Strategy Formulation 9

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After a firm's external and internal environments have been analyzed, it is necessary to review its stated mission and goals to ensure that they are compatible with the firm's internal characteristics and its external environment. Reconsidering the firm's current strategic initiatives is the first step in *evaluating* its activities and thinking about what the firm *should* be doing.

After the firm's mission and ongoing strategic directions are well understood, the organization can begin to craft a strategy. The first step in this process, a **SWOT** (strengths, weaknesses, opportunities, and threats) **analysis**, enables the firm to position itself to take advantage of select opportunities in the environment while avoiding or minimizing environmental threats.[1] In doing so, the organization attempts to emphasize its strengths and moderate the potential negative consequences of its weaknesses. Sometimes referred to as TOWS, the SWOT analysis also helps uncover strengths that have not yet been fully utilized and identify weaknesses that can be corrected. Matching information about the environment with knowledge of the organization's capabilities enables management to formulate realistic strategies for attaining its goals.[2]

SWOT Analysis
An analysis intended to match the firm's strengths and weaknesses (the *S* and *W* in the acronym) with the opportunities and threats (the *O* and *T*) posed by the environment.

9-1 Strengths and Weaknesses

The first two elements of the SWOT analysis—strengths and weaknesses—represent internal firm attributes. In addition, a firm's strengths and weaknesses are considered *relative* to key competitors in its industry. In other words, customer loyalty would be viewed as a strength or weakness for an organization if it is believed to be greater in that firm than in most others in the industry. Hence, strengths can be viewed as artifacts of past success in an organization, whereas weaknesses can be seen as gaps between an organization's current position and the industry norm. As an extension of this logic, the notion of **gap analysis** seeks to identify the distance between a firm's current position and its desired position with regard to an internal weakness. When possible, a firm should take action to close the gap, especially when the gap leaves a firm vulnerable to external threats in its environment.

Gap Analysis
Identifying the distance between a firm's current position and its desired position with regard to an internal weakness. All things equal, it is desirable to take action to close a gap, especially when it leaves a firm vulnerable to external threats in its environment.

The **value chain** is a useful tool for analyzing a firm's strengths and weaknesses and understanding how they might translate into competitive advantage or disadvantage. The value chain describes the activities that comprise the economic performance and capabilities of the firm. Specifically, the value chain identifies primary activities (i.e., those directly related to the firm's product or service) and support activities (i.e., those that assist the primary activities) which create value for customers. As such, the value chain is a conceptual foundation for assessing firm strengths and weaknesses.

Value Chain
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By considering all of the firm's processes from the procurement of raw materials to the delivery of a final product or service, strategic managers can identify discrete activities performed along the way that may add exceptional value to the end product or detract from it.[3] For example, in March 2002, after a gradual decline in travel agency commissions throughout the industry, Delta Airlines announced an end to most of the commissions it pays to travel agents. With Delta's ability to trim sales costs through direct selling, the airline no longer believed that domestic travel agents were adding sufficient value to justify the expense. As is often true with such moves in the airline industry, most other major airlines followed suit.[4]

Firm resources—both tangible and intangible—ultimately constitute the firm's strengths and weaknesses.[5] Merely possessing a resource, however, does not always result in any tangible benefit to the organization. Resources are translated into desired results by **strategic capabilities**, the mechanism through which individuals in an organization coordinate efforts along one or more resources to

Strategic Capabilities
The mechanism through which individuals in an organization coordinate efforts along one or more resources to solve a particular problem.

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solve a particular problem. Although resources and capabilities are sometimes used interchangeably, the distinction between the two is an important one.[6]

The three broad categories of firm resources are as follows:

- **Human resources:** the experience, capabilities, knowledge, skills, and judgment of all the firm's employees
- **Organizational resources:** the firm's systems and processes, including its strategies at various levels, structure, and culture
- **Physical resources:** plant and equipment, geographic locations, access to raw materials, distribution network, and technology

In an optimal setting, all three types of resources work together to provide the firm with a competitive advantage that can be sustained. According to the resource-based perspective discussed in Chapter 1, a firm must utilize resources that are long lasting and not easily acquired by rivals through imitation, transfer, or replication if it is to sustain competitive advantage. When a firm's strategic success is dependent on resources that can readily be acquired by competitors, that success is likely to be temporary. A consideration of an organization's strengths and weaknesses is a means of objectively assessing its resource base.

