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Harvard Business Review

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April 2006

DO-IT-YOURSELF CULTURE CHANGE

...page 60

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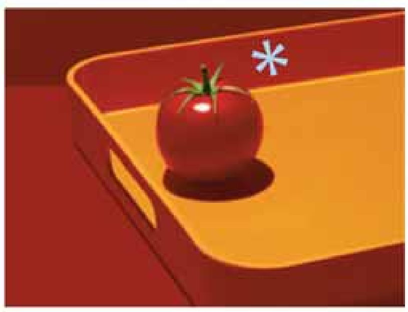

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As ever, it’s at the heart of small business.

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Thomas Friedman
The World Is Flat: A Brief History of the Twenty-First Century

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Most companies have reacted to globalization by cutting costs. But now, pressure is on the top line – growth. Creating new, clearly differentiated value, and defending it. In a word, innovating. Getting special, and staying that way.

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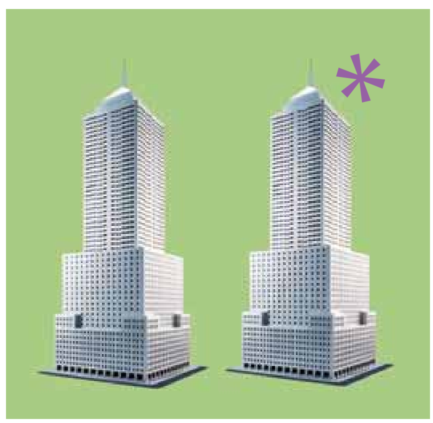

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April 2006

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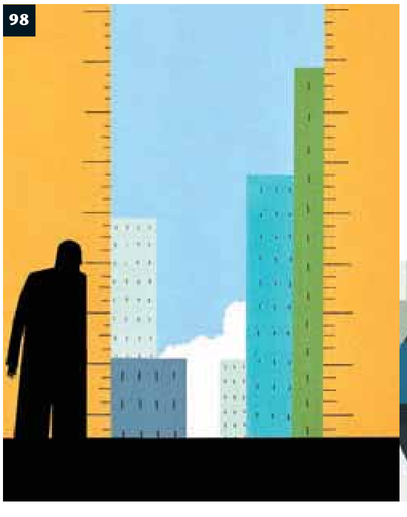

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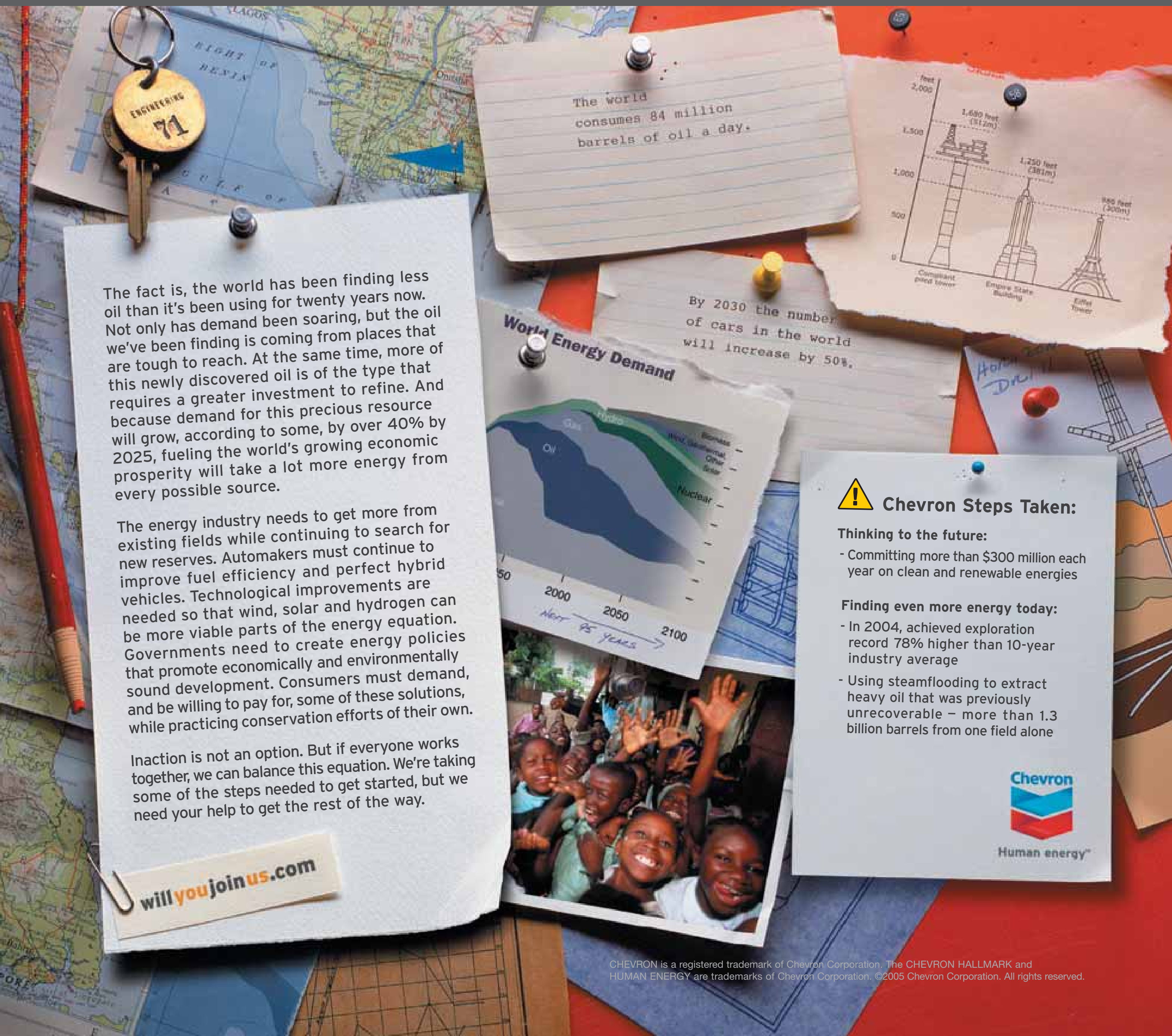
COVER ART: TAVIS COBURN

The world consumes two barrels of oil for every barrel discovered.

So is this something you should be worried about?



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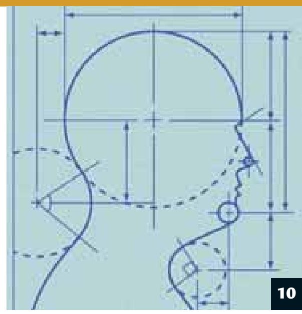
Departments

April 2006

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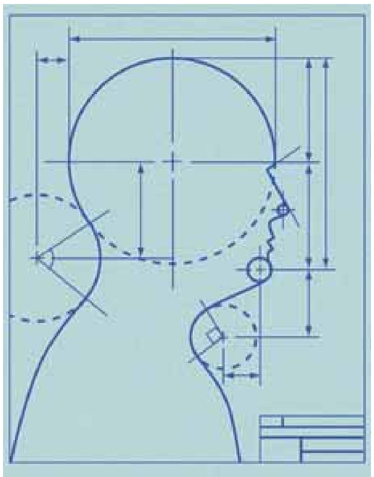
Architects of Change



The literature of change management is filled with pieces of advice that are necessary but not sufficient. You need a burning platform, tools, and champions; you need to realign your organization's incentives so that they support your new purposes. You know that each of these is important but that no one of them will do the job. The literature is also rife with advice that appears contradictory. You need leadership and strong direction, but you need consultation and buy-in. You need to make people move faster than they ever have, but you mustn't get too far in front of them. You can't do it alone, and they can't do it without you.

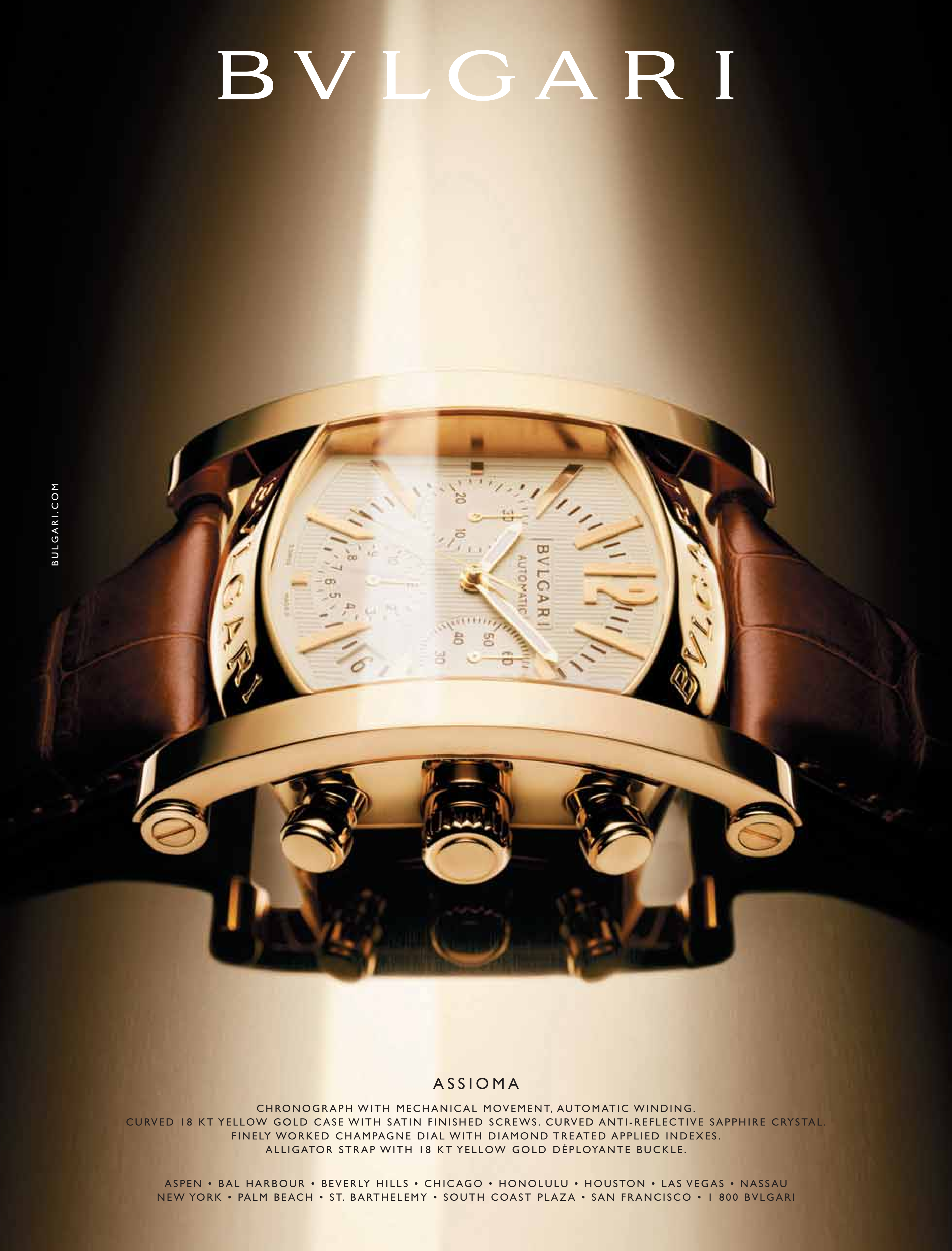
In other words, for change to be anything but superficial and temporary, it must be systemic or – if you'll pardon the jargon – holistic. Social change is no more the sum of its parts than a person is the sum of his. It has to involve every aspect of an organization working together. You know this – and so do we at HBR – but, nevertheless, much of the writing about change management takes the form of checklists and bullet points. Partly this can be explained because people are naturally inclined to break big jobs into manageable pieces; anyone who has watched a toddler knows that people instinctively believe that the best way to see how something works is to dismantle it. Businesspeople in particular are liable to have bullet-point brains because we're an impatient lot who like action and mistrust complexity.

Ram Charan's article in this issue, "Home Depot's Blueprint for Culture Change," is indisputably about action, but it avoids the reductionist trap into which so much change-management literature falls. It is the story of how two people – CEO Bob Nardelli and human resources head Dennis Donovan – together developed what Charan calls a "social architecture" for cultural change at Home Depot, the chain of do-it-yourself superstores. If you pay attention to the business press, you know the bones of the story: Nardelli was a finalist in the search for a successor to Jack Welch at General Electric. When GE's board chose Jeffrey Immelt instead, Home Depot grabbed Nardelli to become CEO, succeeding the company's legendary founder, Bernie Marcus, who became chairman. Marcus and his board knew what employees did not and what the market only suspected: Home Depot's freewheeling, entrepreneurial culture was inherently at odds with the strategy the company needed to meet the threat of competition and seize the opportunities of the twenty-first century. After a rough beginning and a scary drop in Home Depot's stock price, the company's results began a strong, steady improvement, in yet another demonstration of the value of leadership and the managerial skill of GE alumni.

That's the story, and it's a good one, but it's another case of "necessary but not sufficient." It tells what happened, and a bit of how things happened, but it doesn't explain why or reveal how others can learn from it. The actual mechanisms of change remain hidden in a black box; we get to applaud the magicians but not to see the secrets of the trick. Charan's article takes us inside and shows how Nardelli and Donovan approached change not just by looking at strategy but also by redesigning the company's social architecture. By this, Charan says, "I mean the collective ways in which people work together across an organization to support the business model." I once heard someone say that culture cannot be managed directly: "It's like trying to nail Jell-O to the wall." Charan begs to differ. For change to be deep and lasting, the interactions between people – at all levels – need to focus on the right outcomes and consistently produce the right conversations and decisions. Neither leadership, nor tools, nor incentives are sufficient to get you there. You must find a way to manage culture directly. Charan uses Home Depot's experience to show how it's done.

Thomas A. Stewart

ROBERT MEGANCK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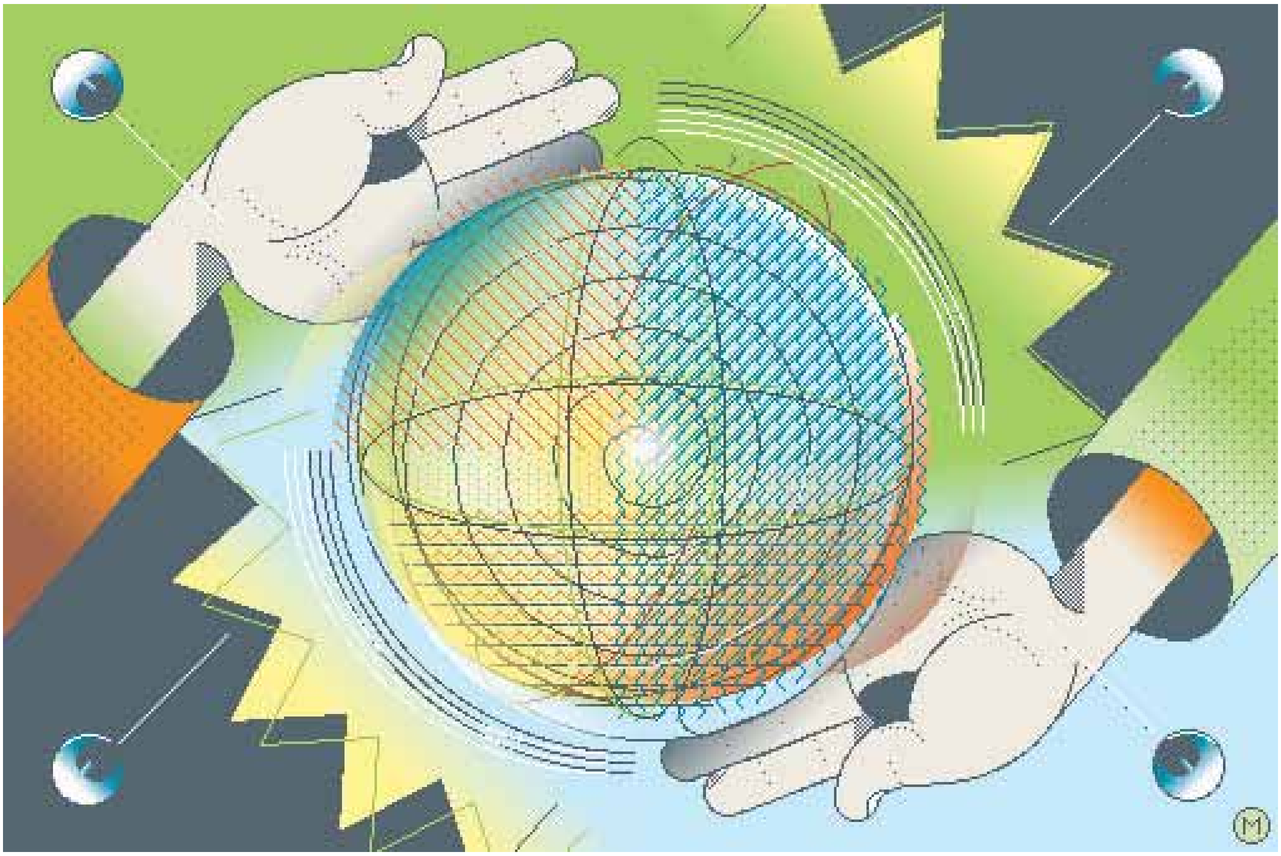

GRIST

The World Is Round *by* LAURENCE PRUSAK

Sometime in 2005, Internet watchers say, the billionth user logged on. No one knows who that was, of course, but according to Web usability expert Jakob Nielsen, "Statistically, we're likely talking about a 24-year-old woman in Shanghai." In news reports, blogs, and cocktail-party conversations, this data point got trotted out to underscore what's become conventional wisdom: The world is flat.

Thomas Friedman, author of the best seller by that name, put the flat-world concept this way in a recent *Wired* interview: "Several technological and political forces have converged, and that has produced a global, Web-enabled playing field that allows for multiple forms of collaboration without regard to geography or distance – or, soon, even language." The playing field Friedman describes is, of course, level – flattened by the unfettered flow of information. "Bill Gates has a nice line," Friedman continued. "[Gates] says, 20 years ago, would you rather have been a B-student in Poughkeepsie or a genius in Shanghai? Twenty years ago you'd rather be a B-student in Poughkeepsie. Today?…Not even close. You'd much prefer to be the genius in Shanghai because you can now export your talents anywhere in the world."

Yes, we are interconnected on a truly astonishing scale. But Gates, Friedman, and many others make a fundamental error when they argue that brute connectivity will level the playing field, giving that twentysomething in Shanghai the ability to compete head-to-head with anyone, anywhere in the world. Their mistake is that they're confusing *information* with *knowledge*.

MARK VON ULRICH

This isn't a new idea. College professors have forever struggled with students' efforts to pass off the former as the latter. But consultants, journalists, and businesspeople have dangerously blurred the distinction as they've championed trillions of dollars worth of IT purchases made with the intention of "managing knowledge." For the most part, what we've built is a vast global IT infrastructure that is very good at moving information, but not knowledge, from one place to another.

What's the difference between information and knowledge? Information is a message, one-dimensional and bounded by its form: a document, an image, a speech, a genome, a recipe, a symphony score. You can package it and instantly distribute it to anyone, anywhere. Google, of course, is currently the ultimate information machine, providing instantaneous access to virtually any piece of information you can imagine – including instructions for how to perform a laparoscopic appendectomy. But I'll wager no one would opt to have an appendectomy performed by that young woman in Shanghai – no matter how much information she'd gathered on the procedure – unless she'd also had years of hands-on surgical training. Only those years of reading, watching, and doing, under a skilled tutor's watchful eye, would give her the knowledge to expertly perform the surgery.

Knowledge results from the assimilation and connecting of information through experience, most often through apprenticeship or mentoring. As a result, it becomes embedded in organizations in ways that, so far, have largely evaded codification. Knowledge gives firms the ability to create new drugs, design racing boats, offer useful competitive advice, and so on. And while the cost of obtaining, storing, and moving information has plummeted, the cost of doing so with knowledge hasn't dropped much at all (in the case of surgical training and some other skills, it has probably increased). That's because no amount of IT can – at least not yet – crack the problem of how to speed knowledge acquisition. It takes about the same amount of time today to learn French, calculus, or chemistry as it did 200 years ago. Knowledge is time-consuming and expensive to develop, retain, and transfer – and that's as true for organizations and countries as it is for individuals.

India and China, in particular, are making rapid strides in their knowledge capabilities. The information-based customer service jobs that world-flattening technologies have made available to people in India have been joined there by truly creative, knowledge-driven software development. And China's information-driven manufacturing capacity is being enhanced by knowledge-based product design. But what percentage of Indians and Chinese are actually participating in this knowledge economy?

Most of the people in the world remain out of the knowledge loop and off the information grid. One billion people on the Internet means there are five and

STUDIES SHOW

Learning the Tricks of the Trade

by MARC ABRAHAMS

Every industry and profession has its own vocabulary: words that describe technologies, processes, and materials. These can sound exotic to the uninitiated, but they're critical to doing the job. Individual companies sometimes have their own custom-tailored definitions. As people move from firm to firm, they must master new terms and new meanings – or fail to assimilate.

Knowing how to talk the talk is the only way to survive in some fields, as Lynda M. Baker, an associate professor in Wayne State University's library and information science program explains in her 2004 study of vice officers posing as sex workers. In "The Information Needs of Female Police Officers Involved in Undercover Prostitution Work" (*Information Research,* October 2004), Baker writes that "to be a credible decoy, officers need to know and become comfortable with the language of the street. Some officers said they learned it on the street by listening to real prostitutes. Others consulted fellow officers for clarification of unknown terms. One officer mentioned receiving a booklet from the police department in Las Vegas with updates on changes in terms. The crucial point is that, to make their case, the officers need to understand completely what a john is requesting."

Similarly, new hires in other professions should be bold when seeking clarification of unfamiliar phrases and alert to possible misunderstandings when communicating with colleagues or customers. "Just in time" may not mean immediate availability any more than a "date" means dinner and a movie.

MARC ABRAHAMS *(marca@chem2.harvard.edu) is the cofounder of the science humor magazine* Annals of Improbable Research *(www.improb.com). In this regular Forethought column, he unearths studies that shed the oblique light of multidisciplinary research on the science of management.*

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a half billion people who aren't on it. Bringing those people into the global conversation is essential to achieving true democratization of knowledge. But simply giving everyone access to e-mail and Google will never in itself flatten the earth. Until our governments, NGOs, schools, corporations, and other institutions embrace the idea that knowledge – not information – is the key to prosperity, most of the world's people will remain a world apart.

LAURENCE PRUSAK *(lprusak@msn.com) is a Distinguished Scholar-in-Residence at Babson College in Wellesley, Massachusetts, and the coauthor of* Working Knowledge *(Harvard Business School Press, 2000) and* What's the Big Idea? *(Harvard Business School Press, 2003).*

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CONTRACT LAW

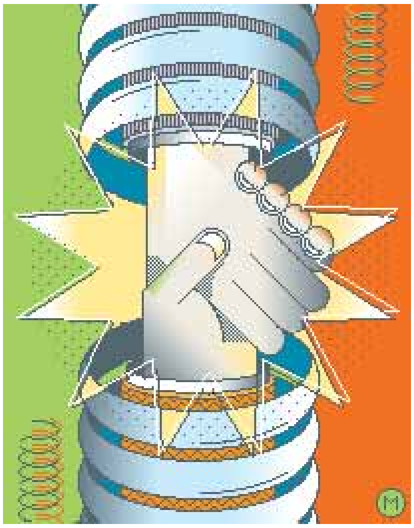
Living Agreements for a Risky World

by RYAN J. ORR

Contracts are meant to enshrine agreements in something like stone. But contracts covering long-term infrastructure investments in emerging markets are written in something closer to sand. As more companies invest in these markets – building roads, bridges, utilities, and telecom systems – contracts must become flexible enough to account for the changes that political and economic instability create.

In case after case, investors have seen agreements brokered with foreign governments change – suddenly and rarely to their benefit. One World Bank study of more than 1,000 long-term investments in Latin American infrastructure concluded that 30% of the underlying contracts were ultimately renegotiated. In the 1990s, two-thirds of the agreements that supported 33 investments in independent power projects in developing countries were similarly revised, a Stanford study showed.

One explanation for the changes is what Harvard economist Raymond Vernon called the "obsolescing bargain": Over the long life cycle of an infrastructure project, negotiating power shifts from the private investor to the government customer. Initially, the customer offers attractive terms because it needs private investment, technology, or management expertise; when the customer has what it desires, it unilaterally changes the terms. Frequently, government takings are triggered by unpredictable events such as economic crises, coups, assassinations, or wars. Such big, destabilizing changes expose issues not covered in the initial agreement and alter both parties' attitudes about suitable risks and rewards. In other cases, government insistence on



contract changes is not the product of an external crisis but of changing political circumstances, public opposition to a project, or opposition within the bureaucracy itself.

Recently, a group of senior lawyers and business executives gathered for the General Counsels' Roundtable at Stanford University under the aegis of the Collaboratory for Research on Global Projects to analyze the legal issues raised by a decade's worth of failed and distressed projects in emerging markets. One outcome of that meeting was the promising, although still not widely accepted, idea that contracts can be redesigned as "living, breathing" frameworks for ongoing negotiation, yet still fix terms solidly enough that parties can obtain necessary financing and operate with acceptable levels of certainty. As one general counsel noted, "Businesspeople want to know: If this thing goes all screwy, what's my safety net? What guarantees do I have? What is the very worst it can be?"

To address conflicting needs for flexibility and predictability, the group proposed two alternatives for improving project outcomes. The first involves the creation of a "governance model" to better align the economic interests of public and private parties through co-ownership and cogovernance of the project company, as is now popular in so-called public-private partnerships. With a shared economic destiny, there may be more incentive for parties to resolve the kinds of disputes that historically have contributed to project failure.

The second alternative involves the use of a number of types of contractual tools. "Shock-absorber clauses" are designed to facilitate low-cost, amicable renegotiation. "Safety-net clauses" satisfy the need for security and provide protections in the event that renegotiations fail. Versions of both appear in many traditional business contracts – although they have not previously been sorted into these categories – and could be combined in contracts that are threatened by political instability.

Shock-absorber clauses take various forms in the business world. In construction contracts, change clauses allow the customer to make unilateral adjustments to the agreement during a project and let the contractor recover costs associated with those changes. The customer benefits because construction continues even when disputes arise. In the pharmaceutical industry, "development and license agreements" allow small research labs to work with global drug development companies under terms that may shift if, for example, a promising product fails clinical trials or an apparently trivial technology turns out to be exceedingly valuable. In international trade, negotiators from different nations may arrange to periodically divide financial rewards that were not anticipated in the original treaty.

Safety-net clauses, also common in many industries, generally state that faltering renegotiations will move to litigation or arbitration. Adopting such clauses for the international arbitration of large projects requires very detailed provisions for variables such as governing law, supervisory agency, language, location, and types of damages. Companies can use existing legal mechanisms to enforce judgments against a contracting government outside its home country in cases where local courts have frustrated attempts to collect arbitral awards. Firms can also state that obtaining political-risk insurance or other types of insurance is a condition for proceeding with a contract.

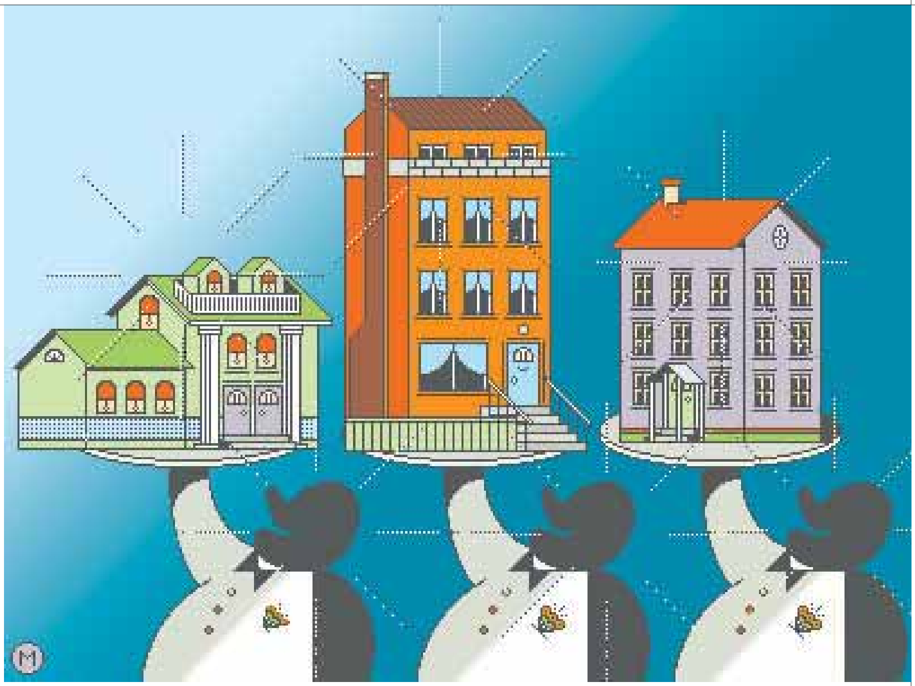
When changed circumstances or attitudes destabilize long-term agreements, companies have two choices: renegotiation or formal dispute resolution. Contracts that combine shock-absorber and safety-net clauses can guarantee a better outcome in either case. For companies looking at the high-risk, high-reward prospect of taking on major projects abroad, these types of contracts provide the starting point for a trust-based partnership – and an ending point should trust ultimately fail.

RYAN J. ORR *(rjorr@stanford.edu) is the executive director of the Collaboratory for Research on Global Projects at Stanford University in California.* Reprint F0604C

CONSUMER BEHAVIOR

What Is Luxury Without Variety?

by MILTON PEDRAZA AND ERIC BONABEAU



Summer homes are more desirable than snack cakes in all but one respect: Many people could, if they chose, buy 100 different kinds of snack cake, while only the superaffluent can afford more than one summer home. In an age when consumers crave variety, luxury items pose a bit of a problem. How do you satisfy affluent people's yen for a range of goods that are simply too pricey to buy in multiples?

The Federal Reserve Bank of New York reported in 2004 that the variety of goods available for sale in the United States quadrupled between 1972 and 2001 and that the purchase of goods in multiple iterations during that time accounted for $280 billion worth of consumer spending. Companies selling everything from coffee to cell phones to comic books have found ways to profit from consumers' desire to choose not one but both – or, ideally, all. Now purveyors of the biggest big-ticket items are figuring out how to do that as well.

For example, in 1998, entrepreneur Rob McGrath created a new business category – the destination club – to satisfy second-home shoppers who dread spending weeks at a time staring at the walls of the same $2 million estate. A twist on the classic time-share model, destination clubs such as McGrath's Tanner & Haley Resorts (formerly Abercrombie & Kent Destination Clubs) acquire luxury properties using the pooled contributions of their members and let members live in them for up to 60 days a year. Up-front fees typically range from $300,000 to $500,000 for a 30-year membership and are partly refundable, with annual dues of $5,000 to $20,000 and per-night payments of $200 to $400.

The economics make sense on both sides. Members avoid the hassles of ownership, but most important, they gain variety – the opportunity to own a home in Paris and London and Rio – freeing them up to spend summers in a different spot every year. The companies, meanwhile, build real-estate portfolios of significant value using members' money, while generating operating income. It's a tricky business: Undercapacity can severely hurt profits, because when several members request the same manse at the same time, the company may be forced to rent another property from an outside supplier. (Overcapacity is usually not a problem, because properties are only acquired when enough new members have joined.) But well-heeled variety seekers are such an attractive market that a number of large real-estate and hospitality corporations are experimenting with this model.

The variety-in-luxury approach is not limited to homes. In Europe, luxury car clubs such as Revo250 and P1 International satisfy the same demographic, offering members their choice of Bentleys, Ferraris, Lamborghinis, and Rolls-Royces for a certain number of days each year. A similar company is about to launch in New York.

These offerings are not examples of fractional ownership, in which access to an item is more important than variety. Even the rich find operating their own private jets expensive and so might want to share that cost, but relatively few would see much value in being able to fly around in more than one plane. In other words, private jets are by and large a luxury commodity. The variety model works only when one product in a line is not the same as another in the consumer's eyes. Still, there is hay to be made for companies willing to reach out to a certain very desirable deep-pocketed demographic that wants only what all consumers want: unlimited freedom to choose.

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Reprint F0604D

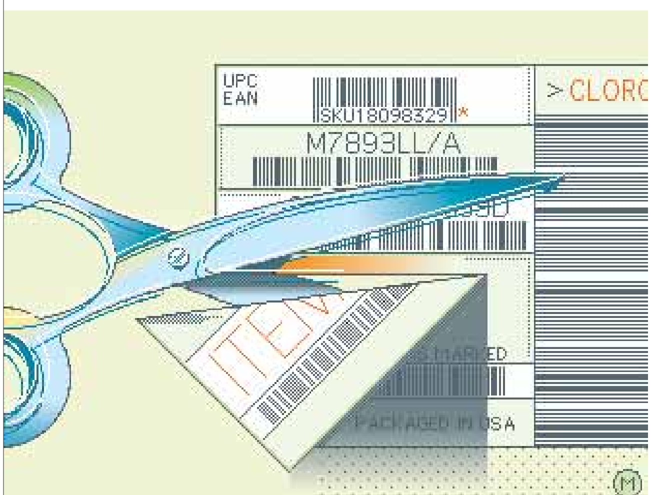
HOW WE DO IT

Growing by Cutting SKUs at Clorox

by REMKO VAN HOEK AND KEVIN PEGELS

Companies want to grow, and one of their most common strategies for doing so is to create new products. These may increase revenues, but of course they don't guarantee profits. In fact, product proliferation often reduces margins. One company we studied found that the bottom 40% of its products generated less than 3% of revenue, and the bottom 25% of its products were highly unprofitable.

Several years ago, Clorox, a $4 billion consumer products company, realized it needed to address the problem of underperforming products. At the time, 30% of the company's stock-keeping units were falling short of sales volume and profit targets. Clorox responded by developing a formal process for evaluating SKU performance and making decisions about which products to cut.



Here's how the process works: As part of the annual business-planning process, yearly reduction goals are established for underperforming SKUs, and a "glide path" (with specific goals for each month) is put in place for reaching the goals. A cross-functional SKU management process team, sponsored by the CFO and led by the director of supply chain planning, meets monthly to track progress, spotlight businesses that are off target, discuss process improvements, and resolve policy issues. The team includes director- or VP-level representatives from sales, marketing, finance, and product supply.

This team uses a dashboard to evaluate the performance of all SKUs against annual sales volume and profit hurdles. The dashboard also rates the performance of each business according to the proportion of SKUs that meet goals. Businesses are graded green if they're exceeding targets, yellow if they're within 5% of targets, and red if they're more than 5% below targets. Red businesses are required to specify tactics for bringing their proportion of lagging products in line with goals. The executive teams of red businesses have to identify underperforming SKUs that will be eliminated and describe the strategy for eliminating them.

Like any business tactic, product rationalization should be approached cautiously. Many companies have attempted to address the issue of underperforming products by ruthlessly cutting the product portfolio. The risk is that a company cuts too deeply into its revenue streams and discovers it has discontinued products that key customers care for, damaging important relationships. Clorox frequently reviews product lines with customers to make sure that it's cutting the correct SKUs.

Today, more than 90% of Clorox's SKUs meet volume and profit targets. Retail sales per SKU have grown by more than 25%, and net customer sales per SKU have almost doubled over the past four years. Clorox now leads its peers in retail sales per SKU in the majority of its categories.

Any company can create an SKU dashboard. But the effort will only work if it becomes embedded in the company's strategy.

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Reprint F0604E

SALES

What B2B Customers Really Expect

by PHILIP KREINDLER AND GOPAL RAJGURU

Most vendors carefully research what customers expect of their products and services, but few, if any, ask customers what they expect of their salespeople. That's a mistake.

We interviewed 120 sales leaders in vendor organizations across a wide variety of industries, from pharmaceuticals and financial services to telecommunications and software. We asked those leaders what they thought customers expected of their salespeople and determined whether they incorporated those expectations into recruitment. We then interviewed 200 of these vendors' customers to see what they really expected when evaluating potential suppliers and where they saw the greatest need for improvement. The exhibit "Customer Expectations Revealed" presents a snapshot of our key findings.

As the exhibit shows, customers put salespeople's subject matter and solution expertise at the top of their list of important qualities. Vendors, however, underestimate its value, ranking it third among qualities they believe customers want most – the same level at which they rank subject matter and solution expertise when recruiting new salespeople.

Conversation

MARIO ALMONDO ON THE INTERSECTION OF ART AND AUTOMAKING

Sparking Creativity at Ferrari

Ferrari is best known for its cutting-edge cars. Less well known are its creative approaches to creativity. HBR asked Mario Almondo, the Italian automaker's director of human resources and organization, how the company inspires its nearly 3,000 employees.

Many companies invest in employee training. What does Ferrari do that's different?
Four years ago, we launched a program called Formula Uomo that combines the creation of an architecturally pleasing and healthy work environment – a place that actually feels people centered – with the development of some unusual training and wellness programs. This isn't just a philanthropic exercise. It's a way to link employees' well-being and personal growth with company performance. For example, staff members can start the day brushing up on their English in a program called English@ breakfast. They can also sign up for English@lunch or gather in the afternoon for English@tea. Deutsche Party is a similar program, in which employees meet with a teacher to practice speaking German. These meetings are free and open to everyone. You can join with a click of the mouse on our intranet. Employees really enjoy these sessions, and, obviously, having multilingual employees is good for Ferrari.

How do you train employees to be creative?
You can't methodically teach creativity. But you can provide an environment that nurtures it. Several times a year, we run a program called Creativity Club that is designed to get employees' creative juices flowing. Each time we hold the club, we have six events at which employees meet various types of artists. We also offer three classes, in six to eight sessions, where these artists teach their skills. We've had painters, sculptors, a jazz musician, a writer, a radio DJ, a photographer, a chef, an actor, an orchestra conductor, and others. The goal is for our employees to learn about how artists generate ideas and solutions.

How do these events work?
Within hours of posting Creativity Club events on our intranet, they're filled. We try to keep most of them small – 18 to 20 people – to make sure participants can really interact with the artists. Sometimes, though, if the artist is particularly popular, we'll allow as many as 100 people in the class. Before the event, which is held outside of business hours, we'll set up a room to create an atmosphere related to the artist's work. For instance, for the sculptor, we put up photos of his work, displayed some of his sculptures, and put his tools on display. The artists talk about their work and the source of their creativity. And they talk about how they use their tools and media to express particular creative ideas. A facilitator – once we had a TV talk show host – gets the conversation going. Then the employees are invited to ask their own questions.

Is this just for the rank and file?
No. We wanted to create an environment where people from all levels of the company, from executives to workers on the assembly line, could mix comfortably and get to know one another. When you get a senior executive and a machinist in the same room talking about photography, they start to communicate about their interests outside of Ferrari. They forget the business and next quarter's numbers for a while.

How do club activities translate into creativity at work?
We're careful not to prescribe what people should take from Creativity Club sessions. We want to activate people's deep, individual creativity – something that traditional training activities rarely do. But by holding the club at the firm, rather than, say, encouraging employees to take art courses elsewhere, we're hoping people will make links between the inspiration they get and their professional activities here. We want to let the creativity metaphor work at the level of their unconscious.

– GARDINER MORSE

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From the customer's point of view, the greatest need for improvement is in salespeople's knowledge of the customer's business and industry (39% of customers expressed dissatisfaction in this area). Vendors are aware of the importance of industry expertise, but less than 25% specifically evaluate customer industry knowledge when recruiting salespeople. This may be because customer industry knowledge is difficult to assess during a recruitment interview or from employer references. Yet, as with subject matter expertise, salespeople shouldn't acquire their industry knowledge on the job; they should bring it with them.

Vendors rank professionalism– flexibility, integrity, reliability, responsiveness, respectfulness, fairness, and understatement – first among the qualities that they believe customers expect of their salespeople. It is ranked much lower in vendor recruitment criteria, however, because (as with industry knowledge) it is difficult to evaluate during the hiring process. Professionalism is a critical attribute; customers appreciate it, too. But customers rank it third behind comprehensive industry knowledge and subject matter expertise. It's a difference in priorities to which vendors should pay close attention.

Social and communication skills such as sensitivity, empathy, willingness to listen, and presentation ability rank last on the customer's wish list but are first among vendor recruitment criteria, illustrating the common belief among sales managers that social skills are more important than other qualities and need to be present from the start, while industry knowledge can be gained later. Our survey suggests that vendors would be wise to put industry and subject matter expertise ahead of social skills when it comes to recruitment.

Vendors shouldn't assume they know what customers want. We recommend that vendors interview their customers to determine which skills and expertise they expect, assess their salespeople's current performance against the desired skills, and develop recruitment procedures and training programs to address the gaps. Vendors should incorporate subject matter and industry expertise into customer satisfaction surveys and performance reviews.

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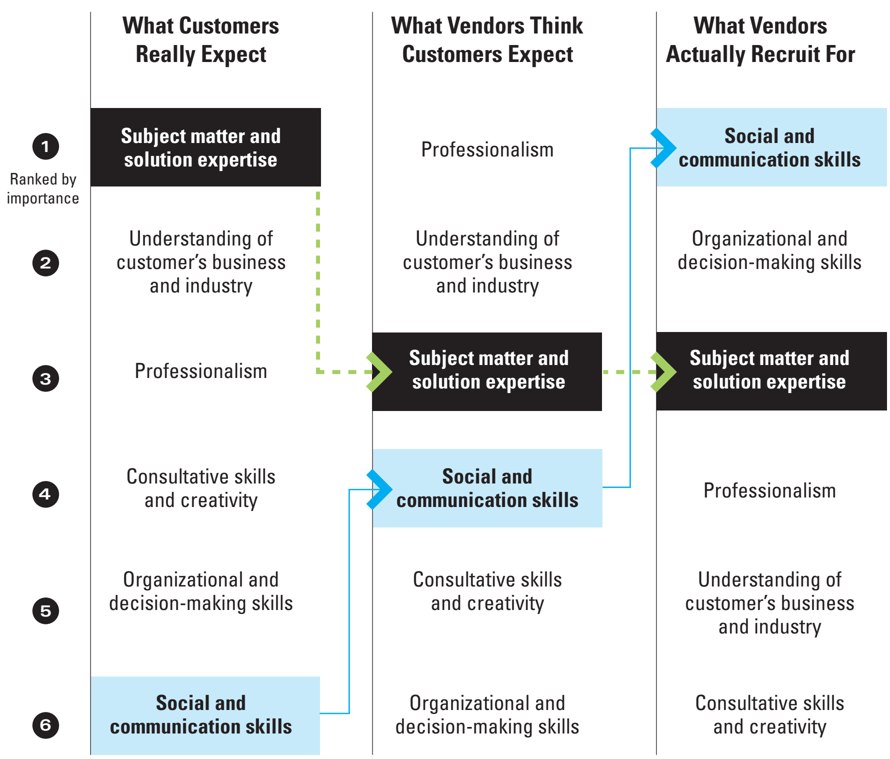
Customer Expectations Revealed

Vendors not only misunderstand what customers want from salespeople but often recruit for attributes that aren't customers' top priorities.



MANAGING YOURSELF

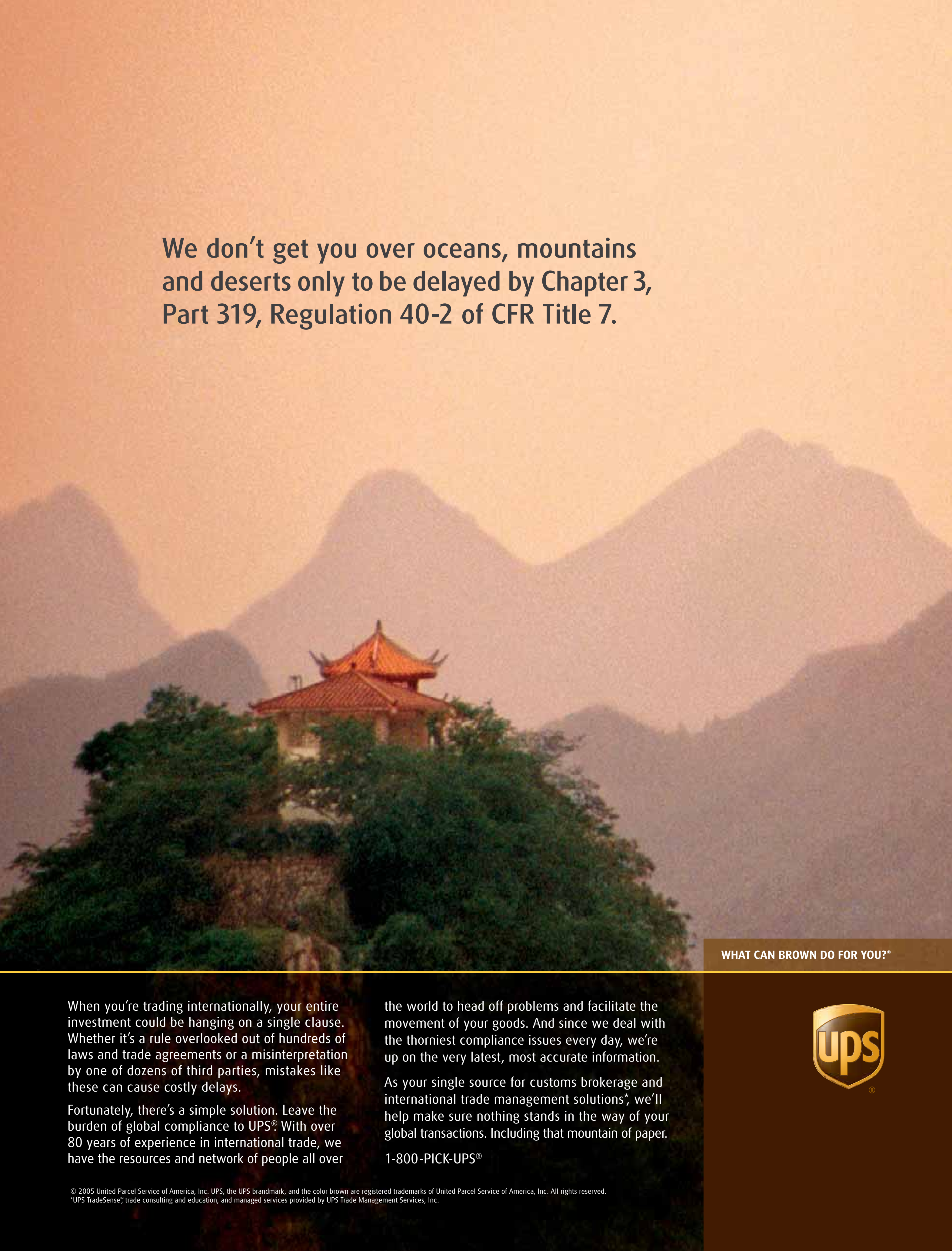
Small Ponds Aren't for Everyone

by SIGRID CAROLINE SCHRODER

For executives eyeing retirement or a mid-career change, the prospect of running a small company seems idyllic. What could be more exciting than building a business from humble beginnings into a powerhouse, calling all the shots and making all the rules? Over 20 years, I have counseled dozens of executives on making such career changes. Almost invariably, they assume that their big-pond expertise will guarantee success in more diminutive pools. But often, they fail because of what they *don't* know: the particular demands of small-business life and, in some cases, their own temperaments. Would-be entrepreneurs should ask themselves two questions. First, do I have what this takes? And second, does this give me what I want?

Here are some of the rocky realities on which corporate refugees repeatedly run aground.

They must be all things to all people. Corporate executives have a seemingly endless supply of support. It is their prerogative to do what they do best and delegate the rest. When they lack expertise, they can find it down the hall or in the London branch or get it from an outside consultant. Entrepreneurs have no such bench strength. Consequently, they can never afford to be specialists. It is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not enough to be brilliant at product development or sales and marketing if you are barely literate in cash flow. The downside of making all the decisions is that you have to make all the decisions – long into the enterprise. And that requires familiarity with all aspects of your company's industry and operations.

They are constantly being distracted by small problems. Entrepreneurs must be proficient at tasks that don't play to their strengths, and they must do things they once may have considered beneath them. I have seen many new company owners get frustrated that they can't spend more time on high-level strategy because they have to do things like choose network equipment and decide whether to lease employee parking spaces in a local lot. Most small companies run so lean that the CEO must be prepared to step in for anyone at any moment, even if that means operating a piece of machinery.

They lose influence and prestige. Performing menial tasks can chip away at one's ego, and so can a decline in public recognition. Former executives shouldn't be surprised when their decisions no longer ripple the markets or the press – but still, many miss the high profile. News stations and big-business monthlies stop asking for interviews. Important buyers won't return calls. And because capitalization is always an issue, entrepreneurs must spend considerable time rattling their cups and defending themselves and their decisions to investors and potential investors. Perpetual mendicancy does little to promote self-esteem.

