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Harvard Business Review

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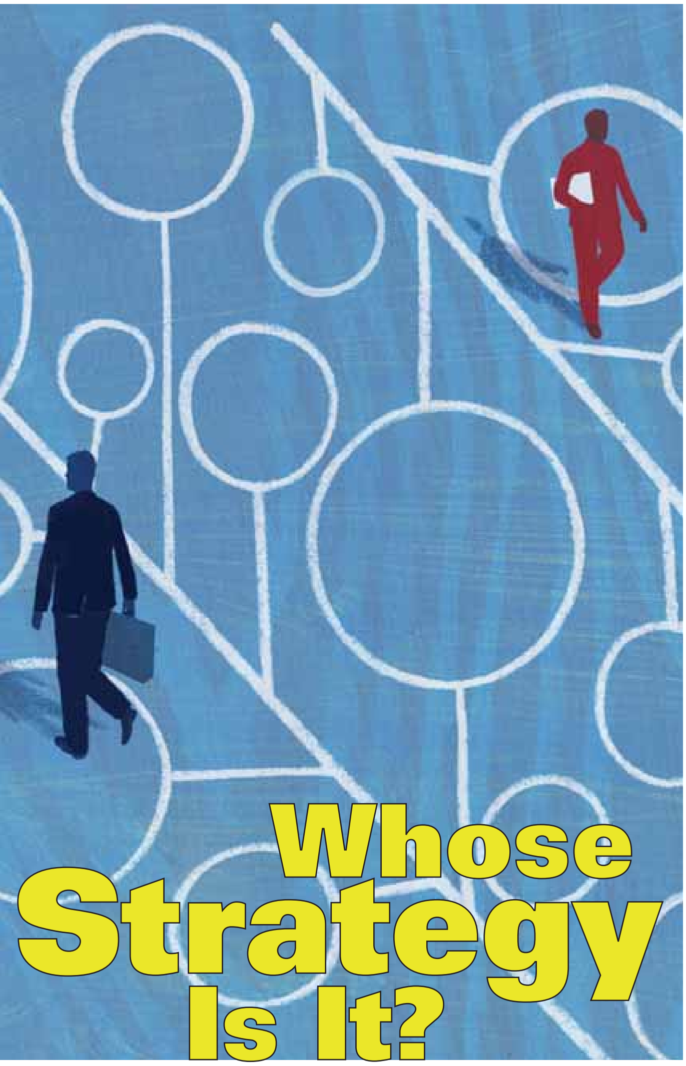

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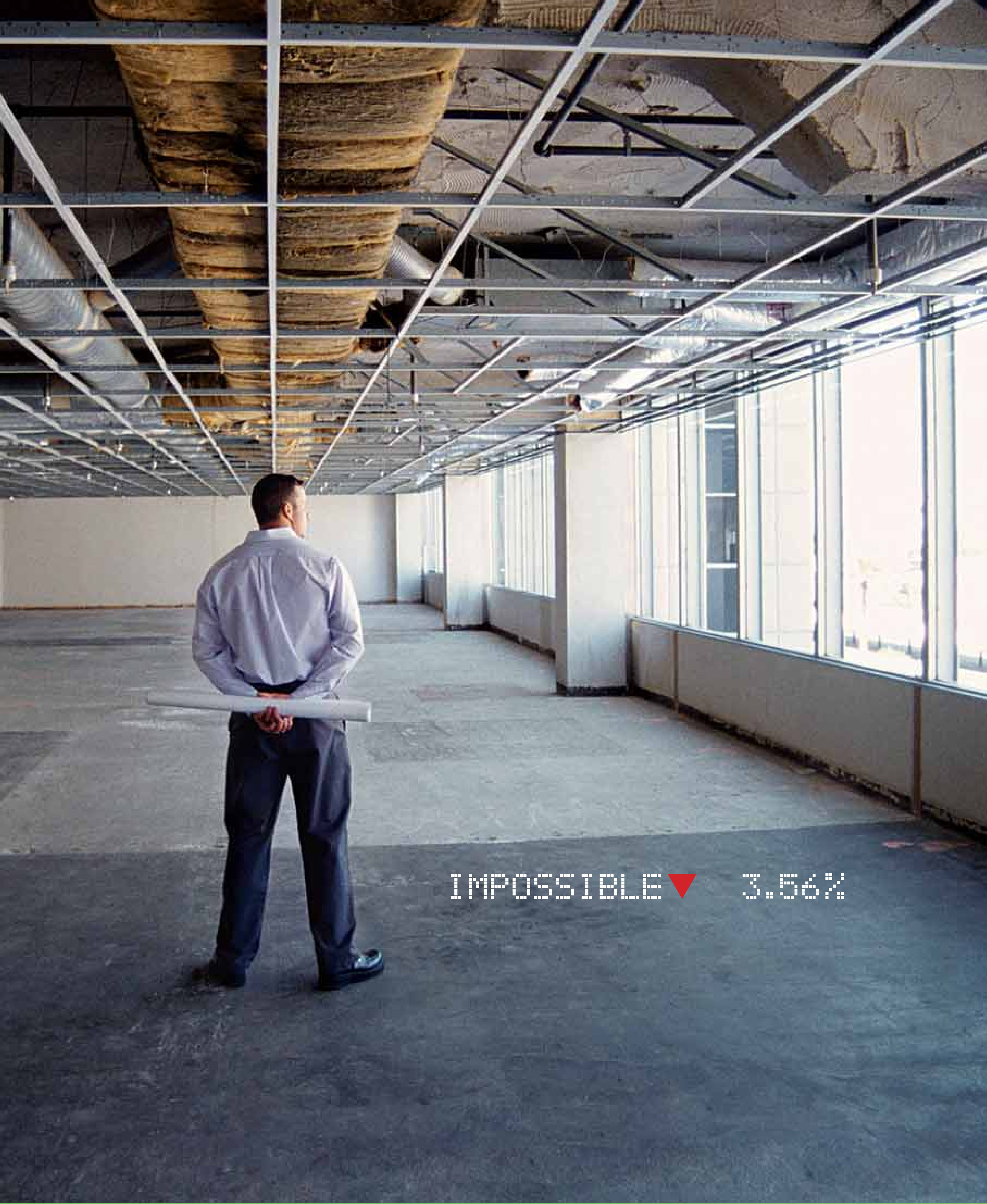
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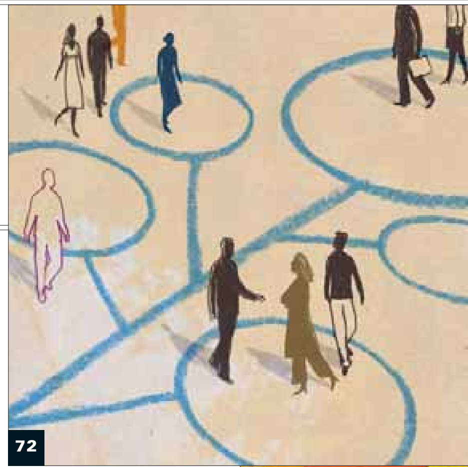

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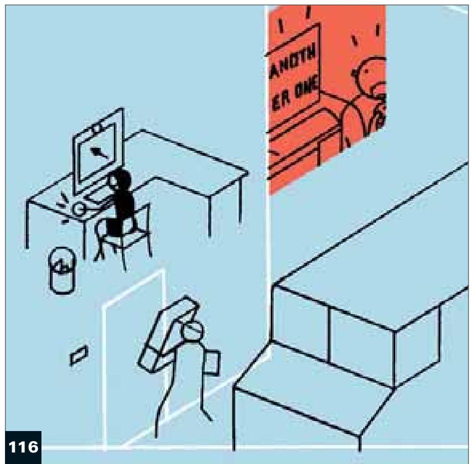

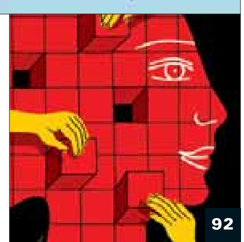

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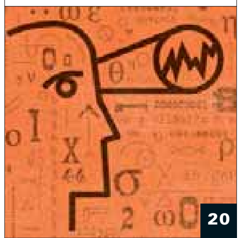

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Ideas with Impact

Robert Meganck

EVERY IDEA GROWS from an encounter – between a hypothesis and reality, between a curious mind and an anomalous fact, between one civilization or field of study and another, between one oyster and one grain of sand. For the past ten, 15 years, people have used the word "convergence" to describe trends in the communications space: As books and articles, audio and video recordings, telephone calls, and documents of all kinds have been produced in the universal language of 1s and 0s – even cash has undergone this metamorphosis – formerly distinct industries have converged. Incumbents have faced upstarts and intruders from across boundaries that used to be distinct: Vide Apple selling music or Comcast selling telephone service.

A number of such convergences are celebrated in this year's HBR List, our annual ingathering of a score of ideas that we believe will shape and reshape business in the months and years to come. Klaus Kleinfeld, CEO of Siemens, and Erich Reinhardt, head of its medical division, write about how health care and the health care industry will change as boundaries between medical and therapeutic disciplines are eroded by information technology. Michael Mankins probes the cash-management practices of private equity firms for ideas that public companies can apply. Geoffrey West, head of the Santa Fe Institute (whose very existence is predicated on the idea that interdisciplinary consilience produces new thinking), describes newfound mathematical science challenging the conventional wisdom that small organizations have an advantage when it comes to innovation.

More than ever, this year's HBR List was a global effort. Senior editors David Champion and Paul Hemp led the team, the former working from France, the latter from our offices in Massachusetts. Our continuing partnership with the World Economic Forum took us to Tokyo, where a WEF regional summit gave us the opportunity to hold a side meeting. A couple of dozen scholars, businesspeople, and other experts joined me, HBR senior editor Anand Raman, and the WEF's Jonathan Schmidt and Sheana Tambourgi for a daylong discussion that inspired several ideas you can read about in these pages and that were discussed at the WEF's annual meeting in Davos.

Though globalization is a trend that has been around for a long time, it still seems new. It's striking, when you think about it, how much more international the dialogue of business has become and how many companies have emerged from obscurity to become global brand names. One of them is Haier, the Chinese appliance maker. Thanks to the enterprise of Ke En from HBR's Chinese edition, we're able to bring you "Raising Haier," Zhang Ruimin's first-person account of his wild ride as Haier's chief executive, from his first day in 1984, when he learned that the company didn't have enough money to pay its workers, to now, when Haier is established as a global competitor with annual sales in excess of RMB100 billion.

Yet some of the biggest problems in business are the oldest. The lead article in this issue is about one of them, and it represents the summation of three decades of research by Harvard Business School's Joseph Bower. Senior executives have long been frustrated by the disconnection between the plans and strategies they so carefully devise and the actual behavior of the managers subordinate to them in the company. The complaint is as old as business, as old as organizational life. (You can find it in Xenophon.) Bower and his coauthor, Clark Gilbert, have approached the problem from the ground up, recognizing that every time a manager allocates resources, that decision moves the company either into or out of alignment with its announced strategy – and neither the manager nor the top executives realize it at the time. Thus to the well-known leadership aspects of alignment the authors add an organizational and procedural one, an understanding of resource allocation processes that mostly take place under the strategic radar. This is a powerful insight that has engaged Bower and a whole generation of scholars who have worked with or been inspired by him. It will change how you think about driving strategy in your business.

Thomas A. Stewart


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Breakthrough Ideas for 2007

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Harvard Business Review

WORLD ECONOMIC FORUM

List

Our annual survey of emerging ideas considers how nanotechnology will affect commerce, what role hope plays in leadership, and why, in an age that practically enshrines accountability, we need to beware of "accountabalism."

EVERY YEAR, THE EDITORS of *Harvard Business Review* have the enviable challenge of putting together the HBR List, tapping our network of authors and sources to find twenty essays that will satisfy our demanding readers' appetite for provocative and important new ideas. For this year's List, we decided to bring those readers into the process. Last May, we posted an invitation on our Web site asking readers to identify the ideas they thought would emerge as breakthroughs in 2007.

The response was gratifying. More than 100 ideas were submitted, from which we picked six for development. One of these, an essay on "conflicted consumers" by the British consultant Karen Fraser, was selected for publication. We will repeat this process for next year's List, and we hope that you, our readers, will participate even more fully.

In the same quest for ideas, HBR has once again joined forces with the World Economic Forum. Last spring, the two organizations hosted a brainstorming seminar in Tokyo at which some two dozen experts from different backgrounds debated which emerging ideas are the most important, generating a number of List candidates in the process. And several of the List essays – marked by asterisks on the preceding page and in the text – were on the agenda of the WEF's annual meeting in Davos, Switzerland, last month.

Given the broad net cast, it's no surprise to find a wide array of authors and ideas represented, including (to name just a few) Geoffrey West of the Santa Fe Institute on the (somewhat surprising) relationship between innovation and organizational size, Siemens CEO Klaus Kleinfeld and Siemens Medical Solutions president Erich Reinhardt on the convergence of imaging technology and biotech, and the Tokyo venture capitalist Yoshito Hori on the growing entrepreneurialism of Japanese society. We hope you'll find these and the other essays in the List as stimulating as we do.

John Hersey

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MARKETING STRATEGY

The Accidental Influentials *

1 In his best-selling book *The Tipping Point,* Malcolm Gladwell argues that "social epidemics" are driven in large part by the actions of a tiny minority of special individuals, often called influentials, who are unusually informed, persuasive, or well connected. The idea is intuitively compelling – we think we see it happening all the time – but it doesn't explain how ideas actually spread.

The supposed importance of influentials derives from a plausible-sounding but largely untested theory called the "two-step flow of communication": Information flows from the media to the influentials and from them to everyone else. Marketers have embraced the two-step flow because it suggests that if they can just find and influence the influentials, those select people will do most of the work for them. The theory also seems to explain the sudden and unexpected popularity of certain looks, brands, or neighborhoods. In many such cases, a cursory search for causes finds that some small group of people was wearing, promoting, or developing whatever it is before anyone else paid attention. Anecdotal evidence of this kind fits nicely with the idea that only certain special people can drive trends.

In recent work, however, my colleague Peter Dodds and I have found that influentials have far less impact on social epidemics than is generally supposed. In fact, they don't seem to be required at all.

Our argument stems from a simple observation about social influence: With the exception of celebrities like Oprah Winfrey – whose outsize presence is primarily a function of media, not interpersonal, influence – even the most influential members of a population simply don't interact with that many others. Yet it is precisely these noncelebrity influentials who, according to the two-step-flow theory, are supposed to drive social epidemics, by influencing their friends and colleagues directly. For a social epidemic to occur, however, each person so affected must then influence his or her own acquaintances, who must in turn influence theirs, and so on; and just how many others pay attention to each of *these* people has little to do with the initial influential. If people in the network just two degrees removed from the initial influential prove resistant, for example, the cascade of change won't propagate very far or affect many people.

Building on this basic truth about interpersonal influence, Dodds and I studied the dynamics of social contagion by conducting thousands of computer simulations of populations, manipulating a number of variables relating to people's ability to influence others and their tendency to be influenced. Our work shows that the principal requirement for what we call "global cascades" – the widespread propagation of influence through networks – is the presence not of a few influentials but, rather, of a critical mass of easily influenced people, each of whom adopts, say, a look or a brand after being exposed to a single adopting neighbor. Regardless of how influential an individual is locally, he or she can exert global influence only if this critical mass is available to propagate a chain reaction.

To be fair, we found that in certain circumstances, highly influential people have a significantly greater chance of triggering a critical mass – and hence a global cascade – than ordinary people. Mostly, however, cascade size and frequency depend on the availability and connectedness of easily influenced people, not on the characteristics of the initiators – just as the size of a forest fire often has little to do with the spark that started it and lots to do with the state of the forest. If the network permits global cascades because it has the right concentration and configuration of adopters, virtually anyone can start one. If it doesn't permit cascades, nobody can. What seems in retrospect to be the special influential quality of a particular person (or group) is, there-

fore, mostly an accident of location and timing.

Although at odds with the dominant interpretation of the two-step flow, our results are actually consistent with a great deal of influentials research – in particular, the finding that influence in any given circumstance depends not only on such personal characteristics as expertise, charisma, and popularity, but also on the details of the circumstance itself. Sometimes people are influential because they are outspoken and gregarious, other times because they are introspective and reflective. Sometimes they are central members of particular groups, and other times they are peripheral. Sometimes they are innovators, and sometimes they are laggards. There are, in fact, so many ways for people to be influential, and so many kinds of influentials, that it is almost impossible to generalize from one situation to another. What our work clarifies, however, is that such generalizations are difficult not because of insufficient data but because any focus on individual attributes alone overlooks the importance of network effects.

Understanding that trends in public opinion are driven not by a few influentials influencing everyone else but by many easily influenced people influencing one another should change how companies incorporate social influence into their marketing campaigns. Because the ultimate impact of any individual – highly influential or not – depends on decisions made by people one, two, or more steps away from her or him, word-of-mouth marketing strategies shouldn't focus on finding supposed influentials. Rather, marketing dollars might better be directed toward helping large numbers of ordinary people – possibly with Web-based social networking tools – to reach and influence others just like them.

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POLITICAL ECONOMY

Entrepreneurial Japan

2

In 2006, Japan experienced an economic revitalization after nearly a decade of deflation, bankruptcies, and sagging profits. The stock market has bounced back, with the Nikkei 225 Index rising to more than 200% of the low it reached in 2003. Office space and labor are scarce. Corporate earnings are at a record high.

Analysts, the media, and the Japanese government attribute this growth to the turnaround of big traditional corporations, such as Toyota, Canon, Nissan, and Nippon Steel, and to industry consolidation, which has created financial giants like Sumitomo Mitsui Banking and JFE Steel. Structural changes implemented by the Koizumi government are often credited with sparking the comeback. But these observers are missing a big part of the story. Japan's rebound is also being fueled by emerging companies in knowledge-intensive industries – companies led by entrepreneurs in their twenties and thirties. A newly entrepreneurial Japan, something that once would have seemed oxymoronic, may ultimately overshadow the much touted start-up cultures in China and India.

The rise of this new Japan – so different from the "old" Japan, characterized by capital-intensive industries in which big manufacturing companies are run by people who've patiently worked their way up through the organization – has come from a confluence of forces. One is a shift in public perceptions of employment. When the financial giant Yamaichi Securities collapsed in 1997, people began to question the long-standing assumption that working for a large company meant a job for life. This questioning has led to an erosion of employee loyalty. Young Japanese workers today have no expectation of lifetime employment or career advancement based on seniority; they focus on furthering their careers through switching jobs or acquiring advanced degrees.

The new mentality has in turn changed public perceptions of entrepreneurs, who for the first time are respected – and exciting – role models for ambitious young Japanese. Kenji Kasahara became an instant celebrity at 31 when the company he founded, a MySpace-like social-networking firm called Mixi, went public in September 2006 and reached a market capitalization of ¥229 billion (approximately $2 billion) within a few days. Hiroshi Mikitani, the founder and CEO of Rakuten, the largest e-commerce company in Japan, has imitated some Silicon Valley entrepreneurs by buying professional baseball and soccer teams.

An entrepreneurial Japan – which once would have seemed oxymoronic – may ultimately overshadow the much touted start-up cultures in China and India.

An entrepreneurial Japan has been further nurtured by, and reflected in, a favorable IPO environment. From

2001 to 2005, 747 Japanese companies – compared with 617 in the United States – went public. Of those that went public in 2005, 96% – up from 94% in 2004 – opened their first day of trading above their offering price. Chinese and Korean companies are increasingly looking to float their shares in the Japanese market.

New ventures also benefit from Japanese strengths. For instance, Japan has a highly developed telecommunications infrastructure, including a robust broadband network. Its average Internet user fees are far lower than those in other developed countries – just six cents per 100 Kbps, compared with 24 cents in South Korea, $1.77 in the United States, $1.89 in China, and $2.77 in Germany. Japan also enjoys the world's highest penetration rate for the mobile Internet, with 90 million mobile phone users, many of whom have 3G handsets.

Perhaps most important, the Japanese economy is still the second largest in the world, representing more than half of the entire Asian economy. Its new ventures can reach critical mass quickly, which gives them an advantage over new ventures in, for example, China and India. Japan's strong base in an array of key technologies and industries – from digital animation to robotics to nanotechnology – creates fertile ground for start-ups in these areas.

When the new Japan is noticed, the attention is often negative. People point to allegations of securities fraud made against the Internet service provider Livedoor, or to insider trading charges brought against the flamboyant financier and shareholder-rights activist Yoshiaki Murakami. But the country's increasing entrepreneurial vitality suggests that in its next stage of prosperity, Japan will be a competitive source of innovation as well as a leading economic power.

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MARKETING STRATEGY

Brand Magic: Harry Potter Marketing

3 The typical brand manager is an ageist. It goes with the territory, because whatever the formal customer segmentation driving a brand strategy, the segments will almost certainly be differentiated by age.

Innéov, a line of nutricosmetics jointly owned by L'Oréal and Nestlé, is a case in point. Its main product, a nutritional supplement called Firmness, targets women aged 45 to 55. One of the Firmness brand manager's greatest worries is that if too many "older" consumers (that is, above 55) are stuck to her brand, 45-year-old potential consumers might get the impression that Firmness is "not yet for them – thank goodness."

Like Harry Potter, the fictional schoolboy wizard who grows older with his readers, brands that mature with their users can prove particularly durable.

Like Firmness, most brands target a specific age group, either explicitly or implicitly, through the choice of media used to advertise them. To serve customers outside that age group, the company has to create new brands. As customers mature, the company must replace them with younger ones and encourage the previous customers to switch to an allied brand rather than to a competitor.

The big problem with this approach to branding is that it positively discourages customer loyalty – and, as we all know, it's a lot cheaper to keep customers than to find new ones. To get around this problem, we propose that companies like L'Oréal consider a new approach. Instead of seeking to build immortal brands that generations mature into and then out of, they could create brands around a given cohort of customers. As the customers matured, the brands would evolve with them. The aim would be to match the needs of that cohort at any moment in time. We call this "Harry Potter marketing," after the fictional schoolboy wizard who grows older with his readers.

How would it look in practice? Let's assume that instead of targeting Frenchwomen "of a certain age," Innéov targeted women born between 1955 and 1965 and launched a brand called Souplesse (Suppleness) in 2005. Because this customer pool would not change over time, the company could explicitly manage for brand loyalty, responding to the actual preferences of its customers rather than trying to sell them a predesigned set of preferences. This more balanced dialogue would enhance the targeted cohort's emotional bonding with the brand. For example, the brand could continue to capitalize on the fact that many of its consumers grew up in the age of disco or thrilled to the tunes of ABBA.

Various components of the marketing mix would be affected. The proportions of active ingredients in Souplesse would progressively change to take customers' aging into account. The company might want to retain the same celebrity (the French actress Carole Bouquet, perhaps, or the fashion icon Inès de la Fressange) to endorse it for many years, creating further emotional bonding. However, her message about the product's benefits would change over time. When most members of the cohort had reached the age of 55, the emphasis could switch from "attacking the first visible signs of aging" to "providing a complete skin treatment." Distribution strategies should take into account the evolution of the cohort's shopping habits. When the majority of the cohort had reached the age of 65, for instance, L'Oréal might make beauty salons a retail option because older consumers spend relatively more time there.

Unlike traditional brands, Souplesse would face a certain death. For most brand managers, this would be a disaster; but L'Oréal would already have launched other Innéov skin creams for subsequent cohorts. Would this constant churn be expensive? Perhaps. But the continual relaunching and repositioning of age-specific brands is also expensive – and our preliminary work with L'Oréal suggests that Harry Potter marketing would not necessarily be more so. For one thing, evolving Harry Potter brands would presumably profit from greater brand loyalty. Of course, this sort of marketing won't work in all industries, and it needs to withstand the test of, well, time. But it could be used for food, health care, clothing, and the media. This perspective can help explain why, for instance, Club Med and Gap, whose original successes were each due to a single generation's strong emotional bonding, have experienced a downturn in their sales.

One last word: A world of cohort-specific brands will probably favor first movers, because if they do their job well, second entrants will find differentiation difficult. This suggests that fans of Harry Potter should proceed quickly.

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KNOWLEDGE MANAGEMENT

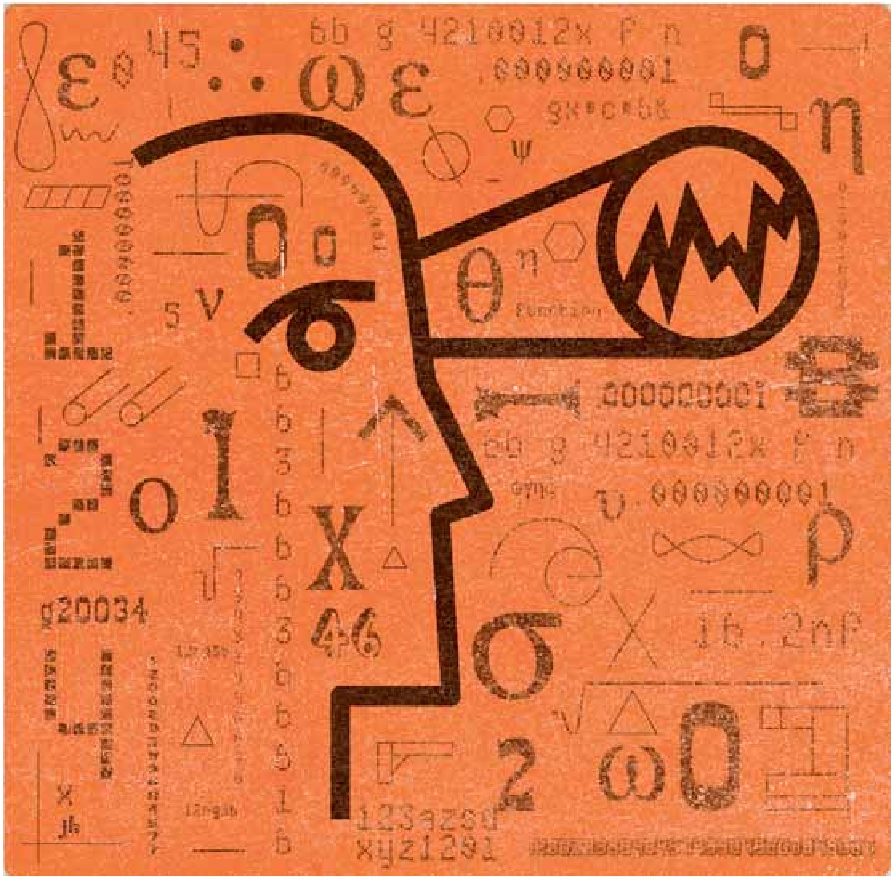
Algorithms in the Attic

4 For a powerful perspective on future business, take a hard look at mathematics past. As computing gets ever faster and cheaper, yesterday's abstruse equations are becoming platforms for tomorrow's breakthroughs. Companies in several industries are now dusting off these formulas and putting them in the service of new products and processes.

Procter & Gamble has been restructuring its supply chain with complex "expressive bidding" algorithms – based on 1950s linear-programming equations – that allow suppliers to bid online with bundled offerings of products and service levels rather than with standardized lots. Google's search engine was possible only because the founders adapted a century-old theorem about matrices to software for ranking Web pages according to links from other sites. Networks like the Web can be expressed as matrices, and a relatively simple calculation gives a ranking of how well each site is connected to the rest of the Web. That formula for automatic ranking – which could be understood and appreciated without a PhD – is one of the most lucrative algorithms ever. The math was there for the taking.

Why should past work, often quite theoretical, be so useful now? Done in the absence of high-speed, low-cost computational capacity, that work put a premium on imaginative quantitative thinking. With today's high-powered processors and broadband networks, those abstractions can point the way to practical software that leaps over current operational constraints. Disruptive opportunities abound.

"There are huge hidden assets in the operations-research community," says



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the MIT professor Richard Larson, a pioneer in probabilistic modeling techniques. "If you gave an army of 20 grad students the mission to rake through the published literature of the past 30 years, they would find stuff that has untapped business potential worth billions of dollars. There are many clever ideas my students worked on decades ago that in today's networked environment would not be an academic exercise but a real business opportunity."

Take, for example, an algorithm that measures the statistics of any queue. This algorithm can automatically assess performance along a wide range of variables. Larson and his colleagues developed the algorithm in the early 1990s with an eye to improving automated teller machines, but it has gotten little notice otherwise. Now that companies increasingly automate customer-service management, this algorithm is a natural tool for monitoring the quality of repeated processes.

Sometimes the equations come from far afield. Consider the mathematics developed to help physicists determine the optimal cooling time for crystallizing molecules packed together as tightly as possible. Tesco, the British retailer, is working these "simulated annealing" algorithms into software for optimizing product placements on store shelves. Or look at "genetic" algorithms, which were intellectual curiosities when they arose in the 1970s to demonstrate how Darwinian principles of fitness and inheritance could be used to "evolve" solutions to problems. Nokia and a few other companies are exploring them in product development. Nokia starts, say, with a design for a new cell phone, and uses genetic algorithms to evolve the design of the phone's antennae within the constraints of the phone's form factor and battery power. Genetic algorithms in which solutions are evolved can deliver results superior to those from analytic algorithms in which solutions are designed.

This work offers the possibility of major advances, but an equally large opportunity may lie in simply getting more managers to use existing quantitative tools in their decision making. There's no doubt, says the Stanford University professor Sam Savage, that literally millions of business spreadsheets would benefit from the stress-testing of key assumptions with "Monte Carlo" random number generators. To improve the reliability of their individual business plans, Savage observes, managers could even plug into enterprise-wide probability estimates.

Only recently have these academic research tools become part of everyday business practice in fields such as engineering and financial services. The rate at which they are intelligently adopted could be a differentiator in the wider marketplace. Cheap algorithms are like cheap labor and cheap capital – a valuable resource when judiciously employed.

The big-box retailers Wal-Mart and Best Buy, for example, are widely regarded as having superior analytic infrastructures. But they don't just hire the smartest "quants"; they push to make their mathematical tools accessible to others. They substitute on-screen representations and visualizations of data for complex numerical equations. They're constantly rethinking when mathematics should automate a decision and when it should simply assist the decision maker. Applied systematically, these tools may help solve what is perhaps the biggest challenge facing retailing: how to efficiently sift through the mountains of data that are now being collected.

Whether looking for breakthroughs or just trying to improve decision making, companies will benefit from greater sophistication around even simple mathematics. A decade ago, big firms began to realize that they were sitting on a treasure trove of underutilized patents and know-how that could be commercialized for willing buyers. Those "Rembrandts in the attic," as Kevin G. Rivette and David Kline put it in their 2000 book by that name, needed the keen eye of an intellectual property curator to appreciate their value. Similarly, we now require quantitative entrepreneurs to seek out existing equations that meet today's pressing business needs. Technology continues to make that quest faster, easier, and cheaper.

Panning for Gold on Dusty Shelves

Today's high-speed, cheap computers have given abstruse mathematical advances immediate practical relevance. With the help of "mathematical entrepreneurs," companies can now adapt these equations and algorithms to a range of business challenges. Here are some examples:

Formula	Date of Original Development	Original Use	Current Business Application
Perron-Frobenius theorem	1800s	Ranking nodes in a network	Improving search engines; analyzing and customizing communication on Web sites
Monte Carlo random number generators	1940s	Testing scenarios for atomic bomb explosions	Evaluating the riskiness of competing capital projects
Genetic algorithms	1970s	Demonstrating Darwinian principles in mathematical problem solving	Developing products by computationally evolving the design in response to constraints
Simulated annealing algorithms	1980s	Determining the cooling time for tightly packed crystallizing molecules	From scheduling complicated processes to optimizing product placement on store shelves

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Most business leaders shy away from the notion of hope, perhaps because declaring that one's organization needs hope feels defeatist.

LEADERSHIP

The Leader from Hope

5 What is hope? Something more than wishful thinking but short of expectation. A rejection of cynicism and dispiritedness. And a state, we believe, quite central to the work of a leader.

Most business leaders, we've discovered in our three years' worth of interviews on the subject, shy away from the word. Perhaps talk of hope comes uncomfortably close to faith and spirituality – or perhaps declaring that one's organization needs hope feels defeatist. "If I set out to instill hope," one might wonder, "am I admitting that our situation is next to hopeless?"

Yet work connected to the positive-psychology movement has made hope discussable in new ways. Hope has been shown to be the key ingredient of resilience in survivors of traumas ranging from prison camps to natural disasters. Many studies have shown that people who score higher on measures of hope also cope better with injuries, diseases, and physical pain; perform better in school; and prove more competitive in sports. Our contribution has been to outline the elements of hope – possibility, agency, worth, openness, and connection – in a way that guides efforts to nurture it in the workplace. The first two are central to the definition of hope: People must see that change is possible and how they can engage personally in that change. The remaining elements have to do with how hope is cultivated in organizations: Hopeful work groups are most often composed of individuals whose worth to the organization has been affirmed, who perceive an openness on the part of management, and who enjoy an authentic sense of connection with their colleagues and with the organization's mission. Even so briefly described, these elements suggest why hope can be an energetic force for positive change to a degree that, say, optimism alone could never be.

Our study of effective executives has uncovered many ways in which their decisions, words, and actions make the people they lead more hopeful. Collectively, these practices are the basis of a leadership tool kit for building and sustaining hope. But the most important change comes when a leader is simply more mindful of this vital part of her or his mission. Much can be accomplished in a reflective pause to ask, "Is what I am about to do or say likely to be destructive or accretive of hope?" It is useful to notice how people express a sense that things might change for the better: They often say of some key actor, "He gives me hope" or "She gives me hope." If you are an executive trying to lead an organization through change, know that hope can be a potent force in your favor. And it's yours to give.

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RESEARCH & DEVELOPMENT

An Emerging Hotbed of User-Centered Innovation *

6 A major auto company recently presented its "innovation road map" for the next ten years to a group of journalists and car enthusiasts. As the presentation progressed, it became increasingly clear that some members of the audience were restless. Finally, one listener stood up and said, "Many of us have already built and installed every single one of the innovations you say you are planning to develop in the next ten years. Wake up and smell the coffee! Come out to the parking lot and take a look at what we have developed and installed in our cars!"

The company's engineers and executives weren't sure how to respond. They certainly couldn't say what they felt: "Users should not act like that! They should wait for us to study their needs and develop new products for *them!*"

In an array of industries, producer-centered innovation is being eclipsed by user-centered innovation – the dreaming up, development, prototyping, and even production of new products by consumers. These users aren't just voicing their needs to companies that are willing to listen; they're inventing and often building what they want.

Breakthrough medical-equipment innovations such as the heart-lung machine and the first automated drug

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pumps were developed by doctors at the leading edge of practice, not by firms that manufacture medical equipment. Novel food categories like sports energy drinks and gels were developed by sports enthusiasts. This process of users' coming up with products is increasingly well documented, and some companies, at least, are actively trying to take advantage of it. But what about governments?

Governments? What do they have to do with the development of something like a sports gel? Actually, governments have always attempted, in a variety of ways, to affect how firms innovate. Most countries, developing and developed alike, view innovation as vital to their economic growth and well-being and spend varying portions of their national budgets to support it. That support has typically come in the form of R&D grants for scientific researchers and R&D tax credits for manufacturers. This focus on technology push has not attracted much controversy. But recent research shows that the 70% to 80% of new product development that fails does so not for lack of advanced technology but because of a failure to understand users' needs. The emergence of user-centered innovation clearly shows that this near-exclusive focus on technological advance is misplaced.

Today, customers aren't just voicing their needs to companies that are willing to listen; they're inventing and often building what they want.

Denmark is taking this sea change in the nature of innovation to heart. In 2005, the Danish government became the first in the world to establish as a national priority, in the words of a government policy statement, "strengthening user-centered innovation."

Like other countries, Denmark had traditionally followed a strategy of technology push. But, as a relatively small country with relatively few resources, it had also been resigned to not winning in the research-investment game. By championing a new innovation paradigm, the Danish government is encouraging numerous methodological flowers to bloom – from programs that improve manufacturers' understanding of users' needs (through ethnographic research, for example) to techniques for identifying user-developed innovations that manufacturers can produce. Successful approaches will be studied in Danish business schools and shared with interested Danish firms.

One such initiative is the Danish User-Centered Innovation Lab, established in 2005. Hosted by Copenhagen Business School and staffed by professors from both CBS and the Aarhus School of Business, the lab is following an approach pioneered at the Massachusetts Institute of Technology a decade ago. As a government-supported partnership between faculty experts at Danish business schools and innovative firms such as Bang & Olufsen, LEGO, and Novo Nordisk, it comes up with new innovation methods that are then tested in partner companies.

Denmark is the first country to bring government innovation policies into line with modern understandings of how innovation really works. If this paradigm shift is successful, many other nations will certainly follow.

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PEOPLE MANAGEMENT

Living with Continuous Partial Attention

7 We all know the phenomenon: You're in a conference room, and all the people around the table are glancing – frequently and surreptitiously – at the cell phones or BlackBerrys they're holding just below table level. They may be checking their e-mail, looking to see who is trying to reach them on muted incoming calls, sending text messages, scanning stock quotes, making dinner reservations – or, more likely, doing several things at once. Such activities don't only draw participants' attention away from the business being conducted at the table; they also compete with one another – sometimes even generating small alerts that suddenly appear and then dissolve on the screen, silently begging, "Look at me!" This constant checking of handheld electronic devices has become epidemic, and it illustrates what I call "continuous partial attention."

Although continuous partial attention appears to mimic that much discussed behavior, multitasking, it springs from a different impulse. When we multitask, we are trying to be more productive and more efficient, giving equal priority to all the things we do – simultaneously filing or copying papers, talking on the phone, eating lunch, and so forth. Multitasking rarely requires much cognitive processing, because the tasks involved are fairly automatic.

Continuous partial attention, by contrast, involves constantly scanning for opportunities and staying on top of contacts, events, and activities in an effort to miss nothing. It's an adaptive behavior that has emerged over the past two decades, in stride with Web-based and mobile computing, and it connects us to a galaxy of possibilities all day every day. The assumption behind the behavior is that personal bandwidth can match the endless bandwidth technology offers.

Continuous partial attention in itself is neither good nor bad. Like many things, it's fine up to a point – but in excess it can cause harm. In a study of the use of BlackBerrys, Gayle Porter, an associate professor at Rutgers University, concluded that addiction to these devices, in the form of constant checking for messages, is deeply entrenched. TNS Research, in a study commissioned by Hewlett-Packard, found that people who attempted to deal with a barrage of messages while working experienced a temporary ten-point drop in IQ over a day's time.

Furthermore, in this sleep-deprived, interruption-driven, always-on world, our ability to focus is compromised. In trying to process a never-ending and ever-widening stream of incoming data, we can put off decisions indefinitely or even burn out.

Not surprisingly, there are signs of a backlash against the tyranny of tantalizing choices. The yearning for a calmer existence has led people to adopt tools – from iPods to TiVo to Google's spare interface – that reduce information overload and support discernment. Instead of seeking out venues in which to make ever more connections with others, to the point of overtaxation, people are seeking refuges, such as yoga and meditation classes or "quiet cars" on trains, in which to make a few meaningful connections.

As businesses respond to this backlash – as they consider management styles and marketing messages that effectively meet people's needs for relief from continuous partial attention and the sensory overload it creates – they can differentiate themselves by offering what their employees and customers increasingly crave: discriminating choices and quality of life.

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MERGERS & ACQUISITIONS

Borrowing from the PE Playbook

8 To survive the economic downturn at the start of the decade, corporations took dramatic steps to reduce costs and improve productivity. As a result, their operating leverage skyrocketed, and when the economy rebounded, corporate profits quickly followed. Since the amount of capital required to sustain organic growth represents a small portion of the cash now coming in, most of these profits are going straight to the balance sheet.

A cash mountain used to be considered a good thing – savings for a rainy day or a war chest for future acquisitions. Today, it's a mixed blessing, and the possibilities for spending the cash wisely are much reduced. For one thing, profitably emptying a war chest isn't as easy as it once was. Private equity firms are hunting for big corporate deals and using their financial leverage to bid up the prices of acquisition targets – effectively pricing "strategic buyers" out of the market. But keeping the cash in the bank isn't an option. Not only does it generate embarrassingly low returns for investors, but it can make a company more attractive to PE firms. With those firms now able to complete transactions of $50 billion or more, this applies even to large corporations once considered immune to buyout. Industrial firms are the most susceptible, but no sector is off limits, as the privatization of SunGard (software and IT services) and HCA (health care) demonstrate.

Giving the cash back to shareholders in the form of dividends isn't a very attractive alternative: It effectively signals that management has run out of promising new growth ideas, which will inevitably affect the share price. Some companies resort to share repurchases, but these create value only if the company is undervalued by investors – which is the exception, not the rule. Of course, companies can always use the cash to pay off debt. But since the after-tax cost of debt is lower than the cost of equity, paying off debt increases value only when a company is overleveraged – that is, has taken on so much debt that it is at risk of going under. In today's markets, most companies are underleveraged.

So what can companies do to profitably rid themselves of this embarrassment of riches? Like it or not, acquisition really is the only option, but to exercise that option effectively, would-

What Does It Take to Create $1 Billion in M&A Value?

Private equity firms create value in acquisitions by being very selective, and smart corporate buyers would do well to imitate them. Small M&A deals tend to create the most value per dollar invested. But small deals involve a lot more work: Deal makers have to close 80 of them, as opposed to just seven very large deals, to make a billion dollars – which means sifting through thousands of potential deals.

Smaller deals create more value...

Average deal size	$50M	$100M	$500M	$1B	$3B
Value creation (per $ invested)	25¢	20¢	15¢	10¢	05¢

...but take more work

Number of deals	80	50	13	10	7
Active pursuits	160	100	26	20	14
Active appraisals	320	200	52	40	28
Starting pipeline	3,200	2,000	520	400	280

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be buyers are going to have to take a few leaves from the PE playbook. To begin with, they're going to have to spend a lot more time looking at potential deals. PE firms create value in acquisitions by being very selective. Research shows that for every deal a PE firm completes, it screens 40, appraises four, and actively pursues two (see the exhibit "What Does It Take to Create $1 Billion in M&A Value?"). Corporate buyers cast smaller nets: Whereas PE firms reject 39 deals for every one they complete, most corporations would struggle to come up with more than four or five targets in the M&A pipeline.

In addition to strengthening their M&A pipelines, companies experienced in making smaller deals should be prepared to leverage their cash mountains in order to acquire companies of equal or greater size. With their strong balance sheets, they should be able to borrow heavily in advance of transactions; they can then use the proceeds from divestitures within their portfolios and those of their acquisitions to pay down the debt quickly. In this regard, the advent of PE firms is actually a blessing, because they are prepared to acquire businesses that commercial buyers won't touch. As a result, the market for companies is much more liquid than before, making it easier to execute mega acquisitions that are contingent on subsequent smaller divestitures.

Finding profitable outlets for excess cash can be challenging. Making acquisitions has always been tough, but in today's market, as private equity players compete for many deals, success is even harder. The smartest companies will incorporate the best practices of PE firms in order to hunt more like them and will take advantage of the liquidity they create in order to hunt with them.

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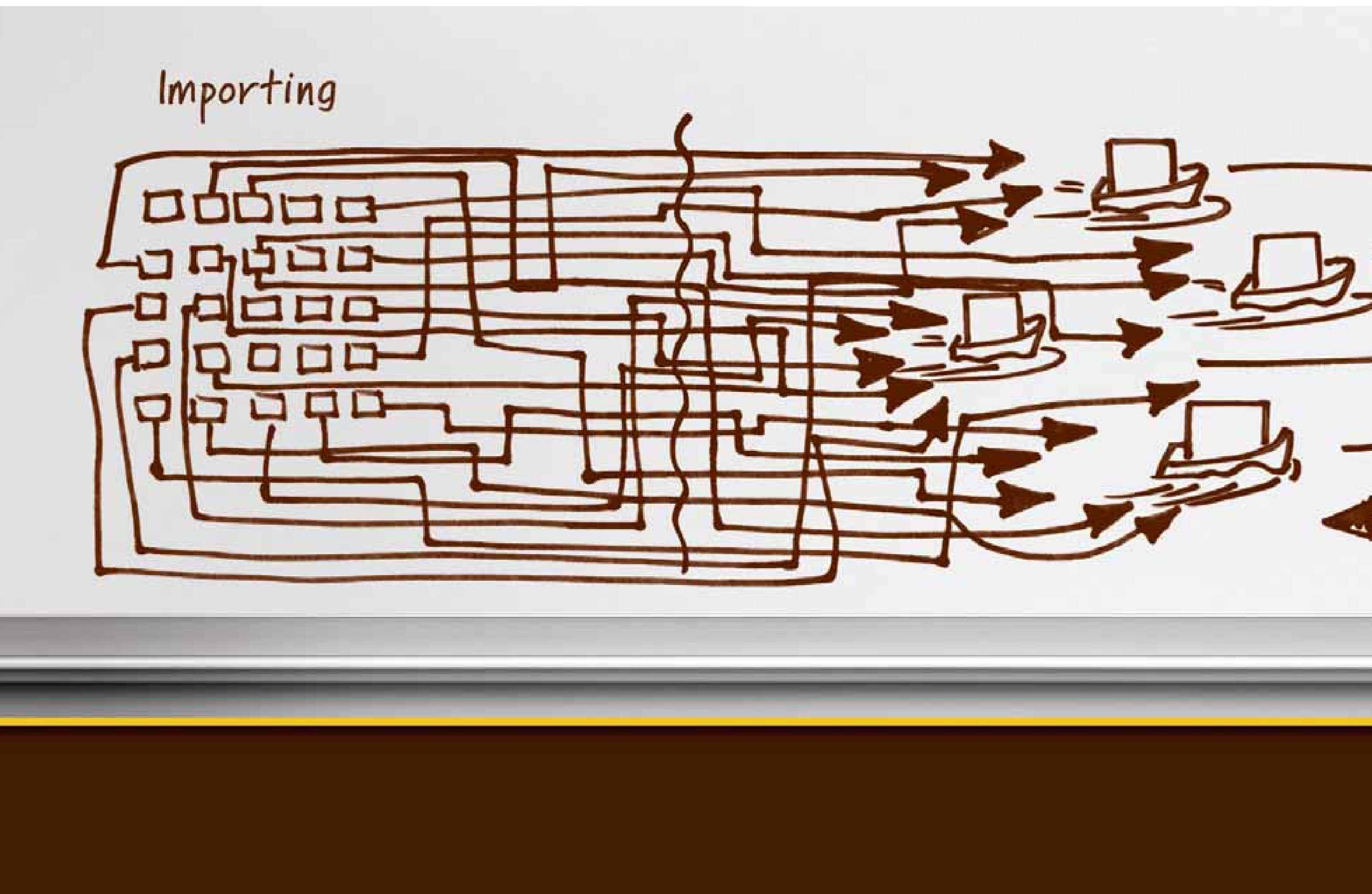
DECISION MAKING

When to Sleep on It

9 Have a difficult decision to make? You should engage in long and careful deliberation, right? Not necessarily. Psychological research shows that conscious deliberation, however long and careful, can be a surprisingly crude and ineffective tool, because the conscious mind has a very limited processing capacity. Most people cannot, for example, compare three organizations differing on 14 dimensions. That is simply too much information for the conscious mind to take in and handle all at once.

