SPECIAL: Breakthrough Ideas for 2005…page 17

Harvard Business Review

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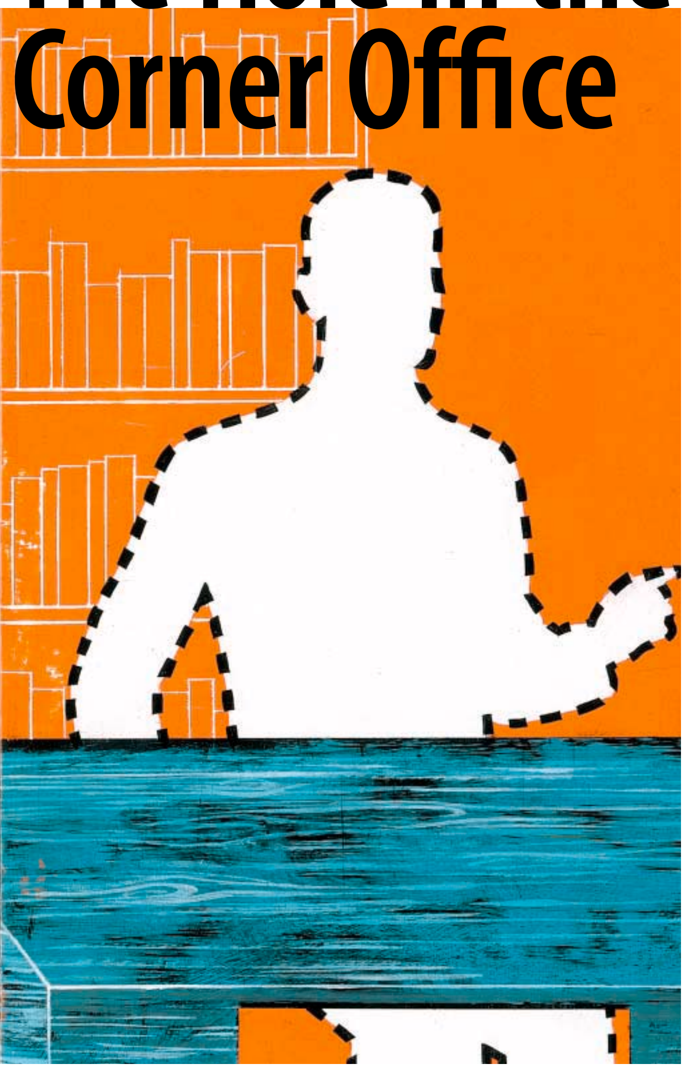
February 2005

The Hole in the Corner Office



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Allstate

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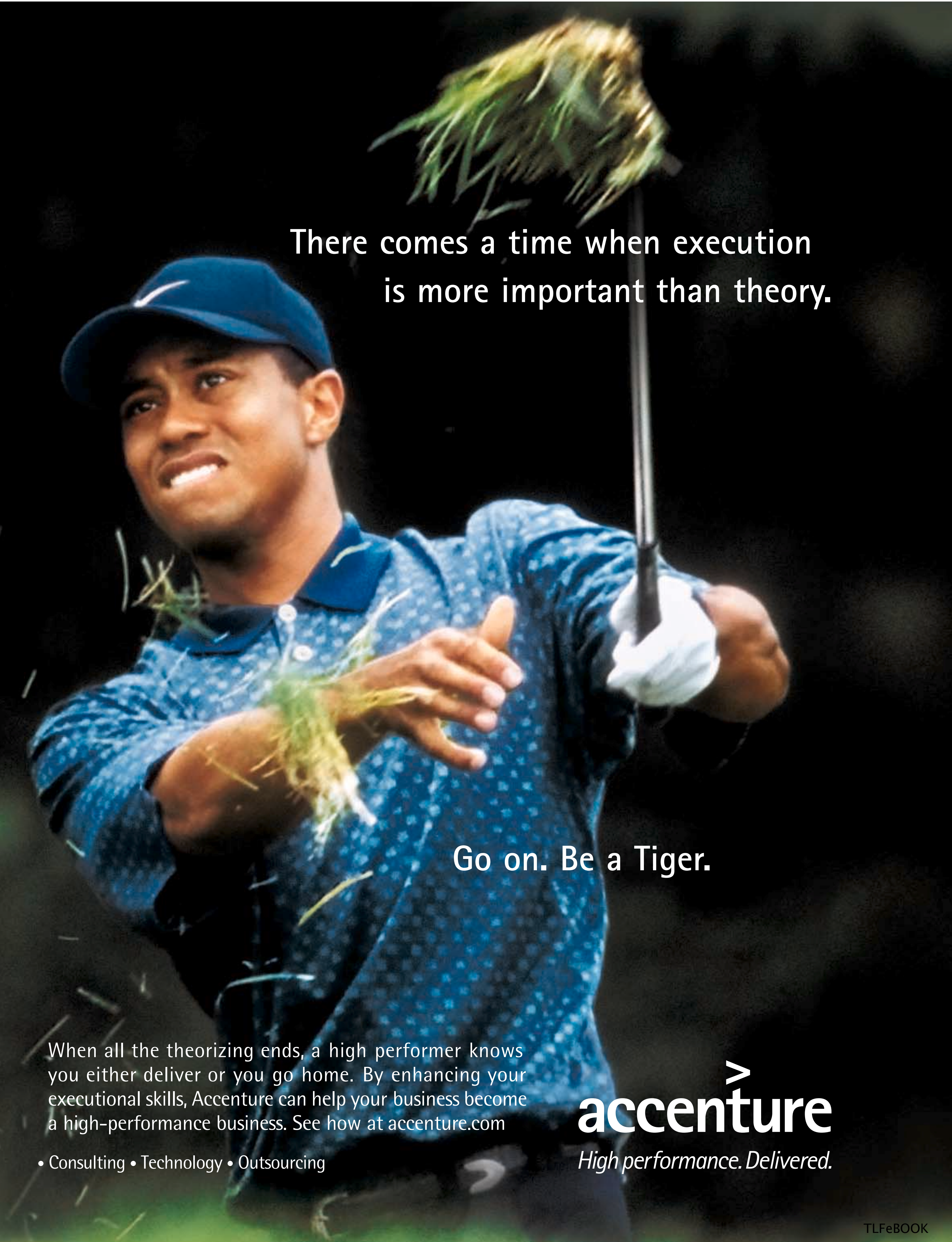
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TLFeBOOK

Picking and Choosing

WHAT KEEPS YOU UP AT NIGHT with fear or excitement? What do you know – or suspect – will change business but isn't widely recognized now? What's the dot on the horizon that will be a big topic on the executive committee's agenda a couple of years hence? Those are the questions that animate our search for breakthrough ideas for the annual HBR List, featured in this issue. Ideas are our stock-in-trade, in every issue, in every article. For several years, we tagged each cover with the phrase "Ideas with Impact." Most of the year, we bring you ideas that have been thoroughly developed and rigorously tested by scholars and other experts. But you have also told us that you expect us to describe emergent ideas the experts suspect are true but cannot yet prove. That's the job of the HBR List – to present ideas that are very much alive but still caterpillars or chrysalides, if you will.

This year, senior editors Leigh Buchanan and Anand Raman led the search party, which took them through the groves of academe, consulting, and, of course, business. In August, we augmented the quest by bringing together a couple of dozen of the smartest people we know for a two-day convocation at the Harvard Faculty Club. A group from the World Economic Forum's Centre for Strategic Insight, headed by Ged Davis, acted as cohosts. We were hoping to find ideas that both of us – HBR and the WEF – felt ought to be brought forward, so that we could present them here in these pages and the WEF could arrange to discuss them at its annual meeting, held in Davos, Switzerland, in the last week of January. Indeed, as you'll see, several of the topics in the List came out of that August gathering and, by the time this is published, will have been the subject of discussion in Davos as well.

If the List looks forward, "Ending the CEO Succession Crisis" is an important article about an issue that is immediate and urgent. For a while now, I've been concerned that something is out of whack (mostly in the U.S.) with the way CEOs are chosen. I thought I saw too many outside hires, too few promotions from within. I certainly saw too many "boomerang CEOs" – old guy retires, new guy comes in and quickly fails, board recalls old guy from the golf course in Scottsdale, and old guy runs the place while board tries again. I dug around a bit to check my hunch, then called Ram Charan.

Bless him, he said exactly what I'd hoped: Agreeing vociferously that CEO succession is in crisis, he offered to write an article about it. Ram, coauthor with Larry Bossidy of *Execution* and *Confronting Reality,* spends much of his time consulting to chief executives and boards of directors. Rarely, he finds, do either take seriously enough their responsibility for CEO succession. When they do begin to focus on the topic, the incumbent CEO is usually nearing retirement. That's too late. Executive talent has to be mined, refined, and annealed in the fires of competition. It takes time. It can't be left to chance. Neither can boards rely on executive search firms. For all their value, search firms' work is no substitute for the kind of succession program that keeps a company's coffers filled with managerial gold.

For one thing, imported talent tends to do less well than homegrown talent. That fact was revealed and explained some months ago in HBR, in "The Risky Business of Hiring Stars" (May 2004), by Harvard Business School professors Boris Groysberg, Ashish Nanda, and Nitin Nohria.

For another thing, a company busy developing talent has the benefit of that talent's work years before the corner office becomes vacant. It will simply be a better-led, better-managed, and better-performing organization. As you see from Ram's article, there are a number of straightforward ways in which CEOs and directors can help their companies become the kind of place where the biggest problem in picking a new CEO is having too many excellent candidates among whom to choose.

Thomas A. Stewart

ROBERT MEGANCK


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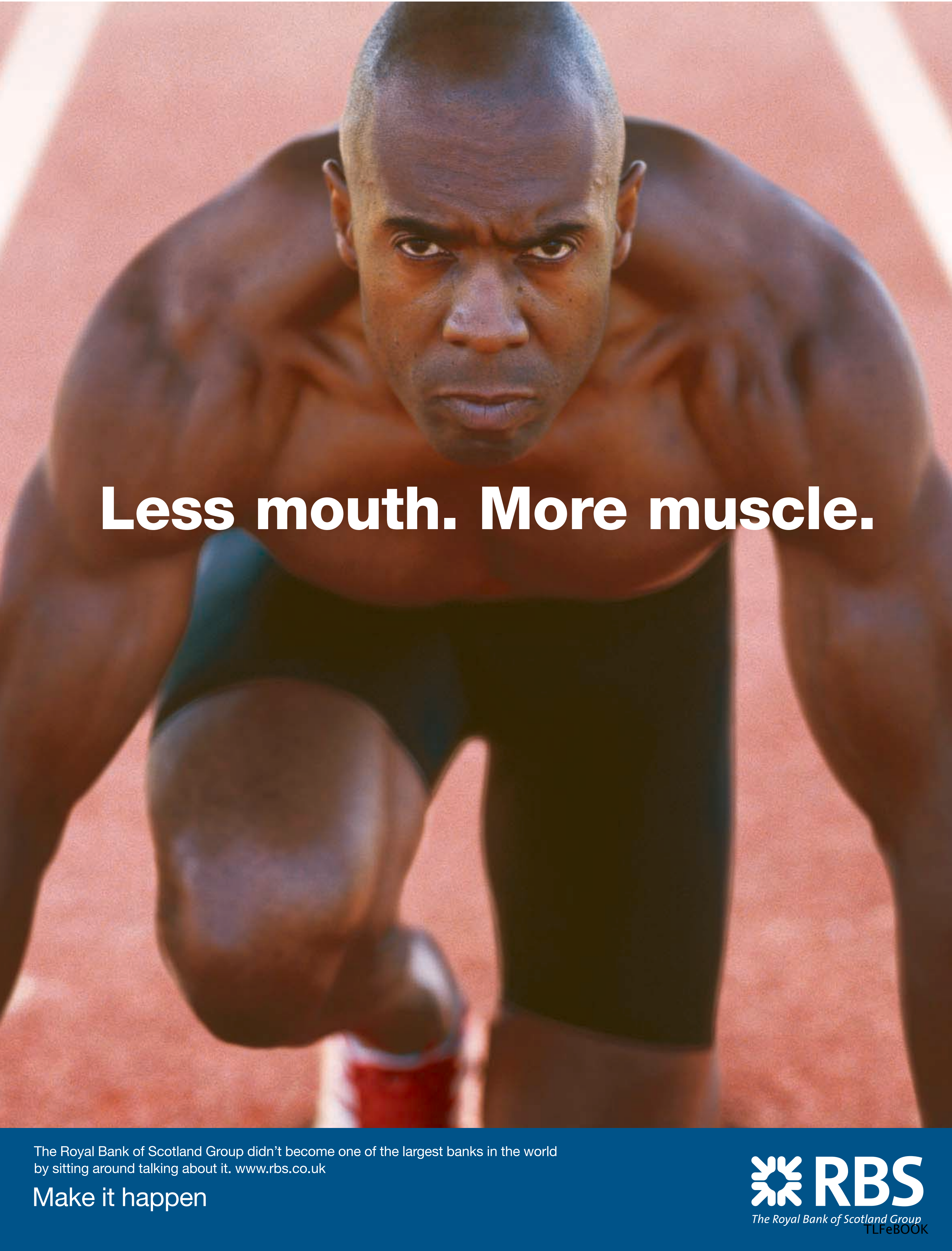
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THE HBR LIST

Our annual survey of emerging management ideas considers the downside of reliability and the upside of flip-flops; new directions for evolving technologies; and the persistent questions of who we are and what we fear.

BREAKTHROUGH IDEAS FOR 2005

There exists a fleeting and deliriously exciting moment in the life of an idea when it teeters between what one person suspects and what everyone accepts. In that moment, months or years before it exerts any practical influence, the idea holds the greatest potential to inspire and incite. Opportunities, implications, and related discoveries open up from it in all directions like a hall of mirrors.

The HBR List is our annual attempt to capture ideas in just that state of becoming: things felt but not yet spoken, innovations that will change – something? everything? – and promising or unnerving developments. This year's offerings are intriguingly varied, yet two timely themes recur. First is a rising preoccupation with identity, embodied in entreaties to make business meaningful as well as reliable, to anoint continuity champions, and to analyze one's organizational DNA. Second is anxiety over unclear or not-yet-present dangers, illustrated by warnings about risks without owners, the potential failure of the global intellectual-property-rights system, and the fear of fear itself.

Our impressive roster of contributors includes Nobel Prize winner Robert C. Merton, renowned anthropologist Mary Catherine Bateson, and Stanford business professor Roderick M. Kramer, the second-place winner of last year's McKinsey Award. In addition, a number of pieces emerged from a two-day brainstorming session hosted by HBR and the World Economic Forum last August; some two dozen of the best and brightest minds from around the world identified nascent ideas with the greatest potential for impact. In January, the WEF further developed some of those themes at its annual meeting in Davos, Switzerland.

1 Flipping Without Flopping

Few attributes are as closely associated with effective leadership as decisiveness. Particularly in moments of crisis or opportunity, we expect our leaders to take swift, sure action and then to remain steadfast.

Given those powerful associations, the demonization of flip-flopping will likely be an enduring relic of the 2004 U.S. presidential campaign. A year ago the worst thing leaders could do was lie. Today, it seems, the worst thing they can do is change their minds. Indeed, no idea has gained greater currency recently than that flip-flopping is the ultimate failure of leadership.

That is worrisome, because leaders must be able to flip-flop without fear. Flip-flopping is not the same thing as indecision – roughly, the inability to arrive at a choice. Rather, it means altering a stance after a choice has been made. Changing course is simply the right move in some circumstances.

Obviously, leaders should flip when they make the wrong decision. Last October, executives at Universal Studios reversed course and pulled the plug on a major, star-studded film, *American Gangster,* as its budget crept toward $100 million. If United Artists' leaders had shown the same decisiveness a quarter century ago, they might have saved the studio and their jobs. Instead, they refused to flip – resulting in what was then the largest flop in Hollywood history: *Heaven's Gate.*

On occasion, an unexpected flip can set the stage for great achievement by dramatically recasting an issue. Ronald Reagan rode into the White House denouncing the Soviet Union as an evil empire ruled by ruthless leaders; he then worked closely with Mikhail Gorbachev to help bring an end to the Cold War. Flipping can also be used strategically to catch opponents off guard. Richard Nixon brilliantly reversed a lifetime of public commitments when he suddenly opened the door to China, diverting the nation's attention from problems at home. Unpredictability, to Nixon, was a potent weapon. "I just get up every morning to confound my enemies," he once said.

Still, leaders face formidable psychological and social pressures to stand by their decisions. In anxious times, especially, people who feel physically and economically threatened yearn for what psychologists call closure. Predictability, too, is important. (For more on the seductive charms of predictability, see the HBR List article "Seek Validity, Not Reliability.") Individuals respond to leaders' words by taking their own actions: A corporate client invests in new software; an employee buys a home. If that leader then does an about-face, the basis for the individual's decision collapses.

Leaders, in turn, desire to appear strong, resolute, and unwavering. The fact that their decisions are often public events – the formal announcement, the justification, the answer to a challenge – makes reversing course even more difficult. Last fall, several commentators labeled Scott McNealy a flip-flopper for proclaiming Sun's support for Linux in a keynote address and then saying at a press conference two days later that the operating system was better suited for hobbyists than for corporate use.

Because a leader will always need the option to re-decide, he should prepare the ground for reversals well in advance. That means building up a store of credibility. And it means sending a powerful message to employees, shareholders, and customers that this leader isn't afraid to take a second look at any decision and to change his mind – if it is in stakeholders' interests.

Leaders – and the public – must recognize that changing one's mind does not signal an inability to lead. Rather, it signals an ability to learn. Senator George McGovern once praised George H.W. Bush for flip-flopping on the value of Medicare. (As a young congressman, Bush had initially opposed it.) "Changing one's mind is not a sin," McGovern said of that change of heart. "It is a way of saying that I'm wiser today than I was yesterday."

> An unexpected flip-flop can set the stage for great achievement by dramatically recasting an issue.

Roderick M. Kramer *(kramer_roderick@gsb.stanford.edu) is the William R. Kimball Professor of Organizational Behavior at Stanford University's Graduate School of Business in California.*

2 Everybody into the Gene Pool*

Businesses big and small are emerging from the U.S. economy's long winter eager to pursue aggressive new growth strategies, but many of their managers are dealing with a nagging suspicion that their organizations aren't up to the challenge. They have a vague sense that the capability they've assembled just isn't firing on all cylinders.

Most of us would agree that life feels different when we're part of a high-performing team, whether it's a "hot group" or some bigger, well-oiled machine. People in those situations spot and capitalize on opportunities swiftly – and seem to draw energy from their work. To an extent, we can sense when another organization has the right stuff.

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

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STEPHEN WEBSTER

But if that kind of thing isn't going on in yours now, how can you make it happen? What levers should you pull?

According to Gary Neilson, a senior vice president at Booz Allen Hamilton, an organization works the way it does thanks mainly to the interaction of four key elements: structure, decision rights, motivators, and information. Like the four nucleotides of DNA, he says, these basic building blocks combine to produce myriad organizational forms – some viable and some not. There isn't one optimal design. Just as high performance in the natural world can take the form of a hummingbird or a husky, in the business world it can be generated by wildly different kinds of companies. The DNA metaphor reveals the danger of tinkering with any one element – say, incentives (motivators) – in isolation. A change in one area will have far-reaching effects and will yield mostly unintended traits. Booz Allen seeks to understand the elements' interactions so well that the consequences of interventions become predictable. "Right now," Neilson says, "we've cracked the diagnostic side of it."

Accenture's Institute for High Performance Business is similarly focused on identifying the factors that can put organizations into the zone, but researchers at the institute prefer to speak in terms of "performance anatomy" rather than DNA, according to the firm's chief strategist, Tim Breene. The implication is that a company is not locked into its fate – it can improve through sustained effort. And what is it that companies must learn to do better? Five things: balance the managerial demands of today and tomorrow; create "talent multipliers" that amplify people's contributions to produce a superior return on salary investments; apply technology strategically rather than for incremental productivity gains; focus on a select few (but diverse) aspects of the business that are critical to success; and continuously renew the organization's vitality. By attaching appropriate metrics and projects to these goals, Breene claims, managers can achieve real performance gains.

Booz Allen's and Accenture's initiatives are important for a few reasons. They are redefining the problem of organizational performance, elevating it above the too-squishy territory of corporate culture and too-mechanistic models of organizational structure. In so doing, they're making the je ne sais quoi of companies more decodable, teachable, and learnable. And they're doing this just at the point when managers most sorely need it.

Across the board, management consulting firms report that clients are hungry for insights on how to close the gap between an organization's performance and its potential. Neilson figures the hunger comes from the bind CEOs find themselves in. Recent years have seen an increase in forced turnover among their ranks, so they feel pressure to "deliver or depart." If a CEO can't come up with the goods instantaneously, he must be able to convince his newly aggressive board that he is moving the organization toward the top of its game. And he must be able to make the same persuasive argument to Wall Street, which assumes slipups are likely along the way and so routinely discounts the potential impact of strategy announcements. Neilson says companies want to get to the point where Wall Street simply assumes they have the ability to execute; ultimately, they'd like to be able to spot the next big thing and be immediately rewarded with a share-price increase. As one CFO succinctly put it: "What I'm looking for is an execution premium."

Wouldn't that be nice? Perhaps it's not such an outlandish thought – if you've already discovered what kind of complex organism you're dealing with, what care and feeding it needs to stay healthy, and what carrots or spurs will get it to rise to a challenge.

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3 The Velcro Organization

Competing in global markets raises thorny issues about organizational design. Functional excellence is a necessity in international markets; that's a given. But a customer orientation is also required. Indeed, when their customers are located in multiple countries, companies need to be responsive to local cultural, legal, and competitive requirements. This isn't textbook knowledge: Managers need to know about the individuals and relationships that make business work in a particular place.

Traditional organizational design assigns responsibility for different parts of the company or division to specific managers. Susan is the sales manager. John is the product manager. That approach has led to complex matrix structures in multinationals, with individuals serving more than one boss. Susan is responsible for sales of dessert products in Spain. She reports to both the country manager for Spain and the product manager for desserts.

Managers in matrix organizations often complain that decision making is slow and the bureaucracy is burdensome. At a more fundamental level, the matrix structure is problematic because, as research shows, structure shapes strategy. The organization's hard wiring, including its information and compensation systems, shapes how managers think about the business. Susan's bosses optimize results in their own organizations because they have the information to do that and because that's what they're rewarded for. The matrix structure is also resistant to change. It doesn't magically rearrange itself, even if, as is so often the case, cross-unit work offers the best bet for growth.

There is a better approach. It asks managers to shift roles depending on the tasks they are performing. For each task, accountability must be clear. If a manager is responsible for several tasks, then she may find herself playing several roles. When Susan is planning the sales efforts for desserts in Spain, she is a line manager with responsibility for results. When she takes part in a strategic planning exercise for new desserts, she may have a staff role – or, if her skill set is appropriate, she may be the leader of the European markets team. The assets of the organization are clearly identified, but how they are assembled varies with the task. I call this the "Velcro organization" because in it, relationships need to be rearranged quickly, easily, and effectively. The approach (without the name) can be seen in many organizations, from WPP and Merck to McKinsey and Harvard Business School.

At HBS, where I've taught for 41 years, the faculty must be able to organize its various skills to deliver core programs. To make that happen, we have learned to play multiple roles. For example, I chair the General Manager Program. One of the program's instructors is the senior associate dean for executive education. For the purposes of that program, he works for me. For purposes of planning executive education, I work for him. Other HBS professors have roles that require them to look after faculty development or program staffing. Depending on the task, we wear different hats.

The important idea here is that managers have major assignments in addition to their primary functional roles. But those roles aren't hardwired into a hierarchy or matrix; they are defined in terms of contingent purposes. When the individuals on a team work on tasks for which they are accountable, they have considerable power to formulate and implement plans using valuable resources. In other circumstances, those individuals have very different powers. Power is in the role, not the individual. And the roles are about helping the organization succeed, not about turf or internal boundaries.

Companies with Velcro capability tend to be flat and tend to be organized around the operating units. The connections of those units to the top look simplistic. The key is that executives have figured out how to move people in and out of different roles. They do it with all kinds of temporary formal groups, such as teams and task forces. These are superimposed on the semipermanent matrix organization of products, functions, and countries. They get the resources they need, and their members work as hard on the temporary assignments as they do on their primary functional roles.

I've done field work related to this topic for a long time. Even so, I can't say with certainty why some organizations are good at helping managers play different roles under different circumstances. But I do know – as you do – that this is the biggest organizational challenge facing a great many businesses. I can also tell you what successful Velcro companies have in common:

• Their business-unit and country managers understand in their bones

> In the Velcro organization, relationships need to be rearranged quickly, easily, and effectively.

what the corporate strategy is and what the strategy means in terms of purposes and priorities.

• Individual operations have a high degree of functional excellence. (Only units that are strong in their own right have managers who are comfortable and effective wearing multiple hats.)

• Managers in individual units believe that their peers in other units are very good at what they do and that they are willing to focus on corporate, rather than unit, success when asked to do so.

• Information systems can track performance across units so that managers get the same answer whether they slice by country, business, or project.

• Compensation systems reward cross-unit effort without diluting the incentive for local effort.

• Finally, the company culture develops senior executives who are comfortable with the ambiguity required of a Velcro organization.

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4 Demand-Side Innovation*

Look over the extensive literature on innovation, and you'll find that most of it deals with how companies should meet challenges on what might be called the supply side. The questions are familiar: How do we innovate better and faster in products and services? How do we ride the waves of disruptive technologies? How do we manage the diffusion of innovations once we have created them? How do we "cross the chasm" from early adopters to early majority? All those challenges are real, but, sad to say, overcoming them will not give you a lasting competitive advantage. In a world of ultracompressed life cycles for products, a company's ability to develop viable new products or services rapidly is more important than ever. The problem is that each brilliant innovation has half the impact and half the shelf life of a product in the previous generation. For most companies, the focus of innovation will have to shift to the demand side.

Demand-side innovation is a different animal, and companies need to manage it differently. It's not about product features or functions but about how a company orchestrates its customer interactions and relationships. It's innovation with respect to *how* companies go to market, as opposed to *what* they bring to market. Of course, every manager considers these questions today, but few companies have thought through the implications deeply. As demand-side innovation becomes the central innovation process within most companies, managers can no longer relegate it to a secondary role. Scattershot implementation won't work. How companies go to market will determine who wins and loses the game.

Innovation on the demand side can uncover new sources of growth by illuminating opportunities in unexpected places. Consider what's happened recently in the competition to sell cellular phones and services. Hewlett-Packard identified villages in rural India as a burgeoning market for mobile telephones, even though customers there cannot afford to buy handsets and won't run up enough usage minutes to justify subsidies for the hardware. HP opened up the phone market by creating a new economic model for handset sales: It leases phones to users and collects rent and usage fees. Closer to home, Sprint created the fastest-growing cellular services brand in the United States by licensing the Virgin Mobile brand; the company did an end run around a mature market by tapping into a new demographic segment – teenagers.

Demand-side innovation can take many forms. In HP's case, it meant revising the underlying economic model of the business. That's what automakers did when they started pushing financing over purchases. More recently, eBay and Priceline have done the same by creating global platforms for consumer-run retail auctions and reverse-marketing travel services, respectively.

Companies can also take a lesson from Sprint and "reskin" their offerings. That is, they can borrow an identity from someone else to appeal more powerfully to target customer segments, or they can create a radically different interface for a familiar offering, as Google did with its simple search site. The most innovative experiment along these lines has been the WiLL brand, a concept that embraces a variety of lifestyle products (cars, consumer electronics, beverages) and that was created by a consortium of Japanese companies including Toyota, Matsushita, and Asahi Breweries. To appeal to a certain hip demographic segment, the product lines shed their old brand skins and pooled their efforts to design and promote WiLL offerings.

Or demand-side innovation can involve customers at an emotional level – creating halo effects for products and services through social, cultural, or linguistic movements. Before the World

Cup in 2002, SK Telecom lost out to a rival in its bid to become the official sponsor. Rather than sit out the season, SK created what was, in effect, a social movement that ultimately signed up more than 5 million South Koreans. In SK's "Be the Reds" campaign, customers identified themselves by wearing bright-red SK-branded shirts at the soccer games. The shirts reinforced South Korean nationalism, promoted the country's team, and became a visual symbol of SK's central place in customers' lives.

to good effect. Nike's success suggests that sometimes the customer's participation is purely psychological. Since the brand aims to connect its products with the idea of achieving one's "personal best," the experience doesn't materialize unless the customer steps up to the challenge.

Demand-side innovation demands in-depth consideration. Companies should manage it for what it is – a core element of corporate strategy. Within most companies, demand-side innovation is, at best, a poor cousin to a host of traditional innovation or R&D activities, an afterthought that's left to marketers, ad agencies, and marketing services companies. Its rising importance suggests that demand-side innovation must become an essential management process and the new focal point of innovation efforts.

Companies can take a lesson from Sprint and "reskin" their offerings. They can borrow an identity from someone else.

Similarly, American automaker Saturn snapped "family portraits" of new Saturn owners with its dealership staffs and followed that up by hosting "reunions" at the company's headquarters in rural Tennessee.

Companies have become more adept at using customer information to customize or personalize their offerings. Every Amazon customer has encountered this in the form of personalized Web page content that is dynamically generated based on his or her search and purchase history. Off-line, too, we see hotel chains, airlines, casinos, and retailers using data from loyalty programs to personalize services for repeat customers.

One last way that companies can pursue demand-side innovation is by involving customers in the creation of products and services. Levi's failed to market customer-designed jeans, but Land's End made it work online with basics such as khaki trousers and men's shirts. Indeed, many offerings – from My Yahoo personal pages to Reflect .com's beauty solutions, which are created according to individual taste – engage customers in the design process

Not surprisingly, some firms specialize in demand-side innovation. The mission of Walker Digital (run by Jay Walker, founder of Priceline) is to dream up demand-side innovations and protect them with business process patents. Walker Digital represents a signpost to the future – a future in which competitive advantage will depend increasingly on demand-side, not supply-side, innovation, and companies will live and die by how distinctively they take their present and future products and services to market.

Jeffrey F. Rayport (jrayport@marketspaceglobal.com) is a cofounder and the chairman of Marketspace, a strategic advisory, executive development, and software unit of the Monitor Group in Cambridge, Massachusetts.

5 You Heard It Here First

For decades, technology and business have delighted customers' eyes with ever brighter, sharper, and sleeker products. Utility is chiefly realized through sight; hearing, by contrast, has remained vision's poor cousin. "If you compare [sound design] to the visual world, we're still 20 years behind," audio guru Dane Davis told *Wired* magazine a few years after winning an Academy Award for his sound-editing work on *The Matrix.* In the interview, Davis described dropping cars from cranes and smacking stuff with wrecking balls to achieve his effects. He'd rather construct noises sitting at his computer. Unfortunately, audio software is not yet up to snuff.

But the ears are coming into their own. Progress in sound technology seems likely to follow the trajectory that computer graphics traced in the last two decades, which means we may be on the threshold of a world in which synthetic sound is ubiquitous and indistinguishable from natural sound. Movies, obviously, will benefit. Video games – whose sound tracks are laughably primitive – will benefit even more. And that's just the beginning: The creation of sounds that are not just realistic but also rich in information suggests applications in many industries.

An intriguing multidisciplinary science called auditory display (AD) is studying how the brain responds to sound, how sound affects things like mood and performance, and how technology can put sound to practical use. Applications emerging from AD are already present in aircraft control panels, surgical equipment, and ICU monitors. The most common use is in alarm systems for people who work in environments that are saturated with visual data, but those applications remain fairly simplistic.

A more exciting technique is data sonification, the transformation of complex data into sound. Qualities such as pitch, volume, and vibrato speed can be mapped to various pieces and kinds of data; listeners extract meaning from the sound patterns. Are the data in clusters or segments? Are there detectable trends? Long-range correlations? The most basic type of sonification is the computer "earcon" (analogous to the visual icon), which represents an event such as the emptying of a desktop recycling bin. But technology companies are exploring far more sophisticated tools that could help users extract meaning from a terabyte or so of data, potentially wringing new value from corporate data warehouses. (Obviously these tools would require significant training. Users of them would have to learn what data are associated with what sound attributes and how to interpret patterns.)

Another promising development is directional sound. That technology essentially does to sound what lasers do to light, shooting a beam so intensely focused that only those within a narrow area can hear it. Advocates are discussing many applications, including billboards that address consumers as they pass but don't disturb the neighbors, radios that allow passengers in a car to listen to their own stations, and various navigational aids for the blind.

The psychological effects of sound are also intriguing. We have long recognized that certain types of music – particularly classical music – positively affect mood and performance. During the Great Depression, Muzak introduced music into typing pools to boost productivity and into elevators to soothe the nerves of early riders. Today, the application of music and other sounds in retail and work environments is a matter of growing interest. In Britain, researchers found that consumers' selection of French or German wine was influenced by whether French or German music was being played at the time of purchase. And businesses are increasingly incorporating music into their brands, marketing CDs that have little or nothing to do with the coffee or home furnishings at their competencies' cores.

The revolution in graphics greatly improved the way people worked with computers and other technology; the revolution in sound may well do the same thing. With all the visual data thrown at us every day, we are in danger of missing the information that really matters. Sound may help us cut through the noise.

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6 Seek Validity, Not Reliability*

Corporations believe that they face problems of ethics and credibility, but the underlying issue may well be a crisis of meaning. CEOs complain that investors care only about quarterly earnings – not about companies' long-term health or the broader role they play in society. That's not all. Customers feel disappointed by the lack of a warm, human connection with the companies that supply them. Employees, particularly young ones, worry that there's nothing meaningful about their work, that it's only about the money. In addition, social activists excoriate businesses, especially transnational corporations, for their lack of conscience. Yet companies pay little attention to the issue of how people find meaning in economic matters.

Business has only itself to blame: Corporate processes and systems have created and, in fact, exacerbated the lack of meaning. Firms have adopted Six Sigma programs to improve the quality of their manufacturing processes, but those initiatives haven't made employees feel that their work is more meaningful.

Companies have installed customer relationship management systems to forge links with consumers, but the latter feel more manipulated than understood as a result. Governments have enacted laws like the Sarbanes-Oxley Act to prevent companies from defrauding investors, but corporate boards sleepwalk through its procedures, and that leaves investors just as vulnerable to fraud as they used to be.

Six Sigma, CRM, Sarbanes-Oxley, and most other corporate systems have one thing in common: They are reliability-oriented processes. They are intended to produce identical or consistent results under all circumstances, often by analyzing objective data from the past. For instance, a perfectly reliable poll would be able to produce the same result from ten random samples of voters. By contrast, a perfectly *valid* poll would be able to predict an election's winner.

Companies don't realize that when they make their systems more reliable, they render them less valid or meaningful. In other words, the processes produce consistent outcomes, but the results may be neither accurate nor desirable. That's because, to make their processes more reliable, companies have to reduce the number of variables and standardize measurements. To achieve high validity, however, systems must take into account a large number of variables and use subjective measurements. Adding squishy variables and using gut feel allows for outcomes that are more accurate, even though the processes may not be able to deliver accurate results consistently. (See the exhibit "Reliability Versus Validity.")

There's a tension between reliability and validity in almost every business system. For instance, most compensation methods, like the Hay system, award points to each job so that companies can calculate how much to pay managers. That results in bias-free compensation levels, but companies can't really use points to rank a human being's value to the organization. So the points approach is balanced against senior executives' judgments about individual managers. A similar balancing act happens when companies test ads. Companies find it convenient to test ads on large samples of people because messages that do well in those tests are bound to appeal to customers. The danger is that the samples may not be representative of the products' users. If firms were to test ads on users, the results wouldn't be as statistically significant, because the samples would be smaller. So firms have to choose between clear results from irrelevant audiences and fuzzy results from relevant audiences. Reliability and validity occupy opposite ends of the spectrum that defines how companies create systems and frame solutions.

Reliability versus Validity

The systems and processes at left can be highly reliable, but they won't necessarily achieve validity in the form of the desired results at right.

Enterprise resource planning	A robust strategy
Customer relationship management	Customer intimacy
Six Sigma and total quality management	Design excellence
Knowledge management systems	Creativity
Incentive compensation	Jobs that have meaning
Shareholder value maximization	Corporate social responsibility
Meeting analysts' quarterly targets	A successful company

While it would be optimal to achieve both validity and reliability, companies have mostly favored reliable processes, for two reasons. First, valid systems require the use of subjective or qualitative data, and companies have an aversion to biases. Second, reliable processes result in claims that are provable because they're based on past data; only the future can provide confirmation of a process's validity.

Unfortunately, companies' obsession with reliability hasn't prevented them from getting on the wrong side of customers or being ambushed by new rivals. Indeed, the quest for greater reliability has created corporations that make little effort to consider the purpose or meaning behind the business results that are endlessly crunched out.

A company that produces reliable, predictable, but meaningless results is not unlike a well-tuned car that runs full speed off a cliff. To save themselves, corporations will have to figure out how to become more welcoming for people who are comfortable handling fuzzy data, using their judgment, and creating a sense of purpose in the workplace. For instance, CEOs should go out and talk in person to customers, even if the sample size isn't statistically significant, rather than sit in their offices and make decisions based on statistically significant market research. Rather than focusing on managing corporate earnings, CFOs should concentrate on helping managers better understand the economics of their businesses.

Senior executives also need to stop promoting managers based on the consistency of their track records and start promoting them for breaking out of the box. Boards must get used to approving plans based on the logic of what might be rather than on regressions of what has always been. They need to understand that variability in outcomes is as likely to be a sign of creativity as a sign of bad management, and that the more they drive out variability, the more they ensconce mediocrity. Finally, stock analysts must realize that when they insist on reliability of earnings, they drive out the creativity, innovation, and emotional

the HBR LIST

BREAKTHROUGH IDEAS FOR 2005

As the breadth of this year's HBR List demonstrates, innovation comes in myriad forms. It can be, for instance, a new idea that resonates with familiar truth, such as anthropologist Mary Catherine Bateson's suggestion that midlife sabbaticals would reinvigorate employees and ward off stagnation. Or it can be an old inspiration given fresh life, such as Professor Roderick Kramer's reminder that great leaders aren't afraid to flip-flop when change is the wisest course.

Great ideas need time to develop. Rarely do they spring from deities' heads fully formed and suited up for battle. The brainstorming for these 20 began with a klatch hosted last summer by HBR and the World Economic Forum, and it continued through the fall, as several insights took on greater definition and others emerged.

TLFeBOOK

the HBR LIST

BREAKTHROUGH IDEAS FOR 2005

1 Flipping Without Flopping

Roderick M. Kramer

The 2004 U.S. presidential campaign made "flip-flop" a dirty word. Great leaders, though, understand that changing course is sometimes the smartest thing to do. The trick to pulling off a reversal? Prepare the ground well in advance, and cast correction as courage.

2 Everybody into the Gene Pool *

Julia Kirby

Many managers eager to pursue ambitious growth strategies suspect that their organizations lack the right stuff to deliver. These leaders want desperately to crack the code of high-performance DNA. But performance anatomies are highly individual and delicately balanced. New research initiatives are making the je ne sais quoi of success more decodable, teachable, and learnable.

3 The Velcro Organization

Joseph L. Bower

When your customers are located around the world, it's not enough to have effective, efficient functions. You also need to know the people and relationships that make business work in particular locales. The rigid organizational structure of most multinationals gets in the way. "Velcro organizations" do better, with managers who can quickly and easily rearrange their roles to meet the challenges of specific tasks.

4 Demand-Side Innovation *

Jeffrey F. Rayport

Each new generation of products and services has half the shelf life of the previous one. To secure a lasting competitive advantage, try shifting your innovation efforts to the demand side. Ultimately, it's how companies orchestrate customer interactions, not just what firms bring to market, that determines whether they live or die.

5 You Heard It Here First

Eric Bonabeau

Although visual technology has about a 20-year jump on audio, the ears are coming into their own. Industries stand to benefit from a host of breakthroughs in sound. Music that influences which wines we buy? Billboards that talk to one person at a time? Believe the buzz.

6 Seek Validity, Not Reliability *

Roger L. Martin

Six Sigma, customer relationship management, and most other corporate systems crank out consistent results, often through analysis of objective data. The outcomes are reliable, but they don't necessarily mean much. Companies that aim for validity instead – by embracing fuzzy data, variability, and inconsistency – open the door to innovation and growth.

7 "When" Is the New "What"

Kirthi Kalyanam and Monte Zweben

Marketers spend so much time fretting over which people to target with what message that they largely ignore the question of *when.* Identifying when needs or desires change and determining when customers want help are the best ways to get through. "Dialogue" marketing helps companies spot the hot irons – and strike.

8 Swapping Your Country's Risks

Robert C. Merton

How can investors in developing countries diversify their risks if capital controls prohibit them from exporting capital overseas? And how can their countries' governments diversify their economies without sinking billions into new industries? By creating an equity swap, which enables domestic and foreign investors to manage risks separately from investments.

9 Wanted: A Continuity Champion *

Thomas A. Stewart

Change is sexy, challenging, a job for heroes. It also has a way of swallowing a company's attention and resources. Continuity needs and deserves champions, too. The core business, after all, is what got you where you are.

10 Blog-Trolling in the Bitstream

Mohanbir Sawhney

Blogs have the grassroots credibility to influence what people think, do, and buy. Because the blogosphere doesn't rely on marketers as other media branches do, companies that want to tap into its selling power have to play by its rules.

11 No Risk Is an Island *

Denise Caruso

Big man-made risks without owners – think of an agricultural disaster sparked by genetically modified food – render traditional risk management all but worthless. When assessing risks of this type, companies must involve a broad community that includes experts and all those who might feel the repercussions.

12 Let Them All Be Power Users

Thomas H. Davenport

Companies load up employees with laptops, PDAs, cell phones, and other gadgets for managing personal information but give little guidance on how best to use them. The result? Knowledge workers, the drivers of the global economy, are far less effective than they could be.

13 A Taboo on Taboos *

Leigh Buchanan

Organizations tiptoe around politically or socially risqué subjects – especially perennial cringe inducers like sex, death, and God. But if a subject makes you uncomfortable, chances are it's exactly what you should be discussing.

14 Toward a New Science of Services

Henry W. Chesbrough

Services contribute even more to the global economy than products do. So shouldn't the science of services be an academic field in its own right? Whether it becomes one may depend on the same criteria – including the extent of corporate support – that set computer science apart from engineering, math, and physics.

15 The Coming Crisis over Intellectual Property Rights *

Kenneth Lieberthal

Although many executives recognize a deteriorating respect for intellectual property rights globally, few see the particular threat posed by recent developments in China. Companies there have started flooding the world's markets with pirated versions of everything from DVDs to airplane parts – and a national emphasis on fostering economic growth at any cost makes it hard to weed out corruption. To keep IPR protections intact, global firms must wake up and take action.

16 Biometrics Meets Services

Jochen Wirtz and Loizos Heracleous

Biometric devices that scan fingerprints, palms, retinas, and faces are already revolutionizing security. The killer app, however, may be locking in business, not locking out bad guys. Singapore Airlines has begun using biometrics to enhance customer service. Other companies could do the same, customizing and streamlining the way people buy clothing, health care, financial services – even a cup of coffee.

17 Getting Time on Your Side *

Mary Catherine Bateson

People are living longer, so we picture them spending more time in retirement. That's the wrong way to look at longevity. Instead, we should capitalize on it, giving employees in midlife a year or two to renew their energy and pursue new passions. Many would return to their jobs motivated to embark on a second stage of high performance.

18 Inversion of Privacy

Jeffrey Rosen

Europeans worry about corporate data surveillance. Americans worry more about government prying. And the young have fewer qualms than their elders about sharing consumer information. Companies wrestling with privacy issues take note: A single policy may never suit all.

19 In Praise of Feedership

Tihamér von Ghyczy and Janis Antonovics

It's easy to understand how corporate Darwinism works: Eat before you're eaten. A closer look at biology, though, shows parasitism to be a far more subtle and cunning strategic model. Businesses would do well to take a lesson from the fig wasp.

20 Don't Believe Everything You Read (Except for This)

Jeffrey Pfeffer

Publishers churn out around 3,500 business titles a year, and – wonder of wonders – not all of them offer good advice. Managers who can't afford to waste time on dreck need help navigating the ideas marketplace. Some rules of thumb: Be skeptical of anything touted as "new," keep an eye out for half-truths, and if someone calls himself a guru, run the other way.

