that can talk to each other, an organizational design that allows people to work across product lines. So how would the company rate each of these intangibles—human, information, and organization capital—against the goal? Those are knowable numbers, if you know enough to look for them.

This is, in my opinion, a breakthrough article. It's certainly so for those of us who have been wrestling with the issues created by the increasing importance of intangibles. Kaplan and Norton's process results in data rigorous enough for a CFO to believe and practical enough for a manager to use. It's also a breakthrough article for people concerned with how to take a great strategy and make it work. The tool Kaplan and Norton propose rates what they call "strategic readiness." If you know how well your intangible assets support your strategy, you have a good idea of how likely that strategy is to succeed. For those of us concerned with execution, that's something akin to the holy grail.

"Measuring the Strategic Readiness of Intangible Assets" is new fruit from seeds Kaplan and his colleagues planted years ago. This month we're also bringing you a whole orchard of seedlings—ideas that will bear fruit for many years to come. I'm referring to the fourth annual HBR List, this time in a new format. In this article, you'll find a score of the most interesting, provocative, hot new ideas in business. Among them: how neurology is changing our ideas about leadership; why companies should spend less time examining their failures and more time studying their successes; what marketing research can learn from operations; and how social network analysis can revitalize your company.

The last item in this issue appears in HBR for the first time. A few months ago, a booklet called *Boom* appeared on my desk. It contained a shrewd and delightful business narrative told entirely in pictures, with a brief textual gloss at the end. Enclosed with the booklet was a note from its creator, Don Moyer, hoping I'd like *Boom.*

I loved it. I called Moyer, who works for Agnew Moyer Smith, a Pittsburgh-based ad agency, and invited him to develop a series of wordless stories for HBR. We talked for a bit, then he began working with senior editor Leigh Buchanan. The result is Panel

Discussion. In this issue, and for the foreseeable future, you'll find it on the last page of the magazine.

As Don said, I hope you like it. Or even love it.



Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review

Click here to visit:
>| http://www.hbsp.org

FROM THE EDITOR

# For Strategy, the Readiness Is All

***by Thomas A. Stewart***

**Thomas A. Stewart**

I met Bob Kaplan in 1990. By then, he was already familiar to HBR readers; his first article for us, "Yesterday's Accounting Undermines Production," appeared in 1984 and won the McKinsey Award that year. The argument in that article—and in Bob's 1987 book *Relevance Lost: The Rise and Fall of Management Accounting,* coauthored with H. Thomas Johnson—was that the numbers companies collected were increasingly irrelevant to the needs, strategies, and real performance of business. At the time, I was investigating the nature and value of intellectual capital, and Bob's work was profoundly pertinent. In a subsequent article in *Fortune,* I wrote, "Intellectual capital can be as ephemeral as the holy grail."

A similar phrase appears in "Measuring the Strategic Readiness of Intangible Assets," the major new article by Kaplan and David Norton in this issue of HBR: "Measuring the value of...intangible assets is the holy grail of accounting." The authors don't claim to have found it; grails aren't to be found on this earth, except in Wagner and in Indiana Jones movies. But Kaplan and Norton have done the next best thing—or maybe something even better than that. They argue that companies should not try to put an overall value on assets like human capital. Instead, companies should first articulate their strategy, then rate their intangibles according to how well those assets are aligned with the strategy. A financial services company, for example, might decide that its strategy is to sell more different services to each customer. If that's the goal, then the company needs a set of intangibles to reach it—a certain number of people skilled in cross-selling, information systems that can talk to each other, an organizational design that allows people to work across product lines. So how would the company rate each of these intangibles—human, information, and organization capital—against the goal? Those are knowable numbers, if you know enough to look for them.

This is, in my opinion, a breakthrough article. It's certainly so for those of us who have been wrestling with the issues created by the increasing importance of intangibles. Kaplan and Norton's process results in data rigorous enough for a CFO to believe and practical enough for a manager to use. It's also a breakthrough article for people concerned with how to take a great strategy and make it work. The tool Kaplan and Norton propose rates what they call "strategic readiness." If you know how well your intangible assets support your strategy, you have a good idea of how likely that strategy is to succeed. For those of us concerned with execution, that's something akin to the holy grail.

"Measuring the Strategic Readiness of Intangible Assets" is new fruit from seeds Kaplan and his colleagues planted years ago. This month we're also bringing you a whole orchard of seedlings—ideas that will bear fruit for many years to come. I'm referring to

the fourth annual HBR List, this time in a new format. In this article, you'll find a score of the most interesting, provocative, hot new ideas in business. Among them: how neurology is changing our ideas about leadership; why companies should spend less time examining their failures and more time studying their successes; what marketing research can learn from operations; and how social network analysis can revitalize your company.

The last item in this issue appears in HBR for the first time. A few months ago, a booklet called *Boom* appeared on my desk. It contained a shrewd and delightful business narrative told entirely in pictures, with a brief textual gloss at the end. Enclosed with the booklet was a note from its creator, Don Moyer, hoping I'd like *Boom*.

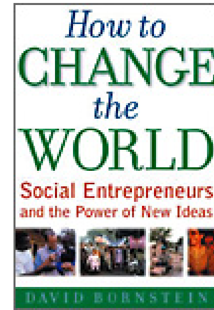
I loved it. I called Moyer, who works for Agnew Moyer Smith, a Pittsburgh-based ad agency, and invited him to develop a series of wordless stories for HBR. We talked for a bit, then he began working with senior editor Leigh Buchanan. The result is Panel Discussion. In this issue, and for the foreseeable future, you'll find it on the last page of the magazine.

As Don said, I hope you like it. Or even love it.

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

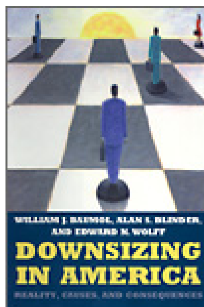
# Books in Brief

***by John T. Landry***




***How to Change the World***
***Social Entrepreneurs and the Power of New Ideas***
David Bornstein
(Oxford University Press, 2004)

Businesspeople often dismiss nonprofit organizers as paternalistic dreamers, but this engaging book shows that the "citizen sector" can be quite aggressive. Bornstein, a journalist, chronicles the Ashoka Foundation and the activists it funds in the developing world. Following the example set by Grameen Bank, Ashoka seeks social entrepreneurs eager to devote themselves full time to making their revolutionary ideas happen. These entrepreneurs take on business challenges that seem hopeless, ones that both governments and companies have abdicated, such as getting electricity to poor farmers in Brazil. With a combination of ingenious practical solutions, a gift for hearing the concerns of the potential beneficiaries, and hardheaded persistence, many of these social entrepreneurs have succeeded—in some cases so well that profit-seeking companies have jumped in. Bornstein notes that the continuing liberalization of markets and politics in many countries has opened opportunities for nonprofits that never existed before. While social entrepreneurs may have little to teach business directly—the borrowing generally goes in the other direction—they can serve as market pioneers, creating profitable businesses where others thought none could survive.



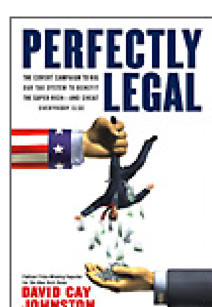

***Downsizing in America***
***Reality, Causes, and Consequences***
William J. Baumol, Alan S. Blinder, and Edward N. Wolff
(Russell Sage Foundation, 2003)

In this careful examination of the United States' last real wave of downsizing (between 1988 and 1992), these economists offer executives good news and bad news. First the good news: Most large companies did so much hiring after their layoffs of this period that they ended up at least as big as they were before making the cuts. Only in manufacturing did big companies generally get smaller; instead of rehiring, they just continued the job cuts they had been making since the 1970s. Now the bad news: The downsizing that did occur had no significant effect on productivity. Instead of trimming fat from the system, the layoffs simply forced the remaining workers to accept lower wages. The authors refrain from speculating about the effects of the most recent layoffs, but their look back offers a useful caution against drawing quick conclusions about business trends.

***Emotional Design***
***Why We Love (or Hate) Everyday Things***
Donald A. Norman
(Basic Books, 2004)

Designers have always recognized the marketing value of aesthetics. Now they have another reason to make products engaging: Beauty can actually boost functionality, argues Norman, a computer scientist and consultant. Cognitive studies have shown that positive emotions relax the mind and make people curious and open to novelty. That's why brainstorming sessions often begin with icebreaking stories and jokes. By the same token, a delightful design can make consumers willing to embrace new or problematic products. Look at the success of BMW's appealing Mini Cooper, which has won rave reviews despite several awkward features. Negative emotions, by contrast, tend to concentrate the mind on an immediate task, which is why people often drive up their anxiety levels with self-imposed deadlines near the end of a project. Similarly, the negative emotions stirred up by the bland, technocratic design of most personal computers often prevent people from discovering the PC's immense functionality. The major challenge to applying these findings, Norman explains in this well-illustrated survey of the emotional drivers in product design, is that customers' responses vary so greatly. Product designers need to tailor their work carefully in order to push the right buttons with the right customers.

---




***Perfectly Legal***
***The Covert Campaign to Rig Our Tax System to Benefit the Super Rich—and Cheat Everybody Else***
David Cay Johnston
(Portfolio, 2004)

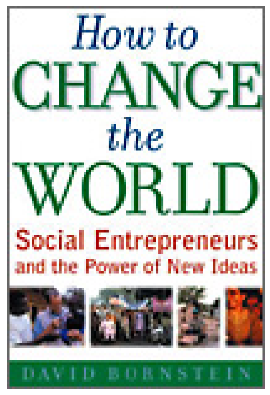
Most American executives have cheered the recent federal policy changes that have lowered corporate and income taxes, but as this eye-opening book explains, the new tax policy favors the wealthy even more than it appears. The government has sharply and consciously cut back on its enforcement of tax law to the point where it spends almost all of its resources hunting down dishonest wage earners rather than exposing the increasingly lucrative and creative tax-evasion schemes companies and wealthy individuals use. A tax system originally designed to be progressive—requiring richer people to pay a greater share of their incomes than poorer people do—now actually favors anyone who can hire a tax lawyer to prepare the proper documents. Johnston, a journalist, focuses on revealing the reality of tax collection rather than on analyzing its consequences. Arguably, the new tax policy may reflect the government's strategy of promoting investment (at least on paper) over consumption, but this new arrangement may be unstable. What happens if upper-middle-class earners, who will eventually bear the brunt of the exploding federal debt, find ways to join the party?



Copyright © 2004 Harvard Business School Publishing. All rights reserved.

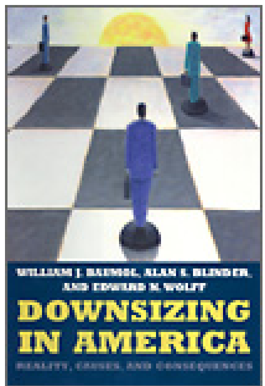
# Books in Brief

***by John T. Landry***




***How to Change the World***
***Social Entrepreneurs and the Power of New Ideas***
David Bornstein
(Oxford University Press, 2004)

Businesspeople often dismiss nonprofit organizers as paternalistic dreamers, but this engaging book shows that the "citizen sector" can be quite aggressive. Bornstein, a journalist, chronicles the Ashoka Foundation and the activists it funds in the developing world. Following the example set by Grameen Bank, Ashoka seeks social entrepreneurs eager to devote themselves full time to making their revolutionary ideas happen. These entrepreneurs take on business challenges that seem hopeless, ones that both governments and companies have abdicated, such as getting electricity to poor farmers in Brazil. With a combination of ingenious practical solutions, a gift for hearing the concerns of the potential beneficiaries, and hardheaded persistence, many of these social entrepreneurs have succeeded—in some cases so well that profit-seeking companies have jumped in. Bornstein notes that the continuing liberalization of markets and politics in many countries has opened opportunities for nonprofits that never existed before. While social entrepreneurs may have little to teach business directly—the borrowing generally goes in the other direction—they can serve as market pioneers, creating profitable businesses where others thought none could survive.




***Downsizing in America***
***Reality, Causes, and Consequences***
William J. Baumol, Alan S. Blinder, and Edward N. Wolff
(Russell Sage Foundation, 2003)

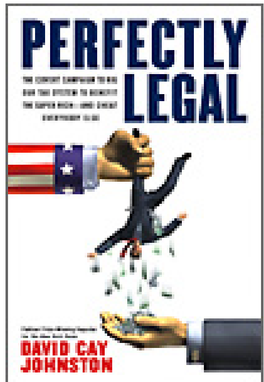
In this careful examination of the United States' last real wave of downsizing (between 1988 and 1992), these economists offer executives good news and bad news. First the good news: Most large companies did so much hiring after their layoffs of this period that they ended up at least as big as they were before making the cuts. Only in manufacturing did big companies generally get smaller; instead of rehiring, they just continued the job cuts they had been making since the 1970s. Now the bad news: The downsizing that did occur had no significant effect on productivity. Instead of trimming fat from the system, the layoffs simply forced the remaining workers to accept lower wages. The authors refrain from speculating about the effects of the most recent layoffs, but their look back offers a useful caution against drawing quick conclusions about business trends.