Of course, if this limited capacity led executives to use only the best and most relevant information, the situation would be fine. But it doesn't. People who mull over their decisions typically

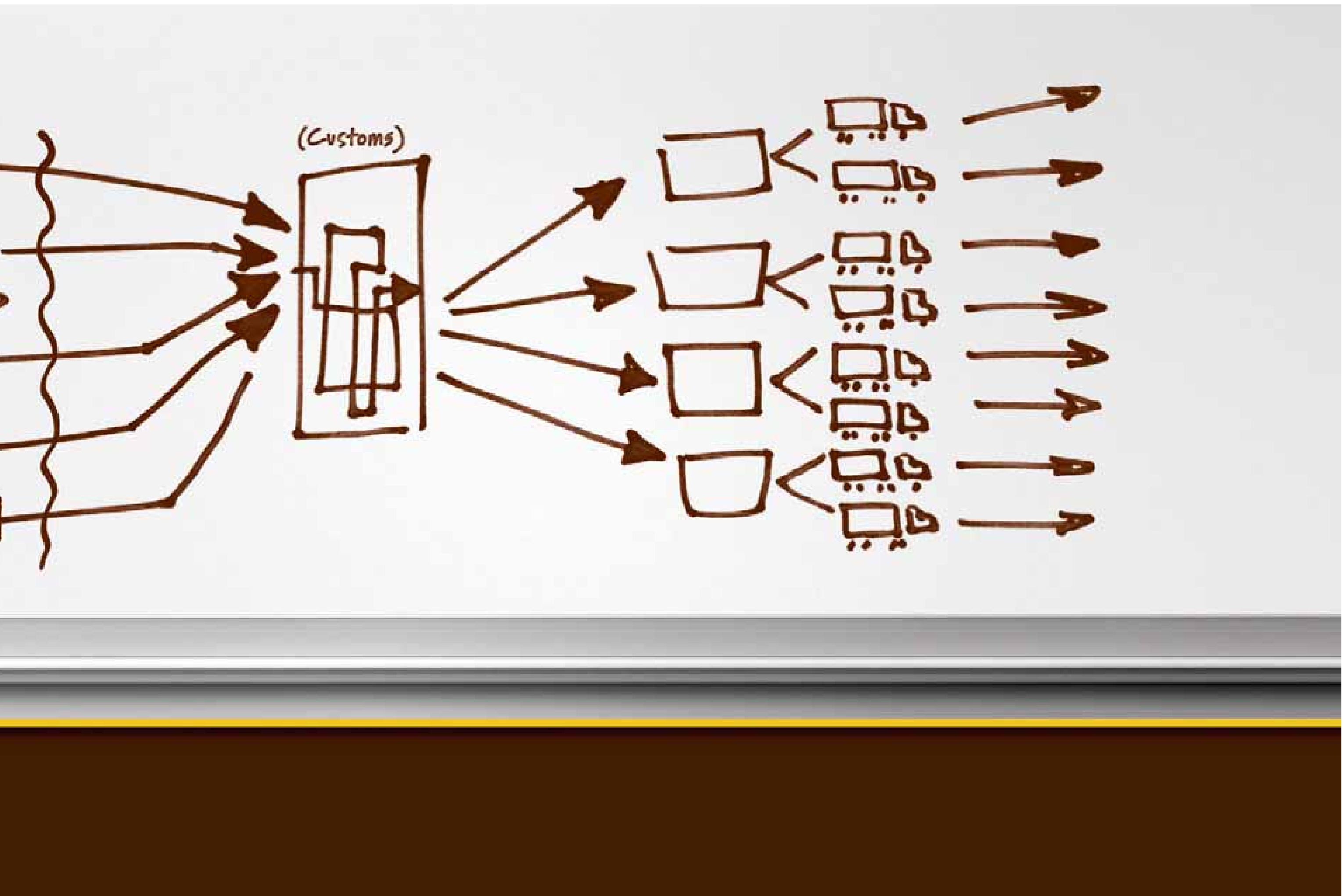


Conscious deliberation, however long and careful, can be a surprisingly crude and ineffective tool.

get the relative importance of the various pros and cons very wrong. In one recent experiment I helped conduct, we studied experts' predictions for World Cup soccer matches. We found that the longer our participants thought about their answers, the more likely they were to include irrelevant information (which city will host the game) at the expense of relevant information (track records of the teams playing). And the more information they factored in, the less accurate their predictions became. The logical conclusion from this and similar experiments is that conscious deliberation leads to sound decisions only when a very limited amount of information is involved.

Luckily, there is another way to make difficult choices: Don't think hard about the decision, and after a while your unconscious mind, which is known to have a far greater processing capacity than your conscious mind, will tell you what you should do. Such an unconsciously generated preference is usually referred to as intuition or a gut feeling – a conviction that one alternative is better than another, even when we can't verbalize why.

The notion of trusting your intuition is, of course, far from new; but what was unexamined until now is whether extensive unconscious thought can make intuition more reliable. Thus, my colleagues and I conducted experiments to test the power of the unconscious mind as a processor of information. We gave our subjects information pertaining to a choice – for example, which of four apartments was the most attractive, or which of four cars was the best. They had three options: They could make a choice immediately; they could take time for conscious deliberation; or they



could figuratively sleep on it – that is, engage in unconscious thought. The subjects who chose the third option were first given information about the decision in question and then given information about an unrelated task, to occupy their conscious minds while their unconscious minds processed the relevant information.

When the unconscious thinkers were asked to choose one of the alternatives, they made better decisions, almost without exception, than the subjects who decided immediately or those who consciously deliberated. Their decisions were better from a normative perspective (more rationally justifiable), from a subjective perspective (more likely to produce post-choice satisfaction), and from an objective perspective (more accurate, as in predictions of soccer-match outcomes).

The moral? Use your conscious mind to acquire all the information you need for making a decision – but don't try to analyze the information. Instead, go on holiday while your unconscious mind digests it for a day or two. Whatever your intuition then tells you is almost certainly going to be the best choice.

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FINANCIAL REPORTING

Here Comes XBRL

10 When the U.S. Securities and Exchange Commission last September announced a $54 million project to accelerate the implementation of XBRL, a new information standard for financial and business reporting, the event hardly seemed like a landmark for companies. The advantage for investors – an enhanced ability to electronically download, analyze, and compare company information submitted to the SEC – got top billing. The SEC chairman, Christopher Cox, briefly noted that adopting the new standard – which is voluntary for SEC filings, at least for now – would also make it easier and less costly for companies to comply with his agency's requirements. But that's just the beginning.

What has largely been overlooked is that XBRL (Extensible Business Reporting Language) will make it much easier to generate, validate, aggregate, and analyze business and financial information, which in turn will improve the quality, timeliness, completeness, and comparability of the information that companies use to make decisions. The new language will allow them to strengthen and ensure the reliability of their internal controls, thereby lowering the cost of maintaining these pervasively manual compliance processes. It will make ERP (enterprise resource planning) systems much more flexible and easier to upgrade or change, dramatically cutting the investments needed to maintain these beasts. And by significantly reducing the amount of effort needed to change and integrate business reporting systems, XBRL will make digesting acquisitions, shedding businesses, reorganizing, and adding new products and business units far less difficult.

All this undoubtedly sounds too good to be true to managers who are rightfully jaded after decades of false promises that the next IT silver bullet is (this time, really!) just around the corner. So what makes XBRL different? Unlike all past technological developments, it doesn't come in a wide variety of proprietary flavors, like ERP systems, operating systems, and customer relationship management systems, to name just a few. XBRL is an open-source standard that was developed by an international public consortium of nearly 500 organizations from 27 countries, including companies, investors, analysts, auditors, regulators, and aggregators of financial data, such as Standard & Poor's. (For more background, see www.xbrl.org, the standard's official Web site.)

In more technical terms, XBRL is the application of XML (Extensible Markup Language, on which the Internet is built) to business reporting. It uses an electronic tag, very much like the bar code on a physical product, to explicitly define information so that it can be easily read by a variety of software applications. XBRL also articulates the relationships among different pieces of information, offers formulas for calculating ratios, provides references to accounting standards and other relevant sources, and can even translate information into different human languages. These attributes mean that processes that now have to be manual because of the difficulty of getting different proprietary applications to work together can be made more automated and streamlined.

Another reason to treat XBRL seriously is that, although its taxonomies are still not fully developed, it is already advancing rapidly throughout the world. More than 8,200 financial institutions in the United States have had to submit their quarterly call reports (risk-oriented filings) in this language to federal banking regulators since the fall of 2005; they are already reaping benefits in the form of lower compliance costs, higher-quality data (for both regulatory and internal purposes), better analytical procedures, and more useful benchmarking data. Meanwhile, some two dozen companies – including Bristol-Myers Squib, Ford, General Electric, Microsoft, PepsiCo, and United Technologies – have been filing 10-Ks and

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10-Qs in XBRL as part of a voluntary SEC pilot program. The SEC's project to revamp its EDGAR (electronic data gathering, analysis, and retrieval) database and to invest in the development of XBRL taxonomies for all industries where they don't exist promises to accelerate adoption across the United States.

Initiatives are also under way in Australia, China, the European Union, India, Japan, Korea, Singapore, and many other places. The European Union's central bank has developed an XBRL-based model for implementing the Basel II framework for risk management. Banco de España, Spain's central bank and the leader of the EU effort, is already applying XBRL in a number of ways, including efforts to fight money laundering. In order to attract more international investors by increasing the transparency of reported information, the Korea Stock Exchange has worked with its 20 largest companies to file information in XBRL. Wacoal, a Kyoto-based maker of lingerie, has used XBRL to enhance its ability to aggregate operating information from the 24 proprietary IT systems used by its businesses in 23 countries. Wacoal needed six months and $50 million to implement the system – a sixth of the time and a third of the money that would have been required for a traditional ERP solution it had considered.

The bottom line: XBRL's benefits go far beyond faster and cheaper compliance. Late adopters beware.

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ORGANIZATIONS

Innovation and Growth: Size Matters *

11 Executives talk about their companies' "DNA" and roles in "business ecosystems," but the analogy to living organisms is more than metaphorical. Like the mathematical laws governing how organisms' metabolism, growth, evolution, and mortality depend on size, there are rules that appear to govern the growth, performance, and even decline of cities and other social organizations. Although we can't yet predict how specific cities or companies will evolve, we've found general mathematical relationships between population size, innovation, and wealth creation that may have important implications for growth strategy in organizations.

By almost any measure, the larger a city's population, the greater the innovation and wealth creation *per person.*

In biology, different species are in many ways scaled versions of one another. Bacteria, mice, elephants, sequoias, and blue whales may look different, but most of their fundamental characteristics, including energy and resource use, genome length, and life span, follow simple mathematical rules. These take the form of so-called power-law scaling relationships that determine how such characteristics change with size. For example, metabolic rate increases as the ¾ power of mass. Put simply, the scaling law says that if an organism's mass increases by a factor of 10,000 (four orders of magnitude), its metabolic rate will increase by a factor of only 1,000 (three orders of magnitude). This represents an enormous economy of scale: the bigger the creature, the less energy per pound it requires to stay alive. This increase of efficiency with size – manifested by the scaling exponent ¾, which we say is "sublinear" because it's less than one – permeates biology. These ubiquitous scaling laws have their origin in the universal properties of the networks that sustain life, such as the cardiovascular and respiratory systems.

Social organizations, like biological organisms, consume energy and resources, depend on networks for the flow of information and materials, and produce artifacts and waste. So it would not be surprising if they obeyed scaling laws governing their growth and evolution. Such laws would suggest that New York, Santa Fe, New Delhi, and ancient Rome are scaled versions of one another in fundamental ways – as, potentially, are Microsoft, Caterpillar, Tesco, and Pan Am. To discover these scaling laws, Luís Bettencourt at Los Alamos National Laboratory, José Lobo at Arizona State University, Dirk Helbing at TU Dresden, and I gathered data across

many urban systems in different countries and at different times, addressing a wide range of characteristics including energy consumption, economic activity, demographics, infrastructure, intellectual innovation, employment of "supercreative" people, and patterns of human behavior such as crime rates and rates of disease spread.

We did indeed find that cities manifest power-law scaling similar to the economy-of-scale relationships observed in biology: a doubling of population requires less than a doubling of certain resources. The material infrastructure that is analogous to biological transport networks – gas stations, lengths of electrical cable, miles of road surface – consistently exhibits sublinear scaling with population.

However, to our surprise, a new scaling phenomenon appeared when we examined quantities that are essentially social in nature and have no simple analogue in biology – those associated with innovation and wealth creation. They include patent activity, number of supercreative people, wages, and GDP. For such quantities the exponent (the analogue of ¾ in metabolic rate) *exceeds* 1, clustering around a common value of 1.2. Thus, a doubling of population is accompanied by more than a doubling of creative and economic output. We call this phenomenon "superlinear" scaling: by almost any measure, the larger a city's population, the greater the innovation and wealth creation *per person.*

Organismic growth, constrained by sublinear power-law scaling derived from the dynamics of biological networks, ultimately ceases, with the equations predicting what size organisms will reach. In contrast, our equations predict that growth associated with superlinear scaling processes observed in social organizations is theoretically unbounded. This would seem to bode well for organizations. Unfortunately, however, the equations also predict that in the absence of continual major innovations, organizations will stop growing and may even contract, leading to either stagnation or ultimate collapse. Furthermore, to prevent this, the time between innovations (the "innovation cycle") must decrease as the system grows.

Though our research has focused on cities, the social and structural similarities between cities and firms suggest that our conclusions extend to companies and industries. If so, the existence of superlinear scaling that links size and creative output has two important consequences: First, it challenges the conventional wisdom that smaller innovation functions are more inventive, and perhaps explains why few organizations have ever matched the creativity of a giant like Bell Labs in its heyday. Second, it shows that because organizations and industries must apparently innovate at a continually accelerating rate to avoid stagnation, economizing by reflexively cutting R&D budgets and creative staffs may be a dangerous strategy over the long term.

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CUSTOMER RELATIONS

Conflicted Consumers

12 Your data indicate strong customer satisfaction: Repeat purchase levels are high, and many customers have been with you for years. Good news, right? Well, appearances can be deceptive.

There may well lie buried in these data a "stealth" segment of apparently loyal customers who have ethical concerns about your company and are poised to switch as soon as a viable alternative emerges. In other words, they buy your product but they'd rather not. I call such customers "conflicted consumers," and my research shows that more of them are out there than business leaders and their market research teams may realize.

In a survey of more than 1,300 consumers in the United Kingdom, nearly one in four said they bought products and services from companies whose ethical reputation they deemed poor or very poor. Their concerns ranged from

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the exploitation of workers to corporate environmental practices to the marketing of harmful products. Among the 40 international companies that were included in the survey, McDonald's had the highest proportion of conflicted consumers: 8% of the company's customers expressed dissatisfaction, primarily with the perceived effect of its products on children's health.

Conflicted consumers are an intriguing bunch. Although they worry that they are making the world a worse place by buying a particular product, they are distinct from hard-core ethical consumers, who either "go green" or go without. Conflicted consumers are simply ready to switch to a brand they perceive as more ethical. Why wait? Usually because they don't believe a convenient alternative exists – yet. And they don't believe that withholding their business would have any effect on how the company operates. Sometimes consumers (typically parents looking for domestic peace) override their own concerns and stick with a company because their families like the product.

Though they are good customers for the moment, their doubts may feed a powerful if latent resentment toward a brand. Their desire for an ethical choice represents a huge amount of potential energy in the marketplace, which can take the form of something more subtle, widespread, and damaging than an old-fashioned product boycott.

Conflicted consumers talk to others about corporations' track records. In fact, 44% of the consumers polled in the survey had spoken about corporate ethics with friends, family, or colleagues in the previous month. And though companies increasingly look to word of mouth as a way to bolster their brands, more than 33% of such conversations negatively portrayed the company or brand discussed. Wireless access to the Internet, which allows conflicted consumers to research opinions about products and services right up to the moment of purchase, will only amplify their misgivings.

Although some companies see little need to pay attention to the preferences of "ethical types" who will never, they believe, buy their products, my research indicates that the distinction between ethical types and "our customers" is blurring, and that the majority of consumers, in one way or another, need to have their concerns addressed.

Karen Fraser (karen@fraserconsultancy.com) is a research consultant and the founder of the London-based Fraser Consultancy, which publishes the Ethical Reputation Index.

DEMOGRAPHICS

What Sells When Father Knows Best

13 The comedian Dick Cavett once quipped, "If your parents never had children, chances are you won't either." It's a funny thought, but it gets at something real.

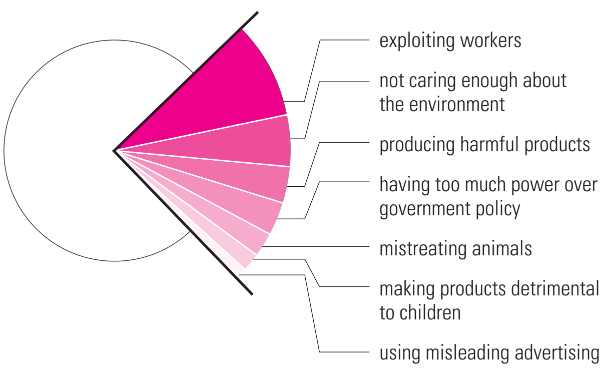
People who are social, religious, or political conservatives tend to have more children, and that fact has profound implications for culture, for politics, and for business. In the United States, for example, fertility rates are 12% higher in states that voted for George W. Bush in the most recent presidential election than in the more liberal and secular states that supported his opponent. Indeed, if the John Kerry states seceded and formed a new nation, its fertility rate would be just 1.8 children per woman – 13% below the level needed to replace the population.

This link between fertility and conservatism is found not only in the United States but in Europe, Israel, the rest of the Middle East, and elsewhere. There is a strong correlation between adherence to traditional Christian, Judaic, or Islamic values and high fertility.

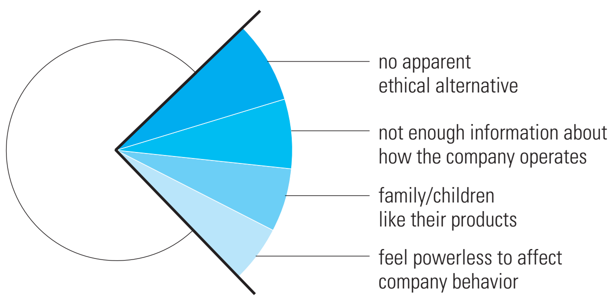
continued on page 44

Holding Their Noses

Almost one in four consumers buy from companies they see as unethical for:



These same consumers stay with those companies for one of several reasons:



Source: Fraser Ethical Index survey of 1,363 adults in the UK

Breakthrough Ideas for 2007

the HBR List in brief

Here's a quick guide to the 20 challenging and provocative ideas to be found in this year's List.


Some think competition.
We think partnership.

the HBR List

Breakthrough Ideas for 2007 > In Brief

The Accidental Influentials*

Duncan J. Watts

1 In his best seller *The Tipping Point,* Malcolm Gladwell argues that "social epidemics" are driven in large part by the actions of a tiny minority of special individuals. The idea seems intuitively right – we think we see it happening all the time. Nevertheless, this isn't actually how ideas spread. It's better to focus on getting enough plain, ordinary people to sign on.

Entrepreneurial Japan

Yoshito Hori

2 Japan's economic rebound is generally attributed to the turnaround of corporate giants and to industry consolidation. But it is also fueled by the emergence of new companies led by entrepreneurs in their twenties and thirties. An entrepreneurial Japan – no longer an oxymoron – may ultimately overshadow the much touted start-up cultures of China and India.

Brand Magic: Harry Potter Marketing

Frédéric Dalsace, Coralie Damay, and David Dubois

3 Most brands target a specific age group. The big problem with this approach is that it positively discourages customer loyalty–and, as we all know, it's a lot cheaper to keep customers than to find new ones. To get around this problem, companies should consider creating brands that mature with their customers.

Algorithms in the Attic

Michael Schrage

4 For a powerful perspective on future business, take a hard look at mathematics past: the old equations collecting dust on academics' shelves. Just as big firms need the keen eye of an intellectual property curator to appreciate the value of old patents and know-how, they will need savvy mathematicians to resurrect long-forgotten equations that, because of advancing technology, can finally be applied to business.

The Leader from Hope

Harry Hutson and Barbara Perry

5 Most business leaders shy away from the word "hope." Yet hope has been shown to be the key ingredient of resilience in survivors of traumas ranging from prison camps to natural disasters. So if you are an executive trying to lead an organization through change, know that hope can be a potent force in your favor. And it's yours to give.

An Emerging Hotbed of User-Centered Innovation *

Eric von Hippel

6 Most countries, developing and developed alike, view innovation as a vital input to their economic growth and spend varying portions of their national budgets to support it in companies and research labs, for the ultimate benefit of essentially passive consumers. Denmark is taking a different tack: It's making "user-centered innovation" a national priority.

Living with Continuous Partial Attention

Linda Stone

7 "Continuous partial attention"–distinct from multitasking–is an adaptive behavior that presumably allows us to keep pace with the never-ending bandwidth technology offers. Now there are signs of a backlash against the tyranny of tantalizing choices.

Borrowing from the PE Playbook

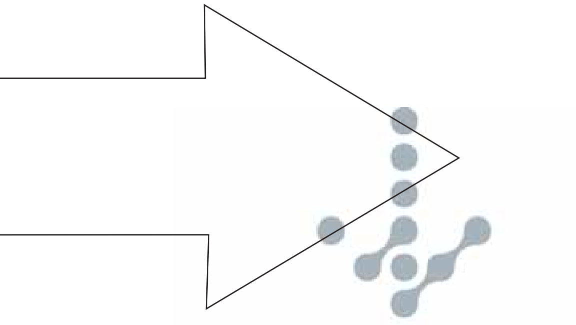
Michael C. Mankins

8 Company coffers are overflowing these days, and inevitably executives are turning to the M&A markets in their quest to put the cash to good use. If they're to avoid repeating the disappointments of previous M&A waves, they will have to take a few leaves from the acquisition playbook of private equity firms.

When to Sleep on It

Ap Dijksterhuis

9 Use your conscious mind to acquire all the information you need to arrive at a difficult decision, but don't try to analyze it. Instead, go on holiday and let your unconscious mind digest the information for a day or two. Whatever your intuition then tells you is almost certainly going to be the best choice.



Here Comes XBRL

Robert G. Eccles, Liv Watson, and Mike Willis

10 A new software standard for financial and business reporting, soon to be adopted by the U.S. Securities and Exchange Commission, will make it dramatically easier to generate, validate, aggregate, and analyze business and financial information–which in turn will improve the quality of the information companies use to make decisions.

Innovation and Growth: Size Matters *

Geoffrey B. West

11 Newfound general mathematical relationships between population size, innovation, and wealth creation challenge the conventional wisdom that smaller innovation functions are more inventive. They may explain why few organizations today have matched the creativity of a giant like Bell Labs in its heyday.

Conflicted Consumers

Karen Fraser

12 Your customer data indicate strong consumer satisfaction: Repeat purchase levels are high, and many customers have been with you for years. Good news, right? Well, appearances can be deceptive. Buried in the data may be a "stealth" segment of apparently loyal customers whose ethical concerns make them ready to bolt as soon as an alternative emerges.

What Sells When Father Knows Best

Phillip Longman

13 The link between conservatism and fertility is found throughout the world, and it portends a comeback for patriarchy and other traditional values. Business leaders must learn how to profit from, or at least prepare for, this trend.

Business in the Nanocosm

Rashi Glazer

14 Though the scientific and technological revolution that may occur as a result of nanotechnology has been much discussed, the sociocultural and business implications are of potentially much greater impact. Nanotechnology may change society over the next few decades just as much as information technology has over the previous few–and in ways that are still hard to grasp.

Act Globally, Think Locally *

Yoko Ishikura

15 Companies are usually told to "think globally and act locally." But thanks to their own global information systems and the Internet, knowledge from faraway places can be acquired relatively easily and cheaply. This means that firms have to discover and quickly incorporate good ideas from these diverse sources before their rivals do.

Seeing Is Treating

Klaus Kleinfeld and Erich Reinhardt

16 When several technologies can be leveraged simultaneously, the possibilities for real breakthroughs in medical care multiply. That is occurring today with the convergence of imaging technology and biotechnology, which promises to radically change the diagnosis and treatment of many chronic diseases, greatly benefiting both patients and the companies that serve them.

The Best Networks Are Really Worknets *

Christopher Meyer

17 The assumption is that if you build a network platform, people will come. If you expect to get real value from your initiative, though, you must think hard and in advance about exactly what function you want the network to perform. That will help you choose the participants, the nature of their experiences, and the technology. In other words, put the *work* in "network" first.

Why U.S. Health Care Costs Aren't Too High

Charles R. Morris

18 Contrary to popular belief, health care costs, broadly defined, are quite probably falling. It is *spending* that is rising, which is not the same thing at all. The benefits of health care for individuals, society, and the economy–such as getting people back to work faster–more than outweigh its direct costs.

In Defense of "Ready, Fire, Aim"

Clay Shirky

19 The bulk of open source projects fail, and most of the remaining successes are quite modest. Still, open systems are a profound threat to many businesses, not only because they outsucceed commercial firms but, more important, because they outfail them.

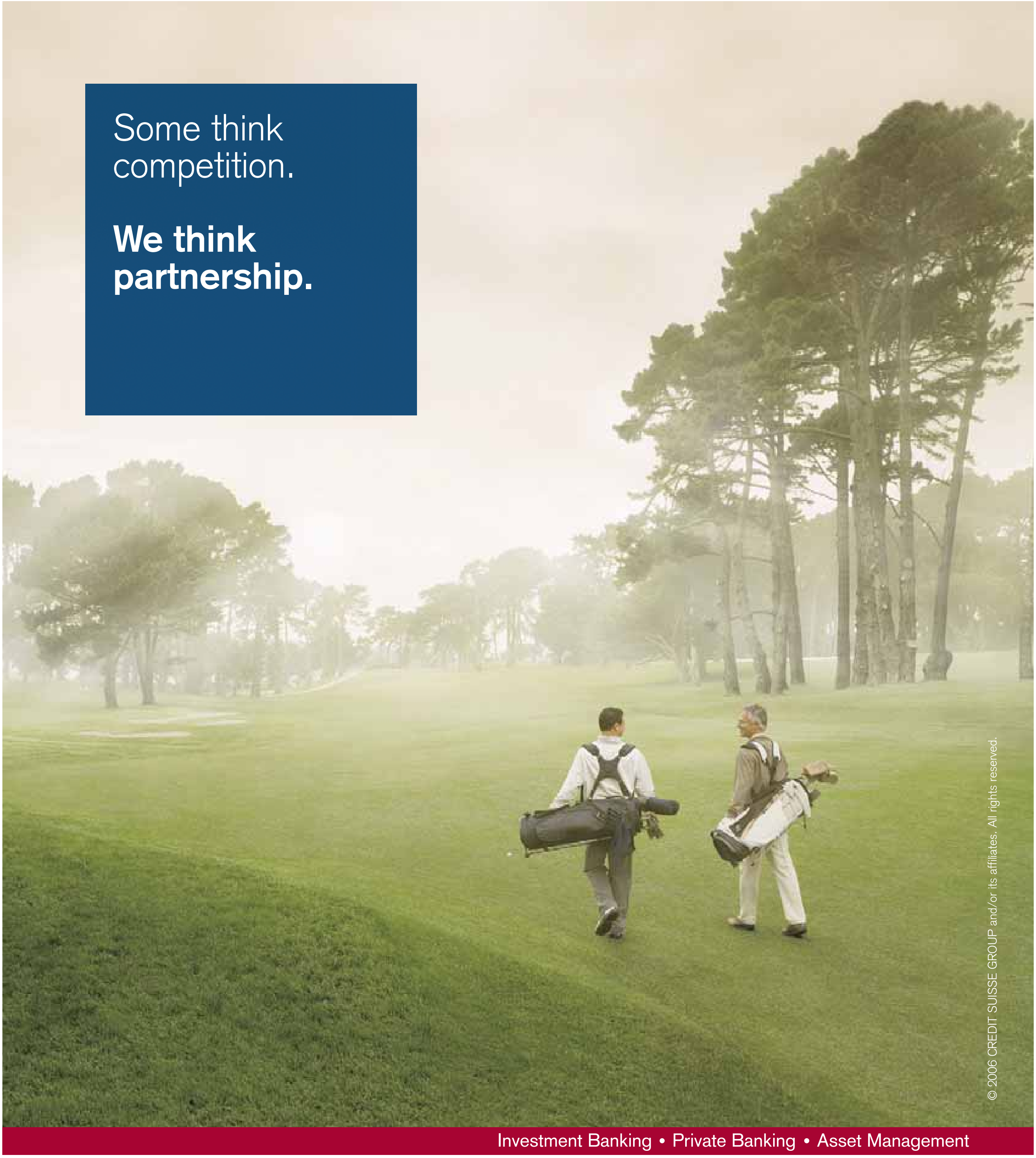
The Folly of Accountabalism

David Weinberger

20 Accountability has gone horribly wrong. It has become "accountabalism," a set of related beliefs and practices that bureaucratize morality and make us believe we can control our lives by adhering to specific rules. But grown-ups prefer clarity and realism to happy superstition.

* Copresented by *Harvard Business Review* and the World Economic Forum

Harvard Business Review WORLD ECONOMIC FORUM


Some think competition.
We think partnership.
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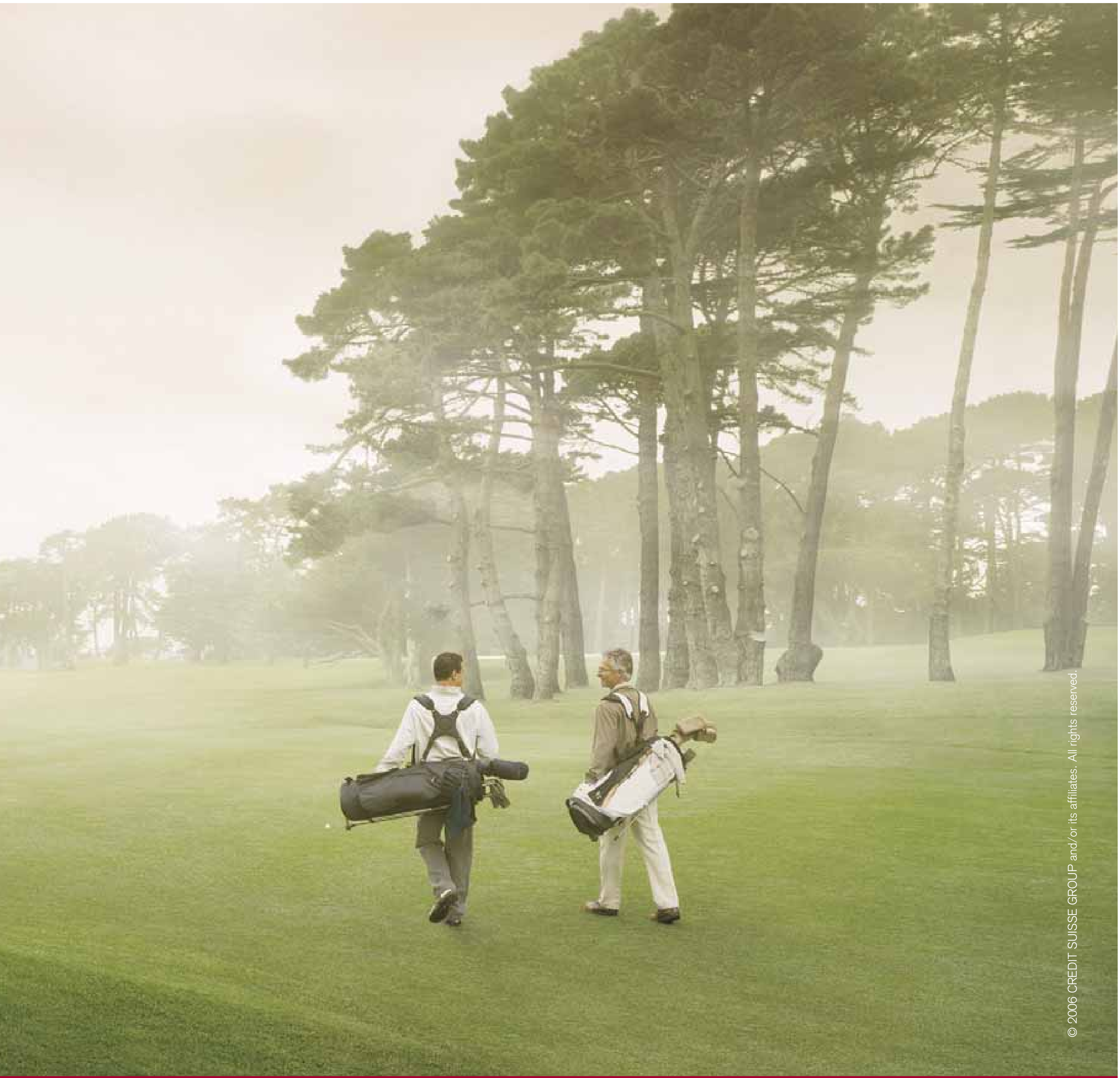

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And as an increasing share of all children is descended from people whose conservative values have led them to raise large families, we see the emergence of societies in which the patriarchal and highly pro-natal values of the Abrahamic religions are dominant.

So what caused the rise of liberal secularism in the first place? Patriarchy, as it has traditionally manifested itself, requires a man to marry a "respectable" wife and to take responsibility for the children she bears him. In part because of these obligations, traditional patriarchy is unappealing to many men. Similarly, many women take issue with the roles a patriarchal society prescribes for them. When broad swaths of the population come from something other than a conservative upbringing – as they did in the 1960s and 1970s – patriarchy's constraints on personal freedom can seem excessive to men and women alike. Then gender roles relax,

Patriarchy always makes a comeback, because its adherents put more genes and ideas into the future than do their secular counterparts. This process is already well under way in the United States.

birthrates fall, and patriarchy goes into retreat.

But patriarchy always makes a comeback, because its adherents put more genes and ideas into the future than do their secular counterparts. This process is already well under way in the United States. For example, among American women just now passing beyond reproductive age, nearly 20% are childless and almost as many have only one child. Consequently, a relatively large share of the next generation is descended from a comparatively narrow and socially conservative segment of society that places a high value on reproduction. Today we see a culture in which social conservatives and the religious-minded play a far greater role than they did forty years ago.

How can business leaders profit from – or at least prepare for – this trend? Businesses that have relied on sex to sell products, or whose products otherwise distract young people from the straight and narrow, should perhaps think twice about brazenly touting, say, sexually explicit or violent films and video games, which could provoke boycotts or outright bans. Rock and hip-hop; licentious celebrities; rootless, childless urban professionals; and other such fixtures of today's marketing campaigns could come to be seen as relics of a decadent past.

Meanwhile, as occurred in the nineteenth century (a similarly conservative period), the political left will probably shed many of its current causes and campaign for a "family wage" sufficient to allow a man to support his children. Employers will find it harder to lure women out of the home and into the workplace, simply because so many of them, having absorbed the pervasive cultural norm, will embrace motherhood and home life. Already the percentage of American women with small children and jobs outside the home is declining.

The new patriarchal family will value products and services that allow fathers to stay home as well. One example is eBay, which drastically lowers the barriers to running a home business. A combination of nanotechnology and biotechnology may allow millions of households to produce large amounts of the food, energy, and manufactured products they currently acquire from the global economy, thus restoring the traditional home-centered economic basis of the patriarchal family.

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TECHNOLOGICAL CHANGE

Business in the Nanocosm

14 The scientific and technological revolution that may occur as a result of nanotechnology has been much discussed. Generally unappreciated so far, but of potentially much greater impact, are the sociocultural and business implications. Nanotechnology may change society over the next few decades just as much as information technology has over the previous few – and in ways that are still hard for our minds to grasp.

Nanotechnology is distinguished from other forms of technology, past and present, by the infinitesimal size of the materials involved (less than 100 nanometers wide) and by its method of operation. Conventional manufacturing carves or distills a purpose-suited device from a mass of raw materials. Nanotechnology, like nature, assembles objects atom by atom, following a design that calls for only what is needed: a place for every atom and every atom in its place. This method of constructing objects (which themselves do not have to be small) will reshape the future not only of manufacturing but also of distribution, retailing, and the environment.

Because conventional manufacturing begins with large and unformed inputs, it needs scale, and economies of scale push factories to become larger and more centralized. If, however, man-

Nanotechnology, like nature, assembles objects atom by atom, following a design that calls for only what is needed.

ufacturing is "additive" (assembling products atom by atom) rather than "subtractive" (distilling them from a mass of materials), factories can be quite small – small enough to be no more than a set of tiny machines and production blueprints – and can be operated almost anywhere. The marginal production costs of these factories should approach zero, and their production processes should create no pollution or waste.

These developments also challenge accepted notions of the economic place of durables – products with a shelf life independent of their utilization. At present, much economic activity amounts to providing "permanent" solutions to ephemeral problems. Thus, the plastic cover placed on a Starbucks cup solely to prevent the purchaser from spilling the scalding contents is of no use whatsoever to a stationary consumer once the brew cools off. Thanks to nanotechnology, however, many products would endure no longer than the need that gave rise to them.

Industrial or business-to-business markets are likely to embrace this technology first, given their quest to reduce costs throughout the value chain, which they could accomplish by eliminating several of its links. Already what are called synthesizers, assemblers, or automated fabricators have been developed to create items, such as prosthetics, using nanotechnology's additive approach. In the next few decades, we may see the domestic, user-friendly successors to these machines – personal manufacturing units, or PMUs – become standard home appliances.

Consider this scenario: In preparing for a dinner party the following day, a couple decides to create a new set of dishes. They sit down at the console of the family PMU (essentially a keyboard, a display screen, and a manufacturing chamber containing the atoms to be assembled). Working with design software (the manufacturing blueprints), they input the instructions and watch as the atoms in the chamber are organized into plates, bowls, and cups. Since the number of atoms used to manufacture the dishes is the same as the number composing them, all the costly steps—extraction or collection of raw materials, transportation, transformation, waste disposal—that currently precede a product's use or consumption are eliminated.

Ever since Adam Smith laid out their essential characteristics, market economies have been understood to rest on specialization: Individuals are producers of one thing and consumers of everything else. In what is sometimes called the nanocosm, by contrast, consumers could become the sole producers of finished products of all kinds. Consequently, they would continually evaluate whether to make or buy. We are all aware of the decentralizing and personally empowering effects of PCs and the Internet. By making individuals largely self-sufficient, the nanocosm would push these effects to the extreme, in essence creating a Robinson Crusoe economy.

Nanotechnology would thus hasten the trend away from manufacturing prowess and physical assets (hardware) as sources of competitive advantage. Obviously, the vast number of companies that offer durable or even disposable items would be at risk – as, ultimately, would those handling inventory and logistics or offering after-sale customer service, maintenance, and repair. In short, the ability of end users to perform for themselves functions now performed by other economic agents would wipe out large segments of the value chain.

Competitive advantage would lie in knowing the customer and designing the manufacturing blueprint and software. We might also anticipate the emergence of a new entity, midway between the traditional make-and-sell, command-and-control organization and the more modern sense-and-respond, adaptive organization. This new entity would function as a systems integrator, focusing on "menu design," component acquisition and assembly, and efficient coordination of the activities and interactions of the market-savvy designer, the PMU maker, the PMU operator, and the provider of the atomic building blocks.

Rashi Glazer is a professor of marketing at Haas School of Business at the University of California, Berkeley, and a codirector of the Center for Marketing and Technology.

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KNOWLEDGE MANAGEMENT

Act Globally, Think Locally *

15 Here's a paradox of our age: The more global the economy and your business, the more important location and physical proximity become. Yes, issues of location – the choice of a factory site, for example, or the tailoring of a marketing message to a region – have always been of strategic importance. However, the conventional emphasis has been on how location affects a company's costs and revenues. In today's knowledge-based economy, we need to reevaluate the very concept of location.

Advances in communication technology have enabled – indeed, require – companies to tap into local information that they can use throughout their businesses. Managers increasingly understand the importance of drawing on diverse sources of information, especially from outside the organization, to spur innovation. For example, ideas that used to emerge from a company's central lab may now be offered up by researchers far from the home office – or by a lone inventor living in a village halfway around the world. Thanks to the Internet and companies' global information systems, businesses can acquire such ideas from out-of-the-way places relatively easily and cheaply. For that reason, though, companies must discover and quickly incorporate good ideas from these diverse sources before their rivals do. In fact, they have less time than ever before to take new ideas to market.

This trend reverses a familiar adage: Whereas companies used to be told to "think globally and act locally," adapting their global strategy to the needs of a particular locality, they must now "act globally and think locally," harvesting knowledge from various localities and using it to shape their global strategy.

The importance of location in a knowledge-based economy isn't only about far-flung places; it's also about those places right outside your door. That's because another way of tapping diverse sources of knowledge is to draw on people and organizations in your vicinity. Unlike the explicit knowledge that can be gathered and transmitted digitally from anywhere in the world, tacit knowledge – which is difficult to codify and, consequently, has great value – can be shared only through repeated interactions, which are usually face-to-face. This, obviously, requires physical proximity. Even in the digital age, the many interactions that take place in the open and flexible networks linking a company, its suppliers, and its professional-service providers are more effective and efficient within physically proximate regions. Think of the decentralized social networks that fostered both competition and cooperation in Silicon Valley, making it a fertile seedbed of innovation. At the very least, a personal encounter is usually required to start a meaningful discussion that will lead to clear decisions and useful outputs. Once the physical meeting takes place, meetings in virtual space can follow – but the reverse order often doesn't deliver results.

In the early 2000s, many Japanese manufacturing firms moved their production plants to China in order to take advantage of lower labor costs. Over time, they realized that some activities, such as exchanges between the production-engineering and manufacturing departments, weren't proving effective – for example, the desired product specifications couldn't be achieved – when the departments were physically separated. There was just too much subtle back-and-forth that needed to occur in person. Partly because of this, some of the companies have moved some of their manufacturing processes back to Japan.

It isn't always easy to know which activities have to be close together geographically. Figuring it out can involve considerable trial and error, as well as constant review to determine when the scope of tacit knowledge – and therefore the necessity of interaction – changes.

Companies today need both global reach, in order to spot useful local ideas and incorporate them into strategy, and physical proximity, in order to effectively tap sources of tacit knowledge and thus sustain competitive advantage. For both, location matters.

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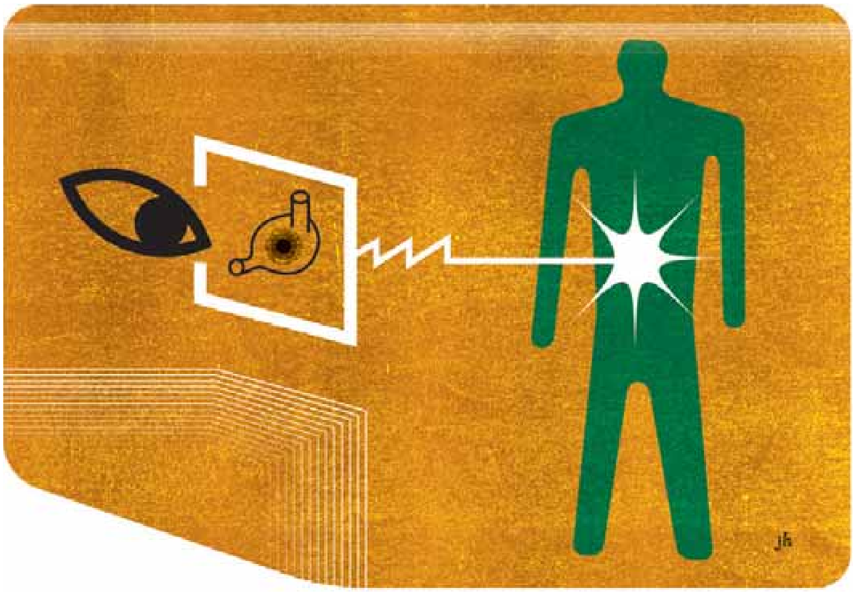

EMERGING TECHNOLOGY

Seeing Is Treating

16 Health care often advances hand in hand with technology. When several technologies can be leveraged simultaneously, the possibilities for real breakthroughs in care multiply. That's occurring today with the convergence of imaging technology and biotechnology – enabled by advanced health care information technology – which promises to radically change diagnosis and treatment for many chronic diseases. Like other technological convergences in our digital and granular world, this one will redefine industry boundaries and inextricably link distinct businesses.

Clearly, early detection of disease saves lives by allowing for more treatment options. Imaging technology now enables a radiographer to see small growths and nodules in, for instance, a patient's liver or lungs. But imaging is performed only if clinically indicated; no patient without symptoms would be prescribed an exam. For this reason, the full potential of early detection can be realized only when in vivo imaging technologies are combined with in vitro laboratory diagnostics. The challenge today is to determine whether patients are at risk for cancer; to regularly screen them if so; and, if growths are discovered, to precisely determine which are potentially cancerous and what type of cancer they could become.

That's where biotechnology comes in: It allows us to go deeper into disease discovery and faster into treatment. Traditionally, doctors determined a nodule's potential for malignancy from its shape and then performed an invasive and often painful biopsy – which sometimes required hospitalization and created delays in treatment. Thanks to molecular diagnostics research, tests of a patient's blood or tissues can reveal risks for and perhaps determine the presence of prostate and other cancers, thus pointing the physician toward monitoring, investigation, or treatment. Researchers can also create molecules that will attach themselves only to specific tumors; when these molecules are combined with a marking agent, advanced imaging technology can use them to discover which tumors are growing, how large they are, and even their precise location.

Biotechnology's real promise lies in the increased potential for combining diagnosis and treatment. The biomarkers just described could, for instance, have a serum attached, or could be used to switch off the tumor's angiogenesis receptors, stopping growth in its tracks. In a similar way, radiation therapy could be carried directly to the tumor, minimizing damage to adjacent healthy tissue. Intelligent IT tools would help physicians compile and manage the data gathered through all these tests to improve patient care and safety.

Such high-tech methods of diagnosis and treatment would not necessarily be simpler than current methods, but they would have a higher success rate and would certainly be easier on patients. And because patients would be cured earlier, before they needed specialized care, survival rates would improve and health care costs would be reduced. In short, the convergence of imaging and biotechnology can improve the quality of health care, the delivery of health care, and the operational and financial performance of both health care providers and medical technology companies.

Klaus Kleinfeld is the president and CEO of Siemens, a global technology and infrastructure conglomerate based in Munich. **Erich Reinhardt** is the president and CEO of Siemens Medical Solutions, based in Erlangen, Germany, which provides solutions in medical imaging, health care information technology, and clinical diagnostics.

ORGANIZATIONS

The Best Networks Are Really Worknets *

17 An unruly nebula of concepts is floating around the business world right now – social webs, open innovation, customer-created content, and more – all exploring one big question: Now that we see the power of human networks, how can we use them to produce value? Applications ranging from InnoCentive, Eli Lilly's network for solving scientific riddles, to Internet

Based Moms, a Web site where work-at-home moms can seek and share advice on starting Internet businesses, prove the point that many heads are better than one. But up to now, network-building efforts have been hit or miss. Our desktops are littered with passwords to communities that no longer exist.

It's too early for a general theory of human networks, but some practical guidelines have emerged from the first few years of experience. Fundamentally, the key to getting payback on investment in a network is to think hard about exactly what kind of value you want the network to create. In other words, you must put the *work* in "network" first.

Networks lend themselves to at least five basic tasks. They can *scan* the horizon, as the Global Business Network does, for events and patterns with implications for corporate strategy. They can help to *solve* problems: InnoCentive does this by posing problems to a far-flung population of scientists. A network can *innovate* for its own benefit. Members of the Polycom User Group, for example, seek new ideas for using Polycom's conferencing products by interacting with other users and by sharing best practices. Networks can be used to exert *influence:* It was only when researchers experiencing errors with the Pentium microprocessor banded together that Intel took the issue seriously. And a network can efficiently *allocate* resources. The staffing company Aquent uses its substantial network to match marketing and communications professionals with projects that need them.

Because networks perform diverse functions, they require diverse forms. By first defining the most important work you want your network to perform – scan, solve, innovate, influence, or allocate – you'll be able to design your "worknet." (See the exhibit "Designing a Worknet" for an analysis of how two networks were constructed to serve their purposes.)

Defining the work first will help point you to the talent your network needs to do its job. It will also guide you in engineering the exchanges among the network's members. No one willingly devotes time and energy to an endeavor without seeing benefits in return; in a well-designed network, the benefits being exchanged are not just economic but also informational and emotional. These three forms of exchange need to be balanced so that both the host and the member feel they have made a fair transaction. That balance may vary greatly for members of different kinds or in different roles. The teenagers who were participating in the worknet of one consumer-products company were there to gain insider status; the professional sociologists and anthropologists were there to learn; and the sponsors were looking for more-effective selling messages.

Designing an appealing experience for members is another important step in constructing a sustainable network. This, too, can be guided by the network's function. For example, will the work be best accomplished through physical interactions, virtual interactions, or a combination of the two? Networks have a particular intensity and rhythm; for any given network to persist, its sponsor must manage this heartbeat continuously.

The right time to decide on and implement the technology of the network – something often mistakenly treated as the first step – is only after the work has been defined, the right kinds of people identified, and the nature of the exchanges and experience carefully considered. After all that, it may be evident that the appropriate "technology" is not Internet-based; a series of events or some other enabler of ongoing communication might be better.

Designing a Worknet

Both Facebook, a site for socializing students, and Procter & Gamble's Vocalpoint, which promotes word-of-mouth marketing among moms, are successful, but their purposes are served in very different ways.

	Define the Work	Identify the Talent	Engineer the Exchanges	Design the Experience	Assemble the Technology
	Decide on the purpose: scan, solve, innovate, influence, allocate…other?	Ensure the right diversity of knowledge, disciplines, cultures, demographics, and personalities	Balance the economic, informational, and emotional rewards for all participants	Create an environment – physical and virtual – that supports the exchanges	Exploit leading-edge technology – but not for its own sake
Facebook	Enable students to form relationships and maintain circles of friends	Students only	*Economic:* none *Informational:* "who's who" and "what's happening" awareness *Emotional:* new and deeper friendships	Simple interface based on the "wall" and the news feed	Web-based with no new functionality required
Vocalpoint	Create consumer awareness of and demand for new products	Women with kids	*Economic:* Product samples and discounts *Informational:* Insight into new products *Emotional:* Pride of being "in the know," respect from having one's voice heard	Clean, bright design and chatty content	E-mail distribution Web-based surveys and chat Live "Coffee Talk" meetings

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The steps in designing a valuable network have a logical sequence, but note that a bad bet at any point in this five-horse parlay can ruin the entire venture. The founders of Facebook, a network to enable students to make and manage their social contacts, learned this lesson in the summer of 2006, when they moved to allow nonstudents access to the network in order to create the possibility of greater ad revenues. Core members considered this an invitation to stalkers and staged a revolt.

Usually, network initiatives screw up less spectacularly. In classic "build it and they will come" fashion, networks are launched as technology-led platforms and come to be populated by arbitrary collections of people. Some members linger and some leave, depending on how they perceive the benefits. In rare cases, value emerges for the network's host. Even more rarely, it's value of the kind that was sought. The odds of getting that value from a network are exponentially higher when you put the work first.