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

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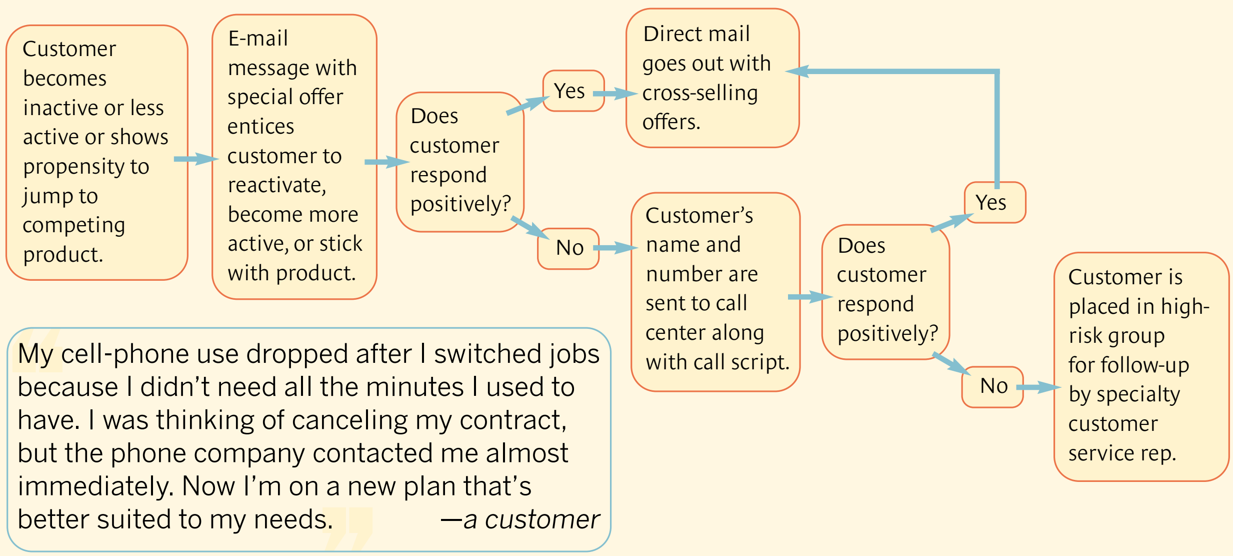
Talk to Me

Dialogue marketing can be used to reactivate or retain customers.



connection with customers and employees that together produce long-term growth in those earnings.

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7 "When" Is the New "What"

The din of marketing has escalated to a cacophony, with the whines of e-mails, phone calls, and direct mailings drowning one another out. But when customers actually require help or when their needs or desires change, they hear nary a peep from companies. That is because marketing organizations spend their time figuring out "whom" to target with "what" message but have largely ignored the question of "when."

Airlines, for example, send an expensive package of promotions with each and every loyalty-program statement to their most valuable customers. But what happens when a customer suddenly stops flying her usual carrier? That defection is a fundamental alteration in behavior that the airline should act on immediately if it wants to keep her business.

Companies in industries ranging from media to financial services to consumer goods are adopting systems that specify when to interact with customers as well as what to say to them. (See the exhibit "Talk to Me.") Instead of blasting out messages according to marketing department schedules, they are monitoring customer activity (or cessation of activity) to spot the conditions under which a communication will have real impact. When those conditions are met, the systems automatically contact the customer with an appropriate, personalized message. The process relies heavily on technology: data warehouses, enterprise software engines, and Web applications and services. The individual pieces are being introduced by several vendors, and some can be built in-house.

Such a capability is one aspect of an emerging practice called dialogue marketing, which achieves much of what relationship marketing promised but never delivered. In this context, a dialogue is a multistep conversation between company and customer that takes place over an extended period, involves multiple channels, and is triggered by customer transitions. Those transitions might include conducting a first transaction in a particular category (first purchase of a suit, first visit to a new property) or purchasing an item that suggests the customer is embarking on a large project (kitchen cabinets, a stroller).

Transitions trigger a step in the dialogue, such as sending a personalized e-mail, alerting a salesperson to make a call, or queuing up a personalized direct mail piece. The system might also create a point-of-sale message for use by a store associate during the customer's next visit–or on the company Web site for an online shopper.

After a transition triggers a communication, the system waits for a response from the customer, then acts accordingly. Lack of a response sets in motion its own sequence of events. Suppose a transition triggers an e-mail message, but after a week the customer still hasn't replied. The silence alerts a salesperson to give the customer a call. The dialogue system waits another week,

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then sends the customer a reminder e-mail with a link to the company's Web site, where he is greeted by personalized information related to his recent transition. An upcoming birthday, a brand promotion, or the purchase of a certain product could generate a specific message leading to another visit and another purchase.

Dialogues can be used to preempt defections, win back lost business, and usher customers through increasing levels of loyalty. For example, Harrah's automatically contacts casino patrons who are approaching the highest tier of its frequent visitor program with such messages as, "You are only one visit away from our Total Diamond reward level." A major regional grocer noticed that loyalty rose after customers visited its online store more than four times, so it designed a communication- and reward-heavy dialogue system to get them to that point. After the fourth visit, the system automatically reduces communications and incentives – and consequently the cost of marketing to that customer.

Consumers say time is their most valuable asset; they won't thank companies that waste theirs with information they don't need. But what is dismissed as junk at the wrong moment may be valued and pursued at the right one. Companies that use dialogue marketing always know the best time to reach their customers.

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8 Swapping Your Country's Risks

You're a citizen of a developing country notorious for its boom and bust cycles. How do you prevent the value of your assets from disappearing during the next economic downturn if capital controls prohibit you from exporting capital overseas?

You're the president of the same country, and you've pledged to reduce your country's dependence on a single industry – silicon chips, say, or textiles. How do you diversify your economy without spending tens of billions of dollars that you don't have and that would be better used for improving the industries in which your country already enjoys an advantage?

The answers to both questions may well be the same: the equity swap, a financial tool that works in much the same way as its famous cousin, the interest rate swap. Imagine that you are an institutional investor, such as a trust bank or a mutual fund, in a developing country and you want to reduce the risks of your domestic stock holdings. You could create an equity swap, arranging with a number of large foreign investors to exchange the dollar returns on your home-country stock investments for the dollar returns on an equivalent amount of investments in other stock markets. The magnitudes of the exchanges would be determined by the "notional," or principal, dollar amount of the assets deemed to have been swapped.

These agreements would effectively transfer the risk of your home-country stock market to foreign investors and could provide you and other domestic investors with the risk/return pattern of a well-diversified world portfolio. Since there are no initial payments between parties, there are no initial capital flows in or out of the countries involved, which would reassure governments worried about dependency on skittish foreign investors. Subsequent payments involve only the difference between the returns on the two assets.

So let's suppose that you enter into an equity swap agreement with a U.S. mutual fund in which you exchange the returns on $1 billion invested in your domestic market for the returns on $1 billion invested in a global stock portfolio. If the global stock market portfolio earns 10% over the subsequent year

> Consumers say time is their most valuable asset; they won't thank companies that waste theirs with information they don't need.

and the developing country market earns 12%, you pay (.12 – .10) × $1 billion, or $20 million, to the mutual fund. If your market underperforms the global stock portfolio, the swap generates net cash flows to you (reversing the numbers in our example gives you a net inflow of $20 million). Note that you make payments only when you can best afford to – when your local market outperforms the world markets.

Foreign investors – including U.S. mutual funds – should be willing parties to this kind of deal. Using swaps, they would avoid both the costs of trading in individual securities in the local markets and the problems of corporate control that arise when foreigners acquire large ownership positions in domestic companies. The situation is unlike that of investments in equities or debt in that foreign investors' default or expropriation exposure would be limited to the difference in returns instead of the total gross return plus principal (that is, $20 million versus $1.12 billion).

The equity swap also makes a useful policy tool. Suppose the government of Taiwan wanted to reduce its economy's

Production line of Toyota's Georgetown, KY manufacturing plant, where the Avalon, Camry and Solara are built.

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For many Americans, Toyota is more than just a source of transport, it's a source of income. With our eight manufacturing plants, sales and marketing operations, research and design facilities, and through our dealers and suppliers, Toyota's U.S. operations are responsible for more than 200,000 jobs. Last year, Toyota team members built more than one million vehicles in the U.S.* And with two new manufacturing plants on the way, we're working to create even more jobs and opportunities in the communities where we do business.

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dependence on U.S. demand for electronic products. Following the usual practice, it would probably sink billions into creating national champions in another industry – automobiles being a typical example. But if other countries' experiences are anything to go by, that would be billions of dollars very badly spent. The diversification could be achieved much more cost-effectively through an equity swap whereby the Taiwanese government would pay returns on a world electronics portfolio in exchange for returns on a world automobile portfolio. In this way, Taiwan would eliminate its exposure to the *world* chip market, over which it has no control. At the same time, it would retain the economic gains from and its risk exposure to the *local* component of its electronics industry, which it does control and in which it can continue making capital investments. The logical counterpart would be a country whose economy is heavily dependent on the automobile industry. With this approach, countries could focus on industries in which they have a comparative advantage and still pursue efficient risk diversification.

All the conditions for an active market in equity swaps already exist. There's no need to create a special exchange for them – swaps are bilateral agreements, and positions are unwound simply by entering into another agreement. Contract terms are standardized under International Swaps and Derivatives Association agreements. In addition, there's a considerable body of global law and convention relating to swap contracts that can be carried over from the interest rate and currency markets. Using mixtures of existing traded indices as the underlying assets would ensure liquidity and make the settlement mechanics fairly straightforward. Contract credit risk is also an important consideration, but here, too, a lot is known about designing solutions, whether by a combination of mark-to-market collateral, purchase of private-sector performance guarantees, or efforts involving government and quasi-government institutional guarantees. And as we've seen, when used for diversification, the contracts call for payments by the party that is doing better economically and thus has the ability to pay.

So far, the market in equity swaps is relatively small. According to statistics from the Bank for International Settlements, as of June 2003, the outstanding notional amounts of assets covered by equity swaps and forward agreements amounted to $601 billion. By comparison, the notional amounts covered by currency swaps totaled $6.4 trillion, and the number for interest rate swaps was a staggering $111 trillion. But once investors and governments start to realize the power of the equity swap, we can expect it to take a much greater share of the overall business in asset swaps.

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9 Wanted: A Continuity Champion*

Few people would deny Lou Gerstner, CEO of IBM from 1993 to 2002, a place among the most effective business leaders of recent times. He ran IBM – we would all agree on this, too – during a period of unprecedented change, especially in the information technology industry. But what were Gerstner's first important decisions? One was to squash talk about breaking up the company. The second was to stand firmly behind IBM's "dinosaur" business, mainframe computing. They were, in other words, decisions to keep some things the same.

The ability to champion change is the very mark of a leader, we hear. Change

Every business worth working for has something worth fighting for, even in the teeth of tremendous pressure to change.

agents are sexy by business standards. They battle strong vested interests and mankind's reluctance to rock a boat, even (or especially) if it leaks. Change will not happen without their heroic assistance.

But that does not mean continuity can fend for itself. Continuity needs champions, too – and rarely gets them, or it gets the wrong kind. On the one hand, leaders who spend too much time midwifing change may neglect traditional, core businesses. (Even as overextended Enron sank downward to darkness, it had a profitable pipeline business.) On the other, the defenders of the status quo too often appear to be – and are – knee-jerk naysayers who champion the wrong continuity. It's more glamorous to be Napoleon (who gained and lost an empire in little more than a decade) than Hadrian (who gave the Roman Empire a stability that endured for generations).

Continuity gets a bad name partly because people misread the literature on leadership and change. In 1977 in these pages, Abraham Zaleznik started the conversation with "Managers and Leaders: Are They Different?" which argued that leaders engage people's motives and dreams, whereas managers are technocrats who have algorithms but not rhythm. In 1990, John Kotter described "What Leaders Really Do." There he said, "Leadership…is about coping with change," and "most companies are overmanaged and underled."

Neither man said, "Leaders are cool people who make change happen, and managers are boring old poops who defend the past." Both argued that leaders and managers need each other. And note this: Kotter's leaders cope with change. That is, they respond to it. They do this by seeing the big picture (while managers focus on detail), setting direction (while managers plan), aligning (while managers organize), and motivating (while managers problem-solve). But "coping with change" can mean standing firm against a tide. "Setting direction" can mean staying the course. Part of the leader's job is to evaluate the threats and opportunities that change creates. Is this a big danger, something that will blow up our business? A big chance, worth pursuing with a lot of resources? When Gerstner fingered life sciences as a major new business for IBM, he acted like a leader by campaigning for change; but for every move like that, he made half a dozen where he led by championing continuity.

It's true that without change a company goes nowhere but down. Also, corporate revolutionaries need all the help they can get, especially in large organizations. For one thing, the employees who are drawn to big companies are likely to value stability. For another, big company processes by their nature slow change to a walking pace.

But the role of the champion of continuity is every bit as challenging. The job is to get maximum effectiveness in coping with change, combined with minimum disruption of the business that, after all, got you to where you are today. He or she should:

- Make sure everyone knows the difference between the big house and the outbuildings. In their eagerness to celebrate what's new, senior managers can create the impression that the core business is an intellectual, financial, and managerial backwater. That's not the way your customers see it; it shouldn't be how employees see it.
- Identify the forces of continuity. A continuity champion should analyze the relative power of what's changing versus what's staying more or less the same. It's easy to overestimate the importance of a novel idea or trend. For example, technological change encourages people to work from home or other remote locations. But before a company starts encouraging telecommuting, it should weigh countervailing forces, such as the growing need for teamwork and cross-functional collaboration, which require people to be together.
- Keep legacy businesses sound. Entropy attacks all things. Managers obsessed with change may not see termites in the main house until too late. Jack Welch, an advocate of change if ever there was one, described his first decade at GE as "fixing the manufacturing guts of this business" – an example of continuity championship. In particular, a business that's considered a cash cow may struggle to get capital; but undernourished cows give less milk.
- Maintain communication between new and legacy businesses. A lot of research suggests that disruptive or innovative businesses develop best apart from legacy businesses. As long as there's one bottom line, however, it is important for a continuity champion to describe what the businesses have in common and to maintain the bridges across which people, money, and culture travel.
- Define what lies outside the reach of change. It may be a business, like mainframes; it may be a process, like leadership development; it may be a belief, like Johnson & Johnson's credo. Every business worth working for has something worth fighting for, even in the teeth of tremendous pressure to change.

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10 Blog-Trolling in the Bitstream

For years, the media on the Internet looked a lot like the media off the Internet. News got out quicker, but it was largely the same news, reported by many of the same people who worked for such corporations as Time Warner and News Corporation. Much of the content was repurposed from traditional outlets–television, newspapers, and magazines. Advertising paid for most of it.

But a different model is emerging from the Internet's primordial soup. The "blogosphere" – a grassroots ecosystem comprising millions of Web logs – is decentralized and ungoverned. But like traditional media (and unlike most personal Web sites), it is gaining the power to influence what people think, do, and buy. The blogosphere has begun to generate its own rating schemes, ratings leaders, business models, and brand-name celebrities. As the blogosphere takes its place among entertainment and information channels, companies must devise strategies for marketing in and around it.

The blogosopher's rules are very different from those of traditional media or dot-coms. In the blogosphere, as in the open-source movement, social recognition matters more than financial gain. Bloggers are driven by a desire to share their ideas and opinions with anyone who cares to tune in. That enhances their credibility, making them more attractive to marketers. But it is also likely to make bloggers more cautious about tainting their reputations by trafficking with corporations. Traditional media and dot-coms need marketers as much as – often more than – marketers need them. The same can't be said of blogs.

Marketers will naturally want their messages promoted on influential blogs and protected from critical ones. But they will find it difficult to navigate this complex blend of advertising, content, dialogue, and public relations. So far, the blogosphere lacks the equivalent of Madison Avenue to serve as a middleman for media buying and ad creation. But that is starting to change. A number of companies – including Blogdex, Daypop, Slashdot, Technorati, and Popdex – are already rating and ranking the popularity and influence of blogs and other consumer-generated media (see the exhibit "Rating the Blogs"). Ratings leaders are also beginning to emerge: Prominent bloggers Andrew Sullivan, Lawrence Lessig, and Glenn Reynolds attract tens of thousands of readers. And an advertising service called Blogads is helping bloggers sell ads. (A business model has arisen with its own catchy neologism: blogonomics.)

Corporate marketers must deal with bloggers differently from they way they deal with traditional media. First, they must realize that the blogosphere is not just a place in which to advertise; it is a medium in which to participate. Marketers can join the conversation on influential blogs related to their products or companies – or, even better, they can become bloggers in their own right by hosting blogs for customers. Most radically, they can host independent bloggers on their Web sites, essentially trading exposure for reach and credibility.

Second, companies must try to cultivate bloggers rather than control them. Instead of making ham-handed efforts to influence bloggers, marketers should attempt to win them over by sharing information openly with those who write about their companies and by responding to the issues that are raised, even – especially – if they are negative.

Third, the blogosphere is fluid and ever changing. Ad buys will become more dynamic, as new technologies and modified contract terms let marketers shift rapidly from blog to blog in pursuit of customers' fickle attention.

The grassroots media will not replace big media any more than online commerce destroyed brick-and-mortar businesses. But the blogosphere will soon take its rightful place as a full-fledged media branch, demanding attention from marketers and advertisers. Markets are conversations, as is noted in the provocative book *The Cluetrain Manifesto.* Blogs are the most conversational of all the forms of media, and marketers can't afford to be left out of the talk.

Rating the Blogs

Several companies are already ranking Web logs by various criteria. Daypop, for example, creates a score that is intended to be proportional to the probability that a reader will arrive at a site while randomly hopping from blog to blog. (The ranking changes all the time; this was the order on December 4, 2004.)

Top Five Blogs, by Daypop Score

1 Just Another Blogger, www.weblog.ro, 128 Web log citations, Daypop score 94.57

2 Slashdot: News for Nerds. Stuff That Matters. www.slashdot.org, 451 Web log citations, Daypop score 87.22

3 Scott Watermasysk, www.scottwater.com, 369 Web log citations, Daypop score 80.94

4 Boing Boing: A Directory of Wonderful Things, www.boingboing.net, 535 Web log citations, Daypop score: 71.14

5 Blogarama: The Blog Directory, www.blogarama.com, 275 Web log citations, Daypop score 67.67

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11 No Risk Is an Island*

It's a risky world, and planetary circumstances at the dawn of 2005 aren't conspiring to make us any less jumpy.

Terrorism and the rocketing U.S. debt are bad enough. Add species-hopping diseases like mad cow and bird flu, a fossil fuel addiction that's changing global weather patterns, plants dispatching engineered DNA to their wild cousins to ambiguous effect, a new nanoindustry that is preparing to release millions of teensy molecular machines into our bodies and the environment with barely a peep heard about consequences, an electrical grid cobbled together with baling wire and spit…A person could develop a nervous tic.

People who manage risk in enterprises are already twitching, trying to avoid more prosaic daily minefields: What if the technology breaks, what if the customers hate it, what if the market crashes again before we get our next round of funding? But the big risks affect them, too. We're all connected, and not just by the (hacker- and virus-infested) Internet – as so many industries discovered after September 11, 2001, again when SARS broke out, and again during the 2003 blackout.

Clearly the enterprise is not isolated from the world it inhabits – not "an island entire of itself," as that famous management expert John Donne wrote. Like it or not, it's forced to cope with blowback from risks well or badly taken by others. Which raises the question: How do you manage the big risks that you can't control and that are, practically speaking, owned by no one?

There is not much new to do about the true "act of God" risks. But of those generated by science and technology, Donne might say: No *risk* is entire of itself, either.

Man-made risks exist in context. We decide as a society, as individuals, and in our enterprises what we think is risky and what we think isn't. These decisions reflect our values and biases. Traditional risk calculations only increase the skew, since they are forced to produce a number that represents the problem – even if the interested parties don't agree on what the problem is, the assumptions that were used to bound it, or whether the calculations even measure anything meaningful.

Companies tend to focus on their immediate interests. But big risk affects people and organizations far beyond the risk taker. Refusal to acknowledge or tackle this point exposes organizations to all kinds of unforeseen liabilities. Whether a beleaguered company suffers from lost profits and jobs or the government coughs up a taxpayer-financed bailout, everybody pays. For example, Monsanto says its transgenic corn and soy are safe. But if something bad happens, every entity that its genetically modified products have touched – food manufacturers, grocery stores, distributors, consumers, and farmers – takes the hit.

> How do you manage the big risks that you can't control and that are owned by no one?

These types of risks are often both anticipated by outsiders and unheeded by decision makers. Yet in several reports, the U.S. National Academy of Sciences has addressed the question of how to work effectively with risks of this sort. The reports strongly suggest that companies adopt a transparent risk-assessment process to avoid the blindered view so often bred by conflicts of interest between risk takers – scientists and inventors and the companies that employ them – and regulators. They state categorically that "value-free" risk assessment is impossible, because each expert's values define the terms of any analysis and because those who conduct risk assessments bring their own biases to the task.

The National Academy of Sciences reports also exhort risk managers to embrace uncertainty in ways that are rarely practiced today – that is, to actively consider questions that may not be answerable or measurable. Although this seems counterintuitive, it greatly improves the technical quality of a risk assessment. The 1994 report "Science and Judgment in Risk Assessment," for example, advised the Environmental Protection Agency not to "abandon assessments when data are inadequate. Instead, seek to explore the implications for research." So if the EPA is grappling with a large unknown like the future impact of genes from genetically modified crops on neighboring plant and animal species, it should pursue research in that area and not base its decisions on existing, possibly irrelevant, data.

And the pièce de résistance: Risk isn't just a social construct. It's a social *endeavor.* To be effective, assessments of big risk must involve a broad, deliberately constructed community of experts and stakeholders. To be trustworthy, they must embrace a cross section of society: experts and professionals, of course, but also anyone who is interested in or affected by the risk.

This method – iterating between analysis and deliberation, experts and stakeholders – is more truthful, less tolerant of bias, and more revealing than most of today's trade-secretive corporations could bear. As a result, it's rarely practiced, particularly in the United States. It's messy, it reeks of humanity, and it seldom yields the tidy probability equation that sells a risk to the executive team. Yet it's been used well in at least a few places–mostly by private risk consultants and a few progressive corporations, and deep within the bowels of a few regulatory organizations that have the courage to confront their own ineffectiveness.

Consider this idea in the context of the commonsensible Nobel-winning theory of Kahneman and Tversky that all people operate from values and biases and not from rationality. When you include technical experts, scientists, and risk managers in your definition of "people," then the benefit of inviting more people to the risk table is a no-brainer. We know what to do and how to do it. What are we waiting for?

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12 Let Them All Be Power Users

"To make knowledge work productive will be the great management task of this century, just as to make manual work productive was the great management task of the last century."

Peter Drucker wrote those words back in 1968, later calling knowledge-worker productivity the decisive competitive factor in the world economy. Let's assume Drucker was – as usual – right. If knowledge workers are the horses pulling the economic plow, have corporations maximized their horsepower? What have organizations done to help knowledge workers become more effective?

Not much, it turns out. Most corporate productivity efforts address production or administrative work. Knowledge workers have largely escaped scrutiny because they often work autonomously, and much of their labor is invisible, taking place inside their brains. Yet increasing amounts of knowledge work – an average of three hours and 14 minutes per day – involves visible, measurable activities performed with electronic communications (see the exhibit "Ripe for Improvement"). Knowledge workers read and write, talk informally and in meetings, and use technology to manage their personal information and knowledge environments. That last type of activity can be observed, calibrated, and improved – but only if employees are shown how to do so.

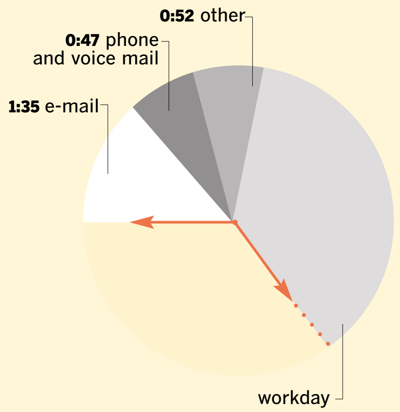
Companies load up knowledge workers with desktop and laptop computers, personal digital assistants, cell phones, wireless communicators, e-mail, voice mail, and instant messaging–then leave them to their own devices, so to speak. Employees receive little or no guidance about how to apply those technologies to their work. And the devices remain largely unintegrated.

As a result, most people aren't very good at managing their personal information. My informal surveys suggest that only about 1% of knowledge workers feel they have mastered this area, and only 4% have received substantial help from their employers. In short, companies' most valuable employees spend 40% of the workday doing something they don't do well and so fail to extract the most from their stock in trade: knowledge. It's a bit like bricklaying before Frank Gilbreth.

A few organizations are wising up. Information technology companies, which after all have something to prove, are heavily represented among the first movers. Intel, for example, has launched an ambitious internal eWorkforce program that segments the company's knowledge workers into types, defines some key tasks (such as arranging and running a global meeting), and supplies education, coaching, and tailored applications to help workers perform those tasks better. Cisco Systems' Change the Way We Work initiative teaches employees how to exploit new personal-information technologies. Microsoft has undertaken both research and internal IT efforts to enhance "information work

Ripe for Improvement

Knowledge workers can calibrate and improve their use of technology if they are shown how. A 2003 survey of office workers who used computers every day showed that they spent, on average, three hours and 14 minutes daily – some 40% of the workday – using e-mail, phones, and other technologies to process work-related information. The survey, which had 504 respondents, was conducted under the auspices of the Information Work Productivity Council.



INCOMING (per day)

- 44 e-mails per person in an average of three accounts (four respondents got 500 messages a day)
- 8 phone calls
- 8 voice-mail messages

OUTGOING (per day)

- 17 e-mails
- 15 phone calls

productivity." Outside the technology ranks, Capital One has turned its IT function loose on the problem. And Raytheon's Space and Airborne Systems division has introduced education programs and policies to turn the company's employees into power users of communication tools.

There are, as yet, no best practices for improving personal-information management. So companies awash with knowledge workers should be experimenting. Internal experts may be the best source for this particular curriculum. Managers might identify a job or process that is both important and knowledge intensive, then observe how the most and least productive employees attack it. Or they can simply ask the most effective users of personal technologies in their organizations what they do. Finally, remember that technology isn't everything. Knowledge workers should also learn how to modify behaviors, priorities, and relationships. Knowledge, after all, is a yeasty, mutable substance, and communication requires nuance as well as speed. The brain remains knowledge workers' principal work space. Employees whose external information environment is well managed can keep that internal environment clutter free and operating at peak efficiency.

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13 A Taboo on Taboos*

A reporter sniffing around PeopleSoft's user conference last fall was surprised by what she didn't smell: fear. Despite the sword of Damocles suspended over their investments by Oracle's hostile takeover bid, customers discussed "comfortable subjects regarding PeopleSoft's business administration programs, such as new features they'd like to see in the next version–rather than whether there will even be a next version," wrote Alorie Gilbert on CNET News.com. Those nonconversations probably sounded a lot like the airlines' 25-year silence on deregulation's threat to their business models. Not to mention the only recently disturbed hush over underfunded pension plans.

The worst thing about elephants in the room is that if you ignore them long enough, they become invisible. That's what happens when companies avoid subjects because they are politically dangerous, socially unacceptable, or just too dire to contemplate. The result can be a failure to anticipate predictable developments and consequent errors in strategy.

The *Encyclopedia Britannica* defines "taboo" as the prohibition of an action that is either sacred or perceived as "dangerous, unclean, and accursed." In organizations, taboos may involve actions (no groping colleagues; no dressing casual-Friday on uptight Monday), but most involve ideas and language. There's substantial literature in an "emperor has no clothes" vein that preaches the need for candor about sensitive internal issues. Employees, we are told, must feel free to speak hard truths: This feature won't work or that process is too cumbersome or has anybody else noticed that the boss is crazy?

But in many companies, painful external issues that can seriously affect strategy never get an airing, says Victor Halberstadt, a professor of economics at Leiden University in the Netherlands. In several large European companies, Halberstadt has observed a widespread unwillingness to broach topics that seem too big or intractable or that call into question the wisdom of government policies or corporate directions. Among the buried hot potatoes: whether European integration is truly manageable or is perhaps overstretched; whether the EU's private sector will continue to deindustrialize; the probability that educational systems are failing the economy; and the unsustainability of current welfare states in Europe.

In many companies, painful external issues that can seriously affect strategy never get an airing.

"There are too many taboos on subjects that can be very serious barriers to long-term economic growth," says Halberstadt. "If we don't talk about them today, then ten or 15 years out, bad things will happen that will be seen as surprises."

Similarly, avoiding social third rails can render organizations' marketing and product development efforts less innovative as the firms gloss over profound ideas with safe, tepid language and images. We know sex sells – explicitly in advertising and more subtly in design and other areas. Sexuality is a serious and complex subject that touches many aspects of our lives (love, self-respect, beauty, procreation, disease). Yet the threat of litigation and the inevitable snicker factor mean most companies never engage the subject in a meaningful way. Language, in particular, becomes enfeebled when we actively eschew provocative words, those most freighted with meaning. Instead we fall back on clichés and euphemisms, which in turn take on their own salacious connotations and must be discarded. (Harvard linguist Steven Pinker calls this "the euphemism treadmill.")

We are embarrassed by sex. We'd rather not think about death. And if we bring up God (or god or gods), noses will get out of joint. Yet sex, death, and God are the most profound considerations of mankind. How can companies hope to remain relevant if they won't discuss them?

IDEO, the famously innovative design firm, set out to topple taboos in its own workforce and in the process to connect more empathically with customers and break down barriers to open collaboration. The company identified several subjects that are deeply felt but difficult to talk about – among them sex, death, and birth – and gave teams the task of exploring and demystifying them. In an exercise that was more extreme example than best practice (the company doesn't expect others to follow its lead), a six-member, coed, cross-functional team immersed itself in all things erotic – visiting a transvestite bar, viewing pornographic movies, and confessing to one another their most intimate experiences. "This was a team exercise of desensitizing them to the subject, but doing it with a huge degree of humor and a huge degree of consciousness," says Paul Bennett, leader of IDEO's consumer experience design practice. "People tend to mythologize and sensationalize sex or any taboo subject when the real thing is much more interesting and provocative."

At project's end, the team developed several not-meant-for-the-real-world offerings, including products to prepare someone for a first sexual experience and a personal trainer for one's sex life. Prior to the taboo-toppling, the group would have been unable to push back its mental boundaries enough to dream those up, according to Bennett.

A somewhat different kind of boundary breaking has more practical business applications. Does everybody in your company see – but no one talk about – the competitor who has been eating away market share 3% a year for the last four years? Is nobody discussing – but everybody fearing – the movement of technology jobs offshore?

The challenge is to enable full and frank discussions of touchy topics without creating a hostile environment. The best place to start, perhaps, is a public acknowledgement of what is not being talked about, followed by education about what is in and out of bounds (with the emphasis on "in"). Halberstadt suggests that top management routinely meet with outsiders who are comfortable with transgression – including artists, independent academics, and some journalists. "They need someone to confront them about these things they would rather ignore," says Halberstadt. "They need someone who will talk about the world as it is."

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14 Toward a New Science of Services

Services is the name of the game in today's economy. Services represent about 80% of the U.S. gross domestic product and between 60% and 80% of the GDPs of the rest of the world's advanced economies. Getting better at services management must be a priority. Companies like General Electric, Xerox, and IBM that are seeing their own businesses shift from products to services are acutely aware of this. (At IBM, for example, more than half of total revenue now comes from services.)

So why can't we agree that services science is a legitimate field? Even as it is researched, written about, and taught, services management is not a discipline in its own right but rather a stepchild of academic fields like marketing or operations. Under their watchful eyes, its growth is being stunted.

That's not to say those disciplines have made no progress. There are marketers doing great work on marketing of services. There are operations people making inroads on the operational challenges of services. (Much has been learned about operational optimization in supply chain management, for example.) A few individuals have become acknowledged experts in the management of certain vertical industries, such as financial services or management consulting.

But we're not making progress across disciplinary boundaries. People in these different areas don't review each other's work because they don't publish in the same journals, and they don't meet because there isn't a definitive conference covering the field. It's no surprise that the work shows little cumulative advance in learning. Logically, for the theory and practice of services management to move forward, the study of services needs its own discipline.

But logic may not matter. The history of science shows us that some new areas become academic fields while others – seemingly just as vibrant and promising – do not. Computer science, now a full-fledged discipline, was once a subspecialty in engineering, math, or physics. By contrast, organization science, associated with Herb Simon and Jim March, never gained its own stance.

My sense is that three factors made the difference for computer science. First was the scale of the phenomenon. As computing reached a critical mass, people generally sensed it was worthy of study in its own right. Second, the tools of the trade – computers, programming languages, compilers, and software – became increasingly widespread, making it easier for research to be built upon. Third, grand challenges energized and united the field – challenges that were of only peripheral interest to students of math, physics, and engineering.

What does that suggest for the future of services science? The signs are promising. There is an extremely important phenomenon to be explained, one even bigger than the preponderance of service businesses in the economy. Consider that in shifting from products to services, a supplier does more for the customer than it used to and thereby allows the customer to off-load some work and thus do more for his own customer. In a phrase favored by high-tech executives, the customer moves "up the stack" in the value-added chain. The result is an enhanced standard of living and prosperity – an extremely important outcome in an advanced economy.

Services also meets the criterion for tools. Business process modeling, for example, now makes it possible to break down a company's business into processes, trace the various activities that constitute each, explain in detail how the parts relate, and figure out how the process might be done differently. Building on that, we have techniques to see how the workings of one process might be reused in other processes and when that would be appropriate, given the inevitable trade-offs between custom and off-the-shelf solutions.

And what of the need for grand challenges? What questions is services science trying to answer that are not well addressed by other fields? Let's start with the problem of innovation in services. Without tangible products to prototype and focus on, how can we determine whether we're designing what customers want? Next: Given that a service is an intangible output produced largely from intangible inputs, how do we measure and improve productivity? Services also bring new urgency to the challenge of tacit knowledge transfer, since service encounters bring together people who would benefit by learning more from each other.

It should be remembered that even computer science didn't emerge fully formed. Decades passed while schools gradually added courses and departments fought over them. It's also worth noting that the very first course in this new field, back in 1946, was developed by IBM. (The senior Tom Watson, then a trustee of Columbia University, persuaded the school to offer it.) The interest of big companies like IBM may likewise make the difference to services science. As IBM senior VP for research Paul Horn notes, "At IBM, we've been working closely with academic institutions to stimulate a cross-disciplinary focus on 'services science.' We need to overcome the silos of departments and disciplines if we are going to generate the innovation needed in a services economy." In the end, corporate support could be the decisive force that brings a coherent new field into being.

Logically, the study of services needs its own discipline. But logic may not matter.

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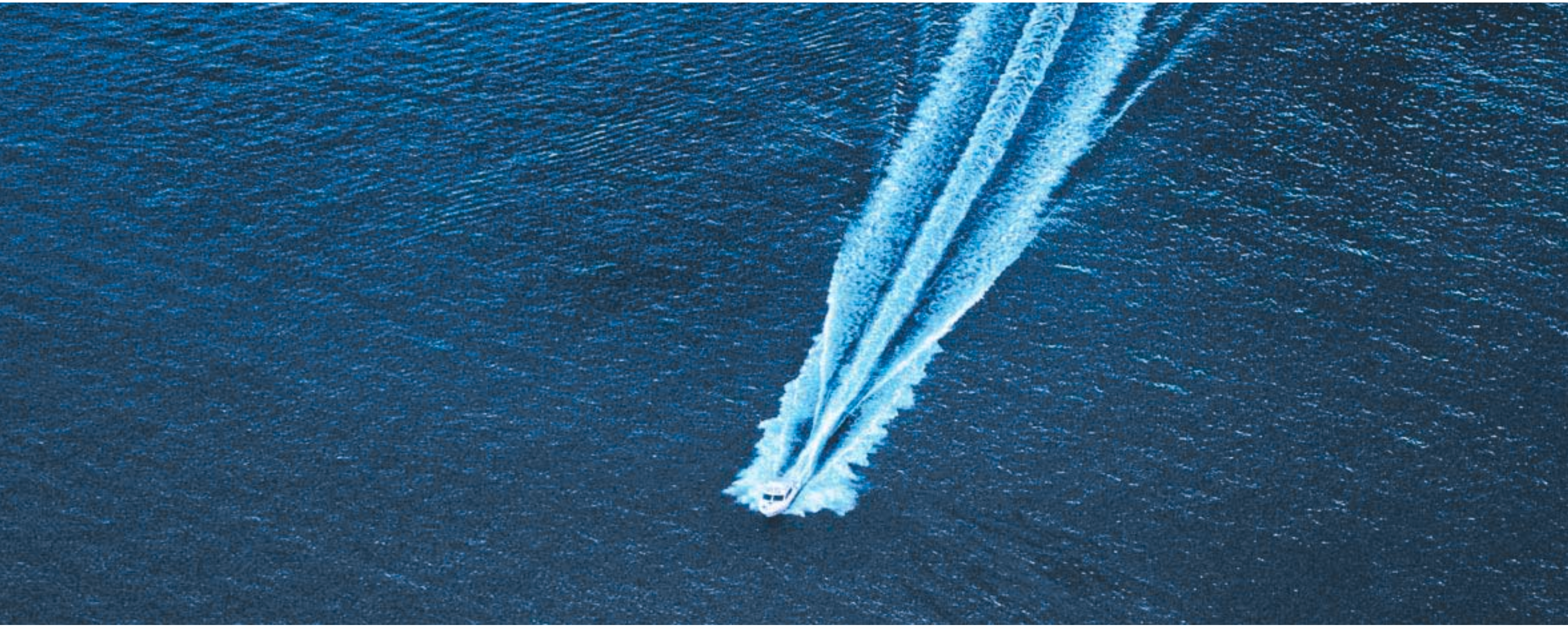
15 The Coming Crisis over Intellectual Property Rights*

The system for protecting intellectual property rights faces a fundamental challenge that governments and corporations haven't fully appreciated yet. Many executives acknowledge the problems that have been posed to the global system by recent attitudinal changes in society: the growing sentiment among consumers that there's nothing wrong with sharing music or video files over



the Internet, for instance, and the rising opposition to transnational corporations that charge remunerative prices for lifesaving drugs in poor countries. Companies are busy responding to the fast-changing environment, but they've underestimated the potential threat from developments in China.

China's reforms have created a situation in which more of its companies now steal intellectual property, including from transnational corporations that do business there. If Chinese companies flood the world's markets with pirated versions of every kind of product from cars and airplane parts to pharmaceuticals and software – as they have started to do – bottom lines everywhere will suffer, and businesses will have to rethink the manner in which they develop new technologies and bring them to market.

That nightmare isn't as far-fetched as it seems. Beijing has turned a socialist economy into a decentralized dynamo through a key device: It has given officials at all levels the freedom to pursue economic growth. Local GDP growth qualifies bureaucrats for promotions, and it puts money in their pockets by giving them opportunities to acquire equity stakes in local firms, to gain employment opportunities for their relatives, and to engage in plain-vanilla corruption. Officials naturally protect "their" companies from punishment even when Chinese courts rule against them on IPR-related issues. Thus, the links between companies' profits and officials' incomes have laid the foundation for widespread theft of intellectual property by Chinese firms.

Moreover, uncertainty surrounds the future scale of intellectual property theft in China. The country's accession to the World Trade Organization in 2001 requires Beijing to limit domestic economic interventions largely to fiscal and monetary policy, law and regulation, and industry-level policies. China is also taking steps to respect intellectual property by setting up IPR courts, and many Chinese firms have sought better protections for their intellectual property. However, those steps will prove insufficient unless Beijing successfully cuts the ties that bind local officials to firms. The central government is finding it difficult to do that because unlike previous reforms, this initiative would take money away from key officials throughout the country. Besides, intellectual property theft in China is easier than ever because of the country's encouragement of foreign investment in order to bring in new technologies; the rising number of Chinese engineers; and technological advances that have made reverse engineering more feasible.

What can firms do? Companies must treat IPR protection as a strategic issue when conducting business in China. They should work out what intellectual property they must protect and what they can afford to lose. They may have to keep key production technologies outside of China. Smart companies will also set up fully owned ventures rather than form joint ventures, so that they can control information in ways that protect their secrets. They should compartmentalize different parts of the production process; find ways to make sure after-sales protections are tied only to products they have manufactured; educate the public on how to differentiate the real from the fake; and pursue pirates in court.

In addition, businesses should band together with other firms in their industries to confront the Chinese government. They should pressure their own governments to use bilateral methods and the mechanisms of the WTO to force improvements in China's IPR enforcement.

At another level, companies should wake up to the reality that the global IPR regime has eroded to the point that if China does not change, they will soon need new models for earning rewards for their innovation investments. In that sense, the China factor could become the straw that breaks the back of the IPR system in the next decade.

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16 Biometrics Meets Services

With today's focus on security, demand is booming for biometric devices that can look at your features and decide if you're who you say you are. Machines that scan fingerprints, palms, retinas, and faces are cropping up in airports, banks, hotels, and even supermarkets to improve security and prevent fraud and theft. But while biometrics may make things safer, security won't be the killer app. Using a fingerprint scan to open a locker – as visitors to the Statue of Liberty now do – is not fundamentally different from (or easier than) using a key. It's just more secure.

But using biometrics to enhance the customer experience – *that* will change how companies do business. Imagine an airline that uses scans of fingerprints and faces to allow travelers to breeze through check-in, customs, security, and boarding in under 60 seconds – and automatically get seat assignments based on their preferences. Who wouldn't choose that carrier over its competitors?

Singapore Airlines (SIA) and its hub, Changi Airport, are collaborating on just such a system, betting on biometrics to improve productivity, reduce costs, lure fliers with unprecedented service, and enhance security to boot. In November, SIA and Changi launched a six-month pilot test of Fully Automated Seamless Travel (FAST) involving 9,000 SIA frequent fliers. Each received a smart card encoded with fingerprint and facial data. At check-in, these travelers simply walk through a separate gateway, slide their cards through a reader, and have their fingerprints and faces scanned. If the card data match the holders' features, the system clears security and immigration, recommends preferred seats, and prints boarding passes. The entire process takes less than a minute, compared with a current average of eight to 15 minutes. SIA and Changi are exploring a similar system for baggage handling; passengers would be able to skip lines and drop off biometrically tagged luggage outside the terminal, to be reunited with it – after scanning – at the destination.

While the airline rolls out these beta tests, it is studying other ways biometrics could enhance services, including speeding ticketing and payment, customizing loyalty-program services, and improving the efficiency of call centers through voice recognition.

Biometrics' ability to improve service delivery in other industries, we believe, will be limited less by technology, regulation, or public acceptance than by imagination. Any service offering in which knowledge of customers' identities and preferences could be used to customize and streamline sales is a candidate. Imagine the principles demonstrated in the SIA-Changi experiment applied to the process by which customers buy clothing, financial services, health care – even a personalized cup of coffee.

In a recent retreat, an SIA task force identified 113 potential uses for biometrics in its business. If that's 113 more than you've thought of, you've got some thinking to do.

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17 Getting Time on Your Side*

We are looking at increased longevity all wrong. People live longer, so we picture them spending more years in old age. Yet if we think of old age as a period of weakness and decline, it has not lengthened significantly. What's longer is the prime of life. Society should adapt to longevity by focusing on the middle of life and position the additional time as

TLFeBOOK

What would it take to offer large numbers of adults a year off (or even two) somewhere around age 50 or 55?

a second stage of healthy, energetic adulthood, postponing rather than lengthening retirement.

It is up to employers to design policies that make this new stage of adulthood vital and creative. Careers, like marriages, can grow stale. Technical training updates obsolete skills, but renewing aspirations is a greater challenge.

We are accustomed to lives that unfold according to a familiar rhythm of preparation and achievement, arrivals and departures, excitement and quiescence. But our mental model of these stages and transitions is fast becoming outdated. Adulthood simply goes on too long without punctuation. The famous midlife crisis is a search for that punctuation, for the feeling that one is making a new start. How much fresh energy, creativity, and loyalty would senior management reap from employees if it could provide that feeling on the job?

A metaphor may be helpful. Adding a room to a house is likely to change the way all the rooms are used. Midcareer renewal is potentially a more dramatic change: Rather than building something on at the back, we are moving the walls and creating an atrium in the center. The atrium is filled with fresh air and sunlight, and it presents an opportunity for reflection on all the rooms that open off of it.

What would it take to offer large numbers of adults a year off (or even two) somewhere around age 50 or 55, a year that would challenge them to rethink their lives and return to their jobs with renewed energy and motivation? One model is the academic sabbatical, designed not as a reward or a vacation but as a way to refresh teachers by letting them tackle new and exciting questions. In an industry equivalent, some employees might return to school; others might perform public service. Some might revisit an earlier dream – writing a novel, for instance – and accomplish it or finally put it to rest.

Afterward, many would return to their jobs eager for fresh responsibilities, motivated to embark on a second era of high performance. A few would decide to follow their discoveries elsewhere. They would be grateful for their new direction; their employers might be glad to have dealt with diminishing productivity so humanely.

It is easiest to make a change when you are clearly at the end of something. Men and women who lose their jobs because of restructuring often seek additional education and may find themselves in more interesting, demanding careers as a result. Lacking a natural transition point, however, even those middle-aged employees who feel bored and trapped in their jobs are unlikely to risk their security for an adventure into the unknown. But many midcareer people would love to make a change and take a chance. In exchange, they would willingly defer retirement for a year or two, expecting that those additional years – and the years leading up to them – would be richer and more satisfying, thanks to the time in the atrium.

The midlife atrium will introduce risks and costs for both employees and employers and will consequently require ingenious design. Employees will need new options for financial planning, and they will need benefits to make the transition less hazardous. Employers will have to change their staffing models and employee development programs. Financial institutions, which focus so profitably on retirement planning, must create products to support this new life stage.

But it will be worth it. Burnout is taking an ever greater toll on companies' productivity and morale. The enemy of stagnation is challenge, the dizzying ascent into an unfamiliar space.

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18 Inversion of Privacy

We know that people will trade some personal information for security or convenience. Still, we never question the idea that almost everyone fundamentally values privacy. For that reason, organizations seeking access to consumer data assume they will always confront reluctance, if not open resistance. They plan protracted sieges armed with trade-offs, reassurances, and warnings.

But blanket, long-range privacy strategies may not be effective. Attitudes toward privacy differ dramatically on the basis of age, geography, and who is doing the prying. And under the influence of shifting demographics, attitudes will likely change even more. Corporate and government policies should take account of those distinctions.