---

***Emotional Design***
***Why We Love (or Hate) Everyday Things***
Donald A. Norman
(Basic Books, 2004)

Designers have always recognized the marketing value of aesthetics. Now they have another reason to make products engaging: Beauty can actually boost functionality, argues Norman, a computer scientist and consultant. Cognitive studies have shown that positive emotions relax the mind and make people curious and open to novelty. That's why brainstorming sessions often begin with icebreaking stories and jokes. By the same token, a delightful design can make consumers willing to embrace new or problematic products. Look at the success of BMW's appealing Mini Cooper, which has won rave reviews despite several awkward features. Negative emotions, by contrast, tend to concentrate the mind on an immediate task, which is why people often drive up their anxiety levels with self-imposed deadlines near the end of a project. Similarly, the negative emotions stirred up by the bland, technocratic design of most personal computers often prevent people from discovering the PC's immense functionality. The major challenge to applying these findings, Norman explains in this well-illustrated survey of the emotional drivers in product design, is that customers' responses vary so greatly. Product designers need to tailor their work carefully in order to push the right buttons with the right customers.

---




***Perfectly Legal***
***The Covert Campaign to Rig Our Tax System to Benefit the Super Rich—and Cheat Everybody Else***
David Cay Johnston
(Portfolio, 2004)

Most American executives have cheered the recent federal policy changes that have lowered corporate and income taxes, but as this eye-opening book explains, the new tax policy favors the wealthy even more than it appears. The government has sharply and consciously cut back on its enforcement of tax law to the point where it spends almost all of its resources hunting down dishonest wage earners rather than exposing the increasingly lucrative and creative tax-evasion schemes companies and wealthy individuals use. A tax system originally designed to be progressive—requiring richer people to pay a greater share of their incomes than poorer people do—now actually favors anyone who can hire a tax lawyer to prepare the proper documents. Johnston, a journalist, focuses on revealing the reality of tax collection rather than on analyzing its consequences. Arguably, the new tax policy may reflect the government's strategy of promoting investment (at least on paper) over consumption, but this new arrangement may be unstable. What happens if upper-middle-class earners, who will eventually bear the brunt of the exploding federal debt, find ways to join the party?

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

>| Printable Version
>| E-mail a Colleague

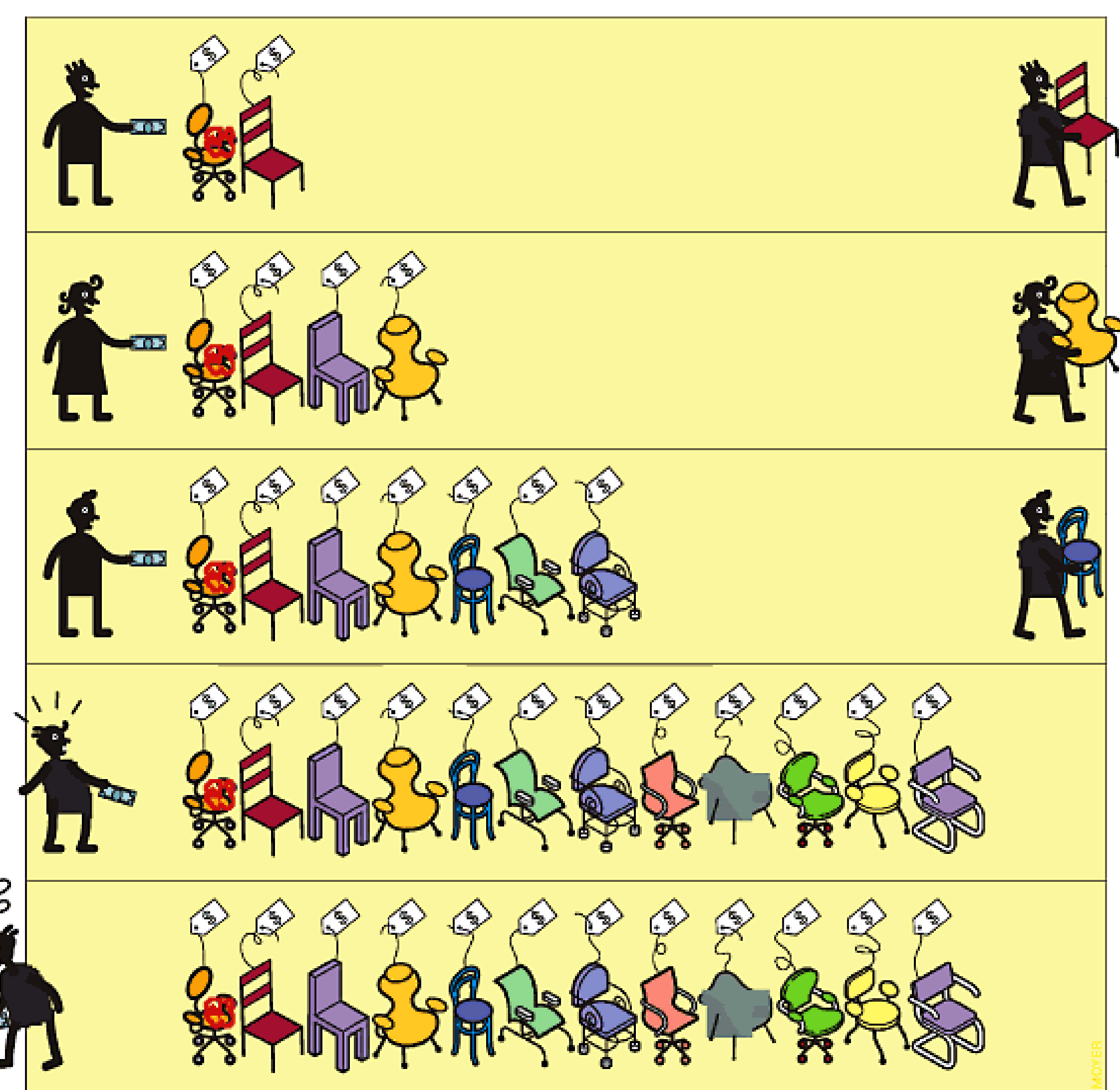
PANEL DISCUSSION

# Opt Artists

***by Don Moyer***

WRITTEN BY

**Don Moyer** can be reached at don@amsite.com



Your customers love choices, but too many can paralyze them. Thirty-plus PDAs. Eighty SUVs. Four thousand mutual funds. Overwhelmed by abundance, they may leave the marketplace empty-handed. It's easier to postpone a buying decision than to wade through all those options.

But no one is hankering for the any-color-as-long-as-it's-black Model T. What they want is advice. An informed opinion. Direction from an intermediary who relishes the quest to find the best and is generous with insights about superior goods and services.

*Consumer Reports* has played that role for 68 years; today shopping advice Web sites proliferate while Malcolm Gladwell's mavens adjudicate on the best cappuccino in Manhattan. In fact, how many buyers of Gladwell's best-seller *The Tipping Point* were influenced by praise from such canny critics as George Stephanopoulos and Michael Lewis?

If a product's quality speaks for itself but no one can hear it, does it make a sound? In a

>| Printable Version

noisy marketplace, target the mouths that matter.



Copyright © 2004 Harvard Business School Publishing. All rights reserved.

February 2004
Online Version
Harvard Business Review

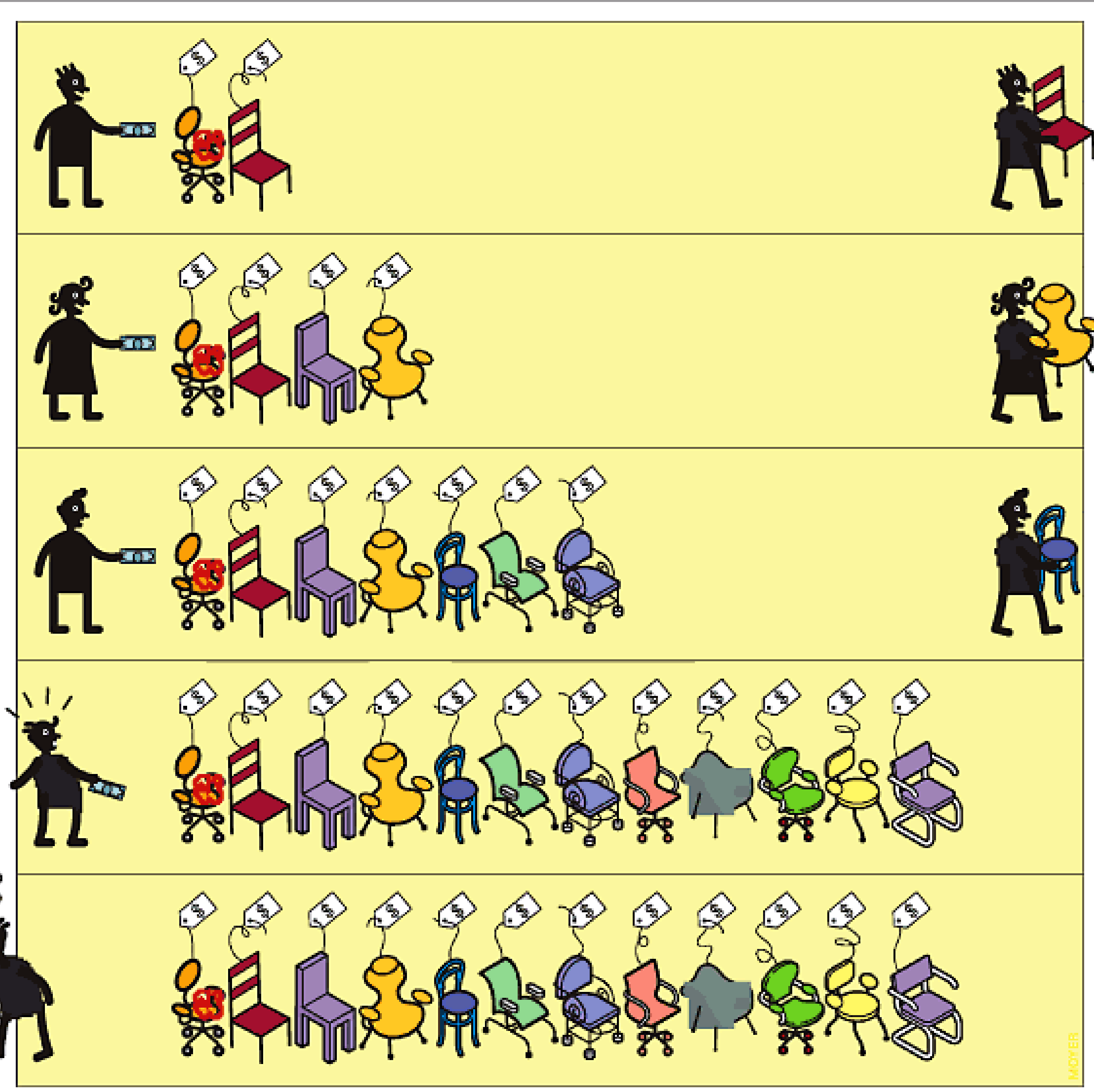
Click here to visit:
>| http://www.hbsp.org



# Opt Artists

*by Don Moyer*

**Don Moyer** can be reached at **don@amsite.com**



Your customers love choices, but too many can paralyze them. Thirty-plus PDAs. Eighty

SUVs. Four thousand mutual funds. Overwhelmed by abundance, they may leave the marketplace empty-handed. It's easier to postpone a buying decision than to wade through all those options.

But no one is hankering for the any-color-as-long-as-it's-black Model T. What they want is advice. An informed opinion. Direction from an intermediary who relishes the quest to find the best and is generous with insights about superior goods and services.

*Consumer Reports* has played that role for 68 years; today shopping advice Web sites proliferate while Malcolm Gladwell's mavens adjudicate on the best cappuccino in Manhattan. In fact, how many buyers of Gladwell's best-seller *The Tipping Point* were influenced by praise from such canny critics as George Stephanopoulos and Michael Lewis?

If a product's quality speaks for itself but no one can hear it, does it make a sound? In a noisy marketplace, target the mouths that matter.

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

# Letters to the Editor

## The Quest for Resilience

Dear Editor:

We have deep respect for the work of Gary Hamel and Liisa Välikangas, but "The Quest for Resilience" (September 2003) points your readers in the wrong direction. Companies need to build the "capacity to change before the case for change becomes desperately obvious." But Hamel and Välikangas propose a utopian corporate capacity that adapts to strategic failure without traumatic wake-up calls of lost market share, protracted earnings slumps, and the need for wrenching turnarounds. A recipe for pain-free learning could work only if learning were solely about developing valuable new ideas.

The strategically important innovations that give companies resilience do not come from experiments, or from multiple bet-hedging experiments, or from people whose careers are protected from the consequences of failed experiments. Instead, senior managers need to develop a commitment to risking their careers to develop new ideas. The value of any new idea only becomes known in the midst of failed pilots, funding losses, and heartbreaking rejiggerings.

Likewise, corporate resilience generally does not come from training senior managers to apply resources, like markets, to a hundred different well-hedged futures. Companies learn to spot difficulties early, invent opportunities in the midst of breakdowns, and fundamentally change how they interact with suppliers and customers by focusing on the core customer concerns they serve. Disconnection occurs when managers begin to seek multiple, hedged, or pain-free solutions. Resilience requires re-igniting managers' passion and commitment to taking chances and working through them, not pain-free experimentation.

***Gerald Adams***
Founder
Vision Consulting
New York

***Chauncey Bell***
Founder and President
The Design Community
San Francisco

## Coming Up Short on Nonfinancial Performance Measurement

Dear Editor:

I absolutely agree with Christopher Ittner and David Larcker's observation in "Coming Up Short on Nonfinancial Performance Measurement" (November 2003) that nonfinancial performance measurements are not as rigorous as they should be and therefore do not drive improvement. I agree, too, that the causes include a lack of accountability and a lack of connection to operating and financial results. I do not agree, however, that the solution is a 300-question survey. Effective nonfinancial measurements are critical to any organization's success. Simplicity is key to that effectiveness.