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POLITICAL ECONOMY

Why U.S. Health Care Costs Aren't Too High

18 There is nearly a consensus that American health care is careening toward fiscal catastrophe. Reasonable estimates of unfunded health care liabilities are sky-high. But the belief that health care costs threaten to wreck the U.S. economy is misguided.

In the first place, procedure by procedure, those costs are quite probably *falling*. It is *spending* that is rising, which is not the same thing at all. The advent of minimally invasive techniques means that, for example, the cost of a gallbladder operation has dropped substantially, and the patient can usually return to work the next day instead of sitting at home for a week. But because many more people are now willing to undergo the surgery, total spending is up. It's the same story with all kinds of medical care, from hip replacement to the treatment of depression. In other industries, falling prices and added features have similarly led to big increases in spending – on PCs, cell phones, and video games, for example – but we call that a productivity triumph, not a "cost" problem.

Three-quarters of health care spending goes toward people who are very sick. Yes, interventions are sometimes overdone, but doctors don't know in advance which of their patients are going to die, and the great majority of very sick patients recover. Over the past thirty years, the death rate from heart attacks has plummeted, so millions of heart attack survivors are now going to work or playing with their grandchildren. And, of course, successful health care always breeds more spending: The people who used to die of heart attacks now live on to consume expensive medications, visit specialists, and contract cancer or Alzheimer's. Does that mean we should stop saving heart attack victims?

Besides, one person's spending is always someone else's revenue. Explain to GE Healthcare ($15 billion in revenues, 45,000 employees, sales in 100 countries) why rising health care spending is a bad thing. The profile of Medtronics – in the areas of growth, profitability, and R&D spending – closely tracks that of Intel ten years ago. Modern operating rooms boast millions of dollars' worth of equipment, and the vendors include global corporate giants and tiny start-ups.

Health care is now, by most measures, America's largest industry and biggest private employer, as well as a major source of competitive advantage for the United States. Health care's growing share of GDP, moreover, is entirely in keeping with historical trends. A hundred and fifty years ago, agriculture accounted for about half of GDP; it accounts for only 3% now. Fifty years ago, a third of the workforce was in manufacturing, but only 10% is now, although real American manufacturing output is currently far higher. Simple economics is driving health care's expansion: As a society grows richer, the marginal value of one more toy inevitably pales in comparison with another year of life in which to enjoy all one's toys.

Without a truly radical adjustment in health care spending patterns, which

…sometimes, all it takes is a little inspiration.

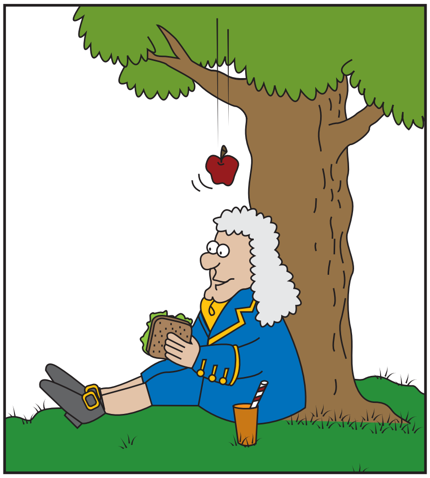
This psychology of individualism is what large businesses will also have to capture if they are to be innovative and competitive in future world markets. High performing large corporations are responding to these changing expectations by re-designing their operating structures. They are transforming their cultures, built upon new-style leadership patterns and abandoning outmoded, 20th century management practices with their stifling emphasis on conformity and compliance. In short, large corporations are imitating the practices of smaller entrepreneurial firms rather than vice versa.

It is in response to this that the world's top business schools are re-defining their executive programmes. Their priority is now to leverage leadership potential; a task that is far more demanding than merely developing management skills. High performing leadership requires self-understanding, empathy and intuition. Only then is it possible to act as coach, mentor and role model to younger colleagues.

This kind of leadership also assumes self-confidence since without this, it is impossible to take risks, make tough decisions and impose a sense of vision upon a large company. These are the qualities the ipod generation expects from its bosses. It expects them to behave as baseball or soccer team coaches; as leaders that will bring out their individual talents to the full but within teams that are committed to achieving a common goal.

Parallel changes are occurring in the field of science and innovation. A UK Department of Trade & Industry study[1] shows that in terms of how science is organised, the success of many Open Source development projects demonstrates that talented people do not need traditional career structures to be creative. And the process whereby North America and Europe sucked in the world's top talent via what has become known as "Brain Drain" is being replaced with what could be called "Brain Circulation", whereby real or virtual teams are assembled in a range of countries. These include the UK, ranked in the top three locations globally for eight scientific disciplines including biological; business; environmental; clinical; pre-clinical and health; social sciences; humanities; and mathematics[2].

It is unlikely that any of these changes would have occurred so swiftly without the dynamic growth of the BRIC economies. These have created a remixed global environment. This offers unprecedented opportunities for companies in the older developed economies who are prepared to embrace 21st century business models and adopt multi-cultural in place of national, parochial mindsets. What is particularly exciting about these developments is that the communication and technology revolution offers just as many global market opportunities for smaller firms as it does for the world's great multinational corporations.



Smaller global firms are now joining their larger counterparts in taking advantage of the advice and services of UK Trade & Investment, the UK Government's international business development organisation which supports businesses seeking to establish in the UK and helps UK companies to grow internationally. With UK Trade & Investment's help, many are meeting the challenges of the Age of the Entrepreneur.

For an insight into some of the key corporate challenges and priorities in 2007 and beyond, and to access the Economist Intelligence Unit's flagship business survey, CEO Briefing 2007, sponsored by UK Trade & Investment, simply click onto **www.ukinvest.gov.uk/ceobriefing**

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1. DTI Sigmascan 288 available from www.sigmascan.org 2. Evidence Limited, 2006

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 **19** 20

there is no reason to expect, demographics alone will drive health care's share of GDP – now 16% – to as high as 25% to 30% over the next couple of decades. In purely economic terms, that would not be a bad thing. Indeed, in terms of trade balances and international competitiveness, it might be a positive development. And even at very modest levels of overall economic growth, people could still increase their spending on cosmetics, video games, and other fun things, although perhaps a tad more slowly than they do now. In short, at least for the foreseeable future, health care in the United States is an economic, a societal, and an affordable good.

To be sure, there are serious problems of waste in health care, just as there are in investment banking, the media, and most other industries. Better oversight may be the answer, but it will be the work of decades. In the meantime, the challenge is one of *financing,* not affordability. The current primary financing mechanisms – employer-based insurance and Medicare – are clearly breaking down. And privatization is an unrealistic solution: While it may, barely, be feasible to privatize old-age pensions (the savings shortfall is far smaller in pensions than it is in health care), privatizing both pensions and health care is a pipe dream.

Instead, in time-honored fashion, a succession of presidents and Congresses will respond to the challenge with a mix of cuts and patches. Spending will keep on rising, and it will continue to shift toward government accounts. Taxes will go up after a lag, and everyone will lie about it. Over time, some highly imperfect but tolerable new accommodation will emerge. Elegant it won't be. That's just the way we do things.

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INNOVATION

In Defense of "Ready, Fire, Aim"

19 The open source software movement has been one of the great successes of the digital age. Open source projects such as the Linux operating system and the Apache Web server – as we learn nearly every time we pick up a business publication – have turned the efforts of a widely distributed group of programmers, who contribute those efforts free, into world-class products.

Yet when we look closely at the open source ecosystem, a very different picture emerges. For example, the world's largest open source site, Sourceforge, hosts more than 100,000 projects, and its most popular software is downloaded tens of thousands of times daily. But most projects have never broken a hundred downloads, and more than half are simply inactive: A project was proposed, but nothing happened.

If the vast majority of open source projects are failures, has the press been wrong to emphasize the movement's few successes? The answer is – obviously and measurably – yes. So can businesses that face seemingly formidable competition from existing or future open systems breathe easy? Absolutely not. Open systems are a profound threat not only because they outsucceed commercial firms but also because they out*fail* them. They grow not in spite of failure but because of it.

In traditional business, trying anything is expensive, even if only in staff time spent discussing the idea; so some advance attempt to distinguish the successes from the failures is required. Even at firms committed to experimentation, considerable effort has to go into reducing the likelihood of failure. And because green-lighting ideas that turn out to be failures will be noticed more than killing radical but promising ones, many people err on the side of caution.

In open systems, by contrast, the cost of failure is reduced, partly because less coordination is required among the various players and partly because each player is willing to accept some of the risks of failure directly. This means that worrying about whether a new idea will succeed is unnecessary; you simply try it out. The institutional barrier between thought and action – the need to convince someone that your idea is worth giving a whirl – doesn't exist. The low cost of trying means that participants can fail like crazy as they continue to build on their successes.

In systems where anyone can try anything, the good has to be filtered from the bad after the fact. The cost of trying to prevent bloggers from saying stupid or silly things, for example, would be high, whereas the cost of allowing anyone to publish anything is low. As a result, filtering services like Technorati have been created to provide guides to what's worth reading; these work the way Google does, judging an individual blog post not according to the quality of its content but according to how often other blogs link to it. If all blogging had to be filtered in advance, the practice would never get off the ground; unfiltered, it would fall to earth. The middle way – publish and *then* filter – keeps the enterprise aloft.

This model is spreading outward from software and media. Meetup.com is a site designed to help users find people with shared interests and arrange meetings in their communities. The most active groups on Meetup right now consist of stay-at-home moms, known as SAHM. These groups are particularly popular in largely suburban metro areas like Atlanta and Houston, where such moms, driving in isolation from one destination to another, are unlikely to meet by accident. Meetup's founders are overeducated, undermarried urbanites. So how did they know that SAHM groups would be such a hit? They didn't. They simply let users propose potential Meetup groups. The majority of proposed groups in fact fail, and most of the rest have moderate

success only. A few, though, like SAHM, are very popular – the same pattern found among open source projects.

This presents a conundrum for business. Clearly, firms can't just start trying everything. Management overhead is real, and the costs of failure can't simply be laid at employees' feet. As a result, open system–like innovation must necessarily continue independent of any firm's ability to either direct or capture all of the value. Some companies' product lines or employee structures may not allow radical experimentation, but smart managers will look for ways to take advantage of this sort of broadly distributed effort. In environments where organizations can reduce the cost of failure by farming out a problem to individuals – who may be induced to participate solely by the chance to learn new skills or to gain the respect of peers – we can expect open systems to make increasing inroads into standard commercial efforts.

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GOVERNANCE

The Folly of Accountabalism

20 Accountability has gone horribly wrong. It has become "accountabalism," the practice of eating sacrificial victims in an attempt to magically ward off evil.

The emphasis on accountability was an understandable response to some god-awful bookkeeping-based scandals. But the notion would never have evolved from a buzzword into the focus of voluminous legislation if we hadn't also been lured by the myth of precision: Because accountability suggests that there is a right and a wrong answer to every question, it flourishes where we can measure results exactly. It spread to schools – where it is eating our young – as a result of our recent irrational exuberance about testing, which forces education to become something that can be measured precisely.

When such disincentives as the threat of having to wear an orange jumpsuit for eight to ten years didn't stop the Enron nightmare and other bad things from happening, accountabalism whispered two seductive lies to us: Systems go wrong because of individuals; and the right set of controls will enable us to prevent individuals from creating disasters. Accountabalism is a type of superstitious thinking that allows us to live in a state of denial about just how little control we individuals have over our environment.

Accountabalism manifests itself in a set of related beliefs and practices:

It looks at complex systems that have gone wrong for complex reasons and *decides the problem can be solved at the next level of detail.* Another set of work procedures is written, and yet more forms are printed up. But businesses are not mechanical, so we can't fine-tune them by making every process a well-regulated routine. Accountabalism turns these complex systems into merely complicated systems, sacrificing innovation and adaptability. How can a company be agile if every change or deviation requires a new set of forms?

Accountabalism *assumes perfection* – if anything goes wrong, it's a sign that the system is broken. That's not true even of mechanical systems: Entropy, friction, and manufacturing tolerances ensure that no machine works perfectly. Social systems are incapable of anything close to perfection, so if something goes wrong in one, that need not mean the system is broken. If an employee cheats on expenses by filling in taxi receipts for himself, the organization doesn't have to "fix" the expense-reporting system by requiring that everyone travel with a notary public.

Accountabalism *is blind to human nature.* For example, it assumes that if we know we're being watched, we won't do wrong – which seriously underestimates the twistiness of human minds and motivations. We are capable of astounding degrees of self-delusion regarding the likelihood of our being caught. Further, by overly formalizing processes, accountabalism refuses to acknowledge that people work and think differently. It eliminates the human variations that move institutions forward and provide a check on the monoculture that accounts for most disastrous decisions. It also makes work no fun.

Accountabalism *bureaucratizes and atomizes responsibility.* While claiming to increase individual responsibility, it drives out human judgment. When a sign-off is required for every step in the work flow, those closest to a process lack the leeway to optimize or rectify it. Similarly, by assuming that an individual's laxness caused a given problem – if so-and-so hadn't been asleep at the switch or hadn't gotten greedy or hadn't assumed that somebody else would clean up the mess, none of this would have happened – accountabalism can miss systemic causes of failure, even, ironically, as it responds to the problem by increasing the system's reach.

Accountabalism tries to squeeze centuries of thought about how to entice people toward good behavior and dissuade them from bad into simple rules by which individuals can be measured and disciplined. It would react to a car crash by putting stop signs at every corner. Bureaucratizing morality or mechanizing a complex organization gives us the sense that we can exert close control. But grown-ups prefer clarity and realism to happy superstition.

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Reprint R0702A
To order, see page 158.

Conventional wisdom would tell you small farms can't operate as efficiently as large ones. But in Poland, Cargill is going beyond the conventional to help small livestock farmers compete. Large farms in Europe have traditionally had the advantage of feed delivery services while small producers must travel to dealers to buy the few bags they require. So Cargill worked with feed dealers to bring the store to the farm, on trucks that efficiently deliver small feed orders on a regular schedule. The dealers get new customers and farmers get service they never thought possible. This is how Cargill works with customers.

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Daniel Vasconcellos

Off-Ramp – or Dead End?

Another 60-hour workweek, another school play missed – and now, another delay in a long-awaited promotion. Is it time to chuck it all?

by Sharman Esarey and Arno Haslberger

CHERYL JAMIS LEANED BACK in her Italian leather chair and gazed out her corner office window, watching glints from the setting sun strike the Mersey River. In just a few moments, she would meet with Marcus Addison, her boss, and she did not know what to do. Should she resign? Should she force the company's hand by issuing some grand ultimatum? Or should she leave it all be for now and assume some opportunity might arise down the road that would let her spend more time with her daughter, Emma? After all, she still loved her job.

At least she would finally get some clarity about the promotion Marcus had mentioned several times. Then she would know what her options were.

Her stomach knotted as she thought about this past weekend, when she had narrowly averted another child care crisis. Frauke, Emma's beloved German au pair, was called to Hamburg suddenly because of an illness in the family. Fortunately, Cheryl hadn't had any urgent work commitments over that weekend, and since her husband, John, was traveling, she and Emma had spent an enjoyable couple of "girls' days" together.

HBR's cases, which are fictional, present common managerial dilemmas and offer concrete solutions from experts.

"Mummy, I wish you didn't work," Emma had sighed. "We could be together all the time."

Cheryl had stroked Emma's soft hair tenderly. "I need to work, darling. Someday you'll understand."

The experience had made Cheryl realize how much she missed her little girl. When Monday morning came, she vaguely resented leaving Emma in the company of her grumbling Gran, who had come up from London to take care of her until Frauke returned.

Cheryl sighed and swiveled the chair back and forth with her feet. Ah well, she thought, everything would get back on track soon. Or not. A pity that the child care panic hadn't brought her any closer to a decision about her future.

She started to think back to how she had come to this pass after spending the better part of a decade at a company she was so passionate about.

The Juggler

Cheryl was the top account manager in a boutique advertising agency when Copro courted and won her. A respected casual-wear retailer and the sole marketer of the sought-after Smitty jeans brand, Copro hired Cheryl to run an in-house marketing team and help launch a new clothing line to appeal to younger, hipper customers. For her part, Cheryl was glad to get away from the dizziness of agency work, and she welcomed the status that came with heading up a group of talented designers, writers, and media specialists.

The marriage was a happy one. Cheryl's ambition, ideas, energy, and enthusiasm were just what the marketing department needed. After one of her television spots – featuring a sexy young woman riding bareback in her new Smitty jeans – won a coveted Olie award, a beaming Marcus had presented her with a bottle of champagne from Derek Lee, the CEO. "Keep up the great work, Cheryl!" the note had said. Cheryl kept the flattering message to herself but made sure she shared the credit – and the champagne – with her team.

Cheryl enjoyed her new responsibilities at Copro, but it had been horrible at times to cope with having a young child when both she and John worked.

Cheryl had been promoted to marketing director while pregnant with Emma. At the time, Marcus had told her that the company was counting on her to come back to work, so Cheryl made sure she never missed a beat. She returned full-time when her daughter was just three months old, leaving Emma in the care of her first nanny – the one who later left Emma sitting in the grocery cart while she packed the bags into the boot of the car, then almost drove off without her.

Cheryl enjoyed her new responsibilities at Copro, and her already solid reputation grew even stronger. But it had been horrible at times to cope with having a young child when both she and John worked. A year and a half ago, when John was on a long business trip, Emma picked up a cold at school that developed into virulent bronchitis – and Frauke got sick, too. For ten days, Cheryl fed them both chicken soup, cleaned the vaporizer, and tried to work despite their coughing fits. She wasn't terribly successful.

Six months later, she asked Marcus if she could reduce her hours.

"I'm sure you think it is rather late to bring this up. Emma is already seven," Cheryl told Marcus.

Marcus nodded, his eyes gleaming sympathetically. "I don't how you manage. I couldn't work so hard without my wife's support."

Cheryl smiled ruefully. True, John hadn't been much help at home, but Frauke was a champ, and Emma got on magnificently with her. "It's not that I can't manage, Marcus. And maybe I should have gone part-time when she was smaller, but I wasn't interested then. Now that she's getting a little older, she seems to need my help more," Cheryl said.

Marcus tugged off his glasses and wiped them with the end of his tie, a nervous gesture that did not bode well for Cheryl's cause. "Cheryl, I'm not going to tell you no," he said. "You can make up your own mind, of course. But I'm advising you against it, not just as your boss but as a friend."

Marcus patted her hand earnestly. "You'll just end up working the same hours for less pay, you know. Your job is a big, responsible one. It just can't be done in four days, let alone three."

"Some of the team might benefit from additional challenges," Cheryl started, but Marcus leaned forward and cut her off.

"Cheryl, you've built a great team over the past few years. Now you're ready to focus on more strategic issues, which will be key for your next step up the ladder."

Cheryl blinked in surprise. She hadn't considered a promotion. It was flattering, of course, but it wasn't on her agenda right now – or was it? *"No,"* she told herself firmly. She'd consider it only when Emma went off to university. But since Marcus was talking about a promotion, she might try another approach and ask for flextime.

"In the past, the company has been…" she paused, searching for the right word, "*reluctant* to consider more flexibility in my current hours. Marcus,

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I wonder if that's something we might revisit."

Marcus raised his eyebrows and tipped back his chair. Cheryl thought some of the tension in the air seeped away. "What do you have in mind?" he asked.

Marcus's glasses reflected the sunlight off the river, and Cheryl couldn't see his eyes. She wondered how far to push. "Emma gets home from school by 3:00 on most days. I could come in earlier and leave earlier on a few of them." She made it a statement, not a question.

Marcus pursed his lips and tapped his fingers on the desktop. "You spend quite a bit of time guiding your team. Do you think a schedule like that is manageable?"

Cheryl mulled the question over. "Tuesdays should be OK. That's the afternoon everyone else on the team meets with their counterparts in sales and production." She paused. She had no regularly scheduled appointments on Wednesday afternoon either, but if Derek or Marcus decided to stop in, that was usually the time they picked. She sighed. Perhaps it was best to drop that one. She lowered her eyes from the view over Marcus's shoulder to catch his gaze. "Wednesdays are probably out, but I think I could arrange Thursdays. I've been holding group meetings then, but I could change them to Wednesday mornings; it'd be more midweek and might even give us an opportunity to take stock as well as to move forward."

"That's probably doable," Marcus said, a smile growing. "I can see I'm going to have to plan for some Tuesday and Thursday breakfast meetings."

He gave her a light clap on the shoulder. Cheryl stood, nodded, and left the room. The plan wasn't everything she wanted, but it was a start.

No Time for Tears

It took only a few months to realize that the small shift in hours wasn't enough.

Emma rang Cheryl on her mobile minutes before a key executive meeting where she was due to give an important marketing presentation. At the sound of Emma's teary voice, Cheryl shoved down her own anxiety and tried to keep her voice steady.

"What is it, honey? What's the matter?"

"Mum, you promised you'd come."

"Come?" Cheryl echoed, wracking her brains to remember what she must have forgotten.

"My play, at lunchtime. You told me you would be there."

Cheryl's stomach roiled. She cursed silently.

She scanned the conference room, which was rapidly filling. The executives were milling about, and there were only a few minutes left before the meeting started. There was absolutely no way she could leave now. "Honey, I'm so sorry. I forgot. I feel terrible, but I don't think I can make it there now."

"Never mind, Mum. You already missed it." Emma rang off.

"I'll make it up to you," Cheryl whispered into the dead phone. If she had a bit more courage, she would just stop negotiating with Copro and take a stand. She thought about her old friend Nancy, who had quit the ad agency and was working solo. Why not do the same?

She decided she could steal a moment to recover unobserved. In the washroom, she dragged in a deep breath and stared at her reflection. She didn't *look* like she'd just stepped into her own Bad Mother nightmare. Was it even possible to be a topflight executive and a good mother?

Cheryl sighed. It wouldn't help to berate herself further. She caught a few strands of wayward hair and fastened them back with a hairpin. Maybe she was overreacting. She had a free weekend coming up. She could take Emma to Alton Towers Theme Park for a couple of days. Yes, that was just the thing. She'd call and book a hotel room after the presentation. And perhaps HR would have some ideas about what she could do longer term.

She stared at her reflection. Was it even possible to be a topflight executive and a good mother?

Feeling somewhat better, Cheryl returned to the conference room. The assembled executives were seated. It was her turn to speak. She forced herself to concentrate and strode to the lectern.

The presentation passed in a blur. Applause followed her closing summary, and she looked up, relieved. She unplugged her computer, tucked away the laser pointer, and packed up the rest of her belongings. She sucked in her breath when she saw Derek approaching. "Good stuff, Cheryl," he said, smiling broadly. She thanked him with a grin and thought, "Just call me Superwoman."

Back in her office, Cheryl booked the hotel for the Alton Towers weekend, which helped her stop chastising herself. She basked in Derek's praise for a few moments before getting back to work.

The next day, Marcus called her in. Cheryl felt good, still buoyed up by Derek's comments and relieved that Emma was happy, too. She had babbled away over dinner about the ferocious Congo River Rapids ride at Alton Towers. And Cheryl was optimistic that HR would have some thoughts for her. She'd get right down there after speaking to Marcus.

"Well done, Cheryl," Marcus said, a big smile on his tanned face. "It was an excellent presentation and a good campaign proposal. It's fresh and original. I'm confident it'll be taken up when the board meets tomorrow."

"Thanks, Marcus," she said. "I was pleased with its reception."

"Derek was really impressed. It's your ticket into the upper echelons."

Cheryl sat up straighter; it was the second time Marcus had mentioned a promotion in recent months. She grinned at him. "Do you have something particular up your sleeve?"

He waved a hand. "Nothing concrete, but there are some possibilities that might be in the frame."

Cheryl found herself sorting through the various VP functions that might be within her reach. Such a position would be a real coup. She'd be one of a handful of women at that level. Despite Marcus's airy dismissal, she knew him well enough to believe there was something in the works.

With a bit of surprise, Cheryl realized the prospect genuinely excited her. She shook her head ruefully. If she couldn't sort out her own values and objectives, she'd never make up her mind about what to do.

It was as if Marcus were reading her thoughts. "It's a good thing you decided against the part-time option a couple months ago."

Cheryl stiffened. "It is? Why do you say that?"

He must have caught the flicker in her eye. "You know how things are, Cheryl. The company has been flexible with your working hours. But look around. There aren't many part-timers at the top of this company or any other. If a promotion is important to you, then that isn't the road." Marcus kicked back. "As it is, you're very well positioned."

Cheryl remembered Emma's sobs over the phone yesterday and wondered how well positioned she could

possibly be. HR, she repeated to herself, would have some advice.

Suddenly, Marcus whacked both hands on his desk and stood. "Listen, I've got a great idea. I don't know why I didn't think of it sooner – it's just the thing to give you some exposure and a chance to develop. I was going to go myself, but, now that I think about it, it would be perfect for you."

Smiling at the boyish grin on Marcus's face, Cheryl asked, "Whatever are you talking about?"

"Why, it's that trip to Boulder I was telling you about the other day. We need to develop our business in the United States. Copro is setting up a task force there next weekend. You can go and take my place."

Cheryl's heart thudded painfully in her chest. Next weekend was her date with Emma at Alton Towers.

"Is it a must?"

"Do you have another commitment?"

Her capital with the company was on a steep upward climb. The higher her position, the more flexibility she might be able to give herself.

"Well, I did have some plans," Cheryl said. She cleared her throat to buy time. "I suppose I could rearrange things."

"The exposure would be fantastic for you." Marcus fastened his gaze on hers. "It's a great opportunity – if you think you can manage it, of course. If not, I can still go."

Cheryl forced a smile to her face. Why could she never say no? The word was just two letters long; it couldn't be that hard to push past her lips. "Well, if you think I'd get a lot out of it, I'll do it."

Marcus smiled. "Great! That's just great. You won't regret it."

Cheryl wasn't so sure. She thought she might be regretting it already. She had no idea what she would say to Emma, and she would have to reschedule the Alton Towers weekend. At least her capital with the company was on a steep upward climb. The higher her position, the more flexibility she might be able to give herself.

A Middle Ground?

"Cheryl, from my perspective, a manager at your level needs high visibility," Deb Roth, the director of HR, said. She shook her head. "That means being in the office, not working part-time or from home. Especially if you want a promotion, which you tell me might be in the offing."

"Deb, I don't want a promotion to the exclusion of all else. I'm trying to find a way to bring greater balance to my life and spend some more time with my daughter. And now I've accepted a trip to Boulder that wasn't essential and conflicts with plans I'd made with her."

"You know, it occurs to me that we do have several women who are doing some unusual job shares," Deb offered. "I don't think they are on the same level as you, but I could look into it – or, alternatively, I could talk to senior management on your behalf. Maybe there is some middle ground that none of us have considered yet."

"Speaking to senior management might put my promotion at risk."

"Not necessarily. The senior team is committed to meeting the staff's needs, where possible. They'll listen, though of course I can't promise anything." Deb tapped her pen on the table between them. "It would help if you could get a better handle on what you want. I used an executive coach when I was debating whether to leave the company some years ago."

Cheryl shot her a look. "You considered leaving, too, did you?"

Deb nodded. "Of course. It's tough, I know. I have three kids of my own, but they're older now." She sighed. "It's more common than you think; I hear a lot of stories. I can give you a coach's name if you'd like."

Cheryl took the number, but she didn't dial it.

The Moment of Truth

Cheryl looked at the Mersey outside her office window and realized the sun had set. The sky was streaked with pinks and oranges. She shoved herself out of her chair and strode to Marcus's office. It was time to find out what high-powered job she was in line for. Then she could pin down her options – and make a choice.

When Marcus opened the door, he was frowning. "I'm glad you're here. We need to talk."

Cheryl raised her brows at him as he waved her to a chair.

"It seems there's a board-level discussion about some of our positions, a strategy debate if you will." He cleared his throat. "In any case, that promotion we expected to come through for you is off the table. Not permanently, mind you, but for the time being."

"What does the 'time being' mean, Marcus?"

"I'm not sure, Cheryl. Listen, I'm really sorry about this. I know you've been coping with a lot and considering your next moves. Please, just don't do anything rash."

"Rash!" Cheryl thought, laughter burbling in her throat. She'd been anything but rash. An idea seized her and she narrowed her eyes on her boss. "Marcus, are you sure this doesn't have to do with my repeated requests for part-time work or telecommuting?"

"No, of course it doesn't. I know Derek thinks highly of you, and I'm sure it's just a matter of time. We value you too much to lose you."

Cheryl frowned. She needed to make a decision. Now.

Should Cheryl stick it out or leave?

Four commentators offer expert advice beginning on page 64.

Monica McGrath (monicam2@wharton.upenn.edu) is an adjunct assistant professor of management at the University of Pennsylvania's Wharton School in Philadelphia.

Cheryl Jamis's frustration is understandable. She's running up against the reality of the "second shift" issue identified by Arlie Russell Hochschild. Women still tend to shoulder the majority of second-shift domestic pressures. Combine these with glass ceiling issues – broken career promises, entrenched stereotypes, and roadblocks to the top – and many female managers reach a tipping point. They start to consider just how high a price they are paying for their ambitions. In their annoyance, they often just quit.

That said, Cheryl is abysmally unprepared for a spontaneous discussion with Marcus Addison. Instead of thinking strategically, she's being a victim and expecting her boss and her company to solve her problems for her. This is at best naive and at worst dangerous, for it makes Marcus wonder if she's really as competent as she appears.

Unfortunately, taking what I call a "step out," or what Sylvia Ann Hewlett calls a career "off-ramp," would be a big mistake for Cheryl. Ten years from now, when Emma is off to college, Cheryl would find it very difficult, if not impossible, to regain her career traction. As Hewlett noted in her March 2005 HBR article, only 40% of women who leave their careers are able to return to full-time, professional jobs. And if Cheryl thinks the solution is to start her own business, she should remember that almost half of all new businesses fail within the first year.

Assuming Cheryl decides to stay on the job, she must handle her conflicting priorities in a way that works both for her and her company. If Cheryl is to be promoted, she must reject the ridiculous premise that "It's so hard to say no." After all, she's already saying no to her promise to herself about Emma. It's time for her to stand up for herself and solve this problem with the same kind of energy and optimism she would bring to any corporate roadblock.

Cheryl should take a few days off and get a clear-eyed look at the situation. As a start, she should try to see things from her boss's perspective. Marcus may be caring and sympathetic, but his focus is on what's best for the business, not what's best for Emma. He has the support of a wife at home; he can't be expected to fully understand Cheryl's situation or make decisions for her. His job, as Cheryl's boss, is to see that she manages her team and contributes to the bottom line, period.

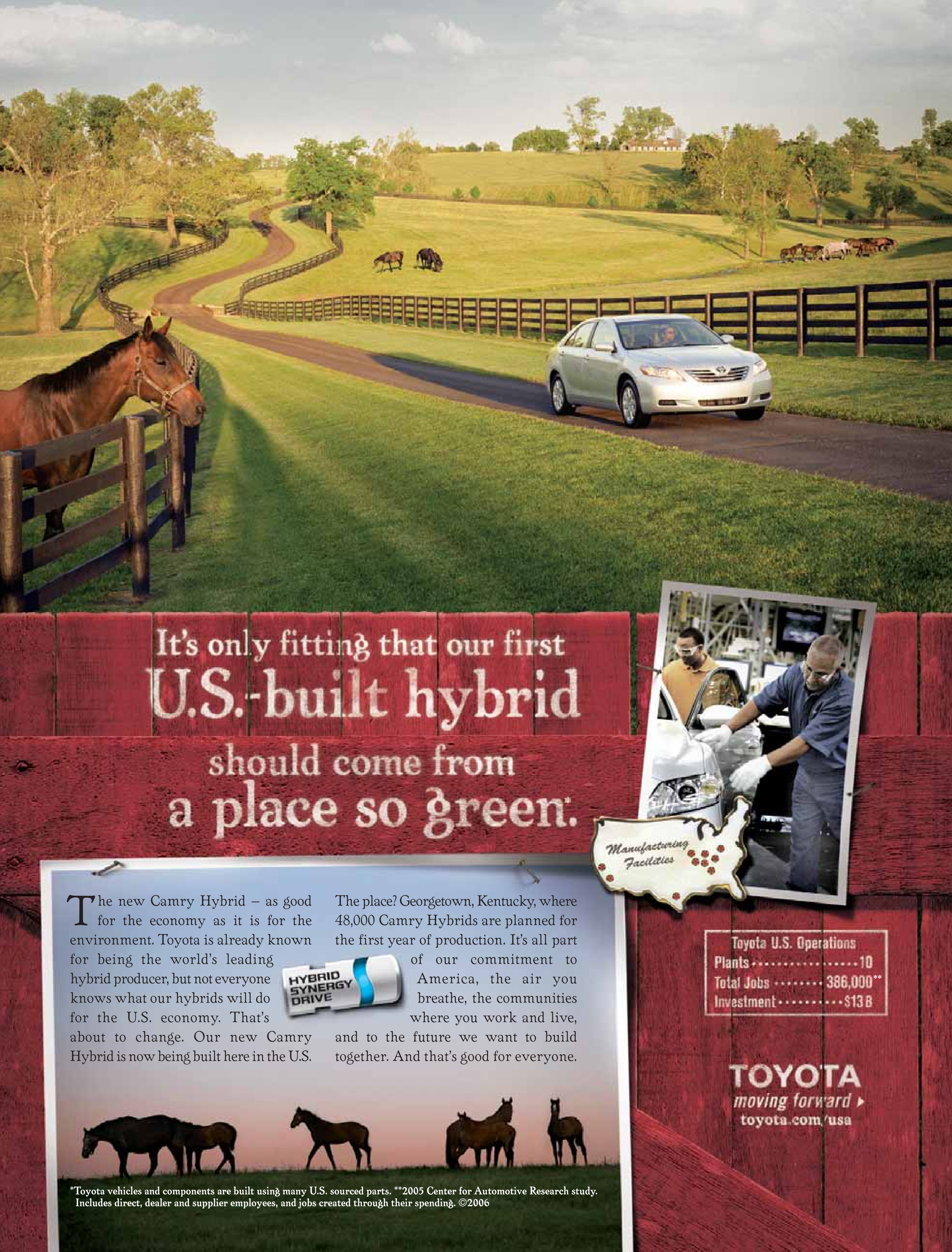
When she returns to work, Cheryl should present Marcus with a firm business case for flexible hours. After reminding Marcus that she is a skilled, ambitious, competent, and proven executive who happens to also be a mom, she should set the terms of the contract. For example, she should say that she will leave early a few days a week and telecommute on Fridays. She should concede that what she is asking for is different from the norm but that there's no reason not to try. She should suggest keeping to the flexible schedule for a set period of time – say, until her next performance review – and then reevaluate it.

She also needs to give Marcus some confidence that the risk will pay off. She should present possible benefits for Marcus to consider and hammer out specific goals and milestones that she will commit to reaching. Given her good relationship with Marcus and her value to the company, the odds are that she will get what she's asking for.

The onus will then be on Cheryl to meet – or, better yet, exceed – her goals. By doing so, she will have convinced Marcus, HR, and the CEO that she is worthy of the promotion. She will also have shown management that it's possible for executives to run Copro *and* have healthy and whole personal lives. And she will prove that women like her are vital to the success of the business.

Combine second-shift domestic pressures with glass ceiling issues – broken career promises, entrenched stereotypes, and roadblocks to the top – and many female managers reach a tipping point.

Wendy Wray



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A powerful woman once told me that a smart, ambitious woman of childbearing age has three choices. Choice number one is to forgo motherhood, follow her dream, and attain a lofty position; in so doing, she will always wonder what life would have been like had she had children. Choice number two is to skip a career, become a mother, and always wonder what she might have attained in the business world. Choice number three is to do a half-baked job of both.

I think there's a fourth choice, one to which Cheryl has only given passing thought. If Copro can't give her what she wants, then she can start her own firm.

I was pregnant with my first child when I started my company back in 1982. I was also pregnant with the idea of wanting to run a successful maternity wear business. I'd certainly heard the dire statistics about start-up failures, but I also knew that running my own show was the only way to both feel wholly satisfied in my work and achieve the flexibility I craved.

Self-employment is Cheryl's ticket. Because she is goal driven and disciplined, she meets two of the most critical criteria for entrepreneurial success.

Cheryl has conflicting desires. She wants to be a top manager, but, even more, she wants to spend time with her daughter. Self-employment is her ticket. Because she is goal driven and disciplined, she also meets two of the most critical criteria for entrepreneurial success. Assuming that she and her husband are willing to take a cut in her income, she can put her self-discipline to work growing her own business. She can calibrate her success over time by working on a project-by-project basis – possibly for Copro, which will undoubtedly be glad to retain her as a contractor – while Emma is young. Later on, when Emma is at university, she can up the ante, devote more time and energy to her clients, and really grow her firm.

Cheryl also needs to understand that flexible hours don't necessarily mean fewer hours. If she wants her business to thrive, she should be prepared to burn the midnight oil and possibly work harder than she's doing now. Starting her business will take time, and as it grows, so will the demands. She still won't make every school play, and she will have far less time for herself.

Whether or not she decides to strike out on her own, I'd advise Cheryl to build more layers of support into her life. In addition to the au pair, she should make sure that someone (whether a relative or a backup babysitter) can help with child care at a moment's notice if Frauke is unavailable.

If Cheryl chooses to work for herself, then it's particularly crucial for her to have the full support of her husband, John. It sounds as if John has left domestic operations to Cheryl while he goes about pursuing his own career. He will have to be willing to eat more takeout dinners. He will have to be understanding when Cheryl dedicates some of her nights and weekends to her business instead of to him. But, most important, he will need to be Cheryl's source of encouragement when her business goes through its ups and downs. If he's willing to do these things, terrific. If not, then she should not consider starting her own business.

Finally, Cheryl should understand that if she does leave Copro to be an entrepreneur, there's no looking back. It's very unlikely that she will be able to get a strong foothold inside a corporation again. And once she injects her money, energy, and pride into starting and running her own business, she'll have to go for broke. The wins and losses will be hers alone, and her life will be a roller-coaster ride. But if her business does take off, she will feel more pride and satisfaction in her work than she could ever have imagined possible within the walls of Copro.


CREATE A BRIGHTER FUTURE.
MAKE PROGRESS.

Robert J. Maricich (rjm@centuryfurniture.com) is the CEO of Century Furniture Industries, headquartered in Hickory, North Carolina.

Senior-level management positions are, by their very nature, intensive, demanding, and full-time. Frankly, Cheryl isn't yet displaying the most important qualities needed in a senior manager: decisiveness, a knack for proactively identifying and solving problems, an ability to prioritize, and courage. While Marcus has empathy for Cheryl's situation, her actions are inconsistent with what it takes to be a senior manager at a global company such as Copro. It is one thing to work out a flextime position with Cheryl at her present level of responsibility; it is quite another to seriously consider her as a candidate for senior management. These are two different playing fields, and only Cheryl can decide which one she wants to be on.

It bothers me that Cheryl doesn't frame her request in an assertive, confident way or offer Marcus a well thought-out, detailed plan explaining how her flextime schedule will work and how it will benefit the company. She's already had a year to come up with an alternative schedule and show Marcus that she could make it work, but instead of demonstrating confidence, she waffles and fumbles.

Cheryl also seems to lack a sense of clear priorities. A capable executive with children can always figure out ways to work an important personal event such as a school play into his or her schedule. And by failing to look Marcus in the eye and say, "I'm sorry, but I have another commitment" when he offers her the Boulder assignment, she is displaying a lack of courage.

Initially, Marcus handles the situation well and deserves credit for being a good manager; in fact, he's everything a mentor should be. He properly sees Cheryl as an investment, coaches her, and gives her all kinds of opportunities to win. He recognizes Cheryl's skills and makes it clear that he wants her to accomplish her personal goals. He even lets her showcase her talents in front of the CEO.

Marcus needs to have a heart-to-heart talk with Cheryl. He can remind her how valuable she is to the company and say he is willing to support her campaign for flextime if it can be a win-win strategy. At the same time, he should candidly tell her that he's troubled by her indecisiveness and lack of strategic thinking. Copro can certainly work out a halfway bargain, but he should insist that she demonstrate her value by taking full responsibility for figuring out her situation.

Assuming that Cheryl can come back with a workable plan, she and Marcus should move forward and see how it goes. Cheryl has earned the opportunity to prove she can handle the assignment with less-demanding time constraints. When she feels ready, she can come back full-time. At that point, provided she begins to show better leadership, they can choose to reevaluate her options.

Cheryl isn't displaying the most important qualities needed in a senior manager: decisiveness, a knack for proactively identifying and solving problems, an ability to prioritize, and courage.

Should she decide that she wants a higher position, Cheryl will need to prove that she can do everything demanded of an executive. Marcus will need to continue to coach her along, encouraging her to take responsibility and demonstrate courage, and to meet with the executive coach recommended by HR. Perhaps he could also pair her with another senior manager who has successfully navigated a similar career crossroad.

Sometimes, selling your boss on what you want is a matter of framing. Cheryl's formal, written plan should detail how she will overcome the problems – both real and perceived – that a flextime schedule can present. Its overarching theme? "How My Plan Will Better Serve Copro." Finally, she and Marcus should work together to establish clear parameters for what will constitute success. That way, both of them will know whether Cheryl's new schedule is allowing her to meet company goals – or whether it's time for her to move on.

Cheryl is very fortunate. She has a good job with a good company, a supportive boss, and a CEO who thinks highly of her. Her biggest issue is not with her company but with her daughter.

Cheryl needs to stop feeling guilty about Emma and start helping her daughter understand that the world of adult work is the world of reality. Cheryl is clearly a well-educated achiever who really enjoys the satisfaction of being in harness and thrives on making her goals. She's earned a place in the professional world. She should be proud of this. It's nothing to apologize for to anyone – certainly not to her daughter. In fact, her open display of ambivalence could be sending Emma all the wrong messages.

Certainly, Cheryl's conundrum is understandable. She's worked her whole life to get where she is. At the same time, she loves her daughter and regrets the time that she can't spend with her. As is still unfortunately the case in most working families, Cheryl shoulders more of the child care burden. Most companies have not evolved to the point where they can help their most talented women deal with the very visceral, difficult tension of trying to balance work and family.

I navigated this tension by going to work part-time and putting my ambitions temporarily on hold. When I came to Egon Zehnder in 1991, I had two children – one a year-old baby. At the time, there weren't many women in the higher echelons, and they were thrilled to have me as a consultant. Like Cheryl, I asked to work part-time because I needed to care for my children, and the firm accommodated my wishes. But there was no such thing as a part-time partner.

The chairman and the CEO, as well as my office leader, wanted very much to help me, but the firm's culture required that those in top positions be fully committed. We made a deal: If I came to work full-time, I would be made partner. I continued to work part-time on important projects, including founding the largest women's professional network in France, which helped me stay in touch, build my own network, and keep my skills sharp. I came back to work full-time to be able to become a partner after the birth of my third daughter, coincidentally named Emma.

My experience taught me that while women should never feel guilty about asking for what they want, it's naive to think that employers can or should bend the rules for them. More and more companies are building flextime into their working arrangements, and this is to be commended; at the same time, global firms require that their senior women be able to travel, to work in different time zones, and to do what it takes to make the firm successful. Women can bring their own style to work, but the commitment of time and energy remains the same for every senior person, regardless of gender.

Equally important for corporate evolution are two questions almost never asked: "What is a good father?" and "How is it possible to be a good father and a topflight executive as well?" I find it fascinating that while 76% of male CEOs have a nonworking spouse, only 27% of female CEOs do.

Assuming Cheryl wants to keep her job and get promoted, she should stop feeling guilty about Emma and start managing her daughter's expectations better. Difficult as it may be to be separate from her daughter now, Cheryl should take consolation from the thought that, though she cannot "have it all" at the same time, she can "have it all in the end." When she's older, Emma will understand that being a good role model is a big part of being a good mother.

Cheryl's biggest issue is not with her company but with her daughter. She needs to stop feeling guilty about Emma and start helping her understand that the world of adult work is the world of reality.

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The cumulative impact of the allocation of resources by managers at any level has more real-world effect on strategy than any plans developed at headquarters.

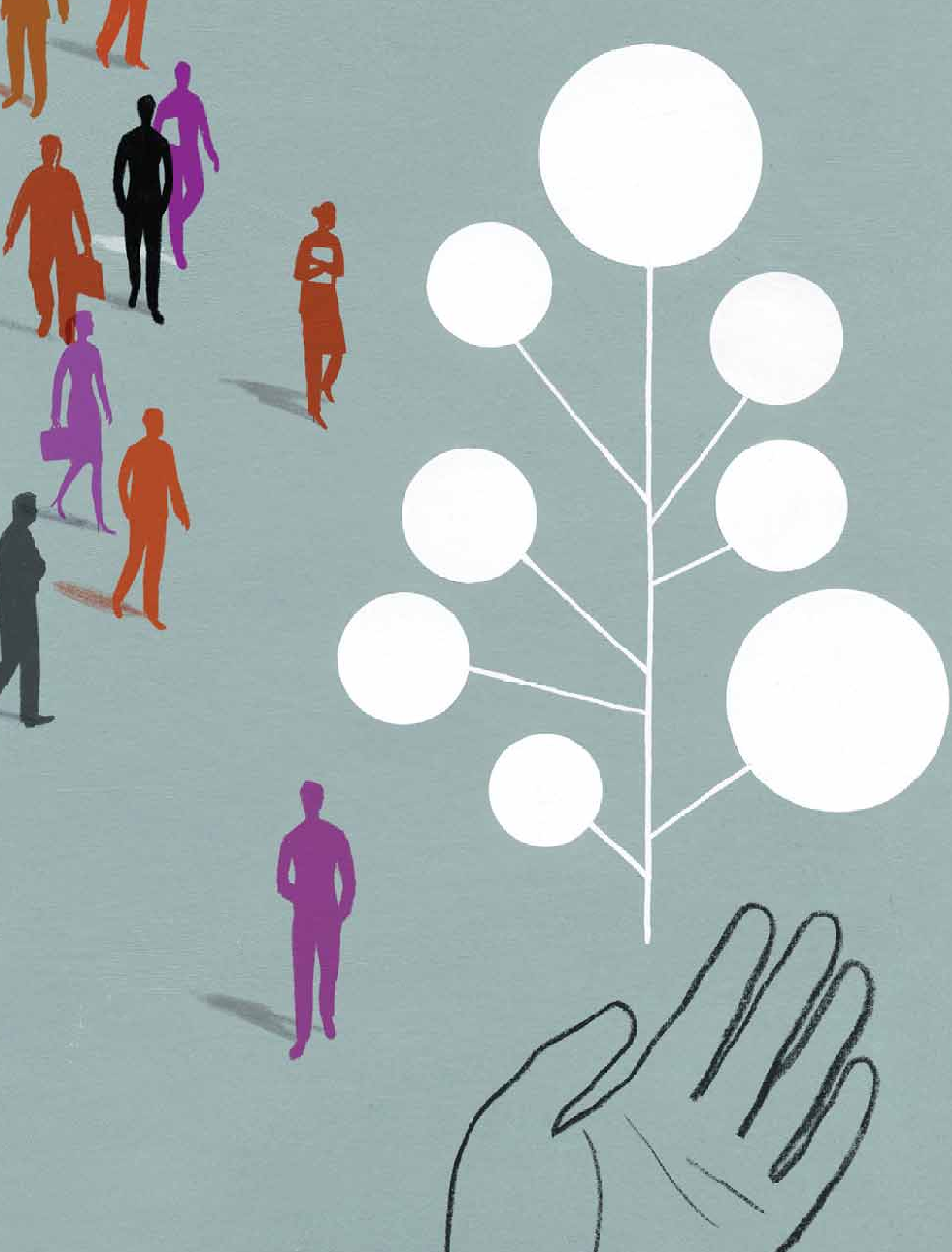
How Managers' Everyday Decisions Create or Destroy Your Company's Strategy

by Joseph L. Bower and Clark G. Gilbert

Our favorite story about how strategy really gets made comes from a visit one of us – the lead author – made to a large company's headquarters. The company controller was concerned and confused about a capital project proposal he'd recently received from one of the company's most important divisions: a request for a large chimney. *Just* a chimney. Curious, the controller flew out to visit the division and discovered that division managers had built a whole plant (minus the chimney) using work orders that did not require corporate approval. The chimney was the only portion of the plant that could not be broken down into small enough chunks to escape corporate scrutiny.

The division managers, it seemed, were eager to get on with building a new business and had despaired of getting corporate

Aude Van Ryn



approval within a reasonable time frame. Convinced that the new capacity was necessary, managers had found a way to build the plant but still needed the chimney. In the end, the division managers were proven right about the need for new capacity and also about the need for speed. The chimney was, ultimately, approved. But who (the controller wondered) was running the company?

We've spent many years, between us, trying to answer that question. In this case, the divisional managers seemed to be calling the shots, at least for their own division. But in general, the answer is more complicated: Senior executives, divisional managers, and operational managers all play a role in deciding which opportunities a company will pursue and which it will pass by (a reasonable definition of "strategy" in the real world). So, for that matter, do customers and the capital markets. What we have found in one research study after another is that how business *really* gets done has little connection to the strategy developed at corporate headquarters. Rather, strategy is crafted, step by step, as managers at all levels of a company – be it a small firm or a large multinational – commit resources to policies, programs, people, and facilities. Because this is true, senior management might consider focusing less attention on thinking through the company's formal strategy and more attention on the processes by which the company allocates resources. Top executives will never be in a position to call all of the resource-allocation shots – nor should they be. But they should learn to identify, and influence, the managers at all levels who can forever alter a company's future.