They are unnervingly vulnerable. Small companies are far more affected than large ones by the loss of a single customer, say, or a sudden spike in oil prices. Minor crises can shake the foundations, and entrepreneurs find their worlds constantly buffeted by external forces.

They have little control over their time. Executives often view small-company life as a kinder, gentler alternative to 60-hour corporate workweeks. Once in control, these dreamers believe, they can design balanced lives for themselves and their employees. But the buck really does stop with you. Uninterrupted vacations and weekends may not have been a part of your past, but they aren't going to be a part of your present, either. Entrepreneurs can travel to the mountains of Nepal, and still the message will reach them: "We're about to lose the Taylor account. What do we do now?"

So what traits do executives who make it in small business have in common? Versatility, obviously, and resilience. But I have observed that the happiest executives turned entrepreneurs are those who can calibrate their definitions of success – not by lowering their sights but by narrowing their horizons. That means deriving satisfaction from a first product run, acceptance by a distributor, or a single customer well served. Executives who consider these victories trivial when compared with the sometimes world-changing influence of their large-company positions should weigh other options for their next act.

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Reprint F0604H

CORPORATE GOVERNANCE

Before You Split That CEO/Chair…

by ROBERT C. POZEN

Often missing from debates on fixing corporate governance is discussion about outcomes: What exactly are companies trying to accomplish by adopting new governance measures? What is the rationale, for example, for separating the roles of board chair and CEO?

Advocates for having an independent chair offer an array of arguments. Here's a sampling:

"You have to reduce the power of the CEO, and one of the very few ways to do that is to separate the chairman-of-the-board position from the CEO position," Harvard Business School professor D. Quinn Mills said in *Corporate Board Member* magazine (March/April 2003).

"Not only will each independent chairman set each board's agenda…the independent chairman can direct a board's attention to the matters most in need of critical review and oversight," SEC chairman William Donaldson stated in a 2004 speech to the Independent Directors Council.

"A chairman of a board of directors who simultaneously holds executive functions cannot independently exercise the task of ultimate supervision of the persons entrusted with management," asserted the Ethos Group in a 2005 proposal to Nestlé shareholders.

Acknowledging the presumed benefits of separating the roles, reports sponsored between 1992 and 2004 by national governments, major stock exchanges, or both in at least 16 countries outside of the

United States have recommended splitting the functions. Indeed, in the United Kingdom, the value of such an arrangement is an article of faith: Today, 95% of the FTSE 100 companies have an independent chair.

But what do we really know about the benefits of separating the roles of chairman and CEO? In a carefully researched article (*Yale Journal of Regulation,* Summer 2001), Yale Law School professor Roberta Romano summarized studies on the economic impact of splitting the chair and CEO roles in U.S. companies (where combined CEO/chairs are the norm), finding that there is no statistically significant difference, in terms of stock price or accounting income, between companies that split the roles and those that don't. And Institutional Shareholder Services, which supports shareholder resolutions that separate the roles of chair and CEO in many circumstances, acknowledged in an independent analysis that "attempts to correlate the separation of positions with market performance have been inconclusive."

In the United Kingdom, a study of UK companies in 2005 by Baruch College professor Jay Dahya concluded that "the separation of the combined CEO and [chair] position is not associated with any (statistically or economically significant) improvement in operating or stock price performance relative to benchmark companies." A study of the results of separating the chair and CEO roles in Swiss companies by professors Markus M. Schmid and Heinz Zimmermann from the University of Basel reached similar conclusions: "We find no evidence of a systematic and significant difference in valuation between firms with combined and firms with separated functions."

Though there is no systematic economic advantage in splitting the CEO and chair positions, the arrangement may still sometimes make sense. For example, if a company promotes its domestic chief operations officer to CEO, it may be useful to have a separate chair who has broad global experience. And a firm that is subject to heavy regulatory scrutiny may find it fruitful to have a chair concentrating on government relations while the CEO focuses on running the business.

One alternative to having an independent chair is to appoint a lead director who can serve many of an independent chair's functions. In 2004, 84% of S&P 500 companies had such a post on their boards. In companies with combined CEO/chairs, lead directors can help set agendas to add or modify items that are critical to shareholder interests. Lead directors can also help companies comply with a new NYSE listing requirement that obliges independent directors to meet regularly in executive session, without the CEO or other managers.

Therefore, companies considering separating the chair and CEO positions should be clear at the outset about what they hope to accomplish. The empirical evidence shows that the split does not generally enhance shareholder value, so make sure that the division is supported by the specific circumstances facing your company. Finally, if you do separate these roles, don't install your former CEO as a permanent board chairman. Studies of companies in the United States and abroad show that this arrangement decreases shareholder value.

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Reprint F0604J

CHINA'S "PLAN"

A Question of (a) Character

by JIANMAO WANG AND LINDA G. SPRAGUE

Until very recently, when the Chinese press mentioned the government's Five-Year Plan, it used the official four-character phrase *wu nian ji hua* (五年计划), which has been in use since the 1950s. But over the past several months, a new character has appeared in the phrase. It's now *wu nian gui hua* (五年规划). In the English press, a variety of words have been used to reflect this change: The "plan" is now referred to as a "program," "road map," "guideline," "blueprint," or "framework." What's going on?

The Five-Year Plan was once the most visible artifact of the Marxist centrally planned system for determining China's economic and social activities. But over the past 27 years, China has systematically transitioned into a socialist market economy. Today, less than 5% of the country's merchandise is priced by the government. The number of industrial state-owned enterprises has plummeted from more than 120,000 in the mid-1990s to around 30,000 in 2005. The government departments that were at the core of the planning system – the State Planning Commission and the State Economic Commission and their local counterparts – don't exist anymore.

In short, the Chinese government no longer intervenes in most business operations and no longer controls most economic activities. Though the Five-Year Program remains as strategic a document as its predecessors, setting directions and intentions for the long term, detailed execution is out of the government's hands and has shifted to the market and enterprises. What a difference a character can make.

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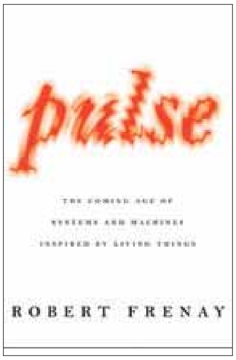
Reviews

Pulse
The Coming Age of Systems and Machines Inspired by Living Things
Robert Frenay
(Farrar, Straus and Giroux, 2006)

People have been building machines inspired by living things since at least the time of Icarus, so you're bound to wonder: Why this book now? The answer lies in the author's conviction that the rise of a "new biology" – systems and machines that work like living things – places us "at the brink of a historic transformation."

Robert Frenay, a former contributing editor to *Audubon* magazine, hauls readers through a sweeping survey of the ways in which biological concepts are influencing nanotechnology and material science, robotics, computer science, agriculture, community planning, economics, and other fields. He tours many cool (though often familiar) technologies that take their cues from biology, ranging from self-propelled nanobots to "a scheme to use beetle carapaces as models for light, superstrong body armor" to electrode implants that provide rudimentary vision for the blind. But readers hoping for an exposition on the latest, gee-whiz hybrids of biological and nonliving technologies will be disappointed. Frenay's real interest, and the point of the book, is not to enumerate advances in technology but to exhaustively build his case that the new biology will fundamentally change human culture.



At the core of Frenay's argument is the notion of businesses as organisms in an economic ecosystem – an idea that's gotten a lot of play in the past few decades (Michael Rothschild's 1990 book *Bionomics* is a classic in the field). To ensure that readers will grasp his overarching idea, Frenay first presents a rather-too-detailed refresher course on ecology, reminding us that ecosystems work because their intricate feedback loops exquisitely balance what's created and consumed to yield a sustainable system.

Thus prepped, we learn that the global economy and the communities and business organisms that populate it constitute an ecosystem out of whack. An economic ecosystem built on the unchecked consumption of resources and driven by wrong information about real costs, Frenay warns, can't last. Distorted feedback loops that fail to incorporate the true costs of depleting oil reserves, for example, or that shift money to whatever region provides the greatest opportunity to externalize costs have created an unsustainable system doomed – "like algae growing mindlessly in a pond" – to exhaust its own resources.

It's a compelling, though not entirely new, idea. Much of it rings true, yet this sprawling book fails to convince that Frenay's new biology is poised to usher in a radical, alternative, sustainable future. Still, it sounds the alarm that the way humans conduct their affairs is unsustainable – and that's a message that bears repeating.

– GARDINER MORSE

Fast Boat to China: Corporate Flight and the Consequences of Free Trade – Lessons from Shanghai
Andrew Ross
(Pantheon, 2006)

Ross isn't the first to note the scarcity and fickleness of skilled workers in China and how, as a result, many foreign companies have had to slow their expansion plans, but he adds an interesting gloss. The workers' disloyalty, Ross suggests, stems not simply from their post-communist sense of liberation but also from the insecurity that comes with knowing the fate of those whose jobs they took. Ross, a prominent American labor critic, thinks this shortage is good: Nothing else is likely to slow the offshoring onslaught that's driving down living standards for white-collar workers in developed countries.

American Theocracy: The Peril and Politics of Radical Religion, Oil, and Borrowed Money in the 21st Century
Kevin Phillips
(Viking Adult, 2006)

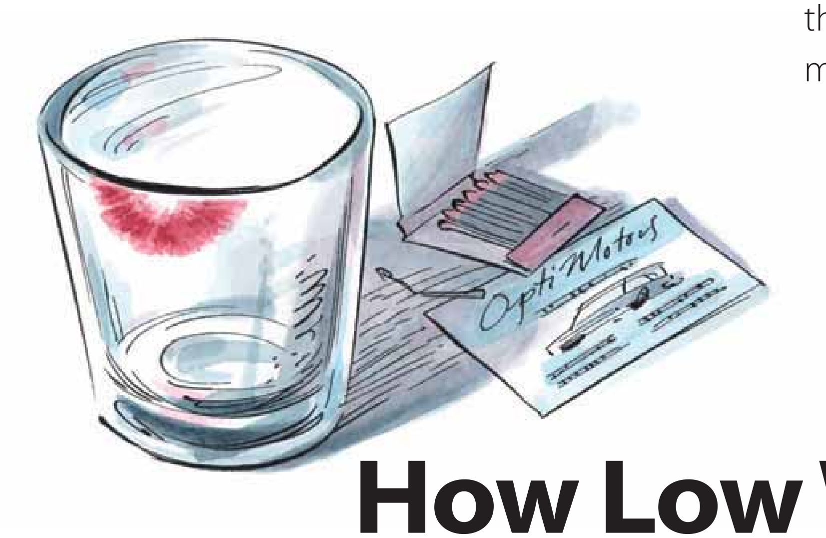
Secular capitalists and fundamentalist Christians have always been odd bedfellows in the Republican coalition that currently rules the United States. Now, suggests Phillips, a former Republican strategist turned social commentator, the latter have gained enormous influence with a faith-based approach to economic policy that favors correct ideology over old-fashioned capitalist values of hard work and sober investment. Unfortunately, this provocative message is buried in a rambling mix of historical details and a rehashing of his previous books' content.

Working with You Is Killing Me: Freeing Yourself from Emotional Traps at Work
Katherine Crowley and Kathi Elster
(Warner Business, 2006)

All the talk about collegial, nonauthoritarian workplaces has had an unfortunate side effect: Managers often give employees too much latitude. Here's a psychotherapist's manual for easygoing supervisors who need to reassert their "parental" authority without undermining morale. The authors' advice is no surprise – unhook emotionally, confront subordinates directly and firmly, and put expectations in writing – but the broad range of colorful vignettes adds useful concreteness.

– JOHN T. LANDRY

Bob Carlton, CEO of an auto parts manufacturer, wouldn't be caught dead in a strip club. But if that's what it takes to make a sale…



How Low Will You Go?

by Mary Edie Mobley and John Humphreys

Bob Carlton watched the pace car peel off and the 43 cars that were clumped behind it roar into full throttle. It was always a thrilling sight–they were packed tighter than minivans in a Wal-Mart parking lot. He studied their first lap of jockeying, then hunched over to fiddle with the knobs on his scanner. He took his sunglasses off – not easy with headphones on. Once he had settled on the right frequency, the banter from the booth filled his ears. But a few minutes later, he shut it off. He couldn't enjoy it, and anyway he needed to think.

Bob was CEO of OptiMotors Industries, a midsize engine-parts fabricator. That sounded pretty important, and he guessed it was. But only a few years ago he would have been in the cheap seats at a race like this – and having a whole lot more fun. He glanced at the empty chairs beside him and scowled. Terrace level: $285 each. The ideal choice for customer entertainment. That was a sore subject now.

When Bob first got into stock cars, there were only cheap seats. That was 30 years ago, back when his uncle Mel still had the muffler shop in their hometown of Chickasaw, Alabama. Mel worked pit crew on weekends, and one by one, all his nephews, and most of his nieces,

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

DANIEL VASCONCELLOS

caught the bug. At one point in his twenties, Bob even tried his hand at driving. But right around the time he was admitting he didn't have the talent to be great, he was finding what he did have a talent for: making the engines hotter. He soon outgrew the corner that Mel gave him in the shop and had his own business and his own racing-team clientele.

He made great products – high quality custom parts for motors – and between that and the phenomenal boom in NASCAR, he never lacked for business. In fact, he had a waiting list that customers were almost ridiculously willing to endure. It was Roland, his accountant, who finally made an issue of it. "Bob, just look at this backlog," he scolded. "If you had half a brain, you'd take that vacant space across town and triple your capacity." The idea was appealing, but it made Bob nervous. "I'd have to take on a lot of debt," he said. "And a whole new level of risk." Roland figured he might be able to help.

Making a sale is about getting time with the client, away from work. For certain customers, the process seems to work better in a club like the Red Ruby.

Starting Shotgun

It was two years ago now that Bob had met the "angels" – the investors Roland had put him in touch with. They were Detroit guys, and really impressive. They asked all the right questions, obviously knew the business. He also had to admit that they had sized him up pretty well. One of the few strings they attached, after the numbers had all been worked out, was that OptiMotors had to invest in some high-powered sales leadership. Fair enough, Bob thought; he was no salesman. He had salespeople, of course, but deep down he thought the real key to his company's success was word of mouth and quality that spoke for itself. He wasn't sure he even knew how to hire "high-powered." The angels were happy to put him on to a headhunter.

No question, Galen McDowell knew how to sell. And he knew how to get higher performance out of the salespeople under him. Bob worried about how the gang would take to a new boss and how they would deal with the expectation that they would raise their game. But Galen's charm immediately won them over. It was easy to see why he had such a great track record. "Let's hope it continues," Bob said to himself. For he had taken the plunge: A gleaming new manufacturing facility was about to come on line, and it would give the company a downright scary production capacity.

During the construction phase, Galen came up to speed by going on calls and helping the salespeople with what he referred to as the low-hanging fruit. Somehow it hadn't seemed so low before. Meanwhile, he recruited a few more guys who, Bob saw, were younger versions of Galen himself. The months went by, and Bob got more and more comfortable with the idea that OptiMotors Industries could be a national player, not just a regional shop. All along, Galen acted as though that were a foregone conclusion.

But even Galen seemed giddy the day the call came in from Kinan Motors. That was last month, and Bob happened to be with Galen when he took the call. He got the gist of it from hearing Galen's side of the conversation – and from the wink Galen shot him halfway through. Galen removed all doubt when he put down the phone. "We've done it!" he said. "Kinan Motors is coming down for the tour."

By that point, the new machines weren't quite so spotless, and they certainly weren't quiet. OptiMotors was in full production mode, chewing rapidly through its backlog. All the kinks were out of the processes, and quality was better than ever. Now, finally, Galen could make some real headway on the bigger prospects he'd been wooing. He'd invited Kinan Motors to come for a visit and kick the tires.

"Wow." Bob was stunned. "What day are we talking about? What do you need me to do?" Galen had been talking about Kinan and its own expansion efforts for weeks. He'd found out they were looking to increase their supplier base. And Galen was sure that if OptiMotors could just get a piece of that business, he'd be able to capture a lot more of it over time. Bob granted him that. Most customers, once they'd worked with OptiMotors, wanted more. But somehow he'd never imagined he'd be working with a big-league outfit like Kinan so soon.

"They're coming in Thursday," Galen said. "Let's plan on my taking them out to dinner that night, and you take them on the tour Friday morning. And can you clear the day, in case they decide to stick around and do business?"

Pole Position

Bob jumped out of his seat when he saw Number 22, Dave Stewart's car, going out of control on the turn. Clearly a case of understeer. "Oh, man," he gasped as the car skidded sideways at 100 miles per hour. Tommy Goehring just missed clipping it. "C'mon, Dave," Bob said under his breath. "Bring it around, bring it around." Somehow the car only kissed the wall. Fifth position, 170-some laps to go. Dave was still in the race. That car needed softer shocks.

While the monitors all around the stands flashed the video, Bob settled back into his seat and ran his own personal replay – of the Thursday when the Kinan guys visited.

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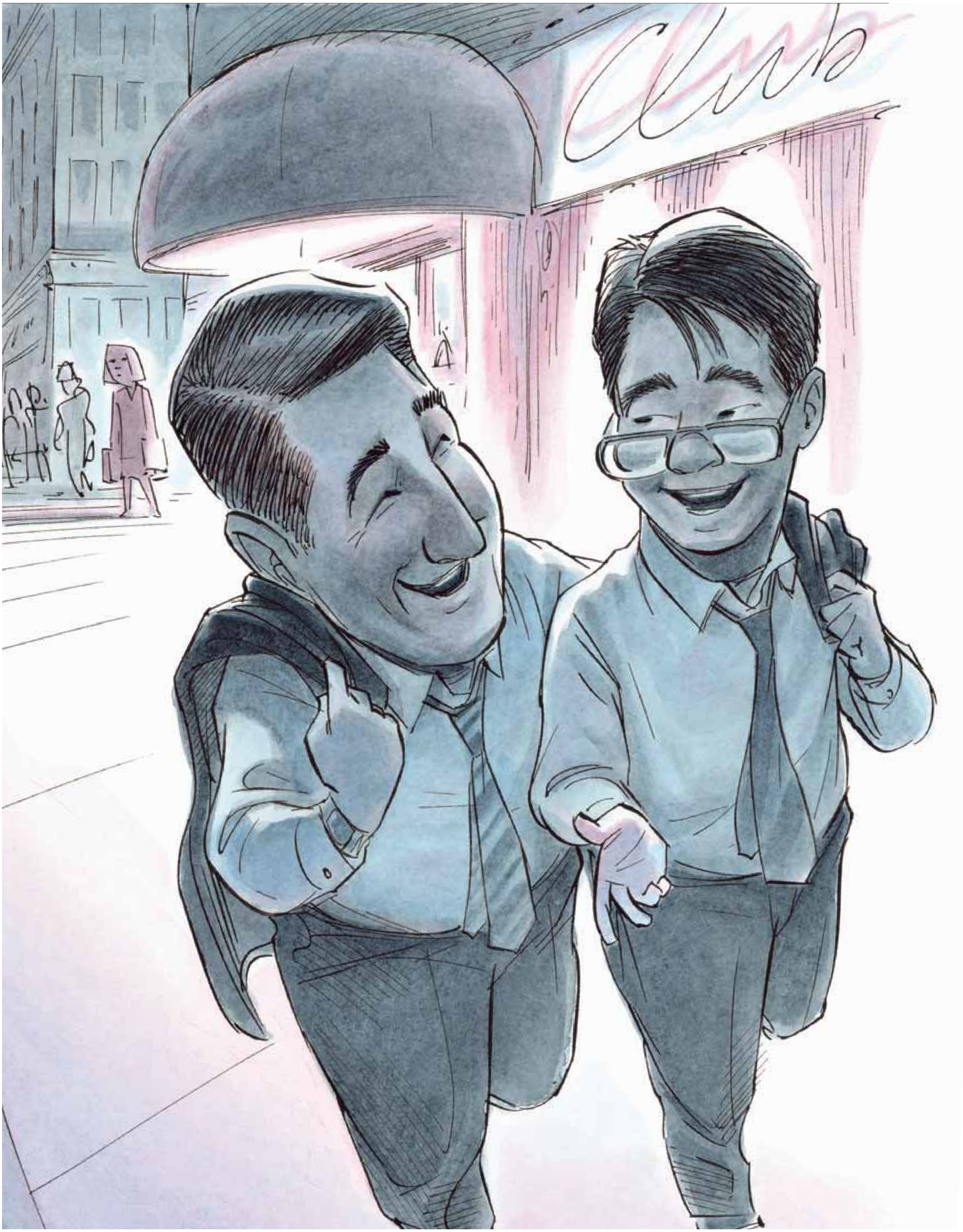
Club

He remembered seeing Galen in the hall that morning. "You ready to turn on the charm tonight?" Bob asked.

"Certainly am," Galen proclaimed with his usual buoyancy. "Their flight is in at 5:15, and I'm taking them straight to dinner, followed by an evening of amusements at the Red Ruby."

Bob's eyebrows shot up. "The Red Ruby? That's a strip club, isn't it?"

Galen smirked at him. "You know it," he declared, "though I think they prefer to call themselves a 'gentlemen's entertainment venue.' Just the place to do a little male bonding."

Bob didn't know how to respond. The news unsettled him, but he wasn't sure exactly why. He certainly didn't think of himself as a prude, and strip clubs obviously were legal (though they weren't his cup of tea). But the Red Ruby Club just wasn't in line with his image of Galen. He seemed to be such a class act, with his tailored suits and expensive shoes. This was a guy who got manicures, for Pete's sake. "I can't see you in that kind of place," Bob said.

"Well, I'd bring back a picture to show you, but I don't believe they allow photography," Galen teased. "Don't worry, Bob," he said. "It's upscale. Full of businesspeople. And this is the right approach with Kinan."

Bob rubbed his chin. "Have we done this before?"

Galen gave him an "Oh, please" look. "You might remember that we were successful in getting the Blain Racing account away from Franklin? I believe David Reed found the Red Ruby to be a useful part of the process."

Bob was astonished. "But David Reed is our top salesman–why would he have to resort to that?"

"I think you've got that turned around," Galen countered. "Knowing what tool to pull out of the sales tool kit is precisely *why* he's so good. He's better than anyone at giving the customer what he wants."

Bob had long prided himself on customer satisfaction, but he'd never thought about it in this light before. He remembered the many fruitless calls he'd paid on the Blain boys over the years. So this was the problem? Those hound dogs.

"Can't you take them somewhere a little less extreme?" Bob asked.

"Dottie's Diner, perhaps? She's a nice lady, and I bet she was a knockout 30 years ago." He paused, sizing up Bob's reaction. "Hey, call me old school, but I don't consider the Red Ruby to be extreme. This is before your time, but I remember when manufacturers supplied tents of hookers at the annual shows. It was crazy, but everybody was trying to outdo each other. Kind of an arms race," he concluded, then couldn't help continuing, "and a legs race, and definitely a…"

Bob cut him off there. "OK, OK, I'm not trying to tell you how to do your job, but–"

Just then Bob's assistant came around the corner with the stack of accounting papers he had to sign off on that morning. He took leave of Galen with a simple request: "Just keep it clean, huh?"

The Low Road

Within a month, Kinan signed a multimillion-dollar contract with OptiMotors Industries. Bob called a companywide meeting to announce the news and used the occasion to tell his people once again that it all came down to workmanship. He told them this was the kind of moment that only an organization that takes pride in its everyday efforts gets to enjoy. And he believed it. But later, when he saw Galen, he couldn't help making a comment. "I guess I didn't tell them the whole story about how the sale was made."

"You told them the truth," Galen assured him. "The quality had to be rock solid or we wouldn't have had a shot at the business." Bob didn't look convinced, so Galen continued, "But even given that, a customer needs to know they can trust you. Trust doesn't happen overnight. It comes gradually. And it starts with the relationship building that the salesman does."

"Sure, I know that," Bob said. "Why do you think I've got season tickets for baseball and football as well as the track? Why am I out there trying to hit a golf ball when golf is clearly not my game?"

"It doesn't bother me. I take customers out for drinks all the time," one saleswoman says. "What's the big difference if there are dancers around?"

"Exactly, and you wouldn't consider it some kind of bribe for business, would you?" Ignoring Bob's slight wince, he pressed on. "It's about getting time with the client, away from work, trying to develop a friendship, form a bond. The thing is, the whole process works a little better in a club like the Red Ruby. For certain customers, that is."

Dangerous Curve

Bob shifted uncomfortably in his contoured plastic chair as he remembered what had happened later that day. He placed his beer, already warm, in the cup holder and used the napkin to mop his brow. Yes, different tactics work for different customers. And for different salespeople.

April Hartley had been Bob's first salesperson. She was the sister of one of his high school buddies, and she'd been in desperate need of a job after her divorce. Even though she'd had no sales experience, she possessed a great personality and a passion for NASCAR. She had no trouble getting appointments and finding out what problems people were trying to solve. She'd call Bob in to close the most promising deals. Now, of course, she was part of Galen's sales team.

"I know I should be talking with Galen," April began in a faltering voice. "But I felt I owed it to you to come here first."

"What's up?" Bob asked with concern.

"It's just – I think it's time for me to move on." April couldn't quite meet his eye. Then, in a rush of words, she explained. Galen had been cracking the whip, setting high goals for the sales staff. Of course she could understand that, but she was already pounding the pavement as hard as she could. When she tried to be a little more creative about cultivating a lead, he had the nerve to take her to task about her expense report.

"You know how Jane Garber is in charge at Garber Custom since Jim's been out of commission?" April asked. "Well, she's a born businesswoman. That place is really on the move now. And it so happens she's also a serious gardener. I sprang for some tickets to a big home and garden show in Huntsville and a car service to take us there. Thought we'd have a girl's day out." April saw Bob's quizzical expression. "It's not playing hooky or anything. I mean, I don't know an orchid from a tulip. I was working that day."

Bob frowned. "This is really not an issue to resign over, April. There must be something else."

"The bigger problem is that I just can't make the kind of numbers he's talking about. Who am I kidding, hanging out at garden shows? The really important accounts, it seems, are looking for more exciting stuff, and I can't give it to them." She glanced at Bob, but now he was the one who couldn't make eye contact. She jutted her chin out. "At least *my* expense reports show the names of the places I visit – not like those bogus receipts the Red Ruby Club hands out."

Bob sat silent for a moment. Sure, he'd seen that line on the accounting reports: "Triple H Media." He knew perfectly well that was the Red Ruby's parent company.

He asked April to hold off on resigning until he had a chance to address her concerns. But her mind was made up. She'd already put out some feelers and knew she could land somewhere else in a heartbeat. "Bob, I want you to know that I will always be grateful for the chance you gave me, and the experience." She stood up to leave. "And as a friend, I guess I should also tell you that I don't think Joan will go as quietly." With that, she turned and walked down the hall to Galen's office.

The Last Lap

By now, the air at the speedway had picked up that distinctive aroma of burning rubber that only a NASCAR fan could love. Bob watched through his binoculars as the pit crew peeled the windshield off Jeff LaPalme's car. That crew was hard to beat. So was LaPalme, even if you didn't always like his style. Funny how people could be so successful but still have a chip on their shoulder. Bob was all set to start jawing away about drivers' personalities, one of his favorite subjects, when he remembered he was alone. Ever since this thing with the Red Ruby Club had come up, he'd been hesitant to take customers to the track. The whole idea of spending a lot of money to soften up an account seemed more complicated every day.

Had April simply lost respect for the organization? And if word got out that the company was making deals at sleazy clubs, how many more employees might OptiMotors lose?

Just that morning, Bob had met with Joan Warren, and the conversation showed him he had to make a decision. Unlike April, Joan had brought significant sales experience to OptiMotors. Although she was still learning about the industry, she was definitely an assertive, skilled closer. In fact, Bob remembered Galen telling him that she was exactly the kind of rep they needed more of.

"Joan, you know you're a valuable part of the team here, right?" Bob asked. "Now, Galen's your boss, and I don't want to get in the middle of that, but as I told him, it would help me to hear your perspective for myself."

Joan was only too happy to oblige. As she told it, she had been working on Alotrex Corporation, a large supplier of various manufacturing components. Alotrex was also a contractor to Kinan Motors, but it wanted a partner to manufacture a significant portion of its steel product line. She had arranged for several representatives to visit OptiMotors so she could make a bid for the deal. And since Galen had been so successful in cementing the relationship with Kinan at the Red Ruby Club, Joan figured that was the way to go again. She asked Galen to play host–but she wanted to go along.

"I told Galen, 'Hey, I can't afford not to be there. I'm the one who's going to follow up.' And, honestly, it doesn't bother me. I take customers out for drinks all the time and soon enough they're treating me just like one of the guys. It's amazing the things they don't mind saying around me. So what's the big difference if this time there are dancers around?"

Galen had told her there *was* a difference. "And he claimed I knew he was right, that I was just trying to force an issue. Well, that wasn't my plan, but now that I think of it, maybe it should be. I do know I won't stand by and be disadvantaged simply because I'm a woman. That's discrimination."

Bob's eyes had widened. Taking potential customers to a strip club wasn't illegal, he knew, but discrimination certainly was.

Now, with the race coming down to its last minutes, his thoughts whirled faster than the cars in front of him. Would Joan try to sue the company, and would she have a case? Would the publicity alone be a problem? He thought of April's departure. She'd always been so proud to be part of OptiMotors. At the end, had she simply lost respect for the organization? And if word got out that the company was making deals at sleazy clubs, how many more employees might they lose?

When does client entertainment cross the line? • Four commentators offer expert advice.

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This case reminds me of a book I read more than 20 years ago: *What They Don't Teach You at Harvard Business School.* The author, Mark H. McCormack, said one of the big areas neglected by the B-school curriculum was how to sell. Among his insights: All things being equal, friends buy from friends. And all things being *unequal,* friends buy from friends. Back in the 1980s, newly minted graduates like me were underlining this sort of stuff in red ink – and were being mentored by quintessential relationship guys like Galen McDowell.

A lot has changed. Particularly in my industry, financial services and asset management, the sales techniques that people used to rely on just aren't viable anymore. The long-term trend toward increased skill specialization means the selling process must focus more on capabilities. In addition, the heightened cost pressure to do more with less puts a damper on some of the golf outings and other "getting to know you" activities. And, of course, there's been a change in the legal and governance climate, thanks in large part to New York attorney general Eliot Spitzer's scrutiny of client gift giving.

SEC policy, as policed by NASD, dictates a $100 per person annual limit on gifts received. The rule, though not new, had come to be widely disregarded. But today, things even the most squeaky-clean firms used to ignore – like giveaways of corporate-logo golf shirts – are dutifully logged at their retail value.

This doesn't mean that spending on client entertainment has become unethical or unimportant. In fact, a careful distinction is drawn in our business between gifts and entertainment. That's appropriate, because having an opportunity for unstructured social interaction is very valuable for the buyer. All business relationships require a foundation of trust. One of the most important things a client tries to ferret out in a sales process is whether the seller shares his or her core value system.

The values question is why Galen's habit of inviting prospects to the Red Ruby Club should worry his boss. Some customers will be downright offended because it is in conflict with their values and perhaps their religious beliefs. But even for those customers who might go along for the ride, such a visit signals a general willingness to take the low road. By contrast, April Hartley's idea of taking her prospect to a garden show gets my full support – even if it involves the same expense and has as little to do with the products OptiMotors Industries sells. To answer the case's question: Although many financial services firms are limiting entertainment costs to avoid the gray area, client entertainment most clearly crosses the line not when expenses reach a certain level but when the tactic undercuts the message the company wants to send about its principles.

Bob Carlton should invest the time to outline those principles for his organization, articulating the three to five overarching values that guide customer support – and all other – decisions. Then he should make it clear to his executives that these principles must be embraced throughout the company's operations. When people talk about setting the "tone from the top," this is what they mean. Bob needs to trust his instincts.

If I were Bob's head of sales, I would ask Bob to articulate that value system for OptiMotors. I would then translate it into formal policies for client entertainment and communicate them clearly to the sales force. Most organizations, by the way, do explicitly draw the line at adult entertainment. But I want to stress that the business principles Bob drums into the organization, not the policies themselves, will ensure that no one turns a blind eye to those "Triple H Media" receipts.

One of the most important things a client tries to ferret out in a sales process is whether the seller shares his or her core value system.

WENDY WRAY

A skilled dancer greases the wheels of a social occasion. By flattering patrons, she makes each one feel special.

A lot of business gets done outside of offices–over dinner, on the golf course, during sports events, and, yes, at strip clubs. It's not often talked about, but plenty of clients are wooed in adult entertainment venues. I have seen estimates that 40% of the clientele at upscale strip clubs are there for "business-related" reasons. These clubs cater to businesspeople by offering luxury liquors, fine dining, valet parking, and private conference rooms.

Visiting a strip club is an inherently different experience from playing a round of golf or going to a racetrack. My research on male customers of strip clubs found that the slightly aberrant and titillating environment, the release from the everyday rules for relating to women, and the ego-boosting nature of the interactions there may all contribute to relationship building between men.

In the workplace, men are often painfully aware of the realities of sexual harassment and worry about accidentally crossing the line. The men I interviewed expressed relief at being able to talk to the dancers "about anything" without penalty. And the strip club's treatment of customers as powerful, masculine, and important enhances their perceptions of themselves and their companions. A skilled dancer further greases the wheels of a social occasion. By flattering patrons, she makes each one feel special. These "ego massages," as one patron called them, can be very effective in helping to put clients in a good mood, in part because they are not coming directly from the salesperson.

Galen is thus correct when he argues that having Joan Warren accompany him on a sales call at the Red Ruby Club would change the dynamics of the meeting. Many men would feel uncomfortable being observed in this environment by a female colleague. Strip clubs for heterosexual men are specifically gendered – they're premised on the idea of female visibility and service for male patrons. When a woman enters a club as a customer, her experience is necessarily different from that of her male counterparts.

So if adult entertainment is used to build client relationships and boost sales, Opti-Motors Industries must find a way to ensure that female reps can compete. Maybe it could form two-person sales teams, each consisting of a man and a woman. If the male rep were to go to a strip club with a customer, the female rep could handle some other aspect of the sale so that the team members could share equally in the commission. And if Bob is concerned about equality, not to mention the bottom line, he should find out how much money is spent with "Triple H Media"; promotional budgets for male and female reps should be comparable. Further, Bob should have employees of both sexes go through sensitivity training around gender issues.

It's not just women who may feel uncomfortable visiting strip clubs for business or knowing that their coworkers are doing so. In the course of my research, and when I was dancing in topless and nude clubs, I met men who claimed that they didn't even want to be there but felt pressured to go along by the groups they were with.

When I was a dancer, I appreciated business customers for financial reasons–patrons can be very generous when someone else is paying the tab. I can imagine that such generosity sometimes extends to their companions as well. But I don't think strip clubs should be given more credit than is due. Some men have told me that the setting poses more of a distraction than an enhancement to getting work done. And while I have heard men say that they need to visit strip clubs to generate business, I have seen no data proving that link. Personally, I never saw anything actually get "signed" in a strip club, except for some pretty large tabs! Opti-Motors' customers could probably be courted and won in a different setting.

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Right now, Galen is holding Bob–and his company–hostage, and it's up to Bob to turn the situation around.

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Galen's approach to selling and sales management is discriminatory–there is no doubt about it. This sort of thing does happen, but I would argue that it's an aberration, not the norm. Personal selling and sales management have become more scientific, a far cry from the manipulative techniques once associated with sales. In the past 30 or 40 years, customers have become very sophisticated. They want to buy value, not just products. Unfortunately, Galen seems to be caught up in the selling methods he learned decades ago.

By relying on male bonding to make sales, Galen acts as if he's peddling a commodity, but OptiMotors makes specialty products that enhance cars' performance. In an industry where even a marginal improvement can turn a loser into a winner, that's a powerful incentive for customers. When he's courting potential clients, therefore, Galen should be thinking beyond simply "How can I get this sale?" and focusing on "How can OptiMotors solve your problems and help you be better at what you do?"

In my research, I have found that good sales reps understand that buying decisions in companies are often made not by individuals but by groups of managers. They always take the trouble to quantify and communicate to customers all the economic, technical, service, and social benefits they provide. By linking decision makers with relevant benefits, the sales rep systematically tackles each decision maker's concerns, communicates how his firm will meet the customer's specific needs, and briefs each buyer about the concerns of the other people in the buying group.

In this case, I blame the CEO. His first mistake was hiring the wrong sales manager. He looked at Galen's numbers but ignored how he achieved them, essentially abdicating responsibility for the entire sales process. From the beginning, Bob should have been very clear that his company stands for high-quality products and that it wins customers through its technical skills and manufacturing capabilities.

I could argue that trips to the Red Ruby Club are an unnecessary expense. Galen may just be having a good time for himself on the company's checkbook. Customers might even be reluctant to accompany him, doing so only because he's persistent and bulldozes them. Right now, Galen is holding Bob–and his company–hostage, and it's up to Bob to turn the situation around.

Bob needs to inspire the rest of the organization with the vision that OptiMotors makes world-class products for world-class customers. Bob should clarify to his staff that ethical behavior cannot be compromised. He has to prove that he has the guts to walk away from business that doesn't fit with OptiMotors' standards. I have enormous respect for April, who wouldn't bend her morals, even though it meant leaving the company.

Since Galen doesn't seem to be willing or able to change, Bob must take the lead in transforming the company's sales force. The reps groomed by Galen will need to be retrained so that their sales activities are no longer divorced from OptiMotors' value offering. They will also need supervision, and the company will need to develop appropriate mechanisms to evaluate and compensate performance.

I am not saying that entertaining customers is wrong. Effective salespeople develop relationships, getting to know customers so that they can better serve their needs. Taking a customer out for a round of golf is a valid way to do that. Technically, any entertainment expense that is ordinary and necessary is fine. An ordinary expense is one that is accepted as a norm in your industry or business; in this case, bringing someone to a NASCAR race would fit. A necessary expense is one that you need in order to get the business. Bringing clients to strip clubs is not a necessary step to closing a deal.

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It's not too late to salvage OptiMotors Industries, but Bob has to act quickly. He must take immediate steps to end discriminatory practices and restore his company's respectability – in the eyes of both employees and outsiders. He must also complete the task his angels set out for him: to build the company's marketing and sales capacities. Personally, I don't think he can do it with Galen on board.

Bob is torn because he believes that Galen has been successful in attracting new clients and closing new deals, but the wins he's had are essentially "fruit of the poisonous tree." They create far more costs than benefits, and they may actually prove fatal, for two reasons. First, generating sales by using lap dancers and sex, or even the less troublesome male bonding, has absolutely nothing to do with the value OptiMotors can provide its customers. This dangerous sales tactic is an enterprise-corrupting, value-eroding shortcut. It diverts the company's attention from building the sustainable marketing channels that are essential to its continued growth.

The boss who shows poor judgment breaks faith with employees; they come to question the legitimacy of other actions the organization takes.

Second, denying a female employee the opportunity to earn a living commensurate with her contributions and capabilities is discriminatory, and it violates basic legal and moral principles of good faith and fair dealing. Even without the sex, the male bonding tactic wouldn't be justifiable or even practical. There are other potential clients, including Garber Custom, for whom male-bonding tactics have no appeal. OptiMotors Industries is losing out on opportunities to build more value-added client relations.

Departures from good judgment and fair dealing are seldom seen as isolated acts. When employees learn that the company tolerates these behaviors, they naturally come to suspect all its managerial decisions. One CEO I knew promoted people who gave contracts to his childhood friends, downplaying other, more competitive, arrangements. The boss who shows poor judgment breaks faith with employees; their trust in that person's character is eroded, and they question the legitimacy of other actions the organization takes.

Bob's goals should be to restore the legitimacy of his business and its practices, to regain the confidence and respect of his employees, and to strengthen his company's sales and marketing capabilities. He must stop OptiMotors Industries from becoming Galen's private playpen. First, he needs to inform his investors of the situation. The angels' contacts may have led to Galen's hiring, but the investors ultimately share Bob's interest in restoring respectable practices. These folks want their money back, with a profit, not a lawsuit that might destroy their reputations and put them out of business. Bob should then call in Galen and terminate his contract. Next, Bob should let his workers know where the company stands on employee opportunities and fairness and on its commitment to adding value to the business through quality customer relations.

Bob should follow up with top salesman David Reed, who has been under Galen's sway. Bob should be sure David understands that he can still be a respected member of the organization if his full efforts go into promoting the new value-oriented tactics. David can also provide important information on the clients involved in "sex for sales." Then Bob and the sales staff should work on damage control, offering April her job back and inviting her and Joan to be a part of this process (if they are willing). He could ask them to call on old accounts to communicate the value OptiMotors Industries places on the customers' business and the company's commitment to excellence and professionalism. Meanwhile, Bob should start looking for an experienced sales manager who is not only successful but also ethical.

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JOYCE RAVID

What leaders do while they are trying to get power is not necessarily what they do after they have it. In the case of U.S. president Lyndon Johnson, the difference reveals both his genius and his shortcomings.

Lessons in Power: Lyndon Johnson Revealed

A Conversation with Historian Robert A. Caro

No one can lead who does not first acquire power, and no leader can be great who does not know how to use power. The trouble is that the combination of the two skills is rare. The temperament and behavior of the ambitious, cynical player adept at amassing power is often at odds with those of the daring and imaginative visionary able to achieve great things with that power.

This tension is as real in business as it is in politics. Students of business leadership, such as Dan Ciampa and Roderick M. Kramer, have described cases, often in the pages of this magazine, of successful senior managers who have stumbled on the last rung of the ladder or failed at the top because they could not make the switch from ambitious executive to corporate leader. They did not know what to do with the power they had so expertly accumulated. Without a vision beyond their own advancement, they were almost paralyzed once the goal had been achieved.

Successful leaders somehow manage to do both – accumulate power and use it to some great end. And few leaders have done both so well as the 36th president of the United States, Lyndon Baines Johnson. For most of his career, Johnson was an archetypical politician, trading favors and flattery in generous measure. He was manipulative and devious, searching out and exploiting the weaknesses of colleagues and rivals alike. Yet once Johnson achieved the power he so ruthlessly sought, he seemed to undergo a sea change, turning into a visionary of breathtaking scope. It was Johnson who first put civil rights on the statute books and who launched the War on Poverty. But then, of course, there was Vietnam. With the benefit of hindsight, it's possible to imagine that Johnson saw this, too, as some kind of statesman's crusade, with communism rather than poverty as the enemy. If so, it was a crusade gone too far, and Johnson ended up destroying the political capital he had so expertly built up over the years.

As far as I'm concerned, biography is a tool for understanding power: how it is acquired and how it is used.

The life of Lyndon Johnson has been the primary focus of historian Robert A. Caro for the past 27 years. Caro is a student of power and leadership, and his works on Johnson and the mighty New York power broker Robert Moses have won him virtually every book award in the country, including two Pulitzer prizes. The London *Times* called his three volumes on Lyndon Johnson – *The Path to Power, Means of Ascent,* and *Master of the Senate* – "a masterpiece….one of the truly great political biographies of the modern age." He is currently at work on a fourth and final volume. Caro's deep understanding of the inner workings of power offers senior executives a nuanced picture of leadership at the highest level.

HBR senior editor Diane Coutu recently met with Robert Caro to discuss what top executives can learn from political leaders. In their conversation, Caro shared his insights about the nature of power, the complexity of ambition, and the role that the greater good can play in the making of a leader. And while Caro preferred not to speak in detail about Vietnam until his final book on Johnson is published, his portrait reveals how Johnson would be just the man to make so huge a mistake as Vietnam.

What follows is abridged and edited from the transcript of the interview.

Why should business executives be interested in the life of Lyndon Johnson?

As far as I'm concerned, biography is a tool for understanding power: how it is acquired and how it is used. I never had any interest in writing about a man or woman just to tell the life of a famous person. All my books are about power and about how leaders use power to accomplish things. We're all taught the Lord Acton saying that power corrupts and absolute power corrupts absolutely. But the more time I spend looking into power, the less I feel that is always true. What I do feel is invariably correct – what power always does – is reveal. Power *reveals.* When a leader gets enough power, when he doesn't need anybody anymore – when he's president of the United States or CEO of a major corporation – then we can see how he always wanted to treat people, and we can also see – by watching what he does with his power – what he wanted to accomplish all along. And if you pick the right subject – like Lyndon Johnson – you can also see through a biography how power can be used for very large purposes indeed.

Lyndon Johnson was enormously skillful in amassing and wielding power. He once said, "I do understand power, whatever else may be said about me. I know where to look for it, and how to use it." He wanted to use it to change the world, and in some ways – civil rights; the Great Society; unfortunately, Vietnam – he did. That's not only power but leadership in the most important sense. That's a rare combination. Many people want to be leaders, but very few *are* leaders in the sense that I mean it: using great power for great purposes.

To use biography in that way, of course, you have to pick subjects who understand, and whose lives show they understood, how to acquire power and use it. I picked two men to write about: first, Robert Moses, because he understood urban political power – how power is used in cities. Robert Moses was never elected to anything in his entire life, but he held power in New York City and State for 44 years, enough power to shape the city the way he wanted it to be shaped. Then I turned to Lyndon Johnson because he understood national political power – understood it better, I think, than any president since Franklin Roosevelt. If you pick men like that, and find out and analyze how they got power and how they used it, you can get closer to an understanding of the true nature of power: how it works in reality – its raw, unadorned essence.

Johnson's early life seems largely to be about acquiring power. Did he ever get beyond this driving ambition?

Yes. And that's what makes his life a study in leadership. Johnson liked power. Of course, you could say with Johnson, in some ways power meant being able to bend people to his will and to ruin their careers and their personal reputations, if necessary. And he could certainly do that. Here's another thing Lyndon Johnson said about himself: "I'm just like a fox. I can see the jugular in any man and go for it." My books on Johnson contain more than a few instances of him destroying men by figuring out their weakness and using it against them. But with Johnson it was more than that. He had a plan.

With a lot of people, when they get power, there's nothing there but the desire for power. They have no agenda but to dominate other men. Lyndon Johnson also sought power to accomplish goals. His drive for power was inseparable from what he wanted power for. As I just said, power reveals, and it's significant to me that when he got it he turned into a great social reformer. At heart he really did care. When I was learning about him, I found this strain of compassion and found that it ran through his whole life.

He could remember when he had had to do physical labor, when he had picked cotton as a boy, so he could put himself in poor people's shoes. When he was a young man in Texas – a 20-year-old schoolteacher in the "Mexican School" in a little town down near the Rio

Grande River – he showed – it's one of the most moving things I learned about him – how he truly wanted to help his impoverished students, and he tried all sorts of things to do that. When he became president and got the power to really help poor people – particularly poor people of color – he used his power to do what he had always wanted to do. He truly was disgusted by the fact that when his black maid drove back to Texas, she had to urinate by the side of the road because no restaurant or gas station would let her use the restroom. Of course, this compassion grew out of the personal experiences of his youth, and in his use of power he had an almost unrivaled talent for personal relationships. In foreign affairs – in Vietnam – personal elements recede in significance, and that helped to lead to the disaster there.

So Johnson was an idealist when it came to civil rights.

He was both a pragmatist and an idealist. Take Johnson's first civil rights bill. There was a lot of dissatisfaction from the left. The liberals wanted everything. They wanted no discrimination in public housing, no discrimination in public accommodations and transportation. But Johnson knew they weren't going to get everything they wanted, so he pushed for what he could get – the right to vote. And supporters of civil rights said, hell, that's nothing. What about all the other rights? But Johnson knew he had to pass one bill at a time. He tried to persuade the liberals that if they could get one bill passed, even a lousy bill, then they could go back and amend it to improve it. He knew that amending a bill is always easier than passing one. He also saw that once people of color got the vote then they would have enough power to start getting other rights for themselves. That's Johnson's great pragmatism at work.

But while pragmatism is essential to the pursuit of power and the achievement of goals, so is idealism. You may not be conscious of it, but if you are a great leader you are inevitably thinking in terms of larger ends. It both fuels your drive to amass power and forces you to decide what you will do with that power. In Johnson's case, the larger end was helping 12 million poor blacks in the South.

Having a larger end like this has always been important for political leaders, of course, but it's a relatively new idea for business, I think. Traditionally, business leaders have been seen as pragmatists concerned with the bottom line rather than as idealists in pursuit of the public good. But today, when CEOs have acquired more and more power to change our lives, they have become like presidents in their own right, and they, too, need to align themselves with something greater than themselves if they hope to become truly great leaders.

What are some of the key elements of Johnson's genius?