Organizations such as First Tennessee, S.C. Johnson, and Prudential have developed processes that show the connection between customer and employee engagement and results and include those indicators in their performance measurements. The Gallup Organization pioneered the Q12 questionnaire, which can measure employee and customer influence on corporate performance. Responses to its 12 questions show a positive correlation between employee engagement and productivity, profitability, customer service, retention, and safety.

SEND A LETTER

We welcome letters from all readers wishing to comment on articles in this issue. Early responses have the best chance of being published. Please be concise and include your title, company affiliation, location, and phone number. E-mail us at hbr_letters@hbsp.harvard.edu, send faxes to 617-783-7493; or write to the Editor, *Harvard Business Review*, 60 Harvard Way, Boston, MA 02163. HBR reserves the right to solicit and edit letters and to republish letters as reprints.

Having worked with this survey for a number of years in a company that employs more than 100,000 people, I can attest not only to those correlations but also to the related behavior changes when survey scores become part of the standard operating measurements. The power of the survey lies in its simplicity and flexibility, allowing each team to identify and correct its own causes for disengagement.

***PJ Smoot***
President
The Point of Contact
Memphis, Tennessee

*Christopher Ittner and David Larcker respond:*

PJ Smoot makes two points in his letter. The first is that simplicity is the key to performance measurement effectiveness. We agree that companies are better off identifying and measuring the "vital few" drivers of success rather than measuring a multitude of useful but less important measures. Simpler measures are also preferable to more complex ones if they are just as informative. However, you should not choose simplicity over performance categories critical to financial results. (Employee and customer factors need not be the only important performance drivers.) You also should not adopt simple measures that lack statistical reliability and validity. Even the Gallup Organization's survey uses 12 questions to assess employee engagement, not just a single question that asks employees how engaged or satisfied they are.

The second point is that a number of companies and consulting firms have developed and validated nonfinancial measures that are linked to financial results (Gallup's Q12 survey being one of many). Again, we acknowledge and applaud their efforts. But adopting measures without conducting further analysis requires caution. The relationship between a nonfinancial measure and financial performance can vary due to different organizations' strategies and competitive environments. Measurement indicators can also vary in terms of their relative importance. For example, in some companies all the Gallup survey questions may be equally important, while in others a subset may be more predictive of future performance. Companies must identify and validate the performance measures that reflect their unique sources of competitive advantage.

## HBR Spotlight: China Tomorrow
## The Great Transition
## The Hidden Dragons

Dear Editor:

Kenneth Lieberthal and Geoffrey Lieberthal's article "The Great Transition" and Ming Zeng and Peter Williamson's article "The Hidden Dragons" (October 2003) both focus attention on underappreciated aspects of the China opportunity. Lieberthal and Lieberthal are right to point out that, after China joins the World Trade Organization, domestic opportunities for multinationals in China will expand. Zeng and Williamson are right to remind multinationals to be wary of domestic enterprises.

"The Great Transition," with its exclusive focus on multinationals, and "The Hidden Dragons," with its concentration on domestic enterprises, undersell China's chance of succeeding with multinational and domestic firms. The success of multinationals should not come at the expense of domestic firms but should spur private-sector entrepreneurship in China.

The Lieberthals are ambitious in providing a blueprint for multinational success. But if Chinese management talent is not nurtured, the implication is that the management know-how of running a factory, marketing a product, or running a laboratory will not spread through the Chinese economy quickly. It will then be harder for multinationals to catalyze new ventures by, for instance, allowing employees to leave to start their own businesses.

Multinationals may worry that their intangible assets, the source of their competitive advantage, will walk out the door with the employees. India's experience suggests that a happier outcome is possible. Firms like Citibank and Hindustan Lever (Unilever) have incorporated local executives at the most senior levels and have served as de facto training institutes for the rest of corporate India. These kinds of practices have made them employers of choice. Former Citibank and Hindustan Lever employees have taken the management techniques they learned at those companies and started their own businesses.

Activity in the domestic private sector and foreign direct investment can be complementary. However, people who leave multinationals to start businesses must have the access to infrastructure, especially management skills. That is not the case in China. A greater commitment to private enterprise will enhance China's ability to get more from the foreign investment it attracts.

It may sound simplistic to say that multinationals should develop Chinese managers. But Chinese policy makers, basking in the adulation of multinationals the world over—including substantial investments originating from a wealthy diaspora—have had the luxury of being able to defer private-enterprise reform. Their attention, instead, has been directed squarely at rolling out the red carpet for foreign private enterprises and keeping troubled state-owned enterprises afloat, while domestic private enterprises remain, at best, neglected. Under these circumstances, it is unrealistic to assume that domestic private enterprise in China will develop without the help of multinationals.

Turning to Zeng and Williamson's Hidden Dragons, I marvel at how Chinese entrepreneurs deal with the ubiquity of government and find ways to align the interests of local government with those of the enterprise. The net result is that you would be hard pressed to find any purely private-sector entrepreneurial effort in China. Protectionism to build national champions, or to back the efforts of a few targeted entrepreneurs, is also common.

Given the country's success at attracting multinationals, it is surprising that few, if any, of the companies highlighted by Zeng and Williamson have benefited from the multinationals in the Chinese backyard. For the most part, Chinese entrepreneurs have apparently been unable to capitalize on the management know-how brought into the country by multinationals.

Here's the inadvertent connection between the two articles: If multinationals follow a blueprint with insufficient attention paid to nurturing Chinese management talent, it will likely result in too few private companies capitalizing on the soft technology and skills that the multinationals inevitably bring.

As MIT Sloan School professor Yasheng Huang and I have argued, India has produced many more private-sector companies—world-class ones, at that—in the past few decades than has China. These are much better governed (by international corporate governance standards) and are spread across many sectors of the Indian economy, beyond software. Not to decry Zeng and Williamson's observations regarding amazing success stories in China, but the Indian benchmark suggests that China actually does not have enough.

Many of India's leading firms in the private sector owe their start to multinationals operating there. India continues to display incompetence in attracting foreign direct investment, but when multinationals do show up, they apparently contribute well beyond the immediate provision of goods and services. General Electric, for example, did much to help India's leading software company, Wipro, get to where it is now. The country's leading biotechnology firm, Biocon, got an early boost through its affiliation with Unilever. And India's leading manufacturer of specialized automotive components, Sundaram Fasteners, has piggybacked on General Motors' global reach and presence.

While India should take a page out of China's book and learn not to scare away multinationals, China should take a page out of India's book and learn how to get the most out of the resources being poured into its economy. If either country pulls this off, I'd be happy to break out the champagne! Until then, the Lieberthals' advice and Zeng and Williamson's admonition to multinationals are all very well and good, but they are not win-win perspectives. Multinationals have much more to gain than to lose from a dynamic private sector in China.

***Tarun Khanna***
Professor, Novartis Fellow
Harvard Business School
Boston

*Kenneth Lieberthal and Geoffrey Lieberthal respond:*

Tarun Khanna raises an important point that is complementary to, rather than at cross-purposes with, our article. Khanna stresses the long-term value to MNCs of promoting the development of China's private sector and therefore underscores the interest MNCs should have in training top Chinese managers.

We did not address training Chinese managers because we lacked the space needed to tackle that issue. The reality is that MNCs have put a great deal of effort into developing top Chinese managers, and Chinese nationals hold highly responsible management positions in a large percentage of multinationals' Chinese ventures. MNCs have also worked hard to upgrade their Chinese suppliers' management capabilities in such sectors as automotive. Anyone addressing a meeting convened by the American Chamber of Commerce of either Beijing or Shanghai sees a lot of Chinese faces in the audience. There is also a substantial body of literature on Chinese HR issues for MNCs.

Many managers who have gained experience in MNCs have then left to set up or join strictly Chinese ventures. Notably few of these have achieved major success. The reasons for this poor showing are not completely clear, but it is likely the Chinese operating environment we describe in our article contributes substantially to these problems. Chinese entrepreneurs may seek to capture the dynamic efficiency of the MNCs in which they worked, but political interference, limited access to credit, and other factors seriously reduce their chances of succeeding.

Nevertheless, some of the Chinese ventures have made it. Motorola, for example, now faces a situation in which the combined sales of handsets produced by Chinese firms equals sales of Motorola's handsets in the country. (Not surprisingly, former Motorola employees run many of those Chinese firms.) We doubt, though, that Motorola is pleased to see this situation develop.

Moreover, as foreign financial institutions become eligible to provide a full array of renminbi banking services, they are likely to increase greatly the pool of credit available to promising private-sector firms. Available credit will combine with managers trained in foreign firms (and foreign business schools) to produce, over time, larger, more sophisticated, and more dynamic private enterprises. Greater vibrancy in the private sector will produce a more robust Chinese economy, and that will serve the interests of MNCs involved there.

*Ming Zeng and Peter Williamson respond:*

Tarun Khanna makes a good point that competition between multinationals and Chinese companies can spur private-sector entrepreneurship in China. The presence of multinationals in China has already been a factor in the emergence of the powerful new breed of private and hybrid-ownership Chinese competitors that we described in our article.

Ultimately, the Hidden Dragons' capacity for rapid learning is what has allowed them to catch up with their Western cousins so quickly. And they have learned through close cooperation with multinational firms as joint-venture partners, distributors, suppliers, and customers, as well as through direct competition in the marketplace. The Legend Group, China's leading maker of personal computers, started as the distributor for AST, Hewlett-Packard, and Toshiba.

From these partnerships, Legend learned a great deal about IT industry and channel management, as well as general management know-how—key ingredients in its current success. When Legend introduced its own brand back in the early 1990s, most of its marketing and sales managers had been trained by HP, and the marketing model was largely borrowed from HP as well. TCL, meanwhile, got its start in the television, personal computers, and mobile-phone industries through successive joint ventures with foreign partners. More recently, senior managers have been migrating from multinationals to Chinese companies, naturally bringing their knowledge with them.

Chinese firms are also growing up as they battle it out with multinationals. For example, Wanjia, a local supermarket established cheek by jowl with Wal-Mart's subsidiary in Shenzhen, was thought to be doomed to failure. But instead, competition forced Wanjia to raise its game and become world class to survive and prosper. Chinese firms observe the best practice right in front of them and then figure out how to imitate, adapt, and, ultimately, maybe improve it, to better fit the local context.

These interactions can provide the kind of win-win outcomes that have helped develop the Indian business sector, as Khanna correctly points out. Competition and cooperation

between multinationals and local firms help raise standards of quality, efficiency, and service and increase market size by fueling growth. But that doesn’t mean multinationals can afford to be complacent. Despite the opportunities for multinationals identified by Lieberthal and Lieberthal, China’s own companies have so far won the dominant share of many of its markets, including TVs, PCs, and home appliances. Even in sectors such as mobile-phone handsets, where Chinese firms had only a 3% share in 1999, they captured almost 50% of China’s booming market in 2003! Inside and outside China, the emerging Chinese dragons could be the real competitors to beat.

## HBR Spotlight: China Tomorrow
## The Chinese Negotiation

Dear Editor:

John Graham and N. Mark Lam’s article “The Chinese Negotiation” (October 2003) provides necessary cultural information for Americans negotiating in China. However, Americans can run into danger if they treat this advice as a list of cultural how-tos. How to interact and communicate given that cultural background is just as critical as the information itself. Otherwise, that background information is reduced to fortune-cookie wisdom. Distinguishing American and Chinese views so starkly can breed an us-versus-them mentality. Variations in emphasis, expression, and degree exist, but individualism and collectivism are two halves of a whole in both America and China. At least two cross-cultural fundamentals must be in the mix to successfully negotiate in China.

First, a negotiator has to take into account the individuals involved. For example, an American that invites the Chinese counterpart out to dinner because the American believes that’s culturally correct may miss the signals that the other person wants to go home early to see his or her child before bedtime. Both are trying to accommodate each other, and yet they both end up doing something they did not want to do. Group information should be treated as a theory to be tested and not as a fact. Many Chinese businesspeople have spent significant time in the United States for education or work, which means they have already negotiated with Americans on American cultural terms. Learning the individual’s way of thinking and preferences is as imperative as the cultural information.

Second, a negotiator needs to look at the dynamics and context of the specific situation. Knowing the roots of each other’s culture is important. But the ways in which an individual uses that information is as important. Neither side usually expects the other to abandon his own culture when entering into a negotiation. It is not assumed that either side gets every cultural nuance right. Both sides must adjust to each other and to unique values and protocols that exist in various business sectors. In a sense, the negotiation is not just over the deal and the relationship; the parties must negotiate how they negotiate with each other.

***Grande Lum***
Principal
ThoughtBridge
San Francisco

*John Graham and N. Mark Lam respond:*

Thank you for your useful insights. We agree with your comments. Of course, as important as they are, cultural differences do not explain all the interesting variations we see in negotiations between Americans and Chinese. Individual and contextual differences such as you describe frequently play crucial roles as well. Indeed, we discuss in detail such important topics in our forthcoming book, *Red China, Green China*.





Copyright © 2004 Harvard Business School Publishing. All rights reserved.

# Letters to the Editor

## The Quest for Resilience

Dear Editor:

We have deep respect for the work of Gary Hamel and Liisa Välikangas, but "The Quest for Resilience" (September 2003) points your readers in the wrong direction. Companies need to build the "capacity to change before the case for change becomes desperately obvious." But Hamel and Välikangas propose a utopian corporate capacity that adapts to strategic failure without traumatic wake-up calls of lost market share, protracted earnings slumps, and the need for wrenching turnarounds. A recipe for pain-free learning could work only if learning were solely about developing valuable new ideas.