At the same time that corporate staff is beginning to roll out initiatives, operating managers invariably are already acting in ways that either undercut or enhance them.

How Strategy Gets Made, and Why

A somewhat longer case story will help illuminate the connection between resource allocation and corporate strategy. It involves Lou Hughes, who took over as chairman of the executive board of Opel, General Motors' large European subsidiary, in April 1989. Just seven months later, in November 1989, the Berlin Wall came down, and shortly thereafter, Volkswagen, Germany's number one automobile producer to Opel's number two, announced a deal with East Germany's state automotive directorate to lock up all of that country's automotive manufacturing capacity and to introduce an East German car in 1994.

A corporate view of strategy making in response to the tectonic crash of the Berlin Wall would have Hughes's staff gather information to be relayed to corporate staff, who would then develop a plan that fit GM's overseas strategy. (At the time, this strategy was to make cars in large, modern, focused factories in low-wage countries such as Spain). The plan would be debated and then possibly approved by the board of directors. The process might take a year – especially since very little concrete data was available on the East German market, and East Germany was still a sovereign country with its own laws and currency guarded by 400,000 Soviet soldiers.

Instead, Hughes did as an energetic, entreprenurial manager running a large subsidiary in a foreign country would do: He worked vigorously to secure a place for Opel in the East German market, in ways that did not fit with corporate strategy and would not have been approved by corporate planners. Rather than waiting to gather data, he created new facts. Acting on an introduction from an Opel union member to the management team of one of the directorate's factories, Hughes negotiated the right to build new capacity in East Germany. He allowed the local factory leader to publicize the deal, induced then-chancellor Helmut Kohl to subsidize the new plant, and drew on talents from other operating divisions of GM to ensure that the facility would be state of the art. GM Europe and corporate headquarters were kept informed, but local decisions drove a steady series of commitments.

As was the case in the chimney story, corporate headquarters was effectively preempted by local management doing what it thought best for the corporation. Despite the apparent contradiction between Opel's plans and corporate strategy, Hughes proposed the commitment of resources, and his proposal was approved first by the European Strategy Board and then by the corporation. Top management (over corporate staff's objections) endorsed Lou Hughes's bottom-up action – and his vision for the future – because he was the local

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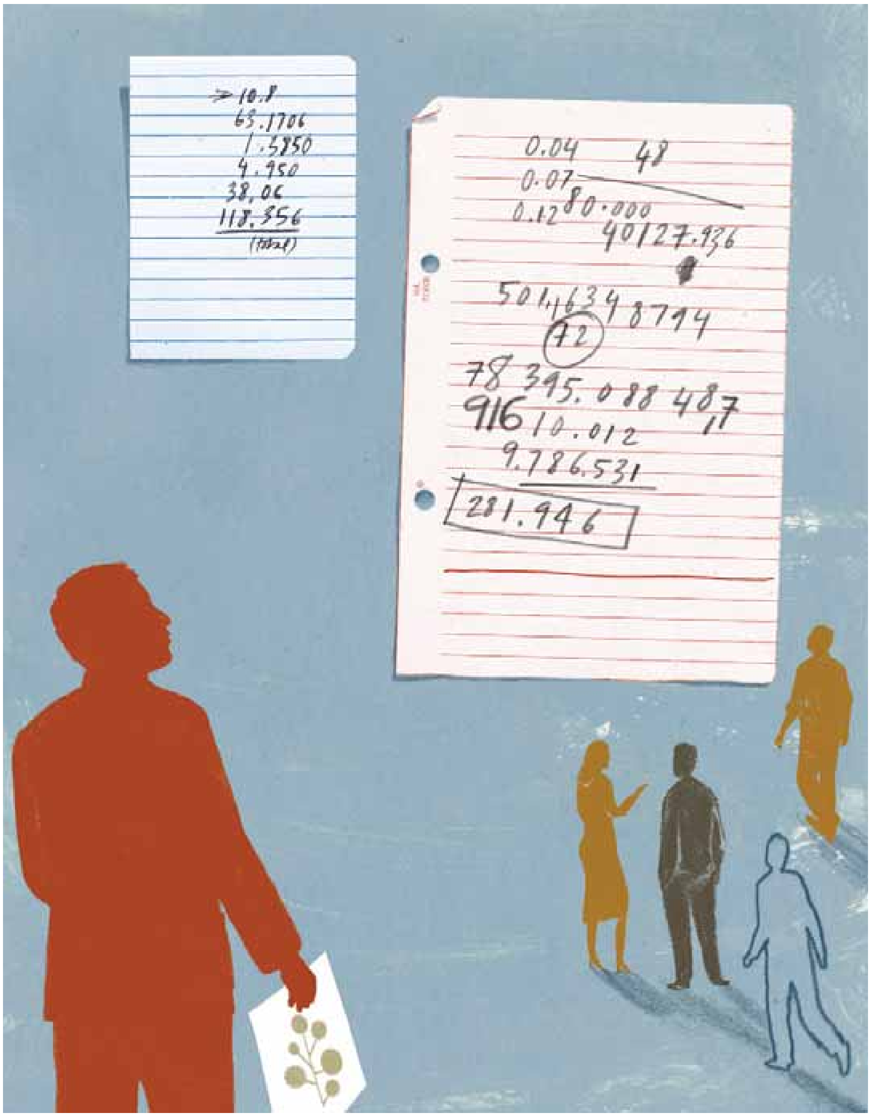
manager, because he had a good track record, and because he was thought to have good judgment. It was more an endorsement of Hughes than of his plan per se.



Does the Opel case demonstrate how resource commitments shape strategy, or is it just an example of an organization out of control? Traditionally minded strategy planners may assume the latter. In fact, the Opel story highlights what we have found to be near universal aspects of the way strategic commitments get made. These fall into two categories.

Organizational structure. The fact that, at any company, responsibility is divided up among various individuals and units has vital consequences for how strategy gets made.

Knowledge is dispersed. For any given strategic question (such as how Opel should enter the East German market), relevant expertise resides in scattered, sometimes unexpected parts of a corporation. When the wall tumbled, managers in the West understood almost nothing about the East German market. The first GM managers to develop any useful knowledge, not surprisingly, were the ones on the spot: Opel's marketing staff. Meanwhile, the GM employees with deep knowledge about lean manufacturing techniques, which would be needed for the new venture, were in California and Canada. Those with the deepest knowledge of overseas strategy and profitability overall were in Detroit, Michigan – but European strategy was developed in Zurich, Switzerland.

Power is dispersed. Lou Hughes's formal authority was limited. He could fund studies and negotiate with East German counterparts, but he could not command his manufacturing director to work with California, nor insist that California work with Opel. The right to approve a plant in a new country lay with the board of GM. For permission to present to the board, Hughes would need to go through GM Europe; in addition, financial and other corporate staff could (and would) provide evaluations of their own. Nonetheless, Hughes's negotiations with the local factory manager and Helmut Kohl could virtually commit GM.

Roles determine perspectives. Miles's Law – the notion that where you stand is a function of where you sit – is central to how strategy gets made in practice. All the managers who would need to cooperate to make an East German initiative possible had different sets of responsibilities for resources and outcomes (like specific levels of sales by model and in total) that shaped their perspectives about what success in a new, eastern European market would look like and what it would be possible to achieve. They all considered a different set of facts, usually those most pertinent to success in their individual operating roles. Hughes's triumph was to convince a group of managers with limited authority that they could deliver on a radical idea.

Decision-making processes. Just as important, the way decisions are made throughout an organization has vital consequences for strategy.

Processes span multiple levels; activities proceed on parallel, independent tracks. The notion of a top-down strategic process depends upon central control of all steps in that process. That level of control almost never exists in a large organization – quite the reverse: At the same time that corporate staff is beginning to plan for and roll out initiatives, operating managers invariably are already acting in ways that either undercut or enhance them. Hughes was developing a strong relationship with Helmut Kohl and obtaining funding for a new East German plant even as GM's corporate staff was looking over sales forecasts and planning GM's next moves in Europe: focused factories in countries that probably would not include East Germany.

Processes are iterative. Crafting strategy is an iterative, real-time process; commitments must be made, then either revised or stepped up as new realities emerge. GM's first commitment came when Hughes took part in a factory worker vote that committed the East German spin-out to Opel; this public act made it hard for GM to back out, especially as Hughes was already lobbying with Helmut Kohl for subsidies. A second level of commitment was obtained when GM funded a facility to assemble 10,000 cars, and those cars were presented to German consumers with massive publicity. Soon after, a third stage was reached when a major manufacturing facility was built. GM's strategy for East Germany was revised at each step along the way. How the automaker's European strategy developed after that would turn on events to come, particularly the movement of currencies and labor costs and developments in GM leadership assignments.

Your managers' judgment is more important than the actual numbers presented. This reality will kill your finance staff, because they are good at crunching numbers, not at gauging what managers understand.

Who's in Control?

A leader can announce a strategy to become global, change core technologies, or open new markets, but that strategy will only be realized if it's in line with the pattern of resource allocation decisions made at every level of the organization. Another well-known business story – Intel's exit from the memory business – illustrates this point. Legend has it that Andy Grove and Gordon Moore were talking about what business Intel should be in. Grove asked Moore what they would do if Intel were a company that they had just acquired. When Moore answered, "Get out of memory," Grove suggested that they do just that. It turned out, though, that Intel's revenues from memory were by this time only 4% of its total sales. Intel's lower-level managers had already exited the business. What Intel *hadn't* done was shut down the flow of research funding into memory (which was still eating up one-third of all research expenditures). Nor had the company announced its exit to the outside world.

Because knowledge and power span organizational levels, managers at each level are likely to have an impact on strategy. External forces can also have a strong effect on how resources are allocated, and, in turn, how strategy evolves. The most powerful of these forces are the company's best customers and the capital markets.

General managers. Strategic decisions are critically affected not just by senior corporate managers, but also by midlevel general managers, their teams, and the operating managers who report to them. These intermediate-level general managers run the fundamental processes that make multibusiness, multinational companies feasible. They are general managers who report to other general managers. Their jobs involve translating broad corporate objectives such as earnings and growth into specifics that operating managers can understand and execute on. They provide corporate management with an integrated picture of what their businesses can accomplish today and might achieve in the future by determining the package of plans, programs, and activities that should drive the strategy for that business.

One of the most obvious ways that these managers in the middle affect strategy is through their decisions about which proposals to send upward for corporate review. One top executive we interviewed communicated his surprised realization of this role: "One fascinating moment came as I met with a key midlevel manager. I had mapped out on a piece of paper the resource allocation process and its effect on the intended and emergent strategies. As we talked, this manager proudly told me that he was the one who set the strategy, not the CEO or board of directors. According to him, he owned the resource allocation process because his boss, who was president of the largest business unit, would not approve anything without his recommendation."

Operational managers. Most strategy analysts ignore the role operating managers have on strategy outcomes, assuming that these managers are too tied to the operational requirements of the business to think strategically. Senior executives overlook the very real impact of operating managers at their peril. For example, in 2000, Toyota launched the Echo, a no-frills vehicle designed partly to protect Toyota from low-cost competition. But deep inside that organization sat salespeople in local retail operations. Because margins (and, more important, sales commissions) were higher on other Toyota vehicles, customers were repeatedly steered toward higher-priced models. Even though the corporate office placed a high priority on the new product, the day-to-day operating decisions of the organization directed the realized strategy of the firm elsewhere.

From the Toyota example, one might conclude that operating managers (salespeople, in this case) constrain innovation because they are not aligned with the strategy of the firm. However, operating managers can redirect and improve strategy in very innovative ways. At Intel, the exit from memory took place over time, because the managers in manufacturing responded to a directive from finance: Allocate plant space so as to maximize gross margin per wafer square inch. Memory and microprocessors used the same silicon wafers, so as competitive conditions worsened in memory, the rule took Intel right out of the business.

Customers. Customer decisions can play a huge role in real strategy formation, particularly in businesses with a few very powerful customers. Companies that stay close to their best customers give them a virtual veto on product development and distribution. By the mid-1990s, Tony Ridder at Knight Ridder recognized that the Internet was going to have a dramatic effect on his newspaper company. Accordingly, he redirected corporate strategy to focus on the Internet, presented annual reports that discussed plans for new media, and moved the headquarters from Miami to San Jose. Despite these bold efforts to change the corporate strategy, the realized strategy continued to be largely controlled by existing advertising customers in the newspaper business. Every day, sales reps had the choice of selling a $40,000 print display ad to their existing print customers or promoting a $2,000 online ad that was unfamiliar, even uninteresting, to these same advertisers. And every day, the sales reps made the logical choice to sell traditional print ads. Despite the explosive growth in online advertising, Knight Ridder and other newspaper companies were largely unsuccessful at tapping into this new and evolving revenue stream. Through their influence on the sales force, the print advertising customers effectively captured the newspapers' resource allocation process and, in effect, its strategy.

Capital markets. Most observers understand that capital markets influence management performance. That they can dramatically reshape strategy is less well documented, but equally true. Earnings pressure can cause a company to exit a market too soon; a dip in stock price can cause a company to scramble to improve short-term performance. One of the clearest cases of this phenomenon comes from a natural experiment in the U.S. telephony market that one of our doctoral students examined. BellSouth and U.S. West were two Baby Bells that formed when AT&T was broken up. Both were born with the same technology, patents, and planning models. Despite their similarities, the capital markets determined that U.S. West's growth prospects were inferior to those of its sibling. In the face of the consequent pressure on earnings, U.S. West's CEO chose to diversify by moving away from regulated telephony and to set high earnings objectives. To meet those objectives, the managers of the cellular business (the general managers in the middle) adopted a strategy of skimming, that is, seeking high margins on the low-volume top end of the market.

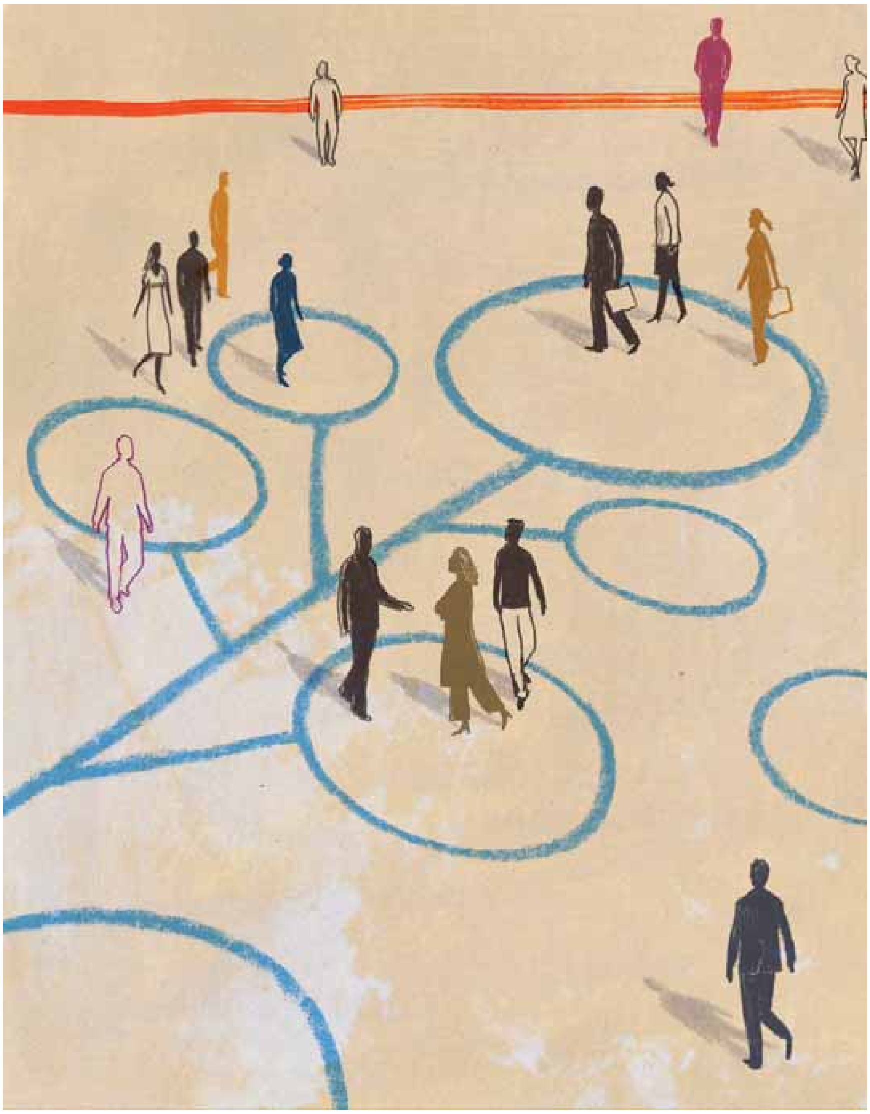
Facing less-intense short-term pressure from the capital markets, BellSouth chose to treat cellular as an opportunity with earning potential equal to that of its wire line business and with much better growth prospects. Managers pursued a strategy of broad market penetration.

BellSouth's and U.S. West's strategic objectives were reflected in the performance measures that were set for the two businesses. Despite similar early performance, the different measures led the two companies to reach very different conclusions about the cellular market. U.S. West was disappointed by results that failed to reach the high financial targets it had set. BellSouth was pleased with the positive first steps and made further investments. U.S. West ultimately divested its business, while BellSouth became one of the leading cellular providers.

Manage It Anyway!

If divisional, middle, and operating managers – as well as customers and capital markets – have such a powerful impact on the resource allocation process and, in turn, on the realized strategy of the firm, what does that imply for the role of corporate leaders? Is the process of strategy formation entirely out of their hands? Of course not. We believe that the complexity of the resource allocation process only increases the need for leadership at the top. But senior leaders have to understand what is happening and adjust their management styles accordingly. Here are six ways that senior managers can direct the strategy of their firm by better understanding the resource allocation process.

Understand the people whose names are on the proposals you read. When you read a proposal to commit scarce people or capital, you should calibrate what you are reading against the track record of the executive who signed the document. If the signing executive has a near-perfect record of proposals implemented, then you know that there is probably little downside in what you are reading, but the upside may be significantly underexploited. Requests for resources are based on stories about the future. Those stories may be summarized with numbers, but they represent judgments about uncertain developments. Very often, your managers' judgment – and your capacity to judge their judgment! – is



more important than the actual numbers presented. This reality will kill your finance staff, because they are good at crunching numbers, not at gauging what managers understand and what they don't.

Recognize the strategic issue, and make sure it is addressed. Almost always, requests for resources require making two decisions: *Should we support this business idea?* and *Is this proposal the right way to go about it?* Most capital budgeting processes are set up to vet projects (in other words, they're aimed at the second question, not the first). It is usually possible to carry out fairly rigorous quantitative analysis comparing the plan of action in a proposal with alternatives. It is important that this analysis be done – and it is often done ad nauseam. But our research shows that the first question, the *business* question, is more important and far more difficult to answer – and it is often ignored. It is easy to invest money in cost-saving projects that will earn precisely the returns forecast in businesses that are losing money overall. After the project, they just lose less. One of our studies showed that companies and their industries poured new money into old technology at the same time that they were investing in facilities based on new technology that made the first set of investments obsolete. Managing resource allocation to build sound strategy requires that the proposal evaluation process begin with the "should we?" question. Should we put a plant in East Germany? In the end, you may decide to back managers rather than their logic, because you want to support them. But do it with your eyes open and controls in place.

When a debate reflects fundamental differences about the strategy, intervene. The "should we" question inevitably focuses on basic issues about how the company wants to compete. It almost always involves evaluating different views that reflect the positions of the executives in question. Lou Hughes thought that he could use a new East German facility to drive change at Opel's main plant. Some at GM headquarters thought it more important to continue expansion at low-cost sites in southern Europe and Latin America. Smart executives use resource allocation opportunities like a new Opel plant in East Germany to trigger strategic discussions that cross organizational perspectives. They bring together managers with different kinds of knowledge to discuss the evolution of strategy, not the details of a project proposal. Andy Grove calls this "getting knowledge power and position power in the same room at the same time." Top executives will almost always have to convene that meeting and pay attention to who is invited. They will also have to work hard to create a collaborative environment.

Use operational managers to get work done across divisional lines. When top managers believe that the right way to serve a market will require two or more divisions to cooperate, they face an immediate problem. Divisional managers obsess about the prospects for their own businesses. A bottom-up approach does not naturally foster cooperation because these managers view the resource allocation process as a way to protect their turf. (They also come at the same strategy question from quite different perspectives – Miles's Law!) Because of this, executives need to reach down to operational managers if they want divisions to cooperate. If freed from divisional measurement and compensation systems, operating talent can be engaged by the opportunity to serve customers better. It won't happen automatically, but we have seen numerous cases in which cross-divisional teams that were assembled and supported by top leadership have been able to work together, even when their divisional superiors resisted the project. For example, marketing services giant WPP successfully created virtual companies, made up of staff from various units, to focus on retail and health care markets. While some division heads saw this as an encroachment on their mandate in these areas, the operating managers reveled in their ability to collectively solve client problems. Of course, the easiest way for a division head to undermine such a project is to deny it the right people. Top managers must make sure that the right questions are asked and that the right people are made available to work on those questions.

Division managers view the resource allocation process as a way to protect their turf. Executives need to reach down to operational managers if they want units to cooperate.

The leadership has to connect the dots. Understand that bottom-up resource allocation processes do not add up to a corporate view. Top management may have to lay out the big picture when more than one division is (or ought to be) involved in a strategy question. When bottom-up processes are at work, several problems can occur. Conflicting divisional perspectives tend to resolve themselves on the basis of which unit has the most power. Or, divisional managers make compromises that share resources in ways that seem fair on paper but are not the best approach strategically. Worse, a division may agree – explicitly or tacitly – not to challenge another division's proposals in return for the same treatment. In many companies, that is the norm. It will be sheer coincidence if the result of this system is what the company could achieve if the divisions were working together with a coherent plan. Top management needs to step in and frame questions that reflect the corporate perspective, especially when large sums of money are involved and conditions are highly uncertain. They must get divisions to ask, "What's best for the company?"

Create a new context that allows leadership to circumvent the regular resource allocation process. Most out-of-the-box or disruptive ideas are badly handled by a bottom-up resource allocation process. It is top management that has to ask, "Is there a technology under development that looks inferior or uncertain today but will undermine our business from beneath once it is properly developed?" Windows NT had this impact on UNIX applications, for example, as did Internet applications on a host of industries. It takes a very well-informed paranoia to ask this question early enough to keep a strong company in the lead. A decision to pursue out-of-the-box ideas often requires a new box: a separate organizational unit with a new location, milestone-type measures instead of annual budgets, and short reporting lines to the top.

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The implication of these six recommendations is really a meta-recommendation. Once you realize that resource allocation decisions make your strategy, then you know you can't rely on a system to manage the resource allocation process. No planning or capital-budgeting procedure can substitute for the best leaders in the company making considered judgments about how to allocate resources. No system of incentives will align divisional objectives so that new opportunities will be studied with the corporate interest in mind. Because of its impact on strategy, the corporate senior management has to engage itself – selectively, to be sure – in the debates that mark inflection points in the process.

This is where top-down process is vital. If you're part of the leadership, you can't delegate responsibility for your company's direction. At Intel and Opel, divisional managers took the right action. But that is often not the case. The management of the mining or semiconductor divisions at GE didn't tell Jack Welch to divest. The management of the television set businesses did not tell Frank Dangeard to shift Thomson into digital postproduction. Quite the contrary, those divisional managers were generating proposals to grow their businesses. The leadership challenge is to give coherent direction to how resources are allocated and, by doing so, align the bottom-up processes with top-down objectives. That's how you drive strategy in a big organization.

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To order, see page 158.

The liberalization of markets is forcing executives and social activists to work together. They are developing new business models that will transform organizations and the lives of poor people everywhere.

Cocreating Business's New Social Compact

by Jeb Brugmann and C.K. Prahalad

IN EARLY 2005, WE MET PRIVATELY WITH THE chairperson of one of the world's biggest banks to discuss business opportunities in catering to poor people. The chairperson responded bluntly. "We don't care about making profits [on such a business]," he said, with the bank's CEO sitting beside him. "There's something even distasteful about the idea of making money off people who earn less than $1 a day." He raised a related issue that, unexpectedly, became the topic of our discussion that morning: how the bank could create, manage, and scale up a program to support elementary schools for poor children in a certain developing country. We were a little surprised that a banker was so preoccupied with a problem

David Pohl

that usually keeps not-for-profit, nongovernmental organizations (NGOs), rather than large corporations, up at night.

A week later, we spent a day with representatives of three relatively small NGOs in India. One specializes in infrastructure development and postdisaster reconstruction. Another focuses on the cultivation and processing of herbal medicines. The third provides business support to rural enterprises. Together, the three organizations also manage several self-help savings and loan groups involving around 50,000 women. The NGOs and their business advisers, some of them executives working for a large global company, wanted our help in deciding which businesses to set up. They had conducted research and market tests on opportunities in the financial services and insurance, construction, consumer products, and health services industries. By the end of the day, the NGOs decided to go ahead with three businesses: selling insurance products, retailing groceries, and providing sanitation facilities to people whose income is around 50 cents a day. We were impressed by the NGOs' desire and readiness to organize local communities so they could manufacture and sell products in the marketplace – just like good entrepreneurs.

Those two meetings, we're convinced, captured more than a fleeting role reversal; they symbolize an enduring shift in the practices of corporations and social groups and, perhaps, in their attitudes toward each other. That may sound like a startling claim. Since the protests against globalization at Seattle and Davos in the late 1990s, people have assumed that the gulf between the private sector and the civil society, as the media call NGOs, has been growing. After all, despite social groups' protests, more countries have opened up to foreign investment, and governments have continued to privatize industries. Meanwhile, companies, especially Western multinational corporations, have come under a dark cloud. Their recent shenanigans – fraud at Enron, insider trading at WorldCom, and inept governance at Hewlett-Packard, not to mention a rash of social, environmental, and health-related controversies at blue-chip companies such as Nike, Shell, and McDonald's – have led to a near crisis of confidence in the role of the modern corporation in society.

However, a countertrend has emerged. Over the last five years, some corporations have started to pay attention to customers at the bottom of the economic pyramid. As the pioneers move into inner cities and villages, their middle managers are spending more time than you might imagine on acquiring local knowledge, value engineering, developing low-cost business models, and community-based marketing. Meanwhile, several NGOs have set up businesses to provide jobs and incomes in order to free people from the tyranny of poverty. Product development, logistics, project management, and scaling techniques are some of the mechanisms they're using to kick-start socioeconomic development in long-neglected communities.

Realizing that they each possess competencies, infrastructure, and knowledge that the other needs to be able to operate in low-income markets, companies and NGOs are trying to learn from and work with each other. For example, Danone has set up a joint venture with Bangladesh's Grameen Bank to manufacture and sell bottom-of-the-pyramid dairy products. Microsoft has tied up with the NGO Pratham to deliver personal computers to Indian villagers, while Intel and two large Indian information technology firms, Wipro and HCL Infosystems, have launched the Community PC in partnership with other NGOs to do the same. Nestlé has joined hands with health professionals and NGOs in Colombia, Peru, and the Philippines to deliver educational programs on nutrition and nutritionally fortified food products to the poor.

As their interests and capabilities converge, these corporations and NGOs are together creating innovative business models that are helping to grow new markets at the bottom of the pyramid and niche segments in mature markets. These models, we believe, will lead to novel frameworks that can renew the corporation's social legitimacy even as they allow for sustainable development and accelerate the eradication of poverty. This convergence is making it imperative that managers in both sectors understand the opportunities and risks in working together.

Liberalization's Unexpected Consequences

Companies and NGOs have arrived at the same place by different routes. Over the last two decades, as many countries opened their economies to foreign competition, often at the behest of the International Monetary Fund and the World Bank, business and the civil society fought bitterly. At first, both sides battled vociferously and publicly with governments over the need for, the nature of, and the pace of economic reforms. While companies, especially multinational corporations, wanted governments to reduce tariffs sharply and allow foreign investment into every sector immediately, the civil society argued that liberalization should take place slowly and only in some industries. Then, as governments softened labor, environmental, and investment regulations to attract foreign investment, the two sectors waged a shadow war over the reforms' future. Finally, as governments played less and less of a regulatory role, corporations and NGOs fought each other directly, debating the boundaries within which socially responsible corporations should operate. Those battles led to three unanticipated consequences.

First, NGOs emerged as the corporate sector's de facto regulators, occupying the vacuum that governments were

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The Three Stages in the Convergence Between the Corporate Sector and the Civil Society

PRECONVERGENCE
Companies and NGOs adopt different attitudes toward liberalization and globalization. They quarrel over the nature and speed of deregulation. They fight over companies' conduct, especially in developing countries.

STAGE ONE
Companies and NGOs realize they have to coexist. They look for ways to influence each other. Some corporations and NGOs execute joint social responsibility projects.

STAGE TWO
Some companies get into bottom-of-the-pyramid segments and niche markets even as NGOs set up businesses in those markets. Companies and NGOs try to learn from, and work with, each other.

STAGE THREE
Companies and NGOs enter into cocreation business relationships. Cocreation entails the development of business models in which companies become a key part of NGOs' capacity to deliver value and vice versa.

leaving behind. They aren't newcomers to the task; for many years, NGOs have influenced markets in areas such as chemical regulation, oil spill liability, air emissions, liquid waste, pharmaceutical and food standards, child labor, and employment discrimination. Their influence has created a regulatory framework tougher than the legal requirements corporations face. NGOs may be small, but through the Internet, even a single person or organization can coordinate "smart mobs," as Howard Rheingold calls them in his 2002 book of the same name, allowing NGOs to mount actions on several fronts simultaneously. For instance, local NGOs attacked the Coca-Cola Company over its use of water in the village of Plachimada in Kerala, India. As accounts have spread from Web site to Web site, the dispute has grown into a worldwide battle over the brand's presence in universities and schools. The escalation of the campaign from market to market and from issue to issue has, as the *Wall Street Journal* wrote, cost Coca-Cola "millions of dollars in lost sales and legal fees in India, and growing damage to its reputation elsewhere."

By publicly inflicting harm to a market leader's reputation, which eventually forces the entire industry to change its practices, the civil society is often successful in getting corporations to conform to its norms. For instance, NGOs' attacks on Nike for violating human rights, on Merck and GlaxoSmithKline for enforcing patents on AIDS medicines, and on Monsanto for introducing genetically modified seeds forced the apparel, pharmaceutical, and agribusiness industries to develop new strategies and rewrite their codes of conduct.

Second, companies have invested heavily to develop expertise to cope with NGOs. They have spent time and money launching countercampaigns to protect their reputations. At first, they did so defensively, using social marketing slogans in advertisements and setting up nonprofit entities with which they maintained arm's-length relationships. Over time, they developed more proactive strategies. Smart corporations, for instance, have learned to take their case directly to consumers. They have developed corporate social responsibility (CSR) initiatives, voluntary self-regulation schemes, and cause-based marketing programs. More recently, they have launched public-interest-cum-advertising campaigns, such as Chevron's on global energy issues and Unilever's on women's beauty, self-esteem, and eating disorders. To run such programs, companies have hired people from the social sector who can bring their networks, credibility, and understanding of NGOs into corporations. For instance, Microsoft's director of community affairs worked with NGOs, the World Bank, and a social venture-capital fund for more than 20 years before joining the software giant. Some corporations are even competing with social groups. By launching coffee, tea, and confectionary products with a guarantee that disadvantaged producers are getting a better deal, for example, North American and European manufacturers and

How Companies and NGOs Find Common Ground

CONVERGENCE AREA	EXAMPLES	CHALLENGES AND INNOVATIONS	
		CORPORATE	NGO
		The Challenge	
Pooling knowledge, competencies, and relationships to build new operating standards and coregulatory schemes.	> The Apparel Industry Partnership > The Forest Stewardship Council > The Marine Stewardship Council > The Kimberley Process	To move from adhering to individual company standards to compliance with industry-wide standards.	To move from spearheading antibusiness campaigns to creating, promoting, and jointly administering standards.
		Innovative responses	
		Companies are > Defining standards through negotiations with NGOs. > Building the ability to participate in global and local NGO networks, forums, boards, and so forth.	NGOs are > Defining standards through negotiation with companies. > Learning to understand microlevel industry operations in, for example, forestry, fishing, and mining.
		The Challenge	
Leveraging each other's credibility and social networks to create access to markets and brand value.	> Companies have set up cause-related marketing as a new area of specialization. > In 2005, companies spent $1 billion in North America on cause-related marketing.	To redefine NGOs as consumer clusters that require special messages and management.	To professionalize brand management.
		Innovative responses	
		Companies are > Adopting NGOs' marketing approaches, such as viral marketing. > Delivering on special brand promises. > Shifting from a reactive to a proactive approach to social sector communications.	NGOs are > Cobranding campaigns with companies. > Marketing themselves to corporate partners' customers and employees, instead of making appeals to the public. > Facing stricter fiscal controls to separate economic decisions from policy decisions.
		The Challenge	
Creating professional development norms and management roles to facilitate coordination between the two sectors.	> Rather than two distinct camps and career paths, companies and NGOs recruit staff from each other. > The two sectors use a common service industry – the same marketing or law firm, for instance. > A plethora of bisector training forums, including social sector MBA programs, are born.	To integrate CSR into business decision making.	To cooperate with companies in some forums and disagree in others.
		Innovative responses	
		Companies are > Aligning strategies for building material assets and reputations. > Integrating social and financial reporting. > Managing cooperation with NGOs in cause-related marketing and public-policy forums. > Encouraging managers to sit on NGO boards and granting leaves of absence to managers doing social sector work.	NGOs are > Creating organizations that seek common ground on policy issues, and facilitate partnerships, with companies. > Integrating activist and business management mentalities into the organization. > Establishing new professional norms related to nondisclosure of sensitive corporate information.

retailers are competing with Fairtrade Labelling Organizations International, which enforces its standards on NGOs and member companies.

Third, markets are emerging as an arena in which companies and NGOs interact. Liberalization has provided corporations with access to new consumers, but reaching low-income customers is difficult nonetheless. Executives have to invent new business models if they are to succeed in those markets, and they often find that NGOs possess the knowledge, local infrastructure, and relationships necessary to make them work. There are NGOs that have created large distribution networks that can furnish food, medicine, and credit, especially in remote areas. They have developed a deep understanding of local cultures and consumption habits. And they have established credibility and earned people's trust by repeatedly assisting disadvantaged communities in the face of poverty, natural disasters, and conflicts. Companies are beginning to work with such organizations to break into new markets. For instance, Telenor has teamed up with Grameen Bank to sell cellular telephones to rural consumers. Telenor has taken advantage of the bank's knowledge of rural microcredit groups' collection and payment system to set up a joint venture, Grameen Phone, in which it has a 62% equity stake. Similarly, World Diagnostics found that, in Uganda, it could best sell its HIV, STD, and malaria test kits through NGO-operated health care networks. The NGOs are helping villagers deal with AIDS, and they have trained medical personnel, set up clinics, and earned the trust of Ugandans along the way.

At the same time, declines worldwide in public spending on social programs have forced NGOs to review their traditional poverty reduction strategies. Where NGOs once saw government aid and private sector charity as the only ways out of poverty, they now see entrepreneurship, too, as a viable approach. They've reframed the poor as "undercapitalized, unappreciated, and undersupported entrepreneurs," and redefined poverty as a problem of "livelihoods development." NGOs such as Care developed this livelihood-oriented approach, providing poor people with training, credit, and collective business infrastructure. Consequently, social groups have discovered business opportunities among their constituents, and scores of social venture capital funds have emerged to support this strategy.

Thus, while companies have discovered the importance of NGOs as paths to markets, social groups have realized that carefully calibrated business models can unleash powerful forces for good. Their interactions have created new links between business innovation and social development. As we shall see in the following pages, companies and NGOs are increasingly going into business together, pursuing scale and profits, social equity, and empowerment as part of an integrated value chain.

The Path to Convergence

Sometimes the best way to understand the future is to look back. When we do, we can see that the relationship between companies and NGOs is moving beyond an adversarial stance toward partnership through systematic, if uncharted, steps. This journey has so far progressed through three phases, each of which has had its teething problems, naysayers, tensions, and benefits.

While companies have discovered the importance of NGOs as paths to markets, social groups have realized that carefully calibrated business models can unleash powerful forces for good.

The be-responsible stage. By the late 1980s, companies and NGOs realized that they couldn't keep fighting; they had to find ways of living with and influencing each other. Some felt they could take the risk of working with the other side to meet specific, albeit limited, objectives. That was the most difficult step; executives and activists had to reexamine perceptions and biases. They had to evaluate the risks to their identities, to their missions, and to their industry standing before they could collaborate with "the enemy."

"Corporate social responsibility" has become a catchall phrase for the ways by which businesses manage reputations and strike relationships with the social sector. Businesses use their resources to work on socially relevant issues as they are defined by NGOs, but most CSR initiatives, such as Exxon Mobil's involvement in the distribution of mosquito nets in Tanzania or General Motors' management of children's education programs in the United States, are unrelated to the companies' core business activities. Some NGOs are willing to work with companies to establish policy dialogues and social programs, but they keep their corporate supporters at arm's length. The pros and cons of CSR have been explored elsewhere (see, for instance, Allen L. White's 2005 report, "Fade, Integrate or Transform: The Future of CSR"), but what is relevant to our story are three convergences that it created:

The convergence of standards of practice and the emergence of joint regulatory frameworks. As companies built relationships with NGOs, the two sides adopted joint regulatory schemes. The civil society and the corporate sector together manage, for instance, the Apparel Industry Partnership, the Forest Stewardship Council, the Marine Stewardship Council, and the Kimberley Process (in the diamond business), which stipulate social and environmental practices in their respective industries. Through these mechanisms, companies have gained access to NGOs' knowledge about local markets and social networks, while social groups have developed more expertise in marketing and specialized business practices.

The convergence of brands, marketing, and communications, and the emergence of the first joint platforms for marketing and customer management. Cause-related marketing captures this trend best. That's when a company markets its products or services to an NGO's loyalists, and the NGO markets itself to the company's customers and employees, generating revenues for both the company and the NGO's charitable activities. In 2005, cause-related marketing initiatives provided around $1 billion to social causes in North America alone. The approach has enabled the two sectors to learn each other's marketing tactics. Now, for instance, some companies use viral-marketing techniques, which NGOs pioneered, while several social groups commission professional advertising firms to design advocacy campaigns. Through such joint-marketing relationships, companies and NGOs have shifted from constructing divergent messages for polarized audiences to creating similar messages for a common audience.

The convergence of professional cadres and career paths, and the emergence of management professionals dedicated to working with companies on social causes and with NGOs on business endeavors. Today, the human rights manager (at Monsanto), the senior manager for corporate responsibility (at Nike), and the sustainable development manager (at Marks and Spencer) work with counterparts at NGOs like the vice president for private sector partnerships at Conservation International. Once, activists would have labeled NGO professionals as sellouts if they went to work with companies, but NGO veterans now hold the communications, community relations, and market development portfolios at several companies. Executives who previously would have signaled their early retirement if they took positions at NGOs find themselves among a cohort of social venture capitalists. In fact, many managers are building their careers by moving back and forth between the two sectors. (We describe the implications of these areas of convergence for the next phase of partnership in the exhibit "How Companies and NGOs Find Common Ground.")

Broadly speaking, CSR started as a way for companies to gather intelligence about NGOs and manage their reputations, and it has wound up providing them with the tools they need to pursue business opportunities in untapped markets. For NGOs, CSR began as a means of persuading companies to change their ways, and it has become a means for them to develop the competencies and confidence to go into business themselves. CSR therefore laid some of the foundations on which corporations and social groups each started experimenting with new business models.

The get-into-business stage. After more than 15 years of globalization, transnational companies have made headway in only the most affluent segments of the developing world. As a percentage of GDP, for example, flows of foreign direct investment to developing countries in Asia and Latin America were no greater in fiscal 2004 than they were in fiscal 1995. These miniscule inflows signal the failure of multinational corporations to change their business models to serve the largest consumer segment in the world: the 4 billion to 5 billion consumers at the bottom of the pyramid. Barring a few exceptions in the telecommunications and fast-moving consumer goods industries, Western companies have performed poorly in serving these customers. For instance, multinational water companies, even in supportive environments like South Africa, have all but given up trying to manage urban water systems. The food-retailing industry operates approximately one store for every 3.4 million people in low-income countries compared with one store per 5,800 people in high-income countries, according to CIES, a food industry trade association based in Paris. Foreign insurance giants have failed to create customer bases in low-income markets. The list of failures and near failures is long.

When companies have succeeded in bottom-of-the-pyramid markets, we found, they have most often done it by leveraging the competencies, networks, and business models that were developed as part of their CSR initiatives or by NGOs. ABN AMRO has entered the microfinance business in Latin America with some help from the NGO Accion International. Barclays has built a successful microbanking operation in Ghana in partnership with 4,000 indigenous moneylenders and their national association. The Shell Foundation has worked with environmental NGOs to test new designs and models for delivering clean and renewable energy to underserved populations. It has created venture capital funds that support local entrepreneurs and integrate them into Royal Dutch Shell's supply chains.

Pick 'n Pay, one of South Africa's largest retailers, started a CSR initiative in the early 1990s to support struggling black farmers and their weak cooperatives, who were left on the edge of financial viability by apartheid. The foundation helped strengthen the cooperatives by providing them with management and marketing skills. When apartheid ended in 1994, Pick 'n Pay immediately started exploring how it could serve people in urban townships. The retailer found that there was an opportunity in providing those consumers with produce that came from their rural homelands. To meet that demand, Pick 'n Pay used the relationships its foundation

underserved markets and gained credibility with local communities.

For instance, after the 2004 tsunami, NGOs in India built microcredit operations as part of the relief effort. In Africa, international NGOs such as Africare and Direct Relief International, together with local groups, built infrastructure to deal with AIDS, famines, and refugee influxes. Along with microcredit and mutual insurance operations, they developed informal networks of traders and state-owned organizations into cooperatives, federations, and export-oriented enterprises. In India, NGOs like the Self Employed Women's Association (SEWA) are working with Indian insurance companies (such as ICICI Prudential), savings and credit cooperatives, and mutual health associations to sell insurance products. In Africa, supported by Western NGOs like Care and Finca International, local NGOs such as L'Association pour le Développement de la Région de Kaya (ADRK) in Burkina Faso, the Malawi Union of Savings and Credit Cooperatives, MicroSave (in Kenya), and Faitière des Unités Coopératives d'Epargne et de Crédit du Togo are selling crop, rain, life, asset-loss, widowhood, health, personal accident, and maternity insurance products to low-income consumers. In Uganda, Microcare has completed a three-year pilot that caters to 3,000 people. The project is being commercialized by a new for-profit company, Microcare Health, which has been set up jointly by Microcare and the Chicago-based insurer Aon.

Some NGOs are positively thriving where state-owned or multinational companies have failed. Two years ago, when the Indian insurance giant, Life Insurance Corporation, found it difficult to collect premiums and pay claims in rural areas in the state of Andhra Pradesh, microcredit federations took over the business. Their extensive knowledge of customers and their superior reach allowed the NGOs to grow the market rapidly. They operate quite profitably, earning an average gross margin of 27%.

As the scale and sophistication of their businesses grow, NGOs have become powerful national players. For instance, in 1986, a small group of street traders formed the African Co-operative for Hawkers and Informal Businesses to fight

had struck to develop reliable suppliers of traditional produce. Later, Pick 'n Pay used the same approach to create another supply chain for organic produce. (For more examples, see C.K. Prahalad's *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits.*)

At the same time, social groups have also set up businesses, usually entering market segments where corporations had been unsuccessful. In 1992, the amount NGOs gave out in development assistance was equal to about 11% of the funds governments in developed countries donated; by 2003, that amount had risen to 16%. In that year, grants from NGOs represented a remarkable 9.4% of public and private development assistance from OECD countries and multilateral agencies, according to the OECD's "Development Co-operation Report 2005." NGOs have used their funds to develop the infrastructure needed to supply people in remote areas with food, medicine, other supplies, and credit when disasters strike. Along the way, they acquired firsthand knowledge of

The New Rules of Company-NGO Engagement

As companies and NGOs work together, they are jointly defining the norms that will govern their future relations and behavior.

- The private and civil society sectors will cocreate markets, along with emerging customers and bottom-of-the-pyramid entrepreneurs, through innovative business models.
- Task-oriented relationships, rather than ideology or policy-driven dialogues, will emerge as the mode of collaboration between companies and NGOs.
- NGOs and companies will need to align global positions and standards and be very local in their ability to serve customers and create value.
- Since both external governance processes and the level of developmental benefits will be internal to the new business models, neither companies nor NGOs can see one another as adversaries.
- Companies and NGOs will gain legitimacy in society by creating bold value propositions that have credible economic, social, and environmental dimensions.
- Companies and NGOs will be under pressure to advocate common policy positions and jointly develop coregulatory schemes.

for their rights. ACHIB today counts 120,000 members in South Africa. It advocates hawkers' interests on policy matters and provides them with support services, such as warehousing infrastructure, bulk procurement, product distribution, microloans, and training. Recently, ACHIB launched a soft drink brand called Hola, which it distributes through a for-profit entity, Main Market Distribution. The cooperative has also entered the advertising business by launching hawker stalls with spaces that big companies can rent, in its words, "to increase awareness for their brands in the informal market."

The Minneapolis-based HealthStore Foundation represents a new breed of nonprofit that is designed from its inception to operate as a business. The foundation was set up by a small group of business professionals who had worked with NGOs in Africa to provide people with safe medicines. It used a franchise model to create 68 owner-operated Child & Family Wellness Shops, which sell health services and medicine in small towns in three districts in Kenya. The outlets operate according to common performance standards, and the HealthStore Foundation provides them with turnkey management systems and support, training owners and helping them select locations that will allow them to serve at least 5,000 households. In 2005, the clinics treated 404,000 patients; buoyed by their success, the NGO plans to set up 30 more outlets in 2007. In addition to private donations, foundation grants, and social venture capital funds, HealthStore also accepts grants from companies.

Some NGOs, like Accion, have succeeded in building multinational businesses. Acting as an agent for large microfinance NGOs, Accion has loaned \$9.4 billion to 4 million people in 22 countries, with a historical repayment rate greater than 97%. In 1992, Accion helped create the first bank in the world dedicated solely to microenterprise – BancoSol in Bolivia. Several of Accion's partners have made the transition from being charity-dependent organizations to becoming banks or other regulated financial institutions. Accion has also helped commercial banks – such as Sogebank in Haiti, Banco del Pichincha in Ecuador, and Banco ABN AMRO Real in Brazil – lend to the self-employed poor. In the United States, Accion has worked with Bank of America and Wachovia to identify potential clients who do not meet standard lending requirements.

The growing strength of NGO-owned businesses in emerging markets is mirrored in developed countries. Nonprofits have been pioneers in trading carbon emissions, producing organic foods, manufacturing herbal supplements, providing pay-as-you-go car-rental services, and many other businesses. For example, Local Sustainability is an Ontario-based NGO that provides engineering and energy management–consulting services to municipalities. It has succeeded where the likes of GE Capital, Philips Utilities, and Ameresco have struggled, owing to the high costs involved in getting political, bureaucratic, and technical representatives of municipalities to invest in making facilities more energy efficient. Through its expertise in generating political commitment for energy and environmental measures, Local Sustainability has been able to land 36 municipalities in Canada and the United States as customers. In the process, it has generated \$2.5 million in revenues and earned a 50% gross margin. Rivals initially criticized the NGO, claiming its not-for-profit status was a public subsidy, but consulting firms such as CH2M Hill now work closely with Local Sustainability because of its skills and reputation.

Before we describe the third stage of company-NGO relations, we must point out that the drive to set up businesses has created tensions within the two sectors. First, both companies and social groups are finding it difficult to manage their new roles. What does a multinational corporation such as Royal Dutch Shell do with the Shell Foundation when it shifts to a "business investment strategy in order to achieve both social and investment goals?" Will an NGO like Local Sustainability better achieve its objective of making facilities more energy efficient by spinning off its consultancy as a for-profit operation or by managing it as a project within its nonprofit structure? The answers aren't clear.

Second, NGOs are often unsure whether a company is a potential collaborator or competitor, and vice versa. On the one hand, nonprofit ventures such as Local Sustainability in Canada and microinsurance networks in India are bagging customers that corporations would dearly love to have. On the other hand, health food retailers such as Whole Foods Market have taken away customers who used to shop at NGO-owned cooperatives. Retailers like Starbucks and Tesco sell products that compete with the NGOs' Fairtrade line of products. Since the companies buy fewer Fairtrade products as result, the turn of events is worrying to the NGOs that created the standard.

Reactions to competition at the bottom of the pyramid can be complicated. ICICI became the biggest manager of microcredit operations in the south Indian state of Tamil Nadu by co-opting the women's microcredit groups that NGOs developed. Many NGOs are resigned to this; ICICI offers a larger range of banking services and provides greater opportunities for entrepreneurs. However, other groups are unhappy that ICICI has taken over their role and the women's self-help groups that they had designed for broader social development purposes. Some are reluctant to forge business relationships with the bank as a result.