When I talk to students and adults about privacy in the digital age, I am struck by a persistent generation gap: The younger the audience, the weaker its concern about personal exposure. For example, when I ask for reactions to the "naked machine," an electronic strip-search device being tested at airports, college and law students are generally unperturbed by it. Business leaders over 40, by contrast, are far less comfortable. Of course, people in the older group worry about displaying the effects of

> Students are generally unperturbed by the "naked machine," an electronic strip-search device being tested at airports. Business leaders over 40 are far less comfortable.

gravity; but they also consider the violation itself to be more grave.

My anecdotal perception is confirmed by empirical studies. A 2000 survey by the Pew Internet and American Life Project found that 67% of 50-to-64-year-old respondents were very concerned about consumer privacy, compared with only 47% of 18-to-29-year-olds. International studies have reached similar conclusions.

Young people's relaxed attitude toward privacy is less a matter of youth (with fewer experiences, they have less to hide) than a matter of upbringing – and is consequently likely to stay with them as they age. Their worldview has been shaped by technologies of personal exposure, including Web logs, cell phones, and digital cameras. They have grown up visiting sites like eBay and Napster, where the identities of the corporations collecting their personal information are masked by interactions with other users like themselves. Self-revelation is prized over reticence in our reality-TV-obsessed culture, because getting noticed matters more than upholding traditional norms of discretion.

Civic privacy is a different matter. Younger people are more concerned than older ones about surveillance by the state. A 2002 survey by the British government found that younger groups were less convinced than older groups of the benefits of sharing private data with the public sector. The older groups trusted government more, largely because of positive experiences with the welfare state during and after World War II. A similar generation gap exists in the United States.

Culture also influences attitudes. For example, Europeans generally worry more about corporate data surveillance, while Americans are concerned with what government is up to. Those geographic differences reflect very different histories. Europeans have traditionally been concerned about protecting the dignity of high-status individuals from a prying public. Americans, by contrast, focus on protecting the liberty of individuals against intrusions by the state. The distinctions are reflected in the regions' privacy laws.

Understanding these differences is crucial for companies as they do more business online, make more sophisticated use of their databases, and cooperate with governments. Younger consumers may be more willing than older ones to trade their personal data for a toaster; but in the United States, at least, neither group will do so if it perceives federal snoops peering over corporate shoulders. As young exhibitionists get older and become the dominant demographic, companies should worry less about collecting data for use inside their own walls and more about cooperating with government security initiatives. To sustain consumer trust, companies should push for amendments to the USA Patriot Act, for example, that would insure accountability and transparency and protect privacy (although further attacks by terrorists may make broader government surveillance widely palatable).

In other markets, where consumers are more resistant to corporate data collection, companies need stricter privacy policies. There is a widespread perception that U.S. companies are less respectful of consumer privacy than are European firms. If not countered, that perception could inhibit the global competitiveness of American corporations.

Public- and private-sector data are increasingly integrated and globalized, making it even harder for organizations to balance the tangle of privacy expectations from around the globe. As the public in different regions grows more open and more suspicious in diverse ways, a single level of optimal protection may be increasingly elusive.

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19 In Praise of Feedership

Of all the biological metaphors used in business discourse, none is more central to strategy than "survival of the fittest," with its implications of incessant rivalry and ruthless competition for scarce resources. But head-to-head competition is only a small, and not even particularly interesting, part of the struggle for survival. The familiar image – in films, literature, and one's imagination – of ferocious predators dominating a nature "red in tooth and claw" is simply not borne out by observations in bush and field. Predators' teeth and claws, fearful and fascinating though they may be, are rarely the utensils of choice at life's table. So what are? Overcome for a moment your natural revulsion and consider the lowly parasite.

The vast majority of species are parasites, exploiting the evolutionary discovery that the best way of making a living is to be closely attached to something else that is living. As much as we may resent their choice of residence, we must respect their strategic genius, for nowhere are life-sustaining warmth, nutrition, and shelter as abundantly present as in other forms of life.

In an economy, such prime real estate would carry a steep price; in biology, the price comes in the form of a coevolutionary race of innovation between parasites' ploys to gain entry and the steadily more formidable defenses of resistant hosts. As a result, both parasites and hosts are characterized by a wondrous complexity of adaptations. These adaptations are far more subtle and cunning than the relatively unimaginative ones that have evolved from predatory competition.

For an illustration of this complex host–parasite negotiation, consider the curious interaction of the fig and its parasite: the fig wasp. Squeezing through a narrow opening, the female wasp forces her way into the richly provisioned interior of the fig to lay her eggs on the developing flowers of the fruit, which will nourish the wasp larvae. The seeds thus lost and the damage due to the forcible entry represent serious costs to the fig.

So far so good for the wasp. But now consider the concessions extracted by the fig in the long process of evolutionary negotiation. The female wasp, moving about the interior of the fig depositing her eggs, fertilizes the flowers with pollen carried on her body from the fig in which she originally emerged. When her female descendants exit through the eye of the fruit, they brush against the pollen-laden male flowers near the opening and carry the precious dust to the figs in which they will build their nests.

And what of the newborn males, which presumably would carry away half of the pollen on journeys of amorous adventure and, as they have no reason to reenter and thus pollinate another fig, provide no benefit to the fig species? Their unfortunate lot is the final concession in the evolutionary bargain struck by the fig and the wasp. When the males hatch, they lack vision, wings, and all but the basic motility required to immediately seek out and mate with the new females. Having acquitted themselves of this reproductive chore, the males expire unceremoniously within the fig, never having seen the light of day and, more important, never having had a chance to waste the precious pollen of the fig.

The value of this peculiar tale–which actually isn't that unusual in the often bizarre world of parasitism – lies not in its specifics but in its suggestion of a rich new way to think about strategic interaction. The survival-of-the-fittest metaphor calls for the mobilization of all resources to deny access to intruders; parasitism, in contrast, suggests to the strategist that there may be benefits in letting down one's defenses. In business, parasitic activity – for example, the infringement or appropriation of patents, brands, and intellectual property–would long ago have become prevalent were it not for the existence of property rights. But in today's global economy, in which tangible assets are becoming less important than intangible ones, the enforcement of those rights is increasingly costly and difficult. Nature, ignorant of formal property rights and hospitable to parasitic species, offers some ideas for turning this threat into a platform for innovation.

For instance, might makers of branded luxury goods view cheap knock-off watches and handbags as "pollen" in winning the brand awareness of consumers whose income does not match their discriminating taste for fashion? Or might the firms learn some valuable insights from their imitators' low-cost production, sourcing, and distribution methods? There are no ready answers to such questions, but (for that very reason) the questions offer a chance to escape the mental tunnel created by a conception of business as being exclusively competitive or predatory and to envision entirely new ways of formulating strategy.

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20 Don't Believe Everything You Read (Except for This)

Organizational leaders are deluged with advice. There are more than 30,000 business books in print, with some 3,500 new titles published each year, and too many management-related articles, newsletters, and Web sites to count. There are not, of course, 3,500 *good* new management ideas – or even old management ideas worth elucidating in 300 pages. Much of this advice is, at best, a waste of time. At worst, it can – if followed – create more problems than it solves.

Reengineering projects, fueled in large part by a certain red-jacketed volume, have experienced an estimated failure rate as high as 70% (a statistic supplied by reengineering champions Michael Hammer and James Champy themselves). And what about all those books and articles that touted Enron's innovative business model and people-management strategies? Consultants, too, can sometimes make matters worse. Blake Nordstrom, president of the department store chain of that name, told me that his predecessor in the job spent about $60 million annually on nearly 50 consultants and consulting firms. Yet the company's results only deteriorated. In fact, things got worse as conflicting advice immobilized the organization. Nordstrom began its successful turnaround when it rediscovered its focus on customer service and the basics of retailing – a strategy it (re-)figured out for itself.

What's a poor executive to do? Here are a few simple, commonsense guidelines to separate the gold from the dross in the management-idea marketplace:

Beware anything touted as "new." In medicine and the physical sciences, discoveries invariably build upon (and their authors acknowledge) the work of others. Innovation is mostly about combining existing ideas in new ways, as product developers at IDEO will tell you, or about finding new uses for existing technologies (Viagra, remember, was originally a drug to treat blood pressure ailments). Rather than pursue "what's new," you would do better to seek "what's true." Ford Motor Company got bored with the mundane details of total quality management, experimented with IT innovations and the Internet, and lost its focus on the details of designing and making great automobiles. Meanwhile, Toyota just kept doing the same things it had always done and did them better and better. The respective results speak for themselves. Toyota's recent profits were higher than Ford's and GM's combined.

Be skeptical of "proof by anecdote." Stories are a useful way of illustrating ideas and bringing them to life, but their color may obscure black-and-white evidence of whether a practice actually worked. For instance, McKinsey's *The War for Talent* was full of compelling stories, but the management practices that were supposedly responsible for companies' financial performance were measured *after* the performance itself was measured. Temporal ordering (cause coming before effect) is a necessary, albeit insufficient, condition for establishing that one thing causes another. In addition, anecdotes may sacrifice critical detail in the interest of enhancing narrative momentum. Sometimes the things that are just too complicated to explain are the things that – to some readers anyway – would have made all the difference.

Be alert for half-truths. That is what my colleague Bob Sutton and I call ideas that are partly or sometimes right but also partly or sometimes wrong. Many ideas fall into this category, such as the importance of financial incentives and the notion that work is so distinct from the rest of life that people can't be themselves on the job. Advice is more likely to be good when it acknowledges its own downsides and suggests ways to cope with them. The risk may be worth taking, and the management approach may be useful, but in order to make sensible judgments, you need to know the whole story.

Avoid self-proclaimed gurus. Whoever first applied the term "guru" to management thinkers probably meant well: The original Sanskrit word means venerable teacher. But over the years the term became associated more with best-sellers and astronomical speaking fees than with original thinking and serious fieldwork.

Understand cognitive biases. I am not talking about the biases described in behavioral decision theory, but about even more insidious distortions. One such bias is the desire to hear (and deliver) good news; another is to prefer ideas we agree with and people who agree with us. Both of these come into play when we work with consultants. Yet as Charlie Bresler of Men's Wearhouse points out, people benefit most from constructive criticism that actually teaches them to do things better. The best management advice need not be downright painful. But like diet advice – perhaps the only subject that generates a comparable amount of verbiage – if it doesn't cause at least a bit of discomfort, it's probably not going to have much impact.

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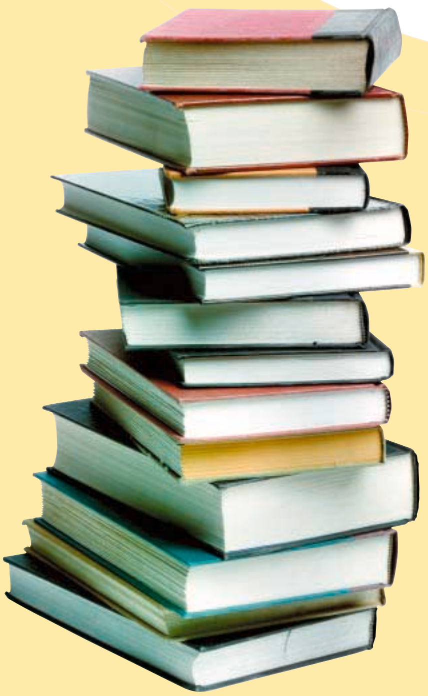
To order, see page 151.

2005 IN BOOKS

In 2004, business books told us how to put drama into meetings, predict which country would be the next economic juggernaut, treat promotions as setbacks, and leverage our inner pirates. Here's what publishers have in store for the coming year.

by John T. Landry



Career Imprints: Creating Leaders Across an Industry
Monica C. Higgins
(Jossey-Bass, March)

Drawing on her study of the biotech industry, Higgins, a Harvard Business School professor, warns boards to pay close attention to the values and habits that CEOs hired from outside carry over from their previous corporate cultures.

The Next Global Stage: Challenges and Opportunities in a Borderless World
Kenichi Ohmae
(Wharton School Publishing, March)

Strategist Ohmae's latest pro-globalization argument focuses on the dynamics of two engines: the rise of regional states and the spread of international platforms such as Microsoft Windows.

House of Lies: How Management Consultants Steal Your Watch and Then Tell You the Time
Martin Kihn
(Warner Business Books, March)

A comedy writer turned consultant draws on skills from his former career to explain the machinations of his current calling. Depending on your perspective, it's either funny or painful.

The One Thing You Need to Know...About Great Managing, Great Leading, and Sustained Individual Success
Marcus Buckingham
(Free Press, March)

The author of *Now, Discover Your Strengths* expands on the argument that focus trumps balance, urging managers to find one essential truth about their work and keep it squarely in their sights.

Hot Property: The Stealing of Ideas in an Age of Globalization
Pat Choate
(Knopf, April)

Western governments are beefing up protection of their citizens' intellectual property, but elsewhere, the vultures are gathering. Economist Choate describes how Western companies are losing out to pirates and counterfeiters, with adverse consequences for profits – and for society.

Moral Intelligence: The Key to Enhancing Business Performance and Leadership Success
Fred Kiel and Doug Lennick
(FT Prentice Hall, April)

Ethics is not so different from other business competencies. Two consultants offer metrics and other tools for developing the skills and habits of moral effectiveness.

The Silicon Eye: How a Silicon Valley Company Aims to Make All Current Computers, Cameras, and Cell Phones Obsolete
George Gilder
(Atlas/Norton, April)

The telecom bust hasn't muted Gilder's enthusiasm for emerging technology. He goes behind the scenes at Foveon, an innovative leader in digital photography.

The World Is Flat: A Brief History of the Twenty-First Century
Thomas L. Friedman
(Farrar, Straus and Giroux, April)
Technology may be a boon for terrorists, says *New York Times* columnist Friedman. But it also allows smart entrepreneurs in developing countries to compete and collaborate with Western companies in surprising ways.

Make Your Own Luck: 12 Practical Steps to Taking Smarter Risks in Business
Eileen C. Shapiro and Howard H. Stevenson
(Portfolio, May)
A consultant and a professor advise executives to apply the techniques of skilled gamblers and develop "predictive intelligence," including an ability to process varied information and act decisively in uncertain times.

Made in China: What Western Managers Can Learn from Trailblazing Chinese Entrepreneurs
Donald Sull with Yong Harry Wang
(Harvard Business School Press, June)
In the midst of China's turbulent growth, a few audacious companies have thrived despite government restrictions and without competing on low-cost labor alone. Their entrepreneurial verve, says Sull, a London Business School professor, offers lessons for companies everywhere.

The Sack of Rome: How Silvio Berlusconi Took Over Italy
Alexander Stille
(Penguin Press, July)
This is a serious journalistic look at how Silvio Berlusconi has controlled much of the Italian media and government. Media magnates in other Western countries may try to do the same, Stille argues.

Competition Demystified: A Radically Simplified Approach to Business Strategy
Bruce Greenwald and Judd Kahn
(Portfolio, August)
Michael Porter's "five forces" have dominated the thinking on positioning in recent decades. Greenwald, a professor at Columbia Business School, says we're better off with a simpler framework centered on barriers to entry within industries.

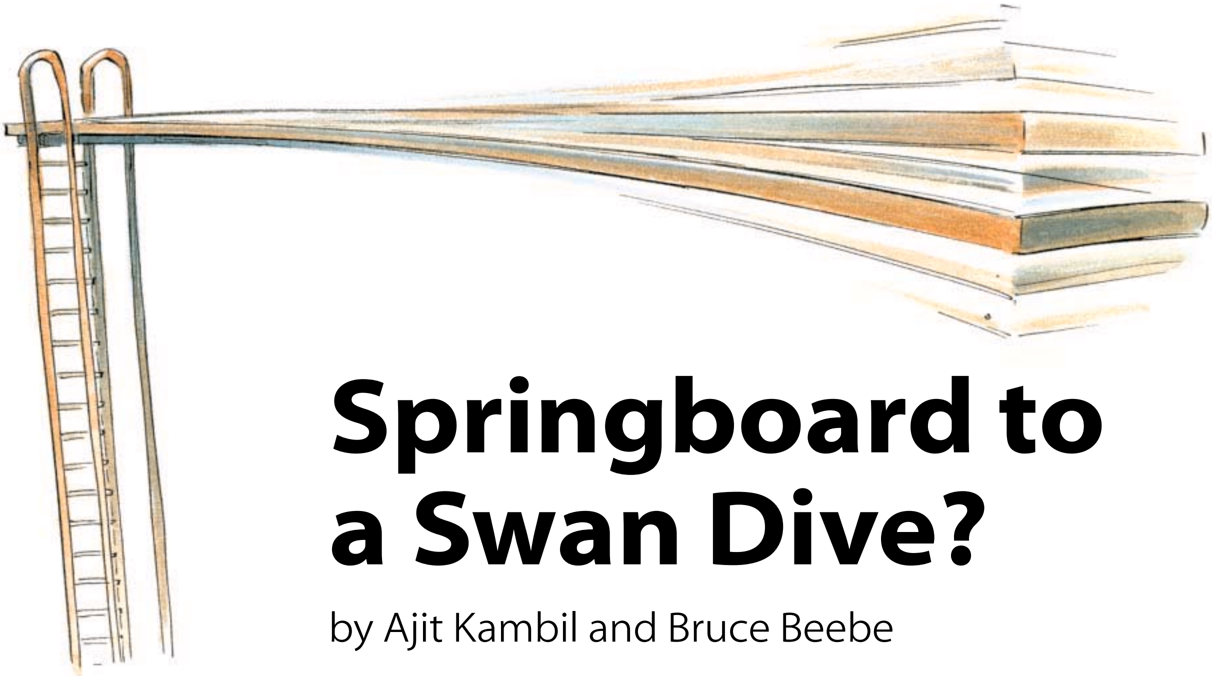
The Care and Feeding of the Knowledge Worker
Thomas H. Davenport
(Harvard Business School Press, September)
Structured processes and top-down decision making demoralize knowledge workers. Davenport, a Babson professor who studied the species in its natural habitat, suggests effective ways to manage these employees.

How Industrial Dynasties Work
David Landes
(Viking, September)
In *The Wealth and Poverty of Nations,* Landes, a Harvard professor emeritus, laid out why entire countries get rich or stay poor. Here, he casts a historian's eye on companies. Once again, culture is at the forefront of his analysis.

The Search
John Battelle
(Portfolio, October)
A veteran Silicon Valley journalist examines the strategy and culture of the search-engine industry. Could Google's privileged position as a Web hub give it extraordinary leverage over Internet commerce?

The Broken Windows Theory for Business
Michael Levine
(Warner Business Books, November)
A popular law-enforcement theory holds that communities can reduce crime by addressing quality-of-life issues. This consultant wonders whether fixing the little things that bother employees will motivate them to tackle the big issues more effectively.

The Leadership Legacy
Robert Galford and Regina Maruca
(Harvard Business School Press, 2006)
Your legacy, by definition, waits for tomorrow, but thinking about it can add meaning to your career today, says coach and development consultant Galford. Deeply felt goals contribute to more authentic and effective leadership.



Springboard to a Swan Dive?

by Ajit Kambil and Bruce Beebe

For John Clough, the CFO of a high-technology firm, the invitation to join the board of a *Fortune* 500 company seemed like an opportunity to move up to the big leagues. Until, that is, he started asking about the demands – and the potential liabilities.

"JOHN, IT'S TOM RUSSELL."

"Hey! To what do I owe the pleasure?"

"I'm afraid it has nothing to do with our favorite pastime."

John Clough, the CFO of NetRF, a technology company based in Salt Lake City, and Tom Russell, a vice president at Moore & Swithins, a respected Manhattan executive-recruiting firm, were avid collectors of flight memorabilia.

"Too bad," John replied. "I thought maybe you'd want to trade your Rickenbacker propeller for one of my TWA swizzle sticks."

"Hah. Actually, I have a different kind of proposal – one I think you're going to like just as much. Benchmark has retained us to find someone for its board, and we think you'd be a terrific candidate. Would you be interested?"

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

DANIEL VASCONCELLOS

John felt his face getting hot. "This is going to be a stretch," he thought. Atlanta-based Benchmark was a *Fortune* 500 packaged-goods company that was many times NetRF's size. John had been at NetRF six years and, in that time, had developed a national reputation, at least in informed circles, for his financial acumen and probity. The buzz around the CFO was surprising in view of NetRF's relatively modest revenues – $300 million in fiscal 2003. But John had built his reputation during a time when many of the financial world's top leaders had proved to be imprudent if not inept.

The offer to join Benchmark's board was tempting, but John wondered: "Will I be spreading myself too thin?"

Still, few would've expected such an important public company to tap John for a directorship–least of all John himself.

As John cradled the receiver against his shoulder, trying to formulate an answer, his thoughts raced back to a scene from B-school. It was the spring of his second year at Sloan, and Mellon Bank's CFO had called John at his basement apartment to invite him to join as an assistant treasurer. He remembered thinking it was a good thing videophones weren't in general use, so shabby were his surroundings and so acute was his embarrassment. John had the same thought now as he surveyed his frayed cubicle, with schedules and memos hastily sorted into messy piles. Tacked on one wall was a small, worn postcard of a barnstormer in a leather cap and goggles. The card read, "I'd rather be down here wishing I was up there than up there wishing I was down here."

Ajit Kambil *is a Boston-based global director of Deloitte Research, a part of Deloitte Services. He is the coauthor of* Making Markets: How Firms Can Design and Profit from Online Auctions and Exchanges *(Harvard Business School Press, 2002).* ***Bruce Beebe*** *is the director of research at Deloitte & Touche's Center for Corporate Governance in New York.*

"Ahem," Tom said, wondering if his friend was still on the other end of the line.

"So what's involved?" John finally responded.

"A lot of flying around–a spring meeting in Charleston, a strategy retreat every year in Aspen. It'd be a great honor for someone at your stage in life. And it would do you good to get to know Benchmark's board members. Maybe Benchmark could be persuaded to buy some of NetRF's products. What do you think?"

"It certainly is an honor," John said, struggling to keep his eagerness under wraps. Be the stoic CFO they're looking for, he told himself. "Could you send me something in writing about what my specific duties would be?"

"Sure, sure. But don't hesitate too long," Tom warned. "The place for due diligence is in the audit committee, which is anxious for your help."

Tom hung up the phone and immediately logged his notes from the conversation into his spreadsheet. Several executives had already turned down his offer, and Benchmark CEO Charlie Duer – Tom's client – was getting impatient. Tom knew that while only 6% of Moore & Swithins's revenues came from director searches, these types of assignments still needed to be handled effectively and expeditiously. Otherwise, companies would stop retaining M&S for their more lucrative executive searches.

"Will he bite?" the recruiter wondered, as he absentmindedly toyed with the scale model of the A6M Zero Japanese fighter plane that had been resting on his desk. "John trusts me," he thought. "After all, I'm the one who introduced him to NetRF, and now we're pals. How could he say no?"

Some 2,000 miles away, John was considering the invitation. NetRF was in a one-story modular building on the outskirts of Salt Lake, almost at the foot of the Wasatch Mountains. A tall chain-link fence enclosed the parking lot; NetRF employees would occasionally see hungry coyotes lurking near the metal. On this day, John saw nothing but cars. Most of his colleagues were engineers who had moved among a couple-dozen tech companies in the region, trying to catch the next wave. He enjoyed the skiing, his Cessna Turbo time-share, and the work, but he realized that there were definite limits to this environment. The 39-year-old executive had been glad to move out West, but he would certainly welcome a reacquaintance with the world of big business back East, if the conditions were right.

NetRF's engineers were focused primarily on designing wireless communications equipment that could be used in offices and homes. Most recently, the company had extended its product lines by making readers for radio frequency identification (RFID) tags. Companies were increasingly relying on RFID chips – next-generation bar codes – to streamline their supply chains, combat consumer and backroom theft, and anticipate product stock-outs. NetRF's RFID readers boasted the most sensitive pickups, the best prices, and the lowest repair and recall rates.

Because of the company's profitability, John had been able to persuade the CEO and the board to expense stock options at a time when it was uncommon for high-tech firms to do so; for that move, he had received a good deal of admiring coverage in the financial trade press. He'd then led the company through one of 2001's most successful IPOs. The company had floated only 17% of its equity, but the capital it raised allowed it to shrink its production cycles from 11 months to seven months.

The offer to join Benchmark's board was tempting, but John wondered: "Will I be spreading myself too thin?" While serving on NetRF's board, he had become friends with Gordon Telford, the former CEO of Peyton Rim, a large auto-parts supplier. Gordon had retired to an enormous ski chalet in Park City, less than 40 miles from Salt Lake. The past few winters, Gordon had invited John and his wife, Missy, to the chalet for

some weekend skiing. In fact, they were driving to Park City the day after tomorrow for another visit. John knew that Philip Tedeschi, the chief outside counsel to both NetRF and Peyton Rim, would also be at the chalet. He made a note to himself to e-mail Philip and Gordon before the weekend; he could discuss the directorship offer with them between trail runs. John turned away from the window and trained his attention on his computer screen. He typed "Benchmark" and "financials" into a search engine and scrolled through the results.

The Lap of Anxiety

It was dusk when John and Missy's yellow Land Rover crunched to a halt at the top of Gordon's steep driveway. Awaiting them inside was a semicircle of Adirondack twig chairs arrayed in front of a cavernous fireplace, which crackled as it warmed. As suitcases were whisked upstairs, Gordon and his wife greeted the couple, walked them farther into the great room, and handed each of them a martini.

"You're going to enjoy those board meetings enormously, John," Gordon began, "and you'll learn a lot besides. I would never have gotten where I did at Peyton if I hadn't had board service on my résumé. It's an indispensable step for a fellow with your possibilities."

"I agree," Philip added as he reached the bottom step of the long quartersawn staircase; from his room upstairs, the attorney had heard John and Missy arrive. "But don't underestimate what's involved. The hours can be considerable–as high as 250 per year these days. Gordon remembers a somewhat more leisurely and trusting world; my legal brethren have since built up a small industry in shareholder derivative suits, strike suits, and proxy challenges to board nominations. Your duties at NetRF are substantial, or so I'd guess from my difficulty getting you on the phone."

John didn't know whether to smile or glare in response to that small dig.

"Are you going to have time to study the big briefing books they send you?" Philip went on. "Do you know whether they'll want you to visit a certain number of plants each year, as some companies expect now?"

"I'm not sure about the visits or the meetings," John replied. "Tom tells me I'm supposed to buy 5,000 shares of stock within 12 months, so let's hope they go up."

"My goodness, Phil, you portray board service as a burden rather than a privilege," Gordon commented.

"It is more of a privilege than ever," Philip argued. "Sarbanes-Oxley and today's tougher courts have invested board members with real responsibility. But with that come some risks." Philip embarked on a tour of the legal landscape, ending with a sketch of the territory he understood best. "You know, Utah is a business-friendly state. Board directors here are protected – even if the company's articles of incorporation don't extend immunity to directors who get into trouble. Where is Benchmark incorporated? Its shareholders, of course, are everywhere."

As Philip listed a series of compelling reasons for not joining the board, John wondered: "Why is he so worried about my situation? I'm not his client."

"Wouldn't NetRF benefit if I joined the Benchmark board?" he asked.

"Well, you can forget about selling RFID products to them," Philip answered. "Your status as an independent director would be compromised."

"I thought we'd determined that most of our future growth is going to come from sales to retailers. We'd like to understand the retail sector the way Benchmark does, so I imagine this could be a real learning experience," John said.

"Tell me, though, how much do you really know about Benchmark?" Philip asked. "I can give you generic warnings, but there's no substitute for finding out everything you can about Benchmark's situation – pending litigation, any environmental issues, who your colleagues are going to be. You should figure out whether you can get along with them before you decide anything. I'll get you a crib sheet with questions to ask."

"I think we need to know what kind of directors-and-officers insurance they're offering," Missy chimed in. As a partner in a local accounting firm, she shuddered to think that everything John and she had built could be taken away.

"Missy, Phil, you depress me," Gordon interrupted. "Let's change the subject. Anybody know how to carve a pheasant?"

Getting to Know You

"He wants to do what?" exclaimed Linton Folds, the chairman of Benchmark's audit committee.

"He says he needs a meeting with your committee, and a separate one with Charlie, before he can give us an answer," Tom said, hoping the static on his cell phone wasn't obscuring his message. John had flown into Atlanta almost two weeks earlier for a meeting with the nominating committee. That visit had been cordial but, from John's perspective, not as informative as it could've been.

"For Pete's sake. I know there are only three of us on the audit committee, but getting our schedules to match is going to be a task and a half," Linton said with exasperation.

"John's no fool," Tom responded. "He knows about the turnover you've experienced and some of the controversy."

"That's to be expected, I suppose," Linton conceded halfheartedly. To boost shareholder confidence post–Sarbanes-Oxley, Benchmark needed to certify that it had designated a financial expert for its audit committee – and John seemed to fit the bill. He would be replacing Linton, who would be stepping down from the committee.

"I'll urge Mary and Sig to find some time within the next two weeks," Linton told Tom. "We'll book a suite at the Ritz-Carlton, and we'll get Charlie to meet with him just before our appointment."

Butting Heads

John's 7 AM meeting with Benchmark's CEO, at the company's downtown headquarters, did not go particularly well. Charlie, like John, had a financial background. So like two accounting wonks – instead of a CEO and a director-to-be – they tangled over Benchmark's ideal capital structure. And when John mentioned that he'd like to chat with a couple of division managers and the new CFO, Charlie bristled. He had been in office only six months – six stressful months.

Charlie had joined Benchmark after its former CEO, CFO, and chief auditor had been fired; the state-employee pension fund had raised questions about the way Benchmark recognized its revenues. Some analysts felt that Benchmark's independent board members had perhaps overreacted by firing the company's senior management. But the business had rebounded with several strong quarters, and Charlie was feeling the pressure to demonstrate to the board that his hiring had not been in vain.

By 8:25 AM, John was back at the Ritz-Carlton to meet with the members of the audit committee.

"How are you, John? I'm Mary Tolliver. This is Sig Rasmussen, and this is Linton Folds."

In his online research, John discovered that Mary was executive VP of marketing at Builder's Bank; that Sig was the founder of Delilah's, a chain of dress shops; and that Linton had led Benchmark until 1996 and once again after the dismissals. "Linton peered into every crevice when he ran things just before Charlie signed on," Mary volunteered. "If Sig or I can't answer your questions, Lin surely can."

"That's reassuring," John said, "since I didn't get to look at the accounts in my meeting with the nominating committee. Granted, my experience with public companies is limited, but I've been around long enough to expect intense public scrutiny. I'm sure you could use my help there.

"First off, let's talk about the revenue-recognition issues. Does Benchmark's stated warranty-claims rate reflect what's really going on? There's a lot of clumping of sales booked at the end of every quarter. When I see that, I want another look at the sales ledger. You've also got receivables you're still carrying as assets, though they're pretty long in the tooth."

Sig chuckled. "Mary and I are not accountants. That's why we need you – to keep us on the straight and narrow."

"I hear your concerns, John," Linton interjected. "And my guess is that you're worried about maintaining more than just Benchmark's margins and good name. But you have nothing to fear." Linton made a point of monitoring judicial developments in Delaware, Benchmark's state of incorporation. "You would have a duty of loyalty to Benchmark, which means acting in its behalf, not your own; and you would have a duty of care, which basically requires you to show up for meetings and pay attention. Do those things, and no court will challenge your business judgment."

The look on John's face suggested that further assurances would be in order. "Keep in mind," Linton continued, "we're not asking you to be our CFO. You're an expert, sure, but you're also expected to rely on *other* experts like Walters & Bluitt, our new auditor."

"And that's Charlie's understanding as well?" John asked, looking at Mary.

"This board doesn't answer to Charlie," she replied, stiffening slightly, "and it wasn't chosen by him. Look, John, Sarbanes-Oxley has ushered in a new world – one that's much safer for companies in compliance. Besides, by serving on the audit committee, you'll know better and sooner than anybody about problems."

After an hour or so, John exchanged contact information with the others, shook hands, and headed for the hotel lobby.

"You should figure out whether you can get along with them before you decide anything."

"Do you think we passed the audition?" Mary asked the others after John had left.

• • •

As he waited for the doorman at the Ritz to hail him a cab, John's cell phone rang. It was Missy. "Your timing is perfect. I left them five minutes ago."

"So, did you get your questions answered? What do you think?" Missy asked her husband.

"Well, it depends on how you look at it. If board membership is just another trophy – a collectible, like that Fokker DR1 altimeter I bought last month – we can probably just sit back and watch our net worth appreciate. But if it's an adventure – like that trip to Mexico we took last year in the Cessna – I'll get to develop my piloting skills but will probably encounter some bumps along the way."

Just then, the cab pulled up. John said goodbye to Missy, climbed into the taxi, and directed the driver to DeKalb-Peachtree Airport. Once there, he settled into the pilot's seat of his Cessna, fired up its engines, pointed the plane down the runway, and embarked on the first leg of his journey West.

Should John join Benchmark's audit committee? • Four commentators offer expert advice.

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Given his age and the allure of board service and its accompanying perks, there is a good chance that John Clough will say yes. If he does, he will suffer for it. Most of John's advisers do not seem to be aware that board membership no longer automatically ensures other opportunities and may actually present risks.

In today's business world, your reputation and prospects are only as bright as the performance of the last board you served on. In other words, board members tend to be lynched for their collective actions, regardless of their individual attempts to do the right thing. John proposed expensing options before it was the popular thing to do, so I suspect he probably would not be afraid to provide the leadership for governance reform. But if John fails to sway a majority to do the right thing – which, in view of Benchmark's weak governance culture, is likely – no one will remember that it was John who smelled smoke and pleaded with the others to take bold action. By joining Benchmark's board, John would be gambling with his reputation and exposing himself to greater liability – all for relative peanuts.

John would be gambling with his reputation and exposing himself to greater liability – all for relative peanuts.

Benchmark's board has three serious defects. First, the directors do not seem to understand their sole responsibility: to serve and protect shareholders. Specifically, they do not behave like owners. The executive dismissals recently ordered seem to be largely the result of pressure from outside the company. And there is still no evidence of a board-directed plan to discover how Benchmark's accounting became so aggressive. Such questionable practices don't just suddenly appear.

Second, top management camouflages problems and deflects sensible direct inquiry from subordinates; it treats such questioning as an intrusion. That is how mistakes grow into scandals. I remember asking a series of probing questions at one company, only to be told, "That would be a lot of 'due-who' for around here." The company went on to disaster. A manager who is afraid to be open, or who shields his direct reports from meaningful director inquiry, is always a sign of trouble at a company.

Third, some of the directors do not seem competent to serve in key positions. The audit committee has no idea, for example, what is at the heart of the company's revenue-recognition problem. It did not dig for answers on its own, nor did it hire independent advisers to look into Benchmark's promotional and discounting practices and to measure the appropriateness of the company's relationships with key customers. The members of the audit committee ought to be able to sort out how basic revenue is recorded. Otherwise, they are just suits in seats. As the only competent member of the audit committee, John would face an uphill battle with his colleagues.

If John is intent on saying yes, he would be wise to make his acceptance conditional on an independent forensic review of the books. Further, he should insist on an assessment of ongoing business risks, conducted by a group from the board that includes him. He should also ask for an increase in the number of executive sessions and the time allotted for them. And he should arrange to meet with the former external auditor and the former CEO to solicit their views. John has to be a catalyst for change *before* he joins the board. Once he accepts the seat, he will likely lose much of his leverage, becoming simply one vote among many.

John doesn't know it, but willing director candidates are in short supply, especially those with financial expertise. All he has to do is quietly market his availability, and the kinds of boards he'd be comfortable serving on will come to him. He can afford to go to Aspen on his own.

WENDY WRAY

John should think twice about joining Benchmark's board and should probably say no for four main reasons.

First, although Benchmark's CEO has a financial background similar to John's, Charlie and his company seem to favor a Wild West–style of financial reporting, while John and his company do not. In today's corporate governance environment, independent directors should play the most important role in selecting board members. A board member who does not have good chemistry with the CEO is not likely to be as effective, or consulted as often, as one who does.

Second, the incumbent directors blithely supply John with nostrums about the standards of legal liability for directors instead of responding to his legitimate questions about the quality and transparency of the firm's financial reporting, which they fail to recognize is their responsibility as well as John's.

Third, it isn't clear that NetRF would benefit in the way John expects it to. If NetRF sold a substantial number of RFID readers to Benchmark, John would lose his status as an independent director under stock exchange rules and, thus, his ability to serve on the audit committee. The posh life of yesteryear's directors and the burnishing of one's résumé are also bad reasons to take a board seat.

Fourth, because of his financial background, John would be the point person on the audit committee and would manage that group's relationship with the external auditor. The result would be an increased time commitment for him. He would also be one of the first witnesses called to testify in any shareholder lawsuit or government investigation.

Yet there may be good reasons for John to join Benchmark's board. He could learn more about retailing and the internal controls and financial-reporting practices of a large public company. NetRF's CEO and the independent directors on NetRF's board should be the final judges of whether John's service on Benchmark's board would interfere with his loyalty and obligations to NetRF. They will want to consider whether John's board membership could actually subvert NetRF's efforts to sell its product to Benchmark's competitors, which may be troubled by the resulting connection between the two companies. Further, John's association with any renewed accounting problems at Benchmark could soil the white-hat reputation that NetRF gained from being an early adopter of option-grant expensing.

If John and NetRF's CEO and board all conclude that the benefits of John's membership on Benchmark's board outweigh the risks, there are a few key items of basic diligence John should complete. He should compare the schedule of Benchmark's board and committee meetings against his own schedule at NetRF. Particularly for a CFO, end-of-quarter and annual earnings-release and SEC reporting deadlines are crunch times. Can John handle both commitments simultaneously? A lawyer (perhaps Philip) who regularly deals with such issues should review Benchmark's articles of incorporation, bylaws, and D&O insurance policy to determine the adequacy of liability protection and insurance coverage available to Benchmark's directors.

The posh life of yesteryear's directors and the burnishing of one's résumé are bad reasons to take a board seat.

John should also meet with Benchmark's new CFO and the engagement partners from the outside auditor and gauge their commitments to transparent reporting. And, as he has apparently begun to do, John should read a cross section of analyst reports and news articles published during the past 12 months to get a clear sense of how Benchmark is viewed in the financial community. He should also obtain Benchmark's most recent 10(k) and 10(q) forms, and any recent 8(k) reports, paying particular attention to any reported changes in accounting principles, the contingencies footnotes, and the Management Discussion and Analysis sections.

The decision to join another company's board is as momentous as the decision to enter into a joint venture with that company. Both can put a person's and a company's reputation and future at risk.

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Allegations of accounting irregularities should not stop John from becoming a director.

Even in this day and age, it's still a real tribute to be offered a position on the board of a company like Benchmark. It's all the more impressive to be offered the chairmanship of the audit committee. Unfortunately, as John's discussion with Philip indicates, the decision to accept such a position is not easy. I share Gordon Telford's positive view of board service: As a general rule, the benefits of saying yes far outweigh the risks – provided you're willing to do the job right. To figure out what he wants, and whether he can do the job right, John needs to ask himself four questions.

The single most important one would be, "Do I have time for the position?" Just a few years ago, it was not uncommon for boards to meet four or five times a year, with committee meetings beginning in the morning and everyone finishing up before lunch. Today, any director of a large public company like Benchmark should probably plan on devoting 100 to 150 hours per year in normal situations. This would not cover committee work, travel, and the crises that inevitably arise. As the CFO of a public company, John is undoubtedly working crazy hours already. He needs to decide whether he is willing to make this additional commitment.

Assuming he has the time for some kind of board service, John must then ask himself, "Is Benchmark the right kind of company for me?" Allegations of accounting irregularities at the organization should not stop John from becoming a director, but he should find out more about how the board and management analyze such irregularities and whether the company's decision-making process is consistent with his professional and ethical standards. He should also check with NetRF's counsel to determine whether his presence on the board would create any conflicts of interest. Because Benchmark cannot afford to have the newly appointed chair of its audit committee resign, the board would surely go along with any reforms he proposes, thereby protecting him from professional embarrassment (or worse).

If John can reassure himself on these points, he must then ask himself, "Am I comfortable playing the role I'm being asked to play?" It's not enough that John has financial and accounting expertise and that Benchmark needs an audit committee member. John should think about whether he would be bringing the right expectations to the job and whether he has the right personality for it. For example, would he be comfortable in what is primarily an oversight role at Benchmark after having exercised operating responsibilities as CFO of NetRF? His tangle with Charlie Duer suggests he may not be. And would he be comfortable asking the kinds of elementary questions new board members must ask in order to learn how the company operates? Again, John's hardheadedness and financial sophistication suggest he may not. However, John does seem as though he'd be willing to ask questions that management does not want to hear, which is necessary for being a good director.

The final question John needs to ask himself paraphrases Nikita Khrushchev during the Cuban Missile Crisis: "Is Benchmark prepared for the worst?" To find out, John needs to use his financial expertise and search several quarters of Benchmark's balance sheets for any potential issues. He also should have counsel determine that Benchmark's D&O policies and indemnification agreements would protect him should he be sued as a director.

Even in today's business environment, directors who put in the time, act in good faith, and have the skills necessary to understand the company's business incur minimal risk of personal liability. They also realize intangible benefits from their board service, some of which can be quite valuable. In John's case, these would include exposure to a wide variety of business issues, the opportunity to build personal and professional networks – and perhaps the chance to have some fun.

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In reading this case, I cringed at every new development. The characters' actions violate not only good corporate governance but also common sense.

Let's begin with the protagonist. John appears to bring a strong ego (he seems confident that Benchmark would benefit if he joined its board) but little else to the table. His limited public-company experience in a small, unrelated business has not prepared him for the complexities of a *Fortune* 500 organization–and most certainly not a company with the obvious challenges Benchmark faces. To his credit, he asks many of the right questions – particularly regarding the financial-reporting issues that resulted in the firings of Benchmark's former CEO, CFO, and chief auditor. These are all enormous red flags.

However, it is less clear that John recognizes the many other red flags around him. Among them are the board members' cavalier attitudes about their responsibilities; the obvious friction between the new CEO and the board; the reluctance of the CEO and the board to provide John additional time and access so that he can conduct his own due diligence; and the fact that as a neophyte director, John would be the only finance expert on the audit committee of a board that has had serious accounting problems. Then factor in John's obvious lack of chemistry with the new CEO. Any rational person would don the running shoes.

Given my vocation, I must say a few words about the recruiter, Tom Russell, who demonstrates a wanton disregard for his client and the candidate alike. An apparent disciple of the old school of board recruiting, he has resorted, likely in desperation, to approaching a friend who, on most counts, appears to be woefully underqualified for the challenge. His attempt to sell the opportunity based on the perks that board service offers is seriously flawed if not unethical.

The recruiter demonstrates his abysmal command of good corporate governance by suggesting that John, by joining the board of directors, may be able to persuade Benchmark to purchase some of NetRF's products. Beyond being an inappropriate motivation for board service, it would (as is pointed out later in the case by NetRF's counsel) imperil the statutory independence of the director, disqualifying him from service on the audit committee.

Although recruiting has become more challenging in the era of Sarbanes-Oxley, there is a wealth of talent in the market to satisfy the needs of any corporate board. Indeed, reputable recruiting firms have faced, and successfully completed, challenging assignments with clients whose problems equaled or exceeded those of Benchmark. In those situations, however, the companies conducted their searches in a fully transparent manner, which is a requirement for recruiting qualified directors. The recruiter is obliged to serve both the client (who is paying the bills) and the candidate. Both parties rely on the recruiter, as a professional intermediary, to provide full disclosure and to act in the best interests of all concerned. To do otherwise, as this recruiter has done, is unconscionable.

The only person in this case study who seems to grasp the extent of the risks is NetRF's attorney, Philip Tedeschi. The audit committee members, to varying degrees, are caricatures of frightened, ill-qualified directors, desperately in search of a quick fix – hardly a group John should want to join.

The boardroom antics described in this case study would be fine fodder for a prime-time sitcom. Sadly, similar scenarios are still being played out in some real-world boardrooms today.

The board members are caricatures of frightened, ill-qualified directors, desperately in search of a quick fix–hardly a group John should want to join.

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Something is seriously amiss in the business of developing and hiring CEOs. Too many top leaders fail in office; too many succession pipelines are bone dry. Here's what boards should do in order to perform their most important job right.

Ending the CEO Succession Crisis

by Ram Charan

WE TALK ABOUT LEADERSHIP as though leaders – like Tolstoy's happy families – are all alike. But CEO leadership should be a subject apart because it is unique in scope and substance and of incomparable importance. CEOs' performance determines the fates of corporations, which collectively influence whole economies. Our standard of living depends upon excellence at the very top.

Who, then, would dispute that CEO selection deserves perpetual front-burner attention from the custodians of a company's welfare? Surely, when time or trauma ushers in change, organizations should be ready with a clear view of current and future needs and with carefully tended pools of candidates.

But they're not. The CEO succession process is broken in North America and is no better in many other parts of the world. Almost half of companies with revenue greater

MATTHEW BANDSUCH

than $500 million have no meaningful CEO succession plan, according to the National Association of Corporate Directors. Even those that have plans aren't happy with them. The Corporate Leadership Council (CLC), a human-resource research organization, surveyed 276 large companies last year and found that only 20% of responding HR executives were satisfied with their top-management succession processes.

That deficiency is simply inexcusable. A CEO or board that has been in place for six or seven years and has not yet provided a pool of qualified candidates, and a robust process for selecting the next leader, is a failure. Everyone talks about emulating such best practitioners as General Electric, but few work very hard at it.