The strategically important innovations that give companies resilience do not come from experiments, or from multiple bet-hedging experiments, or from people whose careers are protected from the consequences of failed experiments. Instead, senior managers need to develop a commitment to risking their careers to develop new ideas. The value of any new idea only becomes known in the midst of failed pilots, funding losses, and heartbreaking rejiggerings.

Likewise, corporate resilience generally does not come from training senior managers to apply resources, like markets, to a hundred different well-hedged futures. Companies learn to spot difficulties early, invent opportunities in the midst of breakdowns, and fundamentally change how they interact with suppliers and customers by focusing on the core customer concerns they serve. Disconnection occurs when managers begin to seek multiple, hedged, or pain-free solutions. Resilience requires re-igniting managers' passion and commitment to taking chances and working through them, not pain-free experimentation.

***Gerald Adams***
Founder
Vision Consulting
New York

***Chauncey Bell***
Founder and President
The Design Community
San Francisco

## Coming Up Short on Nonfinancial Performance Measurement

Dear Editor:

I absolutely agree with Christopher Ittner and David Larcker's observation in "Coming Up Short on Nonfinancial Performance Measurement" (November 2003) that nonfinancial performance measurements are not as rigorous as they should be and therefore do not drive improvement. I agree, too, that the causes include a lack of accountability and a lack of connection to operating and financial results. I do not agree, however, that the solution is a 300-question survey. Effective nonfinancial measurements are critical to any organization's success. Simplicity is key to that effectiveness.

Organizations such as First Tennessee, S.C. Johnson, and Prudential have developed processes that show the connection between customer and employee engagement and results and include those indicators in their performance measurements. The Gallup Organization pioneered the Q12 questionnaire, which can measure employee and customer influence on corporate performance. Responses to its 12 questions show a positive correlation between employee engagement and productivity, profitability, customer service, retention, and safety.

Having worked with this survey for a number of years in a company that employs more than 100,000 people, I can attest not only to those correlations but also to the related behavior changes when survey scores become part of the standard operating measurements. The power of the survey lies in its simplicity and flexibility, allowing each team to identify and correct its own causes for disengagement.

***PJ Smoot***
President
The Point of Contact
Memphis, Tennessee

*Christopher Ittner and David Larcker respond:*

PJ Smoot makes two points in his letter. The first is that simplicity is the key to performance measurement effectiveness. We agree that companies are better off identifying and measuring the "vital few" drivers of success rather than measuring a multitude of useful but less important measures. Simpler measures are also preferable to more complex ones if they are just as informative. However, you should not choose simplicity over performance categories critical to financial results. (Employee and customer factors need not be the only important performance drivers.) You also should not adopt simple measures that lack statistical reliability and validity. Even the Gallup Organization's survey uses 12 questions to assess employee engagement, not just a single question that asks employees how engaged or satisfied they are.

The second point is that a number of companies and consulting firms have developed and validated nonfinancial measures that are linked to financial results (Gallup's Q12 survey being one of many). Again, we acknowledge and applaud their efforts. But adopting measures without conducting further analysis requires caution. The relationship between a nonfinancial measure and financial performance can vary due to different organizations' strategies and competitive environments. Measurement indicators can also vary in terms of their relative importance. For example, in some companies all the Gallup survey questions may be equally important, while in others a subset may be more predictive of future performance. Companies must identify and validate the performance measures that reflect their unique sources of competitive advantage.

**HBR Spotlight: China Tomorrow**
**The Great Transition**
**The Hidden Dragons**

Dear Editor:

Kenneth Lieberthal and Geoffrey Lieberthal's article "The Great Transition" and Ming Zeng and Peter Williamson's article "The Hidden Dragons" (October 2003) both focus attention on underappreciated aspects of the China opportunity. Lieberthal and Lieberthal are right to point out that, after China joins the World Trade Organization, domestic opportunities for multinationals in China will expand. Zeng and Williamson are right to remind multinationals to be wary of domestic enterprises.

"The Great Transition," with its exclusive focus on multinationals, and "The Hidden Dragons," with its concentration on domestic enterprises, undersell China's chance of succeeding with multinational and domestic firms. The success of multinationals should not come at the expense of domestic firms but should spur private-sector entrepreneurship in China.

The Lieberthals are ambitious in providing a blueprint for multinational success. But if Chinese management talent is not nurtured, the implication is that the management know-how of running a factory, marketing a product, or running a laboratory will not spread through the Chinese economy quickly. It will then be harder for multinationals to catalyze new ventures by, for instance, allowing employees to leave to start their own businesses.

Multinationals may worry that their intangible assets, the source of their competitive advantage, will walk out the door with the employees. India's experience suggests that a happier outcome is possible. Firms like Citibank and Hindustan Lever (Unilever) have incorporated local executives at the most senior levels and have served as de facto training institutes for the rest of corporate India. These kinds of practices have made them employers of choice. Former Citibank and Hindustan Lever employees have taken the management techniques they learned at those companies and started their own businesses.

Activity in the domestic private sector and foreign direct investment can be complementary. However, people who leave multinationals to start businesses must have the access to infrastructure, especially management skills. That is not the case in China. A greater commitment to private enterprise will enhance China's ability to get more from the foreign investment it attracts.

It may sound simplistic to say that multinationals should develop Chinese managers. But Chinese policy makers, basking in the adulation of multinationals the world over—including substantial investments originating from a wealthy diaspora—have had the luxury of being able to defer private-enterprise reform. Their attention, instead, has been directed squarely at rolling out the red carpet for foreign private enterprises and keeping troubled state-owned enterprises afloat, while domestic private enterprises remain, at best, neglected. Under these circumstances, it is unrealistic to assume that domestic private enterprise in China will develop without the help of multinationals.

Turning to Zeng and Williamson's Hidden Dragons, I marvel at how Chinese entrepreneurs deal with the ubiquity of government and find ways to align the interests of local government with those of the enterprise. The net result is that you would be hard pressed to find any purely private-sector entrepreneurial effort in China. Protectionism to build national champions, or to back the efforts of a few targeted entrepreneurs, is also common.

Given the country's success at attracting multinationals, it is surprising that few, if any,

of the companies highlighted by Zeng and Williamson have benefited from the multinationals in the Chinese backyard. For the most part, Chinese entrepreneurs have apparently been unable to capitalize on the management know-how brought into the country by multinationals.

Here's the inadvertent connection between the two articles: If multinationals follow a blueprint with insufficient attention paid to nurturing Chinese management talent, it will likely result in too few private companies capitalizing on the soft technology and skills that the multinationals inevitably bring.

As MIT Sloan School professor Yasheng Huang and I have argued, India has produced many more private-sector companies—world-class ones, at that—in the past few decades than has China. These are much better governed (by international corporate governance standards) and are spread across many sectors of the Indian economy, beyond software. Not to decry Zeng and Williamson's observations regarding amazing success stories in China, but the Indian benchmark suggests that China actually does not have enough.

Many of India's leading firms in the private sector owe their start to multinationals operating there. India continues to display incompetence in attracting foreign direct investment, but when multinationals do show up, they apparently contribute well beyond the immediate provision of goods and services. General Electric, for example, did much to help India's leading software company, Wipro, get to where it is now. The country's leading biotechnology firm, Biocon, got an early boost through its affiliation with Unilever. And India's leading manufacturer of specialized automotive components, Sundaram Fasteners, has piggybacked on General Motors' global reach and presence.

While India should take a page out of China's book and learn not to scare away multinationals, China should take a page out of India's book and learn how to get the most out of the resources being poured into its economy. If either country pulls this off, I'd be happy to break out the champagne! Until then, the Lieberthals' advice and Zeng and Williamson's admonition to multinationals are all very well and good, but they are not win-win perspectives. Multinationals have much more to gain than to lose from a dynamic private sector in China.

***Tarun Khanna***
Professor, Novartis Fellow
Harvard Business School
Boston

*Kenneth Lieberthal and Geoffrey Lieberthal respond:*

Tarun Khanna raises an important point that is complementary to, rather than at cross-purposes with, our article. Khanna stresses the long-term value to MNCs of promoting the development of China's private sector and therefore underscores the interest MNCs should have in training top Chinese managers.

We did not address training Chinese managers because we lacked the space needed to tackle that issue. The reality is that MNCs have put a great deal of effort into developing top Chinese managers, and Chinese nationals hold highly responsible management positions in a large percentage of multinationals' Chinese ventures. MNCs have also worked hard to upgrade their Chinese suppliers' management capabilities in such sectors as automotive. Anyone addressing a meeting convened by the American Chamber of Commerce of either Beijing or Shanghai sees a lot of Chinese faces in the audience. There is also a substantial body of literature on Chinese HR issues for MNCs.

Many managers who have gained experience in MNCs have then left to set up or join strictly Chinese ventures. Notably few of these have achieved major success. The reasons for this poor showing are not completely clear, but it is likely the Chinese operating environment we describe in our article contributes substantially to these problems. Chinese entrepreneurs may seek to capture the dynamic efficiency of the MNCs in which they worked, but political interference, limited access to credit, and other factors seriously reduce their chances of succeeding.

Nevertheless, some of the Chinese ventures have made it. Motorola, for example, now faces a situation in which the combined sales of handsets produced by Chinese firms equals sales of Motorola's handsets in the country. (Not surprisingly, former Motorola employees run many of those Chinese firms.) We doubt, though, that Motorola is pleased to see this situation develop.

Moreover, as foreign financial institutions become eligible to provide a full array of renminbi banking services, they are likely to increase greatly the pool of credit available to promising private-sector firms. Available credit will combine with managers trained in foreign firms (and foreign business schools) to produce, over time, larger, more sophisticated, and more dynamic private enterprises. Greater vibrancy in the private sector will produce a more robust Chinese economy, and that will serve the interests of MNCs involved there.

*Ming Zeng and Peter Williamson respond:*

Tarun Khanna makes a good point that competition between multinationals and Chinese companies can spur private-sector entrepreneurship in China. The presence of multinationals in China has already been a factor in the emergence of the powerful new breed of private and hybrid-ownership Chinese competitors that we described in our article.

Ultimately, the Hidden Dragons' capacity for rapid learning is what has allowed them to catch up with their Western cousins so quickly. And they have learned through close cooperation with multinational firms as joint-venture partners, distributors, suppliers, and customers, as well as through direct competition in the marketplace. The Legend Group, China's leading maker of personal computers, started as the distributor for AST, Hewlett-Packard, and Toshiba.

From these partnerships, Legend learned a great deal about IT industry and channel management, as well as general management know-how—key ingredients in its current success. When Legend introduced its own brand back in the early 1990s, most of its marketing and sales managers had been trained by HP, and the marketing model was largely borrowed from HP as well. TCL, meanwhile, got its start in the television, personal computers, and mobile-phone industries through successive joint ventures with foreign partners. More recently, senior managers have been migrating from multinationals to Chinese companies, naturally bringing their knowledge with them.

Chinese firms are also growing up as they battle it out with multinationals. For example, Wanjia, a local supermarket established cheek by jowl with Wal-Mart's subsidiary in Shenzhen, was thought to be doomed to failure. But instead, competition forced Wanjia to raise its game and become world class to survive and prosper. Chinese firms observe the best practice right in front of them and then figure out how to imitate, adapt, and, ultimately, maybe improve it, to better fit the local context.

These interactions can provide the kind of win-win outcomes that have helped develop the Indian business sector, as Khanna correctly points out. Competition and cooperation between multinationals and local firms help raise standards of quality, efficiency, and

service and increase market size by fueling growth. But that doesn't mean multinationals can afford to be complacent. Despite the opportunities for multinationals identified by Lieberthal and Lieberthal, China's own companies have so far won the dominant share of many of its markets, including TVs, PCs, and home appliances. Even in sectors such as mobile-phone handsets, where Chinese firms had only a 3% share in 1999, they captured almost 50% of China's booming market in 2003! Inside and outside China, the emerging Chinese dragons could be the real competitors to beat.

## HBR Spotlight: China Tomorrow
## The Chinese Negotiation

Dear Editor:

John Graham and N. Mark Lam's article "The Chinese Negotiation" (October 2003) provides necessary cultural information for Americans negotiating in China. However, Americans can run into danger if they treat this advice as a list of cultural how-tos. How to interact and communicate given that cultural background is just as critical as the information itself. Otherwise, that background information is reduced to fortune-cookie wisdom. Distinguishing American and Chinese views so starkly can breed an us-versus-them mentality. Variations in emphasis, expression, and degree exist, but individualism and collectivism are two halves of a whole in both America and China. At least two cross-cultural fundamentals must be in the mix to successfully negotiate in China.

First, a negotiator has to take into account the individuals involved. For example, an American that invites the Chinese counterpart out to dinner because the American believes that's culturally correct may miss the signals that the other person wants to go home early to see his or her child before bedtime. Both are trying to accommodate each other, and yet they both end up doing something they did not want to do. Group information should be treated as a theory to be tested and not as a fact. Many Chinese businesspeople have spent significant time in the United States for education or work, which means they have already negotiated with Americans on American cultural terms. Learning the individual's way of thinking and preferences is as imperative as the cultural information.

Second, a negotiator needs to look at the dynamics and context of the specific situation. Knowing the roots of each other's culture is important. But the ways in which an individual uses that information is as important. Neither side usually expects the other to abandon his own culture when entering into a negotiation. It is not assumed that either side gets every cultural nuance right. Both sides must adjust to each other and to unique values and protocols that exist in various business sectors. In a sense, the negotiation is not just over the deal and the relationship; the parties must negotiate how they negotiate with each other.