One key element was his utter realism, his ability to look facts – even very unpleasant facts – in the face and not let himself be deluded by wishful thinking. The political version of a businessman's interest in balance sheets is vote counting. That means knowing how a vote on a controversial bill is going to go in the Senate so that you know whether or not to bring the bill to the floor. A lot of politicians delude themselves in counting votes – fool themselves. They're overly optimistic. They hear what they want to hear; if some senator seems to be agreeing with them, they think he will vote with them in the crunch. Lyndon Johnson never fooled himself. When one of his staffers would come back and say he "thought" he knew which way a senator would vote on an issue, Johnson would say, "What good is thinking to me? Thinking isn't good enough. Thinking is never good enough. I need to *know*." When he was majority leader of the Senate, he was operating for many years with a bare one-vote majority, so every vote counted. And it was said Lyndon Johnson never lost a vote.

Another element in his genius was his ability to find common ground. When there was no obvious common ground, he would work out how to create some. It's 1957, and Johnson wants to pass the civil rights bill. It's a daunting challenge. Because of the Senate's rules governing filibusters, the bill's opponents need to get only 33 votes to kill it, which is why no civil rights bill has been passed since Reconstruction. The South has 22 votes by itself, and if you include the Midwest and Republican conservatives, you get up to 33 very fast. After trying for months to get a bill through, Johnson seems to give up. He goes back to Texas, and if you look at the telephone logs for that time at the ranch, you see that he's not getting many telephone calls. Nobody in Washington can help him – in fact, they're telling him to give up. There comes a time in the life of a leader when nobody can help you out but yourself. Only you can figure out how to go forward – and 99% of people can't do it. Johnson figured it out.

Given the intractable conundrum of how to pass civil rights legislation, most politicians would have given up. Not Johnson. He spent the time down at his ranch working out which of those 33 votes he could win over and how. Of course, he couldn't hope to get votes from Southern senators. But he calculated that the Western and the Rocky Mountain senators could potentially support civil rights because their states didn't have any Negro populations to speak of. If you look in the *Almanac,* you'll find that some of these states had only about 1,000 black inhabitants back then. So while these states had never been for civil rights, they weren't dead set against them either. They just didn't care that much about civil rights. So if he could figure out something they did

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care about, he could promise to give it to them if they would go along with him on civil rights.

Now Johnson knew that one thing these states had always wanted was to have a dam built at a place called Hell's Canyon on the Snake River that runs between Oregon and Idaho and that could provide cheap electric power to many Rocky Mountain states. They had never succeeded in getting the Senate to approve the dam because there were compelling arguments against its construction, and these states on their own did not have the clout to push the legislation through. But Johnson realized that with his help they could get the dam, so he committed his political capital and energy to the task, and in the process of doing that he got an entire block of new allies who were quite prepared to trade their opposition to something their voters didn't care much about in return for something that did have political value for them. It's odd to think that civil rights got passed because someone built a dam in the Rockies, but Johnson saw the connection between the two.

So Johnson was determined to get this legislation through. But wasn't he an opponent of it for much of his career before and in the Senate?

Very much so. Johnson not only voted against civil rights legislation in the House and Senate, he voted against it every single time for 20 years. And he didn't just vote against civil rights – he actively worked against it. But did that mean he was really opposed to civil rights? No, because when he consolidated his power, the first thing he did was pass a civil rights bill. Johnson's early opposition to civil rights stemmed from his realism: He saw things as they were, not as he wanted them to be. Now, that sounds like a really simple thing, and I'm sure they teach you that in business school. But the truth is that it's not simple because every aspect of human nature militates against it. We all hear what we want to hear. We go to a doctor and don't want to learn that we have terminal cancer. We want to hear that there is a way of curing it. Johnson never made that kind of mistake. He realized that he would never amass the power to pass civil rights unless he got close to the people who were already powerful. In the Senate, the powerful senators were almost all Southerners. Given the realities of power at that time, that meant he had to oppose civil rights. So that's what he did. Once again, this showed his pragmatism – not only his pragmatism but his absolute pragmatism.

How did Johnson get close to powerful people?

Among his many techniques was one that was especially striking. With powerful men, he made himself what his friends called a "professional son." In each institution in which he worked, he found an older man who had great power, who had no son of his own, and who was lonely. In Austin, it was the powerful state senator, Alvin Wirtz; in the House of Representatives, it was the Speaker, Sam Rayburn; in the Senate, it was the leader of the Southern block, Richard Russell of Georgia. In each case, he attached himself to the man, kept reminding him that his own father was dead and that he was looking on him as his new "Daddy." Rayburn and Russell were bachelors; Johnson made them part of his family, constantly inviting them over for meals. Sundays were very important in this technique: On Sundays, Johnson would have Russell to brunch, Rayburn to dinner. He wouldn't have them together because, as one of Johnson's friends put it: "He didn't want his two daddies to see how he acted with the other one."

Having a larger end has always been important for political leaders, of course, but it's a relatively new idea for business, I think.

With older men of authority in general, Johnson would do literally what the cliché says: sit at the feet of an older man to absorb his knowledge. He started using this technique in college. If the professor was sitting on a bench on the lawn, students might be sitting around him or sitting next to him, but Lyndon Johnson would often be sitting on the ground, his face turned up to the teacher with an expression of deepest interest on it.

Everyone wants a mentor. How did Johnson get to pick his?

Johnson was brilliant in the way he went about choosing mentors. He was very deliberate about it. After he was elected to the Senate – before he was even sworn in – he sought out Bobby Baker, a 21-year-old cloakroom clerk, because he had heard that Baker knew "where the bodies were buried." And what did he want to ask Baker? Not what the Senate rules were but who had the power. Bobby Baker told Johnson that there was only one man in the Senate who had the power – Richard Russell. This was perhaps the single most important piece of information that Lyndon Johnson acquired during his first year in office. And what was Johnson's first act in the Senate? It wasn't to rise on the floor and speak. It wasn't to sponsor legislation. It was to get close to Richard Russell. Most senators – maybe all senators but Lyndon Johnson – come to the Senate and look for the most powerful, the most prestigious committee to get on. That's not what Johnson did. Once he knew that Russell was the power in the Senate, he checked to see what Russell's committee was. It was Armed Services. So Lyndon Johnson asked to be on the Armed Services committee. And because nobody else wanted to be on that committee, he got straight in.

But I'm sure Johnson wasn't the only person trying to get close to Russell. What did he do that was different?

He worked on Russell's vulnerabilities. Russell was lonely. He had no life outside the Senate. He would come to the Capitol every Saturday because he had no place else to go. So Johnson went to the Capitol every Saturday. Russell ate at little diners around the Capitol, and Johnson began to accompany him to a few hamburger joints after work. Soon they're eating together nearly every day. Russell loved baseball, but he had no one to go to games with. Johnson had no interest in baseball whatsoever, but he told Russell he loved it and went to games with him. And, as with all these older men, he flattered him outrageously. Russell was proud of his legislative artistry; Johnson nicknamed him "the Old Master." When Russell would give him a piece of advice, Johnson would say, "Well, that's a lesson from the Old Master. I'll remember that." Johnson courted Russell so assiduously that Bobby Baker said that if Russell had been a woman, "He would have married him."

That sounds very manipulative.

Yes it was. For Johnson, all men were tools, and to use them he had to know their weaknesses. Of course, most people don't voluntarily show their weaknesses, and he had to employ all manner of stratagems to get people to expose them. For instance, he believed that what a man said with his mouth was less relevant than what he said with his eyes. So he taught his staff to read people's eyes. Another of his favorite gambits was to keep a conversation going. He knew that what a person wants to tell you is never as important as what he doesn't want to tell you, and the longer he could keep a conversation with someone going, the better he could see what that person was avoiding. Not surprisingly, Johnson was a great conversationalist. He seldom read books, but he did know how to read people.

In your biography on Johnson, there is a whole chapter on one of his mistresses. As a biographer, how do you decide when this is an important factor?

It's important if it affects his political and professional life. Sex isn't a factor for every leader. In my first biography of New York power broker Robert Moses, sex was totally divorced from his public life. That's not to say Moses was sexless – in fact, he was reputed to have been a great lover and had a string of affairs with beautiful and glamorous women – but his idea of an affair was to have his chauffeur pick a woman up and bring her to the office. The chauffeur would wait in the driveway to take the woman away afterwards. Often the chauffeur didn't have to wait very long. Then Moses would go back to work. His sexual liaisons had nothing significant to do with his life or work, and they didn't occupy more than a few paragraphs in my book.

Most of Lyndon Johnson's affairs – and there were many of them – were the same. They had very little significance in his life, and I don't even mention them. But one affair was different. It was with a remarkable woman, Alice Glass, who, like him, had come from a small town in Texas and, like him, was rising to prominence in Washington, in her case as the hostess of a fascinating salon.

Johnson did some wonderful things and he did some terrible things, and they all came out of the same place.

Not only was Alice exceptionally beautiful, but she had astute political sense, and at various crises in Lyndon Johnson's career he sought and followed her advice; indeed, on one occasion, she helped him over a major crisis. When he had reached an angry impasse with his most important financial backer, Herman Brown of Brown & Root, she suggested a compromise that insured that Brown would keep supporting him. Lyndon and Alice remained confidantes for many years; she was a significant figure in his life, and you couldn't really tell his story without including her.

And of course you couldn't tell the story of Lyndon Johnson's early days in the Senate without mentioning Helen Gahagan Douglas, because Johnson made her a part of his public life. Although she was married – to the actor Melvyn Douglas – the tall, young senator and the beautiful actress and congresswoman would arrive on Capitol Hill together in the morning and walk around holding hands. It would have been hard to accurately describe Lyndon Johnson in those years without mentioning the woman who was holding his hand.

Do you think leaders like Johnson are born or made?

When I started my earlier biography on Robert Moses, I didn't believe in heredity. But it became impossible to ignore hereditary factors in the case of Lyndon Johnson. Johnson was six foot three. He had this huge nose; he had this big chin, huge ears, very pale white skin; and he had this absolute need to dominate people and to lead. He came from a long line of men, a dozen of them, who were well over six feet tall, who all had huge ears, huge noses, pale skin, and who also had this great need to lead and dominate. They were all the same. They were all frontiersmen who had to lead the raids against the Indians. In Lyndon Johnson's case, the desire for power was particularly strong, even as a four-year-old. At school one day, he went to the blackboard, wrote his name on it in huge letters, and started telling the class that he would one day be president of the United States. With some kids, you'd dismiss that kind of thing as an overactive imagination at work. In Johnson's case, I have to believe heredity had something to do with it.

On the other hand, leaders are not just born, they are also made, and we have to look at the circumstances of Johnson's burning ambition. When he was an adolescent, Johnson's parents went bankrupt. So Johnson lived his life in poverty. More to the point, he spent his boyhood in humiliation. To be a Johnson was to be a figure of ridicule in the Texas Hill Country. He lived in this little town in the middle of nowhere, and that was his whole world. His father was a laughingstock, a quixotic bankrupt rancher, ridiculed by one and all. His brother, Sam, once said to me that "the most important thing for Lyndon was not to be like Daddy." When you hear that, then you understand an awful lot about Lyndon Johnson. He did some wonderful things and he did some terrible things, and they all came out of the same place. He was driven by demons and those demons were real. It wasn't just the poverty he grew up in, it was the loneliness, the terrible loneliness of his youth. When it comes to a great leader like Lyndon Johnson, I would have to say that heredity and humiliation combined to produce his extraordinary drive to succeed. Out of that came the civil rights program. We got the War on Poverty and the Great Society. We also got Vietnam.

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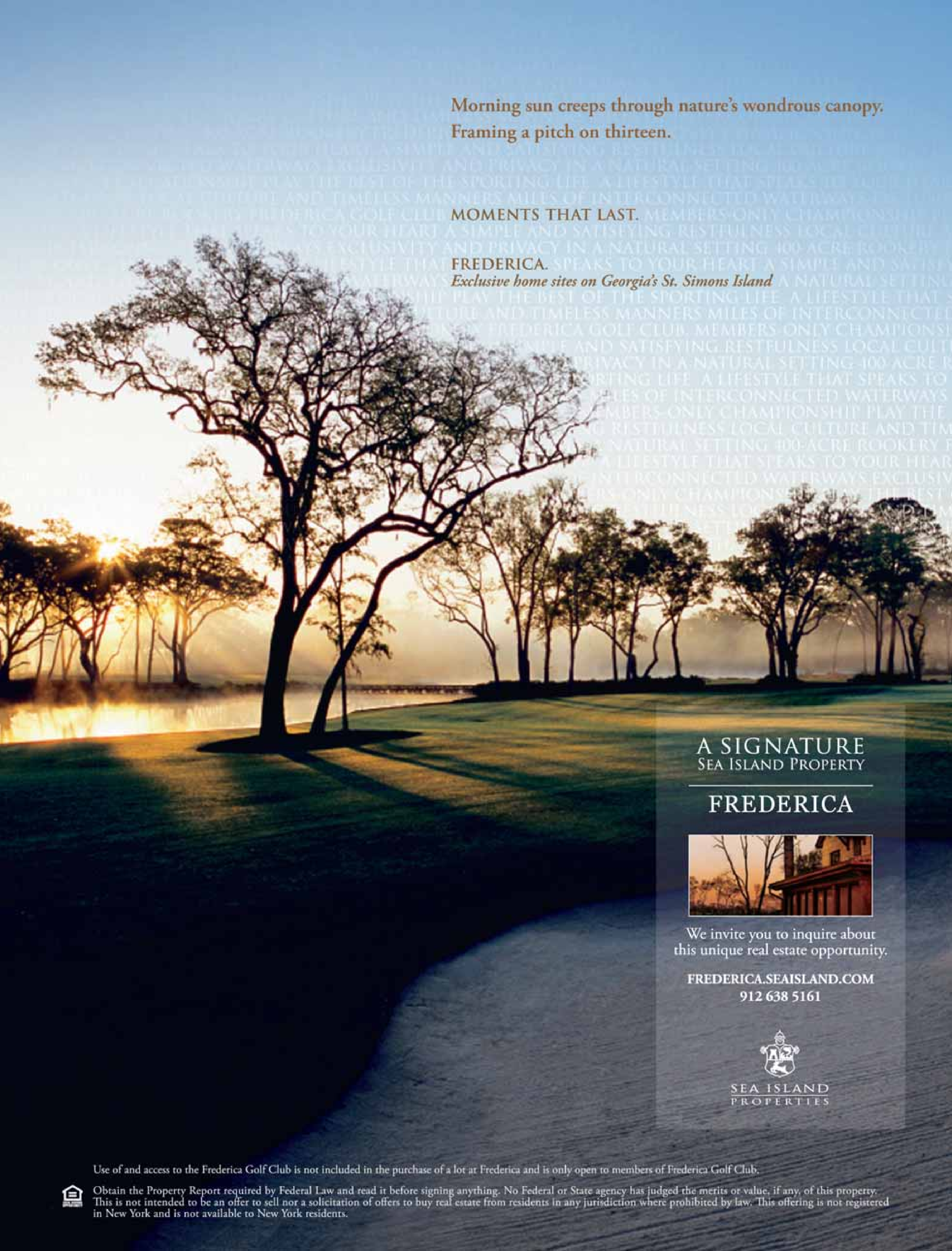
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WINNERS | 2005

THE 47TH ANNUAL

McKinsey Awards

RECOGNIZING EXCELLENCE IN MANAGEMENT THINKING

The McKinsey Awards have for 47 years honored the best thinking to appear in HBR's pages. Reasonable people can disagree on what makes an article "best." But here's how we define it for our judges: the two articles that are most likely to have a lasting, worldwide influence on business. The winning articles present ideas that deftly bridge the gap between theory and practice; that make their way into organizations, where they are discussed, adopted, and even adapted; and that change management for the better.

It has been hard to argue with the judges' choices. In 1979, a young HBS professor by the name of Michael E. Porter won for his first HBR article: "How Competitive Forces Shape Strategy." Seven of the late Peter Drucker's numerous contributions to HBR have been recognized. The list of winners has also included Theodore Levitt's seminal "Marketing Myopia," Robert Hayes and William Abernathy's "Managing Our Way to Economic Decline," and, two years ago, "AIDS Is Your Business," written by a group of six public health researchers. All of these articles have had a significant and positive impact on the way business gets done.

We believe that the judges' picks for this year are no exception to the tradition of excellence – and that they will leave their own distinctive mark on the practice of management.

TO LEARN WHO THIS YEAR'S WINNERS ARE, TURN THE PAGE.

WINNERS | 2005

THE 47TH ANNUAL

McKinsey Awards

RECOGNIZING EXCELLENCE IN MANAGEMENT THINKING

Harvard Business Review is pleased to announce that Pankaj Ghemawat, author of "Regional Strategies for Global Leadership," has won the first-place 2005 McKinsey Award. Steven J. Spear, author of "Fixing Health Care from the Inside, Today," is the second-place winner.

Since 1959, the McKinsey Foundation for Management Research has presented awards recognizing the two best articles published each year in *Harvard Business Review*. The awards, judged by an independent panel of business leaders and scholars, commend outstanding works that are likely to have a major influence on executives worldwide.

FIRST-PLACE WINNER

PANKAJ GHEMAWAT

Regional Strategies for Global Leadership

December 2005

In the past decade, countless international companies have adopted, with great fanfare, something they probably call a "global strategy." Chances are, however, that these strategies have proven less than satisfactory as a road map to competition. That's because global strategies may be ignoring the importance of regions. The rising tide of globalization has been accompanied by increasing, not decreasing, regionalization. In fact, trade within regions, rather than across them, drove the surge of international commerce in the second half of the twentieth century. Companies that find ways of coordinating within and across regions can deliver a powerful competitive advantage.

In this article, Pankaj Ghemawat offers a new framework for competing internationally in a world that is neither truly global nor truly local. He shows how companies can determine if a regional strategy makes sense for them, and he identifies five types of regional strategy they can use in conjunction with local and global initiatives to create value in a highly regionalized world.

Pankaj Ghemawat *is the Jaime and Josefina Chua Tiampo Professor of Business Administration at Harvard Business School in Boston. He is the author of "The Forgotten Strategy" (HBR November 2003).*

SECOND-PLACE WINNER

STEVEN J. SPEAR

Fixing Health Care from the Inside, Today

September 2005

An estimated 98,000 Americans die each year as a result of medical error, and nearly as many succumb to infections they acquire in hospitals. Those rates are unacceptable in the world's most medically advanced country. U.S. hospitals can prevent these tragedies – and save billions upon billions of dollars – without legislation, wrenching market reconfiguration, or major capital investments.

In this article, Steven Spear draws a blueprint detailing how techniques borrowed from the factory floor can improve health care efficiency and patient safety. In case after case, Spear shows how doctors, nurses, and technicians are using continuous improvement techniques pioneered by Toyota to improve patient care and safety. By making small, sometimes dramatically simple process adjustments, medical professionals are eliminating work-arounds and fixing problems on the spot. At one U.S. hospital, deaths from certain kinds of infections have fallen a staggering 87%. At another, similar infection deaths dropped from 19 to one. If every hospital in the country adopted these improvements, the impact would be staggering: billions of dollars and thousands of lives saved.

Steven J. Spear *is a senior fellow at the Institute for Healthcare Improvement in Cambridge, Massachusetts. He is the coauthor, with H. Kent Bowen, of "Decoding the DNA of the Toyota Production System" (HBR September–October 1999) and the author of "Learning to Lead at Toyota" (HBR May 2004).*

JUDGES

McKinsey Awards

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TAVIS COBURN

Deep, lasting culture change requires an integrated approach that remodels a company's social systems. The leadership team of Home Depot employed a remarkable set of tools to do that. **by Ram Charan**

When Robert Nardelli arrived at Home Depot in December 2000, the deck seemed stacked against the new CEO. He had no retailing experience and, in fact, had spent an entire career in industrial, not consumer, businesses. His previous job was running General Electric's power systems division, whose multimillion-dollar generating plants for industry and governments were a far cry from $10 light switches for do-it-yourselfers.

HOME DEPOT'S BLUEPRINT FOR Culture Change

Nardelli also was taking over what seemed to be a wildly successful company, with a 20-year record of growth that had outpaced even Wal-Mart's – but with latent financial and operational problems that threatened its continued growth, and even its future, if they weren't quickly addressed.

To top it off, Nardelli's exacting and tough-minded approach, which he learned at General Electric, set him on a collision course with the freewheeling yet famously close-knit culture fostered by his predecessors, Home Depot's legendary cofounders, Bernie Marcus and Arthur Blank. It was this culture that Nardelli had to reshape if he hoped to bring some big-company muscle to the entrepreneurial organization (which, with revenue of $46 billion in 2000, was sometimes referred to as a "$40 billion start-up") and put the retailer's growth on a secure foundation.

Not surprisingly, Nardelli tackled the challenge partly through personal leadership, mixing encouragement with ultimatum and fostering desired cultural norms like accountability through his own behavior. But he also adopted and adapted an array of specific tools designed to gradually change the company's culture – many of them initiated, coordinated, and implemented by an unlikely lieutenant.

Shortly after arriving, Nardelli hired an old colleague from GE, Dennis Donovan, as his head of human resources. By placing a trusted associate in a position known for its conspicuous lack of influence in most executive suites – and by making him one of Home Depot's highest paid executives – Nardelli signaled that changing the culture would be central to getting the company where it needed to go.

Over the past five years, Home Depot's performance has indeed been put on a stable footing. Although its share price is well below the peak it achieved shortly before Nardelli arrived, and the rate of revenue increase has cooled from the breakneck pace of the late 1990s, the company continues to enjoy robust and profitable growth. Revenue climbed to around $80 billion in 2005, and earnings per share have more than doubled since 2000. Just as important, a platform has been built to generate future growth.

I worked with Bob Nardelli, Dennis Donovan, and other senior executives during that period, and I know that these changes in the business would not have happened without a real and observable change in the culture. Home Depot's experience shows – in perhaps the best example I have seen in my 30-year career – that a cultural transition can be achieved systematically, even under less than favorable conditions, not simply through the charisma of the person leading the change but through the use of mechanisms that alter the social interactions of people in the organization.

The effectiveness of this approach was perhaps most dramatically displayed when a group of Home Depot employees, in a public and spontaneous way, threw their support behind the change in an incident guaranteed to give even the toughest CEO goose bumps.

What got Home Depot from zero to $50 billion in sales wasn't going to get it to the next $50 billion.

An Entrepreneurial Environment

Home Depot is one of the business success stories of the past quarter century. Founded in 1978 in Atlanta, the company grew to more than 1,100 big-box stores by the end of 2000; it reached the $40 billion revenue mark faster than any retailer in history. The company's success stemmed from several distinctive characteristics, including the warehouse feel of its orange stores, complete with low lighting, cluttered aisles, and sparse signage; a "stack it high, watch it fly" philosophy that reflected a primary focus on sales growth; and extraordinary store manager autonomy, aimed at spurring innovation and allowing managers to act quickly when they sensed a change in local market conditions.

Home Depot's culture, set primarily by the charismatic Marcus (known universally among employees as Bernie), was itself a major factor in the company's success. It was marked by an entrepreneurial high-spiritedness and a

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willingness to take risks; a passionate commitment to customers, colleagues, the company, and the community; and an aversion to anything that felt bureaucratic or hierarchical.

Longtime Home Depot executives recall the disdain with which store managers used to view directives from headquarters. Because everyone believed that managers should spend their time on the sales floor with customers, company paperwork often ended up buried under piles on someone's desk, tossed in a wastebasket – or even marked with a company-supplied "B.S." stamp and sent back to the head office. Such behavior was seen as a sign of the company's unflinching focus on the customer. "The idea was to challenge senior managers to think about whether what they were sending out to the stores was worth store managers' time," says Tom Taylor, who started at Home Depot in 1983 as a parking lot attendant and today is executive vice president for merchandising and marketing.

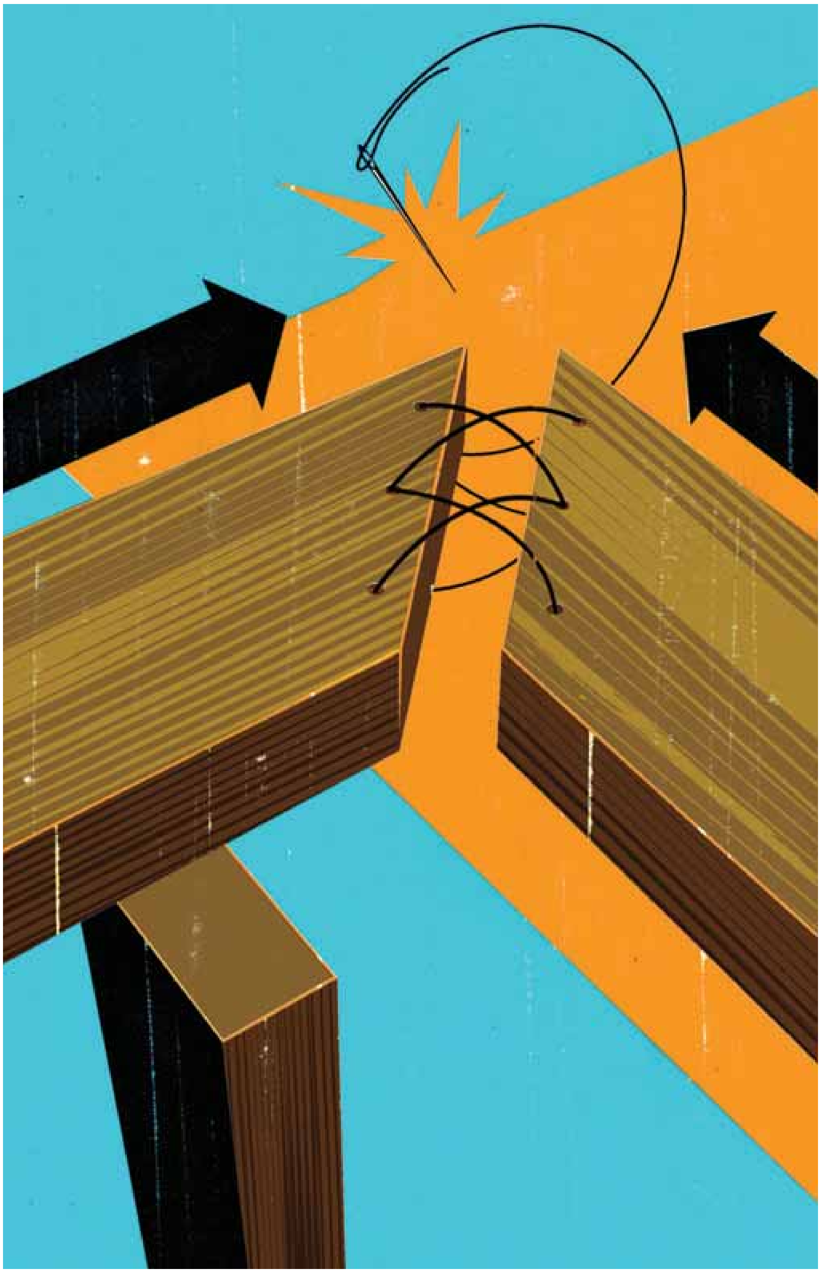
There was a downside to this state of affairs, though. Along with arguably low-value corporate paperwork, an important store safety directive might disappear among the unread memos. And while their sense of entitled autonomy might have freed store managers to respond to local market conditions, it paradoxically made the company as a whole less flexible. A regional buyer might agree to give a supplier of, say, garden furniture, prime display space in dozens of stores in exchange for a price discount of 10% – only to have individual store managers ignore the agreement because they thought it was a bad idea. And as the chain mushroomed in size, the lack of strong career development programs was leading Home Depot to run short of the talented store managers on whom its business model depended.

All in all, the cultural characteristics that had served the retailer well when it had 200 stores started to undermine it when Lowe's began to move into Home Depot's big metropolitan markets from its small-town base in the mid-1990s. Individual autonomy and a focus on sales at any cost eroded profitability, particularly as stores weren't able to benefit from economies of scale that an organization the size of Home Depot should have enjoyed.

A Dose of Discipline

Nardelli's arrival at Home Depot came as a shock. No one had expected that Marcus (then chairman) and Blank (then CEO) would be leaving anytime soon. Most employees simply couldn't picture the company without these father figures. And if there was going to be change at the top of this close-knit organization, in which promotions had nearly always come from within, no one wanted, as Nardelli himself acknowledges, an outsider who would "GE-ize their company and culture."

But the Home Depot board had decided that a seasoned manager with the expertise to drive continued growth needed to be brought in to run what had become a giant



business. The first step would be to deal with immediate problems that weren't readily apparent either to employees or investors. In addition to the shortage of experienced store and district managers and the challenge from Lowe's, which was successfully attracting women shoppers with its brighter stores and a focus on fashionable kitchen, bath, and home-furnishing products, these problems included poor inventory turns, low margins, and weak cash flow.

Nardelli laid out a three-part strategy: enhance the core by improving the profitability of current and future stores in existing markets; extend the business by offering related services such as tool rental and home installation of Home Depot products; and expand the market, both geographically and by serving new kinds of customers, such as big construction contractors.

To meet his strategy goals, Nardelli had to build an organization that understood the opportunity in, and the importance of, taking advantage of its growing scale. Some functions, such as purchasing (or merchandising), needed to be centralized to leverage the buying power that a giant company could wield. Previously autonomous functional, regional, and store operations needed to collaborate – merchandising needed to work more closely with store operations, for instance, to avoid conflicts like the one over the placement of garden furniture. This would be aided by making detailed performance data transparent to all the relevant parties simultaneously, so that people could base decisions on shared information. The merits of the current store environment needed to be reevaluated; its lack of signage and haphazard layout made increasingly less sense for time-pressed shoppers. And a new emphasis needed to be placed on employee training, not only to bolster the managerial ranks but also to transform orange-aproned sales associates from cheerful greeters into knowledgeable advisers who could help customers solve their home improvement problems. As Nardelli likes to say, "What so effectively got Home Depot from zero to $50 billion in sales wasn't going to get it to the next $50 billion."

This new strategy would require a careful renovation of Home Depot's strong culture. Imagine the challenge: Clearly, you wanted to build on the best aspects of the existing culture, particularly people's unusually passionate commitment to the customer and to the company. But you wanted them to rely primarily on data, not on intuition, to assess business and marketplace conditions. And you wanted people to coordinate their efforts, anathema to many in Home Depot's entrepreneurial environment. You wanted people to be accountable for meeting companywide financial and other targets, not contemptuous of them. You wanted people to deliver not just sales growth but also other components of business performance that drive profitability.

Resistance to the changes was fierce, particularly from managers: Much of the top executive team left during Nardelli's first year. But some saw merit in the approach and in fact tried to persuade distraught colleagues to give the new ideas a chance. Over time, attitudes slowly began to change. Some of this resulted from Nardelli's successful efforts to get people to see for themselves why the strategy made sense. But other, more concrete tools, designed to ingrain the new culture into the organization, ultimately prompted employees to pick up a hammer and paintbrush and join the renovation project.

Tools for Culture Change

The mechanisms that Home Depot employed, working in concert, changed what I call a company's *social architecture* – that is, the collective ways in which people work together across an organization to support the business model. Many of them are familiar operating tools. But they were employed in such a way that they changed the human side of the equation: people's behavior, beliefs, social interactions, and the nature of their decision making. It was this social element that allowed Home Depot to achieve – and, more important, to sustain – its dauntingly large-scale and complex cultural transformation. (For a list of some of the tools Home Depot used, see the sidebar "A Culture Change Toolbox.")

The mechanisms fell into several categories: *metrics* (which describe what the culture values and make clear what people will be held accountable for); *processes* (which change how work is done and thus integrate the new culture into the organization); *programs* (which generate support for and provide the first demonstration of the new culture's effectiveness); and *structures* (which provide a framework for the new culture to grow, often by changing where and how decisions are made). Let us examine each in turn.

Metrics: to emphasize new cultural priorities. One of the early things Nardelli and Donovan did was to begin instituting common metrics that produced companywide data in areas that hadn't been consistently measured before. These new performance measurements clearly had an operational purpose, but they also had an important psychological effect. Initially, these metrics showed employees that things weren't going as well as many had thought. For example, data quantifying customer perceptions of the Home Depot shopping experience replaced anecdotal reports of customer satisfaction. Such data made clear that some deeply held beliefs about the stores – the importance, say, of low lighting and other warehouse-like characteristics – needed to be reevaluated.

At the same time, the metrics made clear and reinforced the collaborative behavior and attitudes that Nardelli and Donovan wanted to encourage. Take accountability. When Donovan arrived at Home Depot, he found the company's performance assessment practices less than rigorous. Reviews were usually qualitative and subjective, and standards varied from region to region or even from manager to manager. Donovan would meet with, say, a district manager to go through the performance of store managers and, after some probing, often find managers who enjoyed superior ratings but whose stores were delivering mediocre performance.

Donovan wasn't surprised, given the subjective nature of the performance reviews. As he says, "One of the hardest things for a leader to do is to look somebody in the eye and be honest with them about their performance." So Donovan introduced a standard, companywide performance management process that used mostly quantitative criteria. This made it easier for managers to assess their employees honestly and fairly, enabling them to make the tough calls and put the right people in the right jobs. It also, incidentally, reduced the more than 150 employee evaluation forms used throughout the company to three one-page electronic documents.

Metrics were also used to promote a savvier understanding of the business. For example, with standardized, detailed business data, people could see the relationship among revenue, margins, inventory turns, cash flow, and other measures from store to store and region to region. Getting managers throughout the company to look beyond sales as the sole business goal spurred them to make better decisions.

This might seem obvious, but it's a common problem of companies in periods of rapid expansion. Carl Liebert, executive vice president for Home Depot stores, who worked at Circuit City during a period of high growth in the early 1990s, says that in such an environment, "you don't spend a lot of time thinking about inventory turns. Instead, you focus on opening more stores because the customer loves your box." That's fine until you suddenly find yourself with a competitor that has its own lovely box, as Circuit City did with Best Buy – and Home Depot did with Lowe's.

Companywide metrics also provided a platform for collaboration. By making various aspects of Home Depot's performance transparent to all employees, managers could clearly see – in cold, hard facts – the broader financial impact of their own decisions. This prompted candid discussions about how to improve that performance and focused employees' vaunted commitment on taking the needed actions.

For example, people in merchandising, operations, and stores traditionally distrust one another, as the individuals who buy the goods, get them to the retail outlet, and sell them to the customer seek to shift blame for poor performance along the value chain they all share. Paul Raines, the vice president for stores in Home Depot's southern region, recounts that in the pre-Nardelli years a meeting involving these three groups "was basically a food fight. We would all blame each other for problems, and it was very anecdotal: 'You didn't send me that trac-

A CULTURE CHANGE TOOLBOX

For large corporations to achieve a major – and permanent – change in business performance, they must create a sustainable change in culture. Aware of this, the leaders at Home Depot identified key aspects of the culture that had to change for the company to meet the new performance goals. They then adopted a variety of standard tools in such a way that they strengthened the business *and* modified the culture. As the mechanisms took hold, the energy of employees became positive, further accelerating the change.

Among the tools Home Depot has used are:

Data templates, detailed forms to organize performance data for quarterly business review meetings, which encourage personal accountability, give employees a deeper understanding of business performance, and foster collaboration by putting people on the same page when making decisions.

Strategic Operating and Resource Planning, or SOAR, which is built around an annual eight-day session when Home Depot's 12 top executives work together to balance priorities and select the investments most likely to achieve financial and other business targets.

Disciplined talent reviews, conducted frequently – and consistently from one to the next – which emphasize the need for candor and fairness in dealing with employee performance.

Store manager learning forums that, through role playing, simulations, and other exercises, highlighted the level of competitive threats and made transparent the company's future plans, helping attendees understand the need for the new strategy.

Monday morning conference calls, involving the company's top 15 executives, during which accountability (for business results and for promises made the previous week) is emphasized, as is sharing information (about operations, customers, markets, and competitive conditions).

Employee task forces, staffed by individuals from all levels of the company, to elicit unfiltered input from the people closest to a problem and gain their support for the changes the solution requires.

An array of leadership development programs, including the Future Leaders Program, the Store Leadership Program, and the Merchandising Leadership Program, which raise the bar for performance and ensure continuity of the culture.

Mapping of the HR process, which identified 300 ways that HR tasks could be improved and highlighted the importance of instituting processes to sustain cultural change.

tor I needed' or 'Your stores are terrible.' We might throw a P&L up on the wall, but that was about it."

Today, the quarterly business review meetings that Raines runs for his region are hardly polite tea parties. But the tension is channeled through a template, which includes such data as store-by-store gross margins and category-by-category sales forecasts. With everyone in the room (and across the company) on the same page – more accurately, the same 15 pages – there is little opportunity to offer anecdotal evidence to defend your position or use your rank to support your case. Jointly discussing the data helps people set priorities collectively and even accept allocations of resources that might hurt their own parts of the business.

Processes: to integrate the new culture into the organization. Right after Nardelli became CEO, he instituted a two-hour Monday morning conference call in which the top 15 or so executives give individual reports on the previous week's activities in their areas of responsibility. Initially, the call helped Nardelli educate himself about the business. But over time, his questions evolved and began focusing more on holding people accountable for what they had promised to do the previous week. In fact, the calls have become a powerful tool for Nardelli in his efforts to create a culture of cooperation and accountability. Week after week, the top executive team comes together, hears the same information, makes decisions, and commits to actions that are reviewed by everyone in subsequent calls. This process, repeated like a drumbeat, has built the executive group into a highly integrated team.

The Monday call is mirrored on Monday afternoons by a video cast that goes out to all 1,800 Home Depot stores in the United States. The transmission focuses on the week ahead – upcoming product promotions, the introduction of new product lines, the revenue needed in the last week of a quarter to meet bonus plan targets for sales associates. The broadcast, actually called "The Same Page," creates a link between each store's activities and the bigger picture – and reflects a shift from the old culture, in which all those memos from headquarters were thrown out unread.

A particularly bold social change was the implementation of a Strategic Operating and Resource Planning (or SOAR) process, which melds strategy, operations, and human resource planning. The core of SOAR is an annual, eight-day marathon (referred to by some participants on the final day as "SORE"), during which the senior leadership team decides which competing investments in the business will best help the company meet its three-year financial targets. SOAR was radical for Home Depot on a number of fronts: First, it requires resources to be allocated on the basis of projected future needs rather than, as in most companies, from extrapolations of past events. Second, like the regional quarterly business reviews, in which different functions must balance their interests, SOAR is a collaborative process, one that, in Liebert's words, rises above the narrow "you're doing something that pushes costs from your P&L to my P&L" mind-set.

What makes the process so emblematic of the new Home Depot culture, though, is the way that the planning meeting is integrated with HR planning so that decisions about human resources are aligned with strategic and operating decisions. In a retail business, where human capital is vital to success, a sophisticated HR-planning process is crucial. "Sales associates are to Home Depot what engineers are to NASA," Nardelli says.

Every year, Donovan and Nardelli spend several weeks engaged in a complete and detailed assessment of all aspects of HR – talent recruiting, education, performance management, career development, and the like. The intensive review not only gives the two executives a close-up picture of the company's talent but also helps them learn which HR initiatives are actually working in the field. This can lead to endeavors with dual HR and strategic purposes: A successful effort to, say, hire senior citizens and former military personnel as sales associates and managers – they are seen as ideal employees – is linked with marketing efforts targeted at those groups.

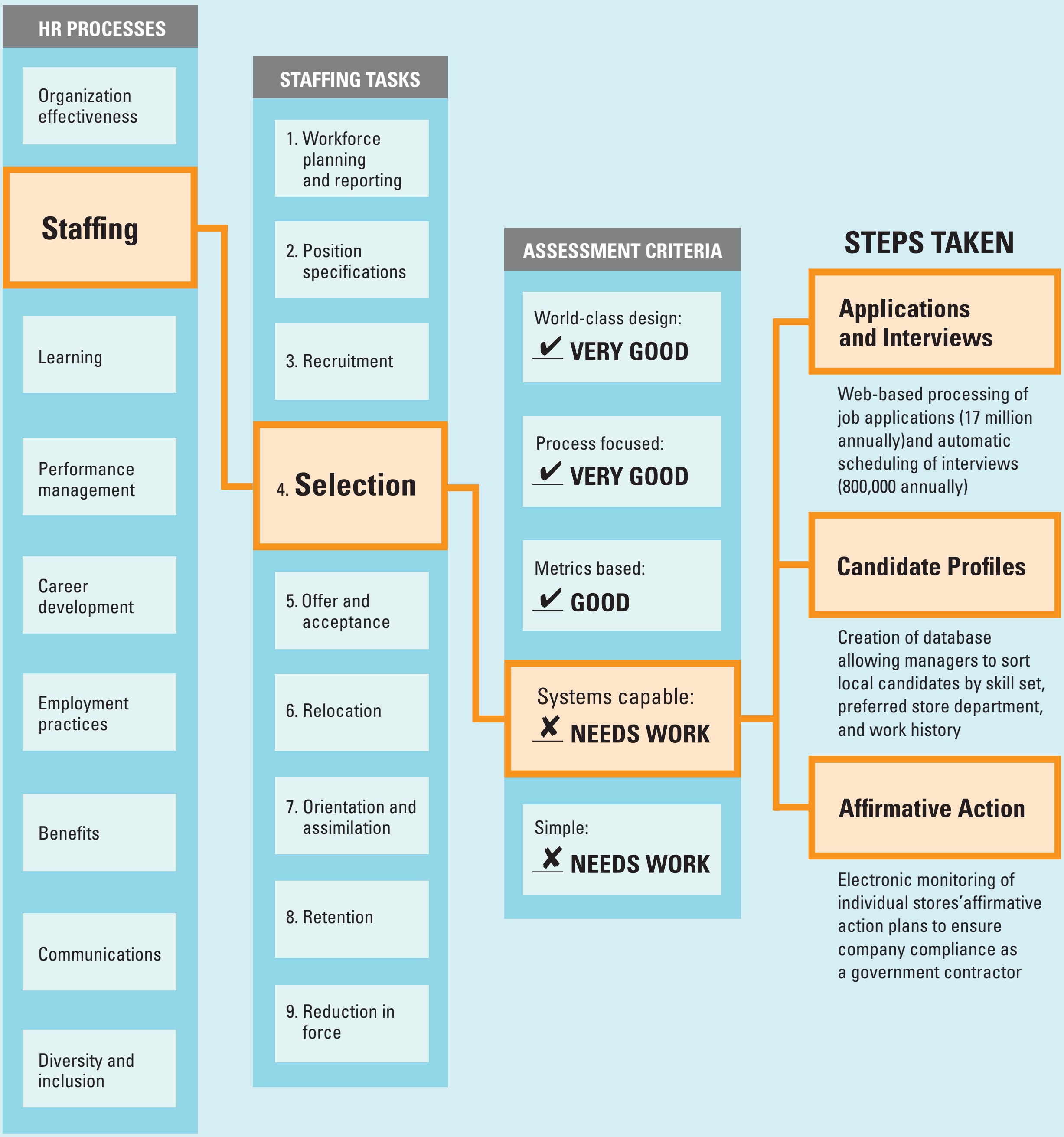
Donovan's belief in the importance of process as a way to embed analysis and rigor into the organization was evident in something he did as soon as he came. He worked with his staff to map what he refers to as "toll gates" – the sequence of tasks that must be successfully completed for every HR process. The staff evaluated how well the HR organization was performing each step and identified those that might be improved. The group then designed 300 initiatives aimed at rectifying shortcomings and agreed to carry out all 300 within three years. (For a look at how Home Depot mapped one of the processes, see the exhibit "Assessing and Improving the HR Function.")

Programs: to build support for culture change. A year and a half after Nardelli took over as CEO, he and Donovan knew that there still was significant opposition within the organization to the changes they were making. The resistance was bolstered by the beating Home Depot was taking in the media and the market – the share price fell from a peak of nearly $70 during the boom years of the late 1990s to just above $20 at the beginning of 2003 – not to mention the company's failure to increase same-store sales. But something else was at work, says Carol Tomé, the company's chief financial officer. "People never had time to grieve for the company Home Depot once was," she says. "The company hadn't been prepared for the change. And though we did a pretty good job explaining to people the *what* of the change, we didn't do a very good job of explaining the *why*."

So over the course of several months in late 2002 and early 2003, Donovan set up a series of five-day learning forums for district and store managers – nearly 1,800 people in all. "Large-scale organizational change is not a spectator sport, and it's easy to be a cynic when you're in the

ASSESSING AND IMPROVING THE HR FUNCTION

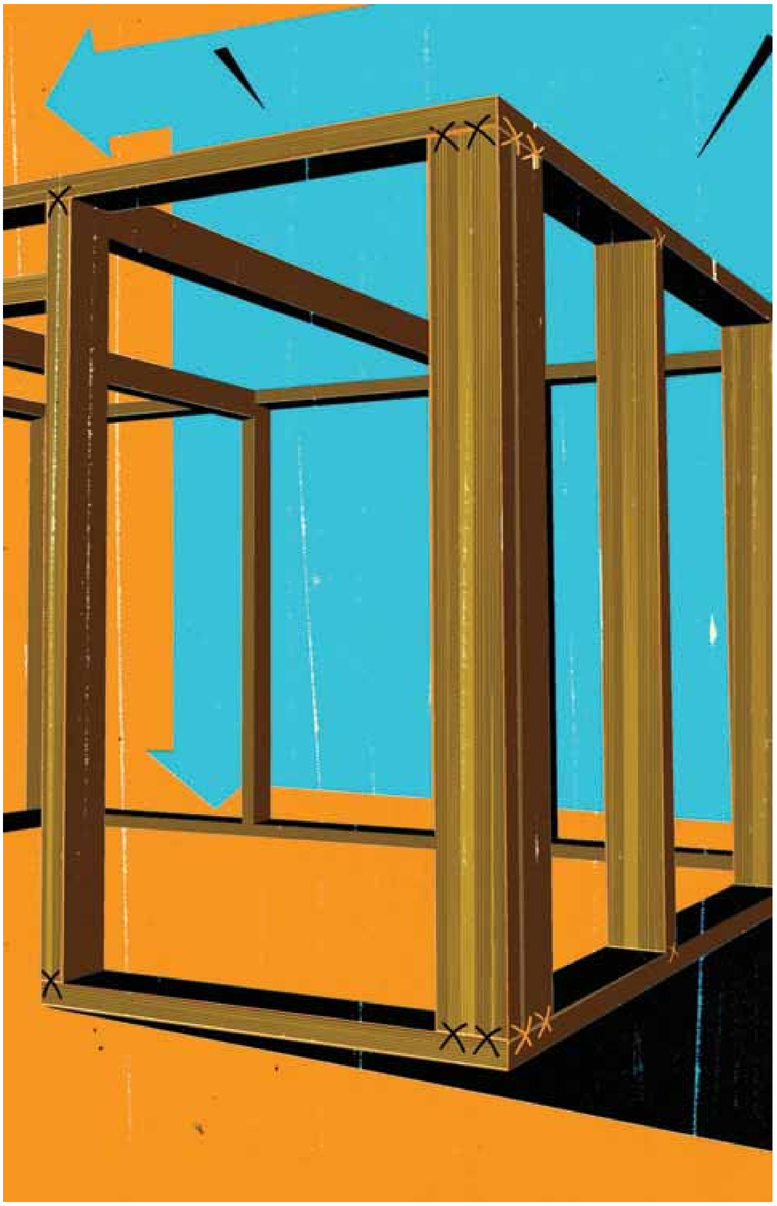
To better manage Home Depot's workforce and to signal the importance of analytic processes in the new culture, human resources head Dennis Donovan conducted a detailed assessment of HR's work. He and his staff examined each of the HR processes, such as staffing, career development, and benefits, and mapped the "toll gates" of each process – that is, the sequence of tasks that must be completed to successfully get the work done. They then evaluated how well the HR organization was performing each of these tasks, based on five criteria: world-class design, a focus on process, the use of quantifiable metrics, systems capability (whether the task could be completed on desktop PCs throughout the company), and simplicity. More than 300 initiatives were identified, all of which were completed.



stands," Donovan says. "It's tough to be a cynic when you're on the playing field." Accordingly, the program included competitive simulation and role-playing exercises. In one such exercise, Donovan asked people to view the company from Nardelli's perspective: "You've just arrived. You want to preserve the proud past of the wonderful company that has been passed on to you. But you also see incredible opportunities in the future, including the possibility of doubling the size of the market by providing products and services for industrial and commercial customers. To step into that future, you know you have to deal with some issues." Then Donovan posed the challenge: "If you're Bob, what do you do? The only rule is… you can't fire the HR guy."