9-2 Human Resources

The most attractive organizational and physical resources are useless without a competent workforce of managers and employees. A firm's human resources can be examined at three levels: (1) the board of directors, (2) top management, and (3) middle management, supervisors, and employees.

9-2a Board of Directors

Because board members are becoming increasingly involved in corporate affairs, they can materially influence the firm's effectiveness. In examining their strengths and weaknesses, one should consider the following issues.

1. *Prospective contributions of corporate board members.* Strong board members possess considerable experience, knowledge, and judgment, as well as valuable outside political connections.
2. *Tenure (experience) as members of the corporate board.* Long-term stability enables board members to gain organizational knowledge, but some turnover is beneficial because new members often bring a fresh perspective to strategic issues.
3. *Connection to the firm (i.e., internal or external) and ability to represent various stakeholders.* Although it is common for several top managers to be board members, a disproportionate representation of them diminishes the identity of the board as a group apart from top management. Ideally, board members should represent diverse stakeholders, including minorities, creditors, customers, and the local community. A diverse board membership can contribute to the health of the firm.
4. *Present level of investment in the firm.* Significant stock ownership may increase the board's responsiveness to shareholders, while significant bond holdings may heighten its concern for creditworthiness and result in a risk-averse posture on strategic issues.

9-2b Top Management

Three issues should be considered relative to the strengths and weaknesses of any firm's top management.

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1. *Backgrounds and capabilities of top managers.* Comprehending their strengths and weaknesses in experience, managerial style, decision-making capability, and team building is useful. Although having executives who possess an intimate knowledge of

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the firm and its industry can be advantageous, managers from diverse and complementary backgrounds may generate innovative strategic ideas. In addition, an organization's management needs may change as the firm grows and matures. Because firms are often started by innovative entrepreneurs who happen to be poor administrators, they often add key administrators to the top management team, which includes the group of top-level executives—headed by the CEO—all of whom play instrumental roles in the strategic management process.

2. *Tenure (experience) as members of top management*. Although lengthy tenure can mean consistent and stable strategy development and implementation, low turnover may breed conformity, complacency, and a failure to explore new opportunities. CEO turnover is even desirable when the firm is unable to meet its performance targets.
3. *Strengths and weaknesses of individual top managers*. Some executives may excel in strategy formulation, for instance, but be weak in implementation. Some may spend considerable time on internal stakeholders and operations, whereas others may concentrate on external constituents. As with the board of directors, it is helpful for board members to possess complementary skills to function well as a team. In addition, several large companies offer financial incentives to sign and retain top executives with knowledge critical to the firm.

9-2c Middle Management, Supervisors, and Employees

Even the best strategies will fail without a talented workforce to implement them. A firm's personnel and their knowledge, abilities, commitment, and performance tend to reflect the firm's HR programs. These factors can be explored by considering five key issues.

1. *Existence of a comprehensive HR planning program*. Developing such a program requires that the firm forecast its personnel needs, including types of positions and requisite qualifications, for the next several years based on its strategic plan.
2. *Strategically relevant knowledge or expertise possessed by members of the firm*. Many firms place a great emphasis on retaining high-quality individuals in critical areas such as R&D or sales. This is a vital issue when a firm is heavily involved in global competition. Interestingly, all companies claim to have the *best* workforce, but clearly this is not always the case.
3. *Emphasis on training and development*. Some firms view training and development as a strategic issue and seek long-term benefits from its training programs. In contrast, other firms view training as a short-term necessity and emphasize cost minimization in their programs.
4. *Turnover*. High turnover relative to levels among close competitors generally reflects personnel problems such as poor management–employee relations, low compensation or benefits, or low job satisfaction due to other causes.
5. *Emphasis on effective performance appraisal (PA)*. Progressive firms utilize PA to provide accurate feedback to managers and employees, link rewards to actual performance, and show managers and employees how to improve performance, as well as comply with all equal employment opportunity requirements. Firms that do not adequately appraise high performers—and reward them—are more likely to lose them.