The result of poor succession planning is often poor performance, which translates into higher turnover and corporate instability. As increased transparency, more vocal institutional investors, and more active boards make greater demands, CEO tenures continue to shrink. Booz Allen Hamilton reports that the global average is now just 7.6 years, down from 9.5 years in 1995. And two out of every five new CEOs fail in the first 18 months, as Dan Ciampa cites in his article "Almost Ready" in last month's HBR.

The problem isn't just that more CEOs are being replaced. The problem is that, in many cases, CEOs are being replaced *badly.* Too often, new leaders are plucked from the well-worn Rolodexes of a small recruiting oligarchy and appointed by directors who have little experience hiring anyone for a position higher than COO, vice chairman, CFO, or president of a large business unit. Hiring a CEO is simply different.

Coaxing former leaders out of retirement is another popular way to fill the void. Celebrated examples include Harry Stonecipher at Boeing, Bill Stavropoulos of Dow Chemical, and Jamie Houghton at Corning. But most "boomerang CEOs" return for just a couple of years, long enough to restore credibility and put a real succession candidate in place. They are not the long-term solution.

To increase their chances of finding a leader who will serve long and well, companies must do three things. First, they should have available a deep pool of internal candidates kept well stocked by a leadership development process that reaches from the bottom to the top. Second, boards should create, then continually update and refine, a succession plan and have in place a thoughtful process for making decisions about candidates. Finally, directors considering outside candidates should be exacting, informed drivers of the executive search process, leading recruiters rather than being led by them.

In my 35 years advising corporations, I have participated in dozens of CEO selections and have closely monitored numerous executive pipelines. Drawing on that experience, I will in these pages first explain why companies make poor appointments and then suggest what they can instead do to make good ones. Using these guidelines, organizations can ensure that all participants – directors, executive recruiters, and sitting CEOs – perform wisely and appropriately when it comes time to choose their next leader.

The Trouble with Outsiders

When companies lack the culture or the processes to grow their own heirs apparent, they have no choice but to look outside. More than a third (37%) of the *Fortune* 1,000 companies are run by external recruits, according to the public affairs firm Burson-Marsteller. Although global data are harder to come by, the worldwide trend appears to be similar. But external candidates are in most cases a greater risk because directors and top management cannot know them as well as they know their own people.

Outsiders are generally chosen because they can do *a* job – turn around the company or restructure the portfolio. But *the* job is to lead a hugely complex organization over many years through an unpredictable progression of shifting markets and competitive terrains. Unfortunately, the requirements for that larger job are often not well defined by the board, which may be focused on finding a savior.

The results are not surprising. In North America, 55% of outside CEOs who departed in 2003 were forced to resign by their boards, compared with 34% of insiders, Booz Allen reports. In Europe, 70% of departing outsiders got the boot, compared with 55% of insiders. Some outside CEOs are barely around long enough to see their photographs hung in the headquarters lobby. Gil Amelio left Apple 17 months after he arrived from National Semiconductor. Ex-IBMer Richard Thoman was out of the top spot at Xerox after 13 months. David Siegel gave up the wheel at Avis Rent A Car for US Airways but departed two years later.

Even under the best circumstances, CEO selection is something of a batting average: Companies will not hit successfully every time. But two or more consecutive outsider outs can have a devastating effect on employees, partners, and strategic position. New leaders import new teams and management styles. Continuity and momentum collapse, the energy to execute dwindles, and morale plummets as employees obsess about who will get the next pink slip. Rather than focus on the competition, companies starts to look inward. Bad external appointments are also expensive, since even poor performance is rewarded with rich severance packages.

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The Trouble with Insiders

On the other hand, sometimes an external candidate exists who is, very simply, the best available choice. A skillful, diligent board may discover an outstanding fit between an outsider and the job at hand. Lou Gerstner and IBM spring to mind. And boards must remember that just as outsiders are not uniformly bad choices, insiders are not uniformly good ones. In certain situations, internal candidates actually present the greater risk.

Some concerns about insiders, ironically, emerge from their very closeness to the company. For example, as "known quantities," they may sail through a lax due-diligence process. Or their social networks and psychological ties may complicate efforts to change the culture. Some will not have had the right experience or been tested in the right ways. Individuals from functional areas may not be up to the task of leading the entire business. Or a shift in the industry or market landscape may render carefully nurtured skills irrelevant. In some cases, the credibility of the outgoing CEO or management team may be so sullied that only a new broom can sweep the company clean.

In North America, 55% of outside CEOs who departed in 2003 were forced to resign, compared with 34% of insiders.

What's more, companies that have no ongoing senior management development program (currently more the rule than the exception) will in all probability need to look outside, maybe for as long as the next ten to 20 years. Outside candidates, in other words, should always be an option. But so long as they remain the only option, and boards lack rigor in identifying and assessing them, succession is imperiled.

The Trouble with CEO Development

Many organizations do a decent job nurturing middle managers, but meaningful leadership development stops well below the apex. The problem manifests itself as a dearth of senior managers, for which companies must increasingly shop in other neighborhoods. Almost half of respondents to the CLC survey had hired a third or more of their senior executive teams from outside, but only 22% of those did so because they considered external candidates irresistibly appealing. Rather, 45% of all respondents judged that it would take too long or be too expensive to develop successors internally.

It's easy to understand why they feel that way. Even where strong development programs exist, very few leaders will ever be qualified to run the company. *Very few.* A $25 billion corporation with 70,000 employees, for instance, may have 3,000 leaders, perhaps 50 to 100 of whom would qualify for one of the ten jobs just below the top. That same company would be fortunate to field five strong internal candidates for CEO – and two or three is a more realistic number. General Electric had around 225,000 workers in 1993 when Jack Welch identified 20 potential successors; over seven years, he winnowed the number to three. In CEO succession, it takes a ton of ore to produce an ounce of gold.

Furthermore, the window in which to spot CEO talent is narrow. Companies require sufficiently seasoned candidates who can be counted on to hold the top job for ten years or more. That puts the age of accession at between 46 and 52. In my experience, for a candidate to be ready by 46, serious development should start by age 30. Recognizing which five saplings in a 3,000-tree forest are the ones to nurture requires a degree of discernment that most line managers and HR departments lack and few are developing.

Some companies do identify candidates early but then fail to evaluate them properly. Such organizations often turn evaluation over to HR, which may rely excessively on packaged databases of leadership traits developed by researchers in the human behavior field. Those programs compare internal high potentials with generic benchmarks along many dimensions, a process that creates fragmented profiles of some cookie-cutter ideal rather than nuanced, individualized portraits. What's more, most of those dimensions reflect only the personality traits and not the skills required of a CEO.

Nor do many companies properly nurture the candidates they identify. Some misjudge the business's needs and consequently emphasize the wrong talents. Only 24% of organizations the CLC surveyed believe their leadership development efforts are aligned with their strategic goals. And those goals can be a moving target, changing in response to sometimes tectonic shifts in the external environment. The marketplace changes. Technology changes. Employees' skills become obsolete even as they develop. What's more, very few in-house executive education programs are designed to impart the skills and know-how that a CEO needs.

But the larger issue is that true development happens on the job, not in a classroom. Few companies know how to get their best people the experiences that would prepare them for the CEO role or to rigorously evaluate them in the jobs they do perform. Many companies, for example,

The Secret of Session C

LOTS OF PEOPLE KNOW about Session C, General Electric's annual, dialogue-intensive review of how its leadership resources match up with its business direction. But inside Session C is a process that almost no one knows about. It's called "tandem assessment," and it is among GE's most potent tools for evaluating CEO candidates – and for helping those rising stars evaluate themselves.

Every year, GE selects a different set of 20 to 25 leaders who might grow into CEOs or top functional leaders and sits each one down for a three- to four-hour session with two human resource heads from outside the person's own business unit. The HR executives trace the budding leader's progression from early childhood (where he grew up, how his parents influenced his style of thinking, what his early values were) through recent accomplishments. They then conduct an exhaustive fact-finding mission both inside and outside the organization, including 360-degree reviews, massive reference checks, and interviews with bosses, direct reports, customers, and peers. Largely eschewing psychology, tandem assessment concentrates instead on observed, measurable performance within the business.

The product of all this effort is a 15- to 20-page document that charts the high potential's work and development over decades. The report – brimming with accolades but also detailing areas for improvement – goes to the nascent leader, who uses it to improve his or her game. It also goes to the individual's business head, the senior human-resource executive in the person's unit, and to corporate headquarters, where it is avidly perused by GE's chairman, the three vice chairmen, and Bill Conaty, senior vice president for corporate human resources. "I usually wait until the end of the workday to read one of these because it takes an hour or so," says Conaty. "You find out incredibly interesting things about people in this process."

Tandem assessment is so intensive that only those swimming closest to the C-suite headwaters undergo it. But GE also encourages business units to conduct their own mini-versions of the exercise.

The process not only hands rising leaders a mirror but also broadens their support network. Using HR executives from outside the subject's business unit ensures objectivity and gives the promising star two new mentors and two new reality checks. "If something pops up during your career that doesn't feel quite right and you want outside calibration," Conaty explains, "you might call one of these individuals and say, 'Hey, look, everybody is telling me great things here, but this just happened. Would you read anything into it?'"

still equate leadership development with circulating candidates through multiple functions. In the 1970s, that was the rule at AT&T, IBM, and Xerox, companies that produced leaders who went on to become CEOs elsewhere – and in some cases failed.

The problem with that approach is that potential candidates don't stay long enough in one position to live with the consequences of their decisions. In addition, functional leaders learn to lead functions, not whole companies. Faced with external competition, they fall back on their functional expertise. You can mine all possible lessons from a turn as VP of marketing and still be blindsided by a P&L.

The Trouble with Boards

Bob Stemple's short stint as the head of General Motors ended ingloriously in 1992 – and so did the accepted wisdom that boards should automatically bless the departing CEO's handpicked successor.

Yet while directors describe CEO succession as one of their most consuming issues, they don't appear consumed by it. In a survey by Mercer Delta and the University of Southern California, 40% of corporate directors called their involvement in CEO succession planning less than optimal. (I would hazard to add that far fewer are satisfied with the *outcome* of their involvement.) Only 21% responded that they were satisfied with their level of participation in developing internal candidates for senior management.

A packed agenda is the chief culprit: Governance and fiduciary duties, in particular, command an outsize share of boards' attention. Mercer Delta asked directors to compare the amount of time they spend now with the amount they spent a year earlier on nine key activities. Large majorities reported devoting more or many more hours to monitoring accounting, Sarbanes-Oxley, risk, and financial performance. They also reported spending less time interacting with and preparing potential CEO successors than on any other activity. Yet boards' work on succession represents probably 80% of the value they deliver. If the choice of CEO successor is superb, all subsequent decisions become easier.

Another huge problem is that the vast majority of search committee members have had no experience working together on a CEO succession. As a result, they seldom coalesce into deep-delving bodies that get to the pith of their companies' fundamental needs. So they end up approaching their search with only the demands of the moment or – worse – the broadest of requirements.

As they audition candidates, directors may be seduced by reputation, particularly if they're considering a Wall Street or media darling. A few aspiring CEOs employ publicists who flog rosy stories to journalists; when those leaders are up for other jobs, their press-bestowed halos follow them. Board members can also be blinded by charisma, by the sheer leaderishness of a candidate. There is nothing intrinsically wrong with charisma, though some criticize it as the sheep's clothing in which hubris lurks. But too often directors become so focused on what candidates are *like* that they don't press hard enough to discover what candidates can and cannot *do.*

For example, one board looking for a new CEO after firing the old one asked for someone who could build a great team and get things done. The recruiter presented such a person–an energetic, focused candidate whose personal qualities quickly won over directors. What the organization really needed was someone who could create a stream of new products and win shelf space from powerful retailers in a volatile marketplace. Unfortunately, the directors never specified those requirements or raised them either during interviews or the background check.

The candidate's upstream-marketing skills were poor to nonexistent. The company's market share declined precipitously, and three years later the CEO was out on his ear. On its second try, the board concentrated so hard on marketing that it ignored execution. The next CEO was a visionary and a marketing genius but was unable to get things done. The company, once first in its market, will probably be sold or stumble into Chapter 11.

Finally, directors too often shunt due diligence onto recruiters. As a result, that process can be quite superficial. One company that left vetting to its recruiter and its investment banker found itself saddled with a leader who botched critical people issues. At a postmortem three years later, directors discovered that at his former company the CEO had routinely punted people problems to the chairman, who had been CEO before him and occupied the office next to his. That would have been nice to know before the pen touched the contract.

The Trouble with Recruiters

Executive recruiters are honest and highly professional. Still, they can wield disproportionate influence in CEO succession decisions. One reason is concentration. Just three recruiters control some 80% of the *Fortune* 100 CEO search market (a single firm claims fully 60% of it), and one or two people within those companies direct the most important searches. These firms' social networks are vast and powerful. Anyone with a smidgen of ambition in the corporate world knows whom they have to know to get ahead.

At the same time, board members' inexperience and consequent inability to precisely define their needs makes recruiters' task difficult. Recruiters must satisfy their clients yet also manage them, helping the search committee to gel so they can extract the criteria they need while keeping requirements broad enough to cast the widest talent net possible.

When committees don't gel, recruiters may step into the vacuum with their own criteria, and directors too often let them. Unfortunately, no executive recruiter can grasp the subtleties of a client's business as well as the client can. In the absence of effective direction, recruiters generally approach each search with a boilerplate of the 20 or so attributes they consider most desirable for any CEO. That formula tends to overemphasize generic qualities like character and vision, as well as team-building, change-management, and relationship skills. Psychology and chemistry are also very important to executive recruiters: Like directors, they may let a personality surplus overshadow a skills deficit.

Just three recruiters control 80% of the* Fortune *100 CEO search market, and one or two people within those companies direct the most important searches.

In one – granted, extreme – case, the longtime CEO of a company with four highly successful businesses and a huge debt level was retiring. The recruiter produced a list of six candidates, pressing one – the head of a very large division at a multinational company–hard on the board. Yet all the recruiter gave the directors was a page-and-a-half description of this candidate's leadership skills; a list of his extensive connections with unions, customers, and government bodies; and an outline of his swift rise through the organization.

A financial performance history for the candidate's division was not included and not publicly available, so a member of the search committee began to dig. He discovered that return on assets under the candidate's supervision was miniscule over the previous five years, even though his division was four times larger than the entire company considering him for CEO. Furthermore, this man had never earned cost of capital in his life. Even so, the recruiter wanted to put him in charge of a business that had certainly done so–and that hoped to rise to the next level.

Fortunately, after much debate, the committee vetoed the recommendation, opting instead for number three on the recruiter's list–the president of another company, who had consistently improved performance and delivered a 20% return on equity. In his first three years, this new CEO took the stock from 24 to 108 in a slow-moving industry. The board was happy. Management was happy. The recruiter's preferred candidate was happy when he was placed at another, larger company – but then he was fired in six months.

Executive recruiters also succumb to the usual-suspects bias, primarily looking for new heads above other companies' necks. It is just plain easier to compile a list of sitting CEOs than to make a case for – or take a risk on – a COO or an executive VP. Some recruiters go so far as to approach sitting CEOs, even with no specific jobs to dangle, and urge them to consider looking elsewhere. The recruiters' goal is to loosen a prized gem from its setting and thereby beat a fellow recruiter to the punch.

Sometimes, the board's selection of recruiter is flawed from the start. A director may jump the gun, recommending a recruiter he has worked well with even before the search committee is formed. Nor do most boards examine search firms' track records – that is, how many of the CEOs the firm has placed have succeeded and how many have failed. Even if directors did ask that question, they're not likely to get the answer because it appears no one is monitoring recruiters' performance. The stock-buying public, by contrast, knows exactly how well directors score on their CEO choices.

How to Succeed at Succession

Charlie Bell's ascension to the top spot at McDonald's within hours of Jim Cantalupo's death reflected well on a company that had its house in order, particularly when compared – as it inevitably was – with Coca-Cola's simultaneous travails. Similarly, NBC's early, orderly announcement that Brian Williams would replace network news anchor Tom Brokaw stands in stark relief to CBS's public uncertainty over Dan Rather's successor. (Anchors are not CEOs, of course, but they are even more visible and arguably as consequential to their organizations' fortunes.)

By now it should be clear that the most important thing companies can do to improve succession is to bolster their leadership development and focus on those very rare people in their ranks who might one day be CEO. Organizations must identify high-potential candidates early in their careers, and global companies must look in all the countries where they operate. As candidates enter the development pipeline, managers must constantly align their charges' education and on-the-job experience with the emerging landscape. And they must rigorously assess the candidates' performance at each developmental stage.

The very best preparation for CEOs is progression through positions with responsibility for steadily larger and more complex P&L centers. A candidate might start by managing a single product, then a customer segment, then a country, then several product lines, then a business unit, and then a division. Whatever the progression, P&L responsibility at every level is key. The Thomson Corporation, a global provider of information solutions, comprises more than 100 P&Ls, so its top people have abundant opportunity to run a $50 million to $100 million business. "That's the best crucible for formulating leaders that I know of," says Jim Smith, executive vice president of human resources and administration.

Companies not set up to provide such opportunities should create jobs – large projects or small internal organizations – that exercise the P&L muscle. Otherwise, they risk elevating an internal candidate who is not prepared. For example, one $10 billion company in a highly capital-intensive and unionized industry has targeted as CEO successor the head of its smallest division. The candidate is a brilliant, articulate young man but has no experience running a big business in general or this type of business in particular (his own division is knowledge intensive, and unionized labor has no presence). The board is considering creating a deputy position within its largest division for this person and making the 59-year-old current division head (who will retire in three years) his coach, granting that coach a bonus if he ensures his successor's success.

Companies with inflexible functional structures will probably be forced to import P&L-tested leaders from outside and place them in very high positions. To reduce the risk, they should bring in such executives three or four years before the expected succession. That can be challenging, however, because many will demand appointment to the top spot in less than a year.

But leadership development is just part of the solution. Boards, too, can greatly improve the chances of finding a strong successor by acting vigilantly before and during the search. Senior executive development should be overseen by the board's compensation and organization committee, which needs to receive periodic reports on the entire pool of potential CEOs and regular updates on those bobbing near the top of it. The committee should spend a third of its time examining lists of the top 20 candidates in the leadership pipeline. In addition, at least 15% of the 60 or so hours that members meet as a full board should be devoted to succession. At minimum, the board ought to dedicate two sessions a year to hashing over at least five CEO candidates, both internal and external.

And directors should personally get to know the company's rising stars. Promising leaders should be invited to board meetings and to the dinners that precede board meetings, and members should talk with them informally whenever possible. Directors should also meet with and observe candidates within the natural habitats of their business operations. In this way, when it comes time to single out CEO candidates, directors will be considering a set of very well-known quantities.

The "Fit" Imperative

The goal of all these interactions and deliberations is for board members to reach a highly refined but dynamic understanding of the CEO position and their options for it long before appointing a successor. Company leaders should be as well defined as puzzle pieces; their strengths and experiences must match the shape of their organizations' needs. That is, they simply must *fit.* Boards achieve fit by specifying, in terms as precise as possible, three or four aspects of talent, know-how, and experience that are nonnegotiable.

Ideally, these attributes pertain to the organization's dominant needs for the next several years, but they should also relate to future growth. In one recent CEO succession, the company, in conjunction with a boutique recruiting firm, began with impossibly broad criteria that included everything from industry leader to change agent. The process floundered until the search committee narrowed its focus to three qualities: experience in segmenting markets according to customer needs; the talent to grow the business organically; and a track record of building strong executive teams. Those three skills, in addition to general leadership traits, delineated the pond in which this company fished.

The job of defining such qualities belongs to the search committee, which should form well before succession is scheduled to take place. As they wrestle with requirements, committee members must constantly keep in mind the company's changing circumstances, so that an understanding of what currently works doesn't congeal into what works, period.

For example, Bank of America flourished under deal maker par excellence Hugh McColl, Jr., for years. But by the time he stepped down in 2001, integration, rather than acquisition, had become the dominant challenge. Having recognized the altered environment several years before, BOA's board chose not a leader in McColl's image but instead Ken Lewis, a company veteran proficient at integration of acquisitions and organic growth. (For an example of how a company integrates its leadership development with its strategy, see the sidebar "The Living Succession Tree.")

Specific, nonnegotiable criteria also let directors keep control when they work with executive recruiters. With good direction, search firms can be a valuable source of objectivity – benchmarking internal candidates against outsiders and making sure that board members consider all possibilities, even if they prefer an insider. Some companies even bring in recruiters to do independent assessments of insider candidates. Their concurrence with a board's judgment carries weight with shareholders and potential critics.

Search firms ask boards to recommend candidates, and they take those recommendations seriously. But, ultimately, it is the recruiter who compiles the list, and the compiler of the list wields considerable influence. Directors must require from recruiters detailed explanations of how the candidates fulfill their criteria. A ten-page report on each is reasonable.

When the time comes to select the new CEO, directors – ordinarily a polite breed, unaccustomed to challenging one another or asking discomforting questions – must engage in a vigorous discussion of the candidates' comparative merits. One search committee that did an outstanding job making the final decision invited five candidates (two internal and three external) to a hotel for a couple of days. The two internal candidates were favorites of two different directors. On the first day, the committee interviewed three candidates, two external and one internal.

The directors split into two groups of three, and each group spoke with one candidate for 90 minutes. After these interviews, the directors broke for 45 minutes to share impressions, then switched candidates. Then the two groups of directors took turns interviewing the third candidate, similarly sharing impressions informally. At the end of the first day, the committee members debated over dinner, and the director who had originally advocated for the internal candidate volunteered that he was indeed not the strongest choice. The next day, they repeated the process with the two other candidates, and the results were remarkably the same, with the director who had originally advocated for the internal candidate changing his mind. In the course of these discussions, all hidden agendas fell away, requirements were honed, and directors were able to reach consensus.

Finally, board members must do due diligence on outside candidates – and do it well. Directors must seek reliable external sources and demand candor from them.

The Living Succession Tree

FOUR YEARS AGO, top management at the Thomson Corporation realized that its CEO succession process had passed out of life and into a stagnant existence on paper. Leadership development chugged along separately from business planning. Human resource groups produced reams of documents and charts dense with the branches of succession trees. "We never used them," says Jim Smith, executive vice president of human resources and administration at the $7 billion global company. "I never saw anybody go to a chart and say, 'Let's look at this.'"

So the company decided to rethink talent management in order to field leaders who could run Thomson under whatever conditions might exist. The new process is built on two principles: Succession planning should happen in lockstep with strategy making, and the current CEO should be intimately and visibly involved.

Each February, Thomson's 200 top managers gather to review corporate initiatives. Then in April, CEO Richard Harrington, CFO Robert Daleo, and Smith conduct strategy reviews with emerging leaders in every business unit. Goals coming out of those talks – related to markets, customers, products, and growth areas – accompany the trio into the next round of discussions, which takes place in June and focuses on management development.

At that point, Harrington, Daleo, and Smith devote eight full days to listening to senior executives (including CEO candidates) report on *their* highest potentials. The trio insists on concrete examples throughout. "It's so easy to generalize on how somebody's doing: 'He's a good guy' and 'She's terrific with people,'" says Smith. "We want to pin down the facts beneath that. 'You say she's good with people. Give me some examples of who she's developed. How many have been promoted?'"

The same people who attended the strategy meetings attend the leadership development meetings, so everyone in the room understands what talent the business requires. And when those same people reconvene again a few months later to discuss budgets, conclusions from the strategy and leadership development rounds inform their decisions. By year's end, Thomson has tightly integrated strategy, leadership, and budget plans. And Harrington and his senior team have spent many, many hours getting to know the company's most-promising CEO candidates.

Smith has three recommendations for companies interested in crafting a similar system, which has proved constructive to managers and the board alike. First, make sure the CEO devotes considerable personal time to identifying, getting to know, and developing leaders. Second, treat leadership development as part of the process used to run the business. And finally, make the process informal enough to encourage conversation. "We used to produce books," says Smith. "Now we have conversations."

Board members should ask first about the candidate's natural talents. If those gifts – admirable as they may be – do not match the position's specific profile, that candidate is not worth pursuing. Needless to say, due diligence is also the time to root out any fatal character flaws.

At this point, the role of the outgoing CEO is chiefly consultative. He or she must be active in spotting and grooming talent, help define the job's requirements, provide accurate information about both internal and external candidates, and facilitate discussions between candidates and directors. But when the choice of successor is imminent, make no mistake: That decision belongs to the board.

Inside a Development Engine

Despite the current crisis, we know it is possible to build organizations that reliably produce great CEOs. Starting after World War II, a few corporations emerged as veritable leadership factories. Companies like General Electric, Emerson Electric, Sherwin-Williams, Procter & Gamble, and Johnson & Johnson managed to stock not only their own corner offices but also many others. (Of course even great companies sometimes stumble: Procter & Gamble had a failure from within when it promoted Durk Jager to the top spot. But it is going great guns under the stewardship of company veteran A.G. Lafley.)

Reuben Mark has sat atop Colgate-Palmolive for 20 years, so the company's CEO succession chops have not been recently proven. But I believe the consumer products giant has a first-rate process for identifying and developing CEO talent. At the very least it produced three internal candidates who are excellent prospects for the job.

Colgate-Palmolive does business in more than 200 countries, and its emerging leaders are correspondingly international and diverse. Leadership evaluation begins during the first year of employment. "It may seem strange to talk about someone who's been here just a year when discussing the pipeline to the CEO," says Bob Joy, senior vice president of global human resources. "But the earlier you start to identify talent, the earlier you can provide the job assignments and develop the broad business experience needed by a CEO candidate."

Each subsidiary identifies its own high potentials and submits that list to local general managers, who add and subtract names and then hand the list off to the division heads. These lists wend their way up the chain until they reach the Colgate-Palmolive Human Resource (CPHR) committee, composed of Colgate's CEO, president, COO, the senior VP of HR, and the senior candidates up for the top job. CPHR modifies and consolidates the lists into a single master list, dispatching it back down the ranks where managers can contest decisions made by those above them. The process takes place once a year.

Those who make the cut are deployed in one of three tracks. The first track, local talent, is for relatively junior staff who might become the direct reports of a general manager. Someone more advanced would be designated regional talent, and given, for example, a significant position in Asia. The most elevated track–global talent–is the reservoir from which the most senior jobs are filled.

Throughout their careers, all these high potentials receive assignments that stretch their abilities and expand their knowledge, exposing them to a variety of markets, cultures, consumers, and business circumstances. CPHR itself designs career paths for general managers and higher positions because the committee is at the same time dynamically developing the profile of Colgate's future leadership team. (Also, says Joy, "you can imagine the kind of resistance you'd get from a division president who would like to keep his high-potential people in his own area.") The thousand or so highest high potentials (out of a total pool of about 2,000) receive outside executive coaching, which includes 360-degree feedback on current and past assignments.

Having identified its high potentials, Colgate strives to bolster their connection to the company. One tactic is recognition: "If you're talking about the future leaders of your company, you want them to feel special," says Joy. "You want them to have Colgate in their veins." Toward that end, the company sponsors a series of "visibility programs." One, for example, gathers high potentials from all over the world at Colgate's New York headquarters for weeklong sessions during which they meet with every senior leader in the company. In addition, each high potential receives a special stock grant, which arrives with a personal letter from the CEO.

Colgate's global growth program mandates that all senior managers retain 90% of their high potentials or lose some compensation. If a high potential at any level, anywhere in the world, does resign, the CEO, the COO, the president, and Joy are alerted within 24 hours and move immediately to retain that person.

Perhaps most important, Joy collaborates with the office of the chairman to connect directors early and often with high potentials in all areas. At the most senior level, functional leaders introduce the board to the top two or three most-promising heirs for their own positions, adding detailed analyses of those candidates' strengths and weaknesses. Emerging leaders routinely take part in presentations to the board and meet informally with directors over lunch. Board members closely track the progress not of one or two people but of the top 200, frequently discussing how each piece fits into the puzzle and what experiences or skills might improve that fit.

As a result, when CEO succession looms, the board and top management will be able to select from candidates they have spent many, many years observing and evaluating. "If you start five years or even ten years before the CEO is going to retire," says Joy, "it may be too late."

Of course Colgate-Palmolive – like General Electric – tackles succession from a position of strength. Its CEO has been two decades in the saddle, and he is passionate on the subject of an heir. Companies with less-veteran chiefs – and whose boards have been negligent in this area – will probably need to line up candidates quickly, while laying a deeper pipeline. They will in all likelihood have to bring in outsiders and position them to gain the requisite business and industry experience. That may mean shaking up the leadership team and reporting structures to free up slots in which outsiders can be tested. This restructuring will probably be resented, but it is necessary pain.

If a high potential at any level, anywhere in the world, resigns, Colgate's CEO, COO, and president are alerted within 24 hours and move immediately to retain that person.

A quick infusion of talent may be a company's only course, but it is no way to run a railroad. Organizations without meaningful pipelines must start now to put them in place. Young companies should create the processes that will come to fruition in five or ten years' time. Choosing the CEO's successor is not one decision but the amalgam of thousands of decisions made by many people every day over years and years. Such meticulous, steady attention to defining needs and evaluating candidates produces strong leaders and inspires succession planners at lower levels to exercise the same discipline.

The trend of CEO failures must be reversed. CEO succession is all boards' paramount responsibility; nothing else so profoundly affects their companies' futures. Directors must start investing their time and energy today. The call for a new leader could come tomorrow.

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To order, see page 151.

JOE MORSE

The "hassle factor" of transacting with other companies isn't always something to be eliminated.

Productive FRICTION

How Difficult Business Partnerships Can Accelerate Innovation

by John Hagel III and John Seely Brown

Managers are in a bind. They are becoming more dependent on business partners – suppliers, distribution channels, and so on – for key elements of business value, but all the effort of coordinating with outsiders takes its toll. It requires time and money to get relevant information about them, negotiate terms, monitor their performance, and, if needs are not being met, switch from one partner to another. As anyone with an MBA can tell you, the burden of such transaction costs was the basis of Ronald Coase's theory of the firm. Coase noted that companies brought activities in-house for one of two reasons: They could execute those activities better than anyone else, or the superior performance they could get elsewhere wasn't worth the extra cost and bother of working with an outsider. The organization took the shape it did because of transaction-cost economics. (See the sidebar "The Nature of Today's Firm.")

Coase's theory seems to have held up as these economics have changed. By reducing the costs of coordination between firms, information and communication technology has brought on steady growth in outsourcing – contracting outside for activities traditionally performed within the organization's own walls. Companies increasingly find that, even when outsiders' capabilities are only marginally better than their own, it's worth buying that expertise on the market. And meanwhile, providers of specialized offerings spring up like mushrooms, as the promise of nearly "frictionless" interaction enhances the value they offer.

But what if Coase – or at least his followers – placed too much emphasis on the coordination costs of transactions? We've seen companies actually gain from their interactions with others, beyond the goods or services contracted for. That is, the interactions themselves seemed to yield benefits. We know of companies that have gotten better at what they do – and improved faster than their competitors – by working with outsiders whose specialized capabilities complement their own. These cases have made us wonder, What if transactions between companies weren't simply a form of cost but could be a source of innovation? What if friction could be made productive?

The Sand in the Oyster

Productive friction makes sense in theory and even has precedent. Liken it, for instance, to "creative abrasion" – a term coined by Gerald Hirshberg, founding director of Nissan Design International (now Nissan Design America), and later developed more fully by Dorothy Leonard in her book *Wellsprings of Knowledge.* Hirshberg believed in pairing designers with different priorities and work styles on a project. The clash made creative sparks fly, but it had another benefit as well: It gave both designers the freedom to go with their own strengths (no matter how quirky) because each person knew that the other would provide balance.

Now let's think about that concept more broadly, looking beyond knowledge building and innovation within or between work groups. Between enterprises, too, there are often difficult problems that both parties have a stake in solving – the most important of which involve finding new ways to meet customers' needs. Different enterprises bring different perspectives and competencies to tackling a problem. And the potential for innovative solutions rises when people from diverse specializations interact.

Here's how this dynamic played out in the development of flat panel display (FPD) technology by a group of businesses in Japan's Kansai-Tokyo corridor. As Thomas P. Murtha, Stefanie Ann Lenway, and Jeffrey A. Hart describe in *Managing New Industry Creation: Global Knowledge Formation and Entrepreneurship in High Technology,* it was the very existence of this business "ecosystem" that enabled the rapid innovation of FPD technology.

Development was concentrated in this specific locale because it had been the breeding ground for FPD's precursor – liquid crystal display (LCD) technology. Starting in the 1960s, Japanese consumer electronics companies such as Sharp and Seiko had great interest in using LCD to create small, inexpensive products like watches and calculators. At the same time, though, some Japanese companies envisioned using similar technology to replace cathode-ray tubes in large-screen televisions. Their investments to that end attracted investments by large U.S. companies such as IBM, Applied Materials, and Corning. By the mid-1980s, a robust and highly specialized local ecosystem of major multinational corporations had formed.

The challenge here was formidable. To become a feasible replacement for cathode-ray tubes in televisions, FPD technology had to meet aggressive size and price-point targets at the product level, and these called for equally aggressive yields in FPD manufacturing facilities (known as "fabs"). The companies were pushing the envelope in terms of product and process performance. The designers had to confer with the manufacturers during the design phase, rather than simply hand over detailed specifications as they would normally do. Because the specs had to come from collaboration, there was an opportunity for productive friction to yield innovative designs.

Productive friction came to bear even more on the design and development of each new generation of fabs. These facilities became important focal points for product designers, equipment manufacturers, and materials suppliers to negotiate how they could collectively boost performance in manufacturing.

With speed being the primary basis for competition, the major members of this ecosystem raced through eight generations – or, as some industry sources keep count, fractional generations – of technology between 1988 (when 14-inch FPD prototypes were first demonstrated) and 1998 (when 14-inch FPDs achieved significant commercial production). Tacit knowledge was rapidly generated among the participants. Companies without a local presence found themselves falling further and further behind.

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Unanticipated problems created friction among the various specialized players, but this led to a lot of product and process innovation. For example, Sharp, one of the leading manufacturers of flat panel displays, tried to simplify its manufacturing process on a new production line to lower costs; the company modified its product design to make it easier to produce larger panels. Sharp wanted to keep these changes secret and thus did not share them with one of its main suppliers, Corning Glass, before the start-up of the new production line. Unfortunately, Sharp's panels on that line failed completely. Resisting the temptation to point fingers, Sharp and Corning decided to work together to find out what went wrong. The close collaboration of the companies' engineers over the next several months led to the development of a new acid treatment for one of Corning's glass products. When used in Sharp's new generation of panels, the treated glass yielded even higher performance than had been expected from the original product.

The new production line and the designs for the panels provided tangible objects for the two sides to negotiate over. The immediate challenge of bringing the new line back up helped keep both parties very focused on specific performance objectives. Rapid iteration between Corning, with its highly specialized knowledge of glass chemistry, and Sharp, with its deep understanding of panel manufacturing processes, produced a breakthrough in product and process design. The glass treatment ended up being used more broadly, in entirely unrelated problem areas, and it became the foundation for panel design innovations in the years ahead. By bringing diverse specializations together around a near-term problem, Sharp and Corning quickly improved their own product and process designs to compete more effectively in the race for lower costs and higher performance.

What's important to understand about this example is that the innovation occurred not because the interactions between the companies were seamless but because the activity at the seams was challenging, stimulating, and catalytic. All companies thrive or wither according to how well they continue to build on their capabilities. In the case of FPD technology development, companies actually accelerated their capability building by mixing it up with other organizations.

Keep in mind, of course, that productive friction doesn't usually happen so naturally. It can't be relied on to carry the day. As we all know, when people with different backgrounds, experiences, and skill sets engage with one another on problems, misunderstandings arise, arguments occur, and time is consumed before resolution and learning take place (if they do at all). Too often, in fact, the friction becomes dysfunctional. Misunderstanding hardens into mistrust, and opposing sides focus on the distance that separates them rather than the common challenges they face.

How do we harness this potentially destructive force so it accelerates learning, generates innovation, and builds capabilities? Let's step back from the specific circumstances of FPD technology and explore more generally some of the elements that help make friction productive.

All Eyes on the Prize. One thing that allows collaborating companies to move forward quickly is a shared sense of what must be achieved. In product development, productive friction is enhanced when teams have clear and aggressive performance targets but few, if any, constraints are imposed on how the product design might meet these targets. The more restrictions there are – for example, a specification that the product must use certain components – the less room there is for problem solving and the greater the potential for dysfunctional friction.

To make performance requirements tangible and immediate, we need what Tara Lemmey, CEO of LENS Ventures, has termed "action points": A specific product must be introduced, performance shortfall addressed, or operations breakdown resolved. In some way, concrete actions must be at stake. Otherwise, it is far too easy to produce abstract "answers" or "perspectives" that give the appearance

The Nature of Today's Firm

In thinking about why companies exist, academics and executives have long been influenced by the seminal essay "The Nature of the Firm," published in 1937 by Ronald Coase, who later won the Nobel Prize in economics. Coase asserted that all economic activity incurs transaction or interaction costs – and that, under certain circumstances, firms provide a more efficient mechanism for accessing and using resources than do open-market transactions. In this view, efficiency is the primary motivation for the rise of firms.

As information technology systematically reduces interaction costs both within and across organizations, perhaps it is time to reassess the rationale for firms. We hasten to add that we are not arguing for the dissolution of the firm. On the contrary, we believe that companies, albeit in somewhat different forms, will continue to play a critical role in economic value creation. But we sense that the reason for their existence is shifting from efficient use of existing resources to capability building and systemic innovation. This is different from – though related to – the argument that core competencies should be a company's basis for strategy. We are suggesting that they should be the basis for the firm itself.

Institutions that can accelerate capability building most effectively will create and capture value. Others will inevitably fall by the wayside.

> Creative sparks fly not when interactions between companies are seamless but when the ***activity at the seams is challenging, stimulating, and catalytic.***

of resolution but gloss over profound disagreements or misunderstandings. Essentially, the same core principle underlies the development of common law. Judges will issue verdicts only on the case at hand and only after adversaries have fully developed their arguments and confronted each other on the facts and issues involved. Judges are generally reluctant to articulate broad principles because they believe that good law emerges only from wisdom applied to specific cases.

Similarly, productive friction in commercial settings occurs precisely when action must be taken – when disagreements or misunderstandings must be brought to the surface, addressed, and resolved. It's vital to capitalize on those action points as they materialize. One of the reasons that the Toyota Production System has been such a fertile source of practice and process innovations is that it seeks to freeze context (even, if necessary, stopping entire assembly lines) and rapidly mobilize appropriate people to address problems as they arise, rather than letting time pass and trying to reconstruct context afterward. By stopping the line until an issue has been resolved or at least fully diagnosed, Toyota creates a compelling action point, allowing friction and rapid resolution. Sharp's production glitch in the FPD example above provided an equally compelling action point.

The power of clear and aggressive performance targets, shaped by a tangible action point, was apparent in a recent project undertaken by the Beck Group, a Dallas-based commercial design and construction firm. Construction, of course, is one of the world's oldest industries – and one of the most challenging. For each major commercial project, dozens (often hundreds) of specialized, independent businesses must come together under tight schedules and work closely with one another to deliver a unique and complex product. The general contractor orchestrates the whole process, recruiting appropriate participants, defining roles, specifying outputs, sequencing units of activity, and monitoring quality along the way.

In this instance, Beck's client had an urgent need to bring a large data center in Dallas online in record time. In fact, the first phase had to be up and running within seven weeks. In the words of Mike Hildebrandt, the project leader from Beck: "We were in a real pressure cooker. We had never delivered a facility in such a short period of time. We had to do things very differently – on the fly – to get the job done."

Hildebrandt was allowed to handpick his own team within Beck, and the company freed him from all other responsibilities so he could focus full-time on this project. Departing from usual practice, Beck did not require subcontractors to bid competitively on the project; the company carefully selected them on the basis of specialized capabilities needed to build this kind of facility. Because of time constraints, complete drawings of the facility were not available when the subcontractors were chosen. The subcontractors met at the construction site three times every week, collaborating to refine the drawings and devise ways to get the job done quickly and reliably. Time urgency removed restrictions that would have been imposed by detailed drawings in a more conventional construction project. The fees were structured to align the interests of the subcontractors. Everyone wanted to complete the project cost-effectively and in the shortest time possible.

Tomato, Tomahto. Productive friction ultimately depends on the people involved. If they don't have relevant specializations and diverse perspectives, their problem solving will be weakened, and they may not even be able to tackle the issues at hand. Yet different skill sets and experiences can create misunderstanding and undermine trust.

Since time is usually at a premium, identifying and connecting with people who have relevant specializations is often a challenge. This is why, in some cases, local ecosystems are hotbeds of productive friction. But even then, specialized "knowledge brokers" may be required to determine who should be involved and to bring these people together. This challenge becomes even more acute in distributed operations like global process networks or dispersed field operations. To mobilize the right people, a knowledge broker needs to be well versed in the practices at hand. In the case of Beck, Mike Hildebrandt played this role. He emphasizes, "If I hadn't had complete freedom to pick the right people for this project, we would never have been able to come up with the innovations required to get the job done."

Even more fundamentally, knowledge brokers help bridge participants' knowledge gaps. This was the case at GaSonics, a developer and manufacturer of semiconductor-processing equipment. Back in 1991, GaSonics had acquired Branson, which made similar equipment. The two companies had perfected different approaches to handling a certain stage of semiconductor manufacturing. Unfortunately, neither method could deliver the required performance as customers moved to a new generation of semiconductor technology.

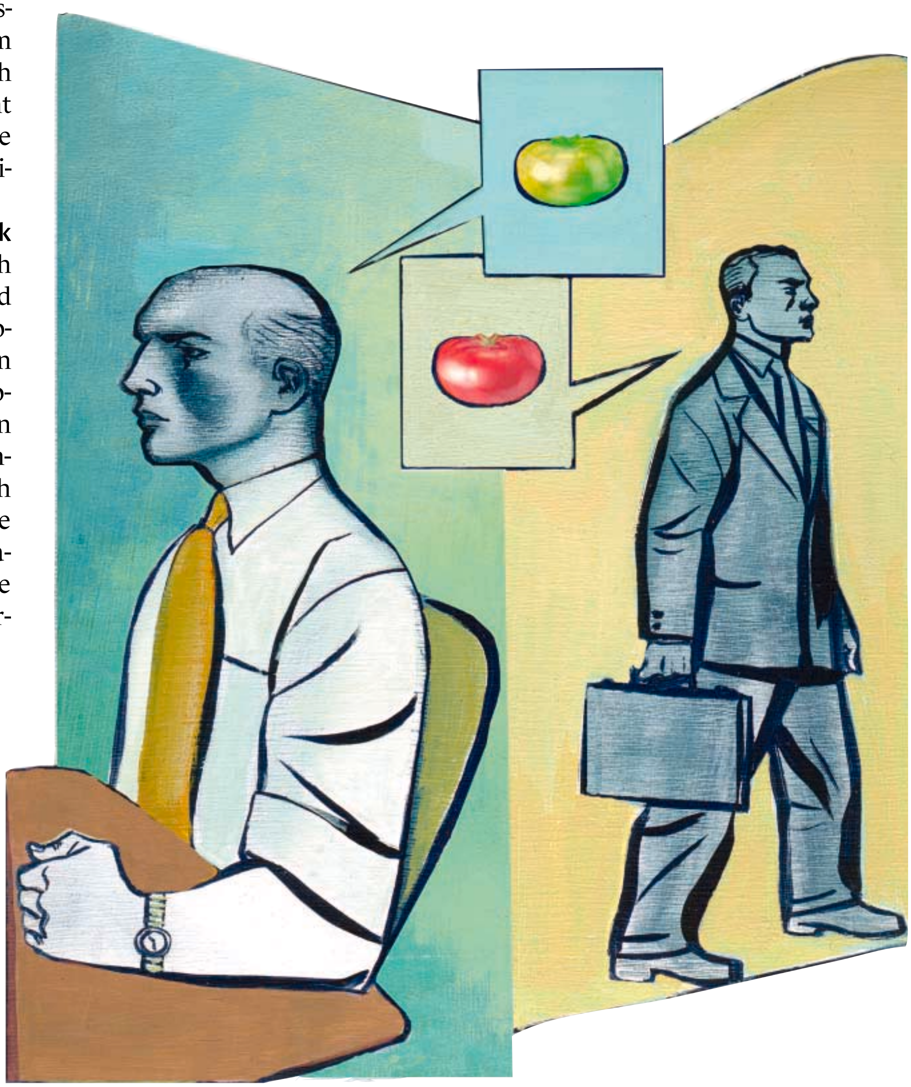
Each company's engineering team was determined to refine its own approach. Fierce battles broke out over which system should prevail. Dave Toole, the CEO of GaSonics at the time and an executive with extensive industry experience, was the knowledge broker. Recognizing that both sides were stuck on processes that just couldn't resolve the issues, Toole urged the teams to look at the problem from a new perspective and consider a two-part solution. This reframing helped the engineers discover that a hybrid approach could be used in the initial phase of processing. By intervening and reorienting the teams at a critical stage in their discussions, Toole was able to help them generate a solution that built upon both sides' experiences. It was an important breakthrough because it facilitated the move to subsequent generations of semiconductor technology.

What We Talk About When We Talk About Innovation. When people with very different skills, experiences, and mind-sets must engage in difficult negotiations, their ability to communicate can be significantly enhanced by an appropriate prototype. By prototype, we mean any object that can be accessed by a number of people and that enables them, with its concrete form, to see beyond the boundaries of their distinct specializations. (Because of this unique value, the term "boundary object" is gaining currency in innovation circles.)