Working in small groups, people put their ideas up on the wall: centralize the buying offices, manage inventory better, offer better training for managers. "And then," Donovan recalls, "five minutes or so into the exercise, someone would inevitably grab the microphone and say, 'Hey, this is what Bob and his team are trying to do.' "

Getting – and sustaining – employee commitment to the new culture has continued in an array of ongoing leadership-training programs, including the Future Leaders Program, the Store Leadership Program, and the Merchandising Leadership Program. And it has filtered into a variety of business operations. For instance, Liebert, in a previous position as senior vice president for operations, sought to institute a bar code system to replace the manual box count used to keep track of incoming goods at stores. He knew the system wouldn't work unless the people on the loading dock could see its merits and were behind it; an earlier attempt to implement the procedure had failed. So Liebert included individuals in night-receiving jobs on the development team and himself worked alongside the night crew several times to learn from people he calls the "subject matter experts."



The resulting system was shaped by input from those directly responsible for using it, and as a result excitement about and support for it spread. As Liebert says of the passionate Home Depot worker: "The orange blood kind of starts boiling, and people say, 'Bring it on.'" What's more, in the new, more business-savvy Home Depot environment, workers could understand and appreciate the business benefits of scanned receiving: more efficient movement of incoming freight and better cost management.

Structure: to create a framework for the radically new culture. When Nardelli became CEO, Home Depot's purchasing operation comprised nine divisional purchasing offices, many of which had different pricing agreements with the same supplier. This meant that the retailer was acting as if it were nine $5 billion companies rather than a single $45 billion company, thus squandering the chance to drive down costs and boost gross margins.

The rationale for centralizing purchasing was clear, but it would be a difficult transition to make without seriously disrupting operations. Furthermore, since decentralization had been, ironically, a central element of the old Home Depot's cohesive culture, the change would have a significant cultural impact. So Nardelli gave the job of overseeing the transition to Donovan, on his first day at the company. The creation of the new organization – defining the new roles, establishing new purchasing processes, staffing the new positions – was to be accomplished in 90 days. As Donovan says, "That's when I learned Bob doesn't operate on a calendar but on a stopwatch."

The initiative culminated in "Super Saturday," during which some 60 top executives – presidents and vice presidents from the nine regional divisions – got together in a room at Atlanta headquarters. The first three hours were spent getting them to agree on the details of the new purchasing function. There wasn't a lot of time for disagreement because the new organization would be unveiled to employees, suppliers, and the media on Monday.

Then the group moved to a large room. On the back wall were the names of more than 100 people working in the existing purchasing organization. On the front wall was an organization chart of the new Atlanta-based merchandising operation. On the side wall was the new field structure. Everyone had résumés of the candidates. Their relative strengths were debated, and a handful of candidates was selected for each of the 20 or so top positions in the new function. When one individual was chosen by consensus for a particular position, the executive who knew that person best went to the phone and made the job offer. If accepted, a dot was placed by that person's name. If not, an offer went to the next person on the list of candidates for the job. (Those not selected for one of the top jobs took lower positions in the new centralized function.) Three and a half hours later, by dinnertime on Saturday, an entirely new organization, with new roles and responsibilities, had been created and staffed. Compensation packages, preapproved by the board, were sent overnight to the newly promoted executives. They started a week later.

The restructuring was a bold and risky business move, the equivalent of a heart transplant for a big retail company, and it had to be done without missing a beat. It was also a bold cultural move, signaling a huge transition toward a more centralized company. The way it was done – so quickly and collectively, with people jointly debating each candidate's merits so that everyone understood the reasons why one individual was chosen over another – planted the seeds of communality, candor, and decisiveness in the new culture. As Donovan says, "At the end of the day, everyone cheered and applauded. It was exhilarating having accomplished together what we did in a single day."

Speed and Sustainability

One of the lessons of Super Saturday is that, as Donovan says, "In the game of change, velocity is your friend." Talk all you want about trying to match the speed of change to an organization's ability to absorb it. Most companies don't have the luxury of moving at their own rate because external factors dictate the tempo. Donovan likes to recall a comment that was frequently made at some early open meetings for employees – that the company needed to pace the changes being proposed – and Nardelli's quick response: "Good point. Give me five minutes. I'm going to go call Lowe's and ask them to slow down for us."

Store managers' autonomy freed them to respond to local conditions, but it made the company as a whole **less flexible**.

But forcing a change too quickly can backfire. Nardelli recounts his initial attempt to improve inventory turnover. "Thou shalt improve inventory turns," he decreed. But the store managers didn't have the customer data and analytic tools they needed to do that – so they simply cut back on ordering. This certainly reduced the amount of merchandise idling on the shelf. In fact, the shelves were empty.

Nardelli's response was swift, decisive, and bold. "You put the brake on your plan," he says. "You place $500 million in orders to reload the shelves, and then you step back and look at where your assumptions were wrong." To reduce inventory turns in a way that worked, store managers were given and taught how to use the needed forecasting and inventory management tools, well known in the industrial sector from which Nardelli came. In describing the desired pace of change, Nardelli uses an image from NASCAR auto racing: Brake into the sharpest turns while never letting up on the throttle.

Assuming the rate of change is more or less right, how do you make change stick? How do you sustain it, integrate it into the organization, embed it in the culture? How do you keep it from being one more initiative that flares up and flames out? Home Depot's experience suggests a number of answers.

Where possible, get people affected by a change to help define the problem and design the solution. Base your change on hard data that everyone has access to. Institutionalize the change by starting with a single project, then move to consistently apply repeatable processes that sustain it. Build accountability into such processes. Create interlocking dependencies between different parts of the organization so that they have a mutual interest in sustaining the change.

Perhaps most important, don't view transformation – even something as cataclysmic as the centralization of purchasing – as a onetime event or a point to be reached. Rather, view it as a work in progress that will constantly need to be modified. External forces require a company to constantly change, and a successful culture has a methodology that allows it to do that.

Take SOAR planning. Over the years, some unintended consequences have emerged, including what CFO Tomé has dubbed "batch processing for capital." "People were holding back until the annual SOAR meeting before seeking funding for good ideas," she says. "But we're trying to run a business *today.* If someone has a great idea today, we should hear about it today." This particular problem was fixed by providing a mechanism for interim approvals of capital requests. To prevent similar kinds of problems, a half day is now set aside at the end of the SOAR session to evaluate how the process can be refined – a huge factor in making it adaptable and sustainable.

The Tide Turns

The inventory turn initiative wasn't the only effort that had to be retooled. Some were scrapped entirely. For example, Nardelli tried to shift the staff mix on the sales floor from 30% part-time to 50% part-time, not only to cut costs but also to gain the flexibility to adjust coverage during busy times of the day. The move was a disaster. Customers complained about bad service. Employees complained that part-timers weren't committed to Home Depot. More fundamentally, the move was seen as an affront to a crucial pillar of Home Depot's traditional culture, in which people thought of the company as a place where they could build a career. Nardelli abandoned the change, and his willingness to correct a mistake enhanced his standing among employees.

But the Home Depot culture today – with its focus on process, hard data, and accountability – is different from what it was five years ago. And there are concrete signs of its acceptance by employees. Not surprisingly, in the new culture, some of those signs take the form of data. Employee surveys, administered by Donovan's department and completed by more than 80% of Home Depot's 300,000-plus workers, showed a rise in a composite measure of various aspects of job satisfaction from one point below the average score for all industries in 2002 to eight points above it in 2004. Relative to the retailing sector in particular, the score represented a rise from five points above the average to 14. The composite measure includes engagement in the business, enjoyment of the employee's existing role, support for the leadership, and confidence in the company's future.

Perhaps the most vivid evidence of people's acceptance of the new culture, though, is anecdotal. In January 2003, Home Depot held the last of the store manager learning forums in Atlanta. The benefits of the business changes generally hadn't yet flowed through to the financial results, and the company was taking a drubbing in the media and the markets. Despite this, or perhaps because of it, the managers were pumped up as the five-day session came to a close. When Nardelli arrived to address them on the last day, the group – which would barely have acknowledged the CEO's presence a year before – rose up in a body and cheered. Manager after manager went to the microphone to say how difficult the changes had been to accept, especially in the face of external criticism, but how they now supported what the company was trying to do. In the words of one: "We've got your back, Bob."

It didn't stop there. Home Depot's senior management team was going to meet with 200 analysts the next day. Some of the store managers decided to, in effect, storm the meeting and tell the analysts how positive they were about the company's future. Taylor, at the time the president of the southern division, recalls getting a call from someone at the forum alerting him to the plan. "We can't let them do that!" Taylor told Nardelli. Yes, it was a nice show of support. But it could be disruptive, and it might look orchestrated. After some discussion, Nardelli weighed in: "Let's let them do it. The only rule is that I don't want anyone telling them what to do."

The next morning, just as the analysts' meeting began, 240 clapping store managers came in from the back of the auditorium and up onto the stage, taking over the gathering. "It scared the hell out of the analysts," as Donovan recalls it. Two managers, including a woman with 20 years' experience, read statements about their support for the changes. There was a hushed silence, and then the store managers broke into a roar.

The managers' burst of energy was a clear sign that the culture had begun to change. The road to this point had been undeniably rocky, and, not surprisingly, there have been bumps since then. Every change effort has persistent skeptics, both inside and outside a company. But in the ensuing months, the leadership team could increasingly sense that people were interacting with one another and making critical decisions in significantly different ways. Crucially, that behavior was becoming a routine part of everyone's daily work. With these cultural changes embedded in the organization, improved business results were sure to follow.

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To order, see page 151.

BRIAN CRONIN

For a leader, a public apology is always a high-risk move. Understanding what apologies can and cannot do will help you avoid both foolhardy stonewalling and unnecessary contrition.

by Barbara Kellerman

When Should a Leader Apologize and When Not?

When we wrong someone we know, even unintentionally, we are generally expected to apologize. The person we hurt feels entitled to an admission of error and an expression of regret. We, in turn, try to ameliorate the situation by saying, "I'm sorry," and perhaps making restitution.

But when we're acting as leaders, the circumstances are different. Leaders are responsible not only for their own behavior but also for that of their followers, who might number in the hundreds, thousands, or even millions. The first question, then, is, Who exactly is the guilty party? The degree of damage is an issue as well. When a leader feels obliged to apologize, especially for a trespass in which followers were involved, the harm inflicted was likely serious, widespread, and enduring.

Since leaders speak for, as well as to, their followers, their apologies have broad implications. The act of apology is carried out not merely at the level of the individual but also at the level of the institution. It is not only personal but also political. It is a performance in which every expression matters and every word becomes part of the public record.

For leaders to apologize publicly is therefore a high-stakes move: for themselves, for their followers, and for the organizations they represent. Refusal to apologize can be smart, or it can be suicidal. Conversely, readiness to apologize can be seen as a sign of strong character or as a sign of weakness. A successful apology can turn enmity into personal and organizational triumph – while an apology that is too little, too late, or too transparently tactical can bring on individual and institutional ruin.

What, then, is to be done? How can leaders decide if and when to apologize publicly?

Why Now?

The question of whether leaders should apologize publicly has never been more urgent. During the last decade or so, the United States in particular has developed an apology culture – apologies of all kinds and for all sorts of transgressions are extended far more frequently than before. In his book *On Apology,* Aaron Lazare offers ample evidence that the number of apologies is on the rise, also pointing out that they have become grist for our collective mill: "Newspaper columnists covering the national and international scene have written about the growing importance of public apologies, while articles, cartoons, advice columns, and radio and television programs have similarly addressed the subject of private apologies."

Members of various professions hardly known in the past as exemplars of humility have begun to discuss what role apology plays in their professional practice. Many physicians, for instance, now at least consider apologizing to a patient for a medical mistake; and within the medical profession generally, there is discussion about when an apology is in order. In addition, new laws have made it significantly easier for medical providers to apologize to their patients. In 2003, Colorado enacted a law stating that an apology extended by a health care provider would, in any civil action, "be inadmissible as evidence of an admission of liability." (Several other states deem expressions of sympathy inadmissible in court – though for them, full apologies are another matter.) While, in the past, fear of a malpractice suit nearly always precluded health care providers from admitting a mistake, University of Florida law professor Jonathan R. Cohen observes in "Toward Candor After Medical Error" (*Harvard Health Policy Review,* Spring 2004), it is "precisely that silence – that failure to admit a mistake and apologize for it – that can prompt a lawsuit."

The rise in the number of leaders *publicly* apologizing has been especially remarkable. Apologies are a tactic leaders now frequently use in an attempt to put behind them, at minimal cost, the errors of their ways. So many corporate executives expressed regret for one or another offense in the summer of 2000 that some business writers called it the "summer of apologies." The transgressions for which leaders begged pardon included unreliable flights, bad phone service, and tire blowouts. Since then, the pattern has continued. The CEO of health care IT company Cerner insulted his management team in an e-mail; when the company's stock took a dive, he apologized for the e-mail he'd sent. Etienne Rachou, head of Air France's European and North African operations, apologized to an Israeli businessman after an Air France pilot referred to the Tel Aviv destination as "Israel-Palestine." John Chambers, CEO of Cisco Systems, asked service providers for their forgiveness because the company hadn't made their needs enough of a priority.

Sometimes leaders even apologize for sins to which they personally have no connection. On a state visit to Poland in 1970, German chancellor Willy Brandt extended a wordless apology for crimes committed three decades earlier by the Nazis against Polish Jews. (Apparently filled with emotion, Brandt dropped to his knees as he approached a Warsaw war memorial.) In 1995, Helge Wehmeier, then president and CEO of Bayer, similarly expressed his deepest regret on behalf of Bayer's original parent company, for its having been complicit in the Holocaust. And just recently, in 2005, Ken Thompson, chairman and CEO of Wachovia, revealed that two of its

A LEADER'S APOLOGY is a performance in which every expression matters and every word becomes part of the public record.

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acquired companies had owned slaves. He added: "On behalf of Wachovia Corporation, I apologize to all Americans, and especially to African-Americans and people of African descent. We are deeply saddened by these findings."

Leaders outside the corporate world have also been doing an impressive amount of breast-beating. In the last several years, former U.S. secretary of defense Robert McNamara apologized repeatedly for his poor judgment during the Vietnam War. Republican U.S. senator Trent Lott apologized for suggesting that the country would have averted many problems if onetime segregationist Strom Thurmond had won the 1948 presidential race. Vicente Fox, the president of Mexico, apologized for saying that Mexicans were willing to take jobs in the United States "that not even blacks want to do." Evangelist Pat Robertson apologized for saying that the United States should kill Venezuela's president, Hugo Chavez, and for suggesting that the stroke suffered by Israeli prime minister Ariel Sharon was divine retribution for "dividing God's land." Cardinal Bernard Law apologized for sexual abuse by priests in the Boston Archdiocese – for "the rupturing of that sacred trust." Oprah Winfrey, who presides over a great media empire and American culture more generally, apologized for defending (and being duped by) James Frey's "memoir" – for leaving "the impression that the truth does not matter." And Lawrence Summers, the president of Harvard, apologized for suggesting that "intrinsic aptitude" might explain the low number of women in science and engineering.

The case of Summers is a striking example of the lengths to which leaders will go to say they're sorry. Having created a firestorm, on campus and beyond, the president apologized again and again. A few days after the incident, Summers sent a letter to every member of the Harvard community that read, in part, "I deeply regret the impact of my comments and apologize for not having weighed them more carefully." At a faculty meeting one month later, Summers said: "I deeply regret having sent a signal of discouragement to people in this room and beyond who have worked very hard for many years to advance the progress of women in science and throughout academic life." And in another letter, this one sent to Harvard faculty two days after that meeting, Summers wrote, "If I could turn back the clock, I would have spoken differently on matters so complex.... I should have left such speculation to those more expert in the relevant fields. I especially regret the backlash directed against individuals who have taken issue with aspects of what I said." (Summers did not apologize right away, and there is evidence that he did so reluctantly. Obviously, it is impossible to know whether a prompt expression of regret would have forestalled the firestorm, which led to his resignation, effective at the end of June 2006.)

Of course, apologies are like everything else: They reflect the cultures within which they are embedded. In Japan, for example, a leader's apology is not nearly so remarkable a gesture as it is in most other countries. One observer went so far as to describe Japan as the "apologetic society par excellence." Still, it is not too much to say that the apology as a form of social exchange is growing in international importance. While the methods may differ – China has apology companies that employ surrogates to provide explanations and express remorse – the apology culture is a global phenomenon.

Why Bother?

Why do we apologize? Why do we ever put ourselves in situations likely to be difficult, humiliating, and even risky? Leaders who apologize publicly are especially vulnerable. They are highly visible. They are expected to appear strong and competent. And whenever they make public statements of any kind, their individual and institutional reputations are at stake. Clearly, then, leaders should not apologize often or lightly. For a leader to express contrition, there needs to be a good, strong reason.

In *Mea Culpa: A Sociology of Apology and Reconciliation,* Nicholas Tavuchis writes that apologies speak to acts that cannot be undone "but that cannot go unnoticed without compromising the current and future relationship of the parties." Thus, this general principle: Leaders will publicly apologize if and when they calculate the costs of doing so to be lower than the costs of not doing so. More precisely, leaders will apologize if and when they calculate that staying silent threatens a "current and future relationship" between them and one or more key constituencies – followers, customers, stockholders, or the public.

After denying and procrastinating for months, President Bill Clinton decided that if he wanted to get back on task, he had no choice but to offer an abject public apology – and a televised one, at that – for having had an inappropriate relationship with Monica Lewinsky. He began by admitting his involvement with the White House intern. He went on to say that "it was wrong" and that he deeply regretted having misled the country. He concluded his prepared statement by telling his wife and daughter that he was ready to do whatever it would take to make things right between them – and by promising to put the past behind him and turn his attention back to the nation's business.

Clinton's apology in the Lewinsky affair was intended to repair, or at least start to repair, two different relationships: his relationship with the American people and his relationship with his family. Given the temper of the times, given the apology culture, the president concluded that his path to forgiveness and redemption was to offer as full and open an apology as the already humiliating circumstances would allow.

In this case, Clinton was taking responsibility for his own bad behavior. In contrast, when M. Douglas Ivester, chairman and CEO of Coca-Cola in the late 1990s, apologized to his European customers for the company's slow response to complaints that Coke products were making them sick, he was taking responsibility, or trying to, for his organization generally.

As is often the case when people have come to feel aggrieved, Ivester made his real mistake at the beginning. Initially, he and company executives based in Brussels played down the problem. They dismissed as unfounded the widespread complaints of nausea and headaches, insisting instead that Coca-Cola's drinks did not, nor could they possibly, pose a health hazard. Only in response to the growing public outcry – and, more importantly, to the bans placed on Coke products by the governments of France, Belgium, the Netherlands, and Luxembourg – did Ivester relent. Up against the wall, he finally promised to investigate the problem thoroughly. And he finally apologized.

Before it was all over, Ivester had declared consumer trust sacred to Coca-Cola, and company executives were described as deeply regretting the problems encountered by their European customers. Clearly concluding that the greater the number his expressions of remorse, the more likely Coca-Cola would be forgiven, Ivester ended up issuing one of the most elaborate public apologies ever offered by an American chief executive. In Belgian newspaper ads, he said, "I'm sorry" or "we regret" or "I apologize" five times.

Ironically, the best evidence from subsequent investigations is that the reported illnesses were the result of mass hysteria rather than contaminated Coca-Cola. (Many of the children who complained of becoming sick had not drunk Coke that day.) Nevertheless, Ivester's professional reputation was badly damaged by his mishandling of the crisis. In fact, he stepped down from his position as CEO just two years after assuming the post.

As the examples of both Clinton and Ivester testify, in general leaders apologize only if and when they feel a pressing political need to do so. Still, there are exceptions to this rule. Sometimes leaders apologize when their self-interest is not immediately at stake – when the only apparent reason for doing so is genuine remorse and regret.

Once again, President Clinton provides a case in point. In 1998, he apologized for the genocide in Rwanda, which had taken place four years earlier, on his watch. On a brief visit to the Rwandan capital, Kigali, he expressed regret and remorse for "not act[ing] quickly enough after the killing began," even though there was no political pressure to apologize. For despite the murder and mayhem – Rwanda's genocide was arguably the most efficient in human history, with 800,000 dead in four months – virtually no one had demanded that Clinton take responsibility. The president's apology was, therefore, authentic rather than simply strategic. It was made to assume some responsibility for the wrongdoing and to admonish the international community never again to stand by and do nearly nothing in the face of mass murder.

There are four possible answers, then, to the question of why a leader would endure the discomfort and assume the risk of offering a public apology. That is, apologies can serve four purposes:

Individual purpose. The leader made a mistake or committed a wrongdoing. The leader publicly apologizes to encourage followers to forgive and forget.

Institutional purpose. One or more persons in the group for which the leader is responsible made a mistake or committed a wrongdoing. The leader publicly apologizes to restore the group's internal cohesion and external reputation.

Intergroup purpose. One or more persons in the group for which the leader is responsible made a mistake or committed a wrongdoing that inflicted harm on one or more persons on the outside. The leader publicly apologizes to repair relations with injured parties.

Moral purpose. The leader experiences genuine remorse for a mistake made or a wrongdoing committed, either individually or institutionally. The leader publicly apologizes to ask forgiveness and seek redemption.

The first three purposes are primarily strategic and rooted in self-interest. The last purpose is primarily authentic: An apology is extended because it is the right thing to do. As a general principle, leaders should apologize only if doing so serves one of these purposes.

Apologizing

People speak of "a simple apology," but there is no such thing. To acknowledge a transgression, seek forgiveness, and make things right is a complex act. Apologies are prompted by fear, guilt, and love – and by the calculation of personal or professional gain. They are shaped by culture, context, and gender. They are base and self-serving or generous and high-minded. And when extended in public, they amount to performances to which different audiences react in different ways.

Moreover, there is a fundamental distinction to be made between an apology offered on behalf of an individual and one made on behalf of an institution. This distinction matters especially in the West, where people expect more from the first type than from the second. Individuals unwilling to apologize when an apology is in order are subject to censure and opprobrium. Institutions, such as large corporations, are not ordinarily bound by this same stringent moral imperative.

What, then, constitutes a good apology, a full apology, one that's likely to work? Above all, a good apology must be seen as genuine, as an honest appeal for forgiveness. Such apologies are usually best offered in a timely manner, and they consist of the following four parts: an acknowledgment of the mistake or wrongdoing, the acceptance of responsibility, an expression of regret, and a promise that the offense will not be repeated.

In corporate America, the good apology extended by Johnson & Johnson during the Tylenol crisis has taken on almost mythic proportions. Although the case is about a quarter-century old, it is still considered a near-perfect example of what a leader should do when things go wrong. In 1982, seven people died from cyanide inserted into Tylenol capsules. Although the crisis was brought on by an individual (who was never caught) rather than an institution (Johnson & Johnson), and subsequent evidence indicated that the killer had no relationship whatsoever to the company, James Burke, Johnson & Johnson's CEO at the time, immediately assumed responsibility for the disaster. People were told not to consume Tylenol products. Production and advertising were halted. And Tylenol capsules already in stores were recalled (at an estimated cost of some $100 million), while company executives worked tirelessly to resolve the crisis.

The Perfect Apology

- Acknowledges the mistake or wrongdoing
- Accepts responsibility
- Expresses regret
- Provides assurance that the offense won't be repeated
- Is well timed

Burke also went public – appearing, for example, on *60 Minutes* – to reaffirm the company's mission. "Our first responsibility is to our customers," he said in an early statement, and he wasted no time inviting consumers to return their bottles of Tylenol for a voucher: "Don't risk it. Take the voucher so that when this crisis is over we can give you a product we both know is safe."

In short, given the nature of the crisis, Burke extended the virtually perfect public apology. He promptly acknowledged the problem. He accepted responsibility. He expressed concern. And he put his money where his mouth was: Not only did he offer to exchange all Tylenol capsules already purchased for Tylenol tablets; he promised new, secure packaging to make certain that the problem would never be repeated.

Marketing experts had opined that the Tylenol brand would not survive – but they were wrong. Within a year, Tylenol (in tamper-resistant packaging) had regained 90% of its market share. If anything, both the company and the brand emerged from the crisis with their reputations enhanced.

As Burke's response to the crisis confirmed, promptness and appropriate timing are important components of a good apology. Consider the case of Exxon (now Exxon Mobile), which was notoriously laggard in apologizing for the effects of the *Exxon Valdez*'s disastrous oil spill along the coast of Alaska in 1989. The company's initial response to the crisis? Silence. CEO Lawrence Rawl waited six days to speak to the media, and he refused to visit the scene of the spill until nearly three weeks after it happened. In fact, Rawl never fully acknowledged the extent of the problem, and Exxon's statements to the public were weak and inconsistent. By the time Exxon extended an apology of sorts, in a print ad, it was too little too late. This slow, inadequate response to the disaster cost Exxon dearly. Customers cut up Exxon credit cards and refused to buy Exxon products, and the company was ultimately obliged to pay huge sums in fines and reparations: $2.5 billion to clean up, $1.1 billion to cover the various settlements, and another $5 billion to compensate for recklessness. Its refusal to acknowledge its role in an environmental disaster left a stain on its reputation that persists to this day.

The point is, good apologies usually work. Bill Clinton's apology for his relationship with Monica Lewinsky did finally enable him to tamp down the media frenzy and better focus on his job as president of the United States. What's more, apologizing did not hurt him one whit in the polls: At the end of his presidency, his job approval rating remained high, at 66%. Similarly, John Chambers, Vicente Fox, Pat Robertson, Lawrence Summers, and others who stumbled were either forgiven as soon as they apologized or, at least, given license to move on. On a more significant level, German reparations and the explicit apologies extended by Willy Brandt and other post–World War II German leaders for Hitler's crimes against the Jews made a big difference, especially in the relations between Germans and Jews.

We can tentatively say, then, that when leaders publicly offer apologies that are both timely and good (as I defined "good" earlier in this article), those apologies have a positive effect. There is no evidence of a good apology that backfired.

Refusing to Apologize

Given the advantages of public apologies promptly and properly extended, why is it that leaders so often refuse to apologize, even when a public apology seems to be in order? Their reasons can be individual or institutional. Because leaders are highly visible, their public apologies are likely to be personally uncomfortable and even professionally risky. Leaders may also be afraid that the admission of a mistake or wrongdoing will damage or destroy the group or organization for which they are responsible – particularly if there is the threat of litigation. There can be good reasons for hanging tough in tough situations, as we shall see, but it is a high-risk strategy.

In times of crisis or scandal, the instinctive reaction of corporate leaders in particular is to deny, and then to deny again. Executives are disinclined to admit to a problem, often even veering in the other direction. Jeffrey Skilling insisted he was "immensely proud" of what he had accomplished at Enron; and once upon a time, Martha Stewart called allegations that she was guilty of insider trading "ridiculous." Of course, denials like these are often the work of lawyers who insist that their clients stonewall, lest an apology be considered an admission of guilt.

But it's risky to insist on innocence when the evidence is obviously to the contrary. Bridgestone/Firestone and Ford provide a notorious example. Their problems began in February 2000, with a televised report of fatal rollover accidents involving Ford Explorers equipped with tires made by Bridgestone/Firestone. Product liability cases are not uncommon in the United States – but they do not normally involve, as did this one, more than 115 deaths. As a result of the flood of complaints that ensued as soon as the problem was made public, the National Highway Traffic Safety Administration started investigating Firestone in May 2000.

Three months later, the pressures were such that the company gave in and issued a recall. But the fact that executives at Bridgestone, the parent company, remained for several weeks all but inaccessible to inquiries, and then stonewalled for months, badly exacerbated the situation, especially since the media stayed with the story, featuring personal tales of tragedy accompanied by lurid photographs of crashed vehicles. In September 2000, corporate leaders from both Bridgestone/Firestone and Ford were called to testify before Congress. However, instead of using the occasion to win over the huge audience – all three major TV networks led with the story on their evening newscasts – executives from both companies came across as being less than open and honest. Moreover, they remained entirely unapologetic, appearing more determined to play down the problem than to confront it.

The story ended badly for Bridgestone/Firestone and Ford. The public relations disaster was so damaging and the fear of litigation so great that both companies finally decided they had no choice but to apologize. Shortly after the appearance in Congress, Masatoshi Ono, then CEO of Bridgestone/Firestone, told the Senate Commerce Committee, "As chief executive officer, I come before you to apologize to you, [to] the American people, and especially to the families who have lost loved ones in these terrible rollover accidents. I also come to accept full and personal responsibility on behalf of Bridgestone/Firestone for the events that led to this hearing." (Later, during a deposition in Nashville, Ono testified that his apology was not to be construed as an admission of fault. To forestall legal liability, he said he had done no more than express sympathy.) Some time later, Ford followed suit. Throughout the crisis, then-CEO Jacques Nasser had insisted that Ford was not to blame: "This is a tire issue," he claimed, "not a vehicle issue." But in the end, the company's stance softened. Attorneys for Ford settled a lawsuit with, and extended a well-publicized bedside apology to, a woman who had been paralyzed in an accident involving a Ford Explorer mounted on Firestone tires. Like Bridgestone/Firestone, though, Ford said its apology did not constitute an admission of fault or legal liability.

LEADERS should not apologize often or lightly. There needs to be a good, strong reason.

Of all the recent refusals of corporate leaders to apologize, perhaps none is more striking than that of Raymond Gilmartin, CEO of Merck from 1994 to 2005. Merck performed well during the first half of Gilmartin's tenure, but it stumbled badly on the back nine. (On the last trading day of 2000, Merck shares closed at $88.61; on Gilmartin's last day at the helm, May 5, 2005, the stock closed at $34.75.) Notably, Gilmartin's last months were clouded by what at this writing threatens to be a calamity: some 7,000 lawsuits against Merck, involving the use of its painkiller Vioxx.

The *New York Times* observed that as the company's Vioxx crisis deepened – the drug has recently been linked in FDA research by David Graham to up to 139,000 heart attacks or deaths arising from cardiac causes – Gilmartin appeared to freeze. Not only did he not apologize; he could hardly get himself to address the issue. And when he did, he was defensive. He insisted that Merck had demonstrated "consistent and rigorous adherence to scientific investigation, transparency and integrity," and he attacked his opponents for disseminating "incomplete and sometimes inaccurate information." When Gilmartin resigned – earlier than planned – he left without in any way assuming responsibility or expressing regret.

Which raises the following questions: Why might Gilmartin have decided to hang tough – and was it the right decision?

There is the possibility that Gilmartin did not apologize simply because he honestly believed he had nothing to apologize for.

Or perhaps he did not apologize because every time a leader publicly apologizes for anything other than personal misconduct, one constituency is being served – but only at the expense of another. Merck is a big company, and an apology by Gilmartin might well have implicated other members of the organization. In situations like these, loyalties are at stake, and so is self-interest. A leader who fails to stand firm risks losing support among the rank and file and even control of the situation.

Or Gilmartin may have concluded that admitting to even a single mistake would leave his own reputation in ruins. As we have seen, leaders typically apologize publicly only if and when they calculate the costs of doing so to be lower than the costs of not doing so. Stonewalling, then, is common.

Finally, Gilmartin might have determined that admitting to even a single mistake would leave the company vulnerable–to the exigencies of the marketplace, to the ambitions of competitors, and to the rapaciousness of a litigious society.

It is, of course, impossible to know what would have happened had Gilmartin acted differently, had he decided to express some measure of responsibility and contrition. But with the benefit of hindsight, Raymond Gilmartin's approach seems ill-advised. His last five years as CEO were obviously dismal. They constitute a record for which he cannot and will not escape blame. Moreover, others in the company–for example, scientists who suspected that Vioxx could be unacceptably risky but who chose to stay silent–are proving vulnerable as well. Perhaps most telling is the fact that Gilmartin failed to keep the floodgates of litigation closed and, in fact, might well have helped to pry them open.

As it turns out, there is evidence that stonewalling is not necessarily smart even in the most potentially litigious situations. Ameeta Patel and Lamar Reinsch of Georgetown University concluded in their study of corporate apologies that the folklore about the legal consequences of apologies is simplistic and misleading, to the detriment of all concerned. They found that apologies can make positive contributions, even "to the apologists' legal strategy." Conversely, the evidence suggests, the refusal to apologize–the unwillingness to accept any responsibility or to express any remorse for situations in which there could clearly be some culpability – can get leaders and their followers into trouble.

We can safely presume that by refusing to apologize, Gilmartin and his successor, Richard T. Clark, were following the advice of company lawyers, who warned that Merck had no choice but to keep mum. It's still possible that the company will do well in court, since the outcomes of most of the thousands of cases against Merck are not yet known. But as Merck bleeds–in November 2005, it announced that it would cut 7,000 jobs and close or sell five plants worldwide – it is hard to imagine that things would have been worse if Gilmartin in particular had assumed some responsibility for the Vioxx crisis and expressed some regret.

Saying Sorry – Selectively

Apologizing in public is not easy, especially for leaders. They are heroes when things go right – and scapegoats when things go wrong.

In addition, public apologies extended by corporate leaders are not, even under the best of circumstances, without risk to their companies. Several experts have warned of the possible downsides. Mary Frances Luce, a marketing professor at Wharton, points out that while apologies can moderate customers' anger, they can also strengthen the negative associations between the brand and the problem. Her colleague Stephen Hoch suggests that since firms tend to deal with a heterogeneous group of customers, a mass apology can be risky simply because not everyone requires an apology. In fact, as Hoch notes, large numbers of customers are likely not even to know about the problem, so when a company apologizes for its inappropriate or illegal behavior, some will say, "Hey, I didn't know you were doing that kind of stuff." And Chris Nelson, a vice president of the global public relations firm Ketchum, cautions that unless apologies are extended wisely and well, "[t]hey might only ensure that the company will face huge legal judgments." He adds, "That's a shame because proper communications often can drain significant amounts of public animosity from a situation." Which is precisely the point. Even those who prescribe caution agree that a good apology made in a timely fashion is more likely to ameliorate a bad situation than to exacerbate it.

We have more anecdotal evidence than hard data on what exactly apologies accomplish. Yet academic research conducted so far does suggest that leaders are prone to overestimate the costs of apologies and underestimate the benefits. We know, for example, that apologies often defuse the anger of those who were injured or feel wronged. In a recent British study of malpractice patients, 37% said they would never have gone to court in the first place had an explanation and an apology been extended. Similarly, a study conducted at the University of Missouri showed that contrary to the conventional wisdom – which is that a defendant in court is smart to avoid an admission of guilt – full apologies are more rather than less likely to result in quick settlements of lawsuits.

In fact, the more severe the injury, the more important the apology is to a resolution of the conflict. Robert Rotberg, the director of Harvard University's Program on Intrastate Conflict and Conflict Resolution, has studied South Africa's Truth and Reconciliation Commission and concluded that apologies can create the possibility of closure in even the most extreme postconflict situations: "The delivery of apology from a dominant side to an aggrieved minority, or from each or all of the contenders mutually, can calm long roiled waters and greatly assist in effecting a successful transition."

President George W. Bush – initially, anyway – took the opposite approach in fielding criticism about the war in Iraq. Whatever your position on whether the United States should have invaded Iraq to begin with, and whatever your position on how the administration has handled the conflict since then, you were probably struck by President Bush's long-standing refusal to admit to anything more than a single "miscalculation," particularly during the period that is officially postwar. This in light of a war that has been longer, messier, and bloodier than anyone in the administration had predicted – and in light of a series of scandals, including those involving torture, for which only a few down the ladder have been held responsible.

We will never know what would have happened had the president been more willing to acknowledge the problems in Iraq earlier. Clearly, Bush was betting that time was on his side – that if he held out long enough, events would turn in his favor. But his certitude, his rigidly held opinion that you can't lead the world if you say you made a mistake (to paraphrase Georgetown University linguist Deborah Tannen), did not yield the result he'd hoped. The situation in Iraq remained unstable at best, and the president's approval ratings, which translate into his capacity to govern effectively, suffered a steep decline. In short, the cost of President Bush's insistence that he appear impervious to human error was high – which explains why, in a series of public appearances toward the end of 2005, Bush finally was more open and honest. While he did not go so far as to apologize, he did specifically acknowledge and assume responsibility for several mistakes. (Almost immediately thereafter, the president's approval ratings went up, five points in some polls, seven in others.)

In the wake of Carly Fiorina's ouster from Hewlett-Packard, *Wall Street Journal* columnist Carol Hymowitz asked, "Is it suicidal to admit publicly that things haven't gone as expected and own up to mistakes? Or should business leaders always appear confident, even invincible?" There are no strict rules on dealing with matters of the human condition. But by looking at both hard data and anecdotal evidence, we can establish some guidelines for when and how a leader should make a public apology.

As I pointed out earlier, a public apology should serve an important individual, institutional, intergroup, or moral purpose. That being said, if the offense is institutional rather than individual, the top leader (the CEO, for example) is not necessarily the best person to extend the apology. Sometimes the institution is better served if someone further down the organizational ladder acknowledges the problem and expresses regret. In other words, leaders of groups and organizations should consider apologizing publicly only if and when a critical interest is at stake, and only if and when they're the only ones who can do the work that needs to be done.

How best to apologize depends on the nature of the situation. A full apology includes acknowledgment of the offense, acceptance of responsibility, expression of regret, and a promise not to repeat the offense. But sometimes a partial apology – for example, the acceptance of responsibility or an expression of regret – is better than nothing. Further, while apologies generally should follow hard on the heels of the transgression, lest the offending individual or institution be viewed as avoiding blame or

A Framework for Apologies

When you or the people you lead mess up, it's not easy to decide whether or not to apologize publicly – or to determine how best to do so. Here are some questions that can guide your approach.

What function would a public apology serve?
- Are you or your organization right? If so, could extending an apology serve your interests anyway?
- Are you or your organization wrong? If so, could extending an apology get you out of a tough situation?

Who would benefit from an apology?
- You personally?
- Your organization more generally?
- Other individuals and institutions you relate to?

Why would an apology matter?
- For strategic reasons?
- For moral reasons?

What happens if you apologize publicly?
- Will an apology placate the injured parties and hasten the resolution?
- Will an apology incite the opposition?
- Will an apology affect your legal jeopardy?

What happens if you don't apologize?
- Is time on your side – will the problem likely fade?
- Will your refusal to apologize (or your refusal to do so promptly) make a bad situation worse?

as begrudging in its atonement, there are situations – for instance, when large numbers of people have suffered – in which haste makes waste.

Even when an apology *is* too late, though, it doesn't have to be too little. When doctors at Duke University Hospital made the catastrophic mistake of transplanting the wrong heart and lungs into a 17-year-old girl, who subsequently died, the hospital's immediate response was to say nothing. In fact, the hospital might not have owned up to the problem at all had it not been for the avalanche of bad publicity. But once the decision was made to come clean, Ralph Snyderman, then CEO of the Duke University Health System, did so openly and honestly. No fewer than nine press releases were issued in five days, and Snyderman agreed to be interviewed by Ed Bradley on *60 Minutes.* On camera, Snyderman admitted the mistake, took responsibility, expressed remorse, and vowed that the hospital would do everything it could to preclude such a calamity from ever happening again.

Once he came forward, Snyderman was able to defuse the situation and resolve the crisis in a way that, under the circumstances, was deemed satisfactory by all concerned. (A few months later, the hospital also agreed to establish a $4 million fund for Latino pediatric services, in memory of the girl who died.) Herein lies an important leadership lesson: In crisis situations particularly, a less-than-perfect apology is often better than no apology at all.

Even so, a good apology will yield better results than a bad one – and "good" has everything to do with selectivity. Here, then, are the answers to the question, When should a leader apologize?
- when doing so is likely to serve an important purpose
- when the offense is of serious consequence
- when it's appropriate that the leader assume responsibility for the offense
- when no one else can get the job done
- when the cost of saying something is likely lower than the cost of staying silent

Unless one or more of these conditions pertain, there is no good reason for leaders to apologize. An apology that is misguided or ill conceived can actually do more harm than good. When an apology is obviously in order, though, even a partial apology is likely to help both leaders and their followers. Similarly, when an apology is called for but none is given, anger and hurt can fester and difficulties may escalate. As recently as late last year (about five years after the fact), Joseph Nocera, a business columnist for the *New York Times,* was still excoriating Stephen Case and Gerald Levin for marrying AOL to Time Warner – and for then failing to take responsibility. Wouldn't Case be more credible, Nocera mused, "if he could just bring himself to say he was sorry" for putting together the "merger from hell"? And for that matter, "has Levin ever apologized for his role in bringing about the dumbest merger of the modern age? I must have missed it."

Most apologies are motivated by self-interest. But the reason they matter is because, ultimately, they serve a larger social purpose. When leaders apologize publicly, whether to or on behalf of their followers, they are engaging in what Tavuchis calls a "secular rite of expiation," which cannot be understood merely in terms of expediency. The attempt to come clean is more than an explanation and more than an admission: It is an exchange in which leaders and their listeners engage in order to move on. It is in turn this transition, from the past to the future, that enables the course correction that mistakes and wrongdoing require.

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To order, see page 151.

For a quarter century, the big winners in consumer markets have pursued strategies of standardization. But success for retailers and product manufacturers now hinges on their ability to cater to local differences – while maintaining scale efficiencies.

by Darrell K. Rigby and Vijay Vishwanath

LOCALIZATION

THE REVOLUTION IN CONSUMER MARKETS

We're in the early stages of a quiet revolution in consumer markets. For decades, the chains that have dominated the landscape – titans like Wal-Mart, Best Buy, and McDonald's – have pursued single-minded strategies of standardization. They've fine-tuned their store formats, merchandise mixes, and operating and marketing processes, and they've rolled out their winning formulas internationally. They've demanded equally rigorous consistency from suppliers, pushing the standardization ethic deep into consumer product companies and across the entire consumer supply chain.

PETE MCARTHUR


TOMATO
SOUP
TOMATO AND PEPPER
SOUP
TOMATO AND SQUASH
SOUP
TOMATO AND SQUASH
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TOMATO AND SQUASH
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SOUP
TOMATO AND PEPPER
SOUP

But the era of standardization is ending. Consumer communities are growing more diverse – in ethnicity, wealth, lifestyle, and values. Many areas, moreover, are now saturated with big-box outlets, and customers are rebelling against cookie-cutter chain stores that threaten the unique characteristics, such as architectural styles and favored brands, of their neighborhoods. When it comes to consumer markets, one size no longer fits all. In response, smart retailers and consumer goods companies are starting to customize their offerings to local markets, rolling out different types of stores, product lines, and alternative approaches to pricing, marketing, staffing, and customer service. They're moving from standardization to localization.

Combining sophisticated data analysis with innovative organizational structures, they're gaining the efficiencies of centralized management without losing the responsiveness of local authority. The greatest benefit of moving from standardization to localization is strategic. Standardized offerings discourage experimentation and are easy for competitors to copy. (Sam Walton openly referred to Kmart as the "laboratory" he copied while growing Wal-Mart.) Customization encourages local experimentation and is difficult for competitors to track, let alone replicate. When well executed, localization strategies can provide a durable competitive edge for retailers and product manufacturers alike.

Reinventing the Big Box

Although standardization has been a powerful strategy in consumer markets, it's reached the point of diminishing returns. Customers are becoming more diverse, according to studies by geodemographers, people who study the population characteristics of specific geographic areas. Measuring ethnicity, age, wealth, urbanization, housing styles, and even family structures, the demographic company Claritas determined in the 1970s that 40 lifestyle segments were sufficient to define the U.S. populace. Today, that number has grown to 66, a 65% increase.

Diversity is not the only nail in standardization's coffin. Many large chains have erected so many stores that they're literally running out of room to expand. They can't open new outlets without cannibalizing old ones. Standardized chains are also meeting with other constraints: Where attractive locations are still available, attempts to build stores often face fierce resistance from community activists. From California to Florida to New Jersey, neighborhoods are passing ordinances that dictate the sizes and even architectural styles of new shops. Building more of the same – long the cornerstone of retailer growth – has been tapped out as a strategy.

Finally, standardization can do the most strategic damage by forcing products and practices into molds. The resulting homogenization of business tends to undermine innovation, all the way up the supply chain. Managers become so focused on meeting tight operational targets – and stamping out exceptions – that they begin to consciously avoid the experimentation that leads to attractive new products, services, and processes. In the end, standardization erodes strategic differentiation and leads inexorably toward commoditization – and the lower growth and profitability that accompany it.

The good news is that there's a way out of standardization's dead end. Technological advances, from checkout scanners and data-mining software to Internet stores and radio frequency identification (a wireless technology that uses small electronic tags to identify and track objects), are providing retailers and their suppliers with deep insight into local preferences and buying behaviors. For the first time, mismatches in supply and demand at individual stores can be pinpointed immediately. The new data make it possible to "localize" stores, products, and services with unprecedented precision. (For an example of the new insights technology can deliver, see the sidebar "Mining the Internet.")

Our analysis of 30 localization leaders, including Best Buy, Tesco, and VF, documents these benefits. Even Wal-Mart, the sultan of standardization, is moving toward localization. The company has made customization the cornerstone of its "store of the community" strategy, announcing that it plans to tailor formats and products to the local clientele in every store in its chain.

Wal-Mart uses a rigorous process to ensure that customization does not undermine its traditional efficiency. That process begins when a store is still on the drawing board. Company real-estate teams deeply research the local customer base when scouting for locations. Designers then create the store's format by combining suitable templates – stores near office parks, for example, with prominent islands featuring ready-made meals for busy workers. Templates allow Wal-Mart to maintain considerable economies of scale. The company has also developed a sophisticated logistics system, encompassing 110 distribution centers in the United States alone, to manage complex delivery schedules quickly and efficiently.

Through its Retail Link program, Wal-Mart works with suppliers to tailor store merchandise with similar precision. Built on a vast database, Retail Link provides both local Wal-Mart managers and vendors with a two-year history of every item's daily sales in every Wal-Mart store. Using the Retail Link Web portal, Wal-Mart and its suppliers can create maps of local customer demand, indicat-

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ing which merchandise should be stocked when and where. For example, Wal-Mart stocks about 60 types of canned chili but carries only three nationwide. The rest are allocated according to local tastes. Five years ago, Wal-Mart used just five planograms (diagrams showing how and where products should be placed on retail shelves) to adapt its soup selection to local preferences. Today, with the help of Retail Link, Wal-Mart and its suppliers use more than 200 finely tuned planograms to match soup assortments to each store's demand patterns – raising soup's growth rate by several points in the process. Product companies also use the system to track their sales and inventory levels in Wal-Mart's stores and distribution centers and to develop pricing and marketing programs to boost sales.

Thinking in Clusters

As Wal-Mart and other leaders have discovered, successful localization hinges on getting the balance right. Too much localization can corrupt the brand and lead to ballooning costs. Too much standardization can bring stagnation, dooming a company to dwindling market share and shrinking profit.

Striking the right balance means understanding which elements of a business should be considered for localization, how costly they are to customize, and how much impact they will have from one store to another. Far from being an all-or-nothing game, localization can take place in myriad ways (see the exhibit "What, Where, and When Should We Localize?"). For one retailer, it might make sense to have a highly localized staffing approach but a standardized product mix, while another retailer may warrant the opposite. Similarly, a manufacturer might localize product features in one area and retailer incentives in another. While it may be prohibitively expensive to customize a product to many locations, it may be possible to gain similar benefits by tailoring the product's packaging or promotions at a far lower cost. Wal-Mart found that while ant and roach killer sells well in the southern United States, consumers in the northern states are turned off by the word "roach." After labeling the pesticide as "ant killer" in northern states, the company has seen sales increase dramatically, according to John Westling, senior vice president.

Of course, customization has its limits. Even with rich data, a company can't customize every element of its business in every location. The sheer complexity would be overwhelming, leading to spiraling costs, if not paralysis. That's why leading localizers have begun using clustering techniques to simplify and smooth decision making, focusing their efforts on the relatively small number of variables that usually drive the bulk of consumer purchases.

Rather than letting local managers' decentralized decisions fragment economies of scale, the pioneering companies have developed a science of analyzing data on local buying patterns to identify communities that exhibit similarities in demand. For example, American Eagle Outfitters, a retailer of fashionable casual wear with 740 U.S. stores, found that customers in western Florida exhibited seasonal purchasing patterns and price elasticities that closely matched those of certain communities in Texas and California. By tailoring assortments and promotions to such clusters of locations rather than to individual stores, companies like American Eagle can benefit from customization while holding on to most of the efficiencies of standardization.

The customization-by-clusters strategy, which Bain first applied to grocery stores in 1995, has proven effective in drugstores, department stores, mass merchants, big-box retailers, restaurants, apparel companies, and a variety of consumer goods manufacturers. Clustering sorts things into groups, or clusters, so that the associations are strong between members of the same cluster and weak between members of different clusters. Clusters enable manageable, modular operations – think again of Wal-Mart's store templates – that capture most of the benefits of customization while also simplifying decisions and protecting economies of scale. Consider a merchandise manager who has to decide how to stock 100,000 items in 1,500 stores for 365 days each year. If she wanted to customize the mix, she would have to make about 54.8 billion decisions (100,000 × 1,500 × 365), many of which would be based on such small sample sizes that the predictions of even sophisticated models would be meaningless. If, however, the merchandise could be clustered into 2,500 classifications, the stores could be clustered into 20 similar types (for example, Latino border locations or upscale suburban places), and the timing (back to school, winter holidays) could be broken into 52 weeks, the number of decisions would be reduced to 2.6 million, which a modern computer model can optimize fairly easily. (For a discussion of a particularly powerful statistical technique used in sorting through many variables, see the sidebar "CHAID: Clustering by the Numbers.")