***Grande Lum***
Principal
ThoughtBridge
San Francisco

*John Graham and N. Mark Lam respond:*

Thank you for your useful insights. We agree with your comments. Of course, as important as they are, cultural differences do not explain all the interesting variations we see in negotiations between Americans and Chinese. Individual and contextual differences such as you describe frequently play crucial roles as well. Indeed, we discuss in detail such important topics in our forthcoming book, *Red China, Green China*.

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

# Reprints and Subscriptions

## Subscription Services

**Subscribe online:** www.hbr.org

### Orders, inquiries, and address changes

**U.S. and Canada**
**Phone:** 800-274-3214
**Fax:** 303-604-7644
**E-mail:** hbursubs@neodata.com
**Address:**
*Harvard Business Review*
P.O. Box 52623
Boulder, CO 80322-2623

**Overseas and Mexico**
**Phone:** 44-1858-438868
**Fax:** 44-1858-468969
**E-mail:** harvard@subscription.co.uk
**Web site:**
www.subscription.co.uk/help/harvard
**Address:**
*Harvard Business Review*
Tower House, Sovereign Park
Lathkill Street
Market Harborough, Leicestershire
LE16 9EF, England

### Rates per year

U.S., $118; Canada, $128USD
International, $165USD; Mexico, $128USD

**Payments accepted**
Visa, MasterCard, American Express; checks in U.S. dollars payable to *Harvard Business Review*. Bills and other receipts may be issued.

## Library Access

Libraries offer online access to current and back issues of *Harvard Business Review* through EBSCO host databases.

## Article Reprints and Permissions

Reprint numbers appear at the end of articles and executive summaries. Contact our customer service team to order reprints or to obtain permission to copy, quote, or translate *Harvard Business Review* articles. Reprints are available in hard copy, as electronic downloads with permission to print, and in customized versions.

### For information or to order

Customer Service Department
Harvard Business School Publishing Corporation
60 Harvard Way
Boston, MA 02163
**Phone:** 617-783-7500
**U.S. and Canada:** 800-988-0886
(8AM – 6PM ET weekdays)
**Fax:** 617-783-7555
**E-mail:** custserv@hbsp.harvard.edu

### Reprint prices

| | |
|---|---|
| 1–9 copies | $6.00 each |
| 10–49 | $5.50 |
| 50–79 | $5.00 |
| 80–99 | $4.50 |
| 100–499 | $4.00 |

(Minimum order, $10. Discounts apply to multiple copies of the same article.)

## *Harvard Business Review* OnPoint Articles and Collections

Many articles are available in enhanced *Harvard Business Review* OnPoint editions, which include a one-page synopsis highlighting key ideas and company examples, the full-text article, and an annotated bibliography. *Harvard Business Review* OnPoint numbers are listed at the end of articles and executive summaries.

*Harvard Business Review* OnPoint collections include three OnPoint articles with a one-page overview comparing the articles' perspectives on a topic. Collection numbers appear at the end of executive summaries.

### *Harvard Business Review* OnPoint prices

**Articles**

| | |
|---|---|
| 1–9 copies | $7.00 each |
| 10–49 | $6.50 |
| 50–79 | $6.00 |
| 80–99 | $5.50 |
| 100–499 | $5.00 |

(Minimum order, $10. Discounts apply to multiple copies of the same article.)

**Collections**

| | |
|---|---|
| 1–9 copies | $16.95 each |
| 10–49 | $13.56 |
| 50–99 | $11.86 |
| 100–499 | $10.17 |

### Custom and Quantity Orders

For quantity estimates or quotes on customized reprints and *Harvard Business Review* OnPoint products, call Frank Tamoshunas at 617-783-7626, fax him at 617-783-7658, or e-mail him at ftamoshunas@hbsp.harvard.edu.

## For subscriptions, reprints, and *Harvard Business Review* OnPoint orders, go to www.hbr.org.

**Postmaster**
Send domestic address changes, orders, and inquiries to:
*Harvard Business Review*, Subscription Service, P.O. Box 52623, Boulder, CO 80322-2623

GST Registration No. 124738345

Periodical postage paid at Boston, Massachusetts, and additional mailing offices.

Printed in the U.S.A.

*Harvard Business Review* (ISSN 0017-8012; USPS 0236-520), published 12 times a year for professional managers, is a program in executive education of the Graduate School of Business Administration, Harvard University; Kim B. Clark, dean. Published by Harvard Business School Publishing Corporation, 60 Harvard Way, Boston, MA 02163.

**Volume 82, Number 2**

**Copyright © 2004 Harvard Business School Publishing. All rights reserved.**

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

# About HBR

**Editor**
Thomas A. Stewart

**Deputy Editor**
Karen Dillon

**Executive Editor**
Sarah Cliffe

**Art Director**
Judi Tomlinson

**Senior Editors**
Leigh Buchanan
David Champion
Diane L. Coutu
Bronwyn Fryer
Ben Gerson
Paul Hemp
Julia Kirby
Gardiner Morse
Ellen Peebles
Anand P. Raman

**Associate Editor**
Eileen Roche

**Consulting Editor**
Louise O'Brien

**Manuscript Editors**
Christina Bortz
Roberta A. Fusaro
Margaret K. Hanshaw
Andrew O'Connell
Andrea Ovans

**Communications Manager**
Cathy Olofson

**Editor for Business Development**
John T. Landry

**Electronic Production Editor**
Susan Catterall Francis

**Electronic Production Specialist**
Dan West

**Senior Production Manager**
Dana Lissy

**Associate Art Director**
Karen Player

**Associate Production Manager**
Christine Wilder

**Senior Designers**
Aimee Bida
Jill Manca

**Design/Production Coordinator**
Heather Barrett

**Executive Editor and Director of Derivative Products**
Jane Heifetz

**Editorial Coordinators**
Kassandra Duane
Andrew Gray

**Contributing Staff**
Amy L. Halliday
Amy N. Monaghan
Suki Sporer

**Technology Project Manager**
Zach Atwell

**Technical Production Coordinator**
Terry Cole

**Editor-at-Large,
Harvard Business School Publishing**
Walter Kiechel

**A Note to Readers**
The views expressed in articles are the authors' and not necessarily those of *Harvard Business Review*, Harvard Business School, or Harvard University. Authors may have consulting or other business relationships with the companies they discuss.

**Submissions**
We encourage prospective authors to follow HBR's "Guidelines for Authors" before submitting manuscripts. To obtain a copy, please go to our Web site at www.hbr.org; write to The Editor, *Harvard Business Review*, 60 Harvard Way, Boston, MA 02163; or send e-mail to hbr_editorial@hbsp.harvard.edu. Unsolicited manuscripts will be returned only if accompanied by a self-addressed stamped envelope.

**Editorial Offices**
60 Harvard Way, Boston, MA 02163
Telephone: 617-783-7410; fax: 617-783-7493

**Volume 82, Number 2
February 2004**
Printed in the U.S.A.

**Publisher**
Cathryn Cronin Cranston

**Circulation Fulfillment Manager**
Heather McCormick

**Manager, Marketing and Operations**
Marisa Maurer

**Advertising Production Manager**
Catharine-Mary Donovan

**Assistant Subscriber Services Manager**
Elizabeth Sottile

**Business Director**
Edward D. Crowley

**Direct Marketing Manager**
Bruce W. Rhodes

**Senior Business Analyst**
Adrienne M. Spelker

**Assistant Advertising Manager** Ashley C. Hartmann

**Worldwide Advertising Offices**
Advertising Director—Worldwide
Trish Henry
212-872-9283

New York:
Maria A. Beacom
Michael J. Carroll
James H. Patten
509 Madison Ave.
15th Floor
New York, NY 10022
212-872-9280; fax: 212-838-9659

Atlanta:
404-256-3800

Boston:
978-287-5400

Chicago:
312-575-1100

Dallas:
214-521-6116

Detroit:
248-524-9000

Los Angeles:
310-207-4399

San Francisco:
415-986-7762

Australia:
612-9954-3288

Beijing:
86-10-6401-9190

France:
33-01-4643-1630

Hong Kong:
852-2516-1101

India:
912-2204-8890

Japan:
81-3-3479-6131

Korea:
82-2-3702-1790

Malaysia:
603-7729-6923

Singapore:
65-6-836-2272

Sweden:
46-8-541-318-37

Taiwan:
886-2-2364-9108

United Kingdom:
44-20-7586-2224

For advertising contact information, please visit our Web site at www.hbradsales.com.

**Subscription Service Information**

**U.S. and Canada**
800-274-3214; fax: 641-842-6101
Rates per year: U.S., $118; Canada, $128USD

**International**
44-1858-438868; fax: 44-1858-468969
Rates per year: International, $165USD; Mexico, $128USD

**Subscribe Online**
www.hbr.org

**Reproduction**
Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage and retrieval system, without written permission.

February 2004
Online Version
Harvard Business Review

Click here to visit:
>| http://www.hbsp.org

FEATURE ARTICLE

# Measuring the Strategic Readiness of Intangible Assets

**A real—and revolutionary—opportunity lies in studying and assessing how well prepared a company's people, systems, and culture are to carry out its strategy.**

***by Robert S. Kaplan and David P. Norton***

**Robert S. Kaplan** (**rkaplan@hbs.edu**) is the Marvin Bower Professor of Leadership Development at Harvard Business School in Boston. **David P. Norton** (**dnorton@bscol.com**) is the founder and president of the Balanced Scorecard Collaborative (www.bscol.com) in Lincoln, Massachusetts. This article is based on their book *Strategy Maps: Converting Intangible Assets into Tangible Outcomes* (Harvard Business School Press, 2004).

How valuable is a company culture that enables employees to understand and believe in their organization's mission, vision, and core values? What's the payoff from investing in a knowledge management system or in a new customer database? Is it more important to improve the skills of all employees or focus on those in just a few key positions?

Measuring the value of such intangible assets is the holy grail of accounting. Employees' skills, IT systems, and organizational cultures are worth far more to many companies than their tangible assets. Unlike financial and physical ones, intangible assets are hard for competitors to imitate, which makes them a powerful source of sustainable competitive advantage. If managers could find a way to estimate the value of their intangible assets, they could measure and manage their company's competitive position much more easily and accurately.

But that's simpler said than done. Unlike financial and physical assets, intangible assets are worth different things to different people. An oil well, for example, is almost as valuable to a retail firm as it is to an oil exploration corporation because either company could sell it swiftly if necessary. But a workforce with a strong sense of customer service and satisfaction is worth far more to the retailer than it would be to the oil company. Also, unlike tangible assets, intangible assets almost never create value by themselves. They need to be combined with other assets. Investments in IT, for example, have little value unless complemented with HR training and incentive programs. And, conversely, many HR training programs have little value unless complemented with modern technology tools. HR and IT investments must be integrated and aligned with corporate strategy if the organization is to realize their full potential. Indeed, when companies separate functions like HR and IT organizationally, they usually end up with competing silos of technical specialization. The HR department argues for increases in employee training, while the IT department lobbies for buying new hardware and software packages.

What's more, intangible assets seldom affect financial performance directly. Instead, they work indirectly through complex chains of cause and effect. Training employees in Total Quality Management and Six Sigma, for instance, should improve process quality. That improvement should then increase customer satisfaction and loyalty—and also create some excess resource capacity. But only if the company can transform that loyalty into improved sales and margins and eliminate or redeploy the excess resources will the investment in training pay off. By contrast, the impact of a new tangible asset is immediate: When a retailer develops a new site, it sees financial benefits from the sales in the newly opened outlet right away.

Although these characteristics make it impossible to value intangible assets on a freestanding basis, they also point the way to a new approach for quantifying how intangible assets add value to the company. By understanding the problems associated with valuing intangible assets, we learn that the measurement of the value they create is embedded in the context of the strategy the company is pursuing. Companies such as Dell, Wal-Mart, or McDonald's that are following a low-cost strategy derive value from Six Sigma and TQM training because their strategies are predicated on continuous process improvement. The strategy of offering customers integrated solutions (rather than discrete products) pursued by Goldman Sachs, IBM Consulting, and the like requires employees good at establishing and maintaining long-term customer relationships. An organization cannot possibly assign a meaningful financial value to an intangible asset like "a motivated and prepared workforce" in a vacuum because value can be derived only in the context of the strategy. What the company *can* measure, however, is whether its workforce is properly trained and motivated to pursue a particular goal.

Viewed in this light, it becomes clear that measuring the value of intangible assets is really about estimating how closely aligned those assets are to the company's strategy. If the company has a sound strategy and if the intangible assets are aligned with that strategy, then the assets will create value for the organization. If the assets are not aligned with the strategy or if the strategy is flawed, then intangible assets will create little value, even if large amounts have been spent on them.

In the following pages, we will draw on the concepts and tools of the Balanced Scorecard to present a way to systematically measure the alignment of the company's human, information, and organization capital—what we call its *strategic readiness*—without which even the best strategy cannot succeed.

## Defining Strategic Readiness

In developing the Balanced Scorecard more than a decade ago, we identified, in its Learning and Growth Perspective, three categories of intangible assets essential for implementing any strategy:

• **Human Capital:** the skills, talent, and knowledge that a company's employees possess.

• **Information Capital:** the company's databases, information systems, networks, and technology infrastructure.

• **Organization Capital:** the company's culture, its leadership, how aligned its people are with its strategic goals, and employees' ability to share knowledge.

To link these intangible assets to a company's strategy and performance, we developed a tool called the "strategy map," which we first introduced in our previous article for *Harvard Business Review,* "Having Trouble with Your Strategy? Then Map

It" (September–October 2000). As the exhibit "The Strategy Map" shows, intangible assets influence a company's performance by enhancing the internal processes most critical to creating value for customers and shareholders. Companies build their strategy maps from the top down, starting with their long-term financial goals and then determining the value proposition that will deliver the revenue growth specified in those goals, identifying the processes most critical to creating and delivering that value proposition, and, finally, determining the human, information, and organization capital the processes require.