In the Beck project, prototypes came in two forms: the rough drawings and, unexpectedly, a whiteboard in the construction site trailer where the subcontractors met three times per week. At first, the board was simply a repository for open issues, helping in the normal way to focus each meeting on what needed resolving. But its role changed as the team turned to one of its thorniest issues: the sequence in which the various mechanical and electrical systems would be put in place. Someone noted that the predrawn grid on the whiteboard corresponded handily to the site's floors, which were made up of two-foot-by-two-foot tiles. Suddenly, the team had a device for collaborating on a creative approach to installing systems simultaneously rather than sequentially.

In retrospect, they came up with a simple solution, specifying that mechanical systems would be located under even-numbered tiles and electrical systems would go under odd-numbered ones. But it had tremendous impact because it allowed various subcontractors to work effectively in parallel. As the idea took shape, the subcontractors gathered excitedly around the whiteboard and explored the implications of this approach for their specific jobs. They quickly visualized how the project would come together and agreed on their individual roles.

An effective prototype can be anything from a clay model to a computer simulation, a process map, or even a spreadsheet. As a group's work evolves, shifting to different kinds of prototypes may enhance the potential for productive friction.



Connecting the Dots. So far, we've been talking about the conditions that create friction and, importantly, keep it from becoming dysfunctional. But productive friction bears limited fruit if it yields only local innovations. For amplified impact, the learning must be captured and disseminated within and across enterprises.

Benefiting broadly from local innovations is difficult, unfortunately, even for capable organizations like the Beck Group. Although Peter Beck, a managing director of the firm, recognized the significance of what the data center construction team had done (and even had them present their experience to Beck's board of directors), there was no further adoption of the improvisational approach. The obstacle was not so much within the company as among its customers. The improvisation on the data center project hinged upon moving away from requirements that subcontractors submit competitive bids. Customers found it hard to trust that, with more degrees of freedom in implementation, a construction team whose members' economic interests were aligned could produce far superior results at a lower cost.

Usually, innovations remain localized, and their economic impact marginalized, because groups do not even think to look for patterns or share best practices. This is especially true with more modest forms of innovation in companies where similar business situations repeatedly emerge. Teams often find, to their dismay, that they have reinvented the wheel – they've come up with an "innovation" that has already been developed and implemented elsewhere.

Customer service is one area where wheels are being reinvented all the time, but the potential for productive friction and pattern recognition is great. Customers employ products in many different environments and work contexts, so a lot of the difficulties they experience are unanticipated. Resolving a breakdown often calls for joint problem solving with the customer and can generate new insight about successful operation of the equipment. In the mid-1990s, Xerox deployed a network-based system called Eureka, an electronic bulletin board on which customer service engineers (CSEs) could post tips on dealing with unusual repair situations. Over the first three years, Eureka captured 30,000 tips and saved Xerox an estimated $100 million a year. Eureka has become an important tool for CSEs to determine whether a given type of breakdown has occurred in the past and, if so, to learn from the way it was resolved. It also contains information that could help product designers spot patterns and improve performance in later generations of products.

Productive friction occurs when people with diverse and appropriate specializations creatively resolve difficult business issues. But to gain its full benefit, companies must also establish processes (supported by new generations of information technology) to help them reflect on the practices emerging from these collaborations, recognize patterns, and increase awareness of high-impact solutions across related groups of practitioners. For mnemonic purposes, think of the ingredients of productive friction as four Ps: performance requirements, people, prototypes, and pattern recognition.

Rubbing Shoulders with the Best

Your ability to generate productive friction with your suppliers and customers is a source of competitive advantage now – but over time, it will become a competitive necessity. Why? Because specialization is the way of the world. As information technology makes it easier for companies to contract with outsiders for more and more of the business tasks that once needed to be performed in-house, organizations sharpen their focus on what it is they do uniquely well. Companies that hew to their old forms will truly find themselves jacks of all trades and masters of none – and this will cripple them in two ways. First, their own core strengths will fall increasingly short of world-class; second, they will not be availing themselves of world-class capability in peripheral functions.

Meanwhile, for the companies that specialize, the name of the game will be capability building. Once you have chosen to focus your resources on a particular function, the imperative is to be the best – and to keep getting better at a faster rate than the competition. How will you accomplish this? Not in isolation, we believe, but through productive friction with other specialized players.

Dell is thinking along these lines, as we can see in its approach to relationships with Taiwanese original design

Will can trump skill. With appropriate motivation, partners will *invest aggressively in building necessary capabilities.*

manufacturers (ODMs). When Dell uses ODMs, it works closely with them, sharing knowledge in formal meetings that occur throughout the product life cycle. These interactions are structured so Dell can systematically integrate its expertise with that of its suppliers and, in the process, build new capabilities.

To extend this logic even further: Imagine you are the best at what you do. Every other specialized company out there wants you as part of its process network. However, your capacity to engage with others in problem solving and innovation is limited. With whom do you choose to rub shoulders? You might answer, "Other world-class companies." But more precisely, you'd choose to engage with companies if you believed doing so would strengthen your own capabilities. In other words, the companies that learn to generate productive friction early will set into motion a virtuous cycle. They will become partners of choice, and that will keep them competitive in the long term.

The real test is whether a company can create relationships that accelerate the capability building of all participants and whether it can amplify the value that each party brings. Note that the amplification must go beyond achieving the static synergies that arise from combining complementary capabilities. It must also grow those benefits over time. When companies leave a business relationship, will they perform better on a stand-alone basis than they did before they entered into it? Have they each enhanced their own capabilities more effectively than they could have without the relationship?

Weaving a Performance Fabric

Bringing together diverse, highly specialized companies and getting them to collaborate in mission-critical business processes is not an easy task. The companies cannot be hardwired to one another; they must be loosely coupled. That is, it is not effective for a company to specify a partner's activities in great detail and then to monitor performance accordingly. Instead, the right approach is to delineate relatively independent modules of activity and assign to each a clearly accountable owner. For every module, performance targets should be defined. Then participants should be left relatively free to improvise within their areas of activity as long as they can meet the performance requirements.

Few companies, however, are comfortable with such arrangements unless there is a basis of shared meaning and trust between the parties involved. Shared meaning and trust – with the assistance of information technology architectures and software – make up the fabric that supports collaboration across enterprise boundaries. We won't discuss the IT dimension at length here, but we should underscore that new generations of information technology will weave the threads of performance fabrics more tightly and, in turn, add opportunities for productive friction. (In our forthcoming book, we will highlight the convergence of three diverse strands of IT innovation: service-oriented architectures, virtualization architectures, and interaction tools such as social software, wireless networks, and other devices that equip people to improvise and innovate together.)

Cisco is one company that appreciates the importance of creating shared meaning across its network of business partners, especially its dispersed, fragmented distribution channels and channel partners. In the view of Tom Kelly, vice president of the company's Internet Learning Solutions Group, the process starts with common perspectives. Cisco invests heavily in training not only its own staff but also its business partners' through structured learning activities, including "emergency" modules that prepare people to deal with time-sensitive business situations. Cisco makes it as easy as possible to search for and access its learning materials online and delivers them in small packages, tailored to specific business needs. Along the way, shared meaning takes hold incrementally.

It also, by necessity, takes hold iteratively. Common points of view cannot simply be imposed. There must be a back-and-forth process by which partners come to an understanding. By the same token, complete alignment is a chimera. The key, then, is to determine at the outset those areas in which shared meaning is most critical, by observing where the most significant misunderstandings occur, and to expand its scope over time.

Trust, too, cannot be established overnight. Most executives seem to believe it is like fine wine: One can only act in good faith and hope it will eventually develop. Yet companies that work skillfully with a broad range of business partners have found that certain tools and approaches *can* be used to accelerate the building of trust. They tend to rely primarily on forward-looking incentives (How can this relationship accelerate our learning and lead to faster improvement of performance?) rather than backward-looking assessments (Has the other party delivered against expectations in the past?). Perhaps because process networks often emerge in rapidly changing environments like apparel and electronics, their orchestrators are painfully aware that the past is not a useful predictor of future performance. Yet they avoid overemphasizing near-term cash rewards, which can actually undermine trust. This is because, in the near term, the cash pool available for distribution among participants is essentially fixed. If one party receives more, then others must do with less. As in all zero-sum games, each party maneuvers to get as much of the pie as it can, and trust erodes.

Those who want to accelerate trust also define the concept narrowly. Rather than pondering the overall trustworthiness of an individual or institution, they focus on the delivery of certain outcomes as promised and the commitment that neither party will abuse privileged access to corporate resources and relationships. Then, they assess the ability and willingness – the "skill and will" – of the other party. For example, apparel giant Li & Fung recruited several former managers of textile plants in the early days of organizing its renowned process network. These seasoned executives could walk through the plant of a potential business partner and, within 30 minutes, determine the plant's capabilities. The company has learned, though, that the skill of a partner is only part of the trust equation, especially over time. Will can trump skill since, with the appropriate motivation, partners will invest aggressively in building necessary capabilities.

Li & Fung's practice also illustrates the somewhat counterintuitive effect on trust when neither party in a relationship is locked in. As a matter of policy, Li & Fung seeks to use between 30% and 70% of the capacity of its process participants. At least 30%, the thinking goes, will result in priority attention from the partner; but more than 70% may mean that the other company is too dependent on Li & Fung. When the stakes get too high in a relationship, so does the threshold for trust.

Other trust accelerators fall into the category of "trust – but verify." Some companies, for example, employ event-notification systems carefully constructed to provide early warnings of potential performance issues, as well as robust exception-handling procedures to ensure that problems are quickly addressed. Performance bonds and other assurance mechanisms can protect against economic losses created by disruptions. Such tools help reduce perceived downside risk and, in the process, strengthen the impact of positive incentives on how rapidly trust is built. Finally, reputation systems administered by process orchestrators can also reward or punish performance.

Companies focused on accelerating trust understand how to use "trust staircases" to minimize risk. They pace their relationships with others to build capability and confidence in quick increments. Early interactions may involve areas of relatively limited business value. Here, each party can test the other's will and skill by refraining from specifying activities in fine detail and instead focusing on defining required outcomes. Alternatively, when substantial business value is at stake, the two parties can begin

Your Real Rationale for Offshoring

The significance of offshoring is widely misunderstood. Most executives look at it simply as a way to achieve near-term savings in operations. But this perspective greatly underestimates the opportunities – and challenges – offshoring creates. In fact, it is a powerful way to rapidly build capabilities and reap the benefits of increased specialization.

We are just now, for instance, seeing the first forays by traditional computer manufacturers into a variety of consumer electronics markets. Gateway, in a very short time, has established a leadership position in the U.S. plasma TV market. Hewlett-Packard has entered the digital camera market and, in only a few years, carved out a 6% market share among leaders like Nikon and Canon. Dell is targeting televisions and smart phones. All of these companies have relied heavily on offshore design suppliers in their core businesses to accelerate their entry into consumer electronics.

Rather than seeing offshoring solely as a form of wage arbitrage, think of it as a form of skill arbitrage supplemented by the opportunity to generate savings through more favorable wages. Even this view, however, doesn't capture the full potential of offshoring. Longer term, we anticipate that it will become a powerful source of innovation in products and services.

Initially, this innovation will be focused on serving the unique needs of demanding consumers in the high-growth emerging economies of China and India. Over time, though, it will disrupt markets in more developed economies as consumers in these places realize that they too can get more value at lower cost.

To continue to create value in this new world, executives must adopt a much more strategic and dynamic view of offshoring. They need to use offshoring (and related outsourcing) decisions to reexamine the most basic question of all: What business are we really in? Companies must be clear about their own areas of expertise before they can leverage the specializations of others.

with detailed activity specifications but, as they gain more experience with each other, start to relax some of the specs and emphasize goals. The trick is to be thoughtful about the sequencing and design of these interactions so that trust rapidly accumulates but risk is managed.

If the necessary underpinnings of shared meaning and dynamic trust are established, companies can work well together, and the friction at their boundaries will likely be productive. Without these elements, the performance fabric quickly unravels, and process networks disintegrate into rivalrous competitors.

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In our relentless quest for efficiency over the past several decades, we have become conditioned to believe that all friction is bad. After all, wasn't a "frictionless economy" the nirvana promised to us by the dot-com visionaries? Friction was a sign of waste. The problem needed to be rooted out wherever it reared its ugly head.

As we move further into the twenty-first century, we will find that we've been too hasty in dismissing friction. The companies that thrive will be those that employ it to aggressively build their own capabilities as well as their partners'. Most organizations will take on higher degrees of specialization – and, therefore, rely more heavily on others to perform business functions that fall outside those specialties. Clearly, we need a more systematic understanding of what it takes to enhance performance across broad networks of participants.

To ensure your own competitive viability, you may need to reassess the criteria you have used in the past for creating and sustaining relationships. For example:

• To what extent did you choose your five most significant business partners because of their ability to spur your own long-term capability building through collaborative improvising and problem solving?

• To what extent do the orchestrators of your process networks focus on accelerating participants' capability building? What is their track record to date?

• What are the five most innovative companies with capabilities that complement yours? Do you have effective business partnerships with them? If not, why not?

The most successful process networks will be those that can maintain a focus on future-oriented capability building. Within them, thoughtfully structured sequences of interactions will facilitate joint knowledge building in the areas that are likely to have the greatest impact on the performance of process participants. We need to learn to embrace friction, even seek it out, when it promises opportunities for learning.

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To order, see page 151.

RANDY GLASBERGEN

"Billy, you've been a fine son, but it's time for a change. I found a child overseas who can do it cheaper."

Eager to reduce their dependence on fund-raising, more and more nonprofits are launching earned-income ventures – with disappointing results.

Should *Nonprofits* Seek Profits?

by William Foster and Jeffrey Bradach

TWENTY YEARS AGO, it would have been shocking for the Chicago Children's Choir to run a singing telegram business and a Ben & Jerry's Scoop Shop or for Shelter, Inc., of Contra Costa County, a California organization dedicated to serving the homeless, to launch a property management firm. Today, it seems routine. Promoted in books and articles, conferences and courses, earned-income initiatives are becoming accepted – even expected – throughout the nonprofit world. In a 2003 Bridgespan Group survey of U.S. nonprofits' executives, half of the respondents said they believed earned income would play an important or extremely important role in bolstering their organizations' revenue in the future.

What's driving nonprofits to pursue profits? The phenomenon is as much social as economic. The general enthusiasm for business, which reached a fever pitch during the booming 1990s, has had a profound impact on nonprofits and the institutions that support them. Like their

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counterparts in the commercial world, managers of nonprofits want to be viewed as active entrepreneurs rather than as passive bureaucrats, and launching a successful commercial venture is one direct route to that goal. Board members, many of whom are accomplished business leaders, often encourage and reinforce that desire. At the same time, many philanthropic foundations and other funders have been zealously urging nonprofits to become financially self-sufficient and have aggressively promoted earned income as a means to "sustainability." As a result, nonprofits increasingly feel compelled to launch earned-income ventures, if only to appear more disciplined, innovative, and businesslike to their stakeholders. (The sidebar "The Pressure from Funders" takes a closer look at such forces.)

But while the case for earned income may seem persuasive at first glance, a closer look reveals reasons for skepticism. Despite the hype, earned income accounts for only a small share of funding in most nonprofit domains, and few of the ventures that have been launched actually make money. Moreover, when we examined how nonprofits evaluate possible ventures, we discovered a pattern of unwarranted optimism. The potential financial returns are often exaggerated, and the challenges of running a successful business are routinely discounted. Most important, commercial ventures can distract nonprofits' managers from their core social missions and, in some cases, even subvert those missions. We're not saying that earned-income ventures have no role in the nonprofit sector, but we believe that unrealistic expectations are distorting managers' decisions, ultimately wasting precious resources and leaving important social needs unmet.

Many foundations have been zealously urging nonprofits to become financially self-sufficient and have promoted earned income as a means to "sustainability."

Rhetoric and Reality

Earned-income ventures are nothing new in the nonprofit sector, of course. Universities, hospitals, and theater groups, for example, have long been run by charitable organizations. What is new is the breadth of interest. No longer relegated to education, health care, and the arts, revenue-generating initiatives are being launched or considered in virtually every nonprofit domain, from human services to housing to the environment. Some of the new ventures derive income from products or services within existing programs; others are completely separate from the nonprofits' core programs. But almost every venture takes the nonprofit into unfamiliar commercial waters.

Burgeoning interest in earned income has generated a flood of publications, events, and experts. How-to books with titles like *Venture Forth! The Essential Guide to Starting a Moneymaking Business in Your Nonprofit Organization* and *Selling Social Change (Without Selling Out)* have recently appeared. The Yale School of Management–The Goldman Sachs Foundation Partnership on Nonprofit Ventures sponsors a celebrated and rigorously judged business-plan competition for nonprofits; in 2004, it garnered more than 500 entries. Even organizations that promote the broader topic of social entrepreneurship, such as the Social Enterprise Alliance, are often primarily focused on earned income. At that group's 2004 National Gathering for Social Entrepreneurs, attendance "flew past 600, a 50% growth rate that dramatically illustrated surging interest in the field of social enterprise," organizers reported. And Nonprofit Business Solutions advertises that it can help "discover the earned-income opportunity you may have missed, for only $100." Indeed, the widespread enthusiasm for earned-income ventures has drowned out the handful of people, such as Greg Dees of Duke and Jed Emerson, a cofounder and former executive director of the Roberts Enterprise Development Fund, who have sounded cautionary notes.

It is clear that there has been a significant increase in the number of nonprofits considering, investing in, and launching ventures, and the press has helped create the impression that these enterprises are contributing substantial profits. In late 2001, for example, the *Chronicle of Philanthropy* ran the headline "The Business of Charity: Nonprofit Groups Reap Billions in Tax-Free Income Annually." The wide circulation of selected data reinforces the notion of a boom in earned income. From the impressive body of work published by Johns Hopkins' Lester Salamon, one statistic is mentioned with particular frequency: "Fees and charges accounted for nearly half of the growth in nonprofit revenue between 1977 and 1997 – more than any other source."

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But out of context, such statistics can be misleading. Fees and charges grew no faster in that 20-year period than other sources of revenue; they represented nearly half of the sector's total revenue in 1997, just as they had in 1977 (see the exhibit "No Outsized Surge in Earned Income"). And the reason the fraction is so high is that educational and health care institutions, which extensively use fee-for-service income, account for nearly 70% of total nonprofit revenue and thus dominate the data.

To more clearly document the prevalence of earned income in the nonprofit sector, Bridgespan analyzed revenue trends from 1991 to 2001. We drew our data from the IRS 990 forms that nonprofits prepare annually to report their finances. While these filings don't list "earned income" per se, they do include a category for "program service revenue," which includes government fees for service as well as private payments and fees. This is far from a perfect proxy, but it is a decent one and, in any case, it is the best available. Our analysis revealed that the relative contribution of program service revenue had actually declined by three percentage points over the ten-year period and that such revenue remains heavily concentrated in health care and education. Outside those domains, earned income's contribution grew substantially only among employment and community-improvement organizations. In environment and youth development, it showed a marginal gain, while in arts, education, housing, recreation, and human services, it declined slightly.

If the growth in the revenue contribution of earned-income ventures seems overstated, so does the financial success of the projects. In discussions of the topic, a handful of success stories are told again and again – cases like those of Pioneer Human Services, the Seattle-based nonprofit that offers job training and counseling to former inmates and others on the margins of society, and Juma Ventures, the Bay Area organization that gives employment opportunities to local youth. These organizations certainly deserve accolades for their income-earning endeavors, but they appear to be the exception, not the rule. At Bridgespan, we are frequently asked to assist nonprofits that have had trouble making their earned-income ventures profitable, and as part of our research we routinely hunt for similar ventures that have been profitable and might thus serve as benchmarks. We almost never find them. We have had no trouble, however, finding money-losing ventures.

Two widely circulated surveys of earned-income ventures seem to suggest that our experience is anomalous. "Enterprising Nonprofits: Revenue Generation in the Nonprofit Sector" by the Yale School of Management–The Goldman Sachs Foundation Partnership on Nonprofit Ventures and "Powering Social Change: Lessons on Community Wealth Generation for Nonprofit Sustainability" by Community Wealth Ventures (CWV) report that between half and two-thirds of the ventures these organizations examined were either profitable or breaking even. Given the challenges of accurately gauging the returns of earned-income ventures, however, we think it is important to keep in mind two caveats about these findings.

The first concerns the composition of the samples. Are they truly representative, or are they biased toward successful (and surviving) initiatives? The Yale–Goldman Sachs Foundation survey solicited research participants by highly publicizing the study through postings and advertisements. Such announcements are an efficient way to attract participants, but they amass a self-selected pool of research subjects, virtually guaranteeing a positive bias. Failing organizations are less likely to volunteer than successful ones–and ventures that have already closed their doors never do. The CWV study drew its initial sample from experts' suggestions and the researchers'

The Pressure from Funders

To further its mission of preparing students for jobs in the culinary arts, a nonprofit job-training agency that we recently worked with raised funds to build a full-scale industrial kitchen. Hoping to earn income as well as advance the agency's social goals, managers used the kitchen to launch a café, a catering operation, and a wholesale food business. They found that by making the nonprofit seem more entrepreneurial, innovative, and disciplined, the commercial endeavors generated enthusiasm among philanthropic foundations. Funders were happy to help bankroll initiatives that seemed likely to push the agency toward sustainability.

But the results of the three enterprises were dismal. Unable to achieve high volumes, the kitchen operations lost more than $250,000 a year. Even from a mission standpoint, the ventures failed. Only ten students a year were being placed in jobs, and only a couple of them were actually going into the culinary arts. Nevertheless, the agency continued to operate the kitchen and the three businesses. Why? Because they had become an integral part of the pitch used to solicit funds. "It was," says one of the agency's leaders, "the part of our story that most excited donors about our operations."

It's understandable that the nonprofit organization would be reluctant to end a program that was generating donations. At the same time, it's problematic that the part of the agency's story that funders so wanted to hear would lead a nonprofit to continue operating a money-losing program that did little to fulfill its mission.

personal contacts; this sample was then expanded through referrals from the initial group of nonprofits. Here again, the probability of a positive bias is high, because successful ventures tend to have a much higher public profile than unsuccessful ones.

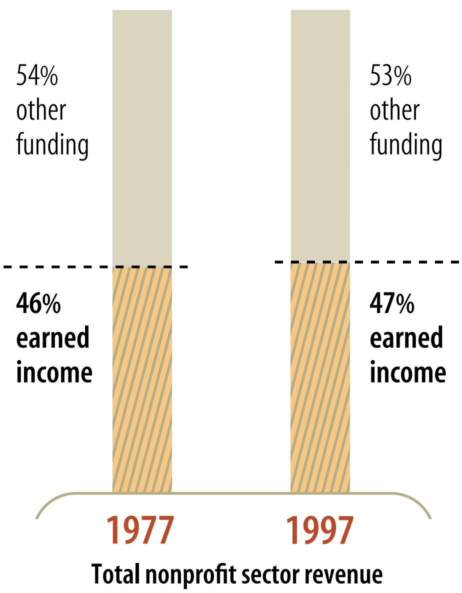
The second caveat involves the definition of "profitable." Are the financial claims accurate? The results were self-reported, and our experience with nonprofits reveals a tendency to overlook or undercount commercial ventures' operating costs (including management time, facilities costs, and other overhead expenses). In addition, the reported "profitability" may not adequately account for hefty start-up costs. This question is difficult to assess in the Yale–Goldman Sachs Foundation study, because the calculation of financial returns is not documented in detail. There is more detail in the CWV calculations, however, and here we find that the reported financial results are probably overly optimistic.

In the CWV study's sample of 72 organizations, only four–just 5%–earned more than $50,000 in annual profit. In addition, the average time to profitability for most organizations was 2.5 years, and the average initial investment for all ventures was $200,000. Assuming a $200,000 start-up cost, two years of zero profit, and $25,000 in annual profit thereafter, a venture would take ten years to repay the initial investment, even without discounting the future profit for inflation. The venture's intangible returns may be real, but from a purely economic perspective, the same return could be generated simply by hiding $200,000 under a mattress for ten years.

To better understand the odds of success, Bridgespan selected a random sample of nonprofits that had received philanthropic funding for an earned-income venture in 2000 or 2001. (We drew the sample from a database of nonprofits maintained by the Foundation Center, a leading nonprofit research organization.) This approach limited the pool to organizations of interest to philanthropy, but it tempered the likelihood of either a positive or negative sample bias. To determine profitability, we conducted interviews with executives of 41 of these organizations – a diverse group of agencies representing the youth services, arts and culture, employment, and community improvement domains and having annual budgets ranging from $200,000 to $15 million. The ventures included both separate enterprises and core programs that had been commercialized. We excluded health and educational institutions from our sample. We also excluded basic cobranding relationships that some nonprofit organizations enter into with for-profit corporations. (The National Wildlife Federation, for instance, endorses environmentally friendly outdoor products like birdbaths sold by Home Depot and receives a percentage of the product sales.) The results were not encouraging: Seventy-one percent of the ventures reported that they were unprofitable, 24% believed that they were profitable, and 5% stated that they were breaking even. Of those that claimed they were profitable, half did not fully account for indirect costs such as allocations of general overhead or senior management time. Simply put, there is every reason to believe that the lion's share of earned-income ventures do not succeed at generating revenues beyond their costs.

No Outsized Surge in Earned Income

Revenues for the nonprofit sector have jumped from $109 billion to $632 billion in a 20-year time span. But the percentage generated by earned income (fees and charges) has stayed nearly the same.



Fees and charges include return on investments. Other funding indicates private contributions and government payments. Based on data from *The New Nonprofit Almanac and Desk Reference.*

The Disadvantages of Nonprofits

Why is there such a gap between the rhetoric and the reality of earned income in the nonprofit sector? One important factor is a lack of realism in evaluating the challenges of running a business. Launching an enterprise is difficult under the best of circumstances. According to the National Federation of Independent Business's Education Foundation, only 39% of small businesses are profitable, and half fail in the first five years. The odds are stacked even higher against nonprofits, for several reasons.

Conflicting Priorities. Unlike purely commercial enterprises, nonprofits focus on both financial and nonfinancial concerns. They may, for instance, feel obliged to pay what they consider a "living wage" or to hire employees from some disadvantaged pool of people. They may price products to be more affordable to low-income groups or offer products that are deemed "better" or "healthier" than market norms. And they may reach out to customers in locations or in groups that have not had access to certain products or services.

Those are all appropriate social objectives. But they can put nonprofits at a distinct disadvantage in the intensely competitive commercial marketplace, dramatically reducing the likelihood that profitability will be achieved. Even if a nonprofit's managers and staff are as talented as its competitors', such secondary considerations can doom a venture by dampening revenues or increasing costs or both. They can also keep a nonprofit from building the kind of highly competitive, profit-focused culture that is essential to the success of many commercial enterprises.

Lack of Business Perspective. Because philanthropic contributions typically do not have significant operating costs associated with them, nonprofits can easily misjudge the actual financial contribution that a venture will deliver. In particular, they tend to overlook the distinction between revenue and profit. If a nonprofit receives an unrestricted charitable donation of $100,000, all $100,000 (except for the comparatively small fund-raising costs) can be put to work in pursuit of the organization's mission. In this case, revenue is essentially the same as profit. However, if a nonprofit generates $100,000 from a venture, such as a catering business, some of the funds must be used to cover expenses. Typically, what's left over is at best a small portion of total sales. An examination of standard for-profit business margins shows, for example, that retail eating and clothing businesses with less than $1 million in annual revenues have profit margins of just 2.5%, while the margins of similarly sized employment agencies (we cite these examples because many nonprofits operate ventures in these areas) run at only 2%. Even if we assume that the margin on a nonprofit's earned-income activity is 10% – an extremely optimistic assumption – a $100,000 business would generate only $10,000 of unrestricted funds in a year. In this regard, the widespread use of the term "earned income" to mean the revenues of nonprofit ventures has not been helpful. It has made the distinction between revenue and profit less clear.

As an example of how widely off the mark financial perspectives can be, consider the experience of a nonprofit we'll call Midwestern Youth Services, or MYS. The organization received philanthropic funding to outfit a commercial kitchen and launch a food products enterprise. It pursued the venture with gusto and hired local youths as staff. One year after its launch, the venture began selling its first product, MYS Salad Dressing, to local supermarkets. MYS prided itself on this initial success and began gearing up to increase its investment in the venture. Fueling its optimism was a sense that the business was already breaking even. The organization believed it spent $3.15 to produce a bottle of salad dressing, which it then sold for $3.50, yielding a 35-cent profit. MYS was confident that even if some costs were unaccounted for, the venture was covering its expenses and profitability was in sight.

> *Despite the hype,* earned income accounts for only a small share of funding in most nonprofit domains, and few of the ventures actually make money.

But an analysis completed by Bridgespan revealed that the relevant expenses were far higher. MYS counted direct labor expenses as well as the cost of ingredients, but it considered only the ingredients going into the bottles and the time employees spent working on the product. In reality, the time spent preparing the dressing was a small percentage of the hours for which employees were paid. The workers' downtime was not being allocated to the product. Similarly, a significant amount of the purchased ingredients was being used for product development or was going unused. With these factors added in, the direct cost per bottle was $10.33.

Yet even that figure was an understatement. The nonprofit had also neglected to account for major indirect expenses, including the kitchen manager's salary, the facilities cost (rent for the kitchen and equipment depreciation), and the venture's share of the nonprofit's overhead (executive salaries and the like). When a modest allocation to cover these expenses was included, the cost per bottle reached a staggering $90. Far from breaking even, the venture was losing nearly $86.50 on every item it sold.

Granted, the cost per unit would shrink with increasing volume. But to break even, MYS would have to increase sales 150-fold, well beyond the kitchen's capacity. Given the philanthropic funding for the start-up costs, the absence of investors clamoring for returns, and some genuinely mission-related objectives, it is easy to see how the nonprofit ended up in this situation. But if an enterprise is designed to make a nonprofit more disciplined, as is often the case, or if it is intended to form the groundwork for greater financial self-sufficiency, such miscalculations can provide false comfort.

Reliance on Indirect Customers. In many earned-income ventures, the intended users can't afford the products or services. That's hardly surprising – many nonprofits work with society's most disadvantaged citizens. But it means that ventures must often rely on indirect customers for their revenues, making for complex and sometimes convoluted business models.

For example, one human services nonprofit recently developed an impressive Internet-based tool to help disadvantaged citizens search for government benefits they might be eligible for. The tool would bring these individuals a direct financial benefit, but it's unlikely they would be able to afford the necessary fees. Would corporations that also serve these people pay for the tool? It's easy to see how the nonprofit could have persuaded itself that the answer is yes – utility companies would surely rather help customers get a government credit for electricity than shut off their power. But the answer is probably no.

That's because third parties cannot calculate with any precision the financial benefit they would receive, so structuring a deal that's attractive to them would be difficult, if not impossible. The utility companies, to continue with the example, would be unable to determine how many of their customers would use the tool or receive the government benefits. And sharing customer data with third parties is never straightforward. Additionally, nonprofit organizations generally know far less about potential indirect customers than they do about their own beneficiaries, and in business, there is no substitute for a deep understanding of customer needs. In many cases, a nonprofit would be better off targeting third parties for grant requests rather than for sales pitches.

Philanthropic Capital and the Escalation of Commitment. Even when nonprofit managers realize that their ventures are facing financial problems, they rarely pull the plug. Instead, as is sometimes the case in the for-profit sector, they tend to throw good money after bad, hoping to turn the ventures around and avoid the embarrassment of failure. One nonprofit, for example, had a mission to offer teenagers a safe after-school environment with Internet access. It found a historic building with more space than the program needed. With government funds, the organization rehabilitated the building and rented out the upper floors. But the rental income didn't cover the lease and maintenance costs, so the nonprofit launched an additional earned-income activity – an after-school café selling cappuccinos and baked goods to the teenagers – to fill the gap. Unfortunately, the teenagers were not interested in, or couldn't afford, its offerings, so the café lost money too.

Rather than abandoning its money-losing ventures, the nonprofit expanded its earned-income program by extending the café's hours, broadening the menu, and opening the doors to adults. The results are not yet known, but the likelihood of success seems low. What remains is the picture of a well-intentioned nonprofit, which had simply intended to offer Internet access to teenagers, on its way to building a large, money-losing conglomerate encompassing property management and food service.

The slope for weakly performing businesses is always slippery, regardless of which sector they belong to. But the problem of commitment escalation is made even more acute when philanthropic contributions provide the funding for an earned-income venture during its first few years. Because expenses during this period are covered, the risk of losing money seems less pressing to the nonprofit. If (or, more likely, when) the philanthropic funding stops a few years later, what began as a well-funded earned-income venture may become an unfortunate legacy.

A Question of Mission

Nonprofits that take a cold look at the disadvantages of launching a commercial business will probably conclude that the odds of it generating real financial returns are extremely low. That does not mean that all potential ventures should be abandoned. Rather, it means that executives of nonprofits must ask a critical question: "Does this venture contribute to our organization's core mission?" If a venture furthers a nonprofit's mission while allowing it to recoup some portion of the costs, the venture could well be attractive even if it never breaks even.

We have found examples of earned-income ventures that do support nonprofits' missions, particularly in the area of job training. Rubicon Bakery, in Richmond, California, employs adults from a wide range of disadvantaged communities to produce premium cakes and tarts that it sells to retailers. Pedal Revolution, in San Fran-

cisco, employs homeless youths to repair and sell bicycles. These businesses operate primarily to fulfill the social goal of providing training to the poor; any money they earn in the process is a side benefit that helps them supplement their philanthropic funding.

Such success stories, however, are rare. Our research reveals that many earned-income ventures fail the mission test as well as the financial test. Our survey of nonprofits' executives asked about their motivations for starting their ventures. Thirty-two percent said they had entered into the endeavors predominantly for mission reasons, whereas 58% cited a mix of financial and mission reasons. Only 10% reported launching ventures purely for the money. But as we probed more deeply into the mission-focused ventures in this survey – and into the endeavors we encountered through our case work – we found that the meaning of "mission focused" often became blurred. In some cases, the ventures were truly central to the missions (for example, a job-training organization creating employment opportunities); others were only loosely related (a children's theater renting out costumes); for still others, there was a vague mission-related element on top of the operation (a children's choir starting an ice cream venture whose employees sing while scooping). The lure of potential "profits" not only distorts financial analysis but also thwarts an impartial evaluation of a venture's mission contribution.

Sometimes, the pursuit of profit directly conflicts with the pursuit of social good. Take the case of one environmental organization that had a unique database of statistics on important environmental issues. The broad dissemination of the information helped support the organization's causes, but the database was expensive to maintain. The organization decided, therefore, to begin charging users for access. But as soon as fees were imposed, the number of users plummeted and dissemination of the information was severely curtailed. The organization had reduced its environmental impact in its effort to generate revenue. That may be a trade-off worth making, but it highlights the complex interplay – and the managerial challenge – of balancing mission and income.

Even without such a direct conflict, an earned-income venture can impede a nonprofit's pursuit of its mission. Launching and running a venture consumes scarce management resources, diluting an organization's focus on its social programs. Consider what happened to an agency we worked with that provides training and support to the disabled. It opened a medical supplies store that proved to be chronically unprofitable – direct costs were routinely more than two times revenue. The store took up more and more of the agency's time and energy as the nonprofit's management team made "figuring out this issue" one of its highest priorities. Yet the store was doing little to fulfill the organization's mission. Only a small

A nonprofit that had simply intended to offer Internet access to teenagers was building a money-losing conglomerate encompassing property management and food service.

percentage of the agency's targeted beneficiaries shopped there. It drew only about 25 customers a week and was competing with at least ten other large stores. After ten difficult years, the agency shut down the venture.

In cases where a clear mission fit is identified, fulfilling the mission's goals through the earned-income venture may be more difficult than envisioned. One job-training organization that focused on serving the homeless wanted to expand the types of training it provided. A major soft drink company offered it the opportunity to run a distribution venture. Enthusiastic about training its beneficiaries in truck driving and enchanted by a partnership with a major corporation, the nonprofit jumped in with both feet. Unfortunately, few of its homeless clients had or could get driver's licenses. To this day, the organization has trouble hiring its target beneficiaries into the venture.

Putting Mission First

Given the low likelihood that earned-income ventures will contribute significant funds and the substantial likelihood that they will hamper the pursuit of a social mission, we urge nonprofits to ask themselves the following questions.

Rather than start with the venture's financial potential, begin with its mission contribution. Ask:

1) What set of mission-focused activities should be our highest priorities?

2) If we had additional, unrestricted philanthropic dollars, would these activities still be our top priorities? In other words, have we made an impartial assessment of our mission priorities?

3) Do any of these activities have the potential to generate earned income? If so, which ones do and how would they do it?

4) Would generating earned income in this manner materially compromise our mission, perhaps by excluding some of our target beneficiaries from the goods or services we sell? How much management time and other resources would the venture probably consume? What's the worst-case scenario for the venture, and what would that scenario mean for our mission and finances?

If, after these questions have been answered, the opportunity still seems promising, then ask:

5) Taking into account any constraints or disadvantages we would have in running a commercial enterprise, what is a preliminary but reasonable estimate of the financial potential for each activity (for example, "The venture might be able to cover half its costs")? Have we fully accounted for all direct and indirect costs in estimating profit (management salaries, facility costs, other overhead)?

6) What additional amount of philanthropic funding would be needed to fully finance the activity?

7) Given the estimated philanthropic requirements of each activity (full cost minus realistic earned-income contribution), which activities deliver the most mission-related impact per philanthropic dollar? (A mission-promoting activity that covers half its costs through earned income could have more impact per philanthropic dollar than a less mission-focused activity that covers three-quarters of its costs.)

8) Would other new or existing activities that don't earn income bring a greater impact per philanthropic dollar contributed?

Such a mission-first approach might lead nonprofits' executives to overlook an enormously attractive business opportunity that isn't mission related. But our experience suggests that such opportunities are few and far between and that the overenthusiastic pursuit of doomed ventures is much more common. The kind of analysis we are proposing can help nonprofits avoid such missteps by imposing rigorous discipline on the evaluation of opportunities. The risk of mission drift and wasted funds will be considerably reduced.

A mission-first assessment of earned-income opportunities also returns the nonprofit sector to its fundamental principles. The reason nonprofits are nonprofits is that the marketplace does not take adequate care of the needs they address. If the most promising mission-based programs are able to generate some earned income, of course they should. For the vast majority of nonprofits, however, that is not a pathway to financial health or to mission accomplishment.

The allure of earned income is understandable, considering the way philanthropy is often practiced today. In many cases, the impulse that leads nonprofits' leaders to search for earned income is their passionate commitment to their organizations' missions; they want to help the organizations escape the challenge – and often the enormous frustration – of attracting the necessary philanthropic support. Most grants are small, short-lived, and restricted to specific uses. Earned income is precious because it comes with no strings attached. It can be used for whatever purpose the nonprofit's leaders deem most important, including operating support for programs that have proven their worth and "overhead" such as managerial talent and development that philanthropic and government funding typically do not cover.

Nevertheless, executives of nonprofit organizations should not be encouraged to search for a holy grail of earned income in the marketplace. Sending social service agencies down that path jeopardizes those who benefit from their programs – and it harms society itself, which depends for its well-being on a vibrant and mission-driven nonprofit sector.

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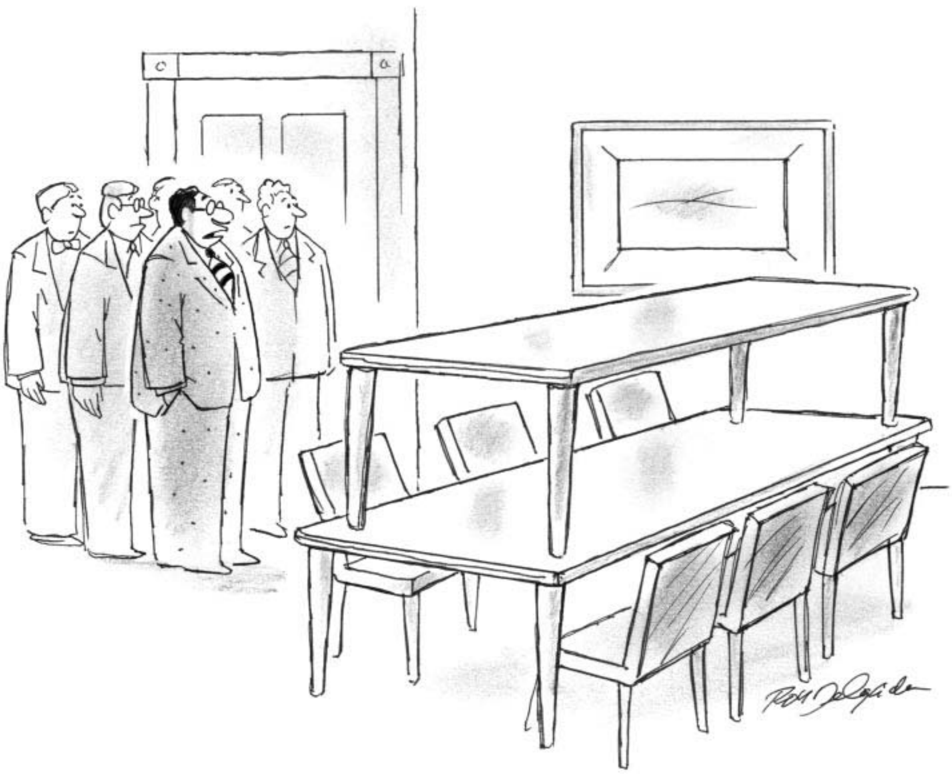

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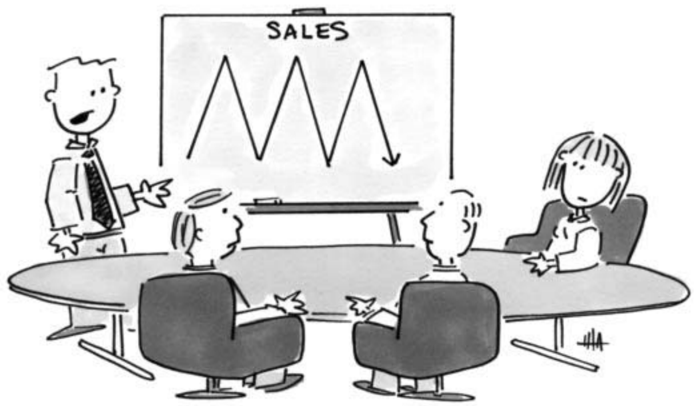

"...and then another drop this month. But I have a really good feeling about next month."

"In keeping with our team approach, we've traded you for two middle managers to be named later."

"This might be the most powerful tool yet to separate a fool from his money."

Change Through Persuasion

by David A. Garvin and Michael A. Roberto

Leaders can make change happen only if they have a coherent strategy for persuasion. The impressive turnaround at a world-renowned teaching hospital shows how to plan a change campaign – and carry it out.

FACED WITH THE NEED for massive change, most managers respond predictably. They revamp the organization's strategy, then round up the usual set of suspects – people, pay, and processes – shifting around staff, realigning incentives, and rooting out inefficiencies. They then wait patiently for performance to improve, only to be bitterly disappointed. For some reason, the right things still don't happen.

Why is change so hard? First of all, most people are reluctant to alter their habits. What worked in the past is good enough; in the absence of a dire threat, employees will keep doing what they've always done. And when an

NICK DEWAR

organization has had a succession of leaders, resistance to change is even stronger. A legacy of disappointment and distrust creates an environment in which employees automatically condemn the next turnaround champion to failure, assuming that he or she is "just like all the others." Calls for sacrifice and self-discipline are met with cynicism, skepticism, and knee-jerk resistance.

Our research into organizational transformation has involved settings as diverse as multinational corporations, government agencies, nonprofits, and high-performing teams like mountaineering expeditions and firefighting crews. We've found that for change to stick, leaders must design and run an effective persuasion campaign – one that begins weeks or months before the actual turnaround plan is set in concrete. Managers must perform significant work up front to ensure that employees will actually listen to tough messages, question old assumptions, and consider new ways of working. This means taking a series of deliberate but subtle steps to recast employees' prevailing views and create a new context for action. Such a shaping process must be actively managed during the first few months of a turnaround, when uncertainty is high and setbacks are inevitable. Otherwise, there is little hope for sustained improvement.

Like a political campaign, a persuasion campaign is largely one of differentiation from the past. To the typical change-averse employee, all restructuring plans look alike. The trick for turnaround leaders is to show employees precisely how their plans differ from their predecessors'. They must convince people that the organization is truly on its deathbed – or, at the very least, that radical changes are required if it is to survive and thrive. (This is a particularly difficult challenge when years of persistent problems have been accompanied by few changes in the status quo.) Turnaround leaders must also gain trust by demonstrating through word and deed that they are the right leaders for the job and must convince employees that theirs is the correct plan for moving forward.

Accomplishing all this calls for a four-part communications strategy. Prior to announcing a policy or issuing a set of instructions, leaders need to set the stage for acceptance. At the time of delivery, they must create the frame through which information and messages are interpreted. As time passes, they must manage the mood so that employees' emotional states support implementation and follow-through. And at critical intervals, they must provide reinforcement to ensure that the desired changes take hold without backsliding.

In the pages that follow, we describe this process in more detail, drawing on the example of the turnaround of Beth Israel Deaconess Medical Center (BIDMC) in Boston. Paul Levy, who became CEO in early 2002, managed to bring the failing hospital back from the brink of ruin. We had ringside seats during the first six months of the turnaround. Levy agreed to hold videotaped interviews with us every two to four weeks during that period as we prepared a case study describing his efforts. He also gave us access to his daily calendar, as well as to assorted e-mail correspondence and internal memorandums and reports. From this wealth of data, we were able to track the change process as it unfolded, without the usual biases and distortions that come from 20/20 hindsight. The story of how Levy tilled the soil for change provides lessons for any CEO in a turnaround situation.