Best Buy is using clustering to move away from a standardized big-box strategy. It has revamped close to 300 of its 700 U.S. stores, introducing "customer-centric" formats to appeal to local shoppers. The company identified five representative types of customers. First, there's "Jill," a busy mother who is the chief buyer for her household and wants quick, personalized help navigating the world of technology. In Eden Prairie, Minnesota, the company designed a store that caters to the needs of this busy suburban moms segment. The company found that this group of previously untapped consumers offered the best opportunity for expansion in the region. To attract this group, the store has an uncluttered layout with wider aisles and warmer lighting, and technology-related toys for children. Personal shopping assistants educate technology neophytes about products, and there's more floor space allocated to household appliances. Although the store still serves other, more traditional electronics shoppers, the company hopes the store can boost its sales by attracting a set of local customers that have felt overwhelmed inside a Best Buy store.

Other stores are being designed around the remaining four types of customers and are based on local demand patterns. For example, there's "Buzz," a technology junkie who wants the latest gear for entertainment and gaming. Stores catering to Buzz have lots of interactive displays that allow shoppers to try out new equipment and media. Then there is "Barry," an affluent, time-pressed professional is looking for high-end equipment and personalized service. Stores tailored to his needs feature a store-within-a-store for pricey home-theater setups. Stores made with "Ray" in mind emphasize moderately priced merchandise with attractive financing plans and loyalty programs for the family man on a budget who wants technology that can enhance his home life. Finally, for small-business customers, there's a set of stores with specially trained staffs, extensive displays of office equipment, and mobile "Geek Squads" of service technicians.

While the chain plans to phase out these individual names beneath its banner, the terminology helped Best Buy crystallize the vision of each target customer for each cluster of stores.

By customizing stores in clusters, rather than individually, Best Buy has been able to maintain many of the scale economies that have long underpinned its success. So far, the new strategy is delivering strong results. The 85 Best Buy stores that had been localized as of early 2005 posted sales gains two times the company's average. Encouraged, the company is accelerating the conversion, with plans to change over all its U.S. stores in three years and localize outlets in other countries as well.

So how do you get started with clustering? Begin by collecting as many data as possible on key elements of your business for each store. (Use the exhibit "What, Where, and When Should We Localize?") If some information is missing or hard to get, don't wait for it to be collected. Use what's readily available to launch the analysis, recognizing that clustering always gets better over time. Use the data to develop clusters and identify customization opportunities. Then estimate the economics (including both sales and costs) of localizing the most promising elements of the customer offering – using as few clusters as possible. A clothing retailer, for example, might find that localized markdown policies offer attractive returns and that climate is the key variable influencing markdown decisions. Further analysis may determine that a small number of store clusters – three, say – will be sufficient to gain the optimum economic benefit. For merchandise mix, by contrast, the key variable might be customer lifestyle, which may require a dozen clusters to get the maximum payoff.

Diversity in the Product Line

As big retailers shift away from standardization, the ripple effects will reshape the entire consumer supply chain. Consumer goods companies will need to introduce more variations into their lines, collaborating closely with retailers to put the right products in the right places at the right times with the right pricing and promotion programs. Manufacturers in general have been slow to make this change. Although they conduct extensive consumer research to develop specialized products for unique segments, they have little confidence that rigid retailers will

What, Where, and When Should We Localize?

Many different elements of a company's business can be customized, separately or in combination. In consumer markets, a useful way to think about the elements is to arrange them into three categories: what's being sold ("offer"), where it's being sold ("location"), and when it's being sold ("time"). The table provides a generic overview of this organization.

WHAT: Offer Variables

Branding
- Store (banner names)
- Product labels
  - Vendor brands
  - Proprietary (private brands)

Store formats
- Size and layout
- Store design type

Merchandise space and assortment
- Division
- Category
- Department
- Classification
- Attributes
  - Style and flavor
  - Color
  - Size
- Good/better/best range
- Pack counts
- Packaging design

Pricing
- Everyday low vs. high-low policies
- Ranges
- Points
- Matching policies

Promotions
- Types
- Temporary price reduction levels
- In-store displays
- Markdown policies
  - Frequency
  - Depth

Vendor policies
- Information sharing
- Expense sharing
- Product collaboration

Marketing programs
- Spending levels
- Media mix
- Major messages

Store service levels
- Store hours
- Labor quality and schedules
- Delivery policies
- Checkout stations
- Special services (e.g., delivery, repair)

Vendor services
- Direct store delivery
- Replenishment and stocking
- Customer education

Operating policies
- Inventory levels
- Sourcing strategies
- Shrink controls
- Information Sharing

WHERE: Location Variables

Consumer characteristics
- Demand patterns
  - Store purchase
  - Area purchase
- Geodemographics and attitudes
  - Population density
  - Age
  - Income
  - Marital Status
  - Ethnicity
  - Religion
  - Lifestyle segment
  - Psychographic

Special Demand Drivers
- School seasons
- Hunting and fishing seasons
- Activities and sights
  - Ski resorts
  - Beach towns
  - Athletic teams
  - Tourist attractions
  - Military bases
- Special events
  - Cinco de Mayo
  - Pioneer Day
  - Religious holidays
- Climate zone
  - Temperature
  - Precipitation
  - Potential weather events

Competitor Characteristics
- Store saturation levels
- Market share
- Store locations
- Store formats
- Pricing levels
- Promotion policies
- Marketing programs

Our Own Store Characteristics
- Our market share
- Our store locations
  - Location characteristics
  - Site quality ratings
- Our store formats
  - Sizes
  - Design types (models)
  - Condition
  - Square footage allocation
  - Special fixtures and displays
  - Merchandise placement zones
- Stores of our sister divisions
  - Locations
  - Merchandise mix

WHEN: Time Variables

Hour	Week	Season
Day	Month	Year

CHAID: Clustering by the Numbers

One of many clustering techniques is called CHAID, short for chi-squared automatic interaction detection. A statistical classification method proposed by G.V. Kass in 1980, CHAID sorts items into groups that are statistically different with respect to criterion or outcome. For example, if we want to know what groupings are associated with store profitability, CHAID might show us that money-losing stores are in high-income neighborhoods with multiple competitors, while the most profitable stores are in rural areas and have the capacity to carry the full product assortment.

A significant benefit of CHAID is that it enables us to analyze the effects of characteristics in combination rather than independent from one another. For example, adding playgrounds to Burger King restaurants may have no impact on average but could be very profitable in suburban restaurants near high populations of young children and very unprofitable in downtown locations with expensive real estate and few children.

Let's demonstrate the process with a department store chain we'll call SuperStuff:

CHAID begins with a list of every store in the SuperStuff system and as much information as possible about each – including sales data by location, time, and item. There is no need to worry about entering too much information, since CHAID will highlight only the variables that create statistically significant differences.

We can then use CHAID to find the combinations of characteristics that best explain any variable we choose to explore. In the example "Assessing Store Profitability," we used CHAID to understand what drives EBIT margins (earnings before interest and taxes) among SuperStuff's 508 department stores.

CHAID begins, at the top, by showing us that the average EBIT margin is 4.2% for SuperStuff's entire population of stores.

CHAID then identifies the first differentiator of EBIT margins as the presence of at least one KillerMart in each SuperStuff store's trade area. The 198 SuperStuff stores with no nearby KillerMarts have an EBIT margin of 6.4%. The 310 SuperStuff stores near KillerMarts have an average EBIT margin of only 2.8%. Sensible, but not terribly surprising so far. The next steps are where CHAID proves most valuable.

For the 310 stores near a KillerMart, CHAID finds that household income levels drive significant profit differences. The 188 stores in neighborhoods with household incomes of more than $50,000 have average EBIT margins of 3.9%. The remaining 122 stores have margins of only 1.1%.

The data also enables CHAID to generate remodeling ideas. Of the 188 stores in higher-income neighborhoods near KillerMarts, the 113 that have allocated more than 50% of their square footage to apparel have EBIT margins of 5.3%. The 75 stores with less than 50% allocated to apparel have EBIT margins of only 1.8%. Apparently, plentiful apparel assortments in high-income areas can help SuperStuff to profitably compete against KillerMart's offering.

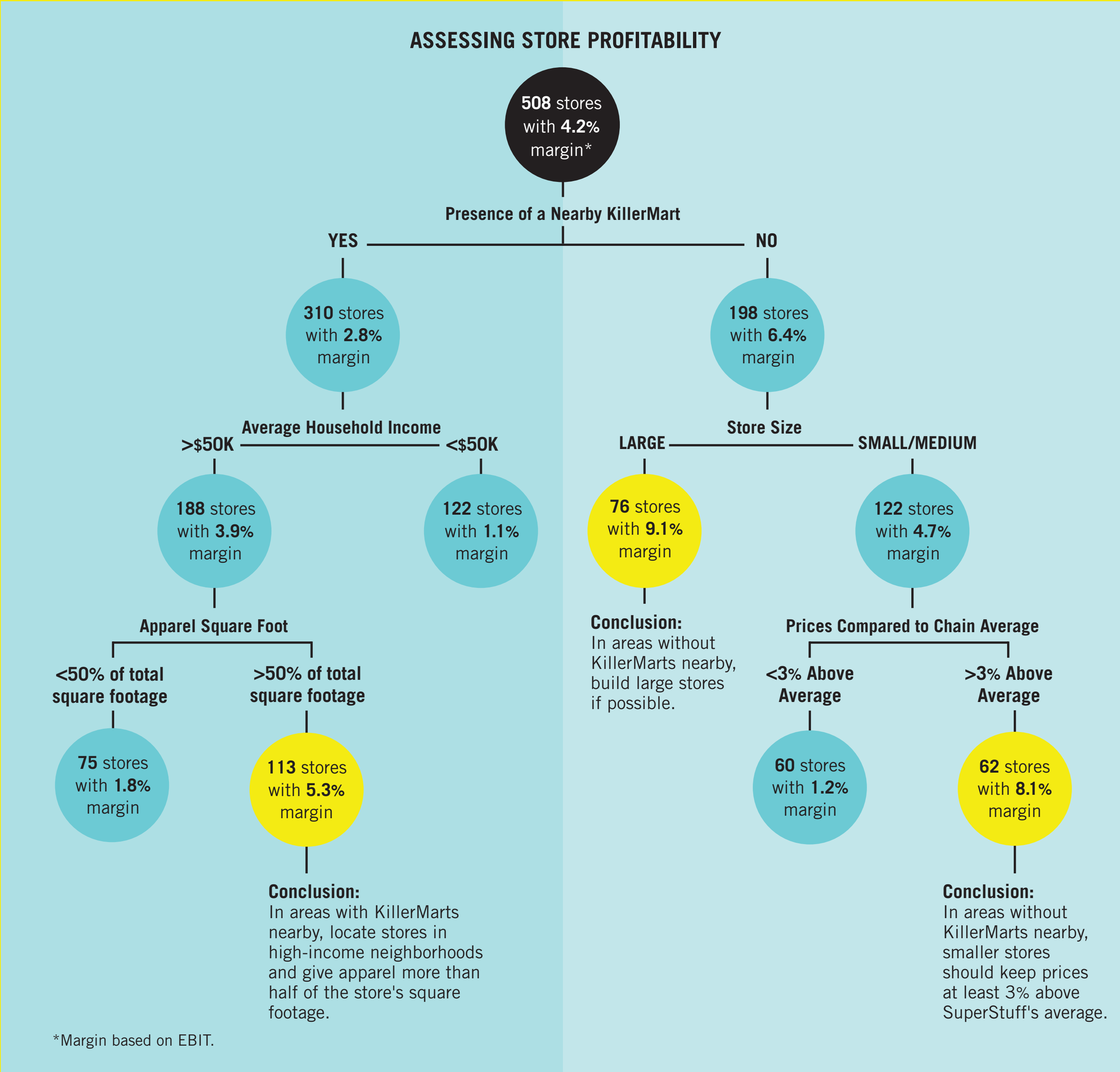
Jumping to the right-hand side of the CHAID tree, we learn about stores that don't face KillerMarts. In those areas, the 76 large-format stores have an average EBIT margin of 9.1%, almost twice as much as the 122 small or midsize stores, which have a margin of only 4.7%. Furthermore, the 60 small or midsize stores that priced an average market basket of groceries less than 3% above SuperStuff's overall average had an EBIT margin of only 1.2%. However, the 62 small or midsize stores with prices more than 3% above SuperStuff's average have a margin of 8.1% – almost seven times more than the 60 stores pricing less than 3% above the average. It seems that small or midsize stores may do better by raising prices in less competitive markets.

While CHAID certainly doesn't provide all the answers, it can help to surface testable hypotheses such as the following:

- When opening new stores, avoid locations near KillerMarts.
- If there is a KillerMart in the area (or one coming soon), position stores in the highest-income neighborhoods.
- When remodeling stores, especially those near KillerMarts, consider allocating more than 50% of the floor space to apparel.
- Smaller stores in areas without KillerMarts should test price increases.

sort, merchandise, and market custom products to the right customer clusters. Products developed for senior citizens will pile up in college communities – slowing inventory turns, forcing costly markdowns, and often leading retailers to drop potentially profitable niche products.

Nevertheless, as growing numbers of retailers are rolling out their own versions of Wal-Mart's Retail Link – including Lowe's (LowesLink) and Target (Partners Online) – a handful of consumer product companies are seizing the advantage by learning to localize. When one food company introduced low-calorie versions of some of its snack foods, it shipped additional cases to stores near Weight Watchers clinics. Cadbury added kiwi-filled chocolate Cadbury Kiwi Royale in New Zealand. Kraft developed Post's Fiesta Fruity Pebbles ready-to-eat cereal especially for Hispanics. Coca-Cola has developed four canned, ready-to-drink coffees for Japan, each formulated for a specific region. Procter & Gamble introduced Curry Prin-

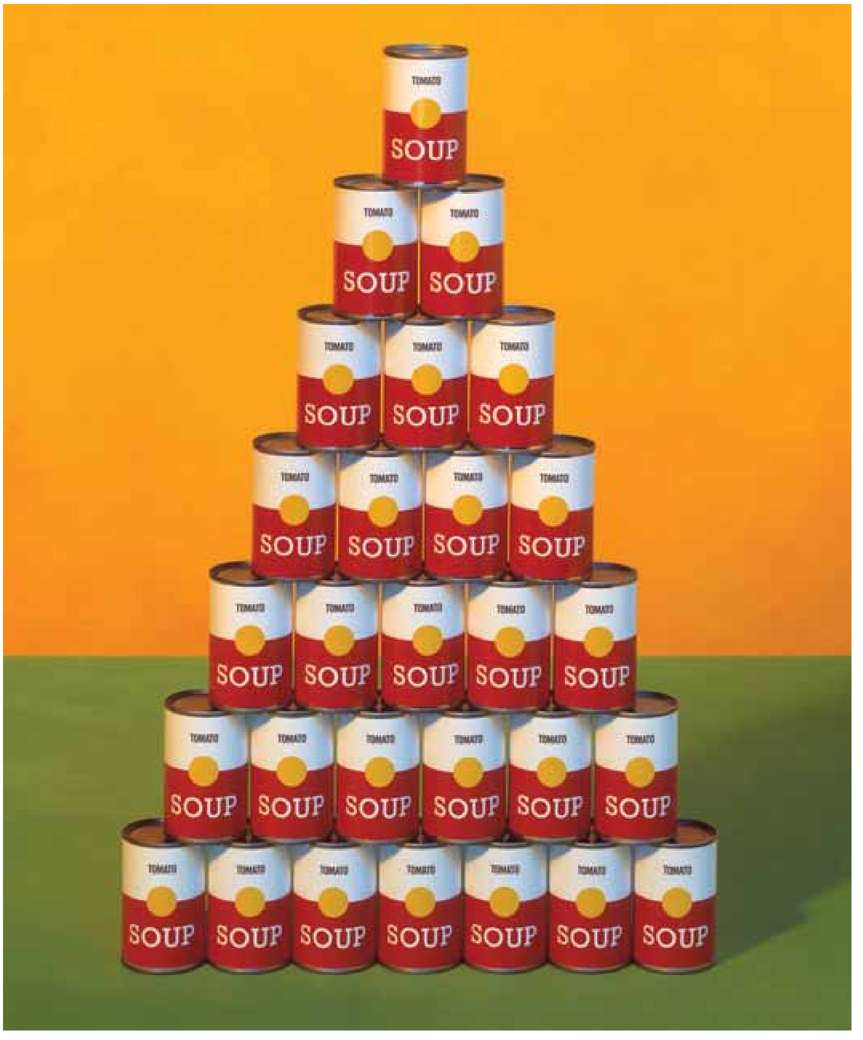


gles in England and, later, Spanish Salsa flavor in England and other parts of Europe and Funky Soy Sauce Pringles in Asia. Frito-Lay developed Nori Seaweed Lay's potato chips for Thailand and A la Turca corn chips with poppy seeds and a dried tomato flavor for Turkey.

One of the leading localizers is consumer products giant VF, a $6 billion apparel maker that owns such popular jeans brands as Lee and Wrangler as well as upscale labels including Nautica and North Face. VF integrates many data sources to identify customization opportunities – to the delight of retailers and consumers. "It is not unusual for localization to improve sales by 40% to 50% while simultaneously reducing store inventories and markdowns," says Boyd Rogers, VF's president for supply chain. "We consider our localization capabilities to be one of our most powerful competitive advantages."

VF combines third-party geodemographic and lifestyle data with daily store-level sales data, extensive consumer research, and competitor analysis to develop localization strategies with retailers, such as Kohl's. VF has found, for instance, that while many buyers now desire lighter-weight denim, male Hispanics still prefer heavier weights. Women in southern California tend to buy shorter denim skirts than those in northern California. Even stores in the same metropolitan area can exhibit very different demand patterns for jeans and other clothes. A store in a community with a large immigrant population, for example, will tend to have greater demand for smaller-size clothing than a store surrounded by nonimmigrant Americans – a subtle testament to America's obesity problem.

For one U.S. chain, VF created 40 clusters, based largely on consumer lifestyle segments and purchasing patterns. Product assortments, marketing strategies, and supply chain systems are tailored to each cluster. VF uses rapid data exchanges to study each store's daily point-of-sales data – not just to replenish shelves but also to discover new demand trends in colors and styles and foster innovation. Through such efforts, VF and its retailers are boosting sales substantially while also avoiding markdowns and returns.



Central Control, Local Touch

A shift to localization raises big management and organizational challenges. The early movers are, in fact, breaking through the old "centralization/decentralization compromise." But it's tricky. Executives' first instinct is often to empower local managers, giving them control over, say, the selection of products on store shelves or major promotional programs.

Such decentralization often backfires, for two simple reasons. First, local managers lack the depth of data, and often the skill, to make consistently smart decisions about buying, merchandising, and operations. Second, giving local managers too much leeway can introduce costly complexity and inconsistency into a business. Indeed, our research found that large manufacturers are less willing to collaborate with, or offer their best terms to, highly decentralized retailers.

J.C. Penney discovered this the hard way in the late 1990s, when it ran into problems by allowing store managers to determine order quantities. Local managers turned out to be too conservative. Seeking to minimize risk, they would buy a wide variety of goods rather than concentrate on hot items. As a result, the stores ran out of popular products quickly and were left with swollen stocks of slow sellers. And because headquarters lacked information on what was in each store, central managers couldn't even see the problems. Between mid-1998 and the end of 2000, Penney's stock price plummeted from $54 to $8.

Then, in 2000, Penney's embarked on a successful turnaround program under the direction of its then-new CEO, Allen Questrom. Penney's went from a decentralized company whose buying and markdown decisions were made at the stores to a centralized, data-driven organization. The management team classified stores into seven clusters on the basis of size and customer demand patterns, developed merchandise and fixture modules, and consolidated purchase orders. It also developed demand-based optimization techniques – allowing product and price ranges, replenishment policies, as well as the timing and depth of markdowns to be tailored to store clusters. Over the next five years, Penney's stock price more than tripled. Comparable department store sales (sales of stores open for 12 consecutive months), having eroded 2.3% in 2000, rose 3.4% in 2001 and 5% in 2004.

As Penney's discovered, efficient localization requires that most decisions be coordinated centrally, by managers with a broad view of demand patterns and sufficient store-level data to distinguish real insights from random noise. To support headquarters decision makers, leading retailers are building sophisticated information systems that draw from many sources – census and other demographic research; data from store scanners and loyalty cards; consumer surveys and unsolicited comments; Internet sales data; data from third-party syndicators like ACNielsen; and intelligence on competitors. Local managers and personnel are also critical sources of information – often picking up signals that computerized systems can't see. When Wal-Mart, for example, introduced kosher food to its store in Berryville, Arkansas, it was acting on a recommendation from the store manager. The company's other data sources had not uncovered the nearby Jewish community.

Central coordination is also essential to forging close relationships between retailers and product suppliers. Product manufacturers have deep knowledge about how

Extreme Localization

While localizers typically customize 5% – 25% of a standardized format, extreme localizers are developing a range of new – but closely related – shopping formats to give targeted customers more convenient purchasing options. This is not conventional segment-based expansion, where retailers build portfolios of brands to serve different sets of customers (think Talbots for women, Talbots for men, and Talbots for kids). Rather, this is sophisticated localization based on insights into three emerging trends in consumer markets:

>> TREND: Consumer purchasing patterns vary not just by segment but also by purchase occasion.

Cross shopping is increasing. The same consumers who buy their computers at a big-box electronics store are heading to a neighborhood electronics shop to pick up one-off peripherals (accessories such as mice, printer cartridges, and cables). By way of response, Best Buy is turning insights from its customer-centric stores into new store formats that draw targeted segments of customers who don't always want to slog through the big box. They are testing out smaller, more convenient stand-alone formats with the launch of Geek Squad stores; Escape, a store that provides 25- to 29-year-old technology buffs a place to hang out; and Studio D, a cozy, neighborhood technology store for the suburban mom who stocks up for the family at Best Buy's large formats but fills her personal technology needs closer to home.

>> TREND: Technological advances allow for more meaningful sharing of customer knowledge and supply costs when chain stores are selling the same items through multiple formats.

By capitalizing on common information systems, supply chain logistics, and purchasing processes, Tesco has embarked on extreme localization in the grocery sector – and is increasing margins and service levels in the process. Through its loyalty cards, Tesco sees what, where, and when customers buy across the full range of store formats. On the basis of that knowledge, Tesco has built five specialized food formats in the UK: Tesco Superstore, a traditional grocery store for weekly suburban shopping; Tesco Extra, a one-stop hypermarket for large shopping trips; Tesco Metro, a smaller supermarket for customers in high-density urban areas; Tesco Express, a tiny convenience store tailored to quick trips in local neighborhoods; and Tesco.com for Web shoppers. Each of these formats is, of course, clustered and localized to meet specific needs. Metro stores, for example, often provide sandwiches at lunchtime, then create prepared meals for customers to pick up on their way home for dinner.

>> TREND: Multiformat customers are generating higher profits and deeper behavioral insights.

Bain's research shows that multiformat customers – those, for example, that buy from a chain's superstore, catalog, Web site, and neighborhood store – typically spend two to six times as much with a retailer as single-format customers do. Each positive experience builds scale and loyalty, making customers more profitable to the retailer and less likely to be seduced by competitors at vulnerable decision points. Additional sales generate additional insights into consumer behaviors under a wide variety of shopping conditions. They provide greater opportunities to test innovative approaches.

Small-scale retailers used to count on local knowledge and scarce real estate to protect them from the big boys. But those barriers are crumbling as sophisticated chains stretch information technology and creative formats. Extreme localization pioneers are building powerful platforms for innovation. Better yet, they are finding space for new growth in crowded landscapes and improving their economics and customer loyalty in the process.

The era of STANDARDIZATION is ending. Consumer communities are growing more DIVERSE–in ethnicity, wealth, lifestyle, and values.

goods sell across all stores in a region. Retailers have equally deep knowledge about how products sell across their networks of stores. Combining those two troves of information allows for a much more comprehensive understanding of both local demand patterns and the way they may cluster across regions.

Leading from the center does not mean that local managers become unthinking robots. In fact, by centralizing data-intensive and scale-sensitive functions such as store design, merchandise assorting, buying, and supply chain management, localization liberates store personnel to do what they do best: Test innovative solutions to local challenges, engage with store guests, and forge strong bonds with their communities. Wal-Mart's store managers are legendary for highlighting hot items and responding to local pricing challenges. Best Buy encourages store employees to create and test hypotheses and share what they have learned throughout the chain. One Best Buy employee recently hypothesized that she could raise store sales by making iPods easier to find. She moved a display to the front of the store, created a shirt that said, "iPods here," and raised the store's sales ranking from 240th to 69th. 7-Eleven knows that corporate headquarters could never predict a busload of football players arriving on a Friday night, but the store manager can. Combining the efficiencies of a national chain with the entrepreneurial touches of a mom-and-pop convenience store, 7-Eleven has created a system that it calls "centrally decentralized."

Mining the Internet

Many retailers have opened online stores to complement their traditional outlets. But the Web is not just a sales channel; it's also a powerful means of collecting data on variations in local demand. Because online stores can offer extensive ranges of products to national, or even global, customer bases, they can track consumer demand patterns much more broadly and precisely than physical stores can. In a traditional store, after all, you never know what the demand might have been for a product you don't have on the shelves. Online stores use centralized merchandise pools to avoid local stock-outs, and excess demand can often be back-ordered for future delivery. By carefully tracking the home addresses of online buyers as well as the products they're buying (or avoiding), chains that maintain Internet stores can use online sales data to inform decisions about what merchandise to stock in which store. And because the online data can be collected in real time, shifts in physical stores' merchandise mixes can be made quickly to respond to spikes in local demand.

A World of Difference

Localization isn't free. The shift requires greater investment in data collection and analysis. And however sophisticated the clustering effort, some economies of scale will need to be sacrificed–in purchasing, marketing, manufacturing, and store construction. Most companies will want to focus their initial efforts on areas offering the greatest and quickest return. For example, the investment is typically lower and the payback faster on localizing markdowns (typically less than one year) than localizing base prices (often two years or more). But as localization skills grow, so do localization opportunities. The systems, data, and organizational processes that first enable a company's leap to localized markdown strategies greatly ease subsequent steps to the localization of pricing, promotion, and marketing programs. (For examples of retailers pushing the frontiers of localization, see the sidebar "Extreme Localization.")

Ultimately, all companies serving consumers will face the challenge of local customization. It's often been assumed that globalization implies ever-greater homogenization of businesses and their products and services. The world, in this view, will be packed with indistinguishable big boxes selling the same goods and services to everyone. But a look at the emerging localization strategies of the leading companies in consumer markets–companies that once shunned customization but now embrace it–reveals how mistaken this assumption is. We are advancing to a world where the strategies of the most successful businesses will be as diverse as the communities they serve.

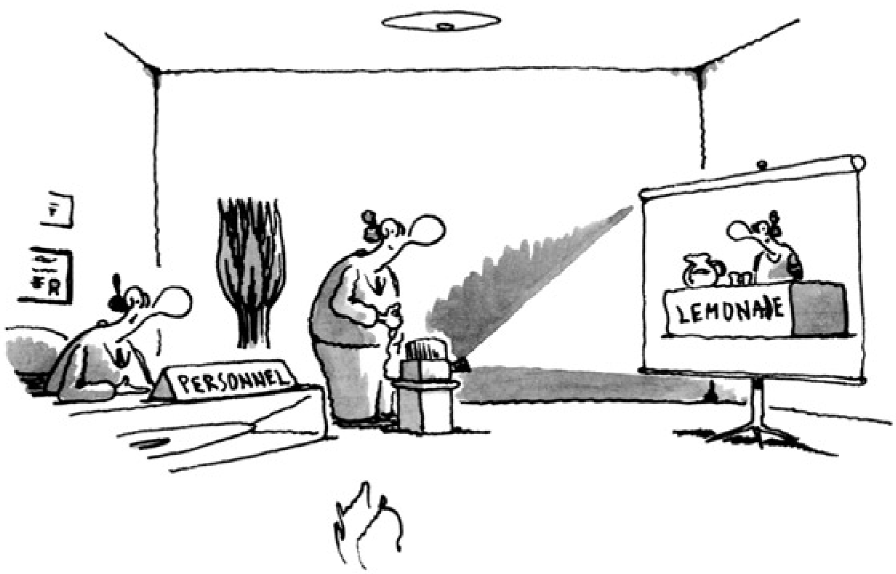
Reprint R0604E; HBR OnPoint 4109
To order, see page 151.

Ego Trip

"You can't go far in business without a good dose of confidence.... [But] chances are that there have been times when you were *too* confident, when your optimism overpowered your judgment....You were very sure – and you were very wrong."

J. Edward Russo and Paul J.H. Schoemaker
"The Overconfidence Quiz"
Harvard Business Review
September–October 1990

"Those who fail to learn from history's mistakes, gentlemen, are destined to be our biggest customers."



"That's enough work history, Mr. Adams. Let's get on with the interview."

DREW DERNAVICH, BILL LONG, SCOTT ARTHUR MASEAR, AND ROBERT J. ZASADNY

"You should have saved a wish for tax exemption."

"When I say the 'greater good,' Benson, I mean myself."

"The chairman will now dance his vision for Crabco in the twenty-first century."

HBR Spotlight

INNOVATION
Improving Your Odds

Bob Dylan once wrote, "He not busy being born is busy dying." That sentiment could serve as the theme for a good third of the articles in the business press, including the ones that appear in these pages. Executives are continually enjoined to innovate and, by innovating, to grow their companies. It's not just the business press exerting pressure; the markets, too, insist that companies grow both the top and the bottom line, quarter after quarter, year in, year out. This market impatience reflects a fundamental economic reality: Companies can't succeed by standing still. So business executives keep themselves extremely busy – creating new products, exploring new markets, adopting new business models, and inventing new organizational cultures.

Dylan's lyric suggests a messy, creative – perhaps even traumatic – process of innovation. And of course aspects of innovation are purely creative. But, increasingly, business innovation is about discipline. It's about building a framework, or adopting a perspective, within which ordinary people can grow something extraordinary. In this spotlight section, we explore two such frameworks. Both articles are about the importance of connecting what you do internally to what's happening externally.

Ron Adner's article, "Match Your Innovation Strategy to Your Innovation Ecosystem," looks at the problem of developing a technology that's only one piece of a final product. Invention that takes place within a complicated "ecosystem" presents timing problems that don't usually occur in consumer product development. Michelin, for example, has invented a tire that allows you to continue driving for up to 100 miles even if your tire has been punctured, but few consumers even know about this advance, because Michelin hasn't yet persuaded more than a few car manufacturers to adopt the product. Adner's article describes a method for assessing project risks when, like Michelin, you are dependent on other companies (not end users) for two things: complementary technologies, and partners who must adopt and incorporate your technology into theirs. Numerous case stories in this article make one thing perfectly clear – inventing a cool new technology is often easier than getting it into the hands (or onto the automobile) of someone who can use it.

"Manage Customer-Centric Innovation – Systematically" suggests that companies need to spend as much time – and money – on "customer R&D" as they do on product R&D. This is one of a number of articles HBR has published recently (all by different authors) on overhauling customer segmentation and, with it, the process by which new products are developed. Larry Selden – who helped Best Buy develop its new, focused store formats – and Ian MacMillan – who has done groundbreaking research on product development – offer a practical, step-by-step guide for reinventing product development and product extension.

As Peter Drucker said in HBR many years ago, innovation is as much about discipline as it is about creativity. These two articles are well matched in that they bring new discipline to the work of innovation; in both cases, the discipline will force practitioners to look outside the boundaries of the firm.

Successful innovation requires tracking your partners and potential adopters as closely as you track your own development process.

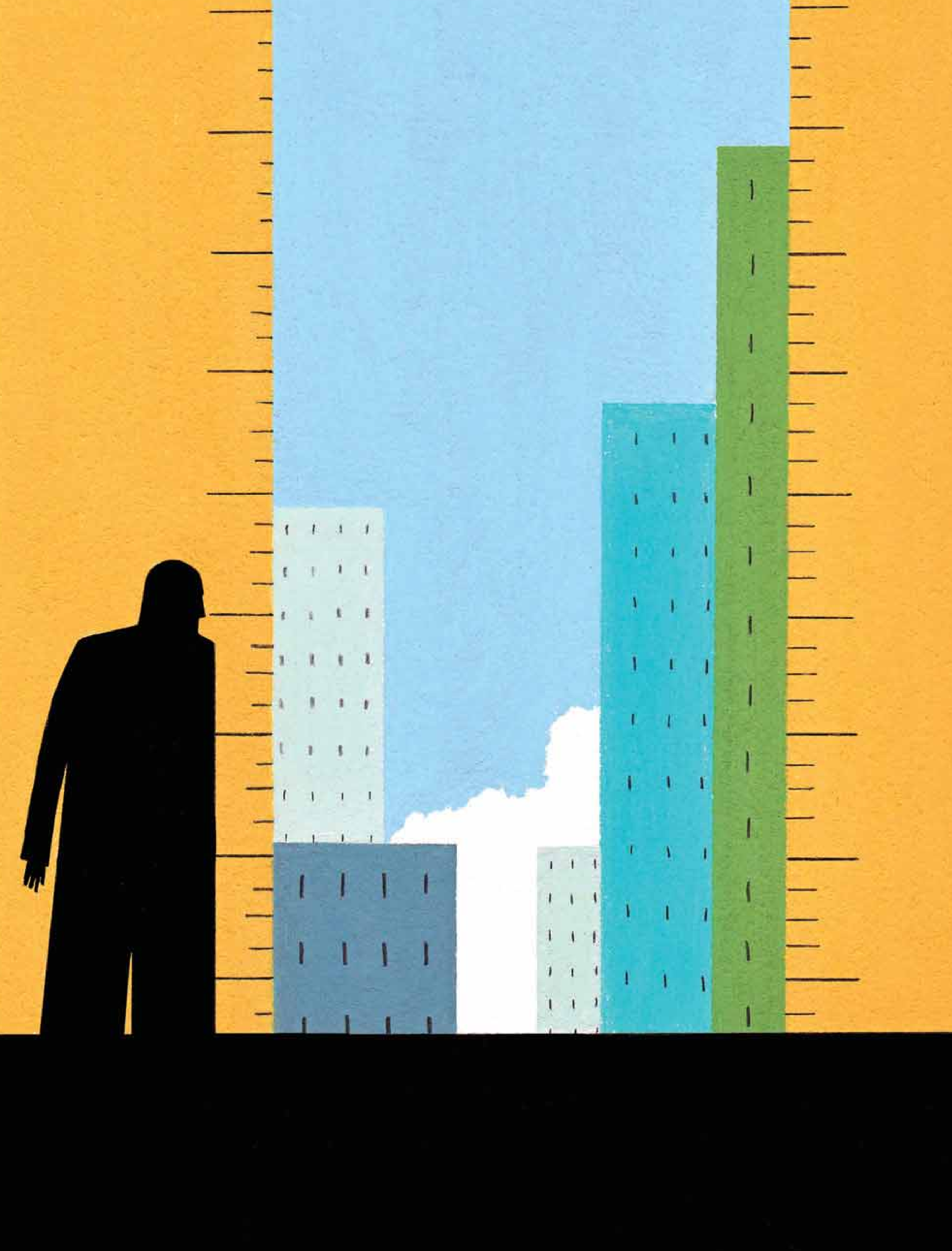
by Ron Adner

Match Your Innovation Strategy to Your Innovation Ecosystem

High-definition televisions should, by now, be a huge success. Philips, Sony, and Thompson invested billions of dollars to develop TV sets with astonishingly high picture quality. From a technology perspective, they succeeded: Console manufacturers have been ready for the mass market since the early 1990s. Yet the category has been an unmitigated failure, not because the consoles are deficient, but because critical complements such as studio production equipment, signal compression technologies, and broadcasting standards were not developed or adopted in time. Underperforming complements have left the console producers in the position of offering a Ferrari in a world without gasoline or highways–an admirable engineering feat, but not one that creates value for customers. Today, more than a decade later, the supporting infrastructure is finally close to being in place. But while the pioneering console makers waited for complements to catch up, the environment changed as new formats and new rivals emerged. An innovation that was once characterized as the biggest market opportunity since color TV is now competing for consumer attention in a crowded market space.

The HDTV story is a poster child for the promise and peril of *innovation ecosystems*–the collaborative arrangements through which firms combine their individual offerings into a coherent, customer-facing solution. Enabled by information technologies that have drastically reduced the costs of coordination, innovation ecosystems have become a core element in the growth strategies of firms in a wide

GEOFF GRANDFIELD



range of industries. While leading exemplars tend to come from high-tech settings (think Intel, Nokia, SAP, and Cisco), ecosystem strategies are being deployed in industries as varied as commercial printing, financial services, basic materials, and logistics provision.

When they work, ecosystems allow firms to create value that no single firm could have created alone. The benefits of these systems – discussed under such labels as platform leadership, keystone strategies, open innovation, value networks, and hyperlinked organizations – are real and well publicized.

For many companies, however, the attempt at ecosystem innovation has been a costly failure. This is because, along with new opportunities, innovation ecosystems also present a new set of risks – new dependencies that can brutally derail a firm's best efforts. Even if a firm develops its own innovation brilliantly, meets and exceeds its customers' needs, and successfully excludes its rivals, a market may not emerge. Whether – and when – it emerges is determined as much by the firm's partners as by its own performance.

Depending on others for your own success has important strategic implications. Timing is nearly always affected: Getting to market ahead of your rivals is of value only if your partners are ready when you arrive. Resource allocation is another strategic consideration: Because critical bottlenecks may reside outside your own organization, allocating resources externally – to partners – can be more effective than allocating resources internally, to your own project. Yet the most important strategic implication is that risk assessment changes dramatically. The due diligence processes in place at most companies are designed to assess opportunities in which the firm can create value on its own. When value is created in an ecosystem, meeting the traditional benchmarks is necessary, but not sufficient, for success.

Absent a systematic approach for analyzing the risks in an ecosystem, the due diligence process will be incomplete. This is a problem because due diligence is central to setting expectations for the new initiative – the benchmark against which results will be measured. When project expectations are based on shaky foundations, success and failure seem increasingly random despite the best project-management efforts. In other words, bad expectations undermine good execution.

The common mistake that managers make is to plan out the full ecosystem, pick their position within it, and act with all haste to create and defend their role in delivering an integrated product or service to the end customer. By setting strategy with a focus on this goal, managers tend to overlook the process, and the order, through which their ecosystem will emerge over time. Creating strategy that explicitly accounts for the delays and challenges that are inherent in collaborative networks is the key to succeeding in ecosystems.

The success of your company's growth strategy hinges on how well you assess your ecosystem's risks. How, then, can you assess these risks in a structured, systematic way? A first step is to specify the different categories of risk that ecosystems present and to understand how they relate to the markets you hope to serve. Innovation ecosystems are characterized by three fundamental types of risk: *initiative risks* – the familiar uncertainties of managing a project; *interdependence risks* – the uncertainties of coordinating with complementary innovators; and *integration risks* – the uncertainties presented by the adoption process across the value chain. The extent of these risks is intimately related to the target market in which the firm hopes to deploy its innovation. (These three types of risk and their interplay appear in the exhibit "Formulating an Ecosystem Strategy.")

When they work, ecosystems allow firms to create value that no single firm could create alone.

Assessing Initiative Risks:
How does your project measure up?

The challenges of delivering a project on time and to specification are familiar to managers, whether the innovation is an RFID chip, a breakfast cereal, or a financial services product. Assessing such initiative risks requires evaluating the feasibility of the product itself, the likely benefit to customers, the relevant competition, the appropriateness of the supply chain, and the quality of the project team. There is extensive literature about how to approach these challenges, and I will not

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attempt to summarize those insights here. Rather, I will focus on how innovating in an ecosystem affects a firm's efforts to manage these risks. (It is important to note, however, that the firm will need to decide which initiative risks to take on internally and which are better shouldered by a partner; which risks should be internal is not written in stone.)

Assessing Interdependence Risks: Whose projects must succeed before yours can?

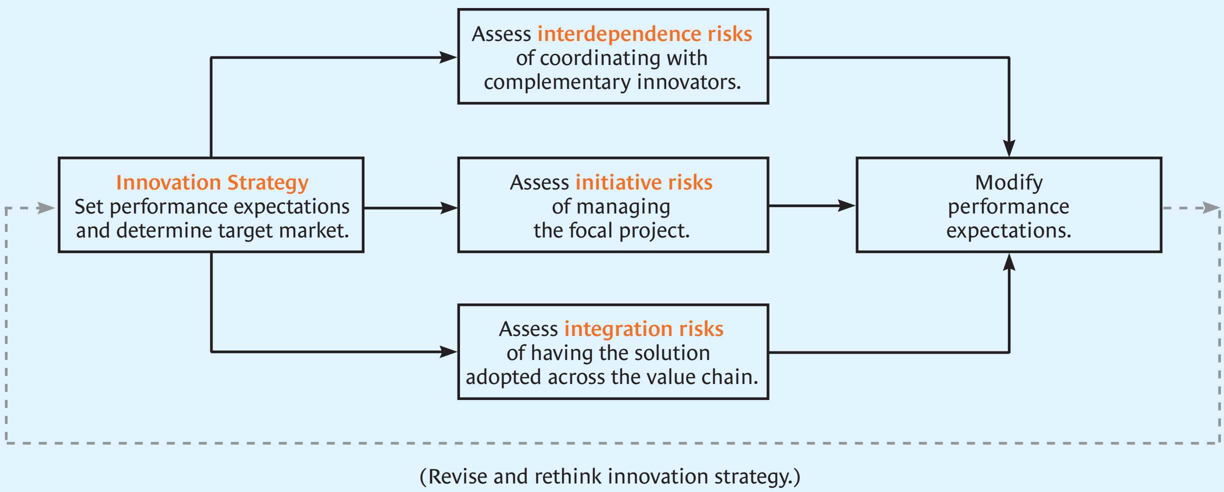
If an innovation is a component of a larger solution that is itself under development, the innovation's success depends not only on its own successful completion but on the successful development and deployment of all other components of the system. Consider the expectations set for third-generation wireless networks. In the late 1990s, mobile operators collectively bid tens of billions of dollars for spectrum licenses with the expectation of huge revenues by 2003 from the delivery of services such as real-time video and location-based content. In assessing risk, these operators focused much of their attention on whether providers such as Nokia and Ericsson would be able to overcome considerable initiative risk to deliver 3G handsets and base stations.

In order for real-time video to become a market success, however, numerous other ecosystem actors had to develop their own distinct innovations separate from the hardware makers' challenges. For example, new software was needed to reformat live video streams to fit the different screen sizes of users' handsets. Routing software was needed to interact with the operators' CRM and billing systems. Digital rights management solutions were needed to assure content owners that their intellectual property would not be pirated. In other words, the on-time delivery of suitable hardware was necessary, but not sufficient, for the on-time deployment of the solution.

Interdependence risk speaks to the joint probability that different partners will be able to satisfy their commitments within a specific time frame. The more dependent

Formulating an Ecosystem Strategy

Strategy making in an innovation ecosystem is iterative – it has to be, because there are so many interconnected pieces and players. Once managers develop a vision of what market they want to enter, with what offering, they come up with a tentative agreement on the performance expectations that would constitute success. They then uncover, and assess, the risks associated with that plan (interdependence risks, initiative risks, and integration risks). That risk assessment process often forces managers to revise their performance expectations and rethink their initial plan. This rethinking might entail accepting lower performance targets, allocating more resources to the project, reassigning development responsibility among the firm and its partners, changing the target market, forgoing the opportunity, lobbying the government for supportive regulatory changes, acquiring a competitor or partner, and so forth.



an innovation is on other developments, the less control it has over its own success.

How should the probability of success be assessed? Traditional due diligence–consulting with managers, double-checking with suppliers, examining historical precedents–yields some confidence about a project's successful completion (to spec, on time). Similar exercises can, and should, be undertaken with all key partners.

What you find out may surprise you. Suppose four suppliers meet to discuss the attractiveness of a potential collaboration. All of them commit to assigning their best resources to their respective initiatives, and all believe that the likelihood of delivering their part of the solution within one year is very high – 90%. Assume that these individual estimates are accurate. How confident should the four suppliers be in the joint venture?

The unfortunate nature of probability is that the true probability of an event taking place is equal to the product (not the average) of the underlying probabilities. While each supplier has a nine-in-ten chance of succeeding, the chance that they will all have succeeded at the end of the year is significantly lower. In this case, it is $0.9 \times 0.9 \times 0.9 \times 0.9$, which is 66%.

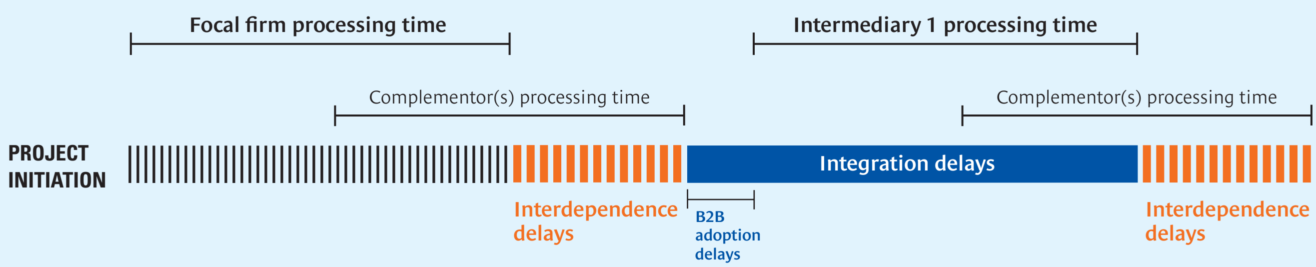
Reflect on the project review meetings that you have attended. How common is it that a room of individually confident managers recognizes the full frailty of their joint effort?

What if one of our four managers is responsible for a particularly challenging development effort, such that his probability of success is 20%? With just one weak link among the four, the joint probability tumbles to $0.9 \times 0.9 \times 0.9 \times 0.2$, which is 15%. These numerical values illustrate the argument. In real business, of course, we don't have access to such fine-grained numbers. We can, however, use simple assessments of risk – a one-to-seven scale, or high/medium/low risk across the system – and apply the same logic. In settings where risk levels are more difficult or costly to specify, going through this exercise will help

Mapping the Ecosystem

Mapping your innovation ecosystem is the best way to determine whether you have set realistic performance expectations for your innovation strategy. Following these steps can reveal where delays in getting the innovation to market might interfere with your success.

1. Identify all the intermediaries that must adopt your innovation before it reaches the end consumer.
2. Identify all the complements (other innovations needed for your innovation) required for you and each of your intermediaries to move the offer forward to the end consumer.
3. Estimate the delays caused by your interdependence with your own complementors (those adding to your innovation with their own innovations).
4. Estimate the delays caused by the adoption process and by the time it takes each intermediary to integrate your solution into its decisions, design cycle, products, and so forth (processing time).
5. Estimate the delays caused by the intermediaries' interdependence with their own complementors and the integration hurdles these intermediaries face in terms of adoption and processing delays.
6. On the basis of those estimates, arrive at a time-to-market for your innovation.
7. Now that you've identified these delays (the interdependence and integration risks), reassess your initial performance expectations and innovation strategy. If the expectations you set at the beginning of the process now seem unrealistic in light of the risks, then consider your options for closing the expectation gap (for example, change your expectations, markets, partners, or strategy).



identify which risk components would be of greatest value to explore in depth.

Now consider the venture – is 15% a bad number? No! There is no such thing as a bad number. There are only bad expectations. Recall that the venture capital industry is built on the expectation of 10%, where bets are made in the belief that nine out of ten investments will be losses. Fifteen percent is fine, as long as the manager is making the investment with an understanding of the true probability of success. Problems arise when the codevelopers gloss over the real risks: "My own initiative has a high chance of succeeding, and since two of my three partners are very confident, the total venture seems pretty secure."

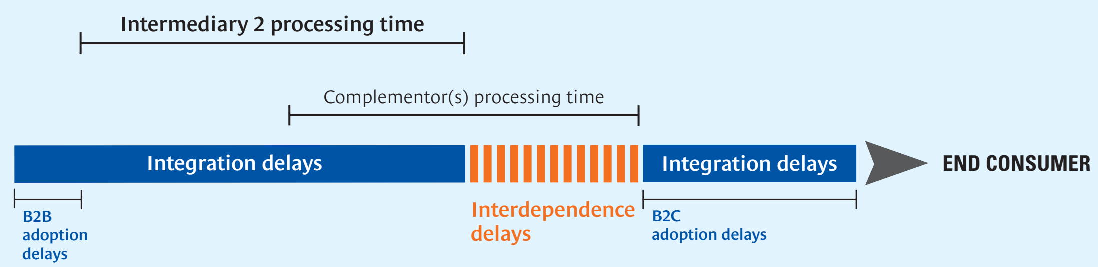
What are the implications of one partner failing to meet its commitment? Generally, failure means delays, which can last weeks, months, or years. Managers must realize that not just the laggard but all his complementors suffer the consequences. Thus, an analysis of interdependence risk can help managers identify the unintended lags and set their expectations accordingly.