The cocreate-businesses stage. As more companies conduct business experiments in bottom-of-the-pyramid markets and NGOs' business acumen evolves, they are realizing each other's limitations and strengths. This has laid the foundation for long-term partnerships between the two sectors based on "cocreation." Cocreation involves the development of an integrated business model in which the company becomes a key part of the NGO's capacity to deliver value and vice versa. Such ventures offer three opportunities:

- To deliver products at low prices to low-income consumers or to provide niche products to consumers in mature markets.
- To create hybrid business models involving corporations, NGOs, and entrepreneurs at the bottom of the economic ladder.
- To revive the corporation's social legitimacy while expanding the NGO's impact.

When companies and NGOs innovate together, the commercial nature of the relationship and their roles can vary, but the outcome is often a breakthrough. In fact, this quiet dialogue, away from public debates, has spawned key principles that will underlie governance structures in the future, as the exhibit "The New Rules of Company-NGO Engagement" shows. Take the case of BP (formerly British Petroleum), which set out to develop a fuel-efficient stove for poor consumers in rural India. Market research showed that consumers wanted the option of switching fuels based on their current income, the availability of fuels, and cooking styles. Working with the Indian Institute of Science in Bangalore, BP developed a portable stove that could use either liquefied petroleum gas (LPG) or biomass as fuel. To meet an additional social objective, BP designed the stove to burn biomass very efficiently, which would eliminate the smoke that causes respiratory illnesses in India.

One of BP's major challenges is distribution and retailing, since only small shops and informal traders cater to villagers in rural India. The company found that if it were to invest in building the distribution infrastructure from scratch, it wouldn't be able to sell the stove at a price that its target customers could afford. BP realized that it would have to work with local people who knew rural consumers and had access to distribution agents in the villages. Although the company could hire marketing experts or social workers as consultants, it wanted to develop relationships cheaply with scores of agents so that it could serve a linguistically disparate, culturally diverse, and physically dispersed customer base. While conducting preliminary market research, BP's managers met with three NGOs–Covenant Centre of Development, IDPMS, and Swayam Shikshan Prayog–that operated microcredit operations and other social enterprises in south India.

BP and the NGOs conducted market research together in order to become acquainted with each other's motivations, standards, and capabilities. After that, the two sides defined a shared strategic intent and developed a set of working principles. They built trust through relationships established between key individuals. Trust grew when BP made a long-term contractual commitment to the project. That trust proved to be pivotal, for instance, when the NGOs decided to consolidate distribution channels in five states to generate economies of scale. Most companies prefer to work with several distributors to spread their risks, but BP, understanding the NGOs' pressures, backed the consolidation. The NGOs established a new company that serves as a joint business vehicle through which village agents can pool their investments, licenses, and risk. That was new; the social groups had never before set up a joint operation with one another or with a corporation.

The two sides worked with each other closely at every stage of the project. They refined the business model, developed the rollout plans, and executed them through joint working groups. BP and the NGOs worked together to identify markets and train the distribution agents. They jointly evaluated the stove's design, costs, usability, and safety. They held discussions about the economics of production, distribution, consumer offers (including financing), capital investment, returns, and risks for everyone involved – not only BP and the NGOs but also customers, distributors, and microcredit federations.

BP and the NGOs also tackled the nonnegotiable issues in tandem. BP, for instance, would not compromise on safety standards for the transportation, storage, and use of LPG or violate its own standards of business ethics. Health and safety standards became a central part of the NGO training curriculum; the NGOs' employees even had to learn to use seat belts while driving around. For their part, the NGOs wanted to protect their credibility and goodwill with villagers. BP therefore had to make some accommodations, as well. The company had to ensure, for instance, that the women the NGO's company recruited as local sales agents were the first to receive cash generated by the business, thus allowing the villagers to recover their working capital.

The benefits of the cocreation approach will have to stand the test of the market, but some advantages are already evident. First, involving credible NGOs that have extensive infrastructure on the ground was tremendously valuable to BP, a foreign company with limited experience in India and no experience with any rural bottom-of-the-pyramid market. Second, the NGOs participated in a complex product-design process and in developing a business model. Doing so benefited them in two ways: They shared in the credit for developing the stove, and they gained credibility as successful collaborators with a global firm. Third, both the company and the NGOs have brought unique balance-sheet advantages to a new business. BP's deep pockets and patience can withstand the trials of a start-up; the NGOs can quickly access other assets, such as land, that the business needs. Finally, BP and the NGOs have together developed a business ecosystem that brings different economic entities – a global corporation, local social organizations, informal micro-entrepreneurs, and a research institute – into an efficient value chain. This alliance offers the promise of more than just access to better products at more affordable prices; it gives people at the bottom of the pyramid, who until now were unable to enjoy the benefits of globalization, a chance to create new livelihoods and gain economic and social influence.

The manner in which BP and the NGOs struck a commercial agreement bears no resemblance to traditional supplier-channel deals.

The manner in which BP and the NGOs struck a commercial agreement bears no resemblance to traditional supplier-channel deals. One difference is the transparency about cost structures and margins. The NGOs, for instance, conducted an analysis of the distribution process, identifying every cost element and breakeven scenario related to LPG cylinders, which are heavier, more regulated, and more dangerous than the products the NGOs usually handle. They conveyed the findings to BP. Suppliers often withhold information from distributors to gain an upper hand during negotiations. In this instance, BP and the NGOs shared their internal economics with each other so they could understand all the choices they faced in terms of distribution costs, consumer service options, growth rates, and breakeven points. This unusual level of transparency helped overcome the traditional mistrust between the two sectors.

Finally, BP and the NGOs developed a financial model that would allow everyone in the value chain to make money. The NGOs had to assume a great deal of the credit risks and legal liabilities for the agents in the villages. They would not have done so unless they were confident that BP was making a long-term investment in the project. The multinational had to reveal business data it would not normally share with distributors. Drawing up the legal contracts that captured the cocreation-based relationship was a huge learning and confidence-building experience, according to managers on both sides. The process engendered a culture of frankness, transparency, and joint problem solving that is unique in the history of company-NGO relationships.

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The same pattern is visible in the cocreation partnerships between ABN AMRO and Accion; Telenor, Danone, and Grameen Bank; Microsoft and Pratham; ICICI Prudential and SEWA; Local Sustainability and CH2M Hill; Microcare and Aon. In all these cases, neither company nor NGO can see the other as an adversary because of their interdependence; both apply assets and competencies to a business that creates greater value for each than their independent efforts could generate. We can judge these partnerships' performance by the level of value they deliver to customers and communities: Companies and NGOs now both share the pressure to perform, cutting through the spin that has too long dominated our understanding of globalization and its opportunities.

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No leader is perfect. The best ones don't try to be – they concentrate on honing their strengths and find others who can make up for their limitations.

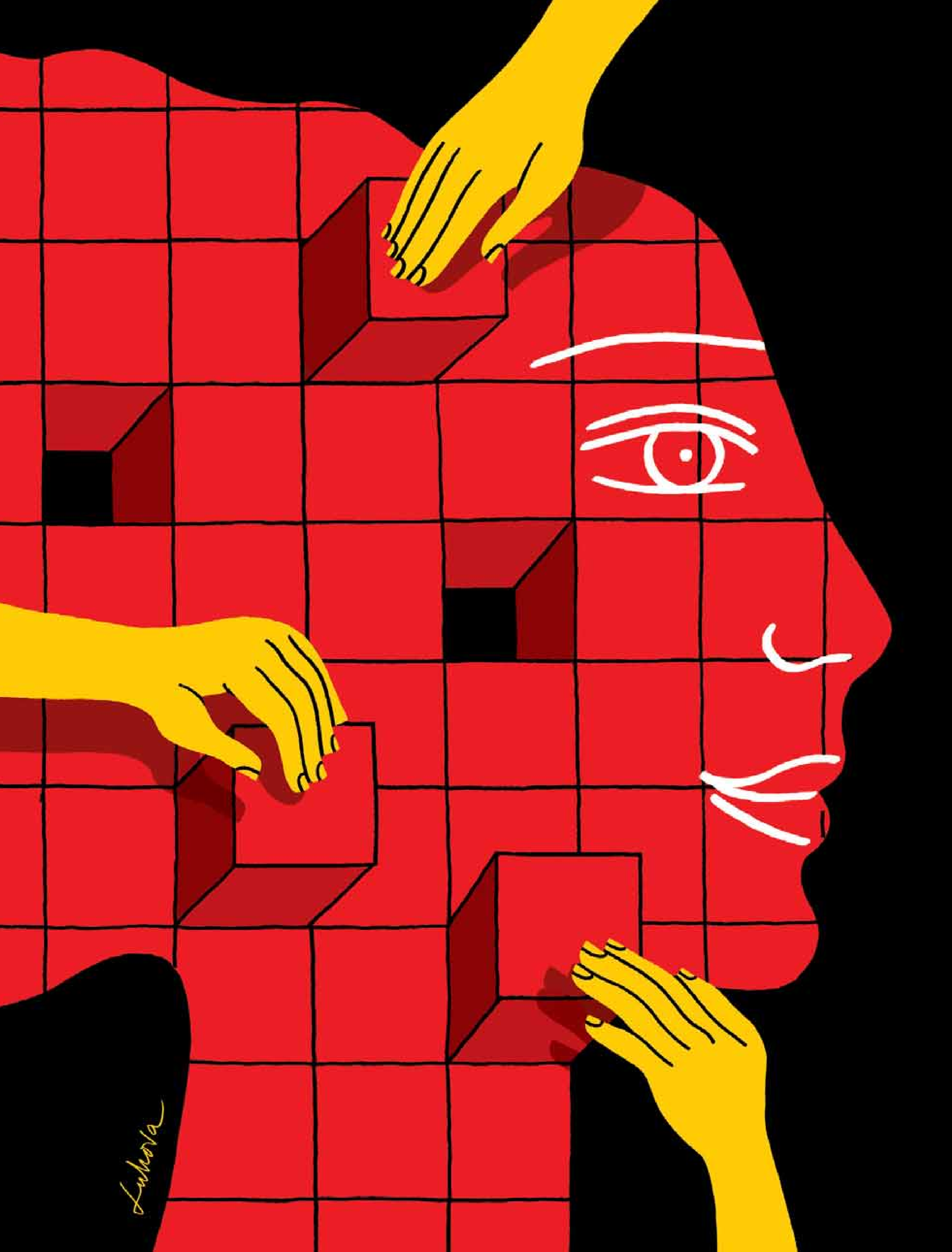
IN PRAISE OF THE INCOMPLETE LEADER

by Deborah Ancona, Thomas W. Malone, Wanda J. Orlikowski, and Peter M. Senge

WE'VE COME TO EXPECT A LOT OF OUR LEADERS. Top executives, the thinking goes, should have the intellectual capacity to make sense of unfathomably complex issues, the imaginative powers to paint a vision of the future that generates everyone's enthusiasm, the operational know-how to translate strategy into concrete plans, and the interpersonal skills to foster commitment to undertakings that could cost people's jobs should they fail. Unfortunately, no single person can possibly live up to those standards.

It's time to end the myth of the complete leader: the flawless person at the top who's got it all figured out. In fact, the sooner leaders stop trying to be all things to all people, the better off their organizations will be. In today's world, the executive's job is

Luba Lukova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no longer to command and control but to cultivate and coordinate the actions of others at all levels of the organization. Only when leaders come to see themselves as incomplete – as having both strengths and weaknesses – will they be able to make up for their missing skills by relying on others.

Corporations have been becoming less hierarchical and more collaborative for decades, of course, as globalization and the growing importance of knowledge work have required that responsibility and initiative be distributed more widely. Moreover, it is now possible for large groups of people to coordinate their actions, not just by bringing lots of information to a few centralized places but also by bringing lots of information to lots of places through ever-growing networks within and beyond the firm. The sheer complexity and ambiguity of problems is humbling. More and more decisions are made in the context of global markets and rapidly – sometimes radically – changing financial, social, political, technological, and environmental forces. Stakeholders such as activists, regulators, and employees all have claims on organizations.

No one person could possibly stay on top of everything. But the myth of the complete leader (and the attendant fear of appearing incompetent) makes many executives try to do just that, exhausting themselves and damaging their organizations in the process. The incomplete leader, by contrast, knows when to let go: when to let those who know the local market do the advertising plan or when to let the engineering team run with its idea of what the customer needs. The incomplete leader also knows that leadership exists throughout the organizational hierarchy – wherever expertise, vision, new ideas, and commitment are found.

We've worked with hundreds of people who have struggled under the weight of the myth of the complete leader. Over the past six years, our work at the MIT Leadership Center has included studying leadership in many organizations and teaching the topic to senior executives, middle managers, and MBA students. In our practice-based programs, we have analyzed numerous accounts of organizational change and watched leaders struggle to meld top-down strategic initiatives with vibrant ideas from the rest of the organization.

All this work has led us to develop a model of distributed leadership. This framework, which synthesizes our own research with ideas from other leadership scholars, views leadership as a set of four capabilities: *sensemaking* (understanding the context in which a company and its people operate), *relating* (building relationships within and across organizations), *visioning* (creating a compelling picture of the future), and *inventing* (developing new ways to achieve the vision).

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Even though managers pay lip service to the importance of mutual understanding, their real focus is on winning the argument.

While somewhat simplified, these capabilities span the intellectual and interpersonal, the rational and intuitive, and the conceptual and creative capacities required in today's business environment. Rarely, if ever, will someone be equally skilled in all four domains. Thus, incomplete leaders differ from incompetent leaders in that they understand what they're good at and what they're not and have good judgment about how they can work with others to build on their strengths and offset their limitations.

Sometimes, leaders need to further develop the capabilities they are weakest in. The exhibits throughout this article provide some suggestions for when and how to do that. Other times, however, it's more important for leaders to find and work with others to compensate for their weaknesses. Teams and organizations – not just individuals – can use this framework to diagnose their strengths and weaknesses and find ways to balance their skill sets.

Sensemaking

The term "sensemaking" was coined by organizational psychologist Karl Weick, and it means just what it sounds like: making sense of the world around us. Leaders are constantly trying to understand the contexts they are operating in. How will new technologies reshape the industry? How will changing cultural expectations shift the role of business in society? How does the globalization of labor markets affect recruitment and expansion plans?

Weick likened the process of sensemaking to cartography. What we map depends on where we look, what factors we choose to focus on, and what aspects of the terrain we decide to represent. Since these choices will shape the kind of map we produce, there is no perfect map of a terrain. Therefore, making sense is more than an act of analysis; it's an act of creativity. (See the exhibit "Engage in Sensemaking.")

The key for leaders is to determine what would be a useful map given their particular goals and then to draw one that adequately represents the situation the organization is facing at that moment. Executives who are strong in this capability know how to quickly capture the complexities of their environment and explain them to others in simple terms. This helps ensure that everyone is working from the same map, which makes it far easier to discuss and plan for the journey ahead. Leaders need to have the courage to present a map that highlights features they believe to be critical, even if their map doesn't conform to the dominant perspective.

When John Reed was CEO of Citibank, the company found itself in a real estate crisis. At the time, common wisdom said that Citibank would need to take a $2 billion write-off, but Reed wasn't sure. He wanted a better understanding of the situation, so to map the problem, he met with federal regulators as well as his managers, the board, potential investors, economists, and real estate experts. He kept asking, "What am I missing here?" After those meetings, he had a much stronger grasp of the problem, and he recalibrated the write-off to $5 billion – which turned out to be a far more accurate estimate. Later, three quarters into the bank's eight-quarter program to deal with the crisis, Reed realized that progress had stopped. He began talking to other CEOs known for their change management skills. This informal benchmarking process led him to devise an organizational redesign.

Throughout the crisis, real estate valuations, investors' requirements, board demands, and management team expectations were all changing and constantly needed to be reassessed. Good leaders understand that sensemaking is a continuous process; they let the map emerge from a melding of observations, data, experiences, conversations, and analyses. In healthy organizations, this sort of sensemaking goes on all the time. People have ongoing dialogues about their interpretations of markets and organizational realities.

At IDEO, a product design firm, sensemaking is step one for all design teams. According to founder David Kelley, team members must act as anthropologists studying an alien culture to understand the potential product from all points of view. When brainstorming a new design, IDEO's teams

ENGAGE IN SENSEMAKING

1. Get data from multiple sources: customers, suppliers, employees, competitors, other departments, and investors.
2. Involve others in your sensemaking. Say what you think you are seeing, and check with people who have different perspectives from yours.
3. Use early observations to shape small experiments in order to test your conclusions. Look for new ways to articulate alternatives and better ways to understand options.
4. Do not simply apply existing frameworks but instead be open to new possibilities. Try not to describe the world in stereotypical ways, such as good guys and bad guys, victims and oppressors, or marketers and engineers.

consider multiple perspectives – that is, they build multiple maps to inform their creative process. One IDEO team was charged with creating a new design for an emergency room. To better understand the experience of a key stakeholder – the patient – team members attached a camera to a patient's head and captured his experience in the ER. The result: nearly ten full hours of film of the ceiling. The sensemaking provoked by this perspective led to a redesign of the ceiling that made it more aesthetically pleasing and able to display important information for patients.

Relating

Many executives who attempt to foster trust, optimism, and consensus often reap anger, cynicism, and conflict instead. That's because they have difficulty relating to others, especially those who don't make sense of the world the way they do. Traditional images of leadership didn't assign much value to relating. Flawless leaders shouldn't need to seek counsel from anyone outside their tight inner circle, the thinking went, and they were expected to issue edicts rather than connect on an emotional level. Times have changed, of course, and in this era of networks, being able to build trusting relationships is a requirement of effective leadership.

Three key ways to do this are *inquiring, advocating,* and *connecting.* The concepts of inquiring and advocating stem from the work of organizational development specialists Chris Argyris and Don Schon. Inquiring means listening with the intention of genuinely understanding the thoughts and feelings of the speaker. Here, the listener suspends judgment and tries to comprehend how and why the speaker has moved from the data of his or her experiences to particular interpretations and conclusions.

Advocating, as the term implies, means explaining one's own point of view. It is the flip side of inquiring, and it's how leaders make clear to others how they reached their interpretations and conclusions. Good leaders distinguish their observations from their opinions and judgments and explain their reasoning without aggression or defensiveness. People with strong relating skills are typically those who've found a healthy balance between inquiring and advocating: They actively try to understand others' views but are able to stand up for their own. (See the exhibit "Build Relationships.")

We've seen countless relationships undermined because people disproportionately emphasized advocating over inquiring. Even though managers pay lip service to the importance of mutual understanding and shared commitment to a course of action, often their real focus is on winning the argument rather than strengthening the connection. Worse, in many organizations, the imbalance goes so far that having one's point of view prevail is what is understood as leadership.

Effective relating does not mean avoiding interpersonal conflict altogether. Argyris and Schon found that "maintaining a smooth surface" of conviviality and apparent agreement is one of the most common defensive routines that limits team effectiveness. Balancing inquiring and advocating is ultimately about showing respect, challenging opinions, asking tough questions, and taking a stand.

Consider Twynstra Gudde (TG), one of the largest independent consulting companies in the Netherlands. A few years ago, it replaced the role of CEO with a team of four managing directors who share leadership responsibilities. Given this unique structure, it's vital that these directors effectively relate to one another. They've adopted simple rules, such as a requirement that each leader give his opinion on every issue, majority-rules voting, and veto power for each director.

Clearly, for TG's senior team model to work, members must be skilled at engaging in dialogue together. They continually practice both inquiring and advocating, and because each director can veto a decision, each must thoroughly explain his reasoning to convince the others' that his perspective has merit. It's not easy to reach this level of mutual respect and trust, but over time, the team members' willingness to create honest connections with one another has paid off handsomely. Although they don't always reach consensus, they are able to settle on a course of action. Since this new form of leadership was introduced, TG has thrived: The company's profits have doubled, and employee satisfaction levels have improved. What's more, TG's leadership structure has served as a model for cooperation throughout the organization as well as in the firm's relations with its clients.

The third aspect of relating, connecting, involves cultivating a network of confidants who can help a leader accomplish a wide range of goals. Leaders who are strong in this capability have many people they can turn to who can help them think through difficult problems or support them in their initiatives. They understand that the time spent building and maintaining these connections is time spent investing in their leadership skills. Be-

BUILD RELATIONSHIPS

1. Spend time trying to understand others' perspectives, listening with an open mind and without judgment.
2. Encourage others to voice their opinions. What do they care about? How do they interpret what's going on? Why?
3. Before expressing your ideas, try to anticipate how others will react to them and how you might best explain them.
4. When expressing your ideas, don't just give a bottom line; explain your reasoning process.
5. Assess the strengths of your current connections: How well do you relate to others when receiving advice? When giving advice? When thinking through difficult problems? When asking for help?

Leaders skilled in visioning use stories and metaphors to paint a vivid picture of what the vision will accomplish, even if they don't have a comprehensive plan for getting there.

cause no one person can possibly have all the answers, or indeed, know all the right questions to ask, it's crucial that leaders be able to tap into a network of people who can fill in the gaps.

Visioning

Sensemaking and relating can be called the enabling capabilities of leadership. They help set the conditions that motivate and sustain change. The next two leadership capabilities – what we call "visioning" and inventing – are creative and action oriented: They produce the focus and energy needed to make change happen.

Visioning involves creating compelling images of the future. While sensemaking charts a map of what is, visioning produces a map of what could be and, more important, what a leader wants the future to be. It consists of far more than pinning a vision statement to the wall. Indeed, a shared vision is not a static thing – it's an ongoing process. Like sensemaking, visioning is dynamic and collaborative, a process of articulating what the members of an organization want to create together.

Fundamentally, visioning gives people a sense of meaning in their work. Leaders who are skilled in this capability are able to get people excited about their view of the future while inviting others to help crystallize that image. (See the exhibit "Create a Vision.") If they realize other people aren't joining in or buying into the vision, they don't just turn up the volume; they engage in a dialogue about the reality they hope to produce. They use stories and metaphors to paint a vivid picture of what the vision will accomplish, even if they don't have a comprehensive plan for getting there. They know that if the vision is credible and compelling enough, others will generate ideas to advance it.

CREATE A VISION

1. Practice creating a vision in many arenas, including your work life, your home life, and in community groups. Ask yourself, "What do I want to create?"
2. Develop a vision about something that inspires you. Your enthusiasm will motivate you and others. Listen to what they find exciting and important.
3. Expect that not all people will share your passion. Be prepared to explain why people should care about your vision and what can be achieved through it. If people don't get it, don't just turn up the volume. Try to construct a shared vision.
4. Don't worry if you don't know how to accomplish the vision. If it is compelling and credible, other people will discover all sorts of ways to make it real – ways you never could have imagined on your own.
5. Use images, metaphors, and stories to convey complex situations that will enable others to act.

In South Africa in the early 1990s, a joke was making the rounds: Given the country's daunting challenges, people had two options, one practical and the other miraculous. The practical option was for everyone to pray for a band of angels to come down from heaven and fix things. The miraculous option was for people to talk with one another until they could find a way forward. In F.W. de Klerk's famous speech in 1990 – his first after assuming leadership – he called for a nonracist South Africa and suggested that negotiation was the only way to achieve a peaceful transition. That speech sparked a set of changes that led to Nelson Mandela's release from Robben Island prison and the return to the country of previously banned political leaders.

Few of South Africa's leaders agreed on much of anything regarding the country's future. It seemed like a long shot, at best, that a scenario-planning process convened by a black professor from the University of the Western Cape and facilitated by a white Canadian from Royal Dutch Shell would be able to bring about any sort of change. But they, together with members of the African National Congress (ANC), the radical Pan Africanist Congress (PAC), and the white business community, were charged with forging a new path for South Africa.

When the team members first met, they focused on collective sensemaking. Their discussions then evolved into a yearlong visioning process. In his book, *Solving Tough Problems,* Adam Kahane, the facilitator, says the group started by telling stories of "left-wing revolution, right-wing revolts, and free market utopias." Eventually, the leadership team drafted a set of scenarios that described the many paths toward disaster and the one toward sustainable development.

They used metaphors and clear imagery to convey the various paths in language that was easy to understand. One negative scenario, for instance,

Most leaders experience a profound dichotomy every day, and it's a heavy burden. They are trapped in the myth of the complete leader – the person at the top without flaws.

was dubbed "Ostrich": A nonrepresentative white government sticks its head in the sand, trying to avoid a negotiated settlement with the black majority. Another negative scenario was labeled "Icarus": A constitutionally unconstrained black government comes to power with noble intentions and embarks on a huge, unsustainable public-spending spree that crashes the economy. This scenario contradicted the popular belief that the country was rich and could simply redistribute wealth from whites to blacks. The Icarus scenario set the stage for a fundamental (and controversial) shift in economic thinking in the ANC and other left-wing parties – a shift that led the ANC government to "strict and consistent fiscal discipline," according to Kahane.

The group's one positive scenario involved the government adopting a set of sustainable policies that would put the country on a path of inclusive growth to successfully rebuild the economy and establish democracy. This option was called "Flamingo," invoking the image of a flock of beautiful birds all taking flight together.

This process of visioning unearthed an extraordinary collective sense of possibility in South Africa. Instead of talking about what other people should do to advance some agenda, the leaders spoke about what they could do to create a better future for everyone. They didn't have an exact implementation plan at the ready, but by creating a credible vision, they paved the way for others to join in and help make their vision a reality.

Leaders who excel in visioning walk the walk; they work to embody the core values and ideas contained in the vision. Darcy Winslow, Nike's global director for women's footwear, is a good example. A 14-year veteran at Nike, Winslow previously held the position of general manager of sustainable business opportunities at the shoe and apparel giant. Her work in that role reflected her own core values, including her passion for the environment. "We had come to see that our customers' health and our own ability to compete were inseparable from the health of the environment," she says. So she initiated the concept of ecologically intelligent product design. Winslow's team worked at determining the chemical composition and environmental effects of every material and process Nike used. They visited factories in China and collected samples of rubber, leather, nylon, polyester, and foams to determine their chemical makeup. This led Winslow and her team to develop a list of "positive" materials – those that weren't harmful to the environment – that they hoped to use in more Nike products. "Environmental sustainability" was no longer just an abstract term on a vision statement; the team now felt a mandate to realize the vision.

CULTIVATE INVENTIVENESS

1. Don't assume that the way things have always been done is the best way to do them.
2. When a new task or change effort emerges, encourage creative ways of getting it done.
3. Experiment with different ways of organizing work. Find alternative methods for grouping and linking people.
4. When working to understand your current environment, ask yourself, "What other options are possible?"

Inventing

Even the most compelling vision will lose its power if it floats, unconnected, above the everyday reality of organizational life. To transform a vision of the future into a present-day reality, leaders need to devise processes that will give it life. This inventing is what moves a business from the abstract world of ideas to the concrete world of implementation. In fact, inventing is similar to execution, but the label "inventing" emphasizes that this process often requires creativity to help people figure out new ways of working together.

To realize a new vision, people usually can't keep doing the same things they've been doing. They need to conceive, design, and put into practice new ways of interacting and organizing. Some of the most famous examples of large-scale organizational innovation come from the automotive industry: Henry Ford's conception of the assembly-line factory and Toyota's famed integrated production system.

More recently, Pierre Omidyar, the founder of eBay, invented through his company a new way of doing large-scale retailing. His vision was of an online community where users would take responsibility for what happened. In a 2001 BusinessWeek Online interview, Omidyar explained, "I had the idea that I wanted to create an efficient market and a level playing field where everyone had equal access to information. I wanted to give the power of the market back to individuals, not just large corporations. That was the driving motivation for creating eBay at the start."

Examining Your Leadership Capabilities

Few people wake up in the morning and say, "I'm a poor sensemaker" or "I just can't relate to others." They tend to experience their own weaknesses more as chronic or inexplicable failures in the organization or in those around them. The following descriptions will help you recognize opportunities to develop your leadership capabilities and identify openings for working with others.

SIGNS OF WEAK SENSEMAKING

1. You feel strongly that you are usually right and others are often wrong.
2. You feel your views describe reality correctly, but others' views do not.
3. You find you are often blindsided by changes in your organization or industry.
4. When things change, you typically feel resentful. (That's not the way it should be!)

SIGNS OF WEAK RELATING

1. You blame others for failed projects.
2. You feel others are constantly letting you down or failing to live up to your expectations.
3. You find that many of your interactions at work are unpleasant, frustrating, or argumentative.
4. You find many of the people you work with untrustworthy.

SIGNS OF WEAK VISIONING

1. You feel your work involves managing an endless series of crises.
2. You feel like you're bouncing from pillar to post with no sense of larger purpose.
3. You often wonder, "Why are we doing this?" or "Does it really matter?"
4. You can't remember the last time you talked to your family or a friend with excitement about your work.

SIGNS OF WEAK INVENTING

1. Your organization's vision seems abstract to you.
2. You have difficulty relating your company's vision to what you are doing today.
3. You notice dysfunctional gaps between your organization's aspirations and the way work is organized.
4. You find that things tend to revert to business as usual.

Consequently, eBay outsources most of the functions of traditional retailing – purchasing, order fulfillment, and customer service, for example – to independent sellers worldwide. The company estimates that more than 430,000 people make their primary living from selling wares on eBay. If those individuals were all employees of eBay, it would be the second largest private employer in the United States after Wal-Mart.

The people who work through eBay are essentially independent store owners, and, as such, they have a huge amount of autonomy in how they do their work. They decide what to sell, when to sell it, how to price, and how to advertise. Coupled with this individual freedom is global scale. EBay's infrastructure enables them to sell their goods all over the world. What makes eBay's inventing so radical is that it represents a new relationship between an organization and its parts. Unlike typical outsourcing, eBay doesn't pay its retailers – they pay the company.

Inventing doesn't have to occur on such a grand scale. It happens every time a person creates a way of approaching a task or figures out how to overcome a previously insurmountable obstacle. In their book *Car Launch,* George Roth and Art Kleiner describe a highly successful product development team in the automobile industry that struggled with completing its designs on time. Much of the source of the problem, the team members concluded, came from the stovepipe organizational structure found in the product development division. Even though they were a "colocated" team dedicated to designing a common new car, members were divided by their different technical expertise, experience, jargon, and norms of working.

When the team invented a mechanical prototyping device that complemented its computer-aided design tools, the group members found that it facilitated a whole new way of collaborating. Multiple groups within the team could quickly create physical mock-ups of design ideas to be tested by the various engineers from different specialties in the team. The group called the device "the harmony buck," because it helped people break out of their comfortable engineering specialties and solve interdependent design problems together. Development of a "full body" physical mock-up of the new car allowed engineers to hang around the prototype, providing a central focal point for their interactions. It enabled them to more easily identify and raise cross-functional issues, and it facilitated mutual problem solving and coordination.

In sum, leaders must be able to succeed at inventing, and this requires both attention to detail and creativity. (See the exhibit "Cultivate Inventiveness.")

Balancing the Four Capabilities

Sensemaking, relating, visioning, and inventing are interdependent. Without sensemaking, there's no common view of reality from which to start. Without relating, people work in isolation or, worse, strive toward different aims. Without visioning, there's no shared direction. And without inventing, a vision remains illusory. No one leader, however, will excel at all four capabilities in equal measure.

Typically, leaders are strong in one or two capabilities. Intel chairman Andy Grove is the quintessential sensemaker, for instance, with a gift for recognizing strategic inflection points that can be exploited for competitive advantage. Herb Kelleher, the former CEO of Southwest Airlines, excels at relating. He remarked in the journal *Leader to Leader* that "We are not afraid to talk to our people with emotion. We're not afraid to tell them, 'We love you.' Because we do." With this emotional connection comes equitable compensation and profit sharing.

Apple CEO Steve Jobs is a visionary whose ambitious dreams and persuasiveness have catalyzed remarkable successes for Apple, Next, and Pixar. Meg Whitman, the CEO of eBay, helped bring Pierre Omidyar's vision of online retailing to life by inventing ways to deal with security, vendor reliability, and product diversification.

Once leaders diagnose their own capabilities, identifying their unique set of strengths and weaknesses, they must search for others who can provide the things they're missing. (See the sidebar "Examining Your Leadership Capabilities.") Leaders who choose only people who mirror themselves are likely to find their organizations tilting in one direction, missing one or more essential capabilities needed to survive in a changing, complex world. That's why it's important to examine the whole organization to make sure it is appropriately balanced as well. It's the leader's responsibility to create an environment that lets people complement one another's strengths and offset one another's weaknesses. In this way, leadership is distributed across multiple people throughout the organization.

• • •

Years ago, one of us attended a three-day meeting on leadership with 15 top managers from different companies. At the close of it, participants were asked to reflect on their experience as leaders. One executive, responsible for more than 50,000 people in his division of a manufacturing corporation, drew two pictures on a flip chart. The image on the left was what he projected to the outside world: It was a large, intimidating face holding up a huge fist. The image on the right represented how he saw himself: a small face with wide eyes, hair standing on end, and an expression of sheer terror.

We believe that most leaders experience that profound dichotomy every day, and it's a heavy burden. How many times have you feigned confidence to superiors or reports when you were really unsure? Have you ever felt comfortable conceding that you were confused by the latest business results or caught off guard by a competitor's move? Would you ever admit to feeling inadequate to cope with the complex issues your firm was facing? Anyone who can identify with these situations knows firsthand what it's like to be trapped in the myth of the complete leader–the person at the top without flaws. It's time to put that myth to rest, not only for the sake of frustrated leaders but also for the health of organizations. Even the most talented leaders require the input and leadership of others, constructively solicited and creatively applied. It's time to celebrate the incomplete–that is, the human–leader.

Reprint R0702E
To order, see page 158.

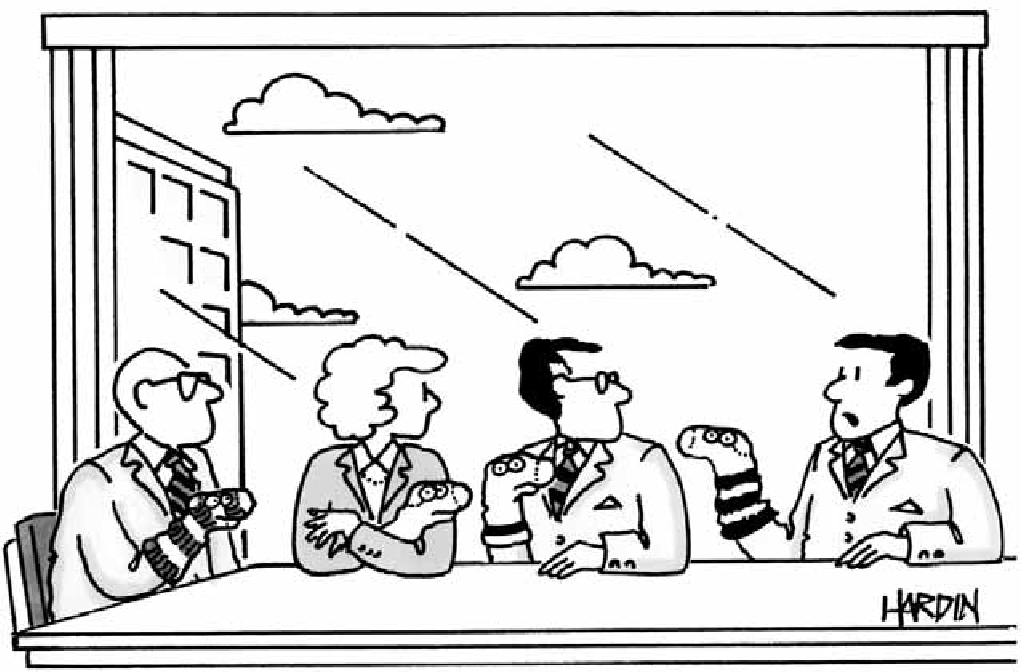
"Finally, to help those of us counting carbs, we've moved to bar graphs instead of pie charts."

Table Talk

> "Dialogue is the basic unit of work in an organization. The quality of the dialogue determines how people gather and process information, how they make decisions, and how they feel about one another and about the outcome of these decisions."

Ram Charan
"Conquering a Culture of Indecision"
Harvard Business Review
April 2001

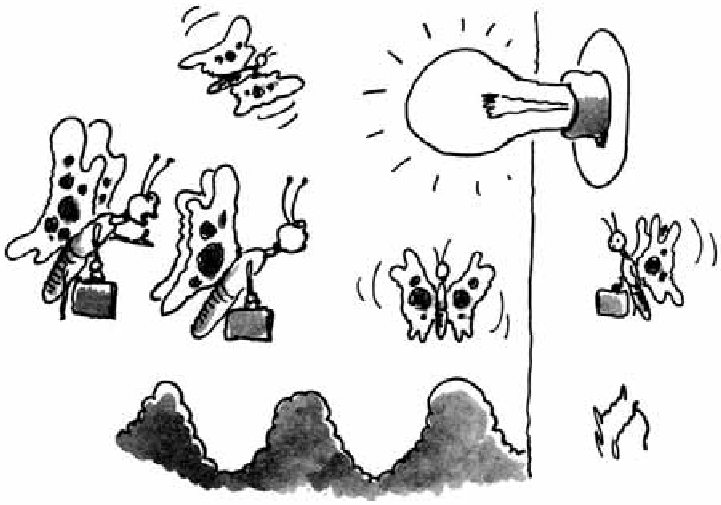
"My lobbyist trumps your legal team."



"Personally, I was hoping for more from the intermediary process."

Pat Byrnes, Roy Delgado, Patrick Hardin, Mike Lynch, and Scott Arthur Masear

"I'm uncertain about this, but I could be wrong."



"Sometimes, I wonder if these endless meetings really accomplish anything."

"Just once I'd like to see us *pass* something on a voice vote."

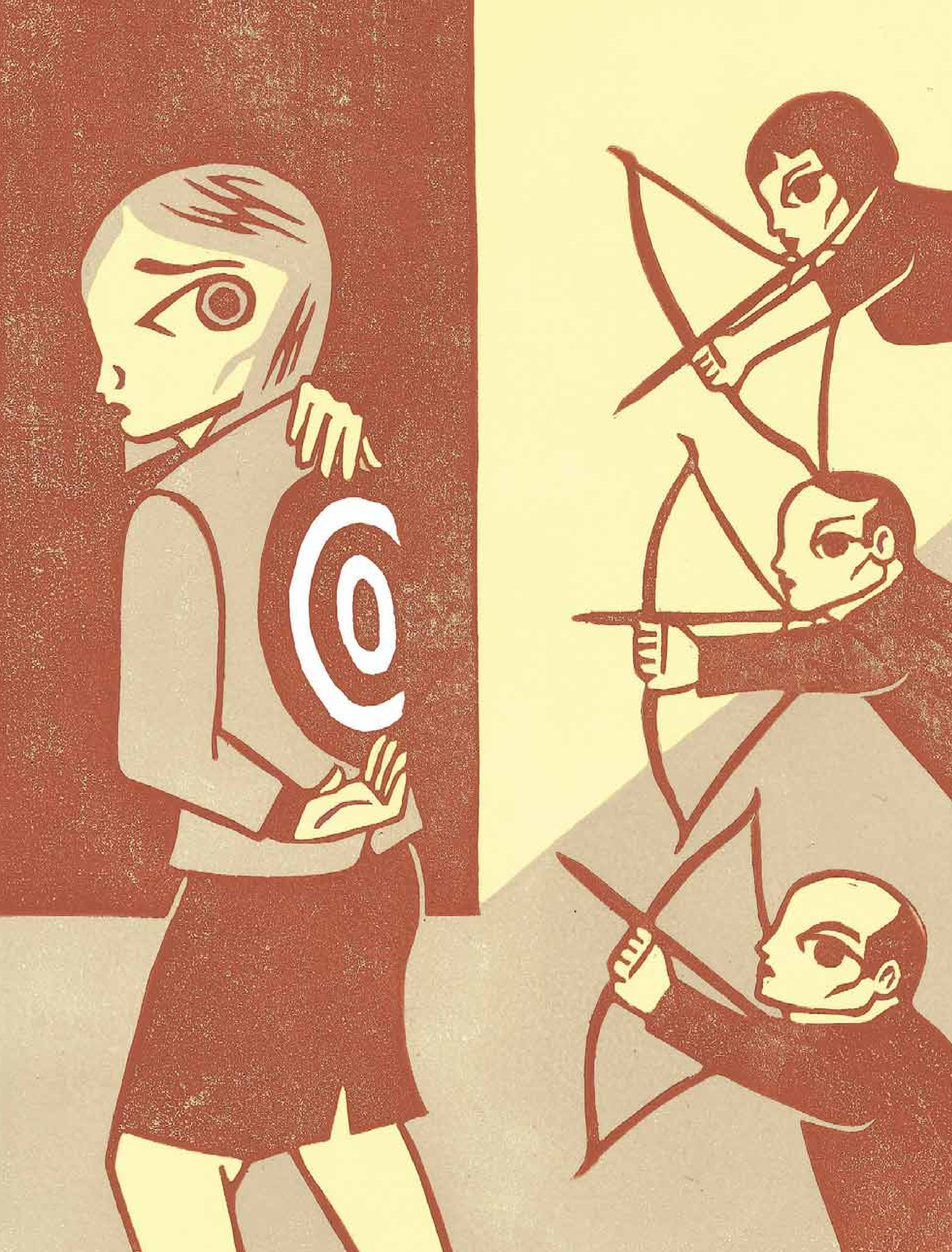
Identify, quantify, and manage the risks to your company's reputation long before a problem or crisis strikes.

REPUTATION and Its Risks

by Robert G. Eccles, Scott C. Newquist, and Roland Schatz

EXECUTIVES KNOW THE IMPORTANCE of their companies' reputations. Firms with strong positive reputations attract better people. They are perceived as providing more value, which often allows them to charge a premium. Their customers are more loyal and buy broader ranges of products and services. Because the market believes that such companies will deliver sustained earnings and future growth, they have higher price-earnings multiples and market values and lower costs of capital. Moreover, in an economy where 70% to 80% of market value comes from hard-to-assess intangible assets such as brand equity, intellectual capital, and goodwill, organizations are especially vulnerable to anything that damages their reputations.

Blair Kelly



Most companies, however, do an inadequate job of managing their reputations in general and the risks to their reputations in particular. They tend to focus their energies on handling the threats to their reputations that have already surfaced. This is not risk management; it is crisis management – a reactive approach whose purpose is to limit the damage. This article provides a framework for proactively managing reputational risks. It explains the factors that affect the level of such risks and then explores how a company can sufficiently quantify and control them. Such a process will help managers do a better job of assessing existing and potential threats to their companies' reputations and deciding whether to accept a given risk or to take actions to avoid or mitigate it.

The Current State of Affairs

Regulators, industry groups, consultants, and individual companies have developed elaborate guidelines over the years for assessing and managing risks in a wide range of areas, from commodity prices to control systems to supply chains to political instability to natural disasters. However, in the absence of agreement on how to define and measure reputational risk, it has been ignored.

Consider the 135-page framework for enterprise risk management (ERM) proposed in 2004 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), a group of professional associations of U.S accountants and financial executives that issues guidelines for internal controls. Although the framework mentions virtually every other imaginable risk, it does not contain a single reference to reputational risk.

Nor does the Basel II international accord for regulating capital requirements for large international banks. In defining operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events," the Basel II framework, issued in 2004 and updated in 2005, specifically excludes strategic and reputational risks. That's mainly because of the difficulty of factoring them into capital-adequacy requirements, most banking-risk professionals would say.

Given this lack of common standards, even sophisticated companies have only a fuzzy idea of how to manage reputational risk. A large U.S. pharmaceutical company reflects the current state of practice among well-run organizations. It has an ERM system for managing operational and financial risks, as well as hazards from external events such as natural disasters, that is loosely based on the COSO framework. The firm's vice president of risk management oversees the system. However, the company manages reputational risks only informally – and unevenly – at the local and product levels. Its leaders consider reputational risk only when they make major decisions such as those involving acquisitions. (The company's due-diligence process includes the evaluation of problems that could affect reputation, including pending lawsuits, weak product-testing procedures, product-liability concerns, and poor control systems for detecting management fraud.) The risk management VP says that reputational risk is not included in the long list of risks for which he is responsible. Then who is responsible? The CEO, the vice president surmises, since that is who oversees the firm's elaborate crisis-response system and is ultimately responsible for dealing with any events that could damage the company's reputation. This pharmaceutical firm is not alone. Contingency plans for crisis management are as close as most large and midsize companies come to reputational-risk management. While such plans are important, it is a mistake to confuse them with a capability for managing reputational risk. Knowing first aid is not the same as protecting your health.

> **"It takes many good deeds to build a good reputation, and only one bad one to lose it."**
> **–Benjamin Franklin**

Determinants of Reputational Risk

Three things determine the extent to which a company is exposed to reputational risk. The first is whether its reputation exceeds its true character. The second is how much external beliefs and expectations change, which can widen or (less

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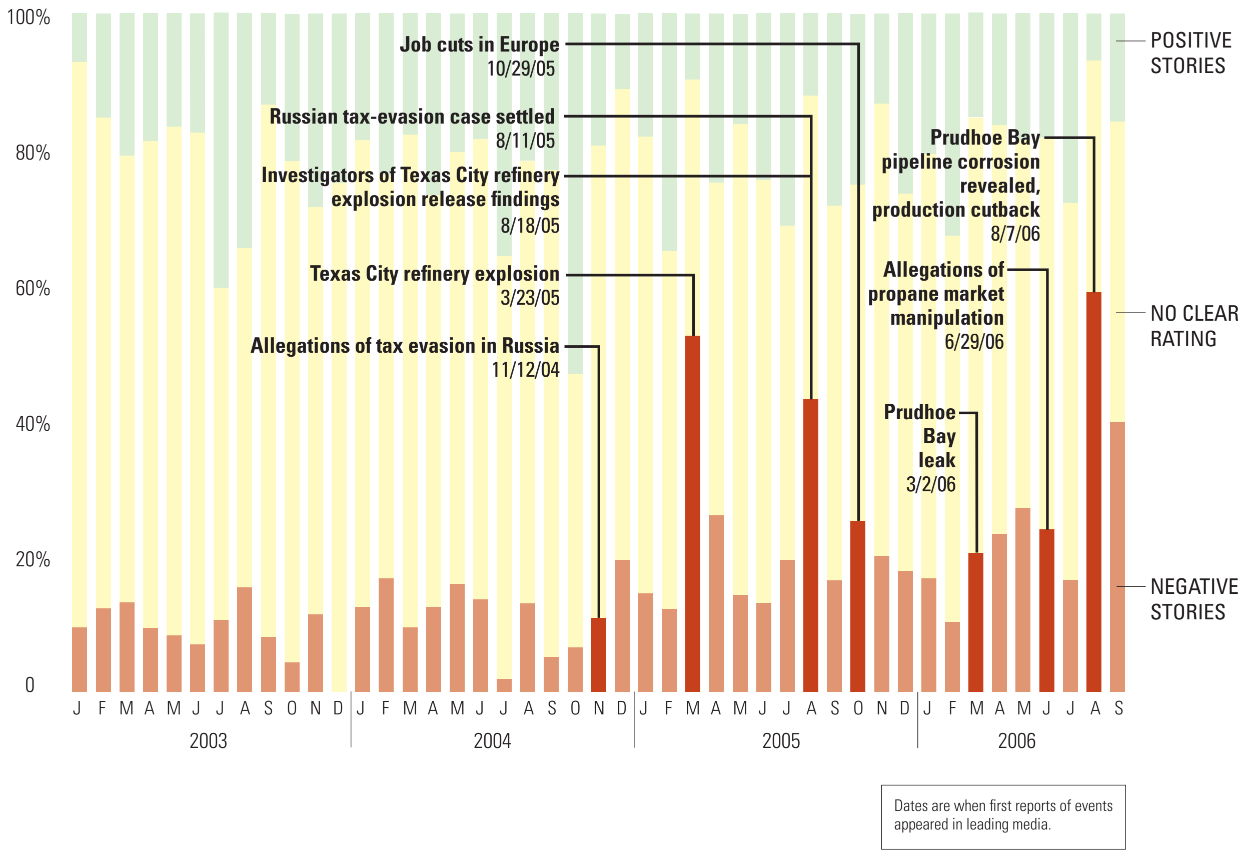
BP's Sinking Image

Media coverage plays a large role in determining a company's reputation. The changing mix of positive and negative stories mentioning BP in the leading British, German, and U.S. media from January 2003 through September 2006 shows how a series of events hurt the oil giant's reputation. During 2003 and 2004, the ratio of positive to negative stories was about two to one. However, stories about an explosion at BP's Texas City refinery, alleged tax evasion in Russia, and job cuts in Europe took their toll in 2005, when positive and negative coverage were roughly equal. Events in 2006 – especially an oil leak at the Prudhoe Bay field in Alaska due to pipeline corrosion, and a subsequent cut in production – caused the number of stories mentioning BP to soar and the mix to become more negative than positive.



likely) narrow this gap. The third is the quality of internal coordination, which also can affect the gap.

Reputation-reality gap. Effectively managing reputational risk begins with recognizing that reputation is a matter of perception. A company's overall reputation is a function of its reputation among its various stakeholders (investors, customers, suppliers, employees, regulators, politicians, nongovernmental organizations, the communities in which the firm operates) in specific categories (product quality, corporate governance, employee relations, customer service, intellectual capital, financial performance, handling of environmental and social issues). A strong positive reputation among stakeholders across multiple categories will result in a strong positive reputation for the company overall.