Like a political campaign, a persuasion campaign is largely one of differentiation from the past.

Setting the Stage

Paul Levy was an unlikely candidate to run BIDMC. He was not a doctor and had never managed a hospital, though he had previously served as the executive dean for administration at Harvard Medical School. His claim to fame was his role as the architect of the Boston Harbor Cleanup, a multibillion-dollar pollution-control project that he had led several years earlier. (Based on this experience, Levy identified a common yet insidiously destructive organizational dynamic that causes dedicated teams to operate in counterproductive ways, which he described in "The Nut Island Effect: When Good Teams Go Wrong," March 2001.) Six years after completing the Boston Harbor project, Levy approached the BIDMC board and applied for the job of cleaning up the troubled hospital.

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Despite his lack of hospital management experience, Levy was appealing to the board. The Boston Harbor Cleanup was a difficult, highly visible change effort that required deft political and managerial skills. Levy had stood firm in the face of tough negotiations and often-heated public resistance and had instilled accountability in city and state agencies. He was also a known quantity to the board, having served on a BIDMC steering committee formed by the board chairman in 2001.

Levy saw the prospective job as one of public service. BIDMC was the product of a difficult 1996 merger between two hospitals – Beth Israel and Deaconess – each of which had distinguished reputations, several best-in-the-world departments and specializations, and deeply devoted staffs. The problems began after the merger. A misguided focus on clinical practice rather than backroom integration, a failure to cut costs, and the repeated inability to execute plans and adapt to changing conditions in the health care marketplace all contributed to BIDMC's dismal performance.

By the time the board settled on Levy, affairs at BIDMC had reached the nadir. The hospital was losing $50 million a year. Relations between the administration and medical staff were strained, as were those between management and the board of directors. Employees felt demoralized, having witnessed the rapid decline in their institution's once-legendary status and the disappointing failure of its past leaders. A critical study was conducted by the Hunter Group, a leading health-care consulting firm. The report, detailing the dire conditions at the hospital and the changes needed to turn things around, had been completed but not yet released. Meanwhile, the state attorney general, who was responsible for overseeing charitable trusts, had put pressure on the board to sell the failing BIDMC to a for-profit institution.

Like many CEOs recruited to fix a difficult situation, Levy's first task was to gain a mandate for the changes ahead. He also recognized that crucial negotiations were best conducted before he took the job, when his leverage was greatest, rather than after taking the reins. In particular, he moved to secure the cooperation of the hospital board by flatly stating his conditions for employment. He told the directors, for example, that should they hire him, they could no longer interfere in day-to-day management decisions. In his second and third meetings with the board's search committee, Levy laid out his timetable and intentions. He insisted that the board decide on his appointment quickly so that he could be on the job before the release of the Hunter report. He told the committee that he intended to push for a smaller, more effective group of directors. Though the conditions were somewhat unusual, the board was convinced that Levy had the experience to lead a successful turnaround, and they accepted his terms. Levy went to work on January 7, 2002.

The next task was to set the stage with the hospital staff. Levy was convinced that the employees, hungry for a turnaround, would do their best to cooperate with him if he could emulate and embody the core values of the hospital culture, rather than impose his personal values. He chose to act as the managerial equivalent of a good doctor–that is, as one who, in dealing with a very ill patient, delivers both the bad news and the chances of success honestly and imparts a realistic sense of hope, without sugar coating.

Like any leader facing a turnaround, Levy also knew he had to develop a bold message that provided compelling reasons to do things differently and then cast that message in capital letters to signal the arrival of a new order. To give his message teeth, he linked it to an implicit threat. Taking his cue from his private discussions with the state attorney general, whom he had persuaded to keep the hospital open for the time being, Levy chose to publicize the very real possibility the hospital would be sold. While he realized he risked frightening the staff and the patients with this bad news, he believed that a strong wake-up call was necessary to get employees to face up to the situation.

During his first morning on the job, Levy delivered an all-hands-on-deck e-mail to the staff. The memo contained four broad messages. It opened with the good news, pointing out that the organization had much to be proud of ("This is a wonderful institution, representing the very best in academic medicine: exemplary patient care, extraordinary research, and fine teaching"). Second, Levy noted that the threat of sale was real ("This is our last chance"). Third, he signaled the kinds of actions employees could expect him to take ("There will be a reduction in staff"). And finally, he described the open management style he would adopt. He would manage by walking around–lunching with staff in the cafeteria, having impromptu conversations in the hallways, talking with employees at every opportunity to discover their concerns. He would communicate directly with employees through e-mail rather than through intermediaries. He also noted that the Hunter report would be posted on the hospital intranet, where all employees would have the opportunity to review its recommendations and submit comments for the final turnaround plan. The direct, open tone of the e-mail memo signaled exactly how Levy's management style would differ from that of his predecessors.

In the afternoon, he disclosed BIDMC's situation in interviews with the *Boston Globe* and the *Boston Herald,* the city's two major newspapers. He told reporters the same thing he had told the hospital's employees: that, in the absence of a turnaround, the hospital would be sold to a for-profit chain and would therefore lose its status as a Harvard teaching hospital. Staving off a sale would require tough measures, including the laying off of anywhere from 500 to 700 employees. Levy insisted that there would be no nursing layoffs, in keeping with the hospital's core values of high-quality patient care. The newspaper reports, together with the memo circulated that morning, served to immediately reset employee expectations while dramatically increasing staff cooperation and willingness to accept whatever new initiatives might prove necessary to the hospital's survival.

Two days later, the critical Hunter report came out and was circulated via the hospital's intranet. Because the report had been produced by an objective third party, employees were open to its unvarnished, warts-and-all view of the hospital's current predicament. The facts were stark, and the staff could no longer claim ignorance. Levy received, and personally responded to, more than 300 e-mail suggestions for improvement in response to the report, many of which he later included in the turnaround plan.

Creating the Frame

Once the stage has been set for acceptance, effective leaders need to help employees interpret proposals for change. Complex plans can be interpreted in any number of ways; not all of them ensure acceptance and favorable outcomes. Skilled leaders therefore use "frames" to provide context and shape perspective for new proposals and plans. By framing the issues, leaders help people digest ideas in particular ways. A frame can take many forms: It can be a companywide presentation that prepares employees before an unexpected change, for example, or a radio interview that provides context following an unsettling layoff.

Levy used one particularly effective framing device to help employees interpret a preliminary draft of the turnaround plan. This device took the form of a detailed e-mail memo accompanying the dense, several-hundred-page plan. The memo explained, in considerable detail, the plan's purpose and expected impact.

The first section of the memo sought to mollify critics and reduce the fears of doctors and nurses. Its tone was positive and uplifting; it discussed BIDMC's mission, strategy, and uncompromising values, emphasizing the hospital's "warm, caring environment." This section of the letter also reaffirmed the importance of remaining an academic medical center, as well as reminding employees of their shared mission and ideals. The second part of the letter told employees what to expect, providing further details about the turnaround plan. It emphasized that tough measures and goals would be required but noted that the specific recommendations were based, for the most part, on the advice in the Hunter report, which employees had already reviewed. The message to employees was, "You've already seen and endorsed the Hunter report. There are no future surprises."

The third part of the letter anticipated and responded to prospective concerns; this had the effect of circumventing objections. This section explicitly diagnosed past plans and explained their deficiencies, which were largely due to their having been imposed top-down, with little employee ownership, buy-in, or discussion. Levy then offered a direct interpretation of what had gone wrong. Past plans, he said, had underestimated the size of the financial problem, set unrealistic expectations for new revenue growth, and failed to test implementation proposals. This section of the letter also drove home the need for change at a deeper, more visceral level than employees had

Dysfunctional Routines

SIX WAYS TO STOP CHANGE IN ITS TRACKS

Just as people are creatures of habit, organizations thrive on routines. Management teams, for example, routinely cut budgets after performance deviates from plan. Routines – predictable, virtually automatic behaviors – are unstated, self-reinforcing, and remarkably resilient. Because they lead to more efficient cognitive processing, they are, for the most part, functional and highly desirable.

Dysfunctional routines, by contrast, are barriers to action and change. Some are outdated behaviors that were appropriate once but are now unhelpful. Others manifest themselves in knee-jerk reactions, passivity, unproductive foot-dragging, and, sometimes, active resistance.

Dysfunctional routines are persistent, but they are not unchangeable. Novelty – the perception that current circumstances are truly different from those that previously prevailed – is one of the most potent forces for dislodging routines. To overcome them, leaders must clearly signal that the context has changed. They must work directly with employees to recognize and publicly examine dysfunctional routines and substitute desired behaviors.

A culture of "no."

In organizations dominated by cynics and critics, there is always a good reason not to do something. Piling on criticism is an easy way to avoid taking risks and claim false superiority. Lou Gerstner gets credit for naming this routine, which he found on his arrival at IBM, but it is common in many organizations. Another CEO described her team's response to new initiatives by likening it to a skeet shoot: "Someone would yell, 'Pull!' there would be a deafening blast, and the idea would be in pieces on the ground." This routine has two sources: a culture that overvalues criticism and analysis, and complex decision-making processes requiring multiple approvals, in which anybody can say "no" but nobody can say "yes." It is especially likely in organizations that are divided into large subunits or segments, led by local leaders with great power who are often unwilling to comply with directives from above.

The dog and pony show must go on.

Some organizations put so much weight on process that they confuse ends and means, form and content. How you present a proposal becomes more important than what you propose. Managers construct presentations carefully and devote large amounts of time to obtaining sign-offs. The result is death by PowerPoint. Despite the appearance of progress, there's little real headway.

The grass is always greener.

To avoid facing challenges in their core business, some managers look to new products, new services, and new lines of business. At times, such diversification is healthy. But all too often these efforts are merely an avoidance tactic that keeps tough problems at arm's length.

After the meeting ends, debate begins.

This routine is often hard to spot because so much of it takes place under cover. Cordial, apparently cooperative meetings are followed by resistance. Sometimes, resisters are covert; often, they end-run established forums entirely and take their concerns directly to the top. The result? Politics triumphs over substance, staff meetings become empty rituals, and meddling becomes the norm.

Ready, aim, aim...

Here, the problem is the organization's inability to settle on a definitive course of action. Staff members generate a continual stream of proposals and reports; managers repeatedly tinker with each one, fine-tuning their choices without ever making a final decision. Often called "analysis paralysis," this pattern is common in perfectionist cultures where mistakes are career threatening and people who rock the boat drown.

This too shall pass.

In organizations where prior leaders repeatedly proclaimed a state of crisis but then made few substantive changes, employees tend to be jaded. In such situations, they develop a heads-down, bunker mentality and a reluctance to respond to management directives. Most believe that the wisest course of action is to ignore new initiatives, work around them, or wait things out.

experienced in the past. It emphasized that this plan was a far more collective effort than past proposals had been, because it incorporated many employee suggestions.

By framing the turnaround proposal this way, Levy accomplished two things. First, he was able to convince employees that the plan belonged to them. Second, the letter served as the basis for an ongoing communication platform. Levy reiterated its points at every opportunity–not only with employees but also in public meetings and in discussions with the press.

Managing the Mood

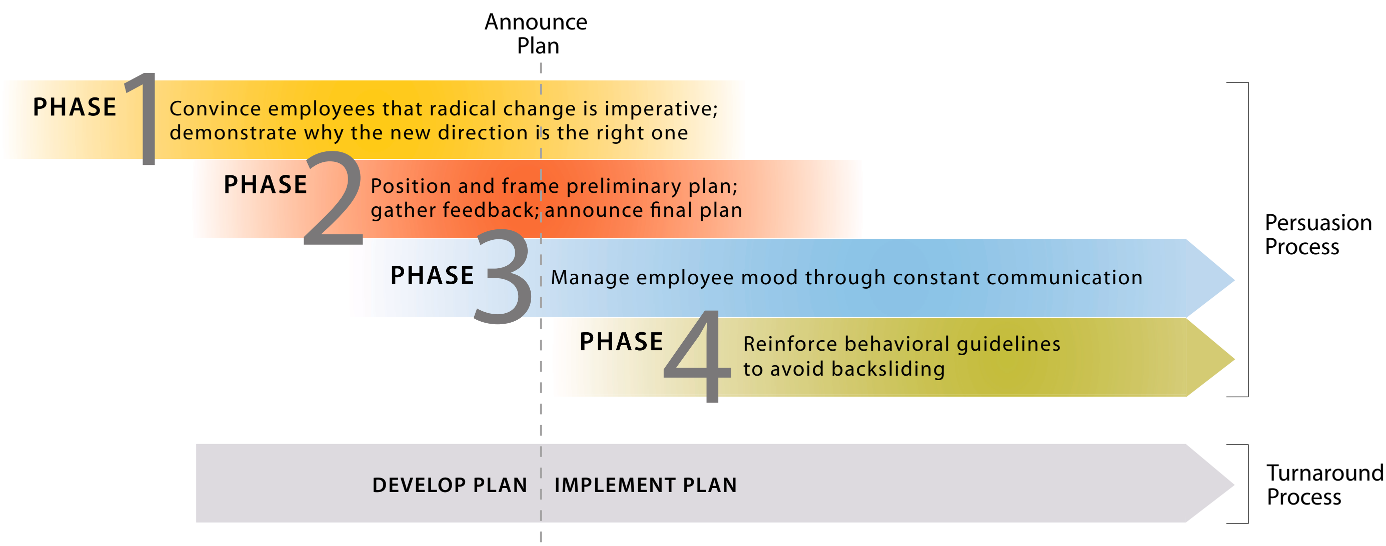
Turnarounds are depressing events, especially when they involve restructuring and downsizing. Relationships are disrupted, friends move on, and jobs disappear. In such settings, managing the mood of the organization becomes an essential leadership skill. Leaders must pay close attention to employees' emotions–the ebb and flow of their feelings and moods–and work hard to preserve a receptive climate for change. Often, this requires a delicate balancing act between presenting good and bad news in just the right proportion. Employees need to feel that their sacrifices have not been in vain and that their accomplishments have been recognized and rewarded. At the same time, they must be reminded that complacency is not an option. The communication challenge is daunting. One must strike the right notes of optimism and realism and carefully calibrate the timing, tone, and positioning of every message.

Paul Levy's challenge was threefold: to give remaining employees time to grieve and recover from layoffs and other difficult measures; to make them feel that he cared for and supported them; and to ensure that the turnaround plan proceeded apace. The process depended on mutual trust and employees' desire to succeed. "I had to calibrate the push and pull of congratulations and pressure, but I also depended on the staff's underlying value system and sense of mission," he said. "They were highly motivated, caring individuals who had stuck with the place through five years of hell. They wanted to do good."

The first step was to acknowledge employees' feelings of depression while helping them look to the future. Immediately after the first round of layoffs, people were feeling listless and dejected; Levy knew that releasing the final version of the turnaround plan too soon after the layoffs could be seen as cold. In an e-mail he sent to all employees a few days later, Levy explicitly empathized

The Four Phases of a Persuasion Campaign

A typical turnaround process consists of two stark phases: plan development, followed by an implementation that may or may not be welcomed by the organization. For the turnaround plan to be widely accepted and adopted, however, the CEO must develop a separate persuasion campaign, the goal of which is to create a continuously receptive environment for change. The campaign begins well before the CEO's first day on the job–or, if the CEO is long established, well before formal development work begins–and continues long after the final plan is announced.



The toughest challenge faced by leaders during a turnaround is to **avoid backsliding** into dysfunctional routines.

with employees' feelings ("This week is a sad one…it is hard for those of us remaining…offices are emptier than usual"). He then urged employees to look forward and concluded on a strongly optimistic note ("…our target is not just survival: It is to thrive and set an example for what a unique academic medical center like ours means for this region"). His upbeat words were reinforced by a piece of good luck that weekend when the underdog New England Patriots won their first Super Bowl championship in dramatic fashion in the last 90 seconds of the game. When Levy returned to work the following Monday, employees were saying, "If the Patriots can do it, we can, too."

The next task was to keep employees focused on the continuing hard work ahead. On April 12, two months into the restructuring process, Levy sent out a "Frequently Asked Questions" e-mail giving a generally favorable view of progress to date. At the same time, he spoke plainly about the need to control costs and reminded employees that merit pay increases would remain on hold. This was hardly the rosy picture that most employees were hoping for, of course. But Levy believed sufficient time had passed that employees could accommodate a more realistic and tough tone on his part.

A month later, everything changed. Operational improvements that were put in place during the first phase of the turnaround had begun to take hold. Financial performance was well ahead of budget, with the best results since the merger. In another e-mail, Levy praised employees lavishly. He also convened a series of open question-and-answer forums, where employees heard more details about the hospital's tangible progress and received kudos for their accomplishments.

Reinforcing Good Habits

Without a doubt, the toughest challenge faced by leaders during a turnaround is to avoid backsliding into dysfunctional routines–habitual patterns of negative behavior by individuals and groups that are triggered automatically and unconsciously by familiar circumstances or stimuli. (For more on how such disruptive patterns work, see the sidebar "Dysfunctional Routines: Six Ways to Stop Change in Its Tracks.") Employees need help maintaining new behaviors, especially when their old ways of working are deeply ingrained and destructive. Effective change leaders provide opportunities for employees to practice desired behaviors repeatedly, while personally modeling new ways of working and providing coaching and support.

In our studies of successful turnarounds, we've found that effective leaders explicitly reinforce organizational values on a constant basis, using actions to back up their words. Their goal is to change behavior, not just ways of thinking. For example, a leader can talk about values such as openness, tolerance, civility, teamwork, delegation, and direct communication in meetings and e-mails. But the message takes hold only if he or she also signals a dislike of disruptive, divisive behaviors by pointedly–and, if necessary, publicly–criticizing them.

At Beth Israel Deaconess Medical Center, the chiefs of medicine, surgery, orthopedics, and other key functions presented Levy with special behavioral challenges, particularly because he was not a doctor. Each medical chief was in essence a "mini-dean," the head of a largely self-contained department with its own faculty, staff, and resources. As academic researchers, they were rewarded primarily for individual achievement. They had limited experience solving business or management problems.

In dealing with the chiefs, Levy chose an approach that blended with a strong dose of discipline with real-time, public reinforcement. He developed guidelines for behavior and insisted that everyone in the hospital measure up to them. In one of his earliest meetings with the chiefs, Levy presented a simple set of "meeting rules," including such chestnuts as "state your objections" and "disagree without being disagreeable," and led a discussion about them, demonstrating the desired behaviors through his own leadership of the meeting. The purpose of these rules was to introduce new standards of interpersonal behavior and, in the process, to combat several dysfunctional routines.

One serious test of Levy's ability to reinforce these norms came a month and a half after he was named CEO. After a staff meeting at which all the department chairs were present, one chief–who had remained silent–sent an e-mail to Levy complaining about a decision made during the meeting. The e-mail copied the other chiefs as well as the chairman of the board. Many CEOs would choose to criticize such behavior privately. But Levy responded in an e-mail to the same audience, publicly denouncing the chief for his tone, his lack of civility, and his failure to speak up earlier in the process, as required by the new meeting rules. It was as close to a public hanging as anyone could get. Several of the chiefs privately expressed their support to Levy; they too had been offended by their peer's presumptuousness. More broadly, the open criticism served to powerfully reinforce new norms while curbing disruptive behavior.

Even as they must set expectations and reinforce behaviors, effective change leaders also recognize that many employees simply do not know how to make decisions as a group or work cooperatively. By delegating critical decisions and responsibilities, a leader can provide employees with ample opportunities to practice new ways of working; in such cases, employees' performance should be evaluated as much on their adherence to the new standards and processes as on their substantive choices. In this spirit, Levy chose to think of himself primarily as a kind of appeals court judge. When employees came to him seeking his intervention on an issue or situation, he explained, he would "review the process used by the 'lower court' to determine if it followed the rules. If so, the decision stands." He did not review cases de novo and substitute his judgment for that of the individual department or unit. He insisted that employees work through difficult issues themselves, even when they were not so inclined, rather than rely on him to tell them what to do. At other times, he intervened personally and coached employees when they lacked basic skills. When two members of his staff disagreed on a proposed course of action, Levy triggered an open, emotional debate, then worked with the participants and their bosses behind the scenes to resolve the differences. At the next staff meeting, he praised the participants' willingness to disagree publicly, reemphasizing that vigorous debate was healthy and desirable and that confrontation was not to be avoided. In this way, employees gained experience in working through their problems on their own.

Performance, of course, is the ultimate measure of a successful turnaround. On that score, BIDMC has done exceedingly well since Levy took the helm. The original restructuring plan called for a three-year improvement process, moving from a $58 million loss in 2001 to break-even in 2004. At the end of the 2004 fiscal year, performance was far ahead of plan, with the hospital reporting a $37.4 million net gain from operations. Revenues were up, while costs were sharply reduced. Decision making was now crisper and more responsive, even though there was little change in the hospital's senior staff or medical leadership. Morale, not surprisingly, was up as well. To take just one indicator, annual nursing turnover, which was 15% to 16% when Levy became CEO, had dropped to 3% by mid-2004. Pleased with the hospital's performance, the board signed Levy to a new three-year contract.

Heads, Hearts, and Hands

It's clear that the key to Paul Levy's success at Beth Israel Deaconess Medical Center is that he understood the importance of making sure the cultural soil had been made ready before planting the seeds of change. In a receptive environment, employees not only understand why change is necessary; they're also emotionally committed to making it happen, and they faithfully execute the required steps.

On a cognitive level, employees in receptive environments are better able to let go of competing, unsubstantiated views of the nature and extent of the problems facing their organizations. They hold the same, objective views of the causes of poor performance. They acknowledge the seriousness of current financial, operational, and marketplace difficulties. And they take responsibility for their own contributions to those problems. Such a shared, fact-based diagnosis is crucial for moving forward.

On an emotional level, employees in receptive environments identify with the organization and its values and are committed to its continued existence. They believe that the organization stands for something more than profitability, market share, or stock performance and is therefore worth saving. Equally important, they trust the leader, believing that he or she shares their values and will fight to preserve them. Leaders earn considerable latitude from employees – and their proposals usually get the benefit of the doubt – when their hearts are thought to be in the right place.

Workers in such environments also have physical, hands-on experience with the new behaviors expected of them. They have seen the coming changes up close and understand what they are getting into. In such an atmosphere where it's acceptable for employees to wrestle with decisions on their own and practice unfamiliar ways of working, a leader can successfully allay irrational fears and undercut the myths that so often accompany major change efforts.

There is a powerful lesson in all this for leaders. To create a receptive environment, persuasion is the ultimate tool. Persuasion promotes understanding; understanding breeds acceptance; acceptance leads to action. Without persuasion, even the best of turnaround plans will fail to take root.

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The HBR Interview
Heinrich von Pierer

Transforming an Industrial GIANT

Interviewed by Thomas A. Stewart and Louise O'Brien

PHOTO COURTESY OF SIEMENS

Changing the culture of a corporate icon like Siemens is the challenge of a lifetime – especially because a German CEO must persuade rather than command.

IN HIS 12 YEARS at the helm of Siemens, CEO Heinrich von Pierer has designed and directed a major transformation. Taking this German icon from a technically superb but slow-moving industrial giant to a disciplined, nimble multinational has posed enormous challenges. Since 1992, Siemens has revamped its portfolio of businesses, expanded its reach into 192 countries, and created a more local-market-driven culture, gaining recognition as one of the best-managed and most competitive companies in the world. In this edited interview with HBR editor Thomas A. Stewart and consulting editor Louise O'Brien, von Pierer describes the requirements for transformation and how he broke down historical barriers at Siemens. He shares his insights about portfolio restructuring, his lessons from competing with GE, and the pros and cons of being based in Europe versus America.

Let's start at the beginning. Why do you think you were chosen to be CEO of Siemens?

I was not the typical candidate or the most experienced guy. But I think my background was different, and the board was looking for someone different. Siemens was an introverted, some would say arrogant, company, particularly in Germany, where 50% of our business and more than 50% of the people were still located at that time. It was a German-driven company, and I think they wanted somebody who was able to communicate better, both internally and externally.

For 18 years–from 1972 to 1990–I was an elected member of the city council in my hometown of Erlangen. I had a lot of fun being in opposition–where the only way to influence things was to convince the other side. Once, I tried to become a member of the Federal Parliament, but I lost by one vote in my party's preelection. So I had to stay with Siemens. That's how I know it's easier to become CEO of Siemens than it is to become a member of the Federal Parliament of Germany!

I am also the only CEO in Germany who is a member of a works council [German labor union]. I bought several factories in East Germany after reunification, and I was made an honorary member of one of their works councils. While I don't have the right to vote, I can actively participate in meetings.

So, although I never really worked in the forefront of politics, I think my experience helped me see the big picture. And at Siemens, the board knew that. They said, "Well, if we want to show a better face to the public, then he's the guy."

What did the world look like when you took over as CEO in 1992?

In 1989, when the Berlin wall came down, we were excited to be celebrating the reunification of Germany. We did not realize something more important: The collapse of the Eastern Bloc was more or less the beginning of globalization. And a global marketplace at that time meant that prices really came down. That's a nice mild phrase to describe what happened. Prices started falling in '89, and the decline became more brutal over time. The prices in some of our businesses dropped by 50% in three years.

Thomas A. Stewart is HBR's editor; Louise O'Brien is a consulting editor at HBR.

A year or so after I took over as CEO, a friend I have a lot of respect for asked me, "Do you know that in your annual report you use the term 'price erosion' 13 times? Is this an excuse?" And it came to me suddenly that it was really an excuse, as if we were saying, "Our company's in bad shape because other people are behaving unreasonably." Complaining about price erosion didn't do us any good. So this comment from my friend was an awakening. He was right, and I knew that our company needed to change.

How did you know where to begin?

You have to do a lot of things at once. That is an important idea: You cannot transform a company along only one dimension. You have to work on all of them at the same time and in a coherent manner. So, we developed our *top*+ program, which concentrates on three things: cost reduction, innovation, and growth.

To compete in the new global economy, we had to reduce our costs dramatically. But innovation had always been an advantage for Siemens, and without that we could not differentiate ourselves from the pure low-cost players in developing countries. We also launched aggressive growth initiatives in Asia and the United States. Since 1995, we've invested over $10 billion in the U.S., and it is now our second-largest market. Wherever we can do something in the United States, we do it. It is still the biggest market in the world, and a very competitive market. Succeeding in the U.S. was critical to becoming more competitive as a company. On the other hand, our margins in the U.S. are higher than in Europe because of differences in cost position.

I also knew if we were not successful in the U.S., we would never achieve the necessary growth for Siemens. So we tailored a *top*+ U.S. business initiative for the region to focus on improving operational performance, increasing profitability, and acting as one Siemens to generate greater cross selling among our operating companies. Our success would rest on two things: first, our ability to create synergies within our portfolio of businesses, and, second, our ability to continue innovating.

In many fields, America is where "the music is playing" as far innovation is concerned. If you look at U.S. patent statistics for the year 2003, you won't believe it: Siemens, in GE's home country, got more patents than GE. We are always number one in Germany, and typically number

> "A FRIEND ASKED ME, 'Do you know that in your annual report you use the term "price erosion" 13 times?'…It came to me suddenly that it was really an excuse."

one or two in Europe, but in the U.S. we are now among the ten biggest patent holders. We both benefit from the U.S. knowledge base and also contribute to it.

Was your transformation more challenging than it would have been if you'd been leading an American company?
A CEO in Germany is different than a CEO in the United States. A CEO in America can give instructions. A CEO in Germany is a member of the board. Nobody has to report to him – that's a big difference. So you need a lot of people supporting you, and this requires communication and negotiation, convincing people. You have to, as I say, emotionalize people – which contrasts with the more traditional command-and-control approach you find at many American companies.

Based on your experience, what are the most important requirements for achieving a corporate transformation?
In addition to cost cutting, innovation, and growth (the three elements of *top*+), the fourth requirement for transformation is culture change. We got this term from the Americans because it didn't exist in German.

Some people told me when I started, "It's nice to talk about culture change, but how long do you think it will take until you really achieve something?"

I said, "Well, two years."

"Young friend," they laughed, "it will take ten years." Unfortunately, they were right.

This was the first time we'd started such a comprehensive program at Siemens, and it was not easy. When I came in as CEO, I was the youngest member of the management team. The rest were older men who had made contributions but were not necessarily interested in making any radical changes. Some of them supported our new goals, but culture change has to be more than talk. You can tell people they need to be more profit oriented, more technology driven, more market driven, but in my experience, if you don't face a crisis, it is difficult to get people to believe you. All of the groups at Siemens that are now very successful went through some kind of crisis.

For example, six or seven years ago, the medical group was losing money. Then the FDA barred us from supplying new products to the U.S. because we had not documented all our work to the FDA's requirements. And so we had to reinvent what we had already invented in order to document it. This was a crisis. We lost more than two years, and the financial analysts told me, "You will never make it with the medical group. Sell it."

Siemens Then & Now

	1992	2004
Revenues	€41 billion	€75 billion
Net Income	€1 billion	€3.4 billion
Revenue per Employee	€99,000	€174,000
Percentage of Workforce in Germany	61%	38%

But I believed in the people. I believed in the strength and the long tradition of this business. So I said, "No, we won't sell." Instead, we cut costs and devoted more resources to innovation, growth initiatives, and culture change. There were no shades of gray. I remember when I went to management meetings, there were 200 people in the room, and I told them, "Look, you will not be sitting here in two years if you don't change."

So culture change is one requirement for transformation, crisis is another. But most important of all was to bring the workers' representatives on board. These people had been with Siemens for many years and had survived numerous cycles. To convince them was the most critical part of our mission. And it took a long time.

We held town hall meetings where I'd speak to 200, or sometimes as many as 3,000, people. Town hall meetings are a good way not only to communicate, encourage, and engage people but also to stress a sense of urgency that they need to accelerate their efforts to make a profit. I played cards with the works council representatives and would even take money away from them. But these informal games gave us time to build trust and a deeper understanding of what was at stake for the company. This guy – I will never forget it – the head of the works council, who is also the deputy chairman of Siemens' supervisory board in Germany, said to his people, "Without the *top*+ program we would be dead." It sounds better in German: *"Ohne top – waren tot."* So, we got strong support from our works council, and I credit the time we both dedicated to understanding what needed to be done.

A final thing that was important was to learn from other companies. We studied the products of all our competitors, but to learn how to run a company, we've taken the most from GE, because it is a diversified company like Siemens.

What did you learn from GE?
First was the very simple message: Be number one or number two in each business, or you will *not* be successful. You can't make it with a portfolio of small businesses. Jack Welch said this before globalization started. We said it afterwards. So we adopted a fix, close, or sell attitude. Except that we added *cooperate* – because there were some businesses, like computers, that, while small, were integral to other larger Siemens businesses, and so we did not want to sell and needed to make an alliance.

The second thing I admired about GE is that people are really the most important thing. I always wondered why they have such excellent people. Was it just that they pay more in the U.S.? I realized it was their people development program–Session C. Jack Welch called it the engine of change for GE. Siemens had an institution near Munich that was similar to Crotonville [GE's training center in New York]. It was a good place for networking, and our young people learned something there. But it was really just an institution, not an engine of change. So we developed our SMR, or Siemens Management Review, based on Session C. Just like at GE, the CEO is involved in all of it. And all the segments and countries are involved. Everyone has to buy in, because you can make people participate, but if it doesn't come from the heart, then the content is worth nothing.

Another thing we learned from GE was how to get the most out of our annual worldwide business conference. Siemens had traditionally held this meeting in July, right before the European holiday season. It would be a bit of an exaggeration to say that it was just a social event, but that was a big part. However, I saw that GE's worldwide business meeting was always held at the beginning of January, and always in the same place. They wanted to send their people a clear message at the beginning of the year about what they want to achieve. So our meeting now takes place the first week of October–to kick off the start of our fiscal year–and it is always in Berlin. This sends a clear message to our people.

We also adopted GE's quarterly business unit meetings. Board members participate, and a few people from corporate–but only a few. The number is really limited because I didn't want to make this a corporate event. I wanted it to be an event like GE's where the CEOs of the groups have to present their quarterly results, what their major problems are, and what should be done in the next 12 months. We have the guy with the worst results present first. We go from worst to best. Over time, this has really changed things. For example, the guy heading our power business used to be the worst, and now he has the best results. See, if you have to present a negative case in front of the most intelligent and experienced people in the company, everybody knows not to be the first. Let's say not to be on the first day–that's the best thing.

Another tool we adopted from GE was benchmarking–and this helped us quite a lot during the '90s to make our people understand that change was necessary. We benchmark primarily against our best competitor. We do this with our own internal consulting team, a practice that was started by Klaus Kleinfeld, who would later run the U.S. business and will succeed me as CEO soon. We now have 170 people in the group, and they are as good as McKinsey or Boston Consulting. People come to us because they know they will not have to be consultants their whole lives. After three or four years, they can take an operating job–like Klaus and several other current members of our executive committee did–and then they infiltrate the company.

One of the major challenges you faced was restructuring Siemens' portfolio of businesses. How did you go about that, and are you satisfied with the results?

One is never satisfied, of course. In retrospect, there were some things I think we did well, and some things we should have done differently. The three main lessons were in the areas of financial markets, alliances, and the internal political and persuasion process.

First, we did a good job of deciding when we should and should not listen to advice from the financial markets. I talk regularly to the analysts, but in the end, you have to make your own decisions. If we had listened to the financial analysts during the 1990s, we would have sold off most of the company by now. Even in the midst of the crisis, I knew our medical business was stronger than they could know, so I didn't listen to them. "It's a cash machine," I thought, "so why should I sell it?" In that respect, it was helpful to be a German company. Traditionally, German companies have been less responsive to the capital markets, which is often a weakness but in this case benefited us.

Then the power business went through a crisis. Again the financial people told me, "Don't invest." It was a good thing that I had some experience in that business. They said, "There's no growth in power." I said, "Wait a bit. There's overcapacity, and this goes in waves." We'd had trouble with our gas turbines, but this was not so unusual. There are always times when we have technical troubles, and then we recover and go on to make a lot of money. So why should I listen to the financial people? In secrecy, we made the decision to keep the power business and buy Westinghouse Power Corporation, which turned out to be a real success story. In fact, it was one of the smartest moves we made in my time as CEO. So this shows the wisdom of the financial markets, you know?

But of course we had to bring some of our activities to the stock market. One example was semiconductors. It was a very volatile business, and our shareholders did not accept this volatility in our results. What's more, one-third of all our capital spending was going to semiconductors. So I knew this was something we should not continue, and I knew 1998 was the right time to sell. We got a very good deal. The only thing I regret was that we didn't bring 49% instead of 33% to market. We should have exited this business faster.

The second thing we learned is that the right answer isn't always to buy or sell every time you have a technical gap. We have to be more open to cooperation with other companies than people have been in the past. It can be difficult for engineers to accept that they can't do everything alone. It can be difficult for a large company to accept a partnership where it does not dominate. But we have to do both.

We partner with many small and medium-sized companies. In fact, for every 160,000 jobs within Siemens in

Germany, we secure another 160,000 in small and medium-sized companies. And these are not just people cleaning or running a canteen; they are also in high-tech areas like software. I started a software initiative at Siemens because I saw how much money GE made on its service business. So to be more cooperative is something we had to teach people.

Our partnership with Fujitsu in the computer business has worked quite well. We were losing money in computers, and if we wanted to grow the business we would have had to invest billions and probably make an acquisition in the U.S. market. We didn't have the right personnel to do this, and the reaction of the financial markets would have been very negative. So we did a joint venture, and now we no longer lose money in computers.

Our most successful partnership is with Bosch in white goods. Siemens competes with it in the automotive business, and it's a cutthroat competitor. But in white goods, we've had an excellent partnership for 40 years and have been able to transfer the spirit of that cooperation from one generation to the next.

An alliance that has been healthy for 40 years? How have you accomplished that?

Business partnerships don't last if you can't manage the conflicts that will always arise. For example, if one party wants to invest $3 billion in this country and the other party doesn't have the money or doesn't want to invest, then the resulting conflict can break things apart. When you cooperate in one part of the business but have an underlying conflict in other parts of the business – as we do with Bosch – you must be very careful. You can't have people talking about the joint venture who are in competition in other areas. Of course, the CEO of Bosch and the CEO of Siemens – we have to cover everything. In this kind of joint venture, personal relations play a very important role. People have to understand and trust each other. You have to work on it like on a marriage. Don't take the other party for granted.

And you said you learned a lot about persuasion.

Yes, this was our third major area of learning. Persuasion was very important during our portfolio restructuring. It always boils down to people. If you have the right people, then you can do anything. When people have to leave the big Siemens family because we are going to sell something, of course there is a lot of noise. But most people, if they lose their jobs they understand why. And while some are not willing or able to change, you cannot just fire them.

But you have to talk to your people in good times as well as bad; you can't try to involve them only when you need to ask a favor of them. Most people also understand that businesses have to make trade-offs. You say, "Look, this is why we invested in Germany, but for us to continue to invest, you have to be willing to help us change."

A recent example was the increase of working time again from 35 hours to 40 hours a week. It is not easy to convince people that they have to work more hours for the same money. The French government criticized Siemens, calling the increase blackmail and saying they did not want to see a similar development in France. But at the same time, they gave $8 billion to Alstrom to save it from bankruptcy. Asking our people to make a contribution, of time not money, in order to avoid the transfer of factories from Germany to Hungary – they call this blackmail? But public subsidies of $8 billion are OK to save jobs? That's a little strange, I think. But I've learned to never criticize politicians in public because then you lose all your influence.

Another major challenge we faced in trying to cut costs was maintaining a balance with our engineering culture. We've always had a competitive edge – even over GE – in innovation. In Germany, we have excellent engineers. But sometimes we overdo it. I know this from my experience in the power business. Customers would ask us for some new product features, and our engineers would say, "No, the customer is not right. To have really wonderful power stations, we would have to add this and that." The result of this thinking was that our price was too high. The competitor came in at a much lower price and offered features on an optional basis so that only the customers who valued these features would have to pay for them. That is market-driven versus engineering-driven thinking.

We learned our lesson the hard way. When Siemens started benchmarking in the '80s, we were not willing to accept the results. We said, "There are cost differentials, but we are better." Resisting benchmarking is not an issue anymore – not for Siemens, or for other German companies I've seen. They are all more customer focused now.

Looking back at how you launched the change process at Siemens, do you think your expectations were too high?

Yes. Was that a bad thing or a good thing? I don't know. You have to strike a balance between aspirational and

> "IF WE HAD LISTENED to the financial analysts during the 1990s, we would have sold off most of the company by now."

realistic to think you can achieve something and find out maybe it was too high a target. But in principle, I think the best thing is to be realistic so you can carefully develop a plan that will help you reach your goals.

You've talked about the importance of the U.S. market to Siemens and how much you learned from your major American competitor. Your successor as CEO is the executive who has led your efforts in the U.S. Is it fair to say that the transformation you led was in some ways the Americanization of Siemens?

This is absolutely correct. I've made our company follow the rules of the financial markets, and the rules of the financial markets are driven by the Americans and the British. We are much more shareholder driven than we were in the past. We made the decision to list on the American exchange because we were proud of our results, and we wanted to show the financial markets that we are shareholder-value driven. I learned a lot about America and how to communicate with the public markets from this listing on the New York Stock Exchange.

In Germany, we try to be modest and not promise too much. So when I went on the road show in the U.S. and the analysts asked me a question, I would reply, "Well, you can see it this way or you can see it that way, but we will go in this direction." This is how I think. You know, normally there are pros and cons to every issue – nothing is black or white.

After the first presentation I gave, the American investment banker who accompanied me on the road show said, "Look, if you continue like this, you will ruin the whole thing. This is impossible, how you behave. You have to say, 'I've understood your question. These are our targets, this is how we will achieve them, and I guarantee it. Next question.'"

Now, my parents came from Austria, and if I talked like that at home, my mother would have refused to sit with me at the table. So I told the investment banker that I couldn't do it. I wouldn't talk like that. Anyway, I was sure that my natural style had convinced everyone. The banker told me again, this time more rudely, that I was ruining the whole thing.

After that, I said to myself, "OK, I did theater back when I was in school, and I was pretty good at it. I can do what they want. Let's try it." At the very next meeting, I said simply, "These are our targets, this is how we're going to achieve them, and I guarantee the results. No problem. Next question." So in the U.S., I had to adapt to a different style.

The other thing my investment-banking friend taught me was that I should never say I'm optimistic – always say I'm confident! If I tried this approach in Germany or in Italy or in Spain or in France, it wouldn't work so well. But I don't criticize this. To succeed in the U.S., you have to learn it. Maybe people are clearer in America: They know what they want to achieve, and so they send a clearer message. In Europe, we are often asked to read between the lines, so you can listen a whole day and still not understand what the message is.

> "I THINK AMERICAN SOCIETY IS DRIVEN MORE by the bottom line than either German or French society. Under the influence of the financial markets, of course, the profit orientation in Europe is growing."

Other than the role of the CEO, are there important differences between American and European companies, and are there things American companies can learn from how Europeans approach business?

If you allow me to say – I think American society is driven more by the bottom line than either German or French society. Under the influence of the financial markets, of course, the profit orientation in Europe is growing, especially in Germany and in our company. But still there are cultural differences. This makes some things harder and some things easier in Europe.

My American colleagues can't imagine operating in the German labor environment. Well, we grew up with this. We grew up with codetermination [the German law that specifies that 50% of the members of a company's supervisory board have to be elected by the workers of a company]. We know how to get along with the works councils. We know how to run a town hall meeting. On the supervisory board, there are ten shareholder representatives and ten employee representatives. This really shocks American CEOs. I tell them, "Look, do you know who is on the compensation committee? Of course, the compensation committee reflects the composition of the board. So there is a worker's representative on the compensation committee."

Now, I would not recommend exporting codetermination because it can slow the decision-making process. It takes time to convince people. But this consensus building can be an advantage. You have to motivate people in order to win their support, so they are less likely to passively resist you than when you give orders and more likely to feel a sense of investment and responsibility in the outcome.

I always recommend the American companies hire an experienced German to run their business in Germany – someone who knows how to deal with local people and local issues. Then you can achieve a lot. Because of Germany's dual system of theoretical and vocational training, a well-trained and motivated workforce is still one of Germany's competitive advantages.

The big challenge you faced was the beginning of globalization. What is the biggest challenge on your successor's desk?

It's globalization also – but in this case, it's the particular challenge of China. I've followed China's development for 20 years. I was there negotiating deals with people wearing Mao jackets. In wintertime, it was so cold indoors that we wore gloves with the fingers cut off just so we could write. And we had nice skiing underwear so that we could survive in the hotels. If you look at the progress since then, it's more than impressive.

The most intriguing – and potentially dangerous – thing about China for European and American companies is the combination of low cost and high tech. The dispute between Cisco and Huawei is an example of this – the first message to us, if you will. But there will be more to come.

Six Chinese engineers cost as much as one American or German engineer. And they work 2,600 hours per year. So how do you deal with this? I don't have the answer, but in my opinion, the risk of *not* being there is higher than the risk of being there. All we can do is build up our own activities there and try to protect our technology. Sometimes it's better to have a Chinese partner because they can help you navigate the bureaucracy. As the old Chinese proverb says, "No way is long with a friend on your side."

We recognized the China opportunity maybe a little bit earlier than other companies, but during the last two or three years I've watched with admiration how fast the American companies are moving to China, with the full support of the American government, and how successful they have been. What the American government is doing is remarkable. They are forcing the Chinese to deal with Taiwan and North Korea, as well as human rights, as negotiating issues. And China has a strong incentive to behave in a reasonable way – with a trading surplus of more than $100 billion! There are strong incentives on both sides to make it work, but without the push coming from American companies, China would not have to change so fast.

To compete with China, any company – or country – will have to stay focused on costs. When the chancellor of Germany talks about his Agenda 2010, it's the same thing we are doing at Siemens with our *top+* program. The government is trying to take $100 billion to $200 billion of social costs out of the economy – things like social and unemployment insurance, regulation, and subsidies. But this alone won't close the gap. Even if we do everything possible to reduce our costs, the Chinese will still have an advantage. We also need to be more innovative and flexible and to educate and train our people better. It is difficult, not only for companies but for whole countries.

Did your executive development process at Siemens affect your succession planning?

Absolutely. Klaus Kleinfeld is a product of our executive development process, as are several other individuals who are now in charge of important activities at Siemens. The management team is getting younger, and this shift would not have been possible without our executive development program. But it takes time. We started the process about five years ago and are now increasingly seeing results.

Many people were surprised when I announced my retirement, because although I hit 64 years old, I hadn't talked about retiring. What happened when Jack Welch retired from GE would have been unthinkable in Germany. I could not select my successor. All I could do was privately prepare the case with the chairman of our supervisory board. We were able to avoid public discussion about the succession, which is a great success at a company where a lot of people normally get involved. And we did not have to lose our second- and third-best candidates. Everyone stayed, and everyone is cooperating. It has all gone very well.

Klaus is only 47. You, too, were a relatively young man when you became CEO. Do you think youth is an advantage or disadvantage for a CEO?

Klaus is better trained for this job than I was when I took over. He's had international experience, he's worked for different groups at Siemens, he knows the business overall from his corporate functions. And he knows that business is not done on the corporate level but where the salespeople are. He has done a good job in the U.S., and that has helped prepare him to be CEO. So the challenges are big, but he's well prepared.