The causes of interdependence risk are numerous. Partners may be late because of internal development challenges, regulatory delays, incentive problems, financial difficulties, leadership crises – even their own interdependence with other parties. An in-depth discussion of how a firm can mitigate interdependence risks is outside the scope of this article. The specifics will vary on a case-by-case basis. Note, however, that once the cause of the problem is identified, the solution often presents itself. For instance, if complements will be late to market or will be overpriced, the firm might react by finding new partners or even moving upstream into that business (as Intel did with PC motherboards). If a complementary firm doesn't have an incentive to develop its offering, the firm might create an exclusive licensing deal so that the reluctant partner doesn't need to worry about competition. If the firm is too dependent on a single partner, it might design the product with a flexible interface. And so on.[1]

Assessing Integration Risks:
Who has to adopt the solution before the customer can?

In many ecosystems, intermediaries are positioned between the innovation and the final customer. The further up the value chain an innovation resides, the larger the number of intermediaries that must adopt it before it can reach volume sales. As the number of intermediaries increases, so does the uncertainty surrounding market success.

Consider the case of Michelin's run-flat tire innovation. Unlike traditional tires, which become useless in the event of a puncture, the run-flat tire allows the driver to continue driving for 100 more miles at speeds up to 50 miles per hour, indicating its need for service with a simple dashboard light. When Michelin began developing the tire in 1992, it believed that this innovation would be as big a win as the introduction of the radial tire 50 years earlier. The company spent years and untold riches developing the tire, which it trademarked under the PAX label. However, when the tire was finally introduced in 1997, no consumer could buy it. Because the tires connect to a vehicle's electronic system, they can be used only in vehicles whose systems have been designed to accommodate them. Since electronics are added in when new cars are designed, Michelin had to wait until a willing OEM's design window opened. An average OEM takes three to four years to move a car from design to volume production. So even if the tire is fortunate enough to be designed into a car model that enjoys market success (an outcome that is far from certain), Michelin's best case is that volume sales will begin three to four years after the tire is introduced. (As it happened, even the few willing OEMs with whom Michelin coordinated design cycles initially offered it as an option on only a very limited set of models.) Michelin still needs to consider other intermediaries as well – garages, which will need to invest in new



equipment and training, and dealers, which will need to understand and support the PAX system – each of whom will have to buy into the concept before the end customer is in a position to make a purchase decision. The status of the run-flat tire speaks to the integration risks of innovation ecosystems: Nine years after its introduction, Michelin's miraculous innovation is standard equipment on only a handful of car models.

Recall that interdependence risk is assessed by *multiplying* probabilities to estimate delays caused by complementary innovators. Integration risk, in contrast, is assessed by *adding* adoption cycles to estimate delays caused by intermediaries.

As an illustration, think about a flat-screen manufacturer that needs eight months to bring a new screen to production. If end consumers require four months to become aware of a new product before they purchase it en masse, how should the manufacturer set expectations for the timing of revenues? Expectations of high revenues 12 months (8 + 4) from the start would be appropriate, but only if the manufacturer sells directly to end users. As an upstream component provider, the screen manufacturer will need to allow for the six months a consumer product manufacturer needs to develop the product into which the screen will be integrated. The screen manufacturer may also need to make allowances for the two-month channel lag during which the distributor stocks the product and trains its sales force. A goal of less than 20 months (8 + 4 + 6 + 2) is likely to lead to missed targets (and, hence, perceived failure).

What if the screen manufacturer could allocate additional resources to reengineer the internal development process and reduce development time by a heroic 50% (from eight months to four months)? In assessing the attractiveness of this investment, the manufacturer should recognize that although it may cut its own development time by half, its total time to market will be reduced by a more modest 20% (from 20 months to 16 months). A series of modest improvements along the downstream chain (for example, coordinating design, marketing in advance, managing channel incentives) may get the product to the consumer faster, and may require substantially fewer resources, than would attempting radical process changes within the firm.

Integration delays are rooted not just in development cycles but also in sales cycles – the time required for adopters at every point along the value chain to become aware of the product, agree to test it, accept the results of the trial, and then scale up their orders. Managing these adoption challenges is the bread and butter of the B2B sales function, but they're often overlooked when initial project goals and milestones are set. Expectations that do not anticipate these delays are bound to disappoint.

The wise analyst will carefully consider the costs and benefits of adoption for each intermediary along the chain. If benefits don't exceed costs at *every* adoption step, intermediaries will not move your offering down the line, and the end user will never have a chance to evaluate it. The cost-benefit assessment, indeed the very metrics used in the evaluation, often varies at different positions along the chain. The principles, however, are uniform. Cost includes *all* costs – direct (the price we charge) and indirect (switching costs, required complementary investments, the risk of something going wrong, and so forth).

It's easy to underestimate the indirect costs. For example, many large enterprises have software licenses for Microsoft Office that entitle them to upgrades at no additional cost, yet many have not shifted from Office 2000 to Office 2003. Clearly, price is not the hindering factor. Rather, it is the transition costs, which require that firm-specific applications built to run on the older generation (macros, forms, and related programs) be requalified and modified to run error free on the new platform. This process can take well over a year, and the cost of potential errors can overwhelm the perceived benefit.

The causes of integration risks are myriad and vary by setting. They are not, however, mysterious. Simply posing the question, "Where are we likely to face integration risks?" will uncover many of the critical challenges, which will in turn suggest likely solutions. For example, if intermediaries are already well into their own design cycle, the focal firm can delay its own development or pay changeover costs. If intermediaries need to readjust their processes to exploit the innovation, the firm can do the reconfiguration studies for them or price its product as a percentage of realized cost savings. A mitigation strategy that warrants mention is government intervention. Particularly in complex ecosystems, such as those in health

If benefits don't exceed costs at every adoption step, intermediaries will not move your offering down the line.

care, firms will often turn to governments in an attempt to overcome adoption inertia. For example, many IT providers are currently lobbying their governments to mandate digitized medical records. These efforts substitute one mode of delay (legislative and administrative lags) for another (the monumental collective inertia of the health care system).

The Costs–and Benefits–of Delay

Innovation ecosystems are seductive. It is easy to overestimate the potential for value creation because so many players are combining capabilities; at the same time, it is easy to underestimate the challenges, since surmounting many of them can seem like someone else's problem, not yours. Even if the market appears to be yearning for a product – think HDTV, WiMax, 3G handsets, handwriting recognition – the delays can close the window of opportunity as existing and emerging substitutes reduce the innovation's relative advantage. For example, fuel cell engines have lost some of their differentiating appeal as gasoline/electric hybrids have improved. Without a perspective on ecosystem-driven delays, managers can commit to overly aggressive targets that they will ultimately miss.

The upside of delays, though, is that in cases where an innovative firm is far ahead of its ecosystem partners, the firm may benefit from slowing down to let the rest of the system catch up. These self-imposed delays go against the grain – rushing to market almost seems hardwired in businesspeople – but they can be the logical outgrowth of a systemic risk assessment. For example, Apple Computer, with its iTunes offer, was a very late mover into the online music-retailing category, which had been pioneered in the mid-1990s. However, the category was held back by lagging complements: Without adequate digital-rights-management solutions in place, the major music labels would not condone online distribution (driving much of the action underground). Absent these critical solutions, and without the convenience of broadband connectivity, the mass market did not emerge. Apple's brilliance was not in being the first to put down a piece of the puzzle but in being the first to put down the last piece of the puzzle.

The exhibit "Mapping the Ecosystem" presents a diagram of a generic ecosystem; it clarifies the ways in which interdependence risk and integration risk contribute to delays. If you take the time to map your own system, the exercise will force you to be explicit about the timing and order in which components are expected to emerge and to confront the consequences of different delays for your innovation strategy.

Target Markets and Ecosystem Risk

The nature of ecosystem risk that an innovator will face depends on the market the innovator hopes to serve. For example, firms that make photovoltaic technologies, which convert sunlight into electricity, face very different internal and external risks in different target markets. The magnitude and character of development challenges, the required complementary innovations, and the downstream adoption requirements will vary greatly depending on whether the target market is municipal power generation (which requires generating millions of watts of power), residential backup power (a few thousand watts), or pocket calculators (a fraction of a watt).

Choosing how to trade off the size of the market opportunity and the magnitude of the inherent ecosystem risk – how to prioritize the possible options – is the essence of innovation strategy. Consider the case of pen-based computing. The holy grail, exemplified by the vision behind Apple Computer's Newton PDA, was to couple a pen interface with handwriting recognition capabilities; together, these would free users from the tyranny of the keyboard. Apple and its partners invested huge sums

A Note on Frameworks

Management frameworks in general, and strategy frameworks in particular, should be approached with suspicion. They rarely tell us anything we don't already know. (The elements presented in the framework this article describes, for example, are well known to anyone involved in innovation.) When approaching a given opportunity, we all have a certain intuition about what the right course of action is, and a framework will rarely change this belief. Quite the contrary – cynics will argue that most frameworks can be applied to make any decision look good. Indeed, they are correct.

My own perspective is that the value of most frameworks lies not in changing a manager's initial intuition but in clarifying the issues that arise when managers with different instincts try to debate the right course of action. A structured framework can transform the debate from a battle of guts, ultimately resolved on the basis of reputation, power, and eloquence (often in that order), into a comparison of the assumptions being made about a given situation's fundamental structure.

A framework presents elements and relationships that provide a grammar for the debate. These debates tend to be productive in that they are fine grained – people can move past areas of agreement, focus on areas of disagreement, and analyze why they hold different beliefs. They either achieve a consensus or make a decision knowing precisely where and why they disagree. In the case of disagreement, the debate will highlight critical assumptions that managers should be particularly mindful of as the venture progresses.

attempting to realize this vision and hence redefine personal computing. They ended up offering an imperfect system whose technical shortcomings led to terrible publicity and, ultimately, withdrawal from the market.

In contrast, Palm also used a pen-based interface but eliminated handwriting recognition. The technology required users to enter their data using a specially adapted symbol set, the Graffiti system, which was much easier for the product to process correctly. In doing so, Palm significantly diluted the value proposition of the original PDA and changed the size of the opportunity. The Newton had attempted to replace personal computers, whereas the Palm attempted to replace date books. Lowering its sights in this way meant that Palm dramatically increased the likelihood of success, albeit in a smaller market.

Although the run-flat tire hasn't taken off in the commercial market, it has met with success in the smaller, yet still significant, defense market, where it is used as a substitute for track treads in vehicles such as the U.S. Army's Stryker troop carrier. With fewer intermediaries, more concentrated buyers, and greater perceived benefit, the military market was a better fit, at least in the short run.

Multiple target markets are available for almost any innovation. Ecosystem maps for different target markets can vary dramatically, even when the core innovation remains the same. A complete view of the different ecosystems is the key to effectively assessing options and prioritizing opportunities.

Strategy in Ecosystems

A growing number of firms in both high- and low-technology industries are pinning their hopes for profitable growth on platforms, services, and solutions. Many of these ventures will not meet their target expectations unless every element in a family of complementary innovations succeeds. Managing this risk is no small challenge. Failure in ecosystems is sometimes caused by technical difficulties in stand-alone innovations and sometimes by the difficulty of coordinating innovations across the system. Often, though, failure occurs because a market does not emerge within the time frame required to support the investment. When you compete in an innovation ecosystem, you must expect and plan for delays, compromises, and disappointments that are, to a substantial extent, outside your control. You should either craft an innovation strategy that mitigates your risks or consider forgoing the opportunity.

In some ways, this message should feel like familiar ground. Ecosystem challenges can be viewed as traditional project management challenges writ large, extending beyond the firm's usual internal boundaries to encompass external factors. That said, crafting strategy in an ecosystem requires the firm to consider traditional questions in somewhat nontraditional ways:

Where to compete. When ecosystem risks are high, markets are uncertain regardless of a firm's confidence in its own innovation. In prioritizing market opportunities, it becomes increasingly important to assess both the project and the system. A complete assessment may show that an opportunity with low internal risks and high external risks is inferior to one with the opposite risk profile.

When to compete. Development costs often rise exponentially when schedules are compressed. Such costs are justified when being first to market offers significant advantage. In an ecosystem, however, being ready with your component ahead of your direct rivals may not confer any advantage if your complementors are not ready when you are. Correct expectations of innovation interdependence and value chain integration may lead firms to slow their development cycle and, in doing so, both conserve their resources and benefit from opportunities to update their strategies over a longer time period.

How to compete. Operating in an ecosystem takes the issue of boundaries (determining which activities to undertake within the firm, which to undertake with partners, and which to take to the open market) to a new level of complexity. Beyond assessing incentives and capabilities, the firm must also address the question of ecosystem leadership. Firms face a choice between taking an active or a passive role in guiding ecosystem development. If you lead an ecosystem, you'll have a chance to tailor its development to your own strengths. (Marco Iansiti and Roy Levien in *The Keystone Advantage* and Annabelle Gawer and Michael Cusumano in *Platform Leadership* provide a rich exploration of these issues.) However, attempting to take the leadership role carries its own risks: It often requires massive resource investments over long periods of time before you find out whether the opportunity is real and whether you have managed to secure the orchestrator role. Taking a less ambitious ecosystem role also requires new choices – which leadership candidates to follow, how aggressively to commit, how to defend turf. In all cases, a clear understanding of the full ecosystem and its dynamics is critical for successful strategy.

When it comes to managing strategy execution, companies are generally on firmer ground, since they confront challenges in managing complementary innovators and adopting intermediaries every day. Established organizational functions take on different management tasks: Supply chain management coordinates with upstream partners, project management oversees the focal innovation, B2B and B2C marketing manages relations with downstream adopters, and business development works with complementary innovators. Managers in these roles have practiced routines for accommodating and adjusting to emerging challenges.

Although these managers' routines are often effective, it is worth reflecting on whether, and how, their *collective* input is incorporated into the initial process of setting performance expectations. Without a clear process for assessing ecosystem risks, they are unlikely to formulate strategy by seeking input from the full set of actors. The likely, and more common, process is that managers in different roles, confronting ecosystem challenges that were not considered in the original strategy, make tactical adjustments – the familiar, reactive changes to project specification, target segment, scope of the offer, partner support allocations – that collectively lead to unintended changes to the strategy. A group risk-assessment process will deliver better expectations and more relevant strategy. (See the sidebar "A Note on Frameworks.")

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Conventional wisdom holds that the success of managers depends on the results they deliver. But what is often overlooked is that these results are themselves evaluated relative to expectations. It is results *relative to expectations* that determine success or failure. In reflecting on Apple's Newton disaster, analysts have argued the problem had less to do with the performance of the Newton itself than with the sales expectations that had been set. Bad expectations can destroy value as easily as bad execution. Consider, however, the relative allocation of time, resources, and energy your firm devotes to setting project goals compared with managing the project after the goals have been determined. Setting expectations is extraordinarily important to the success of a new venture; never an easy task, it is even harder, and even more critical, in the context of new opportunities whose success depends on the success of wholly separate developments. If managers learn to assess ecosystem risks holistically and systematically, they will be able to establish more realistic expectations, develop a more refined set of environmental contingencies, and arrive at a more robust innovation strategy. Collectively, these actions will lead to more effective implementation and more profitable innovation.

Bad expectations can destroy value as easily as bad execution.

1. I am grateful to my students, whose research projects brought to light many of the examples used in this article, and to Matthew Krepps for his insights on mitigation strategies.

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It takes more than good intentions to innovate in a customer-centric way. A disciplined process of customer R&D at the front lines will turn wishes into an enduring competitive edge – and a growing market cap.

by Larry Selden and Ian C. MacMillan

Manage Customer-Centric Innovation – Systematically

No matter how hard companies try, their approaches to innovation often don't grow the top line in the sustained, profitable way investors expect. For many companies, there's a huge difference between what's in their business plans and the market's expectations for growth (as reflected in firms' share prices, market capitalizations, and P/E ratios). This growth gap, as we call it, springs from the fact that companies are pouring money into their insular R&D labs instead of working to understand what the customer wants and then using that understanding to drive innovation. More often than not, the traditional approach thrills R&D teams, but not customers or investors. As a result, even companies that spend the most on R&D remain starved for both customer innovation and market-capitalization growth.

Having collectively worked with senior executives of hundreds of companies all over the world and in all kinds of industries – from heavy manufacturing to abstract research, from retailing to financial services – we have developed a process for making innovation deliver results that meet or exceed market expectations. We call this process customer-centric innovation. CCI is not just about top-line growth; it's about sustained and profitable top-line growth, which in turn raises market capitalization.

GARY SAWYER

At the heart of CCI is a rigorous customer R&D process that helps companies continually improve their understanding of who their customers are and what they need. Customer R&D focuses on developing better ways of communicating value propositions and delivering complete, satisfying experiences to real customers. Since so much of the learning about customers and the experimentation with different segmentations, value propositions, and delivery mechanisms involve those regularly dealing with customers, it is essential for frontline employees to be at the center of the CCI process. Simply put, customer R&D propels the innovation effort away from headquarters and the traditional R&D lab out to those closest to the customer.

Companies that use the disciplined customer R&D process we describe–such as Best Buy, Royal Bank of Canada, and Seven-Eleven Japan – accrue three linked strategic benefits. First, they gain knowledge that is often opaque to competitors, effectively allowing them to block disruptive threats. The more customer-centric you are, the longer it takes your competitors to figure out your game, and the more times you will probably win. Second, employees closest to the customer become intensely engaged through their central role in CCI; as a result, employee loyalty increases, turnover declines, and the customer goes away thrilled. Third, the process of deeply learning about and then addressing customers' needs leads to the kind of innovation that closes the growth gap.

It is essential for frontline employees to be at the center of the customer R&D process.

CCI need not require a huge monetary investment; rather, it may simply require a redirection of funds from traditional product R&D into customer R&D. It also demands an investment of time and patience. Learning to do CCI well is not something that happens overnight. If your company wants a quick fix or an easy solution, it may play right into the hands of a hungrier and perhaps more patient competitor. Indeed, if your competitor is willing to work harder at CCI than you are, you will likely fail. CCI also demands sustained and focused effort and–perhaps hardest of all–a willingness to break through existing mind-sets. (See the sidebar "How to Kill Innovation.") But if you do the hard work, your new offerings will result in a virtuous cycle of learning, sustained profitability, and growth in your market cap.

Cementing Your Innovation Advantage

Companies cannot successfully innovate and grow unless they systematically invest in customer R&D. In doing so, they must take both an offensive and a defensive approach. The offensive strategy has three phases: Establish a deep relationship with core customers, then extend the number of customers beyond the core, and, finally, stretch into new customer realms. The defensive strategy focuses on continually scanning for potential competitive disruptions, as Clayton Christensen terms them.

Let's walk through the phases of our customer R&D process, using the example of Tumi, a leading global marketer of high-end luggage and accessories. Tumi has practiced key elements of customer R&D since 1985 and is renowned for its deep understanding of its customers and its ability to deliver superior value propositions.

Phase 1: Establish and develop the core. The first step in conducting customer R&D is to identify core customer segments and develop mutually beneficial value propositions that exceed the buyers' expectations. The value proposition represents the complete customer experience, including products, services, and any interaction with the company. Having identified this core, the customer R&D team then systematically identifies subsegments, sharpening the alignment between customers' desires and the company's offerings and generating additional profits. At the same time, the company needs to build the capabilities (the organizational infrastructure, customer insight, technology, communications, and field sales operations and logistics support) to create, communicate, and then deliver the new value propositions to the targeted segments.

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In the mid-1980s, Tumi initially targeted the male frequent business air traveler (the so-called road warrior) and endeavored to deeply understand this segment's needs. The company focused on a series of encounters, which we call the consumer consumption chain, that road warriors had with the company. Tumi's goal was to discover which product attributes mattered and which didn't to this segment. (For more information on the consumption chain, see Ian C. MacMillan and Rita Gunther McGrath, "Discover Your Products' Hidden Potential," HBR May–June 1996).

Customer R&D was regarded as so important at this stage that all activity was directed by the CEO, Laurence Franklin, and his top team at headquarters. All managers and executives at Tumi were expected to identify customer needs and contribute solutions, no matter how mundane. They began by exploring the road warrior's luggage requirements, how he evaluated alternatives, and how he made his selection and purchase of a Tumi product. By obtaining feedback directly from consumers and points-of-sale, the team then tracked the road warrior's use of the luggage, the frequency of complaints, returns and repairs, and the rate of product disposal.

Based on customer reactions to the total offering, Franklin and his top managers assessed customer needs. Ease of packing and unpacking as well as mobility, it turned out, were far more important than durability, style, or size. Accordingly, Tumi sought to satisfy the road warrior by designing luggage with easy-open zippers, flap-down zipper pockets, and a host of other features that made packing and unpacking the bag as effortless as possible. The company also came up with inventive ways for the customer to easily transfer suits directly from the closet to the bag or put stacks of clothes on top of each other as if they were in drawers.

The customer R&D team then looked even more closely at this core customer group, subsegmenting male road warriors according to the kinds of trips they took – whether one- or two-night trips or extended journeys to multiple locations. Tumi designed expandable bags that best fit each type of trip, equipping the roller luggage with high-grade wheels tested for durability and performance.

Phase 2: Extend. In this next phase, companies enlarge the business beyond the core segment in two ways.

Phase 2a: Extend capabilities. Customers use or experience products and services within a variety of distinct "life capsules." For example, road warriors' lives aren't just about traveling from plane to hotel to plane to home; these people have at-work capsules, at-home capsules, on-vacation capsules, and so on. Even within each capsule, a customer's needs evolve – so a business traveler may have different needs as he or she gets older or moves up

Do You Have a Growth Gap?

CEOs often feel harassed by sell-side and buy-side analysts' constant pressure to meet quarterly earnings targets. Rather than being bullied into an excessive focus on the very near term, CEOs need to worry about a far more fundamental problem: Do their companies have a growth gap?

Depending on your firm's past record and announcements about future plans, the capital market develops a set of expectations about your future performance and assigns a price to your stock. That price reflects two components: growth and nongrowth. The nongrowth component represents the continuation of all your current investments carried out into the future. The growth component reflects the market's expectations of your ability to build and sustain new profit streams at returns greater than your cost of capital.

For example, if you currently have a market-average P/E ratio of 20, valuation models suggest that about 50% of your stock price springs from new investment opportunities. Based on a mix of past performance and competitive market opportunities, the capital markets have already credited your firm with the capability of continuing to find new investment opportunities, on which you are expected to earn very good returns for a number of years before competitors erode your advantage. But suppose that in reality your company has run out of growth investment opportunities. The difference between market expectations and your actual business plans is the growth gap. No matter how many bold announcements you make about your business plans, the market will over time realize you are not delivering on them and will discount your price. Your P/E ratio will spiral from 20 to 10 – and it will happen quickly.

Surprisingly, few companies know how to address this issue. In our research on S&P 500 firms over a number of years, we've found that by far the majority of the companies that spend the most on traditional product and technology R&D (General Motors and IBM, for example) don't get rewarded with even market-average P/E multiples; investors appear to have little confidence that such traditional R&D spending will produce innovations likely to generate even average future profit growth. Additionally, companies with consistently above-average P/E multiples (Starbucks and Dell, for instance) tend to spend very little on traditional product and technology R&D and focus more on customer R&D. Clearly, most companies need to change the way they go about R&D. Focusing on the customer is the only way to close the growth gap.

Customer R&D Strategy

A successful customer R&D strategy requires that companies play both offense and defense. The offensive strategy is to establish a deep relationship with core customers, then extend the number of customers beyond the core, and finally stretch into new customer realms. The defensive strategy focuses on continually scanning for potential competitive disruptions.

3a ← **2a** ← **1** → **2b** → **3b**

3a	2a	1	2b	3b
Stretch capabilities	Extend capabilities	Current segments	Extend segments	Stretch segments

OFFENSE

Phase 3a
Identify new capabilities that attend to needs in other life capsules of the existing segments, subsegments, or new halos.

Customer Needs
How do we stretch capabilities to meet the needs of core customers in new life capsules (at home, office, school, or on vacation) and of new halo segments?

Phase 2a
Extend existing capabilities to attend to additional needs of the core segments and subsegments.

Customer Needs
How can we satisfy undermet and unmet needs in the current life capsule of existing customers and new subsegments?

Phase 1
Identify and develop a deep understanding of the needs of core target customers.

Customer Needs
What are the current customer's needs that we don't yet know about? How can we deepen our rapport with our current customers?

Phase 2b
Identify halo segments that are similar to core customers and that can be served with very similar capabilities.

Customer Needs
What are the needs of the halo customers that overlap with those of the core but may have different weights? What new needs do they have?

Phase 3b
Identify new segments unrelated to the core, but where current capabilities can be deployed.

Customer Needs
What are the customer groups we're not yet serving, but that have common needs that can be served with our existing capabilities?

DEFENSE
Continuously monitor for shifts in needs and potential disruptive capability threats.
How do we scan for shifts in needs of core and halo segments?
How do we scan for technological capabilities that can disrupt current value propositions?

the corporate ladder. The goal is to extend product capabilities to address these different and changing needs.

In 1991, Tumi's customer R&D team focused on extending the company's capabilities into new products for its existing core segments. Many road warriors not only needed luggage for their clothes, but they also carried expensive and easily damaged laptop computers. Using this information, Tumi launched a highly successful line of office-use products, including a soft, expandable briefcase and portfolio case line that now constitutes more than 25% of the company's business.

Phase 2b: Extend segments. Companies can extend the customer base by discovering potential "halo" customer segments, whose needs are similar to those of existing customers. Here, the goal is to understand the nuances and differences in their needs, modify the value proposition to target these groups, and then tailor products for them based on the existing capabilities of the firm. These halo segments serve to expand the firm's core business.

In 1999, Tumi extended its core customer segment to the rapidly growing halo segment of the female business air traveler, who had different needs for packing clothes, shoes, makeup, and accessories, as well as for carrying briefcases and purses. This segment also needed lighter-weight luggage. Once the customer R&D team had identified this group's specific needs, product R&D engineers reconfigured the luggage designs to accommodate those requirements. One offering was a small, wheeled carry-on bag with compartments for shoes and see-through pouches for toiletries and accessories. Another was a backpack briefcase that freed up a woman's hands while allowing her to safely carry a laptop computer and related paraphernalia. A third product was a hook for hanging a briefcase on wheeled luggage. The female road warrior segment now accounts for at least 20% of Tumi's business.

Phase 3: Stretch. Once a company has extended its business, it can begin to hunt for opportunities to stretch, again in two directions.

Phase 3a: Stretch capabilities. To fulfill the needs of existing segments or new subsegments, a company identifies new capabilities to be developed, as well as new offerings and delivery mechanisms. Tumi's customer R&D team, for example, found that the subsegment of international road warriors carried a growing plethora of IT and telecommunications gadgets, connectors, chargers, and the like. Travelers in this subsegment needed their equipment to operate regardless of their location throughout the world. Tumi discovered that it could address these needs by delivering connectivity product options. Tumi managers researched other industries and scoured consumer electronics trade shows, finding technology partners to help design and package innovative connectivity products. This led to a number of offerings, including PDA portfolios and international connector kits that operated anywhere. The initiative added 2% to Tumi's sales in the first year.

Phase 3b: Stretch segments. In this phase, the company identifies completely new segments unrelated to the core, where it can deploy current capabilities. In 2000, Tumi began appealing to a new customer segment, young male travelers. These "relaxed but wired" customers had many of the same needs as road warriors, but they were more focused on style. They also carried their electronic entertainment – iPods, gaming computers, and portable CD players – in addition to their laptops. Realizing that its existing capabilities could be leveraged to pursue this new segment, Tumi rolled out a line of "wired but relaxed" day bags and luggage with edgier styling and aggressive colors. The T-Tech collection now accounts for 8% of sales.

The more customer-centric you are, the longer it takes your competitors to figure out your game.

Maintain defensiveness. During all these phases, companies must pay close attention to disruption threats from competitors. Here, the customer R&D team aggressively scans for early indications of shifts in customers' needs or growing dissatisfaction with the value propositions on the market, especially in underserved segments. Shifts in customers' expectations can precipitate a need for new value propositions and capabilities. Customer R&D's mission is to know more about the company's existing customers than anyone else on the planet and to ensure that the company is strategically and operationally prepared to preempt any competitor's move. For example, when Netflix launched a mail-driven movie rental business, effectively eliminating the need for late-return fees, Blockbuster had to respond defensively by eliminating its own late fees. Knowing that customers disliked late fees, Blockbuster should have done away with them – thus improving its value proposition – before Netflix made its move.

In defensive mode, the company also scans for shifts in technology. A firm may not yet be able to meet certain

How to Kill Innovation

Customer-centric innovation isn't just a strategy – it's a mind-set founded on the belief that a win for customers and employees is a win for the company. Unfortunately, most companies are unwilling to make the transformation from being product, geography, or function centric to becoming truly customer centric. Below are six mind-sets that block customer-centric innovation.

Spend without reward. Firms pour money into traditional product and technology R&D, but research shows that the market refuses to give them credit for this in the form of even average P/E multiples. Leaders make all kinds of excuses for this state of affairs – "We're in a tough industry" or "All the Street cares about is short-term results" – but shareholders just aren't buying it.

Make R&D an entitlement. Senior managers who negotiate R&D funding typically make their decisions on the basis of the prior year's budget or the company's general cost concerns. At the same time, R&D staff view the funds as an entitlement rather than as a hard-nosed investment focused on exceeding the expectations of customers and investors. The result? Business as usual, and the same boring customer offerings.

Assume people in the field know nothing. Most firms treat R&D as a centralized function run by people with technical backgrounds. "God forbid," a CEO might think, "we put people with real hands-on customer experience in charge of product development – they would never understand the complexities of reverse engineering." This mind-set almost guarantees that products and services don't connect with the customer.

Put Marketing, Finance, and R&D on different planets. These distinctly different functions are more or less autonomous. They rarely communicate, except to consider cutting budgets when overall business performance lags. Such disunity ensures that no one pays attention to what the customer needs and wants from the company as a whole.

Detach Marketing from the customers. Marketing people can't do much for customers beyond feeding them propaganda. When full-fare, first-class airline customers often lack a decent meal or even a pillow, the poor folks in Marketing can only report on customer rage.

Don't rock the boat. Business leaders shy away from organizing their businesses around customers, arguing that doing so is "too complicated" or "too disruptive" for them. But given the lack of organic growth of the average business, shaking up the silo leaders wouldn't be such a bad thing for customers, employees, and shareholders.

customer needs because no technically viable solution exists, but such a disruptive alternative may be emerging. Investing in new technologies or partnering with other companies through licensing agreements, joint ventures, strategic alliances, or acquisitions can buy crucial time to respond to threats.

Tumi faces both kinds of threats. For example, a competitor could develop or acquire materials that are significantly more scuff-proof and wear-resistant than the ones Tumi currently uses. Such a technology breakthrough could have large implications for the female segment, since attractive, new-looking luggage is an important factor for women. The company is also aware that women require a broader selection of styles and colors than it has traditionally offered and that these continually change. Accordingly, Tumi developed its Signature line of colorful wheeled luggage with matching tote bags and purses.

To address disruptive threats, Tumi's customer R&D team works closely with technology R&D to monitor shifts and to identify and secure access to the capabilities that can keep threats at bay. For instance, Tumi continues to stay abreast of developments in super-strong fibers like artificial spider silk and tracks fashion trends among women who purchase haute couture luggage.

Tumi has been able to access many technologically sophisticated solutions without having to develop them in-house by sourcing from other companies. Its ballistic nylon fibers come from DuPont; its extendable handle tubes made of anodized aircraft aluminum come from Boeing; its wheels are made by inline-skating manufacturers like Rollerblade; its padding is made from neoprene used for scuba suits; and so on. These partnerships allow Tumi to rapidly evolve its products without spending enormously on product R&D. Based on what it learns, Tumi can also continually reinvent and patent new kinds of luggage without attempting to build something from scratch every year.

The Field Imperative

Like most companies beginning the customer R&D journey, Tumi orchestrated much of its initial innovation at headquarters with a handful of visionary leaders. In order to sustain innovation, however, it became necessary to push innovation to its retail stores and online channel. Today, Tumi regularly uses an online panel of several thousand customers to get quick responses on new R&D initiatives.

Our experience shows that the only way to sustain customer R&D is by putting customer-facing employees behind the wheel. The benefit is twofold: Companies exponentially expand their knowledge of their patrons, and employees become engaged as they contribute their insight and energy. They want to "win with the customer" (which for us is precisely the definition of being customer centric), and they take intense pride in doing so.

The convenience retailer Seven-Eleven Japan has for years been a leader in this regard. In April 2004, at the Seven-Eleven store across from company headquarters in Tokyo, we observed one part-time worker who single-handedly developed a customer experience resulting in what may have been the best lunch sales day of the year. He was thoroughly educated on Seven-Eleven's systems and product offerings, fully knowledgeable of the customer segments in his store and their respective needs, and empowered to run his department. When the weather one day suddenly switched from cool to hot, he made an early-morning decision to change lunch offerings for the local construction workers who patronized the store. He hypothesized that the workers would be quite warm as they worked in the morning and would prefer to have cool noodles for their lunch. He estimated the number of cool noodle lunches that he could sell and the profit, including the loss for lunches not sold.

He placed his order over the satellite network with the distribution center and then arranged the products and displays to tout cold, refreshing food and drinks. Coordinating with the cashier to estimate the number of construction workers who had actually chosen his value proposition, he was delighted to find that, by the end of the lunch period, everything had sold out at a superb profit. By providing an integrated infrastructure and a culture dedicated to educating, empowering, and engaging those closest to the customer, Seven-Eleven Japan has for years been an exemplar of customer R&D – and one of the most successful convenience retailers in the world.

A Western example is Best Buy, which puts roughly 70,000 store employees in hands-on "customer learning environments" – its retail stores. As part of its customer R&D strategy, Best Buy set out to test proposed value propositions for a number of specific customer segments, measuring the incremental impact of each value proposition on customer profitability and satisfaction over time. Best Buy's initial lab consisted of four existing stores in the northeastern U.S. The lab team consisted of a district manager, a district support team, the store general managers, and the staff in each store.

Best Buy trained the employees in customer profitability management, segment identification, communication, and execution. For example, employees experimented with the product assortment, end-cap displays, and a variety of signage. The results in the Northeast labs were encouraging enough for Best Buy to expand the test to stores on the West Coast. Today, more than 200 of Best Buy's 750 U.S. outlets have been transformed into what the company calls its Customer Centricity stores. The company has reported that these transformed stores have generated year-over-year sales growth nearly double that of the balance of the chain.

The detailed knowledge of customers that companies accumulate through their field learning labs confers a significant advantage over competitors. This knowledge asset is very opaque and difficult for competitors to imitate, extending sometimes very substantially the years of superb financial returns.

By offering increasingly tempting value propositions, firms avoid the trap of having to compete on price.

Beyond Customer R&D

Customer centricity is not just a slogan. It's a prerequisite for sustainable profitable growth. But it's the rare organization that understands what it means to be customer centric, and true customer-centric innovation includes two additional efforts that both frame and go beyond the customer R&D endeavors we have described here.

One of the most important first steps a company should take, even before embarking on customer R&D, is to measure and manage customer profitability. Few companies have tried to discern which customers are profitable and which aren't by fully allocating all invested capital and expenses to individual customers. Even fewer do such analysis on a regular basis and make customer ROIC (return on invested capital) a central metric for business performance. But doing so helps firms get a solid idea of who their customers really are in the first place and where and why they make a profit or don't. Take the example of a specialties chemical company that, rather than assessing profits on a per-product basis, chose to look at profitability on a per-product *and* per-customer level. The company found, as have others in many industries, that the top 20% of customers (in terms of profitability) generated roughly 150%

of the company's profits, while the bottom 20% generally lost at least 100%. The insights from this analysis helped the company segment its customers much more effectively and ensure that the value propositions they developed were mutually beneficial for the customer and the company.

Once the company has done its deep segmentation, capability-development, and value proposition work, the firm should institutionalize customer centricity. This is accomplished by making the customer segments the basic business units of the company; that is, organizing by customer segment rather than by product, geography, or function. Dell, Best Buy, Royal Bank of Canada, and a handful of other firms have set up customer segment units led by individuals who are responsible and accountable for the financial performance and customer satisfaction of those segments. These leaders develop strategies for their segments and allocate resources with the goal of growing "share of wallet" and achieving a high customer return on invested capital from customer R&D.

• • •

By looking closely at customer profitability; segmenting customers according to their needs and desires; creating and delivering a superior customer experience; organizing around the customer; and putting customer-facing people in charge, firms achieve a holistic customer-centric innovation system that puts them ahead of the pack. We have found that CCI has the potential to boost profits not just in retail, but in virtually every business that has direct sales access to large numbers of customers–from financial services to hotels, from consumer goods to manufacturing firms. We have even seen it work when direct access is obscured by a distribution channel; firms like Procter & Gamble use customer R&D to create mutually beneficial value propositions for both their end-user consumers and their supermarket customers. (To read more about the details of creating a truly customer-centric company, see *Angel Customers and Demon Customers,* by Larry Selden and Geoffrey Colvin.)

Firms that practice CCI increase the number of new investments earning large return spreads in excess of capital costs for as long as possible. New customer investments, greater customer return spreads, and longer durations of the spreads all boost a company's value. CCI allows firms to offer increasingly tempting value propositions, helping them to avoid the trap of having to compete on price. The superior returns allow the customer-centric innovator to continually reinvest in the customer knowledge base. The result: a truly virtuous learning cycle and a never-ending source of competitive advantage.

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To order, see page 151.

"Sorry to let you go, Wilcox, but your cell phone just doesn't play the kind of music we like around here."

SCOTT ARTHUR MASEAR


MAN'S MIND STRETCHED TO A NEW IDEA
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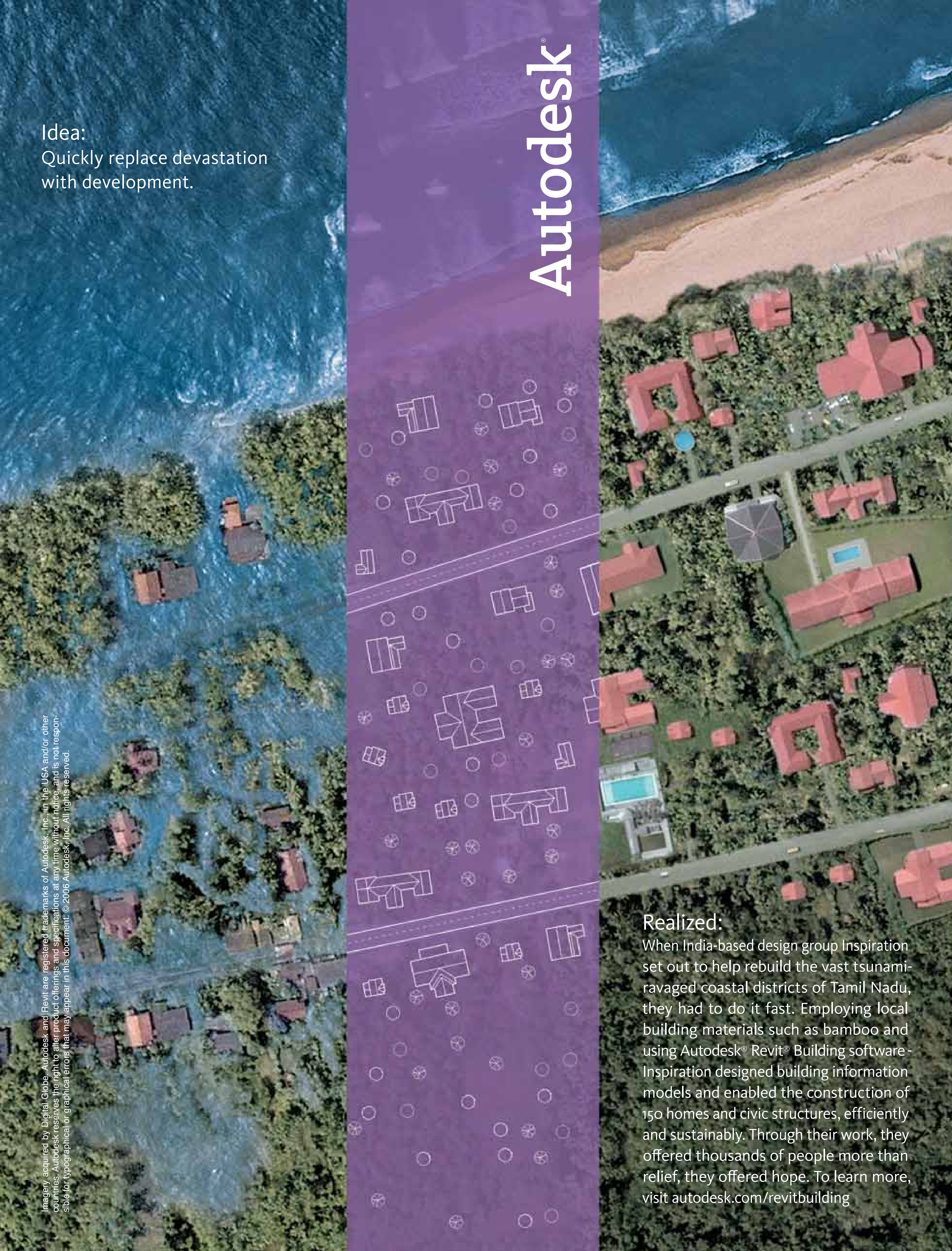
Corporate Leadership for Energy Efficiency

What a difference a generation makes. Nearly 35 years ago, the Club of Rome study essentially concluded that you couldn't achieve economic development without sacrificing the environment. Within the past year, however, two events have underscored the growing conviction that taking the environmental impact into account is critical to ensuring long-term economic success.

First, in May 2005 corporate bellwether General Electric announced that by 2010, GE would double not only its research spending on cleaner technologies, but also its sales of eco-friendly products. No, the third-largest company in the United States wasn't backing off from its relentless pursuit of shareholder value. Precisely the opposite: GE saw an opportunity to make a lot of money in an emerging global marketplace characterized by the demand for products with a lighter environmental footprint. As CEO Jeff Immelt put it, "Green is green."

Second, China, long viewed by the West as being willing to mortgage its environmental future for the sake of fossil-fueled, short-term economic growth, did an about-face. It invited its Asian-Pacific business partners to band together in an effort to create a regional economy capable of producing steady growth while revitalizing the environment. The ecological situation had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Idea:
Quickly replace devastation with development.
Realized:
When India-based design group Inspiration set out to help rebuild the vast tsunami-ravaged coastal districts of Tamil Nadu, they had to do it fast. Employing local building materials such as bamboo and using Autodesk® Revit® Building software - Inspiration designed building information models and enabled the construction of 150 homes and civic structures, efficiently and sustainably. Through their work, they offered thousands of people more than relief, they offered hope. To learn more, visit autodesk.com/revitbuilding
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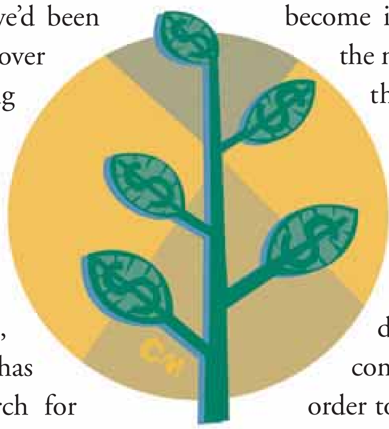
become so dire, China's leaders concluded, that the only solution was a wholesale commitment to green thinking and practices.

We've known for some time that we're living in the twilight of the age of cheap energy. In the late 1990s, the falling price of oil led some to think we'd been given a reprieve. But trends and events over the past two years—including developing countries' accelerating demand for oil, the war in Iraq, and the disruption to the oil production and refining supply chain caused by hurricanes Katrina and Rita—have swept away the last tissue of denial. GE's and China's announcements, in other words, signify that black gold has been replaced by green gold; the search for cleaner, resource-conserving energy is now a necessity.



Creating a "circular economy"

The ultimate goal of a green approach to economic activity, writes William McDonough, principal of the architecture and community design firm William McDonough + Partners, is to use "material inputs that have positive or benign effects on people and the environment" and to employ "manufacturing, distribution, and recovery systems that allow those inputs to be returned to fully productive use (not merely turned into products of lesser value, as in conventional recycling)" [*Harvard Business Review*, February 2006].

It's a laudable goal. But moving toward this circular economy of the future hasn't relieved corporations of the burden of producing consistently good near-term financial results. Sure, today's energy strategies must be innovative, comprehensive, and environment-friendly—but they also have to improve the bottom line.

Some companies are trying to accomplish this by searching for new technologies that use nonrenewable energy more efficiently. Some are reengineering processes to better conserve nonrenewable energy sources. Still others are experimenting with alternative sources of energy that are more renewable and that produce less waste. And more than a few are proceeding down all three paths at once.

Many companies have jumped on the green bandwagon for defensive reasons. They have realized that even if their goods and services are high-quality, their brand suffers if consumers see them as wasteful or selfish. Then, too, much of the policy-making is becoming privatized: Networks of governments, corporations, and nongovernmental organizations are increasingly setting the rules that become industry standards. For example, most of the major global financial institutions adhere to the environmental benchmarks known as the Equator Principles, which require borrowers to meet certain criteria for sustainable development and other social goals. In other words, even if the laws and regulations in a company's home country don't promote eco-friendly practices, the company must often adopt them anyway in order to do business throughout the world.

But far more important than understanding companies' motivation for going green is understanding the shift in their thinking. Casting aside a traditional cost-benefit analysis, which tends to undervalue environmental concerns, leading companies are now taking a more integrated and holistic view of self-interest and development in which economic and ecological concerns are intertwined.

A cradle-to-cradle approach to product and process design

The characteristic design approach of the last century was "cradle to grave," says McDonough. It involved digging up, cutting down, or burning natural resources—releasing toxic material into the environment in the process—to make products that became useless waste at the end of their useful lives. By contrast, McDonough's cradle-to-cradle approach mirrors nature's regenerative cycles so that at the end of its useful life, a product and its component materials are used to make equally valuable new products.

Cradle-to-cradle thinking does not just focus on minimizing toxic pollution and reducing natural resources waste. It goes a big step further, demanding that companies redesign industrial processes so that they don't generate pollution and waste in the first place. Using this approach as a guide, Korean electronics and telecommunications company LG has devised a "Green Management Directive"; its goal is to increase LG's competitiveness through the development of environmentally friendly products and technology. For example, LG's electronics group has found substitutes for mercury, lead, and cadmium in all its products. LG's chemical group is moving toward a zero-tolerance policy concerning the emission of pollutants, which calls for a 50 percent reduction of wastewater and a 40 percent reduction of solid wastes by next year.

In the field of bioplastics, the Italian company Novamont has developed a waste-elimination innovation known as Mater-Bi, a starch-based plastic that stands up to repeated use and extended contact with liquids, yet achieves 90 percent biodegradation in about 50 days. And BASF has created an eco-efficiency analysis that enables firms to calculate the ecological impact of similar products and processes over their entire life cycles.

The green building movement

The typical building is scandalously inefficient. Two-thirds of the energy used to heat it goes up the chimney. Moreover, buildings are responsible for 41 percent of the energy consumption in the United States and 43 percent of the country's carbon dioxide output. In green building designs, the goal is to create structures that produce more energy than they consume, store solar energy, and purify their own waste water, releasing it slowly back into the environment. For example, the headquarters of Cambridge, Mass.–based biotech company Genzyme, located on a remediated brownfield site, boasts 34 percent water savings and 42 percent electricity cost savings. More than half of all the materials used in construction contain recycled content, and more than 90 percent of the construction waste was recycled. Not surprisingly, the Genzyme structure received the highest designation possible under the U.S. Green Building Council's Leadership in Energy and Environmental Design (LEED) rating system.

Other companies, such as Bristol-Myers Squibb, Pitney Bowes, and United Technologies Corp., are following suit. The 54-story Bank of America skyscraper that is being built in Manhattan will use half the energy and potable water of a traditionally designed building, says architect Bob Fox. And in Long Island City, Silvercup Studios has installed a green roof, a thin layer of plants and soil—carefully designed to weigh just one-fifth as much as regular dirt—that will reduce heating and cooling costs, reduce air pollution, and absorb storm water runoff.