---

**The Strategy Map**

Sidebar **R0402C_A** (Located at the end of this article)

---

This article focuses on the bottom—the foundation—of the map and will show how intangible assets actually determine the performance of the critical internal processes. Once that link has been established, it becomes easy to trace the steps back up the map to see exactly how intangible assets relate to the company's strategy and performance. That, in turn, makes it possible to align those assets with the strategy and measure their contribution to it. The degree to which the current set of assets does—or does not—contribute to the performance of the critical internal processes determines the strategic readiness of those assets and thus their value to the organization. The strategic readiness of each type of intangible asset can be thought of as follows:

**Human Capital (HC):** In the case of human capital, strategic readiness is measured by whether employees have the right kind and level of skills to perform the critical internal processes on the strategy map. The first step in estimating HC readiness is to identify the *strategic job families*—the positions in which employees with the right skills, talent, and knowledge have the biggest impact on enhancing the organization's critical internal processes. The next step is to pinpoint the set of specific competencies needed to perform each of those strategic jobs. The difference between the requirements needed to carry out these jobs effectively and the company's current capabilities represents a "competency gap" that measures the organization's HC readiness.

**Information Capital (IC):** The strategic readiness of information capital is a measure of how well the company's strategic IT portfolio of infrastructure and applications supports the critical internal processes. Infrastructure comprises hardware—such as central servers and communication networks—and the managerial expertise—such as standards, disaster planning, and security—required to effectively deliver and use applications. Two categories of applications, in turn, are built on this infrastructure: *Transaction-processing applications,* such as an ERP system, automate the basic repetitive transactions of the enterprise. *Analytic applications* promote analysis, interpretation, and sharing of information and knowledge. Either type may or may not be a *transformational application*—one that changes the prevailing business model of the enterprise. Levi's uses a transformational application to tailor jeans to individual customers. Home Shopping Network uses a transformational application to measure the "profits per second" being generated by currently offered merchandise. Transformational applications have the most potential impact on strategic objectives and require the greatest degree of organization change to deliver their benefits.

**Organization Capital (OC):** Organization capital is perhaps the least understood of the intangible assets, and the task of measuring it is correspondingly difficult. But in looking at the strategic priorities that companies in our database of Balanced Scorecard implementations used for their organization capital objectives, we found a consistent picture. Successful companies had a *culture* in which people were deeply aware of and internalized the mission, vision, and core values needed to execute the company's

strategy. These companies strove for excellent *leadership* at all levels, leadership that could mobilize the organization toward its strategy. They strove for a clear *alignment* between the organization's strategic objectives and individual, team, and departmental goals and incentives. Finally, these companies promoted *teamwork*, especially the sharing of strategic knowledge throughout the organization. Determining OC readiness, we concluded, would involve first identifying the changes in organization capital required by the new strategy—what we call the "organization change agenda"—and then separately identifying and measuring the state of readiness of the company's cultural, leadership, alignment, and teamwork objectives.

Strategic readiness is related to the concept of liquidity, which accountants use to classify financial and physical assets on a company's balance sheet. Accountants divide a firm's assets into various categories, such as cash, accounts receivable, inventory, property, plant and equipment, and long-term investments. These are ordered hierarchically according to the ease and speed with which they can be converted to cash —in other words, according to the degree of their liquidity. Accounts receivable is more liquid than inventory, and both accounts receivable and inventory are classified as short-term assets since they typically convert to cash within 12 months, faster than the cash recovery cycle from such illiquid assets as plant and equipment. Strategic readiness does much the same for intangible assets—the higher their state of readiness, the faster they contribute to generating cash.

### Human Capital Readiness

All jobs are important to the organization; otherwise, people wouldn't be hired and paid to perform them. Organizations may require truck drivers, computer operators, production supervisors, materials handlers, and call center operators and should make it clear that contributions from all these employees can improve organizational performance. But we have found that some jobs have a much greater impact on strategy than others. Managers must identify and focus on the critical few that have the greatest impact on successful strategy implementation.

John Bronson, vice president of human resources at Williams-Sonoma, estimates that people in only five job families determine 80% of his company's strategic priorities. The executive team of a chemical company has identified eight job families critical to its strategy of offering customized innovative solutions. These job families employ, in aggregate, 100 individuals—less than 7% of the total workforce. Kimberlee Williams, vice president of human resources at Unicco, a large integrated facilities-services management company, says that three job families are key to its strategy: project managers, who oversee the operations in specific accounts; operations directors, who broaden the relationships within existing accounts; and business development executives, who help acquire new accounts. These three job families employ only 215 people, less than 4% of the workforce. By focusing human capital development activities on these critical few individuals, the chemical company, Unicco, and Williams-Sonoma can greatly leverage their human capital investments. It is sobering to think that strategic success in these three companies is determined by how well they develop competencies in less than 10% of their workforces.

Once a company identifies its strategic job families, it must define the requirements for these jobs in considerable detail, a task often referred to as "job profiling" or "competency profiling." A competency profile describes the knowledge, skills, and values required by successful occupants in the job family. Often, HR managers will interview individuals who best understand the job requirements to develop a competency profile they can use to recruit, hire, train, and develop people for that position. To see how this might be done, consider Consumer Bank, a composite example distilled from our

experiences in working with about a dozen retail banks.

Consumer Bank was migrating from its historic strategy of promoting individual products to one offering complete financial solutions and one-stop shopping to targeted customers. The map for this new strategy identified seven critical internal processes, one of which was "cross-sell the product line." Human resources and line executives then identified the financial planner as the job most important to the effective performance of this process. A planning workshop further identified four skills fundamental to the financial planner's job: solutions selling, relationship management, product-line knowledge, and professional certification. For each internal process on its strategy map, Consumer Bank replicated this approach, identifying the strategic job families and critical competencies each required. The results are summarized in the exhibit "Human Capital Readiness at Consumer Bank."

---

**Human Capital Readiness at Consumer Bank**

Sidebar **R0402C_B** (Located at the end of this article)

---

To take the next step—assessing the current capabilities and competencies of each of the employees in each strategic job family—companies can draw from a broad range of approaches. For example, employees can themselves assess how well their current capabilities fit the job requirements and then discuss those assessments with a mentor or career manager. Alternatively, an assessor can solicit 360-degree feedback on employees' performance from their supervisors, peers, and subordinates. From these assessments, employees get a clear understanding of their objectives, meaningful feedback on their current levels of skill and performance, and specific recommendations for future personal development.

Consumer Bank estimated that it needed 100 trained and skilled financial planners to execute the cross-selling process. But in assessing its recent targeted hiring, training, and development programs, the bank's HR group determined that only 40 of its financial planners had reached a high enough level of proficiency. The bank's human capital readiness for this piece of the strategy was, therefore, only 40%, as the exhibit shows. By replicating this analysis for all its strategic job families, the bank learned the state of its human capital readiness and thus whether the organization could move forward quickly with its new strategy.

### Information Capital Readiness

Executives must understand how to plan, set priorities for, and manage an information capital portfolio that supports their organization's strategy. As with human capital, the strategy map serves as a starting point for delineating a company's IC objectives. In the case of Consumer Bank, the chief information officer led an initiative to identify the specific information capital needs of each of the seven internal processes previously identified as critical to the bank's new value proposition.

For the customer management process "cross-sell the product line," the workshop team identified an application for customers to analyze and manage their portfolios by themselves (a customer portfolio self-management system) as a transformational application. The workshop team identified an analytical application for the same process (a customer profitability system) and a transaction-processing application (an integrated customer file). The internal process "understand customer segments" also needed a customer profitability system, as well as a separate customer feedback system to support market research. The process "shift to appropriate channel" required a strong foundation of transactional systems, including a packaged CRM software suite that

included modules for lead management, order management, and sales force automation. For the operations process "provide rapid response," participants identified a transformational application (customer self-help) as well as an analytic application (a best-practice community knowledge management system) for sharing successful sales techniques among telemarketers. Finally, the "minimize problems" process required an analytical application (service quality analysis) to identify problems and two related transaction-level systems (one for incident tracking and another for problem management).

After defining its portfolio of IC applications, the project team identified several required components of IT infrastructure. Some applications needed a CRM transactions database. Others required that a Web-enabled infrastructure be integrated into the bank's overall Web site architecture. The team also learned about the need for an internal R&D project to develop a new interactive voice-response technology. All together, the bank's planning process defined an information capital portfolio made up of 14 unique applications (some of which supported more than one internal process) and four IT infrastructure projects. (See the exhibit "Information Capital Readiness at Consumer Bank.")

## Information Capital Readiness at Consumer Bank

The first two rows of the information capital readiness report, like the human capital report, list the company's critical internal processes and its strategic job families. The remaining five rows specify the various items in the IC portfolio, assigning scores indicating how well developed each item is. In this example, Consumer Bank has the IC portfolio it needs to support innovation but is less able to support the jobs most critical to its customer management and operational excellence goals.

| | Operations Management | | Customer Management | | Innovation | |
|---|---|---|---|---|---|---|
| **Strategic Processes** | **Minimize problems** | **Provide rapid response** | **Cross-sell the product line** | **Shift to appropriate channel** | **Understand customer segments** | **Develop new products** |
| **Strategic Job Families** | **Quality manager** | **Call center representative** | **Certified financial planner** | **Telemarketer** | **Consumer marketer** | **Joint venture manager** |
| | **Strategic Information Capital Portfolio** | | | | | |
| **Transformational Applications** | | Customer self-help **4** | Customer portfolio self-management **4** | | | |
| **Analytical Applications** | Service quality analysis **2** | Best-practice community knowledge management system **3** | Customer profitability **3** | Best-practice community knowledge management system **2** | Customer profitability **3** | Best-practice community knowledge management system **2** |
| **Transaction-Processing Applications** | Incident tracking **6**<br>Problem management **2** | Workforce scheduling **3**<br>Problem management **2** | Integrated customer file **2** | CRM/lead management **6**<br>CRM/order management **2**<br>CRM/sales force automation **4** | Customer feedback **2** | Project management **2** |
| **Technology Infrastructure** | Web enabled **3**<br>Computer telephony | Computer telephony | CRM packaged software **2**<br>Web enabled **3** | Web enabled **3**<br>Computer telephony | CRM packaged software **2** | |

**Ratings**

**1** OK

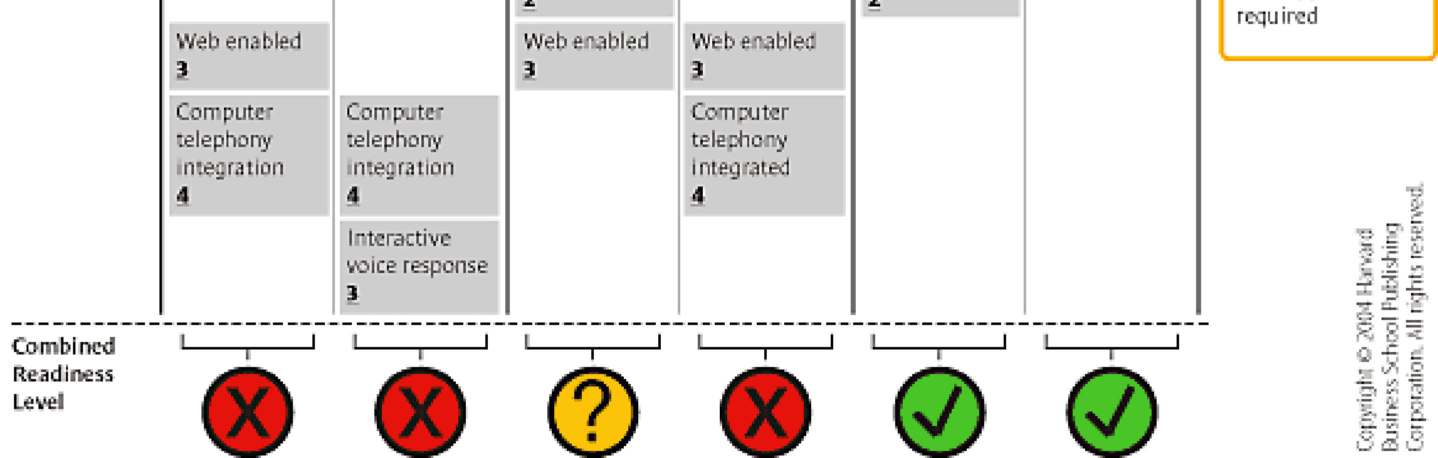
**2** Minor enhancements needed

**3** New development under way

**4** New development behind schedule

**5** Major enhancements required

**6** New application required



Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

The team then turned to assessing the readiness of the bank's existing portfolio of IC infrastructure and applications, assigning a numerical indicator from 1 to 6 to each system. A score of 1 or 2 indicates that the system is already available and operating normally, perhaps needing only minor enhancements. A score of 3 or 4 indicates that the system has been identified and funded but is not yet installed or operational. In other words, current capability does not yet exist but development programs are under way to close the gap. A score of 5 or 6 signals that a new infrastructure or application is needed to support the strategy, but nothing has yet been done to create, fund, and deliver the capability. Managers responsible for the IC development programs provided the subjective judgments for this simple measurement system, and the CIO was responsible for assessing the integrity of the reported numbers. In the IC exhibit, we can also see that Consumer Bank aggregated the readiness measures of individual applications and infrastructure programs—designating them green, yellow, or red, based on the worst-case application in the category—to create a portfolio status report. With such a report, managers can see the strategic readiness of the organization's information capital at a glance, easily pinpointing the areas in which more resources are needed. It is an excellent tool for monitoring a portfolio of information capital development programs.