Is his youth an advantage? Yes and no. Young people bring new ideas and more vitality. On the other hand, if you are a bit older, you know how many mistakes you have made. The best thing is a combination. If people are willing to cooperate, we can get that. My colleagues, most of them older than Klaus, all agreed to promote him to the position. There was no opposition. And he is not the only one on the board under 60 – there are now three others.

I hope to be around long enough to help Klaus avoid some of the difficulties I ran into when I took over. This team cannot afford to lose as much time as we lost then. I know the traps the CEO can fall into. We live under certain constraints that American business leaders do not. If I can make life easier for my successor, I would like to do that. I can help him balance continuity with the drive for change.

This balance between continuity and change is very important. Siemens has been a great company for over 157 years, and I think we have stayed true to our values, particularly during the new-economy hype of the late '90s. We were not seduced or pressured into doing what everyone else was doing. We charted our own course because we had our own values. A company needs this type of compass. But the interpretation of those values has always to be done anew. Globalization, innovation, financial solidity – all of these force a company to keep changing. I'm convinced that in the future, change will have to accelerate.

Something that I hope will be considered part of my legacy is the social responsibility of the company – taking care of people. We all talk about people as our most important resource, but as a matter of fact, who's really taking care of people? It's fine to be shareholder-value driven, but you can't sit in a boardroom and say, "We'll close this and we'll close that, and there go 1,000 people here, 500 there. We don't care." We need the backing of our people. We can't afford to run into a situation where people no longer accept what we do.

I did an interview with the *Financial Times,* the most influential financial newspaper in Europe. I was trying to convince them that we had changed. We were still a company that takes care of its people, but we were also shareholder driven. The headline called me "A Pragmatic Capitalist and a Social Romantic." And I thought, "This is good."

> "SOME PEOPLE [SAID], 'It's nice to talk about culture change, but how long do you think it will take until you really achieve something?' I said, 'Well, two years.' 'Young friend,' they laughed, 'it will take ten years.' Unfortunately, they were right."

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TLFeBOOK

A traditional job-sharing arrangement would have put us onto the mommy track. We had other plans.

Two Executives, One Career

by Cynthia R. Cunningham and Shelley S. Murray

FOR SIX YEARS, we shared a job at Fleet Bank: vice president, global markets foreign exchange. One desk, one chair, one computer, one telephone, and one voice-mail account. We had – still have – one résumé. To our clients and colleagues, we were effectively one person, though one person with the strengths and ideas of two.

We're no longer with Fleet because our department was dissolved last year after Fleet was acquired by Bank of America. But the experience changed the way we think about work, and neither of us intends to work any other way again – not ever. It was a constant challenge to pull off the job share – and a hard sell to management – but we never regretted it. We're taking some time to rejuvenate and to write and speak about our experience, but when we look for a new job, we will look together. If one of us wants to leave our next position, the other will leave as well. The fact is, we've found a working relationship that not only is rewarding and freeing for us but, we are convinced, offers our employers and customers more quality and commitment than a single, full-time manager can muster. For the foreseeable future, we're a package.

When our story began, we were both working 50- to 60-hour weeks, each in different parts of the bank (then BankBoston). We were coming up through the ranks, getting promotions and raises, and loving our work. We enjoyed helping the bank turn a profit, and our professional identities were very important to us. But at the same time, we were making great sacrifices in our personal lives – as many managers do. The decision to make a change came to us in different ways. For Cindy, it was the morning her children (then ages one and three) were already bundled up for day care when she learned the school was closed. She had a major budget meeting that day, so she had to first take her children to work and then rush out to drop them with a woman she hardly knew. For Shelley, it was the day she had to decide whether to buy milk on the way to pick up her four-year-old son from school and risk being late or to get her son first and then drag him into the store.

We'd known each other professionally, though not well, and we had a sense we'd work well together based on what we'd seen of each other in meetings. The bank had a reasonably good reputation for flexibility in the workplace. It was open to flextime – allowing people to stagger their hours – and to other alternative arrangements such as telecommuting and compressed workweeks.

The offer was just the type of thing we were looking for: a move to corporate, a step up the ladder, and double the salary.

Very few people took advantage of these arrangements, however, and those who did were primarily lower-level employees. In fact, both of us had tried a four-day workweek and had had to give it up. For Shelley, it was because she was offered a significant promotion contingent upon her being in the office full-time; for Cindy, it was simply because a new boss didn't like the arrangement. In any event, what we wanted now differed from the standard flextime arrangement. We sought a single combined job that would offer us true balance but not derail our careers.

We talked to 15 executives before we found one willing to take a gamble on us (and even then, we realized he agreed in part because he knew that adding a flexible work arrangement to his division would help him meet his corporate diversity goals). The offer was just the type of thing we were looking for: a move to corporate, a step up the ladder, and double the salary, plus a bonus opportunity, all of which meant that we could each work half the time we used to and yet continue to increase our earning capacity.

The Sell

We marketed ourselves as one person. We had separate résumés before then, of course, but we put them together into one package with a cover letter saying we were looking for a single position that would combine our skills. We were managers at that time, at BankBoston. Every year, staff would rate their bosses on their managerial skills. We both had very high ratings, so we included those in the package along with our performance reviews. We met many times to talk about how best to sell ourselves, which key ideas we wanted to get across, how to interview, and who would make which points. Then we networked aggressively at the most senior level we could (primarily with executive vice presidents and division executives), and we persevered. If one executive didn't show any interest, we moved on to the next person, making it clear that while we wanted to stay at the bank and thought we had a lot to offer, we'd look outside if that's what it would take to get a job on our terms. Our immediate bosses didn't know about our plans; we conducted our search as if we were looking outside the bank.

One of the people we contacted was a female division executive whom Cindy had gotten to know at a weeklong diversity-training program, mandatory for managers at the time. She liked our proposal, and after we met with her she e-mailed her colleagues, including the head of foreign exchange, who turned out to be looking for a senior salesperson. We met with him several times, so he had ample opportunity to challenge our proposal – which he did, vigorously.

We sold ourselves on the basis of our skills, as you would for any job, but we made the argument that we had related but different capabilities and could bring more to the job than one person could alone. We both had a lot of sales and marketing experience, but one of us (Shelley) was more outgoing and comfortable with public speaking, and the other (Cindy) was more analytical. Nonetheless, we knew that we were asking him to go beyond his frame of reference, which was very traditional, and that he'd be taking a risk if he hired us.

We addressed his concerns head-on, one by one. He asked us to describe how we would handle various scenarios – how we would get a project started, whom we'd meet with, whom we'd call. He told us that he'd expect one of us at his daily 7:30 AM meeting and wondered how we would work that out. He worried about what would happen if we didn't get along. Would the business suffer? We said that we were professionals, here to meet a business need, and we had no intention of putting our careers on the line. He asked us how we would manage our responsibilities. He wanted to know how we'd get the work done and how we'd communicate. We reiterated that we would work out any bugs ourselves – that it would be our job to structure the work, keep each other in the loop, and resolve any conflicts. Any problems, we said, would be ours, never his or the business's. In the end, our confidence won him over.

The person who had hired us wasn't someone we would have expected to take that risk, and he certainly put us through our paces. Our first week on the job he gave us a little test. We were learning to work together, learning to balance work and home – and learning a brand-new business at the same time. One day, our boss called Shelley into

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his office saying he had a task for her. He needed a present for his own boss, who was leaving the division, and he needed it that day, engraved, by 4:00 PM. It was about noon. Shelley got into a cab and headed to Shreve, Crump & Low and bought a frame, but the store couldn't engrave it in time. So she went across town and visited five jewelers, finally persuading one to do the work. She got back in time and presented it to our boss. He was thrilled. Shelley was furious but stayed calm. She asked him why he'd wanted her to do something that bore no relation to her skills and experience, and he told her it was to see how fast she could respond to the task. We never saw him give this type of test to a man or, for that matter, to any of the few other women on the trading floor. We were clearly different, and although we'd made it through the interviewing process, at some level he was perhaps not quite ready to see us in the same light as he did our peers.

We didn't like the impression this assignment might make on our new colleagues. But he never asked us to do anything like that again. Over time, he even became something of a mentor. We knew that he wanted us to succeed, and to this day we appreciate the support he gave us. Hiring us helped him meet his diversity goals, but he cared about us as well; in fact, he became one of our biggest advocates. Nonetheless, while we had his support, we learned soon enough that we would have to sell ourselves to the rest of the division every single day.

The Job

Our newly created job was designed to bridge the gap between corporate foreign exchange and the retail branches. Both of us came from the retail world, where we had been managing people and sales. At that time, the retail and corporate sides of the business at BankBoston were like different companies, and while the corporate side did a lot of business in foreign exchange, the branches' revenue from foreign exchange was incidental and unsystematic – a largely untapped opportunity.

MATT HERRING

Suppose, for example, that a customer wants to wire $10,000 to a son or daughter studying at Oxford. It's in the bank's interest for the customer to send the equivalent in British pounds instead of dollars, because then the bank on this end would make the profit on the exchange rather than ceding it to the bank on the other end. It's generally in the customer's interest, too, because he or she knows the exchange rate up front and isn't at the mercy of the bank at the receiving end; it reduces the rate risk.

At that time, though, most of the branch managers and tellers weren't knowledgeable enough to encourage customers to make the exchange on this end. Here was a bank with 450 branches and millions of customers, making only $1 million sending transfers in foreign currency. We were hired because we were well connected and respected in the branch world and could influence our former peers – we were essentially intermediaries. We created training and marketing materials and traveled to the various branches to demystify the business. When we started, the bank wasn't even measuring foreign exchange revenue by branch. So in our first month, we did a major data analysis and found that a small percentage of the branches had the majority of the revenue opportunity. We targeted those branches and, within the first two years, increased revenue to $4 million.

Another early project was transforming the design of the company's main branch, which was in the same building as the executive offices. When you walked in, though, there were no clues that it was anything other than a local bank – no indications that this was the flagship location of a global business. Again, this disparity reflected the fact that the corporate and retail sides of the business operated as separate entities. Succeeding at this task required us to cross organizational boundaries and use our influencing skills, because the branches didn't report to us; branch design was the domain of retail management, not corporate. We also installed the first foreign currency ATMs. You can come back to the U.S. from Europe, put in euros, and get dollars. Or if you're heading abroad, you can put in U.S. dollars and get the currency you need.

Sharing one set of responsibilities meant that we passed projects back and forth, constantly and seamlessly. Neither of us "owned" any particular client or task; the person who was in the office took care of any needs as they came up. We were each in the office two and a half days per week, for a total of 20 hours each. We split the salary 50/50, and we both had full benefits. (To the bank's credit, it offered benefits for employees working 20 hours or more per week.) We both came in on Tuesday mornings–which was our time to strategize, the only point during the week we overlapped – and neither of us was in on Thursday afternoons. The company offered us more hours when we were hired, a total of 50 to 60 per week, and was willing to pay more for the time. We took a risk and refused. Knowing that our days would inevitably be stretched, we felt that we could commit to 20 hours and realistically keep to 25.

We didn't have a desk in the traditional sense but a spot on a trading desk, one long counter shared by many people. Our area had about 18 inches of work space, one computer, one phone, one chair, and two file drawers. On Tuesday mornings, when we were both in, we worked out of a conference room. We tried to schedule important conference calls for those mornings, and we also used those days to share ideas and plan and allocate our time and resources for various projects. We took turns at the computer. We had joint goals and reviews. It was agreed that if an individual performance issue were to come up, our manager would speak to us separately, but no issue ever did.

At the beginning of an important project, we would often go to the first meeting together, especially if we both wanted to acquaint ourselves with the key players, but that was the only time our clients saw us together. We didn't always tell people about our arrangement. We just set expectations that you could call either one of us and left it at that. Even after several years, the manager at the head office didn't know that we were sharing a job. Often, someone would call us and wouldn't know whom he or she spoke to the last time. They'd apologize for not knowing, but we thought it was a good thing – it made us seem more like the single employee we wanted to be.

And we did regular "data dumps," leaving each other voice mails – sometimes 15 or 20 daily – and picking these up throughout the day on separate personal voice-mail boxes, whether we were in or out of the office. We knew that if anything fell through the cracks, there would be no job share. Like anybody else, we made mistakes in our work, but we couldn't afford to let anything go wrong in terms of how we worked together.

We soon found that our complementary skills were the asset we thought they would be. When it came to presentations, for example, Cindy would take primary ownership of the data analysis, and Shelley would do the bulk of the sales presentation. What we hadn't expected was the degree to which we could learn from each other, so that over time Shelley got better at using numbers to get a point across and Cindy became a better presenter.

The Challenges

The challenges we faced in making this arrangement work had little or nothing to do with the actual work itself. There was never a case where we couldn't get a project done because of the job share. Our clients (the retail division) were happy with our work, and we earned millions of dollars for the bank. And our colleagues outside foreign exchange were respectful and supportive. The real challenges came almost exclusively from a lack of management support and our immediate colleagues' suspicions about our arrangement. It became clear early on that many people wanted to see us fail. That was the biggest surprise. We continually had to explain ourselves; we were always on trial – which was a drag on our time, not to mention our morale.

Lack of management support wasn't an issue right away. Although the division executive who hired us wasn't our direct boss – there was a layer in between – his endorsement translated into support from our direct boss. If you have backing from the very top, it tends to trickle down. However, our mentor retired after we'd been there for four years, and the new division executive was indifferent to our arrangement. Our boss began to change his attitude toward us, although nothing changed in our work. One way this played out was his repeated effort to break us into two part-time employees, each with our own projects and areas of focus. We believe that this was, in part, due to the power dynamic of confronting two people at once, and that's understandable. We're both assertive, and dealing with anybody two-on-one might be daunting for a boss and peers. But splitting the job was not a solution we were willing to consider. Instead, we made adjustments, and when possible we addressed people one-on-one. It was a balancing act, though, because we wanted it to be very clear that anyone could contact either of us about any project and receive the same information.

We knew that if anything fell through the cracks, there would be no job share.

Why were we so adamant about one job? The arrangement we had, of course, slowed our career progression; we knew it would. But taking two separate part-time jobs would have thrown us completely off track. In the kind of work we were doing, we needed to be able to respond to issues and client requests on the spot; asking someone to wait a few days while one of us was out of the office would have seriously damaged the quality of our service. We're both ambitious people, and neither of us wanted just a job. We wanted careers. On top of that, we didn't want to give anyone a reason to start comparing us or pitting us against each other. Of course, we are two different people. As clients and colleagues got to know us, they would on occasion approach Cindy about certain things and Shelley about others, but that was rare. We felt strongly that it shouldn't matter which one of us you talked to – and that's why we left each other so many voice mails.

Another issue was that we felt we were frequently held to a different standard. We experienced this, for example, in our last review. One of the 2003 goal categories for all employees at our level was diversity. In our self-assessment, we gave ourselves a five on diversity (on a scale of one to five) because we'd not only met our goal, which was to get involved with the women's groups at the bank and do some speaking, but we'd gone above and beyond, speaking at a national women's leadership conference and getting Fleet to be the lead sponsor of the event.

We handed in our self-assessment, and then the time came for our review. Overall, it was quite fair; we did very well. We were surprised, however, to see that under diversity, our boss had given us a three, which meant "meets expectations." When we asked what it would have taken to get a four, pointing out that we'd exceeded our goal, he said that he would have had to hear from someone outside what a good job we'd done. We soon learned, though, that "meets expectations" meant different things for different people. Later that day, Shelley was chatting with a colleague, and she asked him about his review. It turned out that he'd also gotten a three on diversity. We had essentially the same job, we did the same work, and everyone was supposed to have a diversity goal. But he hadn't done anything in the diversity arena, and he'd received the same rating we had. He was shocked when Shelley told him that we'd gotten a three. He said, "But I didn't do anything."

Our boss also undermined us in subtle ways. For instance, in our six years on the job, we took maybe six sick days between the two of us. Because we were each in the office three days a week, we didn't like to be out if we could possibly avoid it. On at least two of the occasions that one of us called in sick, our boss made a point of approaching the administrative person who kept track of vacation and sick days, saying, "Put down a vacation day for Shelley" (if it was Shelley who was absent). We found this out only because we knew the administrative person. She changed the vacation days back to sick days for us; as employees, we were entitled to both, and nobody else was expected to use a vacation day when out sick.

When it came to colleagues on the trading floor, we often became the targets of jealousy and backstabbing, as well as hidden and not-so-hidden aggression. One coworker, on a daily basis, would say in front of the whole team, loudly enough to call attention to himself, "What time are you leaving today?" This despite the fact that our hours were posted prominently on our computer. Another colleague said several times a week, "Nice of you to come in today." We heard a lot of passive-aggressive comments masquerading as jokes, such as "What do you ladies do on your days off? Make cookies?" They often didn't know how to relate to us. If we ran into a male colleague, he would frequently open the conversation with something like, "Are the kids playing soccer this season?" and not "What do you think about the euro today?"

Sometimes the behavior was overtly aggressive. When we first started, two of the women on the team were very adversarial. They tried to pit us against each other and had meetings with others on our team to talk about us. Early on, in a project we were working on together, one of them said several times to Cindy something to the effect of, "Shelley said yesterday you were going to do this or that." Cindy would have to go out on a limb and say, "No, she didn't say that"–and hope she was right. Eventually, we asked to meet with them and talked it through. They were stunned and angry that we'd brought it up, but although they made excuses, they didn't deny the behavior. In the end, the meeting did help; we were able to develop a professional relationship. But more often than not, we let things go. Only when it affected our work did we approach our adversaries, because we had agreed right up front that we would choose our battles. We should add that outside foreign exchange, we received tremendous support from our colleagues at BankBoston and later Fleet. Foreign exchange was a very traditional environment and one resistant to change. Our work arrangement raised eyebrows, and because we came from the retail rather than corporate division, we brought a new lens to how the group was doing business.

In addition to the other challenges, we had to make some sacrifices when it came to social relationships with our colleagues. Not only did we often miss out on office camaraderie, but it's possible that some of the jealousy and backstabbing would have subsided if we'd had more face time in the office, especially as we weren't able to take part in late-afternoon or after-work socializing. However, we'd made this arrangement to achieve a balance in our lives, and we stuck to our schedules.

The Lessons

We learned a lot from this experience, and we'll carry those lessons into our next jobs. One of the most important is to check your ego at the door. Both of us are competitive by nature, and we both have a lot of opinions; we were accustomed to being self-sufficient and succeeding on our own. Suddenly, there were two of us, and that was a huge adjustment. For instance, we had to accept that we both should have a chance to contribute when we attended meetings together but that neither of us should dominate. Frequently, we would script our approach to meetings in advance. That doesn't mean we always agreed – though our disagreements were rare – but we'd determined that we would never disagree in public. We weren't one person, and we might approach issues in different ways, but we worked that out behind closed doors and came out with a single solution. We needed to present a united front; we didn't want to give anybody a reason to try to divide us in any way. We also had to trust that one would make a reasonable decision, even if it wasn't the same decision the other would make.

It's important to find the right job-share partner, because you're utterly dependent on each other. If the fit isn't perfect, it's not going to work.

Another lesson was to overcommunicate. Early on, we began writing everything down, including the finer points that might not have seemed relevant. Our voice mails to each other included the most mundane details. We described not only everything that came up in meetings, including people's body language, but also chance encounters with colleagues, even if the conversations were about individuals' personal lives. We relayed every single thing that happened in that office, because otherwise we'd be missing a part of what happened during the week. If our communication hadn't been so exhaustive, we couldn't have acted as an integrated employee.

Flexibility was also key. While we tried not to bring much work home on our off days, we did check voice mail throughout the day, and many a time we dealt with issues from home. We had to be even more willing to adjust our schedules than we would have been if we were in a traditional position, because our every move was scrutinized. For example, everyone misses a meeting from time to time, but if we missed a meeting, special significance was attached to our absence. There was one meeting that Shelley couldn't make. Cindy went and was able to step right in, but when review time came, our boss made specific note of the fact that Shelley hadn't been there. In most cases, if a boss feels that an employee missed a key meeting, he might say something at the time. To wait to comment in a review puts a lot of weight on a single missed meeting.

We had to be able to live with risk. At any moment, our boss could have come in and said, "This isn't working anymore." We didn't have a contract; it was an agreement, which could be reviewed at any time – yet our lives were completely tied to this setup. At one point, a few years into the job, out of nowhere our boss told us we had to resubmit our job-share proposal as if it were a completely new request. His aim was to get us to agree to more hours – not because of budget constraints but because the executive who'd hired us had left, which gave our immediate boss an opening to challenge us. We went back and forth with him for months, and we stuck to our guns even though we knew it was a risk, but we did agree to get home e-mail access. It was a lot of work just to maintain the status quo, and even then there was no certainty that it would last. When the merger with Bank of America was announced, the division leader brought all of us in and broke the news. We watched the other faces and saw that suddenly our colleagues felt a dark cloud over their heads. This is how at risk we felt at all times.

Perhaps the biggest lesson was, find the right job-share partner, because you're utterly dependent on each other. If the fit isn't perfect, it's not going to work. As we've said, we are very different. In fact, as part of our outplacement package, we took the Myers-Briggs test, and the consultant was fascinated by our results because we were the complete opposite of each other on nearly every measure. However, our scores matched in one quadrant, which was called "judging." We're both self-starting, systematic, and scheduled. We think that's why our arrangement worked so well for us. If one of us were systematic and the other more laissez-faire, it's easy to imagine that we'd have driven each other crazy. On top of that, we're both very ambitious, with similar goals. We're direct, and we both would prefer to get issues onto the table rather than let them fester. And we're persistent – we wouldn't have gotten the job if we weren't.

• • •

When we first made this career change, the reactions from our friends and colleagues were pretty negative. "A part-time job?" people said. "Why do you want to give up your career?" We felt, instinctively, that it wasn't like any other "part-time" job and that it was the right decision for us. Today, the same people who were initially skeptical of our decision – both inside and outside the bank – are impressed with the outcome. Many people, both men and women, have asked us how we made it work.

While this was a quality-of-life decision, it was also a decision intended to avoid limiting our career options. At the beginning, we thought we would one day be a CEO together. That's no longer the goal; the number of extra hours that would be required would rob us of the balance we fought for in the first place. We don't need the top job to feel as though we're contributing to a company's success. We love to work, we love contributing to an organization, and we think we can accomplish a lot together. A few years from now, when the kids are in college, we'll still work this way. We can't imagine any other way to live.

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Outsourcing has become strategic – yet many executives remain unprepared. A new era of capability sourcing will trigger organizational redesign and require a new set of managerial skills.

Strategic Sourcing

From Periphery to the Core

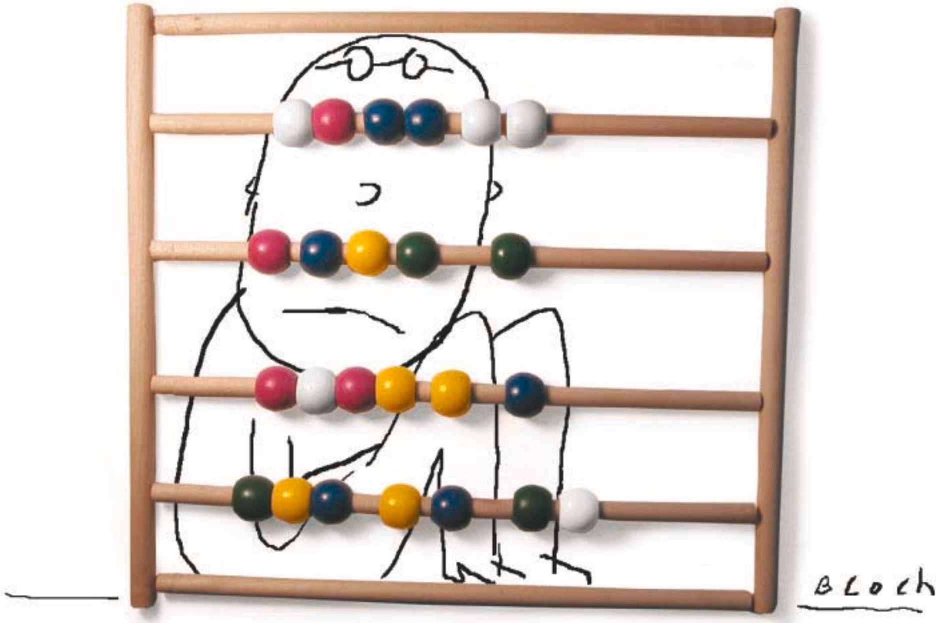
by Mark Gottfredson, Rudy Puryear, and Stephen Phillips

SERGE BLOCH

For years, "sourcing" has been just another word for procurement – a financially material, but strategically peripheral, corporate function. Now, globalization, aided by rapid technology innovation, is changing the basis of competition. It's no longer a company's *ownership* of capabilities that matters but rather its ability to *control and make the most of critical* capabilities, whether or not they reside on the company's balance sheet. Outsourcing is becoming so sophisticated that even core functions like engineering, R&D, manufacturing, and marketing can – and often should – be moved outside. And that, in turn, is changing the way firms think about their organizations, their value chains, and their competitive positions.

Forward-thinking companies are making their value chains more elastic and their organizations more flexible. And with the decline of the vertically integrated business model, sourcing is evolving into a strategic process for organizing and fine-tuning the value chain. The question is no longer whether to outsource a capability or activity but rather *how* to source every single activity in the value chain. This is the new discipline of "capability sourcing."

Perhaps the best window on the new sourcing landscape is a handful of vanguard companies that are transforming what used to be purely internal corporate functions into entirely new industries. Firms like United Parcel Service in logistics management, Solectron in contract manufacturing, and Hewitt Associates in human resource management have created new business models by concentrating scale and skill within a single function. As these and other function-based companies grow, so does the potential value of outsourcing to all companies.



It's not always obvious which functions have the most potential for developing scale and skill. Virgin, for instance, has successfully extended its brand management capabilities from planes and trains to music, mobile phones, personal finance, and even bridal wear. And you might still think of Nike as a sneaker and sportswear company. But as it lends its brand and merchandising expertise to an increasing array of products – from golf instruction centers to MP3 players to eyewear – it's evolving into a focused provider of marketing services to other companies.

Migrating from a vertically integrated company to a specialized provider of a single function is not a winning strategy for everyone. But all companies need to rigorously assess each of their functions to determine in which they have sufficient scale and differentiated skills and in which they don't. Greater focus on capability sourcing can improve a company's strategic position by reducing costs, streamlining the organization, and improving quality. Finding more-qualified partners to provide critical functions usually allows companies to enhance the core capabilities that drive competitive advantage in their industries.

Yet despite the enormous opportunities available through capability sourcing, our research indicates that many executives remain unprepared for this transformation. A recent Bain survey of large and medium-sized companies reports that 82% of large firms in Europe, Asia, and North America have outsourcing arrangements of some kind, and 51% use offshore outsourcers. But almost half say their outsourcing programs fall short of expectations, only 10% are highly satisfied with the costs they're saving, and a mere 6% are highly satisfied with their offshore outsourcing overall.

The reason these efforts often fail to measure up to expectations, even purely in terms of cost savings, is that most companies continue to make sourcing decisions on a piecemeal basis. They have not put hard numbers against the potential value of capability sourcing, and they've been slow to develop a comprehensive sourcing strategy that will keep them competitive in a global economy. To realize the full potential of sourcing, companies must forget the old peripheral and tactical view and make it a core strategic function.

In this article, we'll describe how and why the role of sourcing is changing in the twenty-first-century economy and lay out a practical strategic framework to guide companies through the transition.

The Changing Basis of Competitive Advantage

For over a century, companies competed on the basis of the assets they owned. AT&T, with its direct control of the American telephone network; Bethlehem Steel, with its large-scale manufacturing plants; and Exxon, with its vast oil reserves, each dominated its respective industry. But in the 1980s, the basis of competition began to shift from hard assets to intangible capabilities. Microsoft, for example, became the de facto standard in the computing industry through its skill in writing and marketing software. Wal-Mart transformed retailing through its proprietary approach to supply chain management and its information-rich relationships with customers and suppliers.

A similar shift occurred in the worldwide auto industry. When U.S. automakers began losing market share to Japanese companies, they were forced to confront a growing gap in both cost and quality. Recognizing that upstream component quality was critical to their end product and seeing the success of the Japanese *keiretsu* model of networked suppliers, the Big Three began to move design, engineering, and manufacturing work to specialized partners. They hammered out strategic sourcing relationships for complex subassemblies such as seats, steering columns, and braking systems. To win a significant share of their business, chosen suppliers had to meet tough cost and quality specifications. More important, to ensure the long-term success of a partnership, both parties had to open their books, sharing detailed information that became the basis for continual quality and cost improvements over many years. Both parties shared in the savings generated from improved efficiency, which provided ongoing incentives to identify and remove unnecessary costs.

This new approach to sourcing had profound effects on the automakers' operations and management. For example, Chrysler established what it called "value-managed relationships," in which it consolidated component purchases with the few suppliers it believed could sustain competitive costs, high quality, and efficient delivery. The carmaker and its key suppliers set a common goal of achieving the lowest total systems cost. Before it could reach this goal, however, Chrysler had to refocus its entire procurement function so that it could manage the new, highly collaborative sourcing relationships. That required the company to train and promote a different kind of manager who was capable of understanding system economics, not just one who knew how to nickel-and-dime the supplier base.

The same dynamics were also at work in the credit card industry, which restructured in response to a dramatic change in the basis of competition fueled by technological innovation. In the 1970s, most banks that issued credit cards also processed their own transactions in a very labor-intensive manner. But as computers automated transaction processing, the economies of scale grew significantly, and individual issuers started to pool their transactions to drive down costs. The industry began to separate into those companies that issued cards and managed customers, on the one hand, and those that processed transactions, on the other, as transaction-processing underwent rapid commoditization.

It's no longer ownership of capabilities that matters but rather a company's ability to control and make the most of critical capabilities.

For example, despite having enviable scale in its own transaction-processing operations, American Express, in a prescient strategic move, spun off its transaction-processing business in 1992. Then the company negotiated a long-term service contract with the newly independent entity, First Data. Although Amex executives considered transaction processing a strategic capability – without reliable and efficient processing, it was very difficult to make money in the credit card business – they also saw that commoditization was eliminating any proprietary advantage. As a spin-off, First Data could aggregate Amex's volume with that of other companies (issuing banks would have been reluctant to outsource processing to Amex as a competitor). In that way, American Express could gain additional scale advantages while ensuring long-term cost effectiveness. Going forward, Amex was able to focus on the issuing side of the credit card business and enhance its core capabilities in marketing and risk management.

The decisions Chrysler and American Express made required them to challenge one of the basic tenets of business strategy: that you should always keep strategic capabilities within your walls. As globalization and technology transform more industries, all companies will eventually have to let go of that comfortable but simplistic guideline. A series of geopolitical, macroeconomic, and technological trends has opened the world's markets, made business capabilities much more portable, and produced a level of discontinuity that has no precedent in modern economic history. These events include the fall of the Berlin wall, China's embrace of capitalism, the advent of worldwide tariff reduction agreements, and the spread of cheap, accessible telecommunications infrastructure. In the new era of capability sourcing, companies' value chain decisions will increasingly shape their organizations and determine the kinds of managerial skills they need to acquire and develop in order to survive amid increasingly fluid industry boundaries.

Capability Sourcing at 7-Eleven

To illustrate the power of capability sourcing, let's take a detailed look at one dramatically successful practitioner, which began as a most traditional, vertically integrated company.

Back in 1991, when 7-Eleven's current CEO Jim Keyes was named vice president of planning and chairman of the executive committee, the retailer was losing both money and market share. As the major oil companies added minimarts to more and more of their gas stations, the convenience store industry was becoming crowded and cutthroat, putting both revenue and margins under intense pressure. To attract

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more customers, 7-Eleven needed to cut its operating costs substantially, expand the range of its products and services, and increase the freshness of food items.

Keyes launched a business review aimed at tightening operations, rebuilding competitive advantage, and perhaps divesting a few noncore businesses. The deeper he and his team got, however, the more apparent it became that 7-Eleven was trying to do too many things and was not good enough at any of them. The core of the business, Keyes believed, was merchandising skill – the pricing, positioning, and promotion of gasoline, ready-to-eat food, and sundries for consumers driving cars. But 7-Eleven had always been vertically integrated, controlling most of the activities in its value chain. The company operated its own distribution network, delivered its own gasoline, made its own candy and ice. It even owned the cows that produced the milk it sold. Managers were required to do lots of things other than merchandising – store maintenance, credit card processing, payroll, and IT systems management. Keyes found it hard to believe that the company could be best-in-class in every one of those functions.

As part of his initial assessment, Keyes studied the company's highly successful Japanese unit, whose keiretsu model of tight partnerships with suppliers was unique within 7-Eleven. By relying on an extensive and carefully managed web of suppliers to carry out many day-to-day functions, the Japanese stores were able to reduce their costs and enhance the quality of their operations, spurring rapid growth and strong profits. After considering many options, Keyes concluded that the best way to save the U.S. company was to adopt the Japanese model. The goal he set was to "outsource everything not mission critical." This marked an abrupt and deliberate break with the company's vertically integrated past.

All activities were on the table. Keyes's team even evaluated strategic functions such as product distribution, advertising, and procurement, attempting to identify outside partners with greater expertise and scale. Simply put, if a partner could provide a capability more effectively than 7-Eleven could itself, then that capability became a candidate for outsourcing. Over time, the company relinquished direct ownership of many parts of its business, including HR, finance, IT management, logistics, distribution, product development, and packaging. Yet despite moving at a rapid pace, Keyes remained cautious about losing control and avoided the temptation to take a one-size-fits-all approach to outsourcing.

The way 7-Eleven has structured each partnership depends on how important each function is to the company's competitive distinctiveness. For routine capabilities like benefits administration and accounts payable, 7-Eleven picks providers that can consistently fulfill cost and quality requirements. More strategic capabilities require more complex arrangements. Gasoline retailing, for example, represents an important source of revenue for many 7-Elevens, as gas is often the reason customers come to the stores. So while the firm outsources gasoline distribution to Citgo, it maintains proprietary control over gas pricing and promotion – activities that could differentiate its stores if done well.

The company has paid similarly close attention to its relationship with Frito-Lay, since snack foods are one of the most important product lines for convenience stores. By allowing Frito-Lay to distribute its products directly to the stores, 7-Eleven has been able to take advantage of the chip maker's vast warehousing and transport system. But unlike other convenience store companies,

The Endgame: Dynamic Sourcing

GIVEN THE RAPIDLY SHIFTING CONTOURS of the global economy, companies need to be able to anticipate changes in the economics and geography of outsourcing. It wasn't long ago, for example, that most big companies had to own their own warehouses and operate their own distribution systems. Third-party logistics specialists had neither the skill nor the scale to handle those functions. But today, suppliers like UPS and FedEx are competing fiercely to offer full-service logistics networks, and even the largest companies can now outsource warehousing, distribution, and related activities. Such trends will only accelerate in the future, and those companies that have recognized and prepared for them will be the first to capitalize on them.

So, to ensure that it doesn't quickly become obsolete, a sourcing strategy needs to consider not only present circumstances but also future alternative scenarios. What trends will influence the sourcing options available for each key capability? Is the supplier base growing rapidly, and are innovative new outsourcers emerging? Are different regions of the world investing heavily in particular capabilities – like contract manufacturing or customer service – and will they offer greater cost or quality advantages in the future? The answers to such questions may encourage a company to pursue certain sourcing opportunities that might not be highly attractive based on current numbers but could offer dramatic benefits in the coming months and years. Or they may lead a company to negotiate short-term sourcing contracts to keep options open, rather than enter into long-term relationships. Ultimately, a company's skill in quickly remolding its sourcing arrangements in response to market conditions and rivals' moves may be its strongest competitive advantage.

7-Eleven doesn't allow Frito-Lay to make critical decisions about order quantities or shelf placement. Instead, the retailer mines its extensive data on local customer purchasing patterns to make those decisions on a store-by-store basis.

The choice 7-Eleven has made to maintain control over product selection and stocking illustrates a critical issue in strategic sourcing partnerships: when to keep vital data confidential and when to share them with a partner. Similarly key was 7-Eleven's decision to rely on an outside vendor, IRI, to maintain and format detailed customer purchasing behavior data while keeping the data themselves proprietary. This gives 7-Eleven a picture of the mix of products its customers want in different locations without relying on outside decision makers like Frito-Lay for such information. In this way, 7-Eleven is able to structure its supplier relationships to gain a capability without relinquishing control over decisions that could make or break its business.

For a few targeted product segments, 7-Eleven has identified opportunities that call for an even deeper level of collaboration. Company executives figured out that their traditional, do-it-yourself approach to creating branded products was cutting the company off from the superior scale, resources, and creativity of major food suppliers. So they began sharing information with a select group of manufacturers, allowing them to create custom products for 7-Eleven stores. For example, 7-Eleven worked with Hershey to develop an edible straw based on the candy maker's popular Twizzler treat. In return, Hershey gave 7-Eleven the exclusive right to sell the straw for its first 90 days on the market. To further promote the unique product, 7-Eleven joined with its syrup supplier, Coca-Cola, to come up with a Twizzler-flavored version of its proprietary Slurpee drink. Such exclusive arrangements reduce the strategic risk of sharing customer information while greatly expanding the set of unique products 7-Eleven can offer.

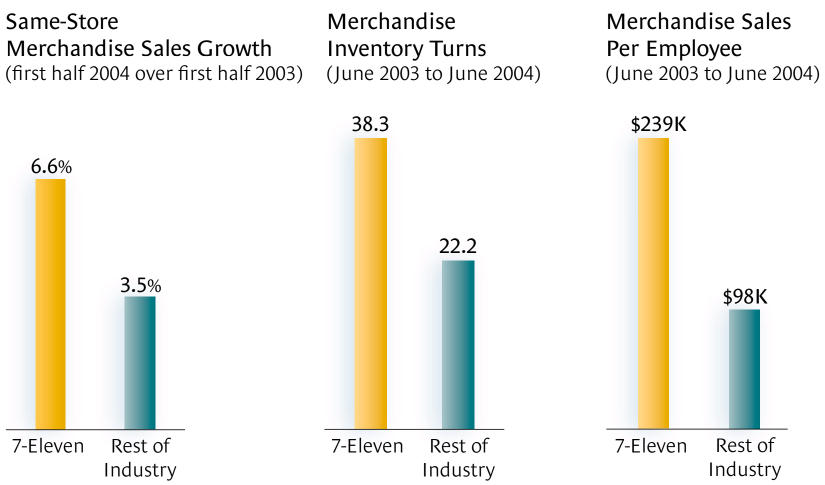
Likewise, when the data on beer sales showed that certain packaging options were more successful than others, 7-Eleven forged a tight partnership with Anheuser-Busch to build sales in those categories. Anheuser-Busch helped 7-Eleven develop a product assortment and establish merchandising standards for a new display. The beer giant also agreed to give 7-Eleven first-look opportunities at new products. In return, 7-Eleven shares its customer information so together the two companies can develop innovative marketing programs, such as a cobranded NASCAR promotion targeting 7-Eleven's core customers and a Major League Baseball promotion campaign. Anheuser-Busch is also using 7-Eleven store data, provided daily by IRI, to test a new order-forecasting system that would link the retailer's orders more tightly with deliveries from the brewer's wholesalers.

In addition to restructuring and enhancing existing activities, 7-Eleven has used creative sourcing partnerships to pioneer entirely new capabilities. It realized, for example, that by being a one-stop source for a broad range of products and services, it could gain a leg up on more narrowly focused competitors. So it has set up a consortium to provide multipurpose kiosks in its stores. American Express supplies ATM functions, Western Union handles money wires, and CashWorks furnishes check-cashing capabilities, while EDS integrates the technical functions of the kiosks. Here, too, 7-Eleven maintains control over the data – in this case, information on how customers use the kiosks – which it views as critical to its competitive edge.

Some of 7-Eleven's outsourcing relationships tie suppliers' financial interests to its own. The company took an equity stake in Affiliated Computer Services, for instance, one of its major IT outsourcers. 7-Eleven also agreed to share productivity gains from a services agreement with Hewlett-Packard. In an even deeper collaboration, the company created a joint venture with prepared-foods distributor E.A. Sween: Combined Distribution Centers (CDC) is a direct-store delivery operation that supplies 7-Elevens with sandwiches and other fresh goods. By drawing on the skills and scale of a specialist, 7-Eleven was able to

The Measure of Success

For 7-Eleven, strategic sourcing has translated into industry dominance. In the past two years, the mini-mart retailer has led all major rivals in same-store merchandise growth, inventory turn rate, and revenue per employee.



Sources: Annual and quarterly SEC filings

cut its distribution costs from more than 15% of revenues to 10% and eventually hopes to cut that figure in half again. But cost reduction is only a secondary benefit. The real gains have come in service. When it owned its own distribution network, 7-Eleven delivered fresh goods to its stores only a couple of times a week. CDC now makes deliveries to stores once, and soon twice, a day. More frequent deliveries mean fresher products, which draw more customers into the stores.

By almost any measure, 7-Eleven's sourcing strategy has transformed the company. In narrowing its focus to a small, strategically vital set of capabilities–in-store merchandising, pricing, ordering, and customer data analysis–the company has reduced its capital assets and overhead while streamlining its organization. It reduced head count 28% from 43,000 in 1991 to 31,000 in 2003 and flattened its organizational structure, cutting managerial levels in half from 12 to six.

Today, 7-Eleven consistently outperforms competitors. Same-store sales have grown in four out of the last five years. In the past two years, it has dominated the industry's vital statistics, with same-store merchandise growth at almost twice the industry average, revenue per employee at just about two-and-a-half times higher, and inventory turns at 72% more than the industry average. (See the exhibit "The Measure of Success.") Furthermore, after its acquisition of two regional U.S. chains (Christy's Markets in the Northeast and Red D Mart in the Midwest), the firm's new business model helped grow sales by more than 30% and increase gross profit margins by 2%. 7-Eleven's stock appreciation over the past five years has outpaced all major competitors, including Casey's General Stores, the Pantry, and Uni-Mart.

Should you always keep strategic capabilities within your walls? As globalization and technology transform more industries, all companies will eventually have to let go of that comfortable but simplistic guideline.

A Framework for Capability Sourcing

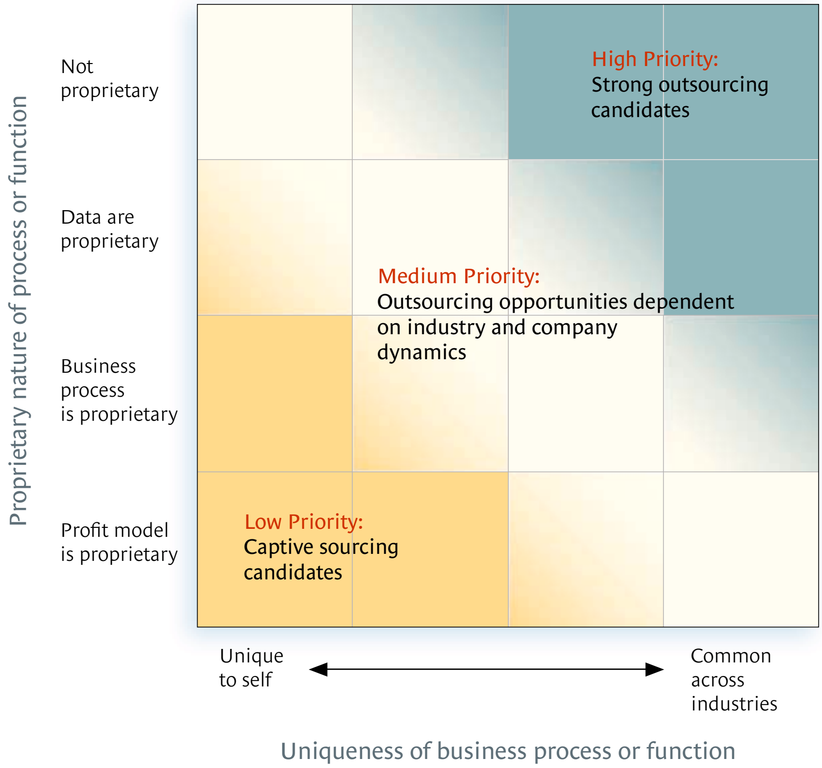
As companies like Chrysler, American Express, and 7-Eleven have discovered, a strategic approach to sourcing can dramatically improve your company's competitive position. So how do you make something that's always been tactical more strategic? You need to stop focusing on incremental cost improvement targets, step back, and reevaluate your strategy and your capabilities. In working through this process with clients, we've found that three steps can ensure that decisions are made objectively and are based on facts.

The first step is to identify the components of your business that represent the *core of the core.* These are the activities that your company does better and cheaper than its rivals. For 7-Eleven, the core of the core is in-store merchandising and product ordering. For drug maker Pfizer, it's developing and marketing pharmaceutical compounds. For American Express, it's identifying customer segments and creating card offerings tailored to them. Everything else exists to support the core of the core.