Green buildings have not fared well in traditional cost-benefit analyses because of their high up-front costs. But companies' interest in green design has been piqued by the realization that over time, it can dramatically lower the cost of operating a building, which represents a significant portion of the total cost of ownership. That interest intensifies with each additional city that stipulates its new buildings be LEED-certified. As a result, a new market has emerged estimated at \$5 billion per year for companies such as Autodesk of San Rafael, California, which makes design software for architects and engineers.

Autodesk's building information modeling (BIM) software, Revit, enables building industry professionals to analyze the performance of a building by, among other things, defining the thermal transmissivity and material characteristics of a building's roof, walls, and windows; or more accurately estimating the amount of illumination required given the effective daylight on the building's site. Autodesk's software is also making it easier to model the environmental impact of various roadway, water handling, and land-use options being considered for building sites.

According to the U.S. Green Building Council, there are more than 3,000 green buildings under development in the United States. What's more, says Phil Bernstein, Autodesk's vice president of building solutions, "41 major U.S. cities are intending to implement green certification requirements for their buildings by 2009. Our customers are increasingly saying that green building is important to them, so we're trying to add specific functionalities to our software that will make it easier for them to do sustainable design."

China's commitment to green building practices has created huge opportunities for many companies. For the model homes in a sustainable rural village project in Liaoning Province, Vermeer Manufacturing Company, a U.S. industrial-equipment firm, is making compressed earth-and-straw-bale block walls. British Petroleum (BP) is making 1,000-watt solar panels. And BASF is providing recyclable, super-insulating polystyrene panels as an alternative to energy-hogging building materials such as coal-fired brick, which was recently banned in many Chinese cities.

The greening of the auto industry

According to JD Power & Associates, the U.S. internal combustion/electric hybrid vehicle market has grown from two models and fewer than 10,000 vehicles in 2000 to 11 models and 212,000 vehicles last year. This represents slightly more than 1 percent of total car market, but for an unconventional technology, it is a good start. Toyota, the market leader, sold 110,000 Priuses in the United States and Canada in 2005, which was double the volume in 2004. By the end of this year, all six of the top-selling car companies in the United States will offer a range of hybrid cars and trucks.

Much has been made of the promise of fuel-cell technology, which eliminates the internal-combustion engine entirely and uses hydrogen to produce electricity. But an affordable fuel-cell car could be decade or more away, and the lack of hydrogen filling stations will likely continue to be a problem until 2020. Even then, according to an MIT study, fuel cell/electric hybrid vehicles would still be less efficient than internal combustion/electric models.

By contrast, experiments involving the combination of rotary internal combustion engines with zirconia ceramic tiles show greater promise over the near term. The higher torque of the rotary engines translates into smoother running; the ceramic technology enables more complete combustion of the fuel. The result: higher performance and lower emissions.

The search for renewable sources of energy

Experiments with alternatives to gasoline and diesel fuel have led to the breakthrough process known as transesterification. This process converts oil from seeds such as soybeans, cottonseed, and the like into "biodiesel" fuel, whose toxic emissions are 80 percent less than those of regular diesel fuel. Brazil, which has huge tracts of land unsuitable for food crops but well-suited for growing oil seeds, has enacted legislation requiring that biodiesel fuel comprise at least 5 percent of all diesel oil sold in the country by 2013. By so doing, the country hopes to eliminate its dependence on foreign sources for 15 percent of its annual diesel consumption.

Brazil has also developed a flexible-fuel car whose combustion engine can burn gasoline, ethanol, or any combination of both. It costs only about $100 to make a car flex-fuel-ready, and the country hopes to make all its new cars flex-fuel-ready by 2008. In the United States, nearly four million cars—some of them from General Motors—already come equipped this way.

All told, global investment in all types of clean, renewal energy reached $30 billion in 2004. The big oil companies have become major players in this effort, so much so that they are more accurately described these days as energy companies. Shell, for example, has launched an initiative to reduce harmful emissions in the world's most polluted cities. BP has grown its solar panel business by 78 percent; cleaner-burning natural gas now accounts for 61 percent of BP's energy sales, up from 52 percent five years ago.

Chevron has invested more than $1 billion since 2000 in alternative and renewable energy technologies—not only biomass but also hydrogen, solar, wind, E85 (ethanol), and advanced battery systems. For example, a wastewater treatment facility in Millbrae, California, recently began working with Chevron to use recycled cooking grease—collected from local restaurants—to partially power its operations. Earlier this year, Chevron completed the installation of a unique hybrid alternative power plant at one of the largest postal service centers in California that combines two solar technologies with hydrogen fuel-cell generation. This installation, along with energy efficiency improvements, will reduce local electric utility emissions by about 6,600 tons of carbon dioxide annually, which is equivalent to planting 1,860 acres of trees.

In addition, Chevron currently generates 1,317 megawatts of electricity through renewable sources such as geothermal, wind and solar energy—the most of any major energy company. "Our goal is to bring alternative and renewable energy technologies to an economically sound position so that they can become part of a broader energy mix, which includes conventional energy sources," says Don Paul, Chevron's vice president and chief technology officer.

Is nuclear really green?

Bringing green technologies to an economically sound position: a generation ago that goal seemed virtually impossible; today it seems eminently reasonable. This is not the only surprising reversal of perspective that has occurred in the past 35 years of public discourse about how to balance economic and environmental needs.

Writing in *Technology Review* last year, no less of an environmentalist than Stewart Brand, creator of the *Whole Earth Catalog* and co-founder and managing director of the Global Business Network, argued that as far as environmental problems go, the specter of global climate change "trumps everything" (May 2005). The elimination of fossil-burning fuels should be our top priority, he continued, but "Kyoto accords, radical conservation in energy transmission and use, wind energy, solar energy, passive solar, hydroelectric energy, biomass, the whole gamut" would make up for only a fraction of the energy provided by fossil fuels. "The only technology ready to fill the gap and stop the carbon dioxide loading of the atmosphere is nuclear power."

Although nuclear power is still anathema in many parts of the United States, for some countries, nuclear power is seen as a key solution to their increasing demand for energy. The smaller, new-generation reactors are high yield, use low-cost fuel, and their pebble-bed design makes them virtually meltdown-proof. Brand went on: "They [nuclear power plants] offer the best avenue to a 'hydrogen economy,' combining high energy and high heat in one place for optimal hydrogen generation."

Physicist and environmentalist Amory Lovins "converted the environmental movement from loathing of the auto industry to fruitful engagement with it," Brand noted. "Someone could do the same with nuclear power plants."

My, my—a generation is a long time.

Loyalty programs abound, but most of them don't accomplish much. If you want yours to perform, here are the five mistakes to avoid.

Your Loyalty Program Is Betraying You

by Joseph C. Nunes and Xavier Drèze

WHAT IS MORE RARE THAN undying loyalty? Apparently, an undying loyalty program. In the past few years, we've seen companies of all kinds killing off the programs they'd designed to inspire greater fidelity in the ranks of customers. Subway, the restaurant chain, got rid of its Sub Club cards, which allowed diners to earn a free sandwich after purchasing eight. In Australia, Coles supermarkets phased out a program that rewarded owners of the company's stock with merchandise discounts ranging from 3% to 7.5%. Online phenomenon eBay quietly pulled the plug on its Anything Points program for U.S. customers. Target missed the mark, it seems, with its innovative approach involving "smart" credit cards. American Airlines and America Online jettisoned their joint customer-loyalty program. The list goes on. Even as loyalty programs are launched left and right, many are being scuttled, and not with a sense of mission accomplished.

How can this be? In many cases, these programs are created by highly competent marketers in otherwise successful businesses. It is now well recognized that an old customer retained is worth more than a new customer won. The concept of rewarding frequent buyers

ALISON SEIFFER

has been around to tinker with at least since the days of the Green Stamp. What could be so hard about a simple loyalty program?

After researching that question in various ways over the past several years, we've learned that there are many aspects of loyalty programs that are hard to get right. The challenges start with clarifying business goals, given that loyalty programs can produce a variety of benefits. They continue with engineering the economics of reward structure and creating incentives good enough to change behavior but not so generous that they erode margins. Not least, there are puzzles of consumer psychology to sort out, which can make two rewards of equal value inspire very different levels of purchasing.

Our research suggests that there are patterns in what the successful loyalty programs get right and in how the others fail. In this article, we share what we have learned conducting our own studies and observing programs in practice. Together, our findings constitute a tool kit for designing something rare indeed: a program that won't do you wrong.

What Can a Loyalty Program Reasonably Do?

Creating a successful loyalty program starts with defining what should be gained from the effort. Only with clear business goals can one design the appropriate mechanisms and judge whether they are operating effectively. So let's take note, first of all, of what a loyalty program cannot do. It cannot, in any true sense, create loyalty. "Loyalty" means faithfulness. It means unswerving devotion. If you are loyal to something–a concept, a person, a product – you are not a fair-weather friend. You stick with it even when doing so runs counter to your interests. But surely this is not something to be expected in any commercial setting; it's scarce enough in love and war.

We don't raise this semantic issue facetiously or with a sense of outrage. Rather, our point is that euphemisms, especially ones as broadly adopted as "customer loyalty," don't make the work of management easier. They muddy the waters and throw marketing efforts off course.

To clarify things, then, let's explore the five goals loyalty programs really can serve.

Keep customers from defecting. In some cases, loyalty programs create what marketers call barriers to exit. That is, they make it hard for customers to switch to new vendors. This is a critical goal in situations where customers typically use only one supplier, as with mobile phone service or home heating oil. Given the high stakes of a customer's lifetime value, the focus is on keeping accounts from falling into enemy hands.

Take, for example, this reward to Sprint's long-distance phone customers: For every dollar they spend with Sprint, they earn an airline mile redeemable with any of five different airlines. Sprint rival AT&T does not offer such a plan. Consequently, all else being equal, a member of any of those five airlines' frequent-flier programs would rather have Sprint as a long-distance carrier. A customer might stick with Sprint even if she became temporarily dissatisfied with the service, because the mileage benefit accrues over time. If she left and later came back, she would have to start accruing miles all over again. This is what's known as lock-in–the customer's equivalent of an employee's "golden handcuffs."

Win greater share of wallet. For goods and services a customer typically buys from more than one seller, a loyalty program can encourage the consolidation of purchases. This applies to air travel, groceries, credit, food and drink, gasoline–all purchases made frequently and in small amounts. The key is to give the customer a reason to steer more of that business into one seller's hands.

Awarding points for purchases is the most common way of doing this. For example, Amazon.com offers a Visa card that rewards shoppers with a point, worth a penny, for every dollar they spend (three points if the dollar goes toward an Amazon purchase), distributed in the form of a $25 Amazon gift certificate when 2,500 points are accumulated. A shopper who might otherwise alternate among stores now has a reason to favor Amazon. Indeed, even if another seller offers a similar program, there is an incentive to consolidate in one place because certificates are issued once a threshold of points has been reached. Many such programs exist in the credit industry, and for good reason: In 2004, the 185 million credit card holders in America each carried an average of four cards. Of course, points programs are used far beyond the world of credit cards. Retail stores and hotels, for instance, also use them–witness Best Buy's Reward Zone program and Starwood's Preferred Guest program, a favorite of business travelers.

If we had any doubts about how effectively a program could increase share of wallet, they were dispelled by Arizona retailer ABCO's success in capturing more of its customers' purchases of baby goods. The Baby Club we helped launch rewarded members with Baby Bucks for purchases; 100 Baby Bucks could be exchanged for a $10 voucher. Within six months, we observed a substantial uptick in the number of transactions involving baby products and in the average number of baby products per transaction, adding up to a 25% net increase in baby product sales. This increase did not occur because there was a sudden baby boom. It was purely the result of parents' driving past competitors to consolidate their baby-related purchases at ABCO.

Of course, the Baby Club was able to achieve such results because it was the first program of its kind in the area. For most companies in competitive markets, that's at best an ephemeral advantage. But even where there are competing programs, it is possible to prevail with the right reward structure. Specifically, your program should feature what economists call a convex reward structure, whereby greater levels of expenditure earn proportionately greater rewards. Homebase, the UK do-it-yourself retailer, has arrived at a two-tiered system that seems to work: Customers save 2% on purchases as soon as they become members of the Spend & Save program. Once they've spent £400, they save 10% on the rest of their purchases that year. Consider the incentive that creates for a homeowner who spends about £800 per year on DIY supplies. If he splits his purchases evenly between Homebase and one of its competitors (spending £400 at each outlet), he receives £8 back from each retailer (assuming that the competitor has a similar program), for a total of £16 in savings. But if he spends the entire £800 at Homebase, he receives £48 back.

Prompt customers to make additional purchases. We've been describing situations where competing for a customer's purchases is a zero-sum game. The expectation is that the customer will buy just so much and no more, and the objective is to capture the largest portion of that amount. But a loyalty program needn't set its sights so low; it can also create incremental demand, spurring purchases that would not otherwise be made.

This is a common effect of multitiered loyalty programs (those with, say, Silver, Gold, and Platinum levels), where each tier brings additional benefits. Customers who are on the cusp of attaining the next status level – or in danger of slipping to a lower one – will often spend more in order to secure the higher ground. To cite one of the most extreme examples we've seen: A friend of ours in Los Angeles found himself 3,000 miles short of United Air Lines' Premier Executive status with just a few weeks remaining in 2005. He took the least expensive qualifying flight, to the frigid destination of Buffalo, New York, where he stayed less than 24 hours before returning.

Even when status levels are not part of a program, a valued reward can lead consumers to accelerate their purchases, and that can add up to increased overall consumption. Working with a chain of car washes on the West Coast, we observed that a loyalty program offering a free wash after eight purchases led drivers to wash their cars more often as they got closer and closer to earning the reward. This same effect has been observed by other researchers studying coffee shop purchases, and it would no doubt apply to small luxuries like tanning and spa sessions, as well. The common thread is that these are goods and services for which consumption is flexible and can be increased easily. A service station might therefore create a reward program for oil changes and see overall sales rise; using it for snow tire changeovers probably would not work out as well.

Yield insight into customer behavior and preferences. A benefit of loyalty programs that has gained prominence in the past decade is their ability to provide useful data about customers. The data can both produce insights about general buying behavior and allow the seller to target promotions to individual customers. Tesco, the UK grocery store chain, is often cited for its expertise in using the data collected from its Clubcard members. Cardholders receive a quarterly mailing with offers so carefully customized that Clive Humby, one of Clubcard's architects, told *Promo* magazine in 2004 that Tesco prints about 4 million variations for each mailing. As data collection and maintenance become easier and cheaper, we are witnessing a proliferation of companies offering to provide marketing insights based on loyalty program data.

Yet one must be careful not to overstate the benefits of collecting consumer purchase data. Initiatives like Tesco's require a dedicated staff of analysts and substantial investments in data management and augmentation. And even then, a company's customer data, taken in isolation, may not yield many novel insights. We were reminded of this when we worked with Twentieth Century Fox Home Entertainment. Few would suspect that online purchasers of X-Men movies would be prime targets for 1930s-era Shirley Temple movies. But indeed, we discovered that action film fans with kids were especially receptive to pitches for the young actress's movies. How could Fox Home Entertainment determine which of its customers had children? Only by combining its own data with information purchased from third-party provider Equifax. The point is, it isn't sufficient to collect loyalty program data and expect that effective marketing moves will spontaneously suggest themselves; one must have a marketing objective in mind and then seek the data.

If food, beverage, fuel, insurance, and other expenses are factored in, a 25,000-mile reward costs less than $15, on average, to fulfill.

Turn a profit. Some loyalty programs can even function as profit centers. Consider American Airlines' AAdvantage program. Even as the airline racks up billions of dollars in debt, the AAdvantage program turns a tidy profit selling miles to other businesses to use as rewards for their customers. AAdvantage clients range from huge concerns like Citibank to small businesses like Ariake, a sushi restaurant in Los Angeles. Consumers of Kellogg's breakfast cereals get thanked with American Airlines miles; so do subscribers to *USA Today*. Together, U.S.-based airlines sell nearly $2 billion worth of miles to more than 22,000 businesses.

This may seem like a loyalty program's crowning achievement, a gambit available only to the long established and mature. In fact, it was the function

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of the earliest broad-based program, S&H Green Stamps. Thomas Sperry (the "S" in "S&H") did not create Green Stamps in 1896 to reward customers of a business S&H owned. The system was conceived as an independent business that would sell stamps to merchants, along with the books to paste them in. S&H's only direct trade with consumers was through redemption centers where people exchanged their stamps for merchandise.

Today, any company with a broad customer base and excess capacity could consider leveraging its loyalty program in the same way. Marriott has done so with its Rewards program, enabling customers to collect points for a future hotel stay by shopping at Target, the Gap, Lands' End, Macy's, or Best Buy. But of course, these types of ventures, while generating additional revenues, also involve all the complexity of running standalone businesses. A critical concern is arriving at the right price per reward point. In the airline business, for example, the average mile sells for about two cents, although it goes for significantly less to high-volume customers like Citibank. This means the airline sells the right to 25,000 miles for about $500 in incremental revenue. In most businesses, economics like this would be disastrous, but airlines are able to keep the true incremental costs quite low. They can limit the availability of qualifying seats, and they count on a certain portion of miles going unredeemed. If food, beverage, fuel, reservations processing, liability insurance, and other miscellaneous expenses are factored in, the 25,000-mile reward actually costs less than $15, on average, to fulfill.

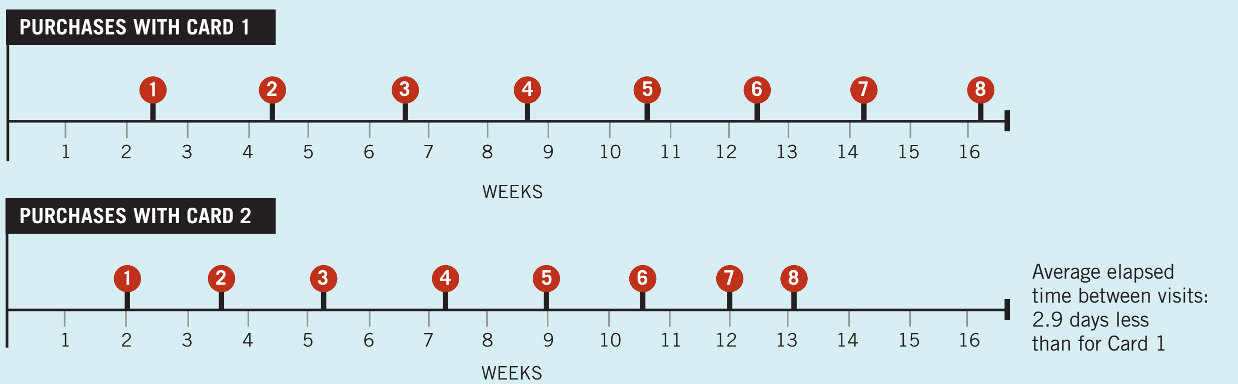
We've outlined five benefits a company can gain from a loyalty program, and the corollary should be clear: Any given program must be designed to serve specific goals, and priorities must be set among them. It's unreasonable to expect to design a program that equally pursues several distinct objectives. Rather, it makes sense to focus on a couple and design the optimal program to serve them. (If additional benefits can then be layered onto that design, fine–but only if that can be done without compromising performance in the key areas.) The unfortunate reality,

The Effect of a Jump Start

In April 2004, we staged an experiment in a car wash business in Los Angeles. The business distributed 300 stampable cards that promised a free car wash after eight paid visits. The cards, however, took two forms. Card 1 was a straightforward buy-eight-get-one offer. Card 2 presented itself as a buy-ten-get-one offer, but customers were told that, as a special promotion, they were being given the first two stamps free. Essentially, then, the economics of the two programs were identical. The question was whether those two stamps, by framing the quest as one that had been undertaken rather than one not yet begun, would have an effect on sales.

The "endowed progress effect," as we termed it, turned out to be substantial. First, total redemptions were higher. While only 19% of the customers with Card 1 stuck with the program and claimed the prize, 34% of Card 2 customers did so. Card 2 customers also came back at a faster rate, as reflected in the diagrams below (which represent only the customers who got all their stamps and earned the free wash). As this comparison shows, the average elapsed time between visits was less for Card 2 than for Card 1. Finally, under both programs, purchasing accelerated: The time between visits became shorter and shorter as the customer got closer to the payoff. But note that the rate of acceleration was greater with Card 2. The time between visits compressed more along the way.

For details on this study, see our article "The Endowed Progress Effect: How Unwarranted Advancement Increases Effort" in the March 2006 issue of the *Journal of Consumer Research*.



however, is that many loyalty programs seem to have no distinct targets squarely in their sights.

The Levers of Loyalty

On the face of it, designing a loyalty program is a straightforward exercise. It must be attractive to customers and not too expensive. Both sides of that equation, however, are easier said than done. Our study of programs in practice suggests that several components are especially important and difficult to design well.

Divisibility of rewards. First, there is a careful balance to strike in what we would term "divisibility," or the number of discrete reward-redemption opportunities a program provides. A program that allows members to redeem points in clusters of 5,000 is twice as divisible as one that allows people to redeem points only in clusters of 10,000. Managers and their customers often diverge in their preferences on this matter. Customers prefer highly divisible programs because they provide many exchange opportunities and thus reduce award waste. They see a low-divisibility program as having such a high threshold for rewards that it deters them from ever embarking on the quest. By contrast, managers don't like offering highly divisible programs because they are not effective at creating consumer lock-in. If one can redeem 5,000 points, why strive to accumulate 10,000? As always is the case when the desires of companies and those of consumers collide, a compromise must be struck. The right level of divisibility will factor in the expected yearly program usage and the amount of company differentiation. Our research shows, for example, that in a grocery store setting (high usage, low differentiation), a \$50 reward for every \$500 spent engenders greater customer loyalty than either a \$10 reward for every \$100 spent or a \$100 reward for every \$1,000 spent (too much and too little divisibility, respectively).

Sense of momentum. Research has proven that the further along members are in a loyalty program, the more they use it. By contrast, at the outset of their membership, their involvement is irresolute. Because they have not yet made any progress, the rewards seem far away. Worse, they have little sense of how easy it will be to achieve the goals. Rather than lose a customer's interest right out of the gate, the best designed programs provide what we've termed "endowed progress," a little push to get things moving. We learned how effective endowed progress can be when we staged a field experiment at a metropolitan car wash. (See the exhibit "The Effect of a Jump Start" for details.)

Let us quickly offer a caveat, however. Customers must see the endowment as earned or warranted by their behavior, or the tactic will have little effect. Indeed, if it smacks of cynicism, it may produce a negative one. Even if the endowed progress is simply cast as a signing bonus for new program members, it should give them a sense of established momentum.

Nature of rewards. Research about the compensation of professional salespeople has shown that they respond more dramatically to performance incentives that promise pleasure (like luxe vacations and, in decades past, fur coats) than to purely utilitarian incentives (like cash bonuses). In the same way, consumers love to be given a treat they would not splurge on with their own money. And so the most successful loyalty programs often feature less functional and more pleasure-providing rewards. When Maritz Loyalty Marketing, which operates loyalty programs for various merchants, analyzed the reward redemptions for its clients in 2005, it found that American consumers preferred the latest electronics (televisions, video games, stereos, DVD players) to household goods (appliances, furniture, art) by a factor of almost two to one. But the benefit of offering nonutilitarian rewards is not simply that they get people excited about the program. In experiencing the reward, people come to have pleasant associations with the brand. Note what happened with Nectar, a UK-based reward program that serves customers of various retail outlets. Its members collected more points (in other words, spent more at program-affiliated stores) during the month immediately following a point redemption than during other months – and the effect was even greater when the points were redeemed for a hedonic reward such as theme park admission.

American Express Incentive Services is well aware of this element in its program design. It divides rewards into two types: sticky and slippery. Sticky rewards stick in the recipient's mind, reinforcing the relationship with the program provider, while slippery rewards are mundane and tend to slip from memory. Which do you think is stickier: the utilitarian reward that's quickly assimilated into the recipient's daily life, or the reward that breaks the routine and may even confer bragging rights? Hoping for stickier rewards, American Express has launched its IN:CHICAGO and IN:LA specialty cards, which allow members in Chicago or Los Angeles to earn "special dining, drinking, and entertainment rewards at some of the city's best spots."

Expansion of relationship. Sometimes, the only effect of a buy-ten-get-one-free program is to give away a product unnecessarily. After all, a customer who likes a product enough to buy it ten times could probably be expected to purchase it again. By making the 11th time free, the company effectively gives the habitual buyer a quantity discount. (Subway's Sub Club used to do exactly this.) More valuable to a company is a program that expands the consumer's repertoire of purchases. For example, instead of giving an 11th cup free, a coffee shop might make the tenth a larger size or throw in a free pastry. As well as being a more hedonic reward, the sample might introduce the consumer to a new product and induce higher future sales. This is one reason airlines are happy to fill empty seats in business or first class with members spending frequent-flier miles for an upgrade. It gives the traveler the taste of a better experience that he might find difficult to live without in the future. In fact, Subway's current plans are to offer franchises a new reward program, featuring a magnetic card that will allow customers to trade points for cookies and other extras.

Combined-currency flexibility. A program in which consumers never redeem points would be very inexpensive to offer. However, it would be of little interest to members. To be attractive, a program must lead to redemption; that's when the benefits really become the most salient to the consumer. The key for managers is to make the redemption as inexpensive as possible to the company. In our research, we have found that if companies allow program members to redeem their points in combination with hard currency, it lowers the psychological cost to consumers. In other words, it can increase the perceived benefit to the consumer without undue cost to the company.

For example, we found that consumers would rather buy a flight with $250 and a copayment of 5,000 frequent-flier miles than with a straight payment of either $300 or 30,000 miles. Small amounts of miles seem trivial to the consumer, as they make most mileage rewards seem too far away. Thus, being able to spend these alternative currencies in smaller amounts (accompanied by cash) is more appealing than spending lots of precious miles on a cheap flight. An expensive flight, however, is another story. (See the exhibit "The Case for Currency Combinations.") More simply put, companies stand to gain incremental sales when they're flexible in how they allow customers to combine currencies.

The typical grocery store loyalty program does not reward loyal behavior; it rewards card ownership.

Mistakes to Avoid

We've been reviewing the finer points of loyalty program design – the elements that, when carefully managed, separate the best programs from mediocre or bad ones. It's easy to come away from such research with the strong sense that the devil is in the details. But in truth, when we reflect on the programs that were outright failures, we see that the issues were not all that nuanced. Loyalty programs typically founder on some simple mistakes. Allow us to offer five basic pieces of advice.

Don't create a new commodity. If your program is tantamount to discounting, then you are only paying people to buy and, paradoxically, creating greater disloyalty. You will inevitably be drawn into the equivalent of a price war, with tit-for-tat competitive moves basically yielding parity and lower profitability all around. Just consider the attempt last August by United Air Lines to poach fliers worried about a mechanics' strike at Northwest Airlines. In an e-mail promotion, United targeted customers in certain midwestern cities with an offer of double miles. Northwest responded by matching the offer for flights taken before early October.

In mid-October, United announced it would award double miles for travel until mid-December. All of this had the opposite effect of what either side wanted – it encouraged price shopping.

It's worth noting that the same thing killed the Green Stamp. Stores began trying to outdo one another by offering double stamps, then triple stamps, and ultimately quadruple stamps, inflating the value of the average stamp to about eight cents on the dollar. Shoppers were happy to go wherever they could collect the most stamps. What had begun as a mechanism for rewarding loyal customers devolved into clumsily concealed price promotions administered by third-party stamp providers. Eventually, stores had had enough and began touting the benefit of lower prices with no stamps attached.

The thought of offering double miles, points, or credits to steal share in the short term is compelling. Almost all loyalty programs, from Best Western's Gold Crown Club to Hilton's HHonors, and from American Express Rewards to Visa Extras, have at one time or another upped the amount of the alternative currency they offer in exchange for sales. But managers must use their loyalty programs for more than a direct payment mechanism for purchases, which is simply not sustainable in the long term.

Don't reward the disloyal. Probably the most familiar example of a program that rewards the unfaithful is the typical grocery store card. Beyond their data-gathering purpose, these cards are meant to attract customers by giving members-only discounts on promotion items. Card-carrying shoppers get the advantages of coupons without having to clip them. Because no store charges for membership, though, shoppers quickly accumulate as many cards as there are local grocers. This type of program does not reward loyal behavior; it rewards card ownership. And sometimes it doesn't even do that, because helpful cashiers are often happy to swipe a dummy card for customers who have forgotten or never signed up for their own.

The Case for Currency Combinations

Some points-based loyalty programs allow customers to combine points with cash to pay for purchases. For instance, a Net SAAver fare advertised on American Airlines' Web site allowed fliers to purchase any ticket normally priced at $189 either for $189 or for $39 plus 16,000 miles.

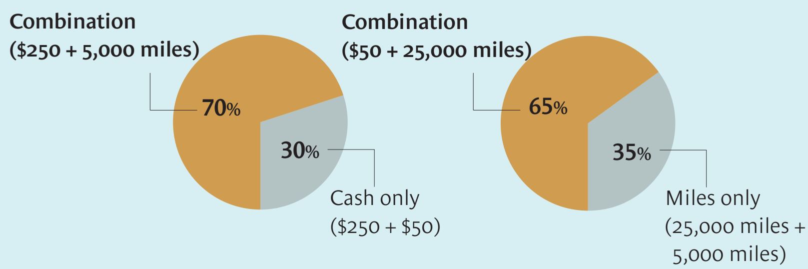
To discover how consumers respond to such combined-currency prices, we asked airline travelers who had experience with miles programs to look at a hypothetical set of pricing options. We presented two scenarios, asking some participants to consider a low-cost flight and others to consider a high-cost flight. For each case, respondents were asked to choose among payment options of all miles, all cash, or a combination of the two. Our respondents in the low-cost scenario could pay for a $300 flight ($250 plus a $50 surcharge for expedited booking) with cash or with 30,000 miles or with a combination of, say, $250 and 5,000 miles. Respondents in the high-cost scenario could pay for a $1,000 flight and a $50 surcharge with $1,050 or with 105,000 miles or with a combination of money and miles.

In pure economic terms, all the options cost the same. But as the charts show, preferences ended up varying based on the cost of the flight. For the low-cost flight, people preferred a combined-currency payment. For the high-cost flight, people preferred a single-currency transaction. In our article "Using Combined-Currency Prices to Lower Consumers' Perceived Cost" (*Journal of Marketing Research,* February 2004), we model the marginal values being placed on miles by consumers and suggest how merchants can optimize their pricing accordingly. For here, it is sufficient to say that consumers do prefer combined-currency pricing under some conditions, and a program with the flexibility to offer it will be more successful than one without that flexibility.

Low-Cost Scenario

A flight worth $250, with a $50 surcharge.

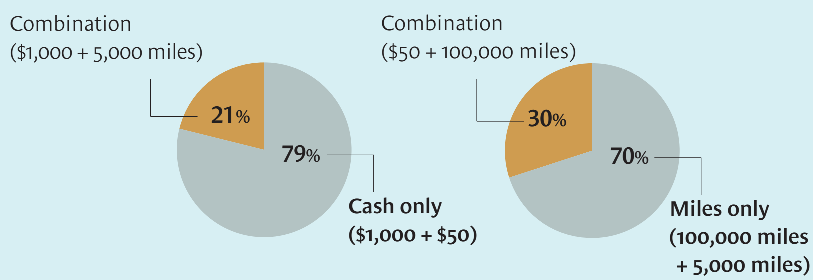
How would you prefer to pay?



High-Cost Scenario

A flight worth $1,000, with a $50 surcharge.

How would you prefer to pay?



Therefore, managers must ensure that their loyalty programs are incentive compatible, designed so it is in customers' best interests to be loyal. A program should reward the use of the card over time rather than on a given purchase occasion, and it should discriminate between more and less loyal customers in the size of its rewards. For example, at the women's clothing chain Chico's, customers become Passport members after spending $500, entitling them to discounts and targeted communications.

Don't reward volume over profitability. Gauging loyalty solely on the basis of such rudimentary measures as purchase quantity can be very misleading. Instead, Harrah's Entertainment, for instance, tracks the types of gambling that people do and focuses on its most profitable customers. Its loyalty program recognizes, for example, that roulette wheels have a different house take than slot machines. Thus, when a customer calls to book a night at one of its properties, Harrah's is able to generate a spot price for the room based on customer profitability as well as availability. Profitable customers might stay for free while others might be charged hundreds of dollars for the same room or even be told that no rooms are available.

Frequent-flier programs are beginning to follow suit. American Airlines revamped its entire AAdvantage system to track members according to their profitability. The program still adheres to the convention of issuing miles to fliers but can use the customer's P&L when making other decisions about the customer relationship.

Keeping track of the profitability of the customers is paramount. Companies reward loyalty because they believe it leads to profits. By tracking profits directly, a company can better target its rewards.

Don't give away the store. There's no reason to cut into profit margins if a customer can be made happy with a costless reward. For example, United Air Lines ranks meal service in its first and business classes based on seniority. A 1K cardholder is asked her choice of entrée before a Premier or Premier Executive cardholder. It costs the airline nothing to bestow this honor, because the numbers and types of meals taken on board do not change. Similarly, Citibank does not answer the customer service calls it receives in the order they are received; rather, wait time is a function of the callers' assets. Many managers refer to this type of preferential treatment as customer recognition. Call it what you like – it effectively rewards the most valuable customers.

Even if managers cannot make customer rewards costless, they can often lower the costs. A classic way to achieve this is to provide coupons rather than straight discounts. Baby Club's 10% discount, for example, was given in the form of Baby Bucks that could be redeemed for $10 vouchers that themselves could be redeemed for groceries at ABCO. When interviewed, club members showed real enthusiasm for the "10% discount" they received. However, when we looked at the liability to the store, we found that the low redemption rate coupled with the profit margin on the sales of the items bought with the coupons reduced the liability from 10% to a mere 1.72%.

Don't promise what you can't deliver. When a loyalty program pledges to reward customers with preferential treatment (shorter lines, expedited delivery, special toll-free numbers), it must ensure that the services provided through these special arrangements are better than the services available to regular customers. This is particularly true when customers can easily compare the two levels of service. While it may be hard to gauge the amount of time others spend waiting on the phone, it is easy to see whether the first-class ticket line moves faster than the regular line. Comparison is especially salient when customers are waiting for their luggage. The premier passenger cannot help but observe how many bags without a bright orange or pink "priority" tag are delivered before he gets his.

To make matters worse, customers do not compare averages with averages; they compare extremes with extremes. That is, they notice the speed of service only when they are not being served promptly. Our research suggests that, on average, airline luggage marked as "priority" tends to come out of the plane faster. Many airlines even have a special container for these bags. Yet we have also found that, frequently, a good number of nonpriority bags are delivered before the last priority bag comes out. If too many nonpriority bags are delivered before priority bags, the premier passenger begins believing that the promise of superior service has been broken. Managers need to ensure that the lower bounds of premium service never look worse than standard service.

Keep the Faith

We began this article with a litany of failures, a sampling of loyalty programs that were dumped for not delivering. In a way, this is the good news, because many other programs that should get canceled continue to limp along.

Yet loyalty programs are ingenious marketing tools when they are designed and executed well. In a wide variety of industry settings, they've proven their ability to reduce churn, increase sales and profitability, and yield the kind of insight that allows a company to provide more valued service to its customers.

Making sure that a company's loyalty program will carry its weight begins with clarifying what the program is expected to do. This requires careful attention to the details of program design, from the value and nature of the rewards to the ways in which they are bestowed and redeemed. Perhaps more than anything, a successful program depends on competent and consistent execution. Even with all of this, true loyalty might be too much to expect, but companies will likely have longer-term relationships with happier customers. And that, to us, sounds like the best kind of competitive advantage.

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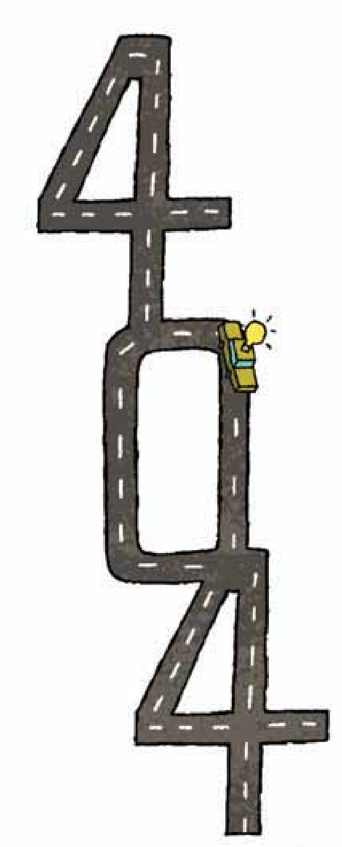
To order, see page 151.

A few smart companies have stopped complaining about Sarbanes-Oxley, the investor-protection law, and turned it to their advantage – bringing operations under better control while driving down compliance costs.

The Unexpected Benefits of Sarbanes-Oxley

by Stephen Wagner and Lee Dittmar



TIM ELLIS

When Congress hurriedly passed the Sarbanes-Oxley Act of 2002, it had in mind combating fraud, improving the reliability of financial reporting, and restoring investor confidence. Understandably, most executives wondered why they should be subjected to the same compliance burdens as those who had been negligent or dishonest. Smaller companies in particular complained about the monopolization of executives' time and costs running into the millions of dollars.

Perhaps SOX's most burdensome element was Section 404, which says that it is management's responsibility to maintain a sound internal-control structure for financial reporting and to assess its own effectiveness, and that it is the auditors' responsibility to attest to the soundness of management's assessment and report on the state of the overall financial control system. (See the sidebar "Taking Control of Controls.")

Yet in the course of providing compliance advice to executives, we discovered a small subset who approached the new law with something like gratitude. For years, and especially when financial reporting had become fast and loose and criminal conduct entrenched at places like WorldCom and Enron, these executives had secretly wished that some of the resources absorbed by their companies' profit centers could have been diverted to improving financial management processes and capabilities. They were thinking not only of protecting stakeholders and shielding their companies from lawsuits but of developing better information about company operations in order to avoid making bad decisions.

However, the burdens of implementing SOX for the first time, in 2004, were so great that this more forward-thinking group could give little time to developing and adopting policies and practices that went beyond literal compliance. Some spoke of putting their planned initiatives in a "parking lot," with the hope of pursuing them the following year. As SOX went into effect, more and more executives began to see the need for internal reforms; indeed, many were startled by the weaknesses and gaps that compliance reviews and assessments had exposed, such as lack of enforcement of existing policies, unnecessary complexity, clogged communications, and a feeble compliance culture.

In any era, the enactment of a law like SOX would probably have prompted a similar stocktaking. But factors in the business world independent of recent abuses had rendered some companies' operations and reporting opaque even to the people in charge, making the timing of SOX's enactment particularly fortunate. These factors included a frantic pace of mergers and acquisitions and less-than-seamless integration of the combined entities; the rapid implementation of new information technologies and their incompatibility with legacy systems, as well as flawed electronic security and Y2K's jury-rigged patches and fixes; foreign expansion, which produced disorienting encounters with unfamiliar languages, cultures, laws, and ways of doing business; the proliferation of business alliances and outsourcing; and the stringing together of supply chains. It is no wonder that actual and reported performance at a number of companies diverged.

Year two of compliance is now complete at most large U.S. companies. Is the parking lot still full of unimplemented change plans? At many organizations, it is. Their executives want to simplify and standardize processes and systems but can't seem to find the time or the resources to do so. But some executives, particularly those who recognized SOX's advantages from the beginning, have figured out how to leverage the new law so that those plans for improvement can be realized.

In year two, a number of companies have begun to standardize and consolidate key financial processes (often in shared service centers); eliminate redundant information systems and unify multiple platforms; minimize inconsistencies in data definitions; automate manual processes; reduce the number of handoffs; better integrate far-flung offices and acquisitions; bring new employees up to speed faster; broaden responsibility for controls; and eliminate unnecessary controls. Moreover, SOX-inspired procedures are beginning to serve as a template for compliance with other statutory regimes. In this article, we describe the broad areas in which SOX compliance has benefited firms' governance, management, and investors.

A focus on the control environment helps ensure that the controls themselves are the second and third lines of defense, not the first.

Strengthening the Control Environment

Good governance is a mixture of the enforceable and the intangible. Organizations with strong governance provide discipline and structure; instill ethical values in employees and train them in the proper procedures; and exhibit behavior at the board and executive levels that the rest of the organization will want to emulate.

These are all components of the control environment, which forms the foundation of internal control. Popularized by the Committee of Sponsoring Organizations of the Treadway Commission in its 1994 report "Internal Control – Integrated Framework," the term "control environment" encompasses the attitudes and values of executives and directors and the degree to which they recognize the importance of method, transparency, and care in the creation and execution of their company's policies and procedures.

A proper control environment is one factor an external auditor considers when called upon to evaluate internal control over financial reporting pursuant to Section 404. Bob Murray, the director of internal audit at Yankee Candle, a $600 million purveyor of scented candles and other household items, regularly sends to the auditing firm copies of internal correspondence emphasizing fraud prevention, internal control, and regulatory compliance. "We hope to score major points with our auditor for doing this," he says (though hastening to add that strengthening the control environment is the company's primary concern).

These "points" are not tallied in any literal sense. Rather, they contribute to the mass of evidence weighed by the external auditor. If a company can demonstrate a strong control environment, then it can reduce the overall scope of its internal-control evaluation. Reduced scope can mean the company need not carry out as many internal tests and the auditor may do less corroborating, resulting in lower compliance costs. (Testing scope is a matter of judgment and perhaps negotiation between the auditor and the company. Indeed, the Public Company Accounting Oversight Board [PCAOB] and the Securities and Exchange Commission encourage auditors to exercise judgment when evaluating financial-reporting controls.)

PepsiCo uses an annual survey of about 100 senior executives to demonstrate the condition of its control culture. Conducted by the company's internal auditors, the questionnaire probes hiring practices, employee evaluation, contract solicitation, incident reporting, objective setting, and other areas. According to Thomas Lardieri, general au-

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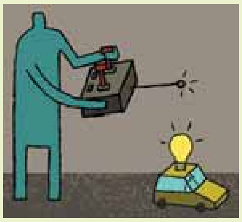
ditor and vice president for risk management, PepsiCo also tests financial employees' understanding of their responsibilities as part of its annual ethics training. The training is administered via an interactive package that includes scenarios of ethical dilemmas one might encounter dealing with customers, suppliers, and colleagues and suggests possible solutions. About 25,000 managers receive the training. The company's remaining 135,000 employees receive a code of ethics manual and some level of reinforcement and training, which varies according to business unit, says Lardieri. Records of this training may be reviewed by the auditors.

In our presentations at business seminars and conferences, we are often asked why we emphasize the control environment so heavily. Our questioners seem to believe that good internal control is predicated on the controls themselves–the cross-checking, the reconciliations, the data verification. We reply that without a strong control environment, a company will never attain good governance. A focus on the control environment helps ensure that the controls themselves are the second and third lines of defense, not the first. Employees who have been made to understand that it's not all right to strike side deals with customers, to recognize revenue prematurely, to conceal possible conflicts of interest, or to look the other way when these types of activities are going on won't be busy circumventing the control system at every turn.

Some executives feel they need to tie every action back to the bottom line. To them we say: Most investor rating services include an assessment of the control environment as part of their overall evaluation of the company. Scores from these services can have a significant impact–either positive or negative–on investor sentiment and the company's cost of capital.

Taking Control of Controls



The phrase "internal control structure and procedures" features prominently in Section 404 of Sarbanes-Oxley. But what exactly is a control structure composed of? A control is a practice established to help ensure that business processes are carried out consistently, safely, with the proper authorization, and in the manner prescribed. Take, for example, the objective of keeping information secure. Controls to achieve this objective might be as straightforward as locking a file cabinet or as elaborate as encrypting computer data.

Sarbanes-Oxley was enacted to improve the reliability of financial reporting; therefore, most of the controls adopted pursuant to the Act concern themselves with the timeliness, integrity, and accuracy of financial data.

Controls fall into two broad categories. *Preventive controls* are intended to eliminate lapses, either intentional or inadvertent. An example would be the segregation of duties in an accounts payable department, so that one person approves an invoice, another prepares the payment, and a third signs the check. In this way an unauthorized payment is kept from being issued. *Detective controls* are designed to identify errors and irregularities that have already occurred. Monthly reconciliation of cash accounts, for example, is undertaken to ferret out such conditions.

An essential element of any Sarbanes-Oxley compliance program is the testing of controls. During the first year the law was in force, many companies and their auditors–because of the law's newness and the lack of regulatory guidance–tested an unnecessarily large number of them. In some cases, the matters being tested were too unimportant to contribute to a material misstatement in the financial reports. In others, a high sampling rate gave no clearer a picture of certain controls' efficacy than a lower rate would have done. To reduce the compliance burden, some companies now resort to "controls rationalization," which involves assessing which activities are most susceptible to error or abuse and whether they could be responsible for a material misstatement. Such controls are tested more frequently; less essential ones may be deemed to fall outside the scope of the testing plan entirely. Many companies have achieved cost savings in the second year of SOX compliance, without any reduction in control effectiveness, by rationalizing their controls in this manner.

Improving Documentation

Documentation activities consumed countless employee hours during the first year of Sarbanes-Oxley, as companies updated operations manuals, revised personnel policies, and recorded control processes. Some minds equate paperwork with busywork, but this labor-intensive effort, to our surprise, received gradually increasing support from the executive suite. The spur was Sections 302 and 404, which require CEOs and CFOs to attest personally to the effectiveness of internal control over financial reporting, and Section 906, which makes "willful failure" to portray the true condition of the company's operations and finances a crime. Section 404 also requires the independent auditor to attest each year to the company's evaluation of its controls. The auditor is expected to assess the documentation of controls and procedures as well as how competently employees perform the control activities for which they are responsible. (See the sidebar "SOX in Brief.")

BlackRock, an investment firm with more than $450 billion in assets under management, took an exhaustive inventory of its written policies and procedures, says Paul Audet, former CFO and now chief executive of the company's cash management business. During this exercise, Audet learned that many job descriptions needed updating. "If you don't properly document job requirements, then you wind up communicating important information solely by word of mouth," he says.

With the advent of Sarbanes-Oxley, Audet saw an opportunity to overhaul the job-description documentation. The benefits of doing so have been especially noticeable during employee absences and periods of high turnover, because the revised documentation has helped new recruits become acclimated more quickly. Clearly defining who's responsible for which business processes is a key element of an internal-control program and facilitates training, oversight, and performance evaluation.

BlackRock's documentation efforts have also increased employees' understanding of operations. Having to commit information to paper (or hard drives) has sent internal auditors and other employees into the field to see firsthand how tasks are accomplished and how they might be improved.

PepsiCo has also benefited from updating its documentation processes. In the course of making these updates, the company determined that inadequate controls existed for pension accounting, a complex process that depends not only on the internal compensation and benefits group but on external actuaries and asset custodians. Lardieri says with dismay, "A lot of steps we assumed were being taken – account reconciliations and interest calculations and data integrity checks – actually weren't."

As soon as the lapses were revealed, the company assigned a controller to its compensation and benefits group, and an internal team identified, documented, and implemented the missing control activities. PepsiCo also started demanding written assurances from its asset custodians that companies with which it did business were adhering to strong internal controls. (Many other companies obtain similar assurances by requiring SAS 70 Type II reports, which certify that an independent auditing firm has examined a service provider's internal controls.) These measures clarified the control responsibilities of the treasury and finance departments and the compensation and benefits group. They also improved data transfers among these functions and with third parties.

A CFO of a *Fortune* 1000 real estate company informed us of another documentation benefit from Sarbanes-Oxley. This executive approached Section 404 documentation confident that his company's sign-offs had been unfailingly executed, only to make what he referred to as a "humbling" discovery: The people signing off on the documents apparently had been merely glancing at the contracts and leases in question. That lack of attention left the company susceptible to unenforceable contract provisions, miscalculated rent escalations, and unexecuted underlying agreements. After disciplining the negligent parties, the company instituted far more rigorous cross-checks of contracts and leases.

While providing compliance advice to executives, we discovered a small subset who approached Sarbanes-Oxley with something like gratitude.