Reputation is distinct from the actual character or behavior of the company and may be better or worse. When the reputation of a company is more positive than its underlying reality, this gap poses a substantial risk. Eventually, the failure of a firm to live up to its billing will be revealed, and its reputation will decline until it more closely matches the reality. BP appears to be learning this the hard way. The energy giant has striven to portray itself as a responsible corporation that cares about the environment. Its efforts have included its extensive "Beyond Petroleum" advertising campaign and a multibillion-dollar initiative to expand its alternative-energy business. But several major events in the past two years are now causing the public to question whether BP is truly so exceptional. (See the exhibit "BP's Sinking Image.")

One was the explosion and fire at its Texas City refinery in March 2005 that killed 15 people and injured scores of others. Another was the leak in a corroded pipeline at its Prudhoe Bay oil field in Alaska that occurred a year later and forced the company to slash production in August 2006. BP has blamed the refinery disaster on lax operating practices, but federal investigators have alleged that cost cutting contributed as well. Employee allegations and company reports suggest that the root cause of the Prudhoe Bay problem may have been inadequate maintenance and inspection practices and management's failure to heed warnings of potential corrosion problems. As media coverage reflects, these events and others have damaged BP's reputation.

To bridge reputation-reality gaps, a company must either improve its ability to meet expectations or reduce expectations by promising less. The problem is, managers may resort to short-term manipulations. For example, reputation-reality gaps concerning financial performance often result in accounting fraud and (ultimately) restatements of results. Computer Associates, Enron, Rite Aid, Tyco, WorldCom, and Xerox are some of the well-known companies that have fallen into this trap in recent years.

Of course, organizations that actually meet the expectations of their various stakeholders may not get full credit for doing so. This often occurs when a company's reputation has been significantly damaged by unfair attacks from special interest groups or inaccurate reporting by the media. It also can happen when a company has made genuine strides in addressing a problem that has hurt its reputation but can't convince stakeholders that its progress is real. For example, Chrysler, Ford, and General Motors improved their cars so much that the quality gap between them and the vehicles made by Japanese companies had largely closed by 2001. Yet, much to the frustration of the Big Three, consumers remain skeptical.

Undeserved poor or mediocre reputations can be maddening. The temptation is to respond to them with resignation and conclude: "No matter what we do, people won't like us, so why bother?" The reason executives should bother – through redoubled efforts to improve reporting and communications – is that their fiduciary obligation to close such reputation-reality gaps is as great as their obligation to improve real performance. Both things drive value creation for shareholders.

Changing beliefs and expectations. The changing beliefs and expectations of stakeholders are another major determinant of reputational risk. When expectations are shifting and the company's character stays the same, the reputation-reality gap widens and risks increase.

There are numerous examples of once-acceptable practices that stakeholders no longer consider to be satisfactory or ethical. Until the 1990s, hostile takeovers in Japan were almost unheard of – but that was partly due to the cross-holding of shares among the elite groups of companies known as keiretsu, a practice that undermined the power of other shareholders. With the weakening of the keiretsu structure during the past ten to 15 years, shareholder rights and takeovers have been on the rise. In the United States, once-acceptable practices now considered improper include brokerage firms using their research functions to sell investment-banking deals; insurance underwriters' incentive payments to brokers, which caused brokers to price and structure coverage to serve underwriters' interests rather than customers'; the appointment of CEOs' friends to boards as "independent directors"; earnings guidance; and smoothing of earnings.

Sometimes norms evolve over time, as did the now widespread expectation in most developed countries that companies should pollute minimally (if at all). A change in the behavior or policies of a leading company can cause stakeholders' expectations to shift quite rapidly, which can imperil the reputations of firms that adhere to old standards. For example, the "ecomagination" initiative launched by General Electric in 2005 has the potential to raise the bar for other companies. It committed GE to doubling its R&D investment in developing cleaner technologies, doubling the revenue from products and services that have significant and measurable environmental benefits, and reducing GE's own greenhouse emissions.

Of course, different stakeholders' expectations can diverge dramatically, which makes the task of determining acceptable norms especially difficult. When GlaxoSmithKline pioneered the development of anti-retroviral drugs to combat AIDS, its reputation for conducting cutting-edge research and product development was reinforced and shareholders were pleased. They were initially on board when GSK led a group of pharmaceutical companies in suing the South African government after it passed legislation in 1997 allow-

> **"Character is like a tree and reputation like its shadow. The shadow is what we think of it; the tree is the real thing."**
>
> **– Abraham Lincoln**

ing the country to import less expensive, generic versions of AIDS drugs covered by GSK patents. But in 2001, GSK shareholders did an about-face in reaction to an intensifying campaign waged by NGOs and to the trial proceedings, which made GSK and the other drug companies look greedy and immoral. With its reputation plunging, GSK relented and granted a South African company a free license to manufacture generic versions of its AIDS drugs–but the damage was already done.

Sometimes, particular events can cause latent concerns to burst to the surface. One example would be all the questions about whether Merck had fully disclosed the potential of its painkiller Vioxx to cause heart attacks and strokes. Merck is embroiled in thousands of lawsuits over the arthritis drug, which it pulled from the market in 2004. The controversy has raised patients' and doctors' expectations that drug companies should disclose more detailed results and analyses of clinical trials, as well as experience in the market after drugs have received regulatory approval.

When such crises strike, companies complain that they have been found guilty (in the courts or in the press) because the rules have changed. But all too often, it's their own fault: They either ignored signs that stakeholders' beliefs and expectations were changing or denied their validity.

In addition, organizations sometimes underestimate how much attitudes can vary by region or country. For example, Monsanto, a developer of genetically modified plants, was badly burned by its failure to anticipate Europeans' deep concerns about genetically modified foods.

Weak internal coordination. Another major source of reputational risk is poor coordination of the decisions made by different business units and functions. If one group creates expectations that another group fails to meet, the company's reputation can suffer. A classic example is the marketing department of a software company that launches a large advertising campaign for a new product before developers have identified and ironed out all the bugs: The company is forced to choose between selling a flawed product and introducing it later than promised.

The timing of unrelated decisions also can put a company's reputation at risk, especially if it causes a stakeholder group to jump to a negative conclusion. This happened to American Airlines in 2003, when it was trying to stave off bankruptcy. At the same time that it was negotiating a major reduction in wages with its unions, its board approved retention bonuses for senior managers and a big payment to a trust fund designed to protect executive pensions in the event of bankruptcy. However, the company didn't tell the unions. Furious when they found out, the unions revisited the concessions package they had approved. The controversy cost CEO Donald J. Carty his job.

Poor internal coordination also inhibits a company's ability to identify changing beliefs and expectations. In virtually all well-run organizations, individual functional groups not only have their fingers on the pulses of various stakeholders but are also actively trying to manage their expectations. Investor Relations (with varying degrees of input from the CFO and the CEO) attempts to ascertain and influence the expectations of analysts and investors; Marketing surveys customers; Advertising buys ads that shape expectations; HR surveys employees; Corporate Communications monitors the media and conveys the company's messages; Corporate Social Responsibility engages with NGOs; and Corporate Affairs monitors new and pending laws and regulations. All of these actions are important to understanding and managing reputational risks. But more often than not, these groups do a bad job of sharing information or coordinating their plans.

Coordination is often poor because the CEO has not assigned this responsibility to a specific person. When 269 executives were asked in 2005 by the Economist Intelligence Unit who at their companies had "major responsibility" for managing reputational risk, 84% responded, "The CEO." This means that nobody is really overseeing the coordination process. Yes, the CEO is the person ultimately responsible for reputational risk, since he or she is ultimately responsible for everything. But the fact of the matter is, the CEO does not have the time to manage the ongoing process of coordinating all the activities that affect reputational risk.

Managing Reputational Risk

Effectively managing reputational risk involves five steps: assessing your company's reputation among stakeholders, evaluating your company's real character, closing reputation-reality gaps, monitoring changing beliefs and expectations, and putting a senior executive below the CEO in charge.

Assess reputation. Since reputation is perception, it is perception that must be measured. This argues for the assessment of reputation in multiple areas, in ways that are contextual, objective, and, if possible, quantitative. Three questions need to be addressed: What is the company's reputation in each area (product quality, financial performance, and so on)? Why? How do these reputations compare with those of the firm's peers?

Various techniques exist for evaluating a company's reputation. They include media analysis, surveys of stakeholders (customers, employees, investors, NGOs) and industry executives, focus groups, and public opinion polls. Although all are useful, a detailed and structured analysis of what the media are saying is especially important because the media shape the perceptions and expectations of all stakeholders.

Today, many companies hire clipping services to gather stories about them. Text- and speech-recognition technologies enable these services to scan a wide range of outlets, including newspapers, magazines, TV, radio, and blogs. They can provide information on such things as the total number of stories, the number per topic, and the source and author of each story. While useful in offering a real-time sample of media coverage, these services are not always accurate in assessing whether a story about a company is positive, negative, or neutral, because of the limits of the computer algorithms that they employ. They also tend to miss stories that cite a company but do not mention it in the headline or first few sentences.

Therefore, the old tool of clipping services needs to be supplemented with strategic media intelligence. This new tool not only analyzes every line in a story but also places the coverage of a company within the context of *all* the stories in the leading media (those that set the tone for the coverage of topics, companies, and people in individual countries). Since the reputation of a company is a function of others' reputations in its industry and the relative reputation of the industry overall, having the complete context is essential for assessing volume and prominence of coverage, topics of interest, and whether the view is positive or negative.

Establishing a positive reputation through the media depends on several factors or practices, according to research by the Media Tenor Institute for Media Analysis (founded by coauthor Roland Schatz) in Lugano, Switzerland.

First, the company has to land and remain on the public's radar screen, which involves staying above what we call the "awareness threshold": a minimum number of stories mentioning or featuring the company in the leading media. This volume, which must be continual, varies somewhat from company to company, depending on industry and country but not on company size.

Second, a positive reputation requires that at least 20% of the stories in the leading media be positive, no more than 10% negative, and the rest neutral. When coverage is above the awareness threshold and is positive overall, the company's reputation benefits from individual positive stories and is less susceptible to being damaged when negative stories appear. If coverage is above the awareness threshold but the majority of stories are negative, a company will not benefit from individual positive stories, and bad news will reinforce its negative reputation. All companies–large or small–should care about staying above their awareness threshold. Even if a small company has a very strong reputation among a small group of core investors or customers, it runs a high risk of suffering considerable damage to its reputation if its media coverage is below the awareness threshold when a crisis hits.

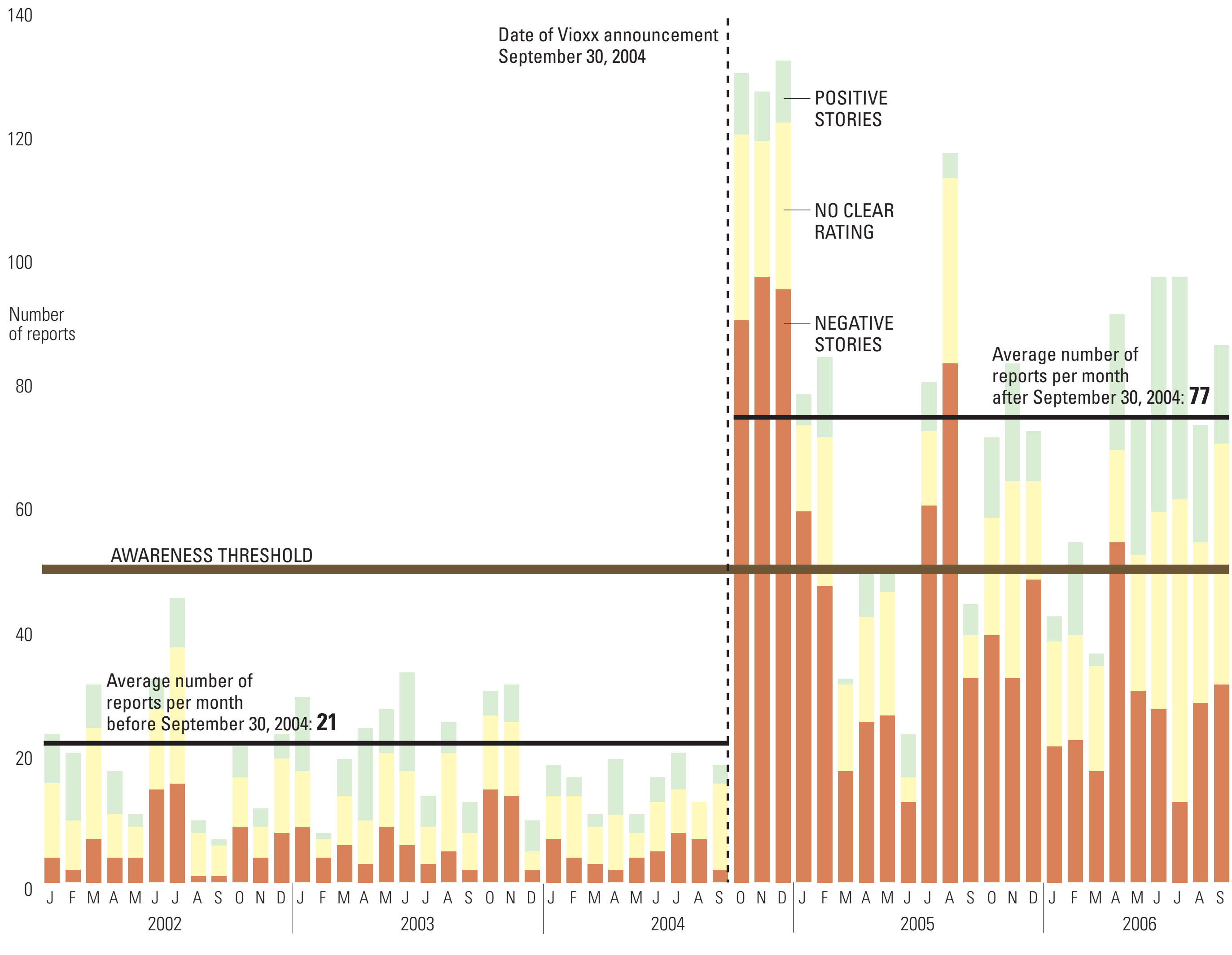
A company's reputation is also vulnerable if the media are focused on just a few topics, such as earnings and the personality of the CEO. Even if the coverage of these topics is extremely favorable, a negative event outside these areas will have a much larger negative impact than it would have if the firm had enjoyed broader positive coverage.

Third, managers can influence the mix of positive, negative, and neutral stories by striving to optimize the company's "share of voice": the percentage of leading-media stories mentioning the firm that quote someone from the organization or cite data it has provided. Media Tenor's research suggests that a company needs to have at least a 35% share of voice in order to keep the proportion of negative stories to a minimum in normal times. Strong relationships and credibility with the press are crucial to attaining a large share of voice and are especially important during a crisis, when a company really needs to communicate its point of view. In such times, management's share of voice needs to be at least 50% to ensure that critics of the company don't prevail. Merck's travails after the problems with Vioxx illustrate the consequences of a company inadequately managing its position in the media. (See the exhibit "Merck: The Perils of a Low Profile.")

Evaluate reality. Next, the company must objectively evaluate its ability to meet the performance expectations of stakeholders. Gauging the organization's true character is difficult for three reasons: First, managers–business unit and

Merck: The Perils of a Low Profile

Merck was ill prepared to defend its reputation when the Vioxx crisis hit. In the 33 months prior to Merck's withdrawal of the pain medication on September 30, 2004, the company had a low profile: There weren't enough leading-media stories mentioning it to keep it above the public's "awareness threshold." Although 27% of the stories were positive, they were neutralized by the 28% that were negative. In addition, before the recall, a woefully inadequate 7% of stories quoted someone from the company or cited data provided by it, meaning Merck didn't have the "share of voice" required to communicate its positions. After the announcement of Vioxx's withdrawal, the average number of stories per month mentioning Merck more than tripled – but 60% of the stories that appeared through September 2006 were negative and only 13% positive. It will be difficult for Merck to rebuild its reputation – especially since its share of voice has decreased to 5.5%.



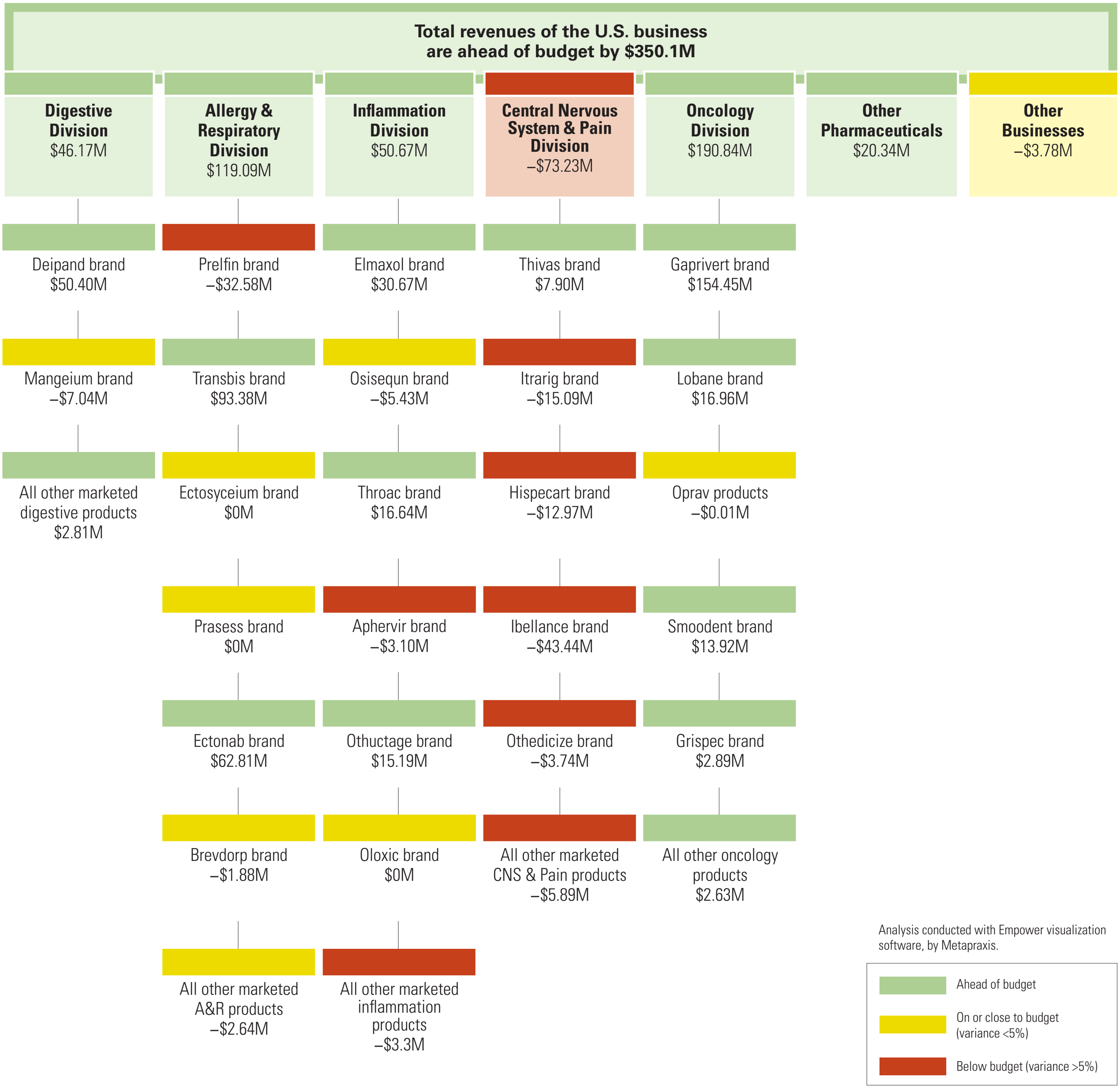
functional heads as well as corporate executives – have a natural tendency to overestimate their organizations' and their own capabilities. Second, executives tend to believe that their company has a good reputation if there is no indication that it is bad, when in fact the company has no reputation in that area. Finally, expectations get managed: Sometimes they are set low in order to ensure that performance objectives will be achieved, and other times they are set optimistically high in an attempt to impress superiors or the market.

As is the case in assessing reputation, the more contextual, objective, and quantitative the approach to evaluating character, the better. Just as the reputation of a company must

One Drug Company's Dashboard for Spotting Potential Risks

A Europe-based pharmaceutical company uses this dashboard to track variances in performance that can lead to risky behavior. (The names of divisions and brands have been changed and the data have been scaled to protect proprietary information.) Although the revenues of the company's U.S. business are ahead of plan, the Central Nervous System & Pain division is projecting that its revenues for the full year will fall short, mainly because of the Ibellance brand's projected performance. At this point, corporate executives should meet with the division's managers to ensure that none of the unit's planned actions to address the projected shortfall – such as special incentive programs for the sales force or prescribing physicians – would create unacceptable reputational risk for the company. And if Ibellance's performance dramatically improves during the rest of the year, they would be wise to investigate again.

Variances from Budget on Revenue Projections, Year-to-Date



Analysis conducted with Empower visualization software, by Metapraxis.

be assessed relative to competitors, so must its reality. For example, performance-improvement targets based only on a company's results for the previous year are meaningless if competitors are performing at a much higher level. The importance of benchmarking financial and stock performance and processes against peers' and those of companies regarded as "best in class" is hardly a revelation. However, the degree of sophistication and detail as well as the accuracy or reliability of benchmarking data can vary enormously. The reasons include transcription errors (a big problem when a large amount of data in paper documents has to be manually entered into electronic spreadsheets), for instance, and the inability to determine whether the way competitors report information in an area is consistent. One company might include customers' purchases of extended warranties in its revenues, while another might not.

Some new tools should help address these issues. One of the most noteworthy is Extensible Business Reporting Language (XBRL). A version of the Internet standards technology Extensible Markup Language (XML), XBRL allows each piece of information in a financial statement to be electronically tagged so that it can be quickly and cheaply pulled into analytical software. These tags are contained in dictionaries, or "taxonomies," based on sets of standards such as the U.S. generally accepted accounting principles. XBRL-formatted financial statements are already available from companies such as EDGAR Online, but these early offerings have limitations. Taxonomies for specific industries must be developed; software for downloading and analyzing XBRL data is still at an early stage; and EDGAR Online's offering includes European companies only if their shares are listed on a U.S. exchange (although an XBRL taxonomy does exist for international financial reporting standards, used by all members of the European Union and a number of other countries). Christopher Cox, the chairman of the Securities and Exchange Commission, is determined to address such limitations and accelerate the widespread adoption of XBRL. Toward that end, he announced in September 2006 that the SEC will invest $54 million in an interactive data system based on XBRL, which "will represent a quantum leap over existing disclosure technologies." (For more detail, see the HBR List item "Here Comes XBRL" in this issue.)

Another valuable new tool for managing reputational risk is visualization software, which uses colors, shapes, and diagrams to communicate the key points in financial and operating data. These displays are a big improvement over the spreadsheets now widely used, which often make it difficult for even the most financially sophisticated executives to spot important anomalies and trends. Because it takes so much time to make sense of spreadsheets, executives tend to focus on the largest business units even though the greatest risks to reputation may reside in smaller ones–such as a struggling foreign subsidiary that has begun to employ questionable means to meet budget targets. (See the exhibit "One Drug Company's Dashboard for Spotting Potential Risks" for an example of a simple but effective use of visualization software to highlight whether business units and products are on track to meet year-end goals.)

Close gaps. When a company's character exceeds its reputation, the gap can be closed with a more effective investor relations and corporate communications program that employs the principles of strategic media intelligence discussed above. If a reputation is unjustifiably positive, the company must either improve its capabilities, behavior, and performance or moderate stakeholders' perceptions. Of course, few companies would choose the latter if there were any way to accomplish the former. If, however, the gap is large, the time required to close it is long, and the damage if stakeholders recognize the reality is likely to be great, then management should seriously consider lowering expectations – although this obviously needs to be done in careful, measured ways.

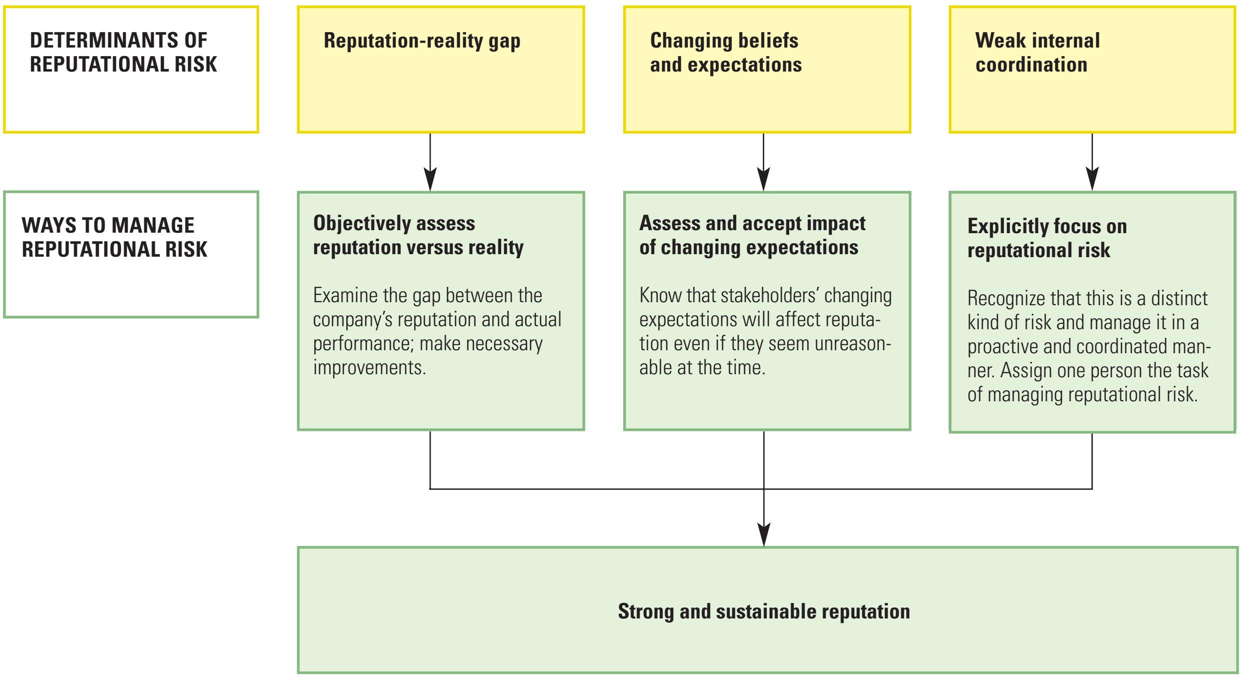
Monitor changing beliefs and expectations. Understanding exactly how beliefs and expectations are evolving is not easy, but there are ways to develop a picture over time. For instance, regular surveys of employees, customers, and other stakeholders can reveal whether their priorities are changing. While most well-run companies conduct such surveys, few take the additional step of considering whether the data suggest that a gap between reputation and reality is materializing or widening. Similarly, periodic surveys of experts in different fields can identify political, demographic, and social trends that could affect the reputation-reality gap. "Open response" questions can be used to elicit new issues of importance–and thus new expectations–that other questions might miss. It is generally useful to supplement these surveys with focus groups and in-depth interviews to develop a deeper understanding of the causes and possible consequences of trends.

Influential NGOs that could make the company a target are one group of stakeholders that should be monitored. These include environmental activists; groups concerned about wages, working conditions, and labor practices; consumers' rights groups; globalization foes; and animals' rights groups. Many executives are skeptical about whether such organizations are genuinely interested in working collaboratively with companies to achieve change for the public good. But NGOs are a fact of life and must be engaged. Interviews with them can also be a good way of identifying issues that may not yet have appeared on the company's radar screen.

Finally, companies need to understand how the media shape the public's beliefs and expectations. Dramatic changes in the amount of coverage influence how fast and to what extent beliefs and expectations change. The large volume and prominent display of stories on the backdating of stock options in recent months is one example of how the media can help set the agenda. The sharp drop in stories about insurance brokers' getting incentive payments from underwriters illustrates how the media can help relegate a hot topic to the back burner.

A Framework for Managing Reputational Risk

Understanding the factors that determine reputational risk enables a company to take actions to address them.



Put one person in charge. Assessing reputation, evaluating reality, identifying and closing gaps, and monitoring changing beliefs and expectations will not happen automatically. The CEO has to give one person responsibility for making these things happen. Obvious candidates are the COO, the CFO, and the heads of risk management, strategic planning, and internal audit. They have the credibility and control some of the resources necessary to do the job. In general, those whose existing responsibilities pose potential conflicts probably shouldn't be chosen. People holding top "spin" jobs, such as the heads of marketing and corporate communications, fall into this category. So does the general counsel, whose job of defending the company means his relationship with stakeholders is often adversarial and whose typical response to media inquiries is "no comment."

The chosen executive should periodically report to top management and the board on what the key reputational risks are and how they are being managed. It is up to the CEO or the board to decide whether the risks are acceptable and, if not, what actions should be taken. In addition, top management and the board should periodically review the risk-management process and make suggestions for improving it.

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Managing reputational risk isn't an extraordinarily expensive undertaking that will require years to implement. At most well-managed companies, many of the elements are already in place in disparate parts of the organization. The additional costs of installing and using the new tools described above to identify risks and design responses are in the low to high six figures, depending on the size and complexity of the company. This is a modest expense compared with the value at stake for many companies.

So the primary challenge is focus: recognizing that reputational risk is a distinct category of risk and giving one person unambiguous responsibility for managing it. This person can then identify all the parts of the organization whose activities can affect or pose risks to its overall reputation and enhance the coordination among its functions and units. The improvements in decision making will undoubtedly result in a better-run company overall.

Senior executives tend to be optimists and cheerleaders. Their natural inclination is to believe the praise heaped on their companies and to discount the criticism. But looking at the world and one's organization through rose-tinted glasses is an abdication of responsibility. Being tough-minded about both will enable a company to build a strong reputation that it deserves.

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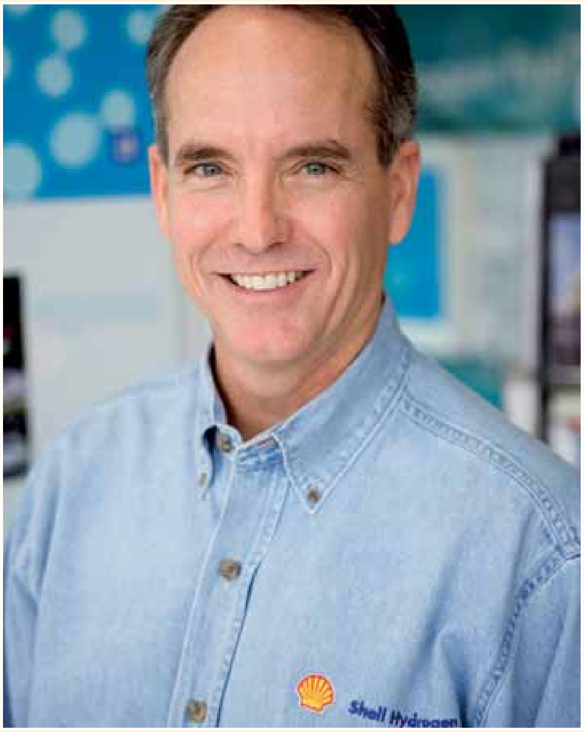
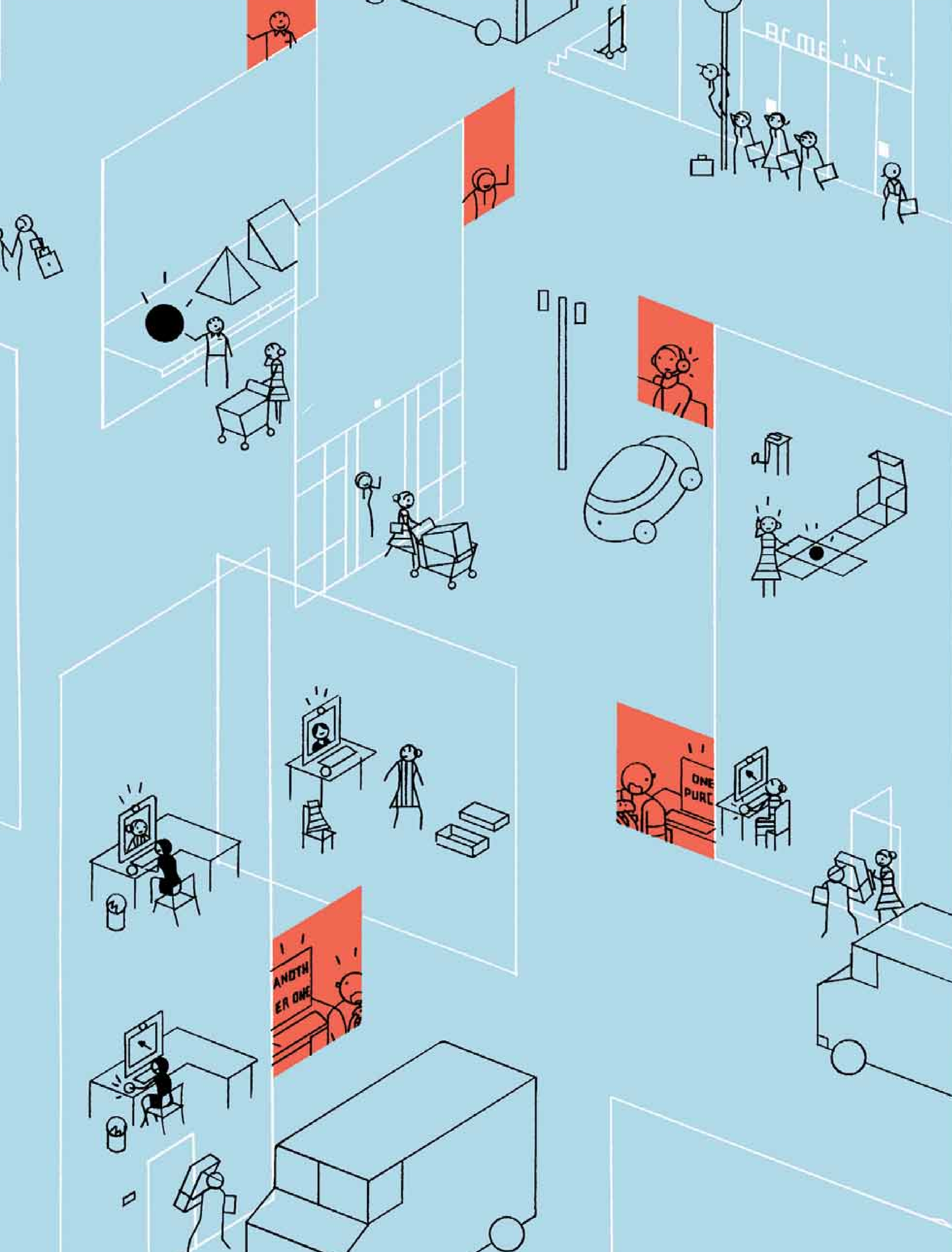
To order, see page 158.

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Companies that systematically monitor customer experience can take important steps to improve it – and their bottom line.

UNDERSTANDING CUSTOMER EXPERIENCE

by Christopher Meyer and Andre Schwager

ANYONE WHO HAS SIGNED UP RECENTLY for cell phone service has faced a stern test in trying to figure out the cost of carry-forward minutes versus free calls within a network and how it compares with the cost of such services as push-to-talk, roaming, and messaging. Many, too, have fallen for a rebate offer only to discover that the form they must fill out rivals a home mortgage application in its detail. And then there are automated telephone systems, in which harried consumers navigate a mazelike menu in search of a real-life human being. So little confidence do consumers have in these

Laurent Cilluffo

electronic surrogates that a few weeks after the Web site www.gethuman.com showed how to reach a live person quickly at ten major consumer sites, instructions for more than 400 additional companies had poured in.

An excess of features, baited rebates, and a paucity of the personal touch are all evidence of indifference to what should be a company's first concern: the quality of customers' experiences. In the first example, the carrier offered a jumble of phone services in part to discourage comparison shopping and thus price wars. In the second, the company offered a hard-to-obtain rebate to stimulate a purchase. And in the third, the goal was to slash staffing costs, despite soothing claims of 24-hour self-service availability. Unfortunately, such cunning makes for customer experiences that engender regret and then the determination to do business elsewhere.

Customer experience encompasses every aspect of a company's offering – the quality of customer care, of course, but also advertising, packaging, product and service features, ease of use, and reliability. Yet few of the people responsible for those things have given sustained thought to how their separate decisions shape customer experience. To the extent they do think about it, they all have different ideas of what customer experience means, and no one more senior oversees everyone's efforts.

Within product businesses, for example, product development defers to marketing when it comes to customer experience issues, and both usually focus on features and specifications. Operations concerns itself mainly with quality, timeliness, and cost. And customer service personnel tend to concentrate on the unfolding transaction but not its connection to those preceding or following it. Even then, much service is rote: Otherwise, why would service reps ask, as they so often do, "Is there anything else I can help you with?" when they haven't even dealt with the original reason for the call or visit?

Some companies don't understand why they should worry about customer experience. Others collect and quantify data on it but don't circulate the findings. Still others do the measuring and distributing but fail to make anyone responsible for putting the information to use. The extent of the problem has been documented in Bain & Company's recent survey of the customers of 362 companies. Only 8% of them described their experience as "superior," yet 80% of the companies surveyed believe that the experience they have been providing is indeed superior. With such a disparity, prospects for improvement are small. But the need is urgent: Consumers have a greater number of choices today than ever before, more complex choices, and more channels through which to pursue them. In such an environment, simple, integrated solutions to problems – not fragmented, burdensome ones – will win the allegiance of the time-pressed consumer. (For more on making the buying process simpler, see James P. Womack and Daniel T. Jones, "Lean Consumption," HBR March 2005.) Moreover, in markets that are increasingly global, it is dangerous to assume that a given offering, communication, or other contact will affect faraway consumers the same way it does those at home.

Although few companies have zeroed in on customer experience, many have been trying to measure customer satisfaction and have plenty of data as a result. The problem is that measuring customer satisfaction does not tell anyone how to achieve it. Customer satisfaction is essentially the culmination of a series of customer experiences or, one could say, the net result of the good ones minus the bad ones. It occurs when the gap between customers' expectations and their subsequent experiences has been closed. To understand how to achieve satisfaction, a company must deconstruct it into its component experiences. Because a great many customer experiences aren't the direct consequence of the brand's messages or the company's actual offerings, a company's reexamination of its initiatives and choices will not suffice. The customers themselves – that is, the full range and unvarnished reality of their prior experiences, and then the expectations, warm or harsh, those have conjured up – must be monitored and probed.

Such attention to customers requires a closed-loop process in which every function worries about delivering a good experience, and senior management ensures that the offering keeps all those parochial conceptions in balance and thus linked to the bottom line. This article will describe how to create such a process, composed of three kinds of customer monitoring: past patterns, present patterns, and potential patterns. (These patterns can also be referred to by the frequency with which they are measured: persistent, periodic, and pulsed.) By understanding the different purposes and different owners of these three techniques – and how they work together (not contentiously) – a company can turn pipe dreams of customer focus into a real business system.

What Customer Experience Is

Customer experience is the internal and subjective response customers have to any direct or indirect contact with a company. Direct contact generally occurs in the course of purchase, use, and service and is usually initiated by the customer. Indirect contact most often involves unplanned encounters with representations of a company's products, services, or brands and takes the form of word-of-mouth rec-

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ommendations or criticisms, advertising, news reports, reviews, and so forth. Such an encounter could occur when Google's whimsical holiday logos pop up on the site's home page at the inception of a search, or it could be the distinctive "potato, potato" sound of a Harley-Davidson motorcycle's exhaust system. It might just be an e-mail from one customer to another.

The secret to a good experience isn't the multiplicity of features on offer. Microsoft Windows, which is rich in features, may provide what a corporate IT director considers a positive experience, but many home users prefer Apple's Macintosh operating system, which offers fewer features and configuration options. A customer's experience with an Apple device begins well before the purchaser turns it on – in the case of the iPod, perhaps with the dancing silhouettes in the TV advertisements. The origami-like (and recyclable) packaging enfolds the iPod as though it were a Fabergé egg made for a czar. A small sticker, "Designed in California, Made in China," communicates the message that Apple is firmly in charge but also interested in keeping costs down. Even Windows users appreciate the device's intuitive, Mac-like feel and find that downloading tracks from iTunes is easier than buying a CD on Amazon. Every Apple product is designed with the overarching purpose of making the time one spends with Apple an enjoyable experience.

A successful brand shapes customers' experiences by embedding the fundamental value proposition in offerings' every feature. For BMW, "the Ultimate Driving Machine" is much more than a slogan; it informs the company's manufacturing and design choices. In 2000, Mercedes-Benz introduced a system that automatically controls the distance between a Mercedes and the car in front. BMW would not consider developing such a feature unless it amplified rather than diminished the driving experience.

Service quality and scope matter, too, but mostly when the core offering is itself a service. For example, the tracking and shipping support FedEx provides on the Internet and by phone is as important to customers as its fundamental value proposition – on-time delivery.

In their concern with logistics – how something is provided, not just what is provided – business-to-business companies take after consumer-service companies. For both, the goal is to provide a positive experience to the end user. The business partner or supplier of a B2B company helps the latter do that first by understanding where in its direct customers' value chain the B2B can make a meaningful contribution, and then when and how. Those are different undertakings from capturing and parsing a given human being's internal, ineffable experience. A business's "experience," one might say, is its manner of functioning, and a B2B company helps its business customers serve their customers by solving their business problems, just as an effective business-to-consumer company fulfills the personal needs of *its* customers. In a B2B context, a good experience is not a thrilling one but one that is trouble-free and hence reassuring to those in charge.

Corporate leaders who would never tolerate a large gap between forecasted and actual revenues prefer to look the other way when company and customer assessments diverge.

Thus, a supplier satisfies the purchasing department of its business customer by providing a balance of costs and benefits; it satisfies operations by offering products or services that are easy to use; and it satisfies a customer's executives by expanding capacity at the same rate as the customer and in general evolving alongside it. Accordingly, sales and marketing do not necessarily monopolize points of contact with customers: Operations people at the first company deal directly with their counterparts at the second, and so forth. The functional nature of the relationship – indeed, the fact that it is a true relationship – creates a pervasive awareness of experience issues and priorities.

Whether it is a business or a consumer being studied, data about its experiences are collected at "touch points": instances of direct contact either with the product or service itself or with representations of it by the company or some third party. We use the term "customer corridor" to portray the series of touch points that a customer experiences. What constitutes a meaningful touch point changes over the course of a customer's life. For a young family with limited time and resources, a brief encounter with an insurance broker or financial planner may be adequate. The same sort of experience wouldn't satisfy a senior with lots of time and a substantial asset base.

Not all touch points are of equivalent value. Service interactions matter more when the core offering is a service. Touch points that advance the customer to a subsequent and more valuable interaction, such as Amazon's straightforward

1-Click ordering, matter even more. Companies need to map the corridor of touch points and watch for snarls. At each touch point, the gap between customer expectations and experience spells the difference between customer delight and something less.

People's expectations are set in part by their previous experiences with a company's offerings. Customers instinctively compare each new experience, positive or otherwise, with their previous ones and judge it accordingly. Expectations can also be shaped by market conditions, the competition, and the customer's personal situation. Even when it is the company's own brand that establishes expectations, the customer can be set up for disappointment. For example, Dell transformed buying computers over the Internet from a risky to a reliable experience. When it extended that set of procedures to the selection and purchase of expensive plasma HDTV sets, however, it disappointed. Dell did an effective job of creating positive customer expectations, but they turned out to be better fulfilled by the in-person sales force at Best Buy.

Ideally, good design makes both the most routine and the weightiest customer experiences – checking a price, getting a question answered, or placing a multimillion-dollar order – pleasant and efficient. However, even when dissatisfaction or wariness arises, artful control of consumer experience can overcome it.

In its development of a new AIDS drug, Gilead Sciences provides a good example of how a failure to understand the experience and expectation component of a consumer segment's dissatisfaction can turn into a failure to reach that segment. Upon releasing the new medication, which had demonstrated advantages over existing ones, Gilead noticed that while sales to patients new to therapy were robust, sales to patients already undergoing treatment were growing far more slowly than expected. For HIV/AIDS patients, switching medications, Gilead discovered, is very different from choosing an alternative cold remedy. Switching requires ending a trusted relationship in the hope of reaching an uncertain improvement level. The company also learned that HIV-positive patients are far more interested in the potential adverse effects of a new drug than in its supposedly superior efficacy. With this new understanding, Gilead decided to emphasize in its marketing the new drug's lower incidence of serious side effects. It also segmented the patients' physicians by their willingness to prescribe a different medication from the ones they knew. Once Gilead made it easier for patients to switch drugs, the market share of the company's main competitor dropped 33%.

CEM Versus CRM

Customer experience management and customer relationship management differ in their subject matter, timing, monitoring, audience, and purpose.

	What	When	How Monitored	Who Uses the Information	Relevance to Future Performance
Customer Experience Management (CEM)	Captures and distributes what a customer thinks about a company	At points of customer interaction: "touch points"	Surveys, targeted studies, observational studies, "voice of customer" research	Business or functional leaders, in order to create fulfillable expectations and better experiences with products and services	Leading: Locates places to add offerings in the gaps between expectations and experience
Customer Relationship Management (CRM)	Captures and distributes what a company knows about a customer	After there is a record of a customer interaction	Point-of-sales data, market research, Web site click-through, automated tracking of sales	Customer-facing groups such as sales, marketing, field service, and customer service, in order to drive more efficient and effective execution	Lagging: Drives cross selling by bundling products in demand with ones that aren't

Why the Neglect?

CEOs may not actively deny the significance of customer experience or, for that matter, the tools used to collect, quantify, and analyze it, but many don't adequately appreciate what those tools can reveal. Three forces in the main conspire to preserve this gap.

Too much money already lavished on CRM. Having spent millions of dollars on customer relationship management software, many CEOs consider their problem to be not a lack of customer information but a superfluity of it. Before investing more time and money, executives justifiably want to know how customer experience data are different and what their value is.

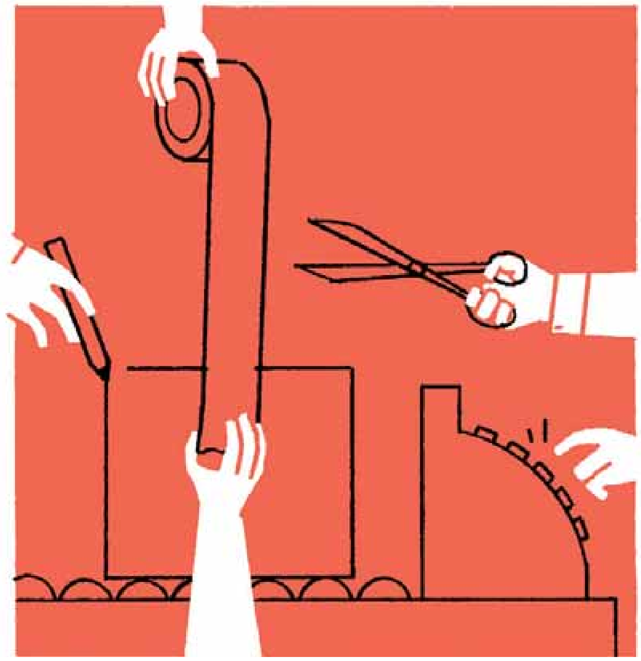
To put it starkly, the difference is that CRM captures what a company knows about a particular customer – his or her history of service requests, product returns, and inquiries, among other things – whereas customer experience data capture customers' subjective thoughts about a particular company. CRM tracks customer actions after the fact; CEM (customer experience management) captures the immediate response of the customer to its encounters with the company. Employees accustomed to reading the marketing department's dry analyses of CRM point-of-sale data easily grasp the distinction upon hearing a frustrated customer's very words. (For a detailed account of the difference between the two approaches, see the exhibit "CEM Versus CRM.")

Moreover, many CEOs don't sufficiently appreciate the distinction between customer satisfaction, which they believe they have heavily documented, and customer experience, which always demands further investigation.

Lack of attunement to customers' needs. Leaders who rose through customer-facing functions, such as Cisco Systems CEO John Chambers, are more likely to act with reference to customer experience than those who have not. When competing new technologies are difficult to choose among, Cisco defers its choice until key customers have registered their reactions. Because the company knows there will be a market for the choice it finally makes, it can afford to commit itself later than its competitors.

In contrast, executives who rose through finance, engineering, or manufacturing often regard managing customer experience as the responsibility of sales, marketing, or customer service.

Fear of what the data may reveal. It's easy to say one's business is customer-driven when there are no data to prove otherwise. Once data start flowing, the bogeymen come out of the closet. Can we afford to do what customers are asking for? How do we choose between conflicting preferences? Can we accept what customers say they are experiencing without first telling them what they should be experiencing? Corporate leaders who would never tolerate a large gap between forecasted and actual revenues prefer to look the other way when company and customer assessments diverge, as they do in the Bain survey.



Executives also hesitate to act on findings because experience data are more ambiguous than customers' actions – the orders they place, for instance. However, statistical analysis has developed to the point where it can dependably quantify both the relative importance of each touch point and the experience it provided. It can also isolate key transactions, accounts, regions, customer segments, and so forth, and then parse the resulting data. About ten years ago, companies started collecting experience information electronically. Now they can instantly combine it with data collected from CRM systems and other customer databases, conduct analyses of both individual and aggregate responses in real time, and then automatically route and track issues needing resolution.