In deciding what to outsource and what to keep inside, 7-Eleven considered two factors: whether a capability was proprietary and whether it was common enough that outside suppliers could achieve scale or other advantages by supplying it to multiple companies. To determine proprietary value, executives asked themselves two questions: Did 7-Eleven carry out the capability in a way that generated measurably more value than its competitors could deliver? And would the company suffer a high degree of strategic damage if rivals could imitate that capability? To deter-

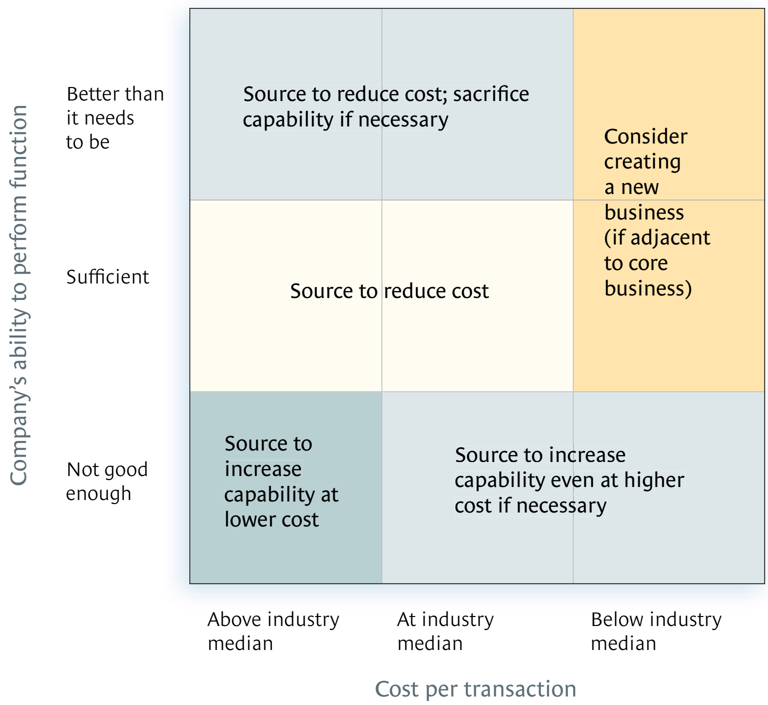
What Should You Outsource?

Using this sourcing opportunities map, you can determine which functions have the highest outsourcing potential and which should remain under your company's control. The vertical axis measures how proprietary a capability is for your company. The horizontal axis plots how common the capability is within or outside your industry. The less proprietary and the more common a function is, the stronger a candidate it is for outsourcing.



How Strong Are Your Capabilities?

Once you've determined which capabilities offer the highest potential value from outsourcing, you need to see how well, and how efficiently, your company currently performs each one of them. This exercise may surprise you: If your cost per transaction is low enough and your quality high enough, you should be thinking of selling that function as a new business in itself.



mine commonality, they had to look outside their company – even outside their industry. They tried to identify capabilities in which outside suppliers were building scale across their industry, or across several industries, because these common business processes or capabilities could pose an immediate or future threat to 7-Eleven's cost position.

By plotting each of your required capabilities on a *sourcing opportunities map* like the one in the exhibit "What Should You Outsource?" you can judge the relative merits of your company's outsourcing possibilities. The vertical axis of the map measures how proprietary a process or function is; the horizontal dimension assesses the degree of commonality, both within and outside your industry. Capabilities that fall in the upper right portion of the map are strong candidates for outsourcing. Those that appear in the lower left section are potential prospects for captive sourcing. Such capabilities may even be candidates for "insourcing" – that is, if you determine that your company is really the best at a given function, you may have an opportunity to perform this function for other companies. One example of successful insourcing is FedEx, which plans and manages inbound transportation for more than 1,500 product suppliers into 26 General Motors power train facilities. This capability puts FedEx at the leading edge of the $225 billion logistics-outsourcing industry.

Opportunities that fall in the middle of the sourcing opportunities map generally require more detailed analysis of both your company and your industry. You will need to consider such factors as regulation, standards, and alternative products to figure out what will happen to those capabilities in the future. To provide a quick sense of the relative financial stakes involved, and highlight the biggest opportunities, the sourcing opportunities map should be populated with bubbles scaled to represent the cost dollars at stake for each capability.

Once you've discovered which capabilities promise high potential for alternative sourcing, the next question is: How should you source them? You need to figure out how your capabilities stack up to what's required. Do you meet, exceed, or fall short of cost and quality requirements? A *capability assessment map* like the one in the exhibit "How Strong Are Your Capabilities?" plots each capability according to its cost and quality relative to top-performing competitors or suppliers. This map will help you determine which key capability gaps your company needs to fill. Perhaps equally important, it will identify any current activities that you could perform with less rigor without incurring any strategic penalty.

7-Eleven had always been a vertically integrated company, delivering its own gasoline, making its own candy and ice. It even owned the cows that produced the milk it sold.

Where capabilities fall on this grid establishes appropriate goals for an outsourcing relationship. Functions that fall, for instance, in the upper left (relatively high-cost functions whose quality levels exceed requirements) should be outsourced to low-cost providers – even if it means a reduction in quality. Capabilities that fall in the lower left (high-cost functions performed relatively poorly) require outsourcing partners that can both reduce costs and improve quality. The capability assessment map also gives you another way to identify insourcing opportunities. Capabilities that fall in the upper right (low-cost, high-quality functions) could become the basis for attractive new businesses.

Following the first two steps of our framework can help you determine what type of control you need over each of your capabilities. The third step is a kind of reality check in which you determine whether a capability that is a strong candidate for strategic sourcing can be carried out at a distance without any loss of quality.

The issue of physical proximity may not seem very strategic, but globalization and advances in technology ensure that it's a constantly moving target. For many functions, including transaction processing, design, engineering, and customer service, the Internet and an increasingly sophisticated telephone infrastructure have made physical proximity much less relevant, at least from a cost perspective. The necessary information and outputs can be transferred electronically at high speed and low cost. For tangible products that must be shipped, however, proximity plays a large role in both cost and timeliness considerations; it may not be feasible to manage the movement of such products from afar. There may also be customer service constraints. Certain product development, sales, and service tasks, for example, may require local interactions. Capabilities that do not require physical proximity are good candidates for offshoring, whether through a traditional outsourcing arrangement or, for proprietary capabilities, through a captive operation.

If you go through this three-step analysis, your company should have the outline of a comprehensive capability sourcing strategy. You will know which capabilities you need to own and protect, which can be best performed by what kind of partners, and how to structure a productive relationship. Formulating the strategy is, of course, only the first stage of a sourcing effort: Partners then have to be chosen, contracts negotiated, and management structures established and monitored. As 7-Eleven found, the success of the strategy often hinges on the creativity with which partnerships are organized and managed. But only by first taking a broad, strategic view of capability sourcing can your company make the most of its sourcing choices.

Reprint R0502J; HBR OnPoint 8878
To order, see page 151.

Cultural Intelligence

P. Christopher Earley and Elaine Mosakowski's article "Cultural Intelligence" (October 2004) prompted my McGill University colleague Henry Mintzberg and me to discuss an observation we've made about middle-economy, bicultural countries: They seem to produce more good global managers than other countries do.

Most countries in Europe have cultures that go back for centuries, so citizens in those nations have little doubt about their identity. Americans, too, are self-assured about their identity. But in the middle-economy countries – we're talking about nations like Australia, Belgium, Canada, Denmark, Finland, the Netherlands, Norway, Singapore, Sweden, or Switzerland – people grow up caught between their own culture and that of the nearby dominant culture. Belgian Walloons are influenced by France, Belgian Flemings by Holland and Germany. Norwegians are influenced by Denmark, the Swiss by Germany, France, and Italy. The Canadian beaver always looks over his shoulder to check whether the American eagle is healthy or angry. And what Ottawa thinks or does economically is usually less important to a Canadian than what Washington, London, or Brussels thinks or does.


BEST PRACTICE

Knowing what makes groups tick is as important as understanding individuals. Successful managers learn to cope with different national, corporate, and vocational cultures.

Cultural Intelligence

by P. Christopher Earley and Elaine Mosakowski

You see them at international airports like Heathrow: posters advertising the global bank HSBC that show a grasshopper and the message "USA–Pest. China–Pet. Northern Thailand–Appetizer."

Taxonomists pinned down the scientific definition of the family Acrididae more than two centuries ago. But culture is so powerful it can affect how even a lowly insect is perceived. So it should come as no surprise that the human actions, gestures, and speech patterns a person encounters in a foreign business setting are subject to an even wider range of interpretations, including ones that can make misunderstandings likely and cooperation impossible. But occasionally an outsider has a seemingly natural ability to interpret someone's unfamiliar and ambiguous gestures in just the way that person's compatriots and colleagues would, even to mirror them. We call that *cultural intelligence* or *CQ*. In a world where crossing boundaries is routine, CQ becomes a vitally important aptitude and skill, and not just for international bankers and borrowers.

Companies, too, have cultures, often very distinctive; anyone who joins a new company spends the first few weeks deciphering its cultural code. Within any large company there are sparring subcultures as well: The sales force can't talk to the engineers, and the PR people lose patience with the lawyers. Departments, divisions, professions, geographical regions–each has a constellation of manners, meanings, histories, and values that will confuse the interloper and cause him or her to stumble. Unless, that is, he or she has a high CQ.

Cultural intelligence is related to emotional intelligence, but it picks up where emotional intelligence leaves off.

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In bicultural countries, citizens are aware of other cultural realities practically from birth. Swiss children have neighbors who speak French, German, or Italian. Singaporeans hear Chinese and English spoken side-by-side. And many Canadians, in the course of a normal day, will switch multiple times between French and English. Such duality provides people with a profound grounding in cultural intelligence. Global firms would do well to consider managers from these countries when cultural intelligence is called for.

Karl Moore
Associate Professor of Marketing Strategy
Faculty of Management
McGill University
Montreal

Earley and Mosakowski's tool for diagnosing cultural intelligence, and the framework provided by its text, leaves much to be desired. Despite the fancy labels, the tool's three dimensions of cultural intelligence are all "cognitive" and seem to be the offspring of some impression-management inventory.

No plausible connection between the three dimensions is offered: Of the six profiles the authors present in the article, only the "chameleon" category is ex-

We welcome letters from all readers wishing to comment on articles in this issue. Early responses have the best chance of being published. Please be concise and include your title, company affiliation, location, and phone number. E-mail us at hbr_letters@hbsp.harvard.edu; send faxes to 617-783-7493; or write to The Editor, Harvard Business Review, *60 Harvard Way, Boston, MA 02163. HBR reserves the right to solicit and edit letters and to republish letters as reprints.*

plicitly connected to the three dimensions of cultural intelligence. (The authors write more about that profile than about the other five put together.)

The authors' use of just 12 items to measure three behavioral quotients trivializes their approach to cultural intelligence. A few brief examples demonstrated the authors' work in culture-bound counseling and mentoring, but the examples weren't explicitly connected to the authors' tool for measuring CI and didn't explore cultural setting as a factor.

The "right" answers to the inventory are obvious – if you are an ideologue of American business. Consider, for example, the authors' presumption that the last dimension (or "facet" as they call it) measures something as grand as emotional/motivational cultural intelligence. A high scorer in this facet – who would assert that she has the confidence to deal with anyone, no matter the culture; to make friends with people from different cultures; to adapt easily to different lifestyles; and to deal with unfamiliar cultural situations – is likely, in reality, to be arrogant and dogmatic, close to being culturally uneducable, and prone to taking a fall rather than fitting into a new environment.

Robert M. March
Corporate Adviser
Silverbrook Research
Sydney, Australia

Earley and Mosakowski respond: It is most satisfying that our work on this topic has led to active debate and extension by various readers. Karl Moore touched upon an important, albeit controversial, direction that work on cultural intelligence might take. He and his colleague raise the idea that particular groups of people may, as a result of their shared experiences, have higher cultural intelligence than other groups. (Moore talks about nationalities in his illustration, but the concept might apply as well to other cultural communities.) Whether such an extrapolation is warranted constitutes an exciting new direction for cultural researchers.

The second letter, by Robert March, takes up the significance of our framework as well as the illustrative assessment tool we provide in the article. March considers the tool to be some variation on an impression-management scale – one, apparently, devised to capture American values, from his description.

We expect that he's referring to what psychologists call "socially desirable response sets" for the items, based on a demand characteristic – that is, a subject in an experiment responds a certain way because that is how he thinks people will want him to respond. Such an assertion is easily dismissed by our empirical work, which is based on several thousand respondents and which utilizes a more elaborate measure. (The items in the assessment tool were drawn from a more thorough empirical survey instrument.) Our research clearly demonstrates that such a response set does not exist.

Take, for example, a survey item such as, "I plan how I'm going to relate to people from a different culture before I meet them." We find that managers often question whether such a premeditated approach is appropriate. Some worry that it takes away from spontaneity, while others believe that such contingency planning is important to their successful interactions.

March's assertions concerning high levels of confidence are especially problematic and misguided given the nearly three decades of work (and hundreds of scientific papers, chapters, and books) by psychologists showing that high confidence is positively related to a wide range of behaviors – including work performance, team functioning, leadership, and job quality – across *several dozen countries.* Perhaps March's strong opinions about the "correct answers" reflect his personal response set.

From a conceptual view, March argues that all the cultural intelligence facets are "cognitive" but surely his idiosyncratic (and incorrect) usage of the term belies the distinctions we raise in the article. Cognition refers to the mental functions of processing – learning, memory, recall, reasoning, and so on. This is different from behaviors, actions, or motivations derived from confidence. Consider the action facet of cultural intelligence. Social mimicry and behavioral adaptation may have a "cognitive" element (a thorough discussion of volitional versus nonvolitional action mediated by cognition is beyond our space limitations here), but many of the actions we describe (for instance, Henri's kiss to greet a colleague, who then recoils without thinking) illustrate responses not under volitional (cognitive) control.

More important, March fails to understand that our framework integrates the three most fundamental aspects of human interaction – strategic thinking and learning, motivation and confidence (efficacy), and behavioral enactment. This isn't impression management; it is human endeavor.

The Wild West of Executive Coaching

As one of the original purveyors of executive coaching (in the early days, we called it individual executive development), I read with interest Stratford Sherman and Alyssa Freas's "The Wild West of Executive Coaching" (November 2004). While executive coaching remains a nascent field, best practices and provider qualifications have begun to emerge.

Executive coaches should possess a well-articulated coaching model (with


The WILD WEST of Executive Coaching

by Stratford Sherman and Alyssa Freas

It's not just individuals who benefit from one-on-one coaching – their employers can gain immensely, too. But in an industry without universally accepted standards, all the parties need to be clear about their goals and how to reach them.

When the senior vice president for organizational development at a leading U.S. bank first sought executive coaches for a few senior leaders, she faced a stampede. Kicking up dust were hundreds of applicants with wildly diverse qualifications, each expecting an interview. To make the selection process manageable, the VP established arbitrary criteria: Candidates needed some sort of coaching certification, plus five years of coaching experience at *Fortune* 500 financial services companies. The executive readily admitted to having no evidence that these criteria would identify good coaches. "I have to screen people somehow," she said. "So I am making stuff up."

Such is life in the untamed terrain of executive coaching. Like the Wild West of yesteryear, this frontier is

RJ. LOUGHRAN

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a beginning, middle, and end); a clear idea of how people change and how systems and corporate culture affect leadership behavior; and an appreciation of the exigencies of the one-to-one relationship – for instance, transference, countertransference, confidentiality, and so on. High-quality coaching requires maturity, self-control, business knowledge, intelligence, and experience. Executive coaches are running with a fast crowd and must be able to keep pace – or else the posse is sure to catch up.

Bertram C. Edelstein
Managing Director
The Edelstein Group
San Diego, California

Sherman and Freas write, correctly, that "no one has yet demonstrated conclusively what makes an executive coach qualified or what makes one approach to executive coaching better than another." But surely, a moment's thought might lead us to ask, "Why would anyone want to prove such a thing?" Given the limitless intellectual and emotional diversity available in most organizations, applying a uniform approach to executive coaching seems as preposterous as covering an entire canvas with a single shade of color and then insisting that we have created a masterpiece of subtlety. Organizations must celebrate *real* diversity and assiduously harness individual executives' given talents rather than pursue *faux* diversity, which forces executives to conform to prescribed standards.

In my view, an executive coach is a catalyst – there to help employees and executives achieve their *own* epiphanies. I am not alone in my thinking; the core philosophy of the International Coaching Federation reflects my beliefs. Coaching tools need to be emancipatory rather than prescriptive – which is why the Birkman instrument, for example, is priceless. It bothers me when I see first-class minds posit 360-degree feedback as a primary, point-of-entry, coaching tool. It is not; it is a supplementary, supportive tool. To imagine otherwise is to deny the goal of the true coaching journey – increased authenticity from within.

Roger Kenrick
Founder
Roger Kenrick Associates
Toronto

Missing from most discussions about executive coaching is the fact that it takes place in a global business environment, one in which people in many industries and at all levels are working side-by-side (and virtually) with multinational colleagues and business partners. As a result, employees and executives need to negotiate myriad corporate, regional, and national cultural differences.

Executive coaching is well established in the United States. But in many other nations it is neither well understood nor widely practiced. Over the past five years, two colleagues and I have been delivering an approach to executive coaching designed specifically for global business leaders who interact with people in and from other nations. From the beginning, we've tried to gain an awareness of what businesspeople in different parts of the world expect from the kind of one-on-one supportive relationship we call coaching. When we extend traditional U.S. executive coaching practices to leaders who are not Americans, misalignments can occur. For example, in the United States, coachees are expected to freely share personal information and feelings; they are active in setting goals and self-reliant in attaining them; and the coach is considered to be facilitative, not an all-knowing sage. But in many other cultures, business leaders' beliefs and expectations about coaching contrast sharply with those listed above, creating a disconnect that can have a disturbing effect on the coaching process and its outcome.

Executive coaches working across borders need to consider the values and expectations of each coachee and modify their approaches accordingly. Only then will global organizations realize the enduring benefits of coaching noted by Sherman and Freas.

Willa Zakin Hallowell
Partner
Grovewell
New York

Sherman and Freas respond: Vigorous debate about the practice of executive coaching is healthy and long overdue. As Bertram Edelstein suggests, a rough consensus already supports the practice of coaching; what's murky is its basis. Roger Kenrick's charming question, "Why would anyone want to prove such a thing?" evokes images of an alternate universe in which buyers and sellers of commercial services do not crave certainty. However, we share his view of 360-degree evaluations as supplementary coaching tools. And while we differ with Willa Zakin Hallowell in her assessment of coaching outside the United States–the practice is well established in many countries we serve–we agree that coaching is most effective when it is freed from unexamined assumptions. This principle applies no less at home than it does abroad.

America's Looming Creativity Crisis

Richard Florida ("America's Looming Creativity Crisis," October 2004) is right to call for educational reforms that will make schools into incubators for creativity, but he overlooks one aspect that we can already control: playtime. Our children are so overscheduled that little time is left to play and daydream, activities critical for developing creativity. From an early age, children are bombarded with brands and characters. They are given answers to remember rather than questions to contemplate. They are given activity kits with all the parts intact rather than the opportunity to figure out what they should do if some parts are missing. The most successful companies recognize that R&D is everybody's job, but they need to set aside time for it.

Tina Nocera
Founder
Parental Wisdom
Nutley, New Jersey

Florida's article raises some important points about U.S. competitiveness. There is a kernel of truth in all his assertions, but the article is too gloomy, too one-sided. Yes, there has been a dip in applications to U.S. universities. And visa ap-


BIG PICTURE

The United States built the world's most powerful economy by producing and attracting human capital. Is America throwing that advantage away?

America's Looming Creativity Crisis
by Richard Florida

THE UNITED STATES OF AMERICA – for generations known around the world as the land of opportunity and innovation – is on the verge of losing its competitive edge. It is facing perhaps its greatest economic challenge since the dawn of the industrial revolution. This challenge has little to do with business costs and even less with manufacturing prowess. And, no, the main competitive threats are not from China or India.

Even though the United States led the world into the era of high-tech industry and constant innovation, it is by no means the nation's manifest destiny to stay on top. In fact, the great majority of U.S. business and political leaders, academics, and economic analysts fail to grasp the true reason behind American success in innovation, economic growth, and prosperity. It is not the country's generous endowment of natural resources, the size of its market, or some indigenous Yankee ingenuity that has powered its global competitiveness for more than a century. America's growth miracle turns on one key factor: its openness to new ideas, which has allowed it to mobilize and harness the creative energies of its people.

As Stanford University economist Paul Romer has long argued, great advances have always come from ideas. Ideas do not fall from the sky; they come from people. People write the software. People design the products. People start the new businesses. Every new thing that gives us pleasure or productivity or convenience, be it an iPod or the tweaks that make a chemical plant more efficient, is the result of human ingenuity.

True, the United States is still the world's center of ingenuity. Its GDP tops $10 trillion, and it is home to great universities, Silicon Valley, and many of the most dynamic companies in information technology, biotech, entertainment, and countless other fields. But the global talent pool and the high-end, high-margin creative industries that used to be the sole province of the U.S., and a crucial source of its prosperity, have begun to disperse around the globe. A host of countries – Ireland, Finland, Canada, Australia, New Zealand, among them – are investing in higher education, cultivating creative people, and churning out stellar products, from Nokia phones to the *Lord of the Rings* movies. Many of these countries have learned from past U.S. success and are shoring up efforts to attract foreign talent – including Americans. If even a handful of these rising nations draws away just 2% to 5% of the creative workers from the U.S., the effect on its economy will be enormous. The United States may well have been the Goliath of the twentieth-century global economy, but it will take just half a dozen twenty-first-century Davids to begin to wear it down.

To stay innovative, America must continue to attract the world's sharpest minds. And to do that, it needs to invest in the further development of its creative sector. Because wherever creativity goes – and, by extension, wherever talent goes – innovation and economic growth are sure to follow.

The Dawn of the Creative Age

There's a whole new class of workers in the U.S. that's 38 million strong: the creative class. At its core are the scientists, engineers, architects, designers, educators, artists, musicians, and entertainers, whose economic function is to create new ideas, new technology, or new content. Also included are the creative professions of business and finance, law, health care, and related fields, in which knowledge workers engage in complex problem solving that involves a great deal of independent judgment. Today, the creative sector of the U.S. economy, broadly defined, employs more than 30% of the workforce (more than all of manufacturing) and accounts for nearly half of all wage and salary income (some $2 trillion) – almost as much as the manufacturing and service sectors together. Indeed, the United States has now entered what I call the Creative Age.

The roots of the Creative Age in the U.S. can be traced to the years surrounding World War II. After the war, federal funding for basic research jumped considerably, and so did the number of people pursuing higher education, thanks in part to the GI Bill. In the private sector, the newly formed venture capital industry provided an avenue for bringing research ideas to market. The social movements of the 1960s popularized the idea of openness; to be different was no longer to be an outcast but to be admired. Freedom of expression allowed new technologies and cultural forms to flourish – from biotechnology to alternative rock.

But the United States doesn't have some intrinsic advantage in the cultivation of creative people, innovative

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plications and green card renewals do take too long, and rejections of them are up. But what Richard Florida forgets, or ignores, is that the rest of the world has problems just as deep as the United States' – probably more so. Europe is dealing with the costs of unemployment, of reunifying Germany, of integrating the EU's newest members, and of slow growth throughout the region. China's economy is always dangerously close to overheating. India is feeling the first seismic shifts caused by growing competition in outsourcing. And there is still instability in the Middle East. The United States is not in danger of a permanent adverse shift; its current difficulties will be overcome by a combination of wise investments and a focused reassertion of the United States as an investment and education destination.

True, in the future there will be multiple loci of knowledge and creativity. Surely this is good for the global economy – and what is good for the world is good for the United States. Increasingly, companies and countries will look outside for ideas and will be more discerning about what they create internally. The United States will be the single biggest beneficiary of this global knowledge base. If it cannot draw foreign nationals to its organizations and universities, it can always outsource knowledge-acquisition operations to third-party countries. Intellectual capital, like financial capital, does not have to be held in the domestic country. The United States will be able to bid top dollar for external sources of knowledge.

The United States still boasts phenomenal wealth, a single language, and a cultural construct that has the support of most of its citizens. The last U.S. presidential election, closely fought and with great polarity of opinions, was conducted without violence or damage to property – an achievement that many regions in the world can't match. Democracy itself generates a premium in creativity.

Peter Sammons
Director
Buy Research
Cambridge, England

Time-Driven Activity-Based Costing

While Robert S. Kaplan and Stephen R. Anderson's evangelism for time-driven activity-based costing is welcome ("Time-Driven Activity-Based Costing," November 2004), it needs to be put into context.

Time-driven ABC has its place in certain departments and for certain activities. Many departments, such as IT and marketing, do not engage in repetitive activities that can be clocked reliably, so using a time-driven methodology to cost activities in those kinds of functions may create more problems than it solves. In situations where much of the work is project based, time-capture systems may already be deployed, and it is more expedient to use that data in the ABC calculation.

Kaplan says activity unit times can be estimated from interviews, observations, or surveys and do not need to be reassessed each time the model is recalculated. Where reliable unit times can be collected – for instance, the duration of a call at an automated call center – they can provide accurate data for a time-driven methodology. However, where estimates of unit times are infrequently reviewed, gross errors in costing can occur. A company's short-term strategies may create variations in unit times – for instance, what if a call center lengthens its employees' scripts to allow more time for cross selling?

In recent years, the arrival of Internet-based ABC applications has made it easier for organizations to routinely collect and collate data. They can report on their costs more frequently, regardless of the methodology used.

Time-driven ABC exposes the cost of excess capacity with a rigor that the other ABC methodologies (time splits and time capture) do not. While each of the methodologies has its strengths, none is perfect for every activity in every business function. In practice, most ABC models are hybrids and always have been, with different methodologies being employed in different departments.

Mike Sherratt
Founder and CEO
ALG Software
Knutsford, England

Kaplan and Anderson respond: While we appreciate Mike Sherratt's endorsement of the time-driven ABC approach, we disagree with his characterization of its limited applicability. Our article describes how the time-driven approach is being implemented rapidly and successfully in many enterprise-wide applications. We've applied time-driven ABC in more than 100 organizations, including several with highly sophisticated and complex IT departments that used the approach for developing accurate charge-out systems for the use of their services. We also fail to share Sherratt's enthusiasm for Internet-based ABC, which only modestly eases the reporting burden while retaining the subjectivity and inaccuracy of traditional ABC's employee time reporting.

Time-driven activity-based costing is not, as the letter writer claims, limited to repetitive, predictable activities. In his example of marketing and project activities, we can readily use actual rather than standard times to calculate the demands on resource capacity. As for updating the model, our article clearly describes how managers can easily adjust unit-time estimates as efficiencies change or as the tasks become more or less complex. In fact, the time-equation innovation in time-driven ABC specifically allows for unit-time estimates to vary based on the complexity of the task performed, such as when cross selling or expediting is involved. Finally, the accuracy of the time-driven model can be validated against actual capacity utilization.

Organizations do not need multiple cost methodologies. Whenever an organization supplies resources to perform work, the time-driven (or – more generally – the capacity-driven) ABC approach works better than traditional ABC to simply and accurately assign resource costs to the processes, products, services, and customers that are consuming the resources' capacities.

Presenteeism: At Work – But Out of It

Paul Hemp's October 2004 article, "Presenteeism: At Work – But Out of It," sheds light on the effect that common illnesses can have on worker productivity. Depression and pain were identified as several of the mainstay conditions studied, but they were listed separately. This separation may be the result of data collection methods, but scientific evidence shows that depression and chronic pain coexist.

Numerous studies have shown that depression is highly prevalent among people who have chronic, painful ailments such as backaches, headaches, gastrointestinal conditions, and joint problems. About 5% to 8% of the general population suffers from major depression; by contrast, among patients with chronic, painful ailments, 30% to 54% suffer from major depression. Depression itself is a strong predictor for the onset of intense, disabling neck and low back pain.

When an employee presents with pain, the employer may need to consider that this pain can coexist with depressive illness. In that case, the managerial and physical interventions should be different than if pain is the sole illness.

Dr. Marios Adamou
Lecturer in Psychiatry
Kent Institute of Medicine and Health Sciences
Research & Development Center
University of Kent
Canterbury, England

February 2005

COMING IN MARCH 2005

Lean Consumption
James P. Womack and
Daniel T. Jones

What Great Managers Do
Marcus Buckingham

Off-Ramps and On-Ramps: Keeping Talented Women on the Road to Success
Sylvia Ann Hewlett and
Carolyn Buck Luce

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THE HBR LIST

Breakthrough Ideas for 2005

The List is HBR's annual attempt to capture ideas in the state of becoming – when they're teetering between what one person suspects and what everyone accepts.

Roderick M. Kramer says it isn't bad when leaders flip-flop. **Julia Kirby** describes new efforts to redefine the problem of organizational performance. **Joseph L. Bower** praises the "Velcro organization," where managerial responsibilities can be rearranged. **Jeffrey F. Rayport** argues that companies must refocus innovation on the "demand side."

Eric Bonabeau describes a future in which computer-generated sound can be used to transmit vast amounts of data. **Roger L. Martin** says corporate systems such as CRM that are highly reliable tend to have little validity. **Kirthi Kalyanam** and **Monte Zweben** report that marketers are learning to contact customers at just the right moment. **Robert C. Merton** explains how equity swaps could help developing countries avoid some of the risk of boom and bust.

Thomas A. Stewart says companies need champions of the status quo. **Mohanbir Sawhney** suggests marketing strategies for the blogosphere. **Denise Caruso** shows how to deal with risks that lack owners. **Thomas H. Davenport** says personal information management – how well we use our PDAs and PCs – is the next productivity frontier.

Leigh Buchanan explores workplace taboos. **Henry W. Chesbrough** argues that the time is ripe for services science to become an academic field. **Kenneth Lieberthal** says China may change everyone's approach to intellectual property. **Jochen Wirtz** and **Loizos Heracleous** describe customer service apps for biometrics.

Mary Catherine Bateson envisions a midlife sabbatical for workers. **Jeffrey Rosen** explains why one privacy policy won't fit everyone. **Tihamér von Ghyczy** and **Janis Antonovics** say firms should embrace parasites. And **Jeffrey Pfeffer** warns business-book buyers to beware.

Additionally, HBR offers a list of intriguing business titles due out in 2005.

Reprint R0502A

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HBR CASE STUDY

Springboard to a Swan Dive?

Ajit Kambil and Bruce Beebe

John Clough, the CFO of NetRF, a tech firm in Salt Lake City, gets an offer he's not sure he wants to refuse. Benchmark, a *Fortune* 500 packaged-goods company, is looking for someone to join its board – specifically, to join the audit committee. "Would you be interested?" the executive recruiter asks.

John's experience with publicly held companies is limited, but he's highly regarded in the financial community for his acumen and probity. At NetRF, a maker of wireless communications equipment, John had championed expensing stock options at a time when it was uncommon for high-tech firms to do so; he'd received a lot of admiring press for that move. In mulling over the offer, the 39-year-old executive and flight enthusiast considers his situation. He loves his work, his Cessna time-share, and the skiing in the Salt Lake area. Board membership would confer on him a certain amount of honor and prestige, but would he be spreading himself too thin?

One colleague, Gordon Telford, extols a few of the virtues of board membership – the opportunity to learn and the chance to expand your business network. But another colleague, Philip Tedeschi, chief outside counsel to NetRF, warns that the hours can be considerable and board members' responsibilities (post-Sarbanes-Oxley) substantial. Subsequent meetings with Benchmark's nominating committee, its CEO, and its audit committee leave John with more questions than answers. Should he join the board?

This fictional case study outlines the risks and rewards that come with board service. Offering expert advice are Peter Goodson, a strategic adviser to corporate boards; John F. Olson, chair of the ABA Business Law Section's Corporate Governance Committee; David J. Berger, a partner at the law firm Wilson Sonsini Goodrich & Rosati; and Charles H. King, managing director at Korn/Ferry International.

Reprint R0502B

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Ending the CEO Succession Crisis

Ram Charan

The CEO succession process is broken. Many companies have no meaningful succession plans, and few of the ones that do are happy with them. CEO tenure is shrinking; in fact, two out of five CEOs fail in their first 18 months.

It isn't just that more CEOs are being replaced; it's that they're being replaced *badly.* The problems extend to every aspect of CEO succession: internal development programs, board supervision, and outside recruitment.

While many organizations do a decent job of nurturing middle managers, few have set up the comprehensive programs needed to find the half-dozen true CEO candidates out of the thousands of leaders in their midst. Even more damaging is the failure of boards to devote enough attention to succession. Search committee members often have no experience hiring CEOs; lacking guidance, they supply either the narrowest or the most general of requirements and then fail to vet either the candidates or the recruiters.

The result is that too often new CEOs are plucked from the well-worn Rolodexes of a remarkably small number of recruiters. These candidates may be strong in charisma but may lack critical skills or otherwise be a bad fit with the company. The resulting high turnover is particularly damaging, since outside CEOs often bring in their own teams, can cause the company to lose focus, and are especially costly to be rid of.

Drawing on over 35 years of experience with CEO succession, the author explains how companies can create a deep pool of internal candidates, how boards can consistently align strategy and leadership development, and how directors can get their money's worth from recruiters. Choosing a CEO should be not one decision but an amalgam of thousands of decisions made by many people every day over years.

Reprint R0502C; HBR OnPoint 8851; OnPoint collection "Hire the Right CEO" 8843

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Productive Friction: How Difficult Business Partnerships Can Accelerate Innovation

John Hagel III and John Seely Brown

Companies are becoming more dependent on business partners, but coordinating with outsiders takes its toll. Negotiating terms, monitoring performance, and, if needs are not being met, switching from one partner to another require time and money. Such transaction costs, Ronald Coase explained in his 1937 essay "The Nature of the Firm," drove many organizations to bring their activities in-house.

But what if Coase placed too much emphasis on these costs? What if friction between companies can be productive? Indeed, as John Hagel and John Seely Brown point out, interactions between organizations can yield benefits beyond the goods or services contracted for. Companies get better at what they do – and improve faster than their competitors – by working with outsiders whose specialized capabilities complement their own. Different enterprises bring different perspectives and competencies. When these enterprises tackle a problem together, they dramatically increase the chances for innovative solutions.

Of course, misunderstandings often arise when people with different backgrounds and skill sets try to collaborate. Opposing sides may focus on the distance that separates them rather than the common challenges they face.

How can companies harness friction so that it builds capabilities? Start by articulating performance goals that everyone buys into. Then make sure people are using tangible prototypes to wrangle over. Finally, assemble teams with committed people who bring different perspectives to the table.

As individual problems are being addressed, take care that the underpinnings of shared meaning and trust are also being woven between the companies. Neither can be dictated – but they can be cultivated. Without them, the performance fabric quickly unravels, and business partnerships disintegrate into rivalrous competition.

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Should Nonprofits Seek Profits?

William Foster and Jeffrey Bradach

Twenty years ago, it would have been shocking for a children's choir to sell singing telegrams or for an organization serving the homeless to dabble in property management. Today, it seems routine. Nonprofits increasingly feel compelled to launch earned-income ventures – not only to appear more disciplined and businesslike to stakeholders but also to reduce their reliance on fundraising.

There's plenty of hype about the value of earned-income ventures in the nonprofit world, but such projects account for only a small share of funding in most nonprofit domains, and few of the ventures make money. Moreover, when the authors examined how nonprofits evaluate potential enterprises, they discovered a pattern of unwarranted optimism. The potential financial returns are often exaggerated, and the challenges of running a successful business are routinely discounted. But the biggest downside of such ventures is that they can distract nonprofits' managers from their core social missions and, in some cases, even subvert those missions.

There are several reasons for the gap between the hype and the reality. One is that an organization's nonfinancial concerns – such as a desire to hire the disadvantaged – can hamper it in the commercial marketplace. Another is that nonprofits' executives tend to overlook the distinction between revenue and profit. For example, a youth services organization that had received funding to launch a food products enterprise hired young people and began making salad dressing. The nonprofit believed it spent $3.15 to produce each bottle of dressing that was sold for $3.50. But when expenses such as unused ingredients and managers' salaries were factored in, the cost per bottle reached a staggering $90.

Earned-income ventures do have a role in the nonprofit sector, the authors say, but unrealistic expectations are distorting managers' decisions, wasting precious resources, and leaving important social needs unmet.

Reprint R0502E

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Change Through Persuasion

David A. Garvin and Michael A. Roberto

Faced with the need for a massive change, most managers respond predictably. They revamp the organization's strategy, shift around staff, and root out inefficiencies. They then wait patiently for performance to improve – only to be bitterly disappointed because they've failed to adequately prepare employees for the change. In this article, the authors contend that to make change stick, leaders must conduct an effective persuasion campaign – one that begins weeks or months before the turnaround plan is set in concrete.

Like a political campaign, a persuasion campaign is largely one of differentiation from the past. Turnaround leaders must convince people that the organization is truly on its deathbed – or, at the very least, that radical changes are required if the organization is to survive and thrive. (This is a particularly difficult challenge when years of persistent problems have been accompanied by few changes in the status quo.) And they must demonstrate through word and deed that they are the right leaders with the right plan.

Accomplishing all this calls for a four-part communications strategy. Prior to announcing a turnaround plan, leaders need to set the stage for employees' acceptance of it. At the time of delivery, they must present a framework through which employees can interpret information and messages about the plan. As time passes, they must manage the mood so that employees' emotional states support implementation and follow-through. And at critical intervals, they must provide reinforcement to ensure that the desired changes take hold and that there's no backsliding.

Using the example of the dramatic turnaround at Boston's Beth Israel Deaconess Medical Center, the authors elucidate the inner workings of a successful change effort.

Reprint R0502F

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THE HBR INTERVIEW

Transforming an Industrial Giant

Heinrich von Pierer

Interviewed by Thomas A. Stewart and Louise O'Brien

In his 12 years at the helm of Siemens, CEO Heinrich von Pierer designed and directed a major transformation. Taking this German icon from a technically superb but slow-moving industrial giant to a disciplined yet nimble multinational has posed enormous challenges.

Since 1992, Siemens has revamped its portfolio of businesses, expanded its reach into 192 countries, and created a more local-market-driven culture, gaining recognition as one of the best-managed and most competitive companies in the world. In this edited interview with HBR editor Thomas A. Stewart and consulting editor Louise O'Brien, von Pierer describes the requirements for transformation and culture change and how he broke down historical barriers at Siemens. He shares his insights about portfolio restructuring, his lessons from competing with GE, and the pros and cons of being based in Europe versus America. He reflects on the true start of globalization after the fall of the Berlin wall and on how dramatically the company needed to change in order to counter the resulting pricing pressures across all of its businesses. He talks, too, about the biggest challenge on his successor's desk–"the particular challenge of China," he says.

Amid all these topics, von Pierer reiterates the importance of people: "We all talk about people as our most important resource, but as a matter of fact, who's really taking care of people?…We need [their] backing. We can't afford to run into a situation where people no longer accept what we do."

Reprint R0502G

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MANAGING YOURSELF

Two Executives, One Career

Cynthia R. Cunningham and Shelley S. Murray

For six years, Cynthia Cunningham and Shelley Murray shared an executive job at Fleet Bank. One desk, one chair, one computer, one telephone, and one voice-mail account. To their clients and colleagues, they were effectively one person, though one person with the strengths and ideas of two, seamlessly handing projects back and forth. Although their department was dissolved after the bank merged with Bank of America, the two continue to consider themselves a package–they have one résumé, and they are seeking their next opportunity together.

Their choice to share a job was not only a quality-of-life decision but one intended to keep their careers on course: "Taking two separate part-time jobs would have thrown us completely off track," they write in this first-person account. "We're both ambitious people, and neither of us wanted just a job. We wanted careers."

In this article, the two highly motivated women reveal their determination to manage the demands of both family and career. Flextime, telecommuting, and compressed workweeks are just some of the options open to executives seeking greater work/life balance, and the job share, as described by Cunningham and Murray, could well be the next solution for those wishing to avoid major trade-offs between their personal and professional lives.

Cunningham and Murray describe in vivid detail how they structured their unusual arrangement, how they sold themselves to management, and the hurdles they faced along the way. Theirs is a win-win story, for the company and for them.

Reprint R0502H

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BEST PRACTICE

Strategic Sourcing: From Periphery to the Core

Mark Gottfredson, Rudy Puryear, and Stephen Phillips

As globalization changes the basis of competition, sourcing is moving from the periphery of corporate functions to the core. Always important in terms of costs, sourcing is becoming a strategic opportunity. But few companies are ready for this shift.

Outsourcing has grown so sophisticated that even critical functions like engineering, R&D, manufacturing, and marketing can–and often should–be moved outside. And that, in turn, is changing the way companies think about their organizations, their value chains, and their competitive positions.

Already, a handful of vanguard companies are transforming what used to be purely internal corporate functions into entirely new industries. Companies like UPS, Solectron, and Hewitt have created new business models by concentrating scale and skill within a single function. As these and other function-based companies grow, so does the potential value of outsourcing to all companies.

Migrating from a vertically integrated company to a specialized provider of a single function is not a winning strategy for everyone. But all companies need to rigorously reassess each of their functions as possible outsourcing candidates. Presented in this article is a simple three-step process to identify which functions your company needs to own and protect, which can be best performed by what kinds of partners, and which could be turned into new business opportunities. The result of such an analysis will be a comprehensive capabilities-sourcing strategy.

As a detailed examination of 7-Eleven's experience shows, the success of the strategy often hinges on the creativity with which partnerships are organized and managed. But only by first taking a broad, strategic view of capabilities sourcing can your company gain the greatest benefit from all of its sourcing choices.

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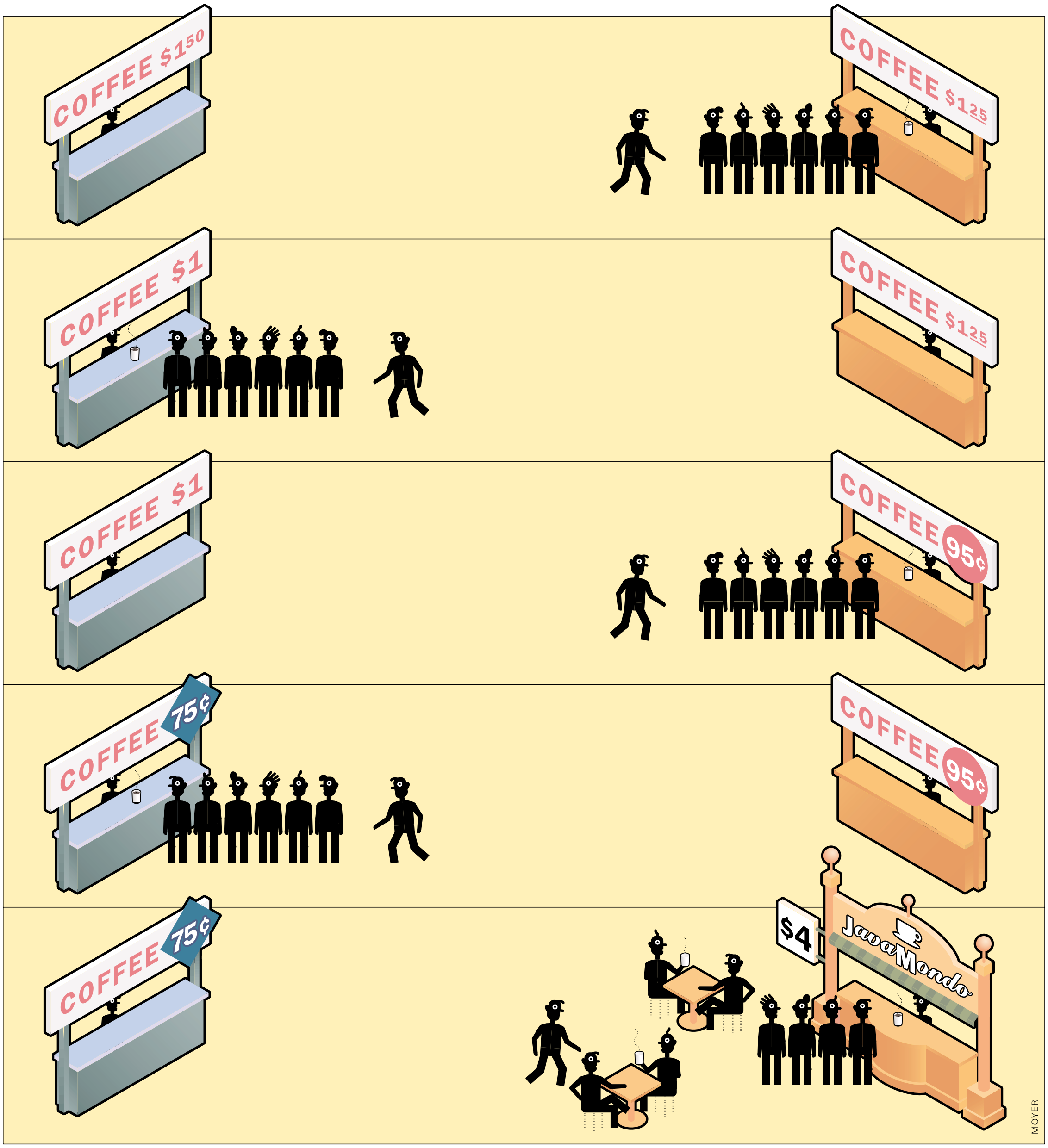

Death by a Thousand Cuts

People go to war for many reasons. Protecting freedom, family, or country is generally considered a noble one. Undercutting a competitor is not. The top line is a potent weapon – but one that must be wielded with finesse, not machismo.

As a strategy, price-cutting can be difficult to sustain; against more efficient competitors, it's impossible. In his first-rate book *Competitive Solutions: The Strategist's Toolkit,* R. Preston McAfee points out that price wars between equals produce injuries on both sides and victory on neither. So launch hostilities only when you're sure you have an overwhelming advantage and can drive the other guy from the market.

Of course, if a competitor attacks, you'll have to put up your dukes. But in peacetime, it's wiser to invest in areas such as R&D, customer service, and marketing, which justify raising prices, not lowering them. After all, cheap – unlike rich and thin – is something you can be to excess.

Don Moyer can be reached at don@amsite.com.

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