Many sophisticated IT organizations already use more quantitative, objective assessments of their information capital portfolios than the subjective process we've just described for Consumer Bank. These organizations survey users to assess their satisfaction with each system. They perform financial analyses to determine the operating and maintenance costs of each application. Some conduct technical audits to assess the underlying quality of the code, ease of use, quality of documentation, and frequency of failure for each application. From this profile, an organization can build strategies for managing its portfolio of existing IC assets just as one would manage a collection of physical assets like machinery or a fleet of trucks. Applications with high levels of maintenance can be streamlined, for example, applications with high operating costs can be optimized, and applications with high levels of user dissatisfaction can be replaced. This more comprehensive approach can be effective for managing a portfolio of applications that are already operational.

### Organization Capital Readiness

Success in performing the critical internal processes identified in an organization's strategy map invariably requires an organization to change in fundamental ways. Assessing OC readiness is essentially about assessing how well the company can mobilize and sustain the organization change agenda associated with its strategy. For instance, if the strategy involves focusing on the customer, the company needs to determine whether its existing culture is customer-centric, whether its leaders have the requisite skills to foster such a culture, whether employees are aware of the goal and are motivated to deliver exceptional customer service, and, finally, how well employees

share with others their knowledge about the company's customers. Let's explore how companies can make these kinds of assessments for each of the four OC dimensions.

**Culture.** Of the four, culture is perhaps the most complex and difficult dimension to understand and describe because it encompasses a wider range of behavioral territory than the others. That's probably why "shaping the culture" is the most often-cited objective in the Learning and Growth section of our Balanced Scorecard database. Executives generally believe that changes in strategy require basic changes in the way business is conducted at all levels of the organization, which means, of course, that people will need to develop new attitudes and behaviors—in other words, change their culture.

Assessment of cultural readiness relies heavily on employee surveys. But in preparing surveys, companies need to distinguish clearly between the values that all employees share—the company's base culture—and the perceptions that employees have of their existing system—the climate. The concept of base culture has its roots in anthropology, which defines an organization's culture as the symbols, myths, and rituals embedded in the group consciousness (or subconscious). To describe a company's base culture, therefore, you have to uncover the organization's systems of shared meanings, assumptions, and values.

The concept of climate has its roots in social psychology and is determined by the way organizational influences—such as the incentive structure or the perceived warmth and support of superiors and peers—affect employees' motivation and behavior. The anthropological component reflects employees' shared attitudes and beliefs independent of the actual organizational infrastructure, while climate reflects their shared perception of existing organizational policies, practices, and procedures, both formal and informal.

Surveying perceptions of existing organizational policies and practices is a fairly straightforward task, but getting at the base culture requires a little more digging. Anthropologists usually rely on storytelling to identify shared beliefs and images, but that approach is inadequate for quantifying the alignment of culture to strategy. Organizational behavior scholars have developed measurement instruments, such as Charles O'Reilly and colleagues' Organizational Culture Profile, in which employees rank 54 value statements according to their perceived importance and relevance in the organization. Once ranked, an organization's culture can be described with a reasonable degree of reliability and validity. Then the organization can assess to what extent the existing culture is consistent with its strategy and what kinds of changes may be needed.

One caveat: Managers do need to be aware that some variations in culture are necessary and desirable in different operating units or functions. The culture of an R&D group, for example, should be different from the culture of a manufacturing unit; the culture of an emergent business unit should be different from the culture of a mature one. Executives should strive for agreement throughout the organization about corporatewide values such as integrity, respect, treatment of colleagues, and commitment to customer satisfaction. But some value statements in the survey instrument should refer to the culture of specific operating units. So, for example, surveys of the employees in operations and service-delivery units would include statements about quality and continuous improvement, whereas the R&D department survey might include statements about creativity and innovation. For employees involved in customer acquisition, statements might relate to retention and growth or to a deep understanding of individual customers' preferences and needs.

**Leadership.** If companies change their strategies, people will have to do some things differently as well. It is the responsibility of leaders at all levels of the organization—from

the CEO of a retail chain down to the local store managers—to help employees identify and understand the changes needed and to motivate and guide them toward the new ways of working.

In researching the best practices in our Balanced Scorecard database, we were able to identify seven generic types of behavioral changes that build organization capital, and each fell into one of two categories: changes that support the creation of value—such as increasing people's focus on the customer—and those required to carry out the company's strategy—such as increasing accountability. The sidebar "Seven Behaviors for Transformation" describes these behavioral changes in more detail.

---

**Seven Behaviors for Transformation**
Sidebar **R0402C_C** (Located at the end of this article)

---

To ensure that it gets the kind of leaders it needs, a company should draw up a *leadership competency model* for each of its leadership positions. This is a kind of job profile that defines the competencies a leader is expected to have to be effective in carrying out the company's strategy. For example, one manufacturing company, attempting to create teams to solve customers' problems, identified and defined three competencies essential for people in team leadership positions:

• **Customer Focus**—Outstanding leaders understand their customers. They place themselves in the customers' minds and spend time with them to understand their current and future needs.

• **Fostering Teamwork**—Outstanding leaders work collaboratively with their own teams and across organizational and geographic boundaries. They empower their teams to achieve excellence.

• **Open Communications**—Outstanding leaders tell the truth. They openly share information with peers, managers, and subordinates. They tell the whole story, not just how it looks from their position.

Often, organizations will measure leadership traits, such as those listed above, through employee surveys. A staff or external unit solicits information from subordinates, peers, and superiors about a leader's mastery of the critical skills. This personal feedback is used mainly for coaching and developing the leader, but the unit can also aggregate the detailed (and confidential) data from the individual reviews to create a status report on the readiness of key leadership competencies needed throughout the organization.

**Alignment.** An organization is aligned when all employees have a commonality of purpose, a shared vision, and an understanding of how their personal roles support the overall strategy. An aligned organization encourages behaviors such as innovation and risk taking because individuals' actions are directed toward achieving high-level objectives. Encouraging and empowering individual initiative in an unaligned organization leads to chaos, as the innovative risk takers pull the organization in contradictory directions.

Achieving alignment is a two-step process. First, managers communicate the high-level strategic objectives in ways that all employees can understand. This involves using a wide range of communication mechanisms: brochures, newsletters, town meetings, orientation and training programs, executive talks, company intranets, and bulletin boards. The goal of this step is to create intrinsic motivation, to inspire employees to internalize the organization's values and objectives so that they want to help the

organization succeed. The next step uses extrinsic motivation. The organization has employees set explicit personal and team objectives aligned to the strategy and establishes incentives that reward employees when they meet personal, departmental, business unit, and corporate targets.

Measuring alignment readiness is relatively straightforward. Many survey instruments are already available for assessing how much employees know about and how well they understand high-level strategic objectives. It is also fairly easy to see whether or not individuals' personal objectives and the company's existing incentive schemes are consistent with the high-level strategy.

For example, a large property and casualty insurance company adopted a new strategy intended to reduce its underwriting losses by creating a tighter link between the underwriters, who decide whether to accept a new piece of business, and the claims agents, who deal with the consequences from poor underwriting decisions. Historically, these specialists lived in different parts of the organization, and their incentives were totally unrelated to each other, which clearly did little to foster cooperation between them or with the line business units they supported. To reflect the new strategy, the company changed to a team-based compensation system in which everyone's incentive pay was based on a common set of measures (their Balanced Scorecard). Underwriters and claims agents, who worked in service departments shared by the various business units, were now rewarded using the Balanced Scorecard measures related to the business units they supported. The company used a survey instrument to capture the employees' perceptions of the improved teamwork created by aligning the incentive systems.

**Teamwork and Knowledge Sharing.** There is no greater waste than a good idea used only once. Most organizations have to go through a cultural change to shift individuals from hoarding to sharing their local knowledge. No asset has greater potential for an organization than the collective knowledge possessed by all its employees. That's why many companies, hoping to generate, organize, develop, and distribute knowledge throughout the organization, have spent millions of dollars to purchase or create formal knowledge management systems.

The challenge in implementing such systems is motivating people to actually document their ideas and knowledge to make them available to others. Most organizations in our Balanced Scorecard database attempted to develop such motivation by selecting "teamwork" and "knowledge sharing" as strategic priorities in their Learning and Growth Perspective. Typical measures for these priorities included the number of best practice ideas the employees identified and used, the percentage of employees who transferred knowledge in a workout process, the number of people who actually used the knowledge management system, how often the system is used, the percentage of information in the knowledge management system that was updated, and how much was obsolete.

For knowledge sharing to matter, it must be aligned with the priorities of the strategy map. For example, one organization—a chemical company—created several best practice communities to complement the internal process objectives on its strategy map. The Improve Workplace Safety community consisted of the safety directors from every facility. They studied the best practices at the high-performing plants and created a best practice–sharing program. The company's output measure, "days away from work," dropped by 70%. In another example, a children's hospital was attempting to reduce costs without reducing the quality of patient care. Intensive discussions resulted in a top-ten list of best practices already being used somewhere in the hospital. The hospital then formed cross-functional medical practice teams of physicians, nurses, and administrators to implement as many of these procedures as they practically could. It measured

success, the output of this knowledge-sharing process, by the "number of best practices utilized." The effective implementation of best practices over the next three years led to dramatic improvements in organizational outcomes: Readmission rates dropped by 50%, cost per case and length of stay each declined by 25%, and both customer satisfaction and quality of care increased. In these and many other examples in our case files, organizations enhanced their performance by aligning the teamwork and knowledge-sharing component of their organization capital with their strategy.

To get an overview of organizational readiness, companies can put the information they obtain from their various surveys and assessments together in a report like the one shown in "Organization Capital Readiness Report." In this exhibit, the leadership measure, drawn from the leadership competency model, displays the company's estimate, based on employee surveys, of the degree to which the company possesses the key attributes for leadership. At 92%, the company is above target on its leadership objective and can be considered strategically ready in terms of this dimension. The company's OC with respect to teamwork and knowledge sharing is also in good shape. But the firm is performing inadequately in alignment and in developing the right culture, and these problems are lowering its overall level of organization capital readiness.

## Organization Capital Readiness Report

The various measures for organization capital readiness should be put together in a readiness report, which shows, for all the components of organization capital, where the company needs to introduce changes to its behaviors and policies. The report shown here is a simplified version of one prepared by a company in our Balanced Scorecard database.

| Attribute | Strategic Objective | Strategic Measure | Target | Actual | |
|---|---|---|---|---|---|
| Culture | Foster awareness and internalization of the mission, vision, and core values needed to execute the strategy | Customer-focused (customer survey; percentage who understand the organization's mission) | 80% | **68%** | ✗ |
| | | Other core values (employee change readiness survey) | 80% | **52%** | ✗ |
| Leadership | Develop leaders at all levels who can mobilize the organization toward its strategy | Leadership gap (percentage of key attributes in competency model rated above threshold) | 90% | **92%** | ✓ |
| Alignment | Align goals and incentives with the strategy at all levels of the organization | Strategic awareness (percentage of staff who can identify organization's strategic priorities) | 80% | **75%** | ✗ |
| | | Strategic alignment (percentage of staff whose objectives and incentives link to Balanced Scorecard) | 100% | **60%** | ✗ |
| Teamwork | Ensure that knowledge and staff assets that have strategic potential are shared | Sharing best practices (number of knowledge management system hits per employee) | 5.0 | **6.1** | ✓ |

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

• • •

The intangible assets described in the Balanced Scorecard's Learning and Growth Perspective are the foundation of every organization's strategy, and the measures in this perspective are the ultimate lead indicators. Human capital becomes most valuable when it is concentrated in the relatively few strategic job families implementing the internal processes critical to the organization's strategy. Information capital creates the greatest value when it provides the requisite infrastructure and strategic applications that complement the human capital. Organizations introducing a new strategy must create a culture of corresponding values, a cadre of exceptional leaders who can lead the change agenda, and an informed workforce aligned to the strategy, working together, and sharing knowledge to help the strategy succeed.

Some managers shy away from measuring their intangible assets because these measures are usually "softer," or more subjective, than the financial measures they conventionally use to motivate and assess performance. The Balanced Scorecard movement has encouraged organizations to face the measurement challenge. Using the systematic approaches set out in this article, companies can now measure what they want, rather than wanting only what they can currently measure. Even if the measures are imprecise, the simple act of attempting to gauge the capabilities of employees, information systems, and organization capital communicates the importance of these drivers for value creation. In the course of our work, we have seen many companies find new ways to measure—and consequently new ways to enhance the value of—their intangible assets. The measurement and management of these assets played a prominent role in their transformation into successful, strategy-focused organizations.

Reprint Number R0402C | HBR OnPoint edition 5887 | HBR OnPoint collection 5933

## The Strategy Map

Sidebar **R0402C_A**

The strategy map provides a framework for linking intangible assets to shareholder value creation through four interrelated perspectives. The *financial perspective* describes the tangible outcomes of the strategy in traditional financial terms, such as ROI, shareholder value, profitability, revenue growth, and lower unit costs. The *customer perspective* defines the value proposition the organization intends to use to generate sales and loyalty from targeted customers. This value proposition forms the context in which the intangible assets create value. The *internal process perspective* identifies the critical few processes that create and deliver the differentiating customer value proposition. At the foundation of the map, we have the *learning and growth perspective,* which identifies the intangible assets that are most important to the strategy. The objectives in this perspective identify which jobs (the human capital), which systems (the information capital), and what kind of climate (the organization capital) are required to support the value-creating internal processes. These intangible assets must be integrated and aligned with the critical internal processes.