Squishier are observation studies and verbatim comments, which for that reason don't get the attention they deserve. Approached, however, with the requisite empathy and insight, they can be in their own way more revealing than concrete findings. For one thing, even consumers sharply aware of a product's or brand's deficiencies can't quite picture what might replace it. That's why Henry Ford said that if he asked his customers before building his first car how he could better meet their transportation needs, they would have said simply, "Give us faster horses." Properly understood, the currents beneath the surface that direct the flow of customer experience data will indicate the shape of the next major transformation.

All Hands on Board

Many organizations place responsibility for collecting and assessing customer experience data within a single, IT-supported customer-facing group. Doing so accomplishes at least three things: It saves money; it protects customers from redundant and annoying solicitations; and it permits direct comparison of customers on the basis of their location, choice of product, or some other criterion.

But it is a mistake to assign to customer-facing groups overall accountability for the design, delivery, and creation of a superior customer experience, thereby excusing those more distant from the customer from understanding it.

In contrast to this common pattern, Palm drew on customer experience to make the Treo one of its most successful products ever. A combination of cell phone and Palm Pilot, the original Treo used the same built-in rechargeable battery as the Palm organizers. When used as a cell phone, the device consumed far more power than it did when used as an organizer. So customers who were heavy users of the cell phone feature found that their Treos were often losing power – and often at an inconvenient distance from their rechargers. Complaints about this problem began showing up in Palm's customer-service transaction surveys. But the customer service department could offer the Treo's unhappy owners only minor power-saving tips.

Dissatisfied with the status quo, customer service vice president Dan Gilbert, showing unusual initiative, distributed the experience data his department had collected to product development, which went to work on the problem. The next-generation Treo came with a battery that users replace. In 2005, sales were 71% higher than the previous year.

Typically, however, a vigorous reaction to intelligence gathered on customer experience requires general management to orchestrate a response to customer problems. Intuit learned that when it tried to address the trouble customers were having installing a new release of TurboTax. The solution turned out to be cross-functional, but no one who had been asked to deal with it was senior enough to "own" the entire installation process.

Obtaining the Right Information

There are three patterns of customer experience information, each with its own pace and level of data collection. (For a detailed breakdown of the three patterns, see the exhibit "Tracking Customer Experience: Persistent, Periodic, Pulsed.")

When companies monitor transactions occurring in large numbers and completed by individual customers, they are looking at *past patterns.* Enterprise Rent-A-Car is supposed to ask every driver returning one of its vehicles, "Would you rent from Enterprise again?" Any new service a France Telecom customer receives is followed by a brief questionnaire on the quality of his or her experience. As these two examples demonstrate, each attempt to determine the quality of the experience directly follows the experience itself. So companies receive by this method an uninterrupted, or "persistent," flow of information, which they then analyze and communicate internally. Although surveys are the tool used most often for gathering data on past patterns, customers are sometimes approached through online forums and blogs. Companies are mostly guided by assertions that win customers' strong agreement, but sometimes customers' failure to react strongly to some feature or service can be just as telling. For this reason, the employees evaluating results must be attuned to areas of customer experience that a survey or other tool does not directly address.

Analyses of *present patterns* are not simply evaluations of the meaning and success of a recent encounter. They envision a continuing relationship with the customer. Consequently, questions may extend to the customer's awareness of alternative suppliers, new features the customer might desire, and what it sees as challenges to its competitiveness. Given the broad scope of the inquiry, this type of monitoring shouldn't be triggered solely by a customer-initiated transaction. Instead, information on a company's key products and services should be gathered at scheduled intervals, or "periodically." Hewlett-Packard and the consulting firm BearingPoint, for example, approach every key customer annually. By initiating contact with different customers at different times throughout the year, BearingPoint has created an almost persistent data flow that does not depend on the completion of a given transaction, while permitting comparisons among customers on a range of issues. BearingPoint learned in this fashion that the best practices it had established in one vertical-market group had not migrated to other groups.

Present patterns are collected through surveys or face-to-face interviews, studies tailored to the subject, or some combination thereof. It helps to prepare customers for the inquiry by telling them the purpose of the survey, how they will hear about the findings, and what role they might play in addressing them. Accordingly, Hewlett-Packard rewards its account managers on survey-participation rates as well as results.

Potential patterns are uncovered by probing for opportunities, which often emerge from interpretation of customer data as well as observation of customer behavior. Like the study Gilead conducted, such probes are outgrowths of strategies usually involving the targeting of particular customer segments and are therefore unscheduled, or "pulsed." The findings are often used to inform the product development process.

Most companies apply a single summary metric to data on past and present patterns. The customer experience metric Net Promoter, for example, registers customers' experiences in aggregate – that is, their positive ones minus their negative ones. Intuit's founder, Scott Cook, uses Net Promoter scores for goal setting and engaging the organization's attention, though he recognizes that a rising or falling score doesn't begin to reveal what is driving the trend.

As relationships with customers deepen, companies tend to collect data with greater frequency. The patterns that

Tracking Customer Experience: Persistent, Periodic, Pulsed

Companies can monitor various patterns of interaction with customers to gain a better understanding of the customer experience they are providing. Depending on the precise information a company is seeking, it may choose to analyze past patterns, present patterns, potential patterns, or a combination. Each pattern requires a distinct method of generating and analyzing data and will yield different types of insights.

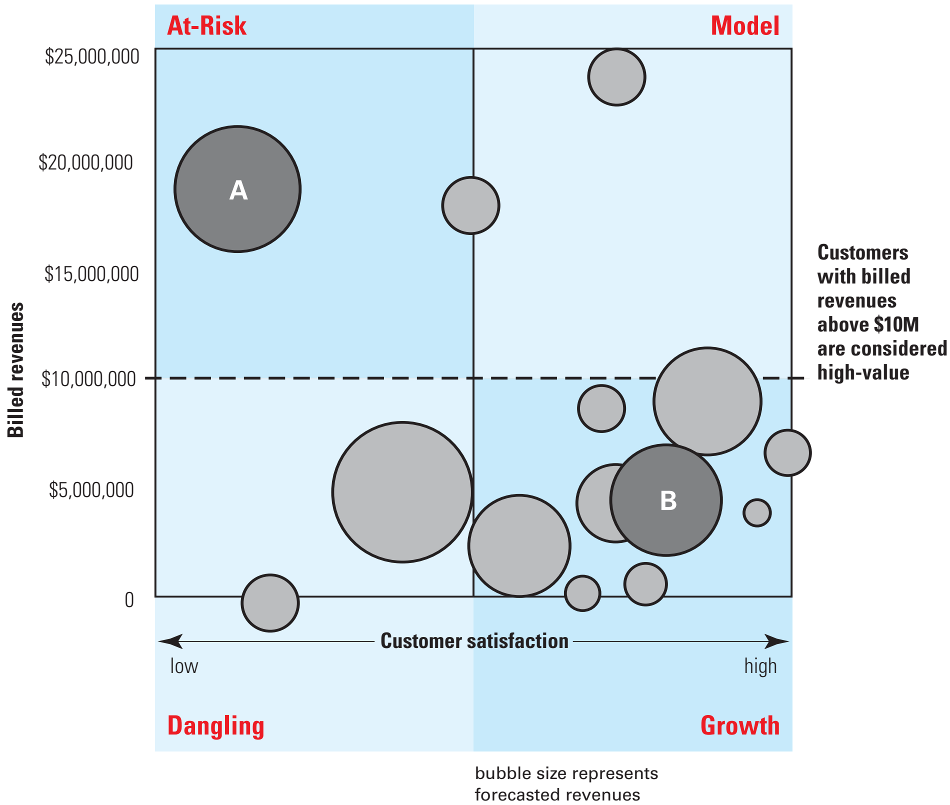
Pattern and Purpose	Owner	Data Collection Frequency and Scope	Collection and Analysis Methodology	Discussion and Action Forums
Past Patterns: Captures a recent experience. > Intended to improve transactional experiences > Tracks experience goals and trends > Assesses impact of new initiatives > Identifies emerging issues Examples: Post-installation or customer service follow-up, new-product-purchase follow-up	Central group or functions	**Persistent:** > Electronic surveys linked to high-volume transactions or an ongoing feedback system > Automatically triggered by the completion of a transaction > Focused, short-cycle, timed data collection > Feedback volunteered by users in online forums	> Web-based, in-person, or phone surveys > User forums and blogs	> Analyzed within functions, central survey groups, or both > Cross-functional issues directed to general managers > Strategic analysis and actions directed by general managers
Present Patterns: Tracks current relationships and experience issues with an eye toward identifying future opportunities. > Keeps a consistent yet deeper watch on state of relationship and other factors > Looks forward as well as backward > Used with more critical populations and issues Examples: Biannual account reviews, "follow them home" user studies	Central group, business units, or functions	**Periodic:** > Quarterly account reviews > Relationship studies > User experience studies > User-group polling	> Web-based surveys preceded by preparation in person > Direct contact in person or by phone > Moderated user forums > Focus groups and other regularly scheduled formats	> Initial analysis by sponsoring group > Broader trends and issues forwarded to general managers' strategic and operating forums > Deeper analysis of emerging issues at the corporate, business unit, or local level
Potential Patterns: Targets inquiries to unveil and test future opportunities. Examples: Ethnographic design studies, special-purpose market studies, focus groups	General management or functions	**Pulsed:** > One-off, special-purpose driven > Interim readings of trends	> Driven by specific customers or unique problems > Very focused > Incorporates existing knowledge of customer relationship	> Centered within sponsoring group, with coordination by and support from central group

emerge suggest further areas of inquiry. For example, present-relationship studies may indicate that on-site service experience is wanting. After improvements are made, it's common to use a transaction survey following each service call to assess progress. A subsequent, more comprehensive survey may show good experience with service response time but low overall ratings, triggering a special study to identify customers' priorities among a range of service experience factors.

Low cost and ease of modification make surveys the overwhelming favorite for measuring past and present patterns. E-mail–based surveys are superior to paper-based ones because they can be more easily shared; they allow rapid distribution; they give the surveyor the flexibility to extend or

Rating Customers

The matrix to the right organizes the customers of HiTouch (a composite of actual companies) on the basis of the level of attention they require. The vertical axis shows billed revenues (products and services provided and paid for). The horizontal axis shows an aggregate score indicating level of customer satisfaction. Customers with low billings but high customer satisfaction, for example, represent growth opportunities for HiTouch. The bubbles on the matrix classify HiTouch's customers according to a third dimension: forecasted revenues (orders placed but not paid for as well as potential orders), indicated by bubble size. Letters inside the bubbles serve strictly as identifiers. So, for example, customer A has the second-highest billings and the second-highest forecasted revenues, but its business is "at risk" because its satisfaction scores are low. Customer B's low billings, high satisfaction, and high forecasted revenues suggest unexploited potential business for HiTouch.



abbreviate the questioning according to the wishes of the respondent or the substance of the response; they minimize delays in analyzing the results; and they lead to quick action, such as a referral to a general manager should scores fall below a predetermined level. E-mail surveys can also be more easily tailored. For example, the surveys Marvin Windows and Doors sends to its distributors are different from those sent to architects who buy its products.

A well-designed survey is not simply one that elicits the desired information. It must itself avoid becoming an unfortunate aspect of the customer experience. Hence, it shouldn't be onerous for the taker or deny him the chance to communicate the special nature of his experience. One way of keeping surveys mercifully brief is to avoid asking about matters like recent purchases that the company already has a record of. Nor should they be triggered by the transactions of regular customers such as purchasing agents. Such customers are, after all, among those a business can least afford to annoy. By the same token, corporate sanctions imposed on dealers who receive low scores shouldn't be so harsh that retailers try to discourage customers from responding by offering to fix any problem on the spot. The individual customer may be placated, but widespread resort to this practice keeps general management from obtaining a broad picture of systemic problems.

Surveys do have their limitations, and focus groups, user-group forums, blogs, and marketing and observational studies can yield insights that surveys cannot. (For more on listening to users, see Dorothy Leonard and Jeffrey Rayport, "Spark Innovation Through Empathic Design," HBR November–December 1997.) Intuit, for example, is a leader in "follow them home" studies. Company representatives visit customers where they live or work and observe how they use Intuit products such as QuickBooks. It was from watching the smallest businesses struggle with QuickBooks Pro that the company recognized a need for a product like QuickBooks Simple Start. These tools lend themselves to the measurement of present and potential patterns, for they entail more time, preparation, and expense than transaction-based surveys.

Acting on Experience Information

Let's take a look at a company we'll call HiTouch – which is actually a composite of companies – as it struggled to create a system for managing customer experience. HiTouch, a business-to-business global financial services provider, received a shocking wake-up call when a top customer shifted half its business to an archrival. HiTouch executives had just completed a quarterly account review classifying the relationship with this account as "superior." The stunned executives wondered what they could have missed.

From their efforts to salvage the account, HiTouch executives learned enough to initiate a companywide effort to improve the experience of all other major accounts. After conducting a mini-audit of existing customer-experience programs, responsible parties, and results, it discovered that its vertical-market groups hardly went further than tracking leads and analyzing buying patterns. Most employees assumed customer experience was the job of marketing or sales. The company's only CEM metric came from a mailed annual customer satisfaction survey whose wording hadn't changed in three years.

HiTouch engaged consultants to help with the initiative. Rather than spending a lot of time establishing formal customer experience goals or a detailed plan, the consultants argued for a "fast prototype" relationship survey of top customers. HiTouch's leaders identified the touch points they knew had disappointed their most important customers. Preventing further customer defections, they realized, would require customer experience goals for every stage of the value chain. These had to serve every vertical market's financial objectives while being compatible with the company's branding.

As the issues piled up, it became clear that the effort needed an executive leader, a budget, and dedicated resources. HiTouch's top sales executive, having become a believer in the process, stepped up. To ensure a good response rate, he asked sales account executives to prep customers receiving the survey. A few showed a predistribution draft to customers so that they could help refine issue selection and tone. Of the various questions settled on, two key ones were "How important to your purchasing decision was HiTouch's brand and the service promise it seemed to make?" and "Do you believe HiTouch delivers the experience promised by its marketing and sales force?" The pilot survey included a summary metric that permitted HiTouch to compare responses by location, service platform, and vertical market.

The sales executive noticed that meetings about the pilot survey, in which salespeople fed customer experience information back to the customers themselves, differed from the typical sales call by shifting the dialogue away from the individual transaction and toward relationship development. They also provided an excellent opportunity to introduce to the customers HiTouch's nonsales employees who were in a position to fix customer problems as they arose. In this fashion, salespeople began to view their jobs less as a functional responsibility than as an organizational process.

Data from the survey began to flow within 24 hours of distribution. Many of customers' verbatim comments were blunt. Some executives became defensive and tried to explain away what the data were saying rather than understand the concerns behind them. Some never quit demanding yet one more data point. Others strained to launch company responses before fully understanding what was being said.

A well-designed survey is not simply one that elicits the desired information. It must itself avoid becoming an unfortunate aspect of the customer experience.

With 60% of the responses in, it became clear which experiences were critical to overall satisfaction. However, they were different in each vertical market, with few exceptions. For each, summary scores were compared with customer revenue. On that basis, finance placed every customer in one of four quadrants (see the exhibit "Rating Customers").

- **Model customers**: good summary scores; good revenue.
- **Growth customers**: good summary scores; higher potential revenue. Candidates for cross selling and upselling.
- **At-Risk customers**: low scores; good revenue. Demanding decisive intervention.
- **Dangling customers**: low scores; low revenue. To be rescued or abandoned.

Auspiciously, the Growth segment had three times as many customers as any of the others. But on further examination it emerged that some of those customers didn't buy as much as those in other quadrants. In fact, one of the largest remaining customers was squarely in the At-Risk quadrant.

The results of the initial survey coincided with the start of the strategic-planning cycle. By the following quarter, every vertical-market team, having shown some customers the findings and described what the team planned to do about them, was ready to send out transaction surveys of customers' experiences with service installation and repair. Every team had also set experience goals for itself and scheduled relationship surveys.

A year later, current experience data had replaced ill-informed opinion at HiTouch. At monthly operations meetings, vertical-market general managers reviewed key customer experience issues, and actions taken, before reviewing financials. A rolling summary of relationship issues unearthed by customer surveys kicked off quarterly executive strategy discussions. Defections within each vertical-market group dropped by an average of 16%.

Not everything worked as hoped. The company set up an executive dashboard to keep track of installation experience issues, but the disclosure of high-volume transaction information so upset the managers responsible that they never got around to resolving the underlying issues. The dashboard was pulled in favor of automatic triggers that channeled problems to specialists or general managers, who began to make good progress in solving them. Increased analyst staffing and simplified reporting helped the general managers identify new opportunities, an area they had been neglecting.

The Employee Experience

Customer experience does not improve until it becomes a top priority and a company's work processes, systems, and structure change to reflect that. When employees observe senior managers persistently demanding experience information and using it to make tough decisions, their own decisions are conditioned by that awareness.

Not long after breaking every software-industry growth record, Siebel Systems (now part of Oracle) saw its satisfaction ratings begin to drop. An adopter of customer experience management, the company had gathered data revealing that customers found a large disparity between actual and expected costs of ownership of Siebel 6, a sales-force automation tool based on a client-server architecture. The proposed solution, a shift to a Web-based architecture in Siebel 7, would require forgoing the development of other major features – and the revenues they generated – for two years. Yet Siebel's leadership went ahead with the shift anyway. Satisfaction levels soon returned to their formerly lofty levels, and employees took heart as management placed experience ahead of revenues.

Once persuaded of the importance of experience, every function has a role to play.

Marketing has to capture the tastes and standards of every one of its targeted market segments, circulate that knowledge within the company, and then tailor all consumer communications accordingly.

Service operations must ensure that processes, skills, and practices are attuned to every touch point. (Present-patterns surveys are good for tracking high-volume touch points such as call centers.)

Product development should do more than specify needed features. It should also design experiences after observing how customers use products and services, learning why they use offerings as they do, and figuring out how existing products might be frustrating them. Ideally, product developers will identify customer behavior that runs counter to a company's expectations and uncover needs that haven't been identified.

Information technology that can collect, analyze, and distribute CEM data, integrate the information with that generated by CRM, and monitor progress must be in place. As the data flow stabilizes, the form of presentation and its degree of detail should be keyed to whichever internal audience the data are meant for. A level of detail that is appropriate for an analyst, for example, can easily overwhelm a line manager. CEM is a play within a play, so to speak; just as customers must have a good experience, employees need to have a good experience digesting information about themselves.

Human resources should put together a communications and training strategy that conveys the economic rationale for CEM and paints a picture of how it will alter work and decision-making processes. Since the front line determines the bulk of customer experience, it would be a good idea to study those employees' individual capabilities, work processes, and attitudes. As for performance management, of course customer experience results should affect compensation. But as we have learned in recent years, incentives that are too powerful are more likely to distort behavior than channel it productively.

Account teams must progress from annual surveys to detailed touch-point analysis, then translate present patterns of customer experience and issues gleaned from recent transactions into action plans that are shared with customers. Not every significant implication is readily apparent. Leaders need to press the data to precipitate customers' concealed longings.

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Customer dissatisfaction is widespread and, because of customers' empowerment, increasingly dangerous. Although companies know a lot about customers' buying habits, incomes, and other characteristics used to classify them, they know little about the thoughts, emotions, and states of mind that customers' interactions with products, services, and brands induce. Yet unless companies know about these subjective experiences and the role every function plays in shaping them, customer satisfaction is more a slogan than an attainable goal.

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To order, see page 158.

Mick Wiggins

Discovering Your Authentic Leadership

We all have the capacity to inspire and empower others. But we must first be willing to devote ourselves to our personal growth and development as leaders.

by Bill George, Peter Sims, Andrew N. McLean, and Diana Mayer

DURING THE PAST 50 YEARS, leadership scholars have conducted more than 1,000 studies in an attempt to determine the definitive styles, characteristics, or personality traits of great leaders. None of these studies has produced a clear profile of the ideal leader. Thank goodness. If scholars had produced a cookie-cutter leadership style, individuals would be forever trying to imitate it. They would make themselves into personae, not people, and others would see through them immediately.

No one can be authentic by trying to imitate someone else. You can learn from others' experiences, but there is no way you can be successful when you are trying to be like them. People trust you when you are genuine and authentic, not a replica of someone else. Amgen CEO and president Kevin Sharer, who gained priceless experience working as Jack Welch's assistant in the 1980s, saw the downside of GE's cult of personality in those days. "Everyone wanted to be like Jack," he explains. "Leadership has many voices. You need to be who you are, not try to emulate somebody else."

Over the past five years, people have developed a deep distrust of leaders. It is increasingly evident that we need a new kind of business leader in the twenty-first century. In 2003, Bill George's book, *Authentic Leadership: Rediscovering the Secrets to Creating Lasting Value,* challenged a new generation to lead authentically. Authentic leaders demonstrate a passion for their purpose, practice their values consistently, and lead with their hearts as well as their heads. They establish long-term, meaningful relationships and have the self-discipline to get results. They know who they are.

Article at a Glance

The largest in-depth study ever undertaken on how people can become and remain authentic leaders shows that an individual does not have to be born with any universal characteristics or traits of a leader.

The journey to authentic leadership begins with understanding the story of your life. Most authentic leaders reported that their stories involved overcoming difficult experiences and using these events to give meaning to their lives.

Authentic leaders work hard at understanding and developing themselves. They use formal and informal support networks to get honest feedback and help ground themselves. They temper their need for public acclaim and financial reward with strong intrinsic motivations.

It may be possible to produce short-term outcomes without being authentic, but authentic leadership drives long-term results. The integrity of authentic leaders helps to sustain organizational results through good times and bad.

Many readers of *Authentic Leadership,* including several CEOs, indicated that they had a tremendous desire to become authentic leaders and wanted to know how. As a result, our research team set out to answer the question, "How can people become and remain authentic leaders?" We interviewed 125 leaders to learn how they developed their leadership abilities. These interviews constitute the largest in-depth study of leadership development ever undertaken. Our interviewees discussed openly and honestly how they realized their potential and candidly shared their life stories, personal struggles, failures, and triumphs.

Analyzing 3,000 pages of transcripts, our team was startled to see you do not have to be born with specific characteristics or traits of a leader. Leadership emerges from your life story.

The people we talked with ranged in age from 23 to 93, with no fewer than 15 per decade. They were chosen based on their reputations for authenticity and effectiveness as leaders, as well as our personal knowledge of them. We also solicited recommendations from other leaders and academics. The resulting group includes women and men from a diverse array of racial, religious, and socioeconomic backgrounds and nationalities. Half of them are CEOs, and the other half comprises a range of profit and nonprofit leaders, midcareer leaders, and young leaders just starting on their journeys.

After interviewing these individuals, we believe we understand why more than 1,000 studies have not produced a profile of an ideal leader. Analyzing 3,000 pages of transcripts, our team was startled to see that these people did not identify any universal characteristics, traits, skills, or styles that led to their success. Rather, their leadership emerged from their life stories. Consciously and subconsciously, they were constantly testing themselves through real-world experiences and reframing their life stories to understand who they were at their core. In doing so, they discovered the purpose of their leadership and learned that being authentic made them more effective.

These findings are extremely encouraging: You do not have to be born with specific characteristics or traits of a leader. You do not have to wait for a tap on the shoulder. You do not have to be at the top of your organization. Instead, you can discover your potential right now. As one of our interviewees, Young & Rubicam chairman and CEO Ann Fudge, said, "All of us have the spark of leadership in us, whether it is in business, in government, or as a nonprofit volunteer. The challenge is to understand ourselves well enough to discover where we can use our leadership gifts to serve others."

Discovering your authentic leadership requires a commitment to developing yourself. Like musicians and athletes, you must devote yourself to a lifetime of realizing your potential. Most people Kroger CEO David Dillon has seen become good leaders were self-taught. Dillon said, "The advice I give to individuals in our company is not to expect the company to hand you a development plan. You need to take responsibility for developing yourself."

In the following pages, we draw upon lessons from our interviews to describe how people become authentic leaders. First and most important, they frame their life stories in ways that allow them to see themselves not as passive observers of their lives but rather as individuals who can develop self-awareness from their experiences. Authentic leaders act on that awareness by practicing their values and principles, sometimes at substantial risk to themselves. They are careful to balance their motivations


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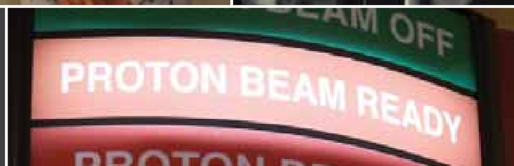
PROTON BEAM READY

so that they are driven by these inner values as much as by a desire for external rewards or recognition. Authentic leaders also keep a strong support team around them, ensuring that they live integrated, grounded lives.

Learning from Your Life Story

The journey to authentic leadership begins with understanding the story of your life. Your life story provides the context for your experiences, and through it, you can find the inspiration to make an impact in the world. As the novelist John Barth once wrote, "The story of your life is not your life. It is your story." In other words, it is your personal narrative that matters, not the mere facts of your life. Your life narrative is like a permanent recording playing in your head. Over and over, you replay the events and personal interactions that are important to your life, attempting to make sense of them to find your place in the world.

While the life stories of authentic leaders cover the full spectrum of experiences – including the positive impact of parents, athletic coaches, teachers, and mentors – many leaders reported that their motivation came from a difficult experience in their lives. They described the transformative effects of the loss of a job; personal illness; the untimely death of a close friend or relative; and feelings of being excluded, discriminated against, and rejected by peers. Rather than seeing themselves as victims, though, authentic leaders used these formative experiences to give meaning to their lives. They reframed these events to rise above their challenges and to discover their passion to lead.

Let's focus now on one leader in particular, Novartis chairman and CEO Daniel Vasella, whose life story was one of the most difficult of all the people we interviewed. He emerged from extreme challenges in his youth to reach the pinnacle of the global pharmaceutical industry, a trajectory that illustrates the trials many leaders have to go through on their journeys to authentic leadership.

Vasella was born in 1953 to a modest family in Fribourg, Switzerland. His early years were filled with medical problems that stoked his passion to become a physician. His first recollections were of a hospital where he was admitted at age four when he suffered from food poisoning. Falling ill with asthma at age five, he was sent alone to the mountains of eastern Switzerland for two summers. He found the four-month separations from his parents especially difficult because his caretaker had an alcohol problem and was unresponsive to his needs.

At age eight, Vasella had tuberculosis, followed by meningitis, and was sent to a sanatorium for a year. Lonely and homesick, he suffered a great deal that year, as his parents rarely visited him. He still remembers the pain and fear when the nurses held him down during the lumbar punctures so that he would not move. One day, a new physician arrived and took time to explain each step of the procedure. Vasella asked the doctor if he could hold a nurse's hand rather than being held down. "The amazing thing is that this time the procedure didn't hurt," Vasella recalls.

Bill George, the former chairman and CEO of Medtronic, is a professor of management practice at Harvard Business School in Boston. Peter Sims established "Leadership Perspectives," a class on leadership development at the Stanford Graduate School of Business in California. Andrew N. McLean is a research associate at Harvard Business School. Diana Mayer is a former Citigroup executive in New York. This article was adapted from *True North: Discover Your Authentic Leadership* by Bill George with Peter Sims (Jossey-Bass, forthcoming in March 2007).

"Afterward, the doctor asked me, 'How was that?' I reached up and gave him a big hug. These human gestures of forgiveness, caring, and compassion made a deep impression on me and on the kind of person I wanted to become."

Throughout his early years, Vasella's life continued to be unsettled. When he was ten, his 18-year-old sister passed away after suffering from cancer for two years. Three years later, his father died in surgery. To support the family, his mother went to work in a distant town and came home only once every three weeks. Left to himself, he and his friends held beer parties and got into frequent fights. This lasted for three years until he met his first girlfriend, whose affection changed his life.

At 20, Vasella entered medical school, later graduating with honors. During medical school, he sought out psychotherapy so he could come to terms with his early experiences and not feel like a victim. Through analysis, he reframed his life story and realized that he wanted to help a wider range of people than he could as an individual practitioner. Upon completion of his residency, he applied to become chief physician at the University of Zurich; however, the search committee considered him too young for the position.

Disappointed but not surprised, Vasella decided to use his abilities to increase his impact on medicine. At that time, he had a growing fascination with finance and business. He talked with the head of the pharmaceutical division of Sandoz, who offered him the opportunity to join the company's U.S. affiliate. In his five years in the United States, Vasella flourished in the stimulating environment, first as a sales representative and later as a product manager, and advanced rapidly through the Sandoz marketing organization.

When Sandoz merged with Ciba-Geigy in 1996, Vasella was named CEO of the combined companies, now called Novartis, despite his young age and limited experience. Once in the CEO's role, Vasella blossomed as a leader. He envisioned the opportunity to build a great global health care company that could help people through lifesaving new drugs, such as Gleevec, which has proved to be highly effective for patients with chronic myeloid leukemia. Drawing on the physician role models of his youth, he built an entirely new Novartis culture centered on compassion, competence, and competition. These moves established Novartis as a giant in the industry and Vasella as a compassionate leader.

Vasella's experience is just one of dozens provided by authentic leaders who traced their inspiration directly from their life stories. Asked what empowered them to lead, these leaders consistently replied that they found their strength through transformative experiences. Those experiences enabled them to understand the deeper purpose of their leadership.

When the 75 members of Stanford Graduate School of Business's Advisory Council were asked to recommend the most important capability for leaders to develop, their answer was nearly unanimous: self-awareness.

Knowing Your Authentic Self

When the 75 members of Stanford Graduate School of Business's Advisory Council were asked to recommend the most important capability for leaders to develop, their answer was nearly unanimous: self-awareness. Yet many leaders, especially those early in their careers, are trying so hard to establish themselves in the world that they leave little time for self-exploration. They strive to achieve success in tangible ways that are recognized in the external world–money, fame, power, status, or a rising stock price. Often their drive enables them to be professionally successful for a while, but they are unable to sustain that success. As they age, they may find something is missing in their lives and realize they are holding back from being the person they want to be. Knowing their authentic selves requires the courage and honesty to open up and examine their experiences. As they do so, leaders become more humane and willing to be vulnerable.

Of all the leaders we interviewed, David Pottruck, former CEO of Charles Schwab, had one of the most persistent journeys to self-awareness. An all-league football player in high school, Pottruck became MVP of his college team at the University of Pennsylvania. After completing his MBA at Wharton and a stint with Citigroup, he joined Charles Schwab as head of marketing, moving from New York to San Francisco. An extremely hard worker, Pottruck could not understand why his new colleagues resented the long hours he put in and his aggressiveness in pushing for results. "I thought my accomplishments would speak for themselves," he said. "It never occurred to me that my level of energy would intimidate and offend other people, because in my mind I was trying to help the company."

Pottruck was shocked when his boss told him, "Dave, your colleagues do not trust you." As he recalled, "That feedback was like a dagger to my heart. I was in denial, as I didn't see myself as others saw me. I became a lightning rod for friction, but I had no idea how self-serving I looked to other people. Still, somewhere in my inner core the feedback resonated as true." Pottruck realized that he could not succeed unless he identified and overcame his blind spots.

Denial can be the greatest hurdle that leaders face in becoming self-aware. They all have egos that need to be stroked, insecurities that need to be smoothed, fears that need to be allayed. Authentic leaders realize that they have to be willing to listen to feedback–especially the kind they don't want to hear. It was only after his second divorce that Pottruck finally was able to acknowledge that he still had large blind spots: "After my second marriage fell apart, I thought I had a wife-selection problem." Then he worked with a counselor who delivered some hard truths: "The good news is you do not have a wife-selection problem; the bad news is you have a husband-behavior problem." Pottruck then made a determined effort to change. As he described it, "I was like a guy who has had three heart attacks and finally realizes he has to quit smoking and lose some weight."

These days Pottruck is happily remarried and listens carefully when his wife offers constructive feedback. He acknowledges that he falls back on his old habits at times, particularly in high stress situations, but now he has developed ways of coping with stress. "I have had enough success in life to have that foundation of self-respect, so I can take the criticism and not deny it. I have finally learned to tolerate my failures and disappointments and not beat myself up."

YOUR DEVELOPMENT AS AN AUTHENTIC LEADER

As you read this article, think about the basis for your leadership development and the path you need to follow to become an authentic leader. Then ask yourself these questions:

1. **Which people and experiences in your early life had the greatest impact on you?**
2. **What tools do you use to become self-aware?** What is your authentic self? What are the moments when you say to yourself, this is the real me?
3. **What are your most deeply held values?** Where did they come from? Have your values changed significantly since your childhood? How do your values inform your actions?
4. **What motivates you extrinsically?** What are your intrinsic motivations? How do you balance extrinsic and intrinsic motivation in your life?
5. **What kind of support team do you have?** How can your support team make you a more authentic leader? How should you diversify your team to broaden your perspective?
6. **Is your life integrated?** Are you able to be the same person in all aspects of your life–personal, work, family, and community? If not, what is holding you back?
7. **What does being authentic mean in your life?** Are you more effective as a leader when you behave authentically? Have you ever paid a price for your authenticity as a leader? Was it worth it?
8. **What steps can you take today, tomorrow, and over the next year to develop your authentic leadership?**

Practicing Your Values and Principles

The values that form the basis for authentic leadership are derived from your beliefs and convictions, but you will not know what your true values are until they are tested under pressure. It is relatively easy to list your values and to live by them when things are going well. When your success, your career, or even your life hangs in the balance, you learn what is most important, what you are prepared to sacrifice, and what trade-offs you are willing to make.

Leadership principles are values translated into action. Having a solid base of values and testing them under fire enables you to develop the principles you will use in leading. For example, a value such as "concern for others"

Denial can be the greatest hurdle that leaders face in becoming self-aware.

might be translated into a leadership principle such as "create a work environment where people are respected for their contributions, provided job security, and allowed to fulfill their potential."

Consider Jon Huntsman, the founder and chairman of Huntsman Corporation. His moral values were deeply challenged when he worked for the Nixon administration in 1972, shortly before Watergate. After a brief stint in the U.S. Department of Health, Education, and Welfare (HEW), he took a job under H.R. Haldeman, President Nixon's powerful chief of staff. Huntsman said he found the experience of taking orders from Haldeman "very mixed. I wasn't geared to take orders, irrespective of whether they were ethically or morally right." He explained, "We had a few clashes, as plenty of things that Haldeman wanted to do were questionable. An amoral atmosphere permeated the White House."

One day, Haldeman directed Huntsman to help him entrap a California congressman who had been opposing a White House initiative. The congressman was part owner of a plant that reportedly employed undocumented workers. To gather information to embarrass the congressman, Haldeman told Huntsman to get the plant manager of a company Huntsman owned to place some undocumented workers at the congressman's plant in an undercover operation.

"There are times when we react too quickly and fail to realize immediately what is right and wrong," Huntsman recalled. "This was one of those times when I didn't think it through. I knew instinctively it was wrong, but it took a few minutes for the notion to percolate. After 15 minutes, my inner moral compass made itself noticed and enabled me to recognize this wasn't the right thing to do. Values that had accompanied me since childhood kicked in. Halfway through my conversation with our plant manager, I said to him, 'Let's not do this. I don't want to play this game. Forget that I called.'"

Huntsman told Haldeman that he would not use his employees in this way. "Here I was saying no to the second most powerful person in the country. He didn't appreciate responses like that, as he viewed them as signs of disloyalty. I might as well have been saying farewell. So be it. I left within the next six months."

Balancing Your Extrinsic and Intrinsic Motivations

Because authentic leaders need to sustain high levels of motivation and keep their lives in balance, it is critically important for them to understand what drives them. There are two types of motivations – extrinsic and intrinsic. Although they are reluctant to admit it, many leaders are propelled to achieve by measuring their success against the outside world's parameters. They enjoy the recognition and status that come with promotions and financial rewards. Intrinsic motivations, on the other hand, are derived from their sense of the meaning of their life. They are closely linked to one's life story and the way one frames it. Examples include personal growth, helping other people develop, taking on social causes, and making a difference in the world. The key is to find a balance between your desires for external validation and the intrinsic motivations that provide fulfillment in your work.

Many interviewees advised aspiring leaders to be wary of getting caught up in social, peer, or parental expectations.

Debra Dunn, who has worked in Silicon Valley for decades as a Hewlett-Packard executive, acknowledged the constant pressures from external sources: "The path of accumulating material possessions is clearly laid out. You know how to measure it. If you don't pursue that path, people wonder what is wrong with you. The only way to avoid getting caught up in materialism is to understand where you find happiness and fulfillment."

Moving away from the external validation of personal achievement is not always easy. Achievement-oriented leaders grow so accustomed to successive accomplishments throughout their early years that it takes courage to pursue their intrinsic motivations. But at some point, most leaders recognize that they need to address more difficult questions in order to pursue truly meaningful success. McKinsey's Alice Woodwark, who at 29 has already achieved notable success, reflected: "My version of achievement was pretty naive, born of things I learned early in life about praise and being valued. But if you're just chasing the rabbit around the course, you're not running toward anything meaningful."

Intrinsic motivations are congruent with your values and are more fulfilling than extrinsic motivations. John Thain, CEO of the New York Stock Exchange, said, "I am motivated by doing a really good job at whatever I am doing, but I prefer to multiply my impact on society through a group of people." Or as Ann Moore, chairman and CEO of Time, put it, "I came here 25 years ago solely because I loved magazines and the publishing world." Moore had a dozen job offers after business school but took the lowest-paying one with Time because of her passion for publishing.

Building Your Support Team

Leaders cannot succeed on their own; even the most outwardly confident executives need support and advice. Without strong relationships to provide perspective, it is very easy to lose your way.

Authentic leaders build extraordinary support teams to help them stay on course. Those teams counsel them in times of uncertainty, help them in times of difficulty, and celebrate with them in times of success. After their hardest days, leaders find comfort in being with people on whom they can rely so they can be open and vulnerable. During the low points, they cherish the friends who appreciate them for who they are, not what they are. Authentic leaders find that their support teams provide affirmation, advice, perspective, and calls for course corrections when needed.

How do you go about building your support team? Most authentic leaders have a multifaceted support structure

Think of your life as a house. Can you knock down the walls between the rooms and be the same person in each of them?

that includes their spouses or significant others, families, mentors, close friends, and colleagues. They build their networks over time, as the experiences, shared histories, and openness with people close to them create the trust and confidence they need in times of trial and uncertainty. Leaders must give as much to their supporters as they get from them so that mutually beneficial relationships can develop.

It starts with having at least one person in your life with whom you can be completely yourself, warts and all, and still be accepted unconditionally. Often that person is the only one who can tell you the honest truth. Most leaders have their closest relationships with their spouses, although some develop these bonds with another family member, a close friend, or a trusted mentor. When leaders can rely on unconditional support, they are more likely to accept themselves for who they really are.

Many relationships grow over time through an expression of shared values and a common purpose. Randy Komisar of venture capital firm Kleiner Perkins Caufield & Byers said his marriage to Hewlett-Packard's Debra Dunn is lasting because it is rooted in similar values. "Debra and I are very independent but extremely harmonious in terms of our personal aspirations, values, and principles. We have a strong resonance around questions like, 'What is your legacy in this world?' It is important to be in sync about what we do with our lives."

Many leaders have had a mentor who changed their lives. The best mentoring interactions spark mutual learning, exploration of similar values, and shared enjoyment. If people are only looking for a leg up from their mentors, instead of being interested in their mentors' lives as well, the relationships will not last for long. It is the two-way nature of the connection that sustains it.

Personal and professional support groups can take many forms. Piper Jaffray's Tad Piper is a member of an Alcoholics Anonymous group. He noted, "These are not CEOs. They are just a group of nice, hard-working people who are trying to stay sober, lead good lives, and work with each other about being open, honest, and vulnerable. We reinforce each other's behavior by talking about our chemical dependency in a disciplined way as we go through the 12 steps. I feel blessed to be surrounded by people who are thinking about those kinds of issues and actually doing something, not just talking about them."

Bill George's experiences echo Piper's: In 1974, he joined a men's group that formed after a weekend retreat. More than 30 years later, the group is still meeting every Wednesday morning. After an opening period of catching up on each other's lives and dealing with any particular difficulty someone may be facing, one of the group's eight members leads a discussion on a topic he has selected. These discussions are open, probing, and often profound. The key to their success is that people say what they really believe without fear of judgment, criticism, or reprisal. All the members consider the group to be one of the most important aspects of their lives, enabling them to clarify their beliefs, values, and understanding of vital issues, as well as serving as a source of honest feedback when they need it most.

Integrating Your Life by Staying Grounded

Integrating their lives is one of the greatest challenges leaders face. To lead a balanced life, you need to bring together all of its constituent elements – work, family, community, and friends – so that you can be the same person in each environment. Think of your life as a house, with a bedroom for your personal life, a study for your professional life, a family room for your family, and a living room to share with your friends. Can you knock down the walls between these rooms and be the same person in each of them?

As John Donahoe, president of eBay Marketplaces and former worldwide managing director of Bain, stressed, being authentic means maintaining a sense of self no matter where you are. He warned, "The world can shape you if you let it. To have a sense of yourself as you live, you must make conscious choices. Sometimes the choices are really hard, and you make a lot of mistakes."

Authentic leaders have a steady and confident presence. They do not show up as one person one day and another person the next. Integration takes discipline, particularly during stressful times when it is easy to become reactive and slip back into bad habits. Donahoe feels strongly that integrating his life has enabled him to become a more effective leader. "There is no nirvana," he said. "The struggle is constant, as the trade-offs don't get any easier as you get older." But for authentic leaders, personal and professional lives are not a zero-sum game. As Donahoe said, "I have no doubt today that my children have made me a far more effective leader in the workplace. Having a strong personal life has made the difference."

Leading is high-stress work. There is no way to avoid stress when you are responsible for people, organizations, outcomes, and managing the constant uncertainties of the environment. The higher you go, the greater your freedom to control your destiny but also the higher the degree of stress. The question is not whether you can avoid stress but how you can control it to maintain your own sense of equilibrium.

Authentic leaders are constantly aware of the importance of staying grounded. Besides spending time with their families and close friends, authentic leaders get physical exercise, engage in spiritual practices, do community service, and return to the places where they grew up. All are essential to their effectiveness as leaders, enabling them to sustain their authenticity.

Empowering People to Lead

Now that we have discussed the process of discovering your authentic leadership, let's look at how authentic leaders empower people in their organizations to achieve superior long-term results, which is the bottom line for all leaders.

Authentic leaders recognize that leadership is not about their success or about getting loyal subordinates to follow them. They know the key to a successful organization is having empowered leaders at all levels, including those who have no direct reports. They not only inspire those around them, they empower those individuals to step up and lead.

A reputation for building relationships and empowering people was instrumental in chairman and CEO Anne Mulcahy's stunning turnaround of Xerox. When Mulcahy was asked to take the company's reins from her failed predecessor, Xerox had $18 billion in debt, and all credit lines were exhausted. With the share price in free fall, morale was at an all-time low. To make matters worse, the SEC was investigating the company's revenue recognition practices.

Mulcahy's appointment came as a surprise to everyone – including Mulcahy herself. A Xerox veteran, she had worked in field sales and on the corporate staff for 25 years, but not in finance, R&D, or manufacturing. How could Mulcahy cope with this crisis when she had had no financial experience? She brought to the CEO role the relationships she had built over 25 years, an impeccable understanding of the organization, and, above all, her credibility as an authentic leader. She bled for Xerox, and everyone knew it. Because of that, they were willing to go the extra mile for her.

After her appointment, Mulcahy met personally with the company's top 100 executives to ask them if they would stay with the company despite the challenges ahead. "I knew there were people who weren't supportive of me," she said. "So I confronted a couple of them and said, 'This is about the company.'" The first two people Mulcahy talked with, both of whom ran big operating units, decided to leave, but the remaining 98 committed to stay.

Throughout the crisis, people in Xerox were empowered by Mulcahy to step up and lead in order to restore the company to its former greatness. In the end, her leadership enabled Xerox to avoid bankruptcy as she paid back $10 billion in debt and restored revenue growth and profitability with a combination of cost savings and innovative new products. The stock price tripled as a result.

Superior results over a sustained period of time is the ultimate mark of an authentic leader.

• • •

Like Mulcahy, all leaders have to deliver bottom-line results. By creating a virtuous circle in which the results reinforce the effectiveness of their leadership, authentic leaders are able to sustain those results through good times and bad. Their success enables them to attract talented people and align employees' activities with shared goals, as they empower others on their team to lead by taking on greater challenges. Indeed, superior results over a sustained period of time is the ultimate mark of an authentic leader. It may be possible to drive short-term outcomes without being authentic, but authentic leadership is the only way we know to create sustainable long-term results.

For authentic leaders, there are special rewards. No individual achievement can equal the pleasure of leading a group of people to achieve a worthy goal. When you cross the finish line together, all the pain and suffering you may have experienced quickly vanishes. It is replaced by a deep inner satisfaction that you have empowered others and thus made the world a better place. That's the challenge and the fulfillment of authentic leadership.

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Harley Schwadron

"And you wanted to hibernate!"

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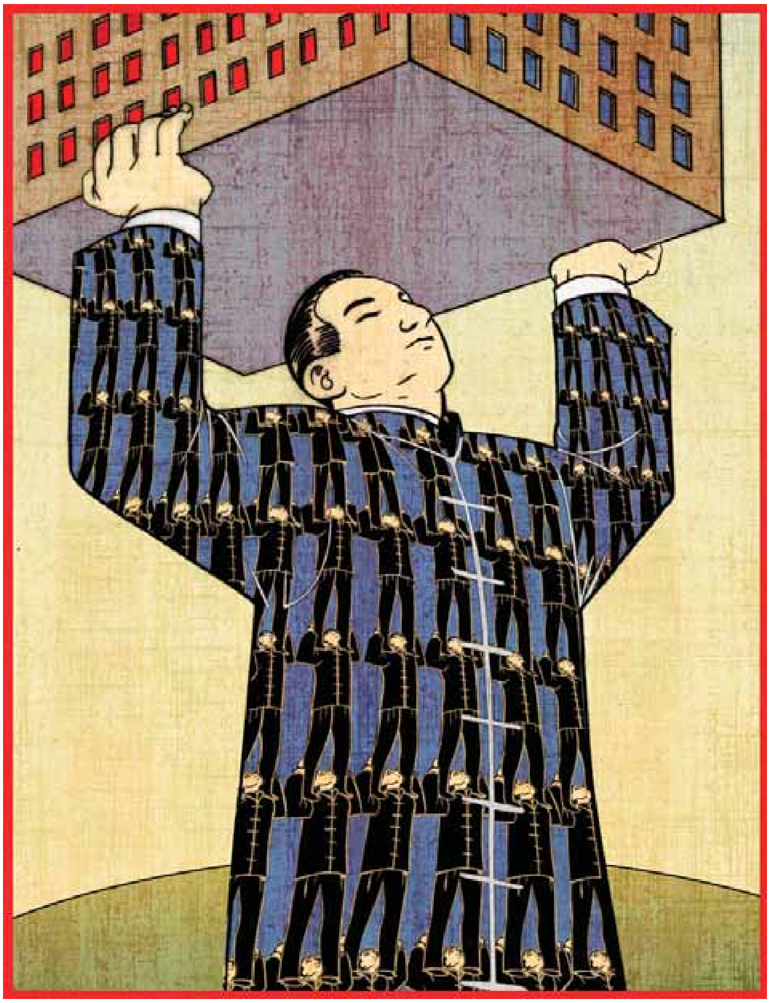

Sally Wern Comport

Raising Haier

Twenty-two years ago, the Qingdao Refrigerator Factory was a dump, its workers were unpaid, and its products were shoddy. Today it's called Haier. The home-appliance giant is China's best-known global company – and its CEO has proved that he is one of the world's experts in leading and surviving change.

by Zhang Ruimin

PEOPLE RESPECT THE LEADERSHIP of an organization for different reasons in different periods. When you start a business, your employees are willing to follow you if you set a good example and bear more hardships than they do. In my early days at Haier, when I went on a business trip, I often had to set out right away. If there was no seat available on the train, I would spend two yuan to rent a small camp stool and sit in the aisle. That was seen and heeded by employees.

Later, it's conviction that appeals to people. When we started building Haier Industrial Park in the 1990s, people held back, expecting problems to arise. But as it became clear to them that

I'd spare no effort to make it a reality, everyone got on board.

Today, I believe, what Haier's employees need is to be allowed to make decisions for themselves and not to feel that they are following me in their work. The philosopher Lao-tzu said, "In the highest antiquity, the people did not know that there were rulers." I take his meaning to be that a leader whose existence is unknown to his subordinates is really the most brilliant one.

Five Catties of Fish

When I took the job of director of the Qingdao Refrigerator Factory in December 1984, the existence of the company was at stake. Indeed, most people thought its situation was hopeless. The factory's net debt stood at RMB1.47 million, and I was the fourth director appointed in that single year. The previous three had either left on their own or been kicked out – no one was able to shoulder the responsibility. More than 800 workers were anxiously awaiting pay that was several months in arrears. Not surprisingly, the employee turnover rate was high. An additional 51 workers applied for a transfer to a different company when my appointment was announced.