Increasing Audit Committee Involvement

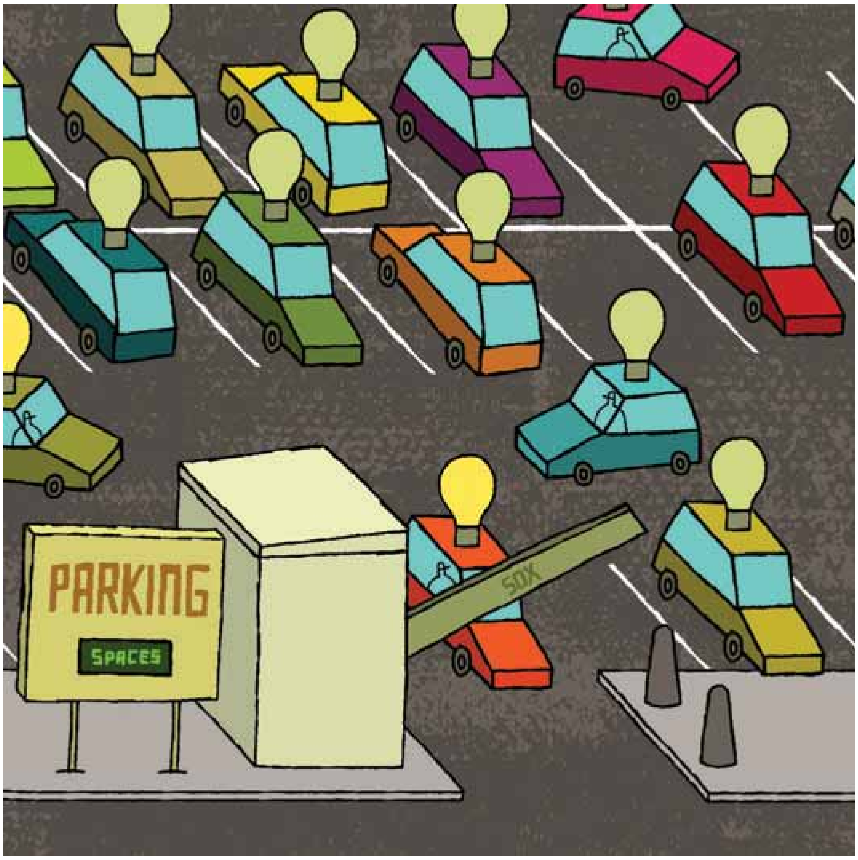
Not long ago, board seats were considered by some to be plum assignments, bringing stature and financial rewards but requiring only limited effort. Today, by contrast, directors face increased legal liability for inattention and, thus, a heavier workload. In addition, all members of the audit committee must be free of most financial and personal ties to the company, and at least one committee member should be a "financial expert," according to Sarbanes-Oxley. If not, the company must say so. Thus, it should come as no surprise that board membership has changed substantially. It appears that both recruits and veterans are taking their new responsibilities very seriously, as evidenced by longer and more frequent committee meetings and the more pointed questions members pose.

For many CFOs we've worked with, the transformation has been dramatic: "At the very next meeting of our audit committee, it was a different world in terms of members' engagement level," says one executive. "Some would argue that this intensity should have been there all along, but the fact is, it wasn't."

Yankee Candle CFO Bruce Besanko, who was working at another consumer products company when Sarbanes-Oxley was enacted, says that the Act changed the atmosphere on that company's audit committee. Besanko explains that before Sarbanes-Oxley, many companies used the same Big Four accounting firm for both auditing and consulting, often with the preponderance of fees going to consultants. While SEC rules forbid independent auditors to assist in the design of internal financial information systems, other types of consulting services are permissible. Nevertheless, a number of audit committees, including Yankee Candle's, have asked their independent auditors to stop providing certain consulting services to the company, except under limited and tightly controlled circumstances. (It should be noted that Sarbanes-Oxley states that *any* additional services to be provided by the external auditor are subject to the audit committee's explicit approval.)

Exploiting Convergence Opportunities

Two approaches to Sarbanes-Oxley predominate. Some executives dutifully meet SOX requirements, but at minimum cost and utilizing the fewest possible resources. Others leverage the re-



sources expended on compliance to obtain a return on their investment.

RSA Security, a $300 million technology company that helps organizations protect online identities and digital assets, decided to straddle those approaches, combining Sarbanes-Oxley compliance with other regulatory obligations to gain efficiencies and reduce overall costs. The company convened a team to identify commonalities among the statutory regimes with which it had to comply, including the Health Insurance Portability and Accountability Act of 1996 (HIPAA), the Gramm-Leach-Bliley (GLB) Act, California's Security Breach Information Act, and other laws to protect privacy and combat identity theft.

One area of convergence was employee record keeping. Like most companies, RSA Security maintains computerized HR files that contain personal data relating to pay, health benefits, and Social Security. Various laws and regulations govern the handling of these records: Financial information is protected under Sarbanes-Oxley, health benefits under HIPAA, and Social Security and other personal information under various federal and state privacy statutes.

John Parsons, RSA Security's vice president of finance and chief accounting officer, says the executive team realized that a single set of controls could be used for compliance with the various acts, given the similar way the data were organized and the acts' common interest in protecting the data's integrity and security. In response, functions such as IT and HR adopted a single set of controls that determined employee level of access to the computer system. An example of this consolidation was a single log-on for benefits, payroll, and other data. "Depending on their level and role, some employees get 'read only' rights to the files; some have the ability to change the data; and some, of course, are denied access," Parsons explains.

RSA Security adopted a similar convergence approach for its International Organization for Standardization (ISO) 9000 project, an international certification program administered by a Geneva-based NGO representing hundreds of national standard-setting bodies. ISO sets standards for quality management and quality assurance in such areas as production processes, record keeping, equipment maintenance, employee training, and customer relations.

The commonalities between the ISO and SOX projects weren't readily apparent to the two teams working on them (an operations team for the former and a finance team for the latter) because the two groups worked in separate buildings, with little awareness of each other's activities.

Both teams were charged with documenting dozens of business processes and determining how efficiently they were designed and operated. The ISO team, for example, examined processes established to ensure that only high-quality, fully debugged software reached the marketplace, while the SOX team, for example, scrutinized the account reconciliation process. When Parsons examined a detailed flowchart of the revenue cycle that his SOX team had prepared, it occurred to him that the ISO team was mapping exactly the same process. "Why," he asks, "would we have two different maps for the same business process? We certainly didn't need two process maps, two risk assessments, and two sets of controls over the revenue cycle from generation of the invoice to receipt of payment. So we drove what were completely parallel ISO and SOX processes into one converged process map and operational approach."

The benefits have gone beyond cost savings. "We were also able to free up people and reallocate their time to higher-value activities," he says. Instead of tying up so many employees in the revenue-draining chores of compliance and certification, RSA Security rededicated some of them to operational improvements, such as streamlining the customer order process and expanding supply chain capabilities.

Standardizing Processes

While process standardization will never be mistaken for low-hanging fruit, many believe it's worth the climb. The work of identifying and addressing inconsistencies across operating units and locations can be substantial, but so can the yield.

Consider the case of a large clothing manufacturer that operates retail outlets nationwide under several well-known brand names. During the company's first stage of Sarbanes-Oxley compliance, Deloitte & Touche partners met with the CFO and his staff to review the processes in place for recording basic financial transactions. We started with accounts receivable and learned that each division of the company imposed different due and dunning dates, late fees, and interest rates on customers. If the divisions had been independent companies, these inconsistencies would have been innocuous, but each of these units fed its financial data into consolidated financial statements, and these nonstandardized processes made a mess of the aged-receivable and bad-debt accounts.

An analogous situation existed at Sunoco. In documenting its procedures for Section 404, CFO Tom Hofmann was reminded that the company "had three or four different ways to get an invoice into the system." Sunoco's refining business varied the billing process by product category, be it aircraft fuel, lubricants, or wholesale heating oil.

"These transactions aren't that different," Hofmann says. "Why would we have different billing methods?" He chalked up the discrepancy to the historical independence of the various business groups and the lack of pressure to standardize. So, on his team's advice, he commissioned a single form that could capture all the information required to process a customer order. This consistency, Hofmann says, reduces the chances for error in data entry and consolidation.

Having to rebill customers to correct invoicing mistakes can have a cascading effect on operations: Every invoicing discrepancy, whether caught internally or flagged by a customer, must be investigated and reconciled, and the invoice must then be canceled, redone, and redelivered. As a consequence, the cash flow cycle is interrupted, and customer relations may become strained. At Sun-

SOX in Brief

The Sarbanes-Oxley Act of 2002 is almost defiantly brief; Section 404, for example, totals a mere 173 words. Significantly more verbose are the various rules, standards, and elaborations issued by the Public Company Accounting Oversight Board and the Securities and Exchange Commission. For most companies, Sections 302 and 404 represent the bulk of compliance work.

Section 302 (Title III–Corporate Responsibility): Corporate Responsibility for Financial Reports. This section requires that CEOs and CFOs personally certify the accuracy of financial statements and disclosures in the periodic reports and that those statements fairly present in all material aspects the results of operations and financial condition of the company. Furthermore, the executives must certify that financial controls and procedures have been implemented and evaluated, and that any changes to the system of internal control since the previous quarter have been noted.

Section 404 (Title IV–Enhanced Financial Disclosures): Management Assessment of Internal Controls. This section calls for an annual evaluation of internal controls and procedures for financial reporting. Like Section 302, Section 404 requires CEOs and CFOs to periodically assess and vouch for their effectiveness.

Section 404 also obliges companies to include an internal-control report in their annual report. Although the SEC has not spelled out all of the elements of the internal-control report, it has indicated that the document should contain the following:

- a statement acknowledging responsibility for establishing and maintaining adequate internal control over financial reporting
- a statement identifying the internal-control framework used to evaluate the effectiveness of internal control over financial reporting
- an assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year
- disclosure of any material weaknesses in the company's internal control over financial reporting (if any material weaknesses exist, then internal control over financial reporting is deemed ineffective)
- a statement that the independent auditor has issued a report on the company's assessment of internal control over financial reporting

In addition, Section 404 requires a company's external auditor to examine and report on management's assessment of internal controls, as well as the effectiveness of the controls themselves.

Section 906 (Title IX–White-Collar Crime Penalty Enhancements): Corporate Responsibility for Financial Reports. This section requires CEOs and CFOs to sign and certify the report containing financial statements; they must confirm that the document complies with SEC reporting requirements and fairly represents the company's financial condition and results. Willful failure to comply with this requirement can result in fines of up to $5 million and imprisonment for up to 20 years.

oco, creating a single, standardized form for every type of product reduced these problems to a minimum.

The potential benefits of standardization also caught the attention of executives at Kimberly-Clark, the consumer products manufacturer. Mark Buthman, senior vice president and CFO, says his company's Sarbanes-Oxley work spotlighted an area rife with inconsistency: manual journal entries. "It may not seem that journal entries would be such a big deal, but we have hundreds of people around the world generating them," says Buthman, whose company employs more than 60,000 workers in 38 countries.

Before Sarbanes-Oxley, the company's journal-entry process varied widely by division and location, with some employees creating entries by hand, others keying them into Excel spreadsheets, and still others logging them into the company's SAP financial software program. The process for reviewing the entries was also fragmented, with some reviews conducted by people not senior enough. The management at Kimberly-Clark decided to have staff log all journal entries into the company's SAP system. "Instead of having hundreds of ad hoc procedures for journal entries, we now have just three," Buthman says. Data are now more consistent and reliable, and fewer employees and man-hours are required to accomplish the same task, he says.

Standardization is also a bottom-line issue for Manpower, a $16 billion provider of employment services operating in 72 countries. With more than 2 million temporary and permanent employees on the company's payroll, the need to maintain rigorous checks and balances is significant. "Even minor decimal or application coding errors can have a huge impact," says Nancy Creuziger, a vice president and the company's controller.

To guard against these types of errors, Manpower standardized its change-management process for software development. Any code alterations are now subjected to a series of reviews, tests, analyses, and approvals before going live. A regression test is introduced near the end of the development process to validate the new code. During the test, technicians operate two machines concurrently, one running the old code and the other the new. The same data are put into each, and the output is compared in order to identify coding errors. The exercise is designed to reveal any programming changes that don't fall within the scope of the development plan.

Besides averting financial losses, standardizing the software coding processes also helps streamline the development cycle. "You standardize a process only after defining the most efficient way of doing it," Creuziger notes. For a company that develops global software applications for its business units, development and support costs can be cut substantially. Further benefits accrue when internal and external auditors come knocking, since standardized processes can be evaluated more quickly and thus more cheaply.

Because of the difficulties companies have experienced conducting their own internal-control assessments, most blanch at the thought of verifying third parties' internal controls.

Reducing Complexity

Some tasks are inherently complex – designing computer chips, tracking weather patterns, mapping the human genome. Others are needlessly so. In the case of Iron Mountain, a $1.8 billion records and information management company, merger and acquisition activity contributed to an increasingly cumbersome organizational structure. Over a ten-year period, the company had acquired more than 150 competitors and complementary businesses. It acquired another 50 companies indirectly when it purchased its largest competitor, Pierce Leahy, which had just completed an acquisition spree of its own.

Simplification was always the game plan at Iron Mountain, says John F. Kenny, Jr., executive vice president and CFO, but the extensive testing requirements of Sarbanes-Oxley accelerated these efforts. Each acquired company came with its own organizational chart; Iron Mountain integrated and streamlined the reporting structure. Each acquisition brought its own accounting practices; Iron Mountain centralized all accounting activities. Some of the companies ran Unix while others ran Linux, Novell NetWare, or Windows; Iron Mountain opted for a single platform. Many of the companies calculated taxes by hand or on spreadsheets; Iron Mountain automated tax estimation and payments.

"We can't say with certainty that such-and-such improvement has led to, say, a 5% reduction in costs," says Kenny. Nonetheless, he and other executives believe that the company has made significant gains in efficiency.

Strengthening Weak Links

Another source of complexity arises from outsourcing, partnerships, and shared-services arrangements, known collectively as the "extended enterprise." Although businesses have long outsourced such tasks as manufacturing, order fulfillment, payroll, accounting, human resources, shipping, tax reporting, and coupon and warranty processing, SOX has recast these relationships.

One SOX-related complication arises when the partner company engages in activities that materially affect the primary company's financials. These can include hosting IT applications, managing IT infrastructure, providing services in accounts receivable or accounts payable, processing payroll, managing benefits, and maintaining warehouse inventories. In such cases, the primary company must obtain evidence of effective internal control at the partner company, ideally in the form of an SAS 70

Type II report that the partner provides. If, however, the service provider is unwilling or unable to do so, the primary company must conduct its own audit.

In view of the difficulties companies have experienced conducting their own internal-control assessments, most blanch at the thought of verifying third parties' internal controls. As a result, many of our respective firms' clients are reevaluating their outsourcing arrangements and partnerships. Yankee Candle's CFO, for one, plans to take a hard line if he can't obtain an SAS 70 report. "If it is a major partner that impacts our financials, we will terminate the relationship," Besanko says.

Minimizing Human Error

Ask most auditors what they consider to be the weakest aspect of internal control, and they'll tell you, "Manual processes." The human beings charged with carrying them out may be fatigued, distracted, stressed, malicious, or absent. Michael Hammer, the originator of reengineering, was fond of saying that it is "the 'biological work units' that cause most of your problems." Automated controls, if properly designed and implemented, aren't susceptible to such pitfalls. Yet in our experience, most controls are still manual.

Because automated controls are more reliable, only a single sample of an activity may need to be tested. (A manual control of the same activity could require dozens of tests.) Also, according to recent PCAOB guidance, some automated controls can be tested every three years instead of every year, as long as the company can demonstrate that the control has not been changed. Some companies step up their security measures to ensure that unauthorized software modifications can't be made. For example, many firms now require passwords of at least eight characters consisting of numbers, symbols, and both lowercase and uppercase letters. Users must change passwords at least every three months and are locked out after several consecutive incorrect entries.

Still, some situations call for human judgment. Manpower strives to find a balance between automated and manual controls. For example, its automated monitoring system flags sales adjustments exceeding $10,000. But sometimes such adjustments are permissible. "You need human judgment to determine whether the override is reasonable or whether it needs to be investigated further," says Creuziger. "Even highly automated systems need the possibility of human override in special circumstances."

Ask most auditors what the weakest aspect of internal control is, and they'll tell you, "Manual processes."

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Whether companies saw the need for internal reform before SOX or have made plans only recently, too few have actually implemented business improvements. The reasons for this are several: Audit committees have not insisted that their companies go beyond protecting their assets and reputation; CEOs haven't deployed sufficient resources to handle the burden of doing so; CFOs haven't been ingenious enough at devising ways SOX can contribute real value; and CEOs, CFOs, and internal audit departments haven't collaborated to identify areas where gains in value could be used to offset the costs of compliance.

More than a year since the first Section 404 deadline arrived, Sarbanes-Oxley still inspires fear in boards and top executives–of enforcement actions, of the stock market's reaction to a deficiency, and of personal liability. Fear can be a powerful generator of upstanding conduct. But business runs on discovering and creating value. The procrastinators need to start viewing the Sarbanes-Oxley Act of 2002 as an ally in that effort.

Reprint R0604J
To order, see page 151.

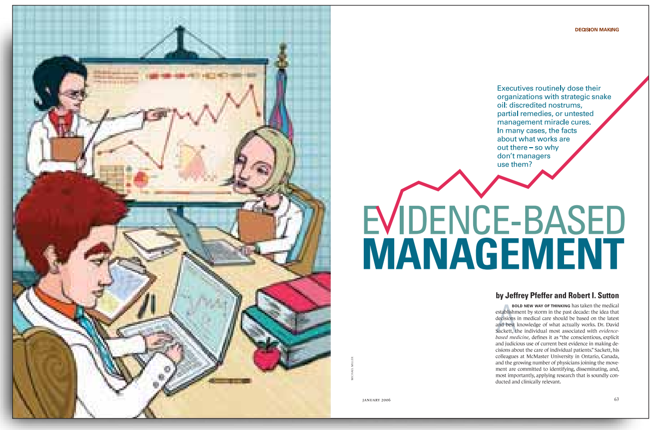
"He is here, but he doesn't know that I know he's here."

P. C. VEY

Evidence-Based Management

As a professional working on health-care quality improvement, I was pleased to read Jeffrey Pfeffer and Robert I. Sutton's article "Evidenced-Based Management" (January 2006). Two points that are implied in the article warrant additional emphasis, as they may be important to readers considering changes in their organizations.

First, an infrastructure is essential to support the creation and use of evidence. The authors correctly point out


DECISION MAKING

Executives routinely dose their organizations with strategic snake oil: discredited nostrums, partial remedies, or untested management miracle cures. In many cases, the facts about what works are out there – so why don't managers use them?

EVIDENCE-BASED MANAGEMENT

by Jeffrey Pfeffer and Robert I. Sutton

A BOLD NEW WAY OF THINKING has taken the medical establishment by storm in the past decade: the idea that decisions in medical care should be based on the latest and best knowledge of what actually works. Dr. David Sackett, the individual most associated with *evidence-based medicine,* defines it as "the conscientious, explicit and judicious use of current best evidence in making decisions about the care of individual patients." Sackett, his colleagues at McMaster University in Ontario, Canada, and the growing number of physicians joining the movement are committed to identifying, disseminating, and, most importantly, applying research that is soundly conducted and clinically relevant.

MICHAEL MILLER

JANUARY 2006

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the poor track record companies have when trying to emulate successful programs, such as the Toyota Improvement System or the Army After Action Review. Based on my own work, I would say that these failures can be traced back to the lack of infrastructure.

Second, the authors also correctly note the challenge to executives when management is based on evidence that anyone can provide or interpret. In our recent work with high-performing health-care teams, we found that evidence-based teamwork can lead to a physician taking a more specific role as a physician scientist, a change that many doctors report is more professionally satisfying. This finding is consistent with other reports that managers take on a more distinct role when they manage their unit or department from shared evidence.

Our own work in using evidence to improve care has focused on evidence-based management of teamwork. We have found that when an infrastructure supports the use of evidence to deliver better care, then the stage is set to extend evidence to care management. To create such an infrastructure, an organization must teach people to work from evidence, provide tools for gathering and sharing evidence, promote a just culture, and more. Once all of these elements are in place, health care can be transformed.

David Boan
Vice President, Research
Delmarva Foundation for Medical Care
Easton, Maryland

I agree with many of the points Pfeffer and Sutton make. One very important issue that they overlook, however, is quick decisions. In business situations, as well as in real life, you often have to make on-the-spot decisions without first considering all the available information. Gut feeling and intuition can be very important ways of making the right choices under these circumstances. Over time, you build up knowledge based on prior decisions, which you then can use to make new decisions.

Another problem is the question of "evidence." According to the authors, there is relevant and right information

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available to support every decision. Is that really so?

In my opinion, the authors could have divided decisions into subcategories. Analyzing whether decisions are based on time (here and now or not here and now) or importance (very important or not so important), for instance, could be a useful tool for management.

Thomas Hosszu
Controller
Nestlé Nordic
Copenhagen, Denmark

Pfeffer and Sutton respond: It is impossible for managers to find the facts before making some pressing decisions, but too many use time pressure to justify basing nearly every decision on gut instinct. This is a dangerous path. These managers invoke imperfect information as an excuse for avoiding the hard thinking required to uncover new ideas and better evidence – virtually ensuring that the future will be a perfect imitation of the past.

David Boan's comments on infrastructure are correct: Implementing fact-based decisions requires the capacity to gather and analyze information. Yet leaders should not use a poor infrastructure as an excuse to avoid digging into the logic of current decisions, nor should they use it as an excuse for doing what they have always done. Even companies with excellent infrastructures can't generate rigorous data for every decision, but their leaders learn from small experiments, pilot programs, and qualitative data.

Thomas Hosszu is right that sometimes action is imperative. That is no excuse for avoiding evidence-based management. Many business leaders claim to be too rushed to commit to reflection, review, and evidence, but such practices are routine in medicine and the military precisely because of the severe pressure to make instant decisions. Yes, experience is the only way that managers can learn their craft, but those who are too confident in their well-honed instincts are flirting with disaster. Decades of psychological research shows that people routinely fall into dangerous ruts. Andrew Hargadon at the University of California at Davis asks managers who claim to base a decision on 20 years of experience, "Do you have 20 years of experience, or do you have the same year of experience repeated 20 times?"

There are always unknown risks and pressure to act on incomplete information, and it is impossible to anticipate the consequences of every decision. But when our money is at stake, we bet on leaders who are committed to finding, facing, and acting on the hard facts rather than on those who view such objectives as hopeless and naive.

Decisions Without Blinders

Max H. Bazerman and Dolly Chugh's article, "Decisions Without Blinders" (January 2006), offers fascinating insights about how bounded awareness affects executives, and what they can do about it. A key blinder, the "failure to see information," also applies to stock market investors.

In our article, "Limited Attention, Information Disclosure, and Financial Reporting," in the *Journal of Accounting and Economics* (December 2003), we showed that if investors neglect certain kinds of accounting information, management has a strategic incentive to manipulate disclosures. For example, firms accentuate the positive in their pro forma earnings disclosures, which often show up prominently on the newswires but are not part of their audited financial statements. Our theory suggests that when pro forma earnings are higher than GAAP earnings – and they almost always are – investors will tend to overvalue the firm, causing its stock to subsequently perform poorly. In this and other research, we apply the notion of bounded investor awareness (which we call "limited attention") to such issues as the effects of expensing employee stock options, the power of earnings management to distort stock prices, and the temptation for managers to withhold adverse information about their firms.

A firm that makes a lot of accounting adjustments to boost earnings over time, or that capitalizes its spending as fixed assets rather than expensing, will end up with a bloated balance sheet. In the December 2004 issue of the same journal, we and our coauthors, Kewei Hou and Yinglei Zhang, found that companies with bloated balance sheets are overvalued by the market. As a result, investors can predict future stock returns using balance sheet information. Investors with limited attention focus on an accounting measure of profitability (earnings) and neglect cash profitability (free cash flow), which is also informative about value. When we cumulated the deviation between the two over time, we got a measure of how bloated a firm's balance sheet is.

Investors who focus only on the income statement fail to recognize the warning signs on the balance sheet. Neglecting relevant information can cause stock market mispricing. As a result, a profitable trading strategy can be built from our bloatedness measure.

David Hirshleifer
Ralph M. Kurtz Chair in Finance
Siew Hong Teoh
Associate Professor of Finance
Fisher College of Business
The Ohio State University
Columbus, Ohio

Growing Talent as If Your Business Depended on It

There is a striking parallel between Jeffrey M. Cohn, Rakesh Khurana, and Laura Reeves' article, "Growing Talent as If Your Business Depended on It" (October 2005), and Warren G. Bennis and James O'Toole's "How Business Schools Lost Their Way" (May 2005) that applies to many B-school grads, particularly those who went to business school at night in professional MBA programs, as I did. Many in my peer group had their education paid for by their employers but now complain that their companies have not offered them management promotion opportunities or identified them as being in a select pool for succession planning. One would expect that these individuals, having earned an MBA studying at night while having a full-time job, would now be identified by their companies as ambitious, energetic people with the skills to succeed at higher levels. But, it seems these two articles have happened on a phenomenon that may be the unintended consequence of pursuing an MBA degree while working: Your present employer may not fully appreciate your desire to succeed nor the skill set you may have. An interesting study would be to see how many professional MBA students actually received promotions or more management responsibility within the same company after receiving their degrees. My guess is that there would be little correlation between the two scenarios.

Michael Petridis
CEO
Ourania
Dallas

Cohn, Khurana, and Reeves respond: It is clear from Michael Petridis's letter that talent management is still broken in many companies. There are two sides to the equation, of course – leadership development and succession planning. The obvious but elusive goal is an optimal balance between the two.

Getting on top management's and even the board's radar requires high-potential managers to take advantage of two types of development opportunities: internal opportunities like mentoring, coaching, and stretch assignments, and external opportunities, such as executive MBA programs. But these pursuits are not all equally effective.

Recent research on MBA programs shows that the quality and usefulness of a general MBA degree (sought by day, night, or part time) vary widely. Because MBAs are not professional degrees with uniform codes of ethics or continuing education requirements of professional certifications, it has been argued that they primarily provide access to elite social networks rather than impart specific technical knowledge. Therefore, the usefulness of an MBA degree for career advancement should be considered within the context of a specific organization. The individual's challenge is to understand the universe of possibilities, then leverage the right ones.

What, then, is the host organization's responsibility? It has to offer a range of developmental opportunities. The goal is not to be the next GE – sponsoring every leadership development activity under the sun. For most companies, that would be a waste of resources. CEOs need to take a sober, objective look at what makes sense for their rising stars. They should select a few candidates for a high-potential managers program, keep them on their radar, and invest in a handful of leadership development activities that both further strategic objectives and build talent.

Decisions and Desire

I enjoyed reading Gardiner Morse's article, "Decisions and Desire" (January 2006), in the special issue on decision making. Morse recounts the famous ultimatum game in which one participant must convince another participant to agree on their respective shares of a fund held entirely by the first participant; each participant gets to keep whatever share they agree on, but lack of agreement deprives both of any share. Sheer logic would imply that the second participant should agree to any offer, no matter how paltry, on the theory that anything is better than nothing. But experiments show that the minimum share to ensure agreement is much more than a token.

The standard conclusion is that this result demonstrates that our primal brain can overrule our rational brain, with illogical consequences. I agree that the experiment shows our primal brain prevailing over our rational brain, but I doubt that the result is illogical. Our brains evolved to enable effective collaboration in small groups over a long time. In this environment, it is essential to group survival, and to the survival of individuals lower in the hierarchy, to share resources. The experiment shows that individuals lower in the hierarchy, or simply less fortunate at the moment, know instinctively that to survive they must demonstrate to those more fortunate or higher in the hierarchy that merely token sharing causes all to suffer. If they do not prove this point, they will perish; the only issue will be how fast they perish. I suggest, therefore, that the outcome of the ultimatum game is not really illogical when viewed in an evolutionary context.

Ralph E. Avery
Rockville, Maryland

All the Wrong Moves

I was surprised that none of the commentators in "All the Wrong Moves," by David A. Garvin (January 2006), picked up on Nora Stern's comment that the CEO, Don Rifkin, should take a more dictatorial approach to decision making.

In my view, Rifkin should be a more active chairman: draw out the various arguments and seek consensus in meetings. If a common view is not forthcoming, then he should weigh the options and make the decision himself. More often than not, a timely decision is more effective than a late but absolutely correct decision. However, as other commentators noted, this approach does require Rifkin to be on top of the issues. He was not, as the problems with the acquisition made clear. His executives need to brief him effectively, and he needs to challenge anything he does not understand. Only then will he be able to build the big picture he needs.

Even when meetings are called on short notice, they should have a clear objective and agenda so that people can be as well prepared as possible and focus on the corporate rather than functional imperatives.

Early in my career I was left in complete charge of a business. The entrepreneur who owned it told me that if a decision was urgently needed I was to make it. As long as I made the decision in good faith based on the information available, he said he would back me (which he did). He also felt that few decisions were irreversible, so they could always be revised in the light of new information. I have found myself returning to this valuable lesson throughout my career.

Martin Wilson
CEO, Programs Director
Solidus – Programs Consultancy
Nottingham, England

Are You Working Too Hard?

Science proves what we knew all along: Do what comes naturally. This is exactly what I've been doing all my life: working hard, relaxing – then gathering insights (well, not always), and then working hard again.

Managers at large companies should read this conversation with Herbert Benson (November 2005) and stop harassing employees with comments like "Shouldn't you be working on that report?" It's no wonder some smaller, less structured companies get so far ahead in creativity: at these companies, it's OK to relax, whether that means playing air guitar or video games, or going for a run.

Andras Both
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Executive Summaries

April 2006

"Home Depot's experience shows – in perhaps the best example I have seen in my 30-year career – that a cultural transition can be achieved systematically."

– page 60

COVER STORY

60 | Home Depot's Blueprint for Culture Change

Ram Charan

What could be harder than turning around a seemingly wildly successful company by imposing a centralized framework on a heretofore radically decentralized, anti-establishment, free-spirited organization? That was the challenge GE alumnus Robert Nardelli faced when he abruptly succeeded Home Depot's popular founders, Bernie Marcus and Arthur Blank, as the top executive in December 2000.

Talk about a shock: No one expected Marcus and Blank, both in their fifties, to leave. And, as Nardelli himself acknowledges, the last thing anyone wanted was an outsider who would "GE-ize their company and culture."

But despite its glossy high-growth exterior, Home Depot was standing on shaky financial footings. Rapid expansion had stretched cash flow, inventory turns, profits, and store manager ranks thin. Each store's vaunted independence was making the company as a whole highly inflexible, unable to take advantage of economies of scale. What so effectively got Home Depot from zero to $50 billion in sales wasn't going to get it to the next $50 billion.

The story of the vision, strategy, and leadership skills Nardelli used to move Home Depot to the next level has been told. But vision, strategy, and leadership alone – while necessary – are not enough. Typically, culture change is unsystematic and, when it works, is based on the charisma of the person leading the change, Charan says. "But Home Depot shows – in perhaps the best example I have seen in my 30-year career – that a cultural transition can be achieved systematically."

In this article, Charan lays out the panoply of tools that, wielded in a coordinated and systematic fashion, enabled Home Depot to get a grip on its freewheeling culture so that the company could reap – and sustain – the advantages inherent in its size. Many an up-and-coming company would do well to look to this model to gain similar advantage when the time comes to exchange the thrill of entrepreneurial spirit for the strength of established power.

Reprint R0604C; HBR OnPoint 4079; OnPoint collection "CEOs on Leading Change" 4117

IDEAS & TRENDS

FORETHOUGHT

18 | The World Is Round It's conventional wisdom that the Internet has made the world flatter. But we're not necessarily smarter, and many people have been left behind. **Reprint F0604A**

Learning the Tricks of the Trade Each profession has its own vocabulary. Knowing how to talk the talk is critical – in some fields more than others. **Reprint F0604B**

Living Agreements for a Risky World In emerging markets, contracts must be both flexible *and* rigid. "Shock absorber" and "safety net" clauses offer firms a living, breathing solution. **Reprint F0604C**

What Is Luxury Without Variety? Today's consumers crave variety. A new approach to providing luxury gives the super affluent access to a range of big-ticket items. **Reprint F0604D**

Growing by Cutting SKUs at Clorox New products don't always mean increased profits. At Clorox, a formal process for determining which products to cut has boosted SKU sales and margins. **Reprint F0604E**

Sparking Creativity at Ferrari Ferrari depends on a creative workforce to build its gorgeous cars. Companies can take a lesson from its unique approach to inspiring employees. **Reprint F0604F**

What B2B Customers Really Expect Companies aggressively research what customers want. Yet most vendors just don't understand what customers expect of their salespeople. **Reprint F0604G**

Small Ponds Aren't for Everyone Corporate refugees dream of running small firms. The realities of the job, though, can be humbling. **Reprint F0604H**

Before You Split That CEO/Chair… What's the rationale for dividing the roles of chairman and CEO? Studies show that, usually, doing so has no effect on the company's performance. **Reprint F0604J**

A Question of (a) Character China's Five-Year Plan is now called a Five-Year Guideline, reflecting the country's transition to a market economy. **Reprint F0604K**

Book Reviews Featuring Robert Frenay's *Pulse: The Coming Age of Systems and Machines Inspired by Living Things,* with reviews of three other books.

CUSTOMER RELATIONS

HBR CASE STUDY

33 | How Low Will You Go?

Mary Edie Mobley and John Humphreys

When Bob Carlton decided to expand Opti-Motors, the Alabama engine-parts manufacturer he had founded, he knew he'd have to take on a lot of debt. So he followed a headhunter's advice and hired Galen McDowell to bring new energy to sales.

No question, Galen knew how to sell. He quickly hooked a big-league outfit, Kinan Motors, as a potential customer. He invited their representatives to come take a tour of the company and, while they were in town, visit the Red Ruby Club.

The Red Ruby? That's a strip club.

Galen assured Bob it was upscale and full of businesspeople. He said his reps had often made use of the club to woo important accounts away from rivals. As if to prove his point, Kinan quickly signed a multimillion-dollar contract with Opti-Motors after the visit.

Then April Hartley, Bob's first salesperson, quit. She had been trying to build relationships with customers, but the really big accounts, it seemed, were looking for "more exciting stuff" than she could give them. Now Joan Warren – another saleswoman, and one who would happily close a deal anywhere she got the chance – is complaining because Galen won't let her go to the Red Ruby with him. "I won't stand by and be disadvantaged simply because I'm a woman," she says.

When does client entertainment cross the line? Four experts discuss this fictional case study: John Brown, the director of institutional sales and customer relations at Fortis Investments; Katherine Frank, a former dancer who is now an author and postdoctoral fellow at the University of Wisconsin–Madison; Das Narayandas, a professor of business administration at Harvard Business School; and Denise Rousseau, a professor at Carnegie Mellon's Heinz School of Public Policy and Tepper School of Business.

Reprint R0604A
Reprint R0604X: Case only
Reprint R0604Z: Commentary only

LEADERSHIP

47 | Lessons in Power: Lyndon Johnson Revealed

A Conversation with Historian Robert A. Caro

No one can lead who does not first acquire power, and no leader can be great who does not know how to use that power. The trouble is that the combination of the two skills is rare. Amassing power requires ambition, a focused pragmatism, and a certain ruthlessness that is often at odds with the daring, idealistic vision needed to achieve great things with that power.

The tension is as real in business as it is in politics. This magazine is replete with examples of successful senior managers who could not make the switch from ambitious executive to corporate leader because they did not know what to do with the power they had so expertly accumulated.

Robert Caro is a student of power. For the past 27 years, the two-time Pulitzer prize–winning biographer of Robert Moses and Lyndon Johnson has focused on the question of how Johnson amassed and wielded power. Caro's deep understanding of the inner workings of power offers senior executives a nuanced picture of leadership at the highest level.

In this wide-ranging conversation, Caro shares his insights about the nature of power, the complexity of ambition, and the role that the greater good can play in the making of a leader. Power doesn't always corrupt, he insists. But what it invariably does is reveal a leader's true nature.

"Today, when CEOs have acquired more and more power to change our lives," Caro says, "they have become like presidents in their own right, and they, too, need to align themselves with something greater than themselves if they hope to become truly great leaders."

Reprint R0604B

LEADERSHIP

72 | When Should a Leader Apologize – and When Not?

Barbara Kellerman

When corporate leaders or the organizations they represent mess up, they face the difficult decision of whether or not to apologize publicly. A public apology is a risky move. It's highly political, and every word matters. Refusal to apologize can be smart, or it can be suicidal. Readiness to apologize can be seen as a sign of character or one of weakness. A successful apology can turn enmity into personal and organizational triumph – while an apology that's too little, too late, or too transparently tactical can open the floodgates to individual and institutional ruin.

Since the stakes are so high, Kellerman says, leaders should not extend public apologies often or lightly. One or more of the following conditions should apply:

- The apology is likely to serve an important purpose.
- The offense is of serious consequence.
- It's appropriate that the leader assume responsibility for the offense.
- The leader is the only one who can get the job done.
- The cost of saying something is likely lower than the cost of staying silent.

The author draws her conclusions from hard data and abundant anecdotal evidence, examining notoriously bad apologizers as well as exceptionally good ones.

While selectivity is key, good apologies usually do work. What constitutes a good apology? Acknowledgment of the mistake or wrongdoing, acceptance of responsibility, expression of regret, and assurance that the offense will not be repeated.

Reprint R0604D

STRATEGY & COMPETITION

82 | Localization: The Revolution in Consumer Markets

Darrell K. Rigby and Vijay Vishwanath

Standardization has been a powerful strategy in consumer markets, but it's reached the point of diminishing returns. And diversity is not the only chink in standardization's armor: Attempts to build stores in the remaining attractive locations often meet fierce resistance from community activists. From California to Florida to New Jersey, neighborhoods are passing ordinances that dictate the sizes and even architectural styles of new shops. Building more of the same – long the cornerstone of retailer growth – seems to be tapped out as a strategy.

Of course, a company can't customize every element of its business in every location. Strategists have begun to use clustering techniques to simplify and smooth out decision making and to focus their efforts on the relatively small number of variables that usually drive the bulk of consumer purchases.

The customization-by-clusters approach, which began as a strategy for grocery stores in 1995, has since proven effective in drugstores, department stores, mass merchants, big-box retailers, restaurants, apparel companies, and a variety of consumer goods manufacturers. Clustering sorts things into groups, so that the associations are strong between members of the same cluster and weak between members of different clusters.

In fact, by centralizing data-intensive and scale-sensitive functions (such as store design, merchandise assortment, buying, and supply chain management), localization liberates store personnel to do what they do best: Test innovative solutions to local challenges and forge strong bonds with communities.

Ultimately, all companies serving consumers will face the challenge of local customization. We are advancing to a world where the strategies of the most successful businesses will be as diverse as the communities they serve.

Reprint R0604E; HBR OnPoint 4109

HBR Spotlight INNOVATION

98 | Match Your Innovation Strategy to Your Innovation Ecosystem

Ron Adner

High-definition televisions should, by now, be a huge success. Philips, Sony, and Thompson invested billions of dollars to develop TV sets with astonishing picture quality. From a technology perspective, they've succeeded: Console manufacturers have been ready for the mass market since the early 1990s. Yet the category has been an unmitigated failure, not because of deficiencies, but because critical complements such as studio production equipment were not developed or adopted in time. Underperforming complements have left console producers in the position of offering a Ferrari in a world without gasoline or highways – an admirable engineering feat, but not one that creates value for customers.

The HDTV story exemplifies the promise and peril of *innovation ecosystems* – the collaborative arrangements through which firms combine their individual offers into a coherent, customer-facing solution. When they work, innovation ecosystems allow companies to create value that no one firm could have created alone. The benefits of these systems are real. But for many organizations the attempt at ecosystem innovation has been a costly failure. This is because, along with new opportunities, innovation ecosystems also present a new set of risks that can brutally derail a firm's best efforts.

Innovation ecosystems are characterized by three fundamental types of risk: *initiative risks* – the familiar uncertainties of managing a project; *interdependence risks* – the uncertainties of coordinating with complementary innovators; and *integration risks* – the uncertainties presented by the adoption process across the value chain. Firms that assess ecosystem risks holistically and systematically will be able to establish more realistic expectations, develop a more refined set of environmental contingencies, and arrive at a more robust innovation strategy. Collectively, these actions will lead to more effective implementation and more profitable innovation.

Reprint R0604F; HBR OnPoint 4087

108 | Manage Customer-Centric Innovation – Systematically

Larry Selden and Ian C. MacMillan

No matter how hard companies try, their approaches to innovation often don't grow the top line in the sustained, profitable way investors expect. For many companies, there's a huge difference between what's in their business plans and the market's expectations for growth (as reflected in firms' share prices, market capitalizations, and P/E ratios). This growth gap springs from the fact that companies are pouring money into their insular R&D labs instead of working to understand what the customer wants and using that understanding to drive innovation. As a result, even companies that spend the most on R&D remain starved for both customer innovation and market-capitalization growth.

In this article, the authors spell out a systematic approach to innovation that continuously fuels sustained, profitable growth. They call this approach customer-centric innovation, or CCI. At the heart of CCI is a rigorous customer R&D process that helps companies to continually improve their understanding of who their customers are and what they need. By so doing, they consistently create or improve their customer value proposition. Customer R&D also focuses on better ways of communicating value propositions and delivering the complete experience to real customers. Since so much of the learning about customers and so much of the experimentation with different segmentations, value propositions, and delivery mechanisms involve the people who regularly deal with customers, it is absolutely essential for frontline employees to be at the center of the CCI process. Simply put, customer R&D propels the innovation effort away from headquarters and the traditional R&D lab out to those closest to the customer. Using the example of the luggage manufacturer Tumi, the authors provide a step-by-step approach for achieving true customer-centric innovation.

Reprint R0604G

MARKETING

124 | Your Loyalty Program Is Betraying You

Joseph C. Nunes and Xavier Drèze

Even as loyalty programs are launched left and right, many are being scuttled. How can that be? These days, everyone knows that an old customer retained is worth more than a new customer won. What is so hard about making a simple loyalty program work?

Quite a lot, the authors say. The biggest challenges include clarifying business goals, engineering the reward structure, and creating incentives powerful enough to change buying behavior but not so generous that they erode margins. Additionally, companies have to sort out the puzzles of consumer psychology, which can result, for example, in two rewards of equal economic value inspiring very different levels of purchasing.

In their research, the authors have discovered patterns in what the successful loyalty programs get right and in how the others fail. Together, their findings constitute a tool kit for designing something rare indeed: a program that won't do you wrong.

To begin with, it's important to know exactly what a loyalty program can do. It can keep customers from defecting, induce them to consolidate certain purchases with one seller (in other words, win a greater share of wallet), prompt customers to make additional purchases, yield insight into their behavior and preferences, and turn a profit. A program can meet these objectives in several ways – for instance, by offering rewards (points, say, or frequent-flier miles) divisible enough to provide many redemption opportunities but not so divisible that they fail to lock in customers.

Companies striving to generate customer loyalty should avoid five common mistakes: Don't create a new commodity, which can result in price wars and other tit-for-tat competitive moves; don't cater to the disloyal by making rewards easy for just anyone to reap; don't reward purchasing volume over profitability; don't give away the store; and, finally, don't promise what can't be delivered.

Reprint R0604H; HBR OnPoint 4095

GOVERNANCE

133 | The Unexpected Benefits of Sarbanes-Oxley

Stephen Wagner and Lee Dittmar

In the wake of a series of gross corporate abuses around the turn of the century, Congress passed Sarbanes-Oxley, which was intended to make corporate governance more rigorous, financial practices more transparent, and management criminally liable for lapses. The first year of implementation was costly and onerous, far more so than companies had been led to expect. In the view of a few open-minded firms, however, the second year of compliance turned out to be not only less costly and less onerous (as doing something for the second time usually turns out to be), but a source of valuable insights into operations, which management has translated into improved efficiencies and cost savings.

The areas of improvement go well beyond technical statutory compliance. They include a strengthened control environment; more reliable documentation; increased audit committee involvement; better, less burdensome compliance with other statutory regimes; more standardized processes for IT and other functions; reduced complexity of organizational processes; better internal controls within partner companies; and more effective use of both automated and manual controls. The result is not only shareholder protection, the official purpose of the act, but also enhanced shareholder value.

More than a year since the first deadline arrived, Sarbanes-Oxley still inspires fear – of enforcement actions, of the stock market's reaction to a deficiency, and of personal liability. Fear can be a powerful generator of upstanding conduct. But businesses run on discovering and creating value. Companies need to start viewing Sarbanes-Oxley as an ally in that effort.

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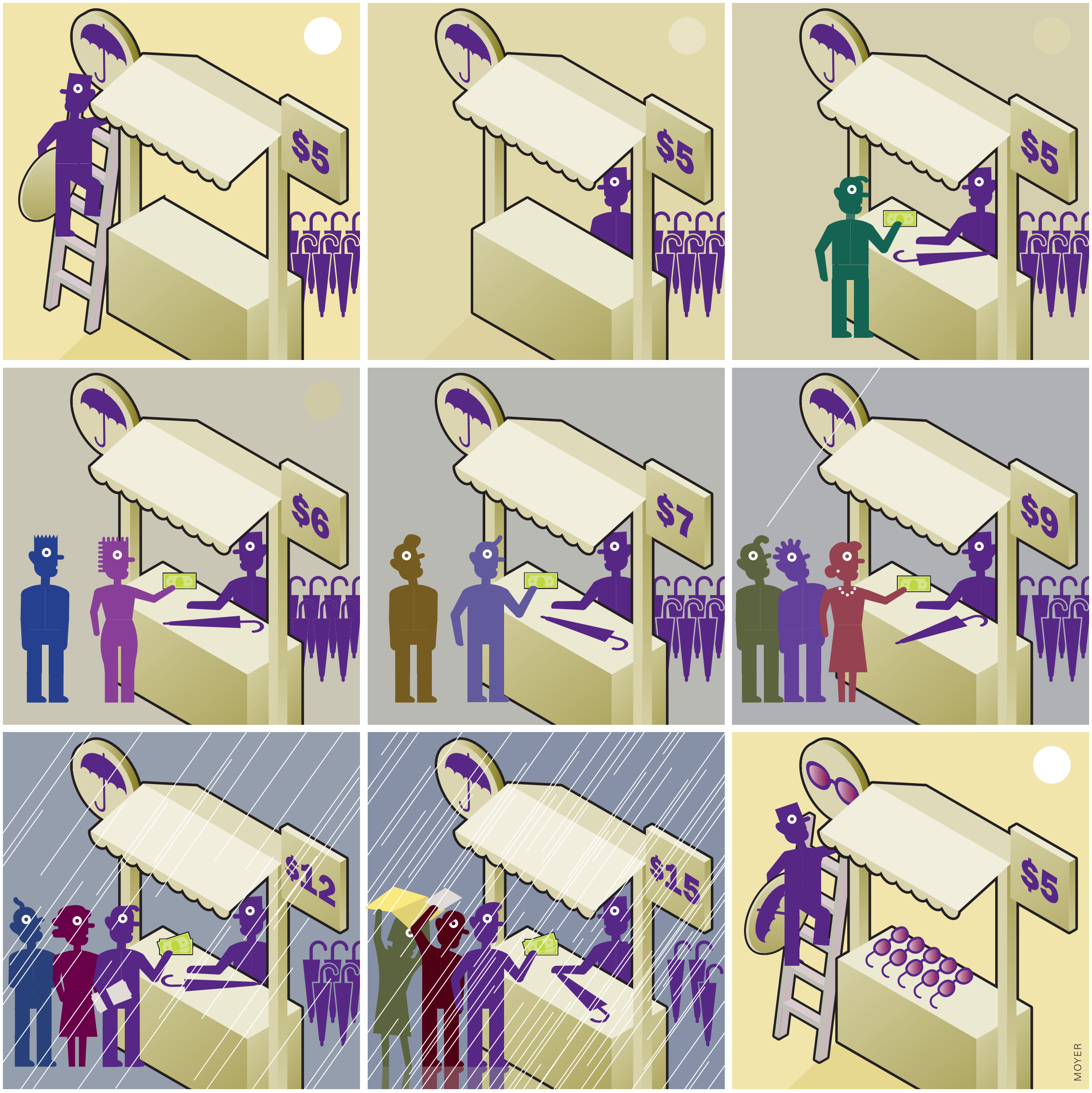
by Don Moyer



Basics Training

Supply and demand continue to dance in the same embrace Alfred Marshall describes in *Principles of Economics.* Price is determined by the point where supply and demand balance – and that point can move as conditions change. More than a century has passed since Marshall propounded his model, and still you can take it to the bank.

We are always trying to glimpse what lies around the corner: the thing that will, or could, or might be. As a result, we sometimes forget the fundamentals. Some things do not change, and those things are more than just facts – they are *truths.* Yet businesspeople, anxious to move onward and upward, are often impatient or dismissive of the basics.

In their excellent book *Common Sense Economics,* James Gwartney, Richard Stroup, and Dwight Lee assert that "a nation of economic illiterates is unlikely to remain prosperous for very long." Such books are worth reading not because they introduce new thinking, but because they reinforce the foundation on which we build our own new thinking. The label "Economics 101" is generally viewed as disparaging. But who among us wouldn't benefit from a refresher course?

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