Sustained Shareholder Value

Productivity Strategy | Revenue Growth Strategy

Financial Perspective
- Improve cost structure
- Increase asset utilization
- Enhance customer value
- Expand revenue opportunities

Customer Value Proposition

Customer Perspective
- Price
- Quality
- Availability
- Selection
- Functionality
- Service
- Partnership
- Brand

*Product/Service Attributes* | *Relationship* | *Image*

Internal Process Perspective
- **Operations Management** Produce and deliver products and services
- **Customer Management** Enhance customer value
- **Innovation** Create new products and services
- **Regulatory and Social** Improve communities and the environment

*How intangible assets fit into the strategy map*

Strategic Job Families | Strategic IT Portfolio | Organization Change Agenda

Creating Alignment and Readiness

Learning and Growth Perspective
- **Human Capital**
  - Skills
  - Training
  - Knowledge
- **Information Capital**
  - Systems
  - Databases
  - Networks
- **Organization Capital**
  - Culture
  - Leadership
  - Alignment
  - Teamwork

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

## Human Capital Readiness at Consumer Bank

Sidebar **R0402C_B**

Here we can see how human capital at our composite company, Consumer Bank, is linked to its critical strategic processes and how well the company scores in terms of the skills and capabilities it needs. The top row lists the internal processes the bank identified as critical to delivering its value proposition. The second row shows the jobs that have the greatest influence on those processes—the *strategic job families*. The third row lists the competencies needed for each job, and the fourth row specifies the number of people with those skills the company requires.

| | Operations Management | | Customer Management | | Innovation | | Regulatory and Social | |
|---|---|---|---|---|---|---|---|---|
| Strategic Processes | Minimize problems | Provide rapid response | Cross-sell the product line | Shift to appropriate channel | Understand customer segments | Develop new products | Diversify workforce | |
| Strategic Job Families | Quality manager | Call center representative | Certified financial planner | Telemarketer | Consumer marketer | Joint venture manager | Community recruiter | |
| Competency Profile | • Six Sigma program<br>• Problem management system | • Customer interaction center<br>• Problem management system<br>• Team building | • Solutions selling<br>• Relationship management<br>• Product-line knowledge<br>• Professional certification | • Phone selling<br>• Product-line knowledge<br>• Order management system | • Market research<br>• Market communi-cation<br>• Cross-business process | • Relationship management<br>• Negotiation<br>• E-commerce know-how | • Community roots<br>• Public relations<br>• Legal frameworks | Overall Assessment of Human Capital Readiness |
| Number Required | 30 | 20 | 100 | 20 | 10 | 30 | 10 | |
| Strategic Job Readiness | 100% | 90% | 40% | 50% | 20% | 70% | 80% | 65% |
| | ✓ | ✓ | X | X | X | ? | ✓ | X |

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

The bottom row shows how ready Consumer Bank's human capital is for its new strategy. Taken together, these internal assessments indicate the extent to which the bank actually has the capacity it needs. The bank is in excellent shape for its two operations management processes (100% and 90% readiness) but deficient for the two customer management processes (only 40% and 50% readiness) and for one of the innovation processes (20% readiness). The aggregate measure of 65% human capital readiness (in the red zone) is a weighted average of readiness scores for all seven strategic job families. In terms of human capital, this report tells executives how quickly they can implement their new strategy.

## Seven Behaviors for Transformation

Sidebar **R0402C_C**

All new strategies require employees to make, and leaders to identify and foster, some specific changes in behavior. But in our research, companies that have successfully changed their strategies have needed only a limited number of behavioral changes—just seven, in fact—to maximize the contributions of their people to the execution of their new strategies. The changes fall into two categories:

• **Value Creation:** Behaviors that support value creation are those that increase focus on customers, innovation, and results.

• **Strategy Execution:** Behaviors that support strategy execution are those that increase employees' understanding of the company's mission, vision and values; accountability; communications; and teamwork.

Of course, no organization will try to change all seven behaviors at once. Typically, a

company will identify the two to four most important ones for implementing a specific strategy. For example, firms in deregulated industries like utilities or telecommunications now place a heavy emphasis on becoming customer focused and innovative, which are, for them, totally new behaviors. Previously, operating from a monopoly position, they had focused on operating efficiency and on avoiding risks to protect revenues.

That said, customer focus was the most frequently identified required new behavior in all the companies we studied. That's partly because virtually every strategy initiative starts with a clarification or redefinition of the customer value proposition. But some new strategies impose different priorities. Companies introducing shareholder value programs, for example, may already be sufficiently customer focused and will need instead to focus on results.

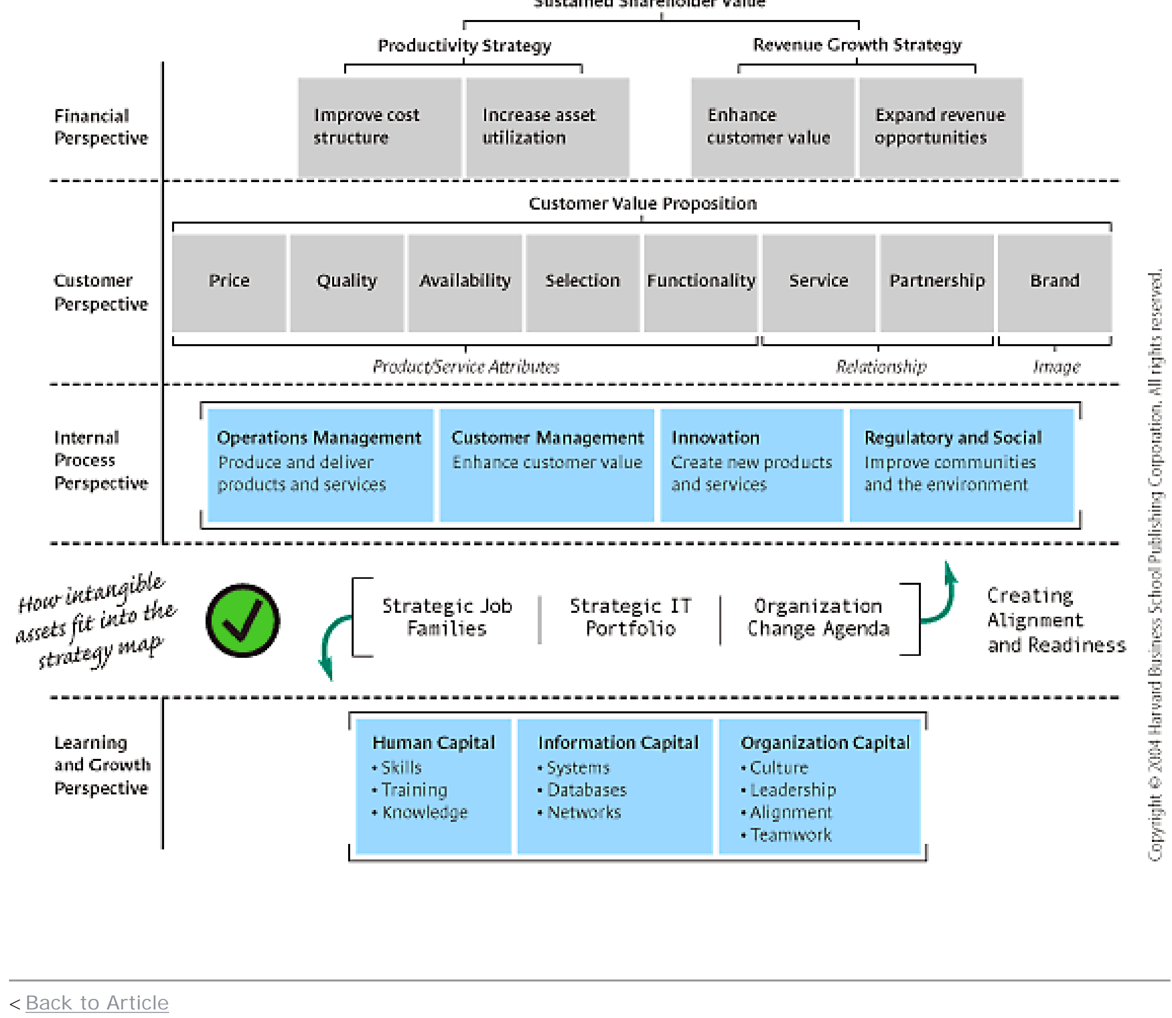
Companies adopting strategies that require high degrees of integration commonly need to increase communication. That was so, for instance, for one pharmaceutical company in our database that was attempting to transfer knowledge and marketplace experience from its commercial division to its product development group.

Copyright © 2004 Harvard Business School Publishing.
This content may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage or retrieval system, without written permission. Requests for permission should be directed to permissions@hbsp.harvard.edu, 1-888-500-1020, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, MA 02163.

Measuring the Strategic Readiness of Intangible Assets

# The Strategy Map

The strategy map provides a framework for linking intangible assets to shareholder value creation through four interrelated perspectives. The *financial perspective* describes the tangible outcomes of the strategy in traditional financial terms, such as ROI, shareholder value, profitability, revenue growth, and lower unit costs. The *customer perspective* defines the value proposition the organization intends to use to generate sales and loyalty from targeted customers. This value proposition forms the context in which the intangible assets create value. The *internal process perspective* identifies the critical few processes that create and deliver the differentiating customer value proposition. At the foundation of the map, we have the *learning and growth perspective,* which identifies the intangible assets that are most important to the strategy. The objectives in this perspective identify which jobs (the human capital), which systems (the information capital), and what kind of climate (the organization capital) are required to support the value-creating internal processes. These intangible assets must be integrated and aligned with the critical internal processes.




< Back to Article

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

## Measuring the Strategic Readiness of Intangible Assets

# Human Capital Readiness at Consumer Bank

Here we can see how human capital at our composite company, Consumer Bank, is linked to its critical strategic processes and how well the company scores in terms of the skills and capabilities it needs. The top row lists the internal processes the bank identified as critical to delivering its value proposition. The second row shows the jobs that have the greatest influence on those processes—the *strategic job families*. The third row lists the competencies needed for each job, and the fourth row specifies the number of people with those skills the company requires.

| | Operations Management | | Customer Management | | Innovation | | Regulatory and Social | |
|---|---|---|---|---|---|---|---|---|
| Strategic Processes | Minimize problems | Provide rapid response | Cross-sell the product line | Shift to appropriate channel | Understand customer segments | Develop new products | Diversify workforce | |
| Strategic Job Families | Quality manager | Call center representative | Certified financial planner | Telemarketer | Consumer marketer | Joint venture manager | Community recruiter | |
| Competency Profile | • Six Sigma program<br>• Problem management system | • Customer interaction center<br>• Problem management system<br>• Team building | • Solutions selling<br>• Relationship management<br>• Product-line knowledge<br>• Professional certification | • Phone selling<br>• Product-line knowledge<br>• Order management system | • Market research<br>• Market communi-cation<br>• Cross-business process | • Relationship management<br>• Negotiation<br>• E-commerce know-how | • Community roots<br>• Public relations<br>• Legal frameworks | |
| Number Required | 30 | 20 | 100 | 20 | 10 | 30 | 10 | Overall Assessment of Human Capital Readiness |
| Strategic Job Readiness | 100% | 90% | 40% | 50% | 20% | 70% | 80% | 65% |
| | ✓ | ✓ | ✗ | ✗ | ✗ | ? | ✓ | ✗ |

Copyright © 2004 Harvard Business School Publishing Corporation. All rights reserved.

The bottom row shows how ready Consumer Bank's human capital is for its new strategy. Taken together, these internal assessments indicate the extent to which the bank actually has the capacity it needs. The bank is in excellent shape for its two operations management processes (100% and 90% readiness) but deficient for the two customer management processes (only 40% and 50% readiness) and for one of the innovation processes (20% readiness). The aggregate measure of 65% human capital readiness (in the red zone) is a weighted average of readiness scores for all seven strategic job families. In terms of human capital, this report tells executives how quickly they can implement their new strategy.

< Back to Article

Copyright © 2004 Harvard Business School Publishing. All rights reserved.

Measuring the Strategic Readiness of Intangible Assets

# Seven Behaviors for Transformation

All new strategies require employees to make, and leaders to identify and foster, some specific changes in behavior. But in our research, companies that have successfully changed their strategies have needed only a limited number of behavioral changes—just seven, in fact—to maximize the contributions of their people to the execution of their new strategies. The changes fall into two categories:

• **Value Creation:** Behaviors that support value creation are those that increase focus on customers, innovation, and results.

• **Strategy Execution:** Behaviors that support strategy execution are those that increase employees' understanding of the company's mission, vision and values; accountability; communications; and teamwork.

Of course, no organization will try to change all seven behaviors at once. Typically, a company will identify the two to four most important ones for implementing a specific strategy. For example, firms in deregulated industries like utilities or telecommunications now place a heavy emphasis on becoming customer focused and innovative, which are, for them, totally new behaviors. Previously, operating from a monopoly position, they had focused on operating efficiency and on avoiding risks to protect revenues.

That said, customer focus was the most frequently identified required new behavior in all the companies we studied. That's partly because virtually every strategy initiative starts with a clarification or redefinition of the customer value proposition. But some new strategies impose different priorities. Companies introducing shareholder value programs, for example, may already be sufficiently customer focused and will need instead to focus on results.

Companies adopting strategies that require high degrees of integration commonly need to increase communication. That was so, for instance, for one pharmaceutical company in our database that was attempting to transfer knowledge and marketplace experience from its commercial division to its product development group.

< Back to Article

Copyright © 2004 Harvard Business School Publishing. All rights reserved.