There was no time for idle talk. The first thing I focused on was the employees' salaries. When I think back to the first half year of my tenure, that is the challenge I vividly remember, because I had to face it every month. We were not a state-owned enterprise, and given our debt load, the banks were not willing to lend money to us. But luckily, another option materialized. China's policy of reform and opening to the outside world meant that wealth was accumulating beyond the cities, in the urban-rural junctional areas. I was able to borrow money from the nearby production brigade.

Certainly, employees were very happy simply to get their pay, but I wanted to go further. Soon after my arrival, when the Chinese Lunar New Year came around, I borrowed again to buy each worker a New Year's gift of five catties of fish. It may seem laughable now, but that gesture had an immediate and positive effect. It put hope into employees' hearts that our factory had a chance. I then borrowed tens of thousands more yuan to replace the truck that was many employees' transportation to and from work. The truck made for a terrible ride, especially for those who carried children in their arms, so I went to the added expense of buying a bus. Again, it was a small change by today's standards, but it had a real impact on morale. How could a factory that was obviously getting better and better be about to fail?

Once I had won some goodwill, I started demanding good work. There was very little discipline in the factory up to that point; people tended to do things as they saw fit. Rules and regulations existed in writing but had never been seriously upheld. I spelled out the terms for people: I would guarantee payment of their salaries every month, but only on the condition that they strictly obeyed the working disciplines I established. Then I set forth my new rules, beginning with "Urinating or defecating in workshops is prohibited" and "Stealing company property is prohibited." These were actual habits to be combated.

The government at that time did not allow companies to fire workers. Those who violated factory rules could be given demerits or, much more seriously, be deprived of factory membership (that is, no longer part of the company's collective ownership) and placed on probation. Once, when we were cleaning a warehouse, some workers were seen carrying away materials. We caught one of them and within an hour posted the consequences on the factory bulletin board: That worker was deprived of factory membership and placed on probation. This punishment came as a huge shock to people.

My main purpose, however, in establishing strict discipline was not to punish those who made mistakes. I knew that the great majority of employees wanted from the bottom of their hearts to be good employees. The problem was that the atmosphere was too bad for them to work well in. Far from frightening employees, stronger discipline in the factory endowed them with confidence and hope. The change in morale was obvious within six months.

Everything Turns for the Better

If you want to build confidence in others, you yourself must be confident. Why did I have faith that the factory would prosper? The straightforward answer is that I knew it was just about to install a new production line that would improve quality and efficiency. I knew this because it was I who had pushed for the new line as a manager at the factory's governing body, the Qingdao Home Appliance Company. For the same reason, when the third factory director of the year announced his departure, I felt I must take responsibility for the change. I had also spent several months studying the national

Article at a Glance

People respect the leadership of an organization for different reasons in different periods. First, for the example the leader sets. Then, for the leader's conviction in decision making. Finally, for the leader's ability to honor employees' capabilities and initiative.

Zhang Ruimin's leadership of Haier Group initially consisted of improving morale and establishing discipline – an appropriate focus for a small business in severe disarray.

As the company grew, Zhang's leadership style evolved to feature more consensus building and competitive strategy development.

Zhang's hope for Haier is that the leader at the top of the organization will become less and less important as managerial processes make the company's market successes self-sustaining.

consumer market. I knew that if we could motivate our employees to work more efficiently and improve manufacturing quality, our products would surely find buyers.

But my confidence also had a deeper basis than the data at hand. I think it is a common phenomenon among the generation that lived through the Cultural Revolution (I was still a high school student when it began) that we learned not to recoil at the sight of difficulties. It isn't that we became arrogant – or, much less, that we were blinded by optimism. Rather, we gained a different perspective on life and the prospect of failure. The things that happened during that period made us reflect more deeply on human nature and society. We learned that everything can turn for the better and all kinds of challenges can be overcome. There is no crisis that cannot be resolved.

Confidence alone does not make for leadership, but in those early days, it was the closest thing I had to a "leadership style." Unlike many young people today, I didn't have a formal MBA education. But because of the small size of our company, I did know most of the employees by name. I could make a decision in the morning and approach the workers at noon to learn their reaction and check the results. My leadership then was task centered and authoritative – I made the decisions and expected the rank and file to carry them out strictly. Today, this would not be considered a proper way of managing. But at the time, we were a small enterprise in disorder, and there was a very important role for it. Even the workers wanted me to lead in that way.

Now that the company is much larger – we have more than 50,000 full-time employees – that old way of leading would never work. I've had to learn over the years how to articulate the advantages of a change I want to bring about, and ensure that the new practice is accepted. A perfect example was when Haier embarked on a major business process-reengineering effort in 1998 and some senior executives openly objected to it. By then, Haier had grown from a small factory into a big company consisting of many plants and business units, and each had its own suppliers, manufacturing assets, sales organization, human resources processes, and so forth. I was in favor of standardizing and consolidating much of this in such a way that the various functions, from procurement to marketing, would be integrated and driven by order information. I knew that would not be easily accomplished; in fact, we set a timeline of ten years for completing the work. But to me, the logic was clear. I thought of the advice of Sun Tzu in *The Art of War:* One must first "exhibit the coyness of a maiden" and "afterwards emulate the rapidity of a running hare." At the outset, I tried to think over every possible circumstance and result. Once I decided to start consolidating, I made a commitment to carry it through to the end.

What I didn't anticipate was the degree to which some executives would resent what they saw as a loss of power. Their very negative attitudes toward the change showed up in the next half year's time as our sales fell.

By then I was on a serious campaign to communicate the message, talking with senior executives again and again, outlining the advantages of integrating the processes. I explained, for example, that when each division did procurement for itself, our procurement power was dispersed and it was almost impossible to get the best supplier or the most favorable price. And that when marketers from our refrigerator, air conditioner, and washing machine divisions all showed up separately at the same store to negotiate promotions, the store's management was being pestered beyond endurance – and we were doing nothing to convey a uniform corporate image. Gradually, everyone saw the power we would all gain through process integration.

Dumplings on a Construction Site

I have never considered myself an outstanding leader, but I think I'm a person who has an indomitable will. Once I set a definite goal, I must succeed. Many other enterprises have pursued the same business as Haier over the years in the same economic environment. The difficulties they met with were our difficulties as well. The difference is that many of them were too willing to give up.

Zhang Ruimin is the chief executive officer of Haier Group, headquartered in Qingdao, China. This article is adapted from the interview with Mr. Zhang that appeared in the January 2007 issue of *Harvard Business Review China*.

In 1991, for example, I decided to expand the capacity of our factory and build the Haier Industrial Park. We took a large piece of land, laid the foundations, built the underground utility infrastructure – and in the process, spent all the money our company had. At that time China was employing a macrocontrol policy, and the money market was so tight that we couldn't get loans. The total budget was RMB1.5 billion, but the company had accumulated only RMB80 million, and all of it had already been plowed into the project.

Many people in our company, from management to assembly-line workers, were questioning the necessity of building such a facility. To them, having a product supply that fell short of demand was not such a bad thing; fast sales and high margins brought us a pretty good life. So why throw the money we earned into this industrial park, which wouldn't produce returns for years? Why not build housing for employees instead? Why not give them higher salaries? Having studied the national economic situation, I was convinced that building the industrial park made sense. Even despite China's policy, I felt certain the economy would grow at a fast rate so that our capacity would be severely inadequate before long. And in fact, in 1993 China entered a period of overheated economic growth. Many companies in our industry didn't start their projects until then – at which point they had missed the best opportunity for development.

As I tell the story today, I sound assured, but at the time I feared that I wouldn't ride out the crisis. I wasn't alone. The construction company also suspected I'd be unable to make the remaining payments on the project. In that moment of doubt, I drew on my past experience. On the Lunar New Year's Eve of 1992, I came to the construction site and enjoyed dumplings with the workers. Together we celebrated the New Year and talked about the project, and the confidence of the construction company grew.

The Smallest Company in the World

People often speak of Haier with reference to General Electric, and that great company is certainly one of our benchmarks. To me, the essence of Jack Welch's accomplishment at GE was that he simultaneously turned his company into the largest one in the world and into the smallest – by making each employee full of vigor.

I want each employee coming to work for Haier to have the sense that he or she can find a place in the company to realize his or her own values as well as creating value for the enterprise. I have no desire to oversupervise employees. Nor is my goal to grow the company to a certain size. The list of the world's largest 500 companies changes dramatically every decade. Size is no protection against failure if you are not able to fill each employee with vitality. Instead, I want Haier to get to the point where all employees create their own value on a globalized platform. If we are able to accomplish this, we can make Haier a very competitive enterprise.

Toward that end, there are three areas that I must think about carefully every day. First, have we provided employees with sufficient room to create value and to achieve self-realization?

Size is no protection against failure if you are not able to fill each employee with vitality.

Do people just passively come to work every day as requested? Or do they actively come here to fulfill their ambitions? Part of making sure it's the latter is having the right organizational structure – one that is as boundaryless and flat as possible. Many big companies organize themselves around divisions and have very linear, functional structures. But Haier will do better if it has project teams being formed according to market demands, made up of members from multiple divisions. In that kind of setup, the emphasis stays on what will serve the market, not what will please someone further up in the company hierarchy. Employees feel they have a customer to answer to, more so than a superior.

That is not an easy orientation to bring about. One important reason that people tend to focus so much on their bosses is that their pay is determined by those bosses. So the second thing that I am currently very focused on is ensuring that compensation provides an incentive for employees to behave in a market-driven way. We've changed things such that Haier employees are rewarded in large part according to the performance of their teams. If a project group is asked to increase the gross profit margin of a certain product from 8% to 10%, it might go about that in any number of ways. It might change the product design, improve the manufacturing processes, figure out a way to pay less for raw materials, or make other changes. Regardless of whether the group does this in the way I or some other member of management would, if the task is accomplished, every member of the team gets a bonus in line with his or her respective contributions. In fact, Haier does not have a position-related compensation system at all. Instead of being paid according to their titles, employees are paid solely for results. It's no surprise that people who leave the company are often heard complaining about the low salary they received from Haier!

The third thing I think about every day is that fundamental strategic question, how on earth are we different from the competition? If a company has no points of differentiation, it rapidly devolves into a commodity player with no chance for long-term success. Most obviously, differentiation comes from product innovation, which we engage in on multiple levels. What we call "three-season product innovation" serves the current market with fast-cycle product improvements. Over a longer horizon, we work on technology developments that will fuel new products three years out. And we are always engaged in basic research that may yield breakthroughs in the long term: a refrigerator, for example, that needs no compressor, or a washing machine that operates without detergent or even without water. Meanwhile, I am trying to build our marketing capability into a point of differentiation. In particular, our recent forays into direct marketing and delivery and our ability to generate positive cash flows are important go-to-market innovations that have eluded many Chinese companies – because they are very hard to achieve.

But it's another kind of differentiation that I am most adamant about achieving. Today, there is a wide gap between Chinese enterprises and major foreign companies – but it isn't mainly a technology gap. The key difference is in management talent. Therefore, we are making tremendous efforts to improve the quality of human resources.

There is a wide gap between Chinese enterprises and major foreign companies – but it isn't mainly a technology gap. The key difference is in management talent.

It's working, I believe, thanks to a difference that already exists at Haier: a corporate culture that embraces constant progress and the belief that victory comes through change.

My Successor's Brilliance

When you have been at the helm of a company for more than 20 years and seen it grow from a single dilapidated and debt-ridden factory to a global competitor with annual sales in excess of RMB100 billion, questions about succession naturally begin to arise. I tend to deflect those questions, and not only because I personally want to remain focused on enhancing the competitiveness of Haier. My larger hope is that the question of who sits in the CEO's chair is of less and less importance. Haier should not be a company ruled by one man or woman but, rather, a self-sustaining system of excellent managerial processes. I have always liked what Peter Drucker said about leadership's having little to do with charisma and other qualities. As he put it, "Leadership is a means that is mundane, unromantic, and boring. Its essence is performance."

Today, the biggest problem at Haier lies in the fact that its leaders are still embroiled in operational execution issues. The enterprise will become great when it is able to operate by itself, with employees acting as their own leaders, understanding what to do to satisfy market and customer demand. The future CEO of Haier will then be able to focus wholly on strategic issues and make decisions from a global point of view.

If that sounds like the chief executive will be aloof or disconnected from the rank and file, then I have created the wrong impression. Quite the contrary, it worries me that so many young people join the managerial ranks of companies immediately after graduating university, never having been managed by others. Coming of age in the Cultural Revolution, I of course missed the opportunity to attend university and was thrown abruptly to the bottom of working society. There is no question in my mind that those years exerted a significant influence on how I now go about leading others. When I dine with Haier workers, as I do nearly every day, or when I drop in unannounced at a workplace, I am always looking to renew my understanding of their perspective. Perhaps I have not achieved what Lao-tzu described – a populace unaware of the presence of their ruler. But that brilliance may be within my successor's reach.

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"Our chairman should be here any minute – I hear the opening strains of his theme music."

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Letters to the Editor

Ten Ways to Create Shareholder Value

Alfred Rappaport's article "Ten Ways to Create Shareholder Value" (September 2006) is clear as an update of the "shareholder value" approach, but that very clarity reveals some problems with the theory.

I agree that companies should be managed so as to improve their long-term health and not just to accept or


10 Ways to Create Shareholder Value

by Alfred Rappaport

Companies profess devotion to shareholder value but rarely follow the practices that maximize it. What will it take to make your company a level 10 value creator?

It's become fashionable to blame the pursuit of shareholder value for the ills besetting corporate America: managers and investors obsessed with next quarter's results, failure to invest in long-term growth, and even the accounting scandals that have grabbed headlines. When executives destroy the value they are supposed to be creating, they almost always claim that stock market pressure made them do it.

The reality is that the shareholder value principle has not failed management; rather, it is management that has betrayed the principle. In the 1990s, for example, many companies introduced stock options as a major component of executive compensation. The idea was to align the interests of management with those of shareholders. But the generous distribution of options largely failed to motivate value-friendly behavior because their design almost guaranteed that they would produce the opposite result. To start with, relatively short vesting periods, combined with a belief that short-term earnings fuel stock prices, encouraged executives to manage earnings, exercise their options early, and cash out opportunistically. The common practice of accelerating the vesting date for a CEO's

Simon Pemberton

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improve the current year's earnings. But I feel strongly that pursuing shareholder value is not a good way to manage a company. It is based on the following axioms, which have no strong theoretical or practical basis and take an all too optimistic view of human nature:

- A company has "real value," and this lies in its market capitalization (number of shares multiplied by share price), which in turn equals the present discounted value of future cash flows from the company's operations.
- The stock market (the totality of investors) can accurately value companies, even including cash flow from projects to be introduced in the future.
- It is best for the long-term health of a company that management make decisions with the intention of continually increasing the share price.
- The CEO and executives can honestly and exactly estimate future earnings and cash flow.
- Paying CEOs and executives on the basis of shares or share options will induce management to find ways to increase its company's value and share price simultaneously.

Rappaport writes, "Do not manage earnings or provide earnings guidance." I absolutely agree. In fact, I think the SEC should prohibit the reporting of quarterly earnings. If executives might do something wrong in order to improve the share price, we cannot trust them to correctly report present earnings, much less to correctly estimate and publish future earnings and cash flow. So why should we suppose that market capitalization – which moves in accordance with expectations for the future – will give us a company's real value? And why should we forget that these executives have stock options that improve when the share price goes up? In other words, why should we give human nature too much of a chance?

As for "focusing on earnings," it is true that accounting data don't show a company's increase in real value during the

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reporting period. This would be feasible only if the balance sheet showed the real value of the company on the reporting date, which it obviously cannot. Apart from the possibility that management might "improve" financial statements, the balance sheets of U.S. companies have a number of problems:

• Expected shortfalls from pension funds and future health costs of at least $300 billion are not included in companies' financial statements.

• In many companies, the assets side includes considerable amounts of goodwill, which supports from 50% to 100% of stockholders' equity. Goodwill breaks two basic accounting conventions: that earnings from periods after the reporting date should not be included, and that earnings should not be included if there is no evidence as to their amount. In a number of cases, goodwill has been written off when it becomes clear that the projected earnings will not be realized (which is what happened with AOL Time Warner, for instance).

• Intangibles arising out of real costs, such as software, which amount to an investment of $1 trillion per year, are not shown as an asset reflecting the economic reality but are expensed in each year.

It is, however, important to note a company's yearly earnings figure, because if the company has not shown a sufficient margin, cash flow, or ROI in the present year, doubt is cast on its plans for improving value in future years. Also, accounting data do help to show where the company has been efficient, or could be more efficient, in its current operations.

It is not true that WorldCom, Enron, and Nortel Networks destroyed a large part of their value because they did not "meet investor expectations." Very simply, they were showing accounting losses, had a negative cash flow, and could not meet contractual payments. Curiously, the "infallible" market did not understand until the last moment that these companies were in great difficulties. Possibly many people thought, "Since Enron is valued by the market at $80 billion, there can't be anything wrong with it." Everyone believed everyone else!

Peter Van der Heyden
Consultant
Asesoría Más +
Puebla, Mexico

Rappaport responds: Peter Van der Heyden introduces a curious contradiction when he asserts that companies should be managed to improve their long-term health and then goes on to claim that shareholder value is not a good way to manage. After all, a company's value depends on its long-term ability to generate cash to fund value-creating growth and pay dividends to its shareholders. What could be better for a company's long-term health than a management that embraces shareholder value as its governing principle? If companies are not in the business of creating value for their shareholders, where will the capital needed to grow the economy come from?

Equally puzzling is Van der Heyden's rejection of shareholder value management on the grounds that CEOs cannot exactly estimate future earnings and cash flow, and the stock market cannot accurately value companies. In a sea of uncertainty, there is no "right" forecast of future cash flows or "true" value of a company's shares. Indeed, pay for performance is all about rewarding management for how well it performs in the face of uncertainty. And equity investors recognize that they may not earn a premium over the risk-free rate to compensate them for the additional risk they assume. In brief, uncertainty is not an impediment to the use of shareholder value; rather, it's what makes the implementation of sound shareholder value practices absolutely crucial to an organization's success.

Finally, each of the financial reporting shortcomings Van der Heyden presents is addressed by the proposed corporate performance statement, which provides investors with substantially greater value-relevant and transparent information than traditional financial statements do.

Mastering the Three Worlds of Information Technology

Andrew McAfee's article, "Mastering the Three Worlds of Information Technology" (November 2006), demonstrates the need for fresh ideas to help us break out of an intellectual rut. The fundamental problem is that his perspective is too technologycentric. IT is simply too narrow and confining as a concept; the conversation should be about enterprise information management.

High-performance organizations recognize IT as a tool that can help connect people, information, and enterprise objectives. In the workplace, people integrate information tools and technologies. Over the course of an hour, a knowledge worker may write an e-mail, read (or write) a blog, check a spreadsheet, use computer-aided design, and employ supply-chain management to check or calibrate production sequences. A team might use a wiki and software for enterprise resource planning. Yet McAfee separates IT into three discrete categories – functional, network, and enterprise – rather than integrating it.

Several questions demand new answers: How can information be managed strategically to benefit the organization? What information is needed, when, in which form, and accessible to whom? How do people actually create, move, store, access, and use information? How can technology create more robust, useful, and creative links between organizations' two greatest resources: people and information? McAfee may be on the right track, but his analysis does not break out of the restrictive bounds of a now-outdated focus on IT.

Bruce W. Dearstyne
Professor of Information Studies, Retired
University of Maryland
Albany, New York

McAfee responds: Bruce Dearstyne's comments illustrate the belief, common in some academic circles, that it's vital to study the effects of information technology yet somehow inappropriate to study the technologies themselves. Instead, we should concentrate on "enterprise information management" and ignore the actual tools used to do the managing.

I find this akin to advising the mayor of a city that she should concentrate on municipal transportation management while at the same time discouraging her from thinking about the important differences among subways, light-rail, buses, taxis, and private cars. To achieve her goals, the mayor will have to select from transport technologies that offer divergent capabilities and are perceived very differently by their users.

The same holds true for business leaders trying to achieve their goals with IT. In both cases, decision makers must understand what the different technologies will do for them and what they need to do to ensure that their choices are successfully adopted and fully exploited. My article presents a model to help IT decision makers with this work.

Focusing on information blurs important distinctions rather than highlights them. For example, e-mail, an ERP system, and a wiki all facilitate information flow. That does not mean they're interchangeable. Benefits will not necessarily triple if all three are deployed. And there is no guarantee that users will embrace them all equally.

The executives I've taught, and the companies I've studied and worked with, spend a great deal of time and energy on IT decisions and efforts. They'd be very surprised to hear that their focus is "now outdated." And they'd be nonplussed at the suggestion that they can or should think about information without explicitly thinking about information technologies.

Can Science Be a Business?

I read Gary P. Pisano's article, "Can Science Be a Business: Lessons from Biotech" (October 2006), with interest. Given the economic performance of the biotechnology industry as a whole over the past 30 years, why do the public markets continue to invest in nonrevenue-producing companies? Simply stated, the hope that biotechnology can create a dramatically better tomorrow for patients helps make the industry great for stock pickers. The outcomes for small companies tend to be binary and driven by a visible event (usually a clinical trial), and the payoffs are large. The few successful companies have created enormous returns for their investors. Stock analysts invest a great deal of energy in collecting information,


Can Science Be a Business?
Lessons from Biotech

conducting surveys, and reading the medical literature to gain an edge. There is a well-developed marketplace for intellectual property and know-how, and therefore it is possible to create hundreds of millions or even billions of dollars of market value in a company that lacks revenue. All of this behavior is predicated on the assumption that the margins on patent-protected products will continue to be robust.

Macroeconomic pressures on health care costs and political activism to rein in health care expenditures are leading many countries to install price and use controls on pharmaceuticals. Depending on the pace and severity of these political fixes, margins on pharmaceutical products could undergo significant pressure – and the anatomy of the biotechnology industry would respond accordingly. This response could have a negative impact on innovation and the industry's ability to advance health and patient care.

Whether biotechnology's anatomy will undergo an evolution or a revolution remains to be seen. Ultimately, investment in the science of biotechnology is dependent on the political and social debate around the business of biotechnology.

James C. Mullen
President and CEO
Biogen Idec
Cambridge, Massachusetts

Gary Pisano does a good job of describing various challenges and risks inherent in the pharmaceutical and biotechnology industries, but the integration he prescribes is already occurring. For example, Lilly – a leader in both small-molecule pharmaceuticals and biotech products – realized early on that partnerships are vital to its strategy of growth through innovation. Our most recent success is Byetta – a new treatment for people with Type 2 diabetes – with our partner Amylin.

In addition to its core business development activities of licensing and acquisitions, Lilly established a corporate venture-capital group – Lilly Ventures – to provide a window on early-stage innovation and to create a vehicle to assist in the capitalization of early-stage biotechnology companies. Lilly founded Innocentive as an Internet-based network to support the global solving of specific product development problems. In addition to its internal and external research and development, Lilly creates "spinouts" of technologies that can be better funded in the venture-capital environment, including companies such as CoLucid and Targanta. We call this "outpartnering."

As a company with diverse classes of therapeutic agents, Lilly believes that a flexible but integrated R&D architecture is critical to achieving and sustaining an innovation-based strategy. That said, as Pisano points out, we as an industry have much to learn, and Lilly values its partners as essential contributors to success in this journey.

Sidney Taurel
Chairman of the Board and CEO
Eli Lilly and Company
Indianapolis

Pisano responds: Jim Mullen, like many others, believes that strong intellectual property and high prices are needed to maintain investment and stimulate innovation in the biotech sector. To date, the sector has had both, and yet its financial performance has not been strong – suggesting that more intense price pressures and less favorable IP will just weaken it further. But one need only look at the electronics industry to recognize that intense competition (and resulting price pressures) does not spell doom for innovation. In general, IP protection in electronics is relatively weak (it is easy to invent around patents), and competition is intense. Prices fall extremely quickly. And yet we see lots of innovation. Why? In electronics, companies must innovate to thrive because the prices of old products erode so rapidly. The complexities of the regulatory environment and of issues surrounding access to health care make analogies perilous. However, in general, everything possible from both a regulatory and a general policy perspective (including pricing) should be done to stimulate competition based on innovation – the route by which biotechnology's promise will be realized.

I thank Sidney Taurel for his letter.

Rethinking Political Correctness

Thank you for publishing Robin J. Ely, Debra E. Meyerson, and Martin N. Davidson's article, "Rethinking Political Correctness" (September 2006). I was particularly struck by its guidelines for leaders, which says that they must be able to create a safe environment for open dialogue and should personally and openly display vulnerability and humility when addressing these topics. This certainly runs counter to the ideal of the strong, infallible leader who has more to teach his employees than to learn from them. Even when I was at school, I observed that minority groups were asked to take the first step in providing feedback, only to be asked subsequently to offer specific examples and hard proof to counter any defensive reactions. That sort of experience makes people cynical and resigned to the status quo. If leaders display their own need for further development in this area, then they establish good intentions and set a constructive example for their employees to follow.

Livia Oh
London

The Tools of Cooperation and Change

I was surprised to learn in the sidebar analysis provided by Clayton M. Christensen, Matthew Marx, and Howard H. Stevenson in "The Tools of Cooperation and Change" (October 2006) that Japan and Western Europe – which I assume includes Germany – are societies in which the populations share values in the upper-right quadrant of the agreement matrix. While that may be true today, that was certainly not the case in 1939.

These paragons of agreement were only brought to that happy state by the imposition of democracy on former fascist dictatorships. Perhaps the authors have forgotten that America and its allies were forced to "impose democracy" on its former foes during the Second World War. This is in direct contradiction to the conclusion that when America has ordered countries to establish democracies, chaos has ensued. Obviously, that was not the case in Japan or Germany. The conclusion that democracy will not work in Iraq because the enabling conditions do not preexist is contradicted by the very examples the authors have chosen.

It is also inaccurate to use Russia as an example of America "snap[ping] its fingers." The continuing evolution of the political situation in the former USSR, while welcomed by all democracies, was not imposed by the United States. Quite the contrary: The overthrow of the

Communist regime was the spontaneous result of a deeply shared shift in culture from the lower-left toward the upper-right quadrant of the agreement matrix. In any event, it is too early to predict with certainty that the new democracies have failed.

Finally, the article itself holds up Jamie Dimon as an example of a manager who used "power tools" to elicit cooperation in the absence of agreement. Once consensus began to grow, these tools were put aside. Of course, the ultimate power tool is military force and occupation. Our declared objective in Iraq is to use our troops to create a stable environment in which democracy ("consensus") can grow. Why does HBR recommend that strategy for businesses but discourage it for countries?

Erick Holt
Attorney
Munich, Germany

In the article "The Tools of Change," I object to the authors' use of the "Balkan Peninsula" as an example of "no consensus" in the exhibit "The Agreement Matrix." When Yugoslavia (only half of the Balkans) was a federation under Marshal Josip Broz Tito, or after Tito's death, when the lack of adequate reforms and changes led to bloody wars among the Yugoslav (not Balkan Peninsula) republics, their assessment would have been accurate.

However, since the end of the wars in the 1990s, the newly independent republics of Slovenia, Croatia, Bosnia and Herzegovina, Macedonia, Serbia, and Montenegro occupy the upper-right quadrant of the matrix. Citizens now enjoy broad consensus on what they want and how to achieve it. Without resorting to coercive "power tools," these nations have changed their political systems to multiparty democracies, improved their economies through significant private initiative, and sought integration into the European Union and NATO.

Mladen Bandic
Director
Transeuropean Motorway
Zagreb, Croatia

Christensen, Marx, and Stevenson respond: Like companies, as countries succeed, they move to the upper right of the matrix. For example, the economies of Korea, Chile, Singapore, and Taiwan were governed through the 1970s and into the 1980s by strong and relatively honest rulers. As those societies prospered, consensus emerged within each nation regarding what its people wanted and how to get it, and they each moved toward the upper right of the matrix, where democracy becomes possible and desirable. Similarly, the enabling preconditions for democracy existed in pre- and postwar Germany, even though Hitler temporarily seized power. Eventually, the same shift will occur in Russia and, we hope, China. But the model implies that, for the time being, we should recognize the value of relatively honest rulers who are able and willing to wield the tools of power temporarily until consensus builds on both axes.

Mladen Bandic's observation supports our point completely, though he doesn't realize it. Once the tool of disaggregation was used in the Balkans, each of the countries found itself in the upper-right quadrant, where democracy could thrive. If some entity tried to group all of those nations together into a single state again, the region would plunge into the lower left – and the model asserts that a democratic state would struggle to govern in peace.

Our article maintains that there is no "best" place to be. It is simply important to recognize where one is and what will work in each situation. The model, therefore, predicts that when the antagonistic regions of Iraq are herded into one artificial nation, power tools will be required to create the changes needed for peace – and democracy will not work. We might wish that it would, but while Iraq is still in the lower-left quadrant, it won't. However, if the tool of disaggregation was used in Iraq, as it was in the Balkans, then each of the resulting nations – within itself – could find it has stronger levels of agreement on both axes, and the tool of democracy could be effective within each.

Executive Summaries

FEBRUARY 2007

"Crafting strategy is an iterative, real-time process; commitments must be made, then either revised or stepped up as new realities emerge."
– page 72

COVER STORY

72 | How Managers' Everyday Decisions Create – or Destroy – Your Company's Strategy

Joseph L. Bower and Clark G. Gilbert

Senior executives have long been frustrated by the disconnection between the plans and strategies they devise and the actual behavior of the managers throughout the company. This article approaches the problem from the ground up, recognizing that every time a manager allocates resources, that decision moves the company either into or out of alignment with its announced strategy.

A well-known story – Intel's exit from the memory business – illustrates this point. When discussing what businesses Intel should be in, Andy Grove asked Gordon Moore what they would do if Intel were a company that they had just acquired. When Moore answered, "Get out of memory," they decided to do just that. It turned out, though, that Intel's revenues from memory were by this time only 4% of total sales. Intel's lower-level managers had *already* exited the business. What Intel hadn't done was to shut down the flow of research funding into memory (which was still eating up one-third of all research expenditures); nor had the company announced its exit to the outside world.

Because divisional and operating managers – as well as customers and capital markets – have such a powerful impact on the realized strategy of the firm, senior management might consider focusing less on the company's formal strategy and more on the processes by which the company allocates resources. Top managers must know the track record of the people who are making resource allocation proposals; recognize the strategic issues at stake; reach down to operational managers to work across division lines; frame resource questions to reflect the corporate perspective, especially when large sums of money are involved and conditions are highly uncertain; and create a new context that allows top executives to circumvent the regular resource allocation process when necessary.

Reprint R0702C; HBR OnPoint 1831

GENERAL MANAGEMENT

THE HBR LIST

20 | Breakthrough Ideas for 2007

Our annual survey of ideas and trends that will make an impact on business:

Duncan J. Watts contends that ordinary people, not "influentials," drive social epidemics. **Yoshito Hori** predicts that Japan's young entrepreneurs could outshine those in China and India. **Frédéric Dalsace**, **Coralie Damay**, and **David Dubois** propose brands that – like Harry Potter – mature with their customers. **Michael Schrage** reveals the hidden value in long-forgotten equations. **Harry Hutson** and **Barbara Perry** put hope back in the executive repertoire. **Eric von Hippel** spotlights Denmark, where "user-centered innovation" is a national priority. **Linda Stone** detects a backlash against cellphone and BlackBerry addiction. **Michael C. Mankins** suggests where to put all that excess cash. **Ap Dijksterhuis** reaffirms the value of sleeping on a decision. **Robert G. Eccles**, **Liv Watson,** and **Mike Willis** report on a new software standard that will make business and financial information dramatically easier to generate, aggregate, and analyze. **Geoffrey B. West** challenges the conventional wisdom that smaller innovation functions are more inventive. **Karen Fraser** warns of apparently loyal customers who are poised to bolt for ethical reasons. **Phillip Longman** predicts the return of large patriarchal families and their effects on marketing strategy. **Rashi Glazer** illustrates the sociocultural and business implications of nanotechnology. **Yoko Ishikura** urges global firms to "think locally." **Klaus Kleinfeld** and **Erich Reinhardt** explore the convergence of imaging technology and biotech and its enormous benefits for medical care. **Christopher Meyer** advises focusing on what you want from your network before you build the platform. **Charles R. Morris** asserts that health care costs are falling; it's spending that's on the rise. **Clay Shirky** shows why open source projects succeed by failing. **David Weinberger** claims that accountability has morphed into superstitious "accountabalism."

Reprint R0702A

MANAGING PEOPLE

HBR CASE STUDY

57 | Off-Ramp – or Dead End?

Sharman Esarey and Arno Haslberger

Cheryl Jamis, the high-powered marketing director for a large UK-based clothing retailer, seems to have it all – corner office included. What's more, she loves her job. But her professional dedication is beginning to jeopardize another job she is passionate about: being a mom.

As Cheryl's career has grown, so has her daughter, Emma. And while juggling the two has never been easy, it's been manageable. Emma has ended up taking a backseat to whatever work crisis loomed at the moment, but now that she is seven, it is becoming harder to put her on hold.

Marcus Addison, Cheryl's boss, seems sympathetic to her efforts to succeed as a professional and a mother. So when she suggests reducing her hours, she is taken aback by his response: "You'll just end up working the same hours for less pay, you know. Your job is a big, responsible one. It just can't be done in four days, let alone three." Then he implies – albeit vaguely – that she could soon be on the next step up the ladder.

Before Cheryl has time to digest that possibility, however, Marcus tosses her yet another curveball: a chance to take his place on a business trip to the United States – a great opportunity. Though it means canceling a long-overdue weekend away with her daughter, Cheryl accepts – then almost immediately regrets it. When she goes to Marcus's office to hash things out, he preempts her speech with one of his own: The promotion he'd expected for her is off the table, at least for the time being. Now Cheryl has to make a decision: Should she stick it out or chuck it all?

Commenting on this fictional case study are Monica McGrath, an adjunct assistant professor of management at the University of Pennsylvania's Wharton School; Rebecca Matthias, a cofounder and the president and COO of Mothers Work; Robert J. Maricich, the CEO of Century Furniture; and Evelyne Sevin, a Paris-based partner at Egon Zehnder International.

Reprint R0702B

Reprint Case only R0702X

Reprint Commentary only R0702Z

GLOBALIZATION

80 | Cocreating Business's New Social Compact

Jeb Brugmann and C.K. Prahalad

Moving beyond decades of mutual distrust and animosity, corporations and nongovernmental organizations (NGOs) are learning to cooperate with each other. Realizing that their interests are converging, the two sides are working together to create innovative business models that are helping to grow new markets and accelerate the eradication of poverty.

The path to convergence has proceeded in three stages. In the initial *be-responsible* stage, companies and NGOs, realizing that they had to coexist, started to look for ways to influence each other through joint social responsibility projects. This experience paved the way for the *get-into-business* stage, in which NGOs and companies sought to serve the poor by setting up successful businesses. In the process, NGOs learned business discipline from the private sector, while corporations gained an appreciation for the local knowledge, low-cost business models, and community-based marketing techniques that the NGOs have mastered.

Increased success on both sides has laid the foundation for the *cocreate-business* stage, in which companies and NGOs become key parts of each other's capacity to deliver value. When BP sought to market a duel-fuel portable stove in India, it set up one such cocreation system with three Indian NGOs. The system allowed BP to bring the innovative stove to a geographically dispersed market through myriad local distributors without incurring distribution costs so high that the product would become unaffordable. The company sold its stoves profitably, the NGOs gained access to a lucrative revenue stream that could fund other projects, and consumers got more than the ability to sit down to a hot meal – they got the opportunity to earn incomes as the local distributors and thus to gain economic and social influence.

Reprint R0702D; HBR OnPoint 1829

LEADERSHIP

92 | In Praise of the Incomplete Leader

Deborah Ancona, Thomas W. Malone, Wanda J. Orlikowski, and Peter M. Senge

Today's top executives are expected to do everything right, from coming up with solutions to unfathomably complex problems to having the charisma and prescience to rally stakeholders around a perfect vision of the future. But no one leader can be all things to all people.

It's time to end the myth of the complete leader, say the authors. Those at the top must come to understand their weaknesses as well as their strengths. Only by embracing the ways in which they are incomplete can leaders fill in the gaps in their knowledge with others' skills. The incomplete leader has the confidence and humility to recognize unique talents and perspectives throughout the organization – and to let those qualities shine.

The authors' work studying leadership over the past six years has led them to develop a framework of distributed leadership. Within that model, leadership consists of four capabilities: sensemaking, relating, "visioning," and inventing. Sensemaking involves understanding and mapping the context in which a company and its people operate. A leader skilled in this area can quickly identify the complexities of a given situation and explain them to others. The second capability, relating, means being able to build trusting relationships with others through inquiring (listening with intention), advocating (explaining one's own point of view), and connecting (establishing a network of allies who can help a leader accomplish his or her goals). Visioning, the third capability, means coming up with a compelling image of the future. It is a collaborative process that articulates what the members of an organization want to create. Finally, inventing involves developing new ways to bring that vision to life.

Rarely will a single person be skilled in all four areas. That's why it's critical that leaders find others who can offset their limitations and complement their strengths. Those who don't will not only bear the burden of leadership alone but will find themselves at the helm of an unbalanced ship.

Reprint R0702E

RISK MANAGEMENT

104 | Reputation and Its Risks

Robert G. Eccles, Scott C. Newquist, and Roland Schatz

Regulators, industry groups, consultants, and individual companies have developed elaborate guidelines over the years for assessing and managing risks in a wide range of areas, from commodity prices to natural disasters. Yet they have all but ignored reputational risk, mostly because they aren't sure how to define or measure it.

That's a big problem, say the authors. Because so much market value comes from hard-to-assess intangible assets like brand equity and intellectual capital, organizations are especially vulnerable to anything that damages their reputations. Moreover, companies with strong positive reputations attract better talent and are perceived as providing more value in their products and services, which often allows them to charge a premium. Their customers are more loyal and buy broader ranges of products and services. Since the market believes that such companies will deliver sustained earnings and future growth, they have higher price-earnings multiples and market values and lower costs of capital.

Most companies, however, do an inadequate job of managing their reputations in general and the risks to their reputations in particular. They tend to focus their energies on handling the threats to their reputations that have already surfaced. That is not risk management; it is crisis management – a reactive approach aimed at limiting the damage. The authors provide a framework for actively managing reputational risk. They introduce three factors (the reputation-reality gap, changing beliefs and expectations, and weak internal coordination) that affect the level of such risks and then explore several ways to sufficiently quantify and control those factors. The process outlined in this article will help managers do a better job of assessing existing and potential threats to their companies' reputations and deciding whether to accept a particular risk or take actions to avoid or mitigate it.

Reprint R0702F

CUSTOMER RELATIONS

116 | Understanding Customer Experience

Christopher Meyer and Andre Schwager

Anyone who has signed up for cell phone service, attempted to claim a rebate, or navigated a call center has probably suffered from a company's apparent indifference to what should be its first concern: the customer experiences that culminate in either satisfaction or disappointment and defection.

Customer experience is the subjective response customers have to direct or indirect contact with a company. It encompasses every aspect of an offering: customer care, advertising, packaging, features, ease of use, reliability. Customer experience is shaped by customers' expectations, which largely reflect previous experiences. Few CEOs would argue against the significance of customer experience or against measuring and analyzing it. But many don't appreciate how those activities differ from CRM or just how illuminating the data can be. For instance, the majority of the companies in a recent survey believed they have been providing "superior" experiences to customers, but most customers disagreed.

The authors describe a customer experience management (CEM) process that involves three kinds of monitoring: past patterns (evaluating completed transactions), present patterns (tracking current relationships), and potential patterns (conducting inquiries in the hope of unveiling future opportunities). Data are collected at or about touch points through such methods as surveys, interviews, focus groups, and online forums. Companies need to involve every function in the effort, not just a single customer-facing group.

The authors go on to illustrate how a cross-functional CEM system is created. With such a system, companies can discover which customers are prospects for growth and which require immediate intervention.

Reprint R0702G

LEADERSHIP

129 | Discovering Your Authentic Leadership

Bill George, Peter Sims, Andrew N. McLean, and Diana Mayer

The ongoing problems in business leadership over the past five years have underscored the need for a new kind of leader in the twenty-first century: the authentic leader. Author Bill George, a Harvard Business School professor and the former chairman and CEO of Medtronic, and his colleagues, conducted the largest leadership development study ever undertaken. They interviewed 125 business leaders from different racial, religious, national, and socioeconomic backgrounds to understand how leaders become and remain authentic. Their interviews showed that you do not have to be born with any particular characteristics or traits to lead. You also do not have to be at the top of your organization. Anyone can learn to be an authentic leader.

The journey begins with leaders understanding their life stories. Authentic leaders frame their stories in ways that allow them to see themselves not as passive observers but as individuals who learn from their experiences. These leaders make time to examine their experiences and to reflect on them, and in doing so they grow as individuals and as leaders. Authentic leaders also work hard at developing self-awareness through persistent and often courageous self-exploration. Denial can be the greatest hurdle that leaders face in becoming self-aware, but authentic leaders ask for, and listen to, honest feedback. They also use formal and informal support networks to help them stay grounded and lead integrated lives.

The authors argue that achieving business results over a sustained period of time is the ultimate mark of authentic leadership. It may be possible to drive short-term outcomes without being authentic, but authentic leadership is the only way to create long-term results.

Reprint R0702H

LEADERSHIP

141 | Raising Haier

Zhang Ruimin

Zhang Ruimin's leadership of the renowned Haier Group began before the Chinese company even carried that name. More than 20 years ago, Zhang was appointed director of the Qingdao Refrigerator Factory, which faced enormous debt and didn't seem likely to survive, let alone prosper. The main challenge in those early days was boosting the morale of his workers, who had gone unpaid for months and grown deeply dispirited. Zhang borrowed money so he could catch up on payroll and make other improvements – and his employees took heart.

Once he had won their goodwill, Zhang explains in this first-person account, he started demanding good work. There was very little discipline in the factory up to that point. Rules and regulations existed in writing but had never been seriously upheld. Zhang guaranteed the payment of salaries, but only on the condition that people obeyed the policies he established – some as simple as "Stealing company property is prohibited." Those who violated factory rules could be given demerits or even deprived of factory membership (that is, no longer allowed to be part of the company's collective ownership). Far from intimidating employees, this boost in discipline gave people a sense of security and hope.

Now that Haier is a world-class operation competing in global markets, Zhang's focus as chief executive has shifted from setting a strong example to giving employees room to make their own decisions and realize their goals. To that end, he is striving to create an organizational structure that is as flat and has as few boundaries as possible. He is also emphasizing what will serve the market, not what will please someone further up in the company hierarchy. Employees, he believes, should feel that they have a customer to answer to, more so than a superior.

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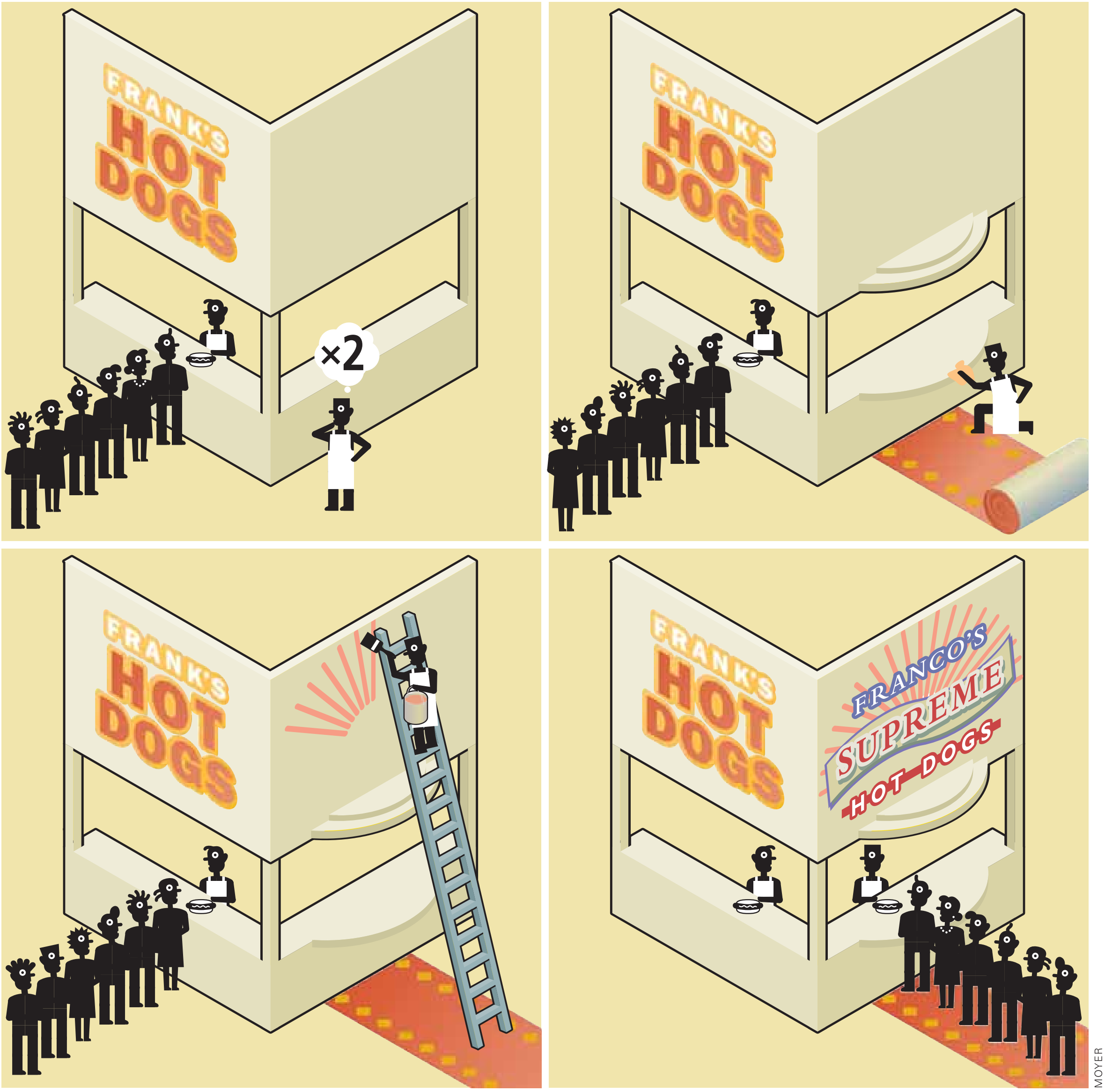

Let's Eat

Cannibalism represents – as a consultant might say to a tribe considering such a practice – a waste of human resources. Corporate cannibalization – creating new products or services that eat into your existing business – can represent a waste of company resources. John A. Quelch and David Kenny warn in "Extend Profits, Not Product Lines" (HBR September–October 1994) that introducing brand and product extensions can cause trouble when it doesn't lead to more consumption, confuses the customer, weakens the brand, and carries hidden costs that nibble away at profits.

Consequently, firms are justifiably reluctant to cook up new products or services that may compete with what they are already doing. But as Matthew Bishop points out in *Essential Economics,* "Eating people is wrong. Eating your own business may not be." He reminds us that some markets are ripe for innovation and what economist Joseph Schumpeter called creative destruction, in which a new product destroys the market for an existing product. "In this environment," Bishop writes, "the best course of action for successful firms that want to avoid losing their market to a rival with an innovation may be to carry out the creative destruction themselves." Eat or be eaten.

Don Moyer can be reached at dmoyer@thoughtformdesign.com.

**There are 193 countries in the world.
None of them are energy independent.**

So who's holding whom over a barrel?


Global Oil Flows
Source: Energy Information Administration
The fact is, the vast majority of countries rely on the few energy-producing nations that won the geological lottery, blessing them with abundant hydrocarbons. And yet, even regions with plenty of raw resources import some form of energy. Saudi Arabia, for example, the world's largest oil exporter, imports refined petroleum products like gasoline.
So if energy independence is an unrealistic goal, how does everyone get the fuel they need, especially in a world of rising demand, supply disruptions, natural disasters, and unstable regimes?
True global energy security will be a result of cooperation and engagement, not isolationism. When investment and expertise are allowed to flow freely across borders, the engine of innovation is ignited, prosperity is fueled and the energy available to everyone increases. At the same time, balancing the needs of producers and consumers is as crucial as increasing supply and curbing demand. Only then will the world enjoy energy peace-of-mind.
Succeeding in securing energy for everyone doesn't have to come at the expense of anyone. Once we all start to think differently about energy, then we can truly make this promise a reality.
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ENERGY IMPORTS BY OIL EXPORTING COUNTRIES
GASOLINE
ELECTRICITY
NATURAL GAS
COAL
Saudi Arabia
Russia
Norway
UAE
Nigeria
Source: Energy Information Administration
WHAT NEEDS TO BE DONE
– DIVERSIFY ENERGY SUPPLIES
. FIND MORE TRADITIONAL FUELS
. DEVELOP ALTERNATIVES AND RENEWABLES
– FOSTER OPEN MARKETS & TRANSPARENCY
– ENCOURAGE CONSERVATION/ ENERGY EFFICIENCY
Chevron Steps Taken:
• Investing over $15 billion a year to bring energy to market.
• Developing energy through partnerships in 26 countries.
• Committing hundreds of millions annually to alternative and renewable energies to diversify supply.
• Since 1992, have made our own energy go further by increasing our efficiency by 24%.
Chevron
Human energy
Projected Global Oil Demand
2004 DEMAND 82 mbpd*
2030 DEMAND 115 mbpd