9-3 Organizational Resources

The alignment between organizational resources and business strategy is critical for long-term success. Researchers have utilized the term *dynamic capabilities* to refer to the set of specific and identifiable processes controlled by an organization, such as product development and strategic decision making.[7] In this regard, seven key issues are noteworthy.

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1. *Consistency among corporate, business, and functional strategies*. To facilitate strategy integration, managers at the corporate, business unit, and functional level should be represented at each level of strategic planning. The strategy at each level should influence and be influenced by the strategy at the other levels.
2. *Consistency between organizational strategies and the firm's mission and goals*. The mission, goals, and strategies must be compatible and integrated to reflect a clear sense of identity and purpose for the organization.
3. *Consistency between the firm's strategies and its culture*. For a strategy to be effective, it must be supported by an organizational culture that emphasizes values that support it.
4. *Consistency between the firm's strategies and its structure*. It is important to note any structural changes that might be required should the organization seek to implement a major change in strategy.
5. *Position in the industry*. All things equal, firms that possess strong market positions are in a better position to implement strategic changes than those in weak positions. For firms operating globally, this assessment must be made in the various nations in which the firm operates.
6. *Product and service quality*. It is important to comprehend how quality levels of the firm's products and services compare with those of rival firms.
7. *Reputation of the firm and/or brand*. Many firms have established reputations for factors such as high quality and customer service. A 2004 *Financial Times* global survey identified strength in brands such as General Electric, Microsoft, Toyota, IBM, and Wal-Mart. In contrast, little confidence was placed on scandal-ridden firms such as Enron, Parmalat, and WorldCom.[8]

9-4 Physical Resources

Physical resources can differ considerably from one organization to another, even among close competitors. For example, Amazon.com requires different physical plants than a software consulting firm. Nonetheless, five issues concerning the strengths and weaknesses of physical resources should be considered.

1. *Currency of technology*. All things equal, competitors with superior technology and the ability to use it have a decided competitive advantage in the marketplace. This is especially true in global markets and should be assessed in each of the nations in which the firm operates.
2. *Quality and sophistication of distribution network*. Distribution networks apply to both manufacturing and service concerns. The American Airlines domination of passenger gates at Dallas–Fort Worth Airport and Delta's similar control in Atlanta give both of these service companies a competitive advantage.
3. *Production capacity*. A continual backlog of orders may indicate a growing market acceptance of a firm's product, or it may depict serious problems associated with insufficient capacity. Capacity may be expanded by increasing production shifts or obtaining additional facilities, but such measures can be costly.
4. *Reliable access to cost-effective sources of supplies*. Suppliers who are unreliable, lack effective quality control programs, or cannot control their costs well do not foster a competitive advantage for the buying firm.
5. *Favorable location(s)*. Ideally, the organization should be located where skilled labor, suppliers, and customers are readily accessible.

The unique combination of a firm's human, organizational, and physical resources—as transformed into capabilities—should be emphasized in its strategy. As the firm acquires additional resources, unique synergies occur between its new and existing resources. Because each firm possesses its own distinct

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Case Analysis 9-1

Step 16: What Strengths Exist for the Organization?

Step 17: What Weaknesses Exist for the Organization?

Although resources and strategic capabilities are the foundation for a firm's strengths and weaknesses, it is not necessary to discuss the transition from resources to strengths and weaknesses in this section. Rather, the organization's strengths and weaknesses should be listed, each with as much depth and justification as possible. Many possible organizational strengths and weaknesses can emanate from its resource base, including but not limited to the following:

1. Advertising
2. Brand names
3. Channel management
4. Company reputation
5. Computer information system
6. Control systems
7. Costs
8. Customer loyalty
9. Decision making
10. Distribution
11. Economies of scale
12. Environmental scanning
13. Financial resources
14. Forecasting
15. Government lobbying
16. Human resources
17. Inventory management
18. Internet presence
19. Labor relations
20. Leadership
21. Location
22. Management
23. Manufacturing and operations
24. Market share
25. Organizational structure
26. Physical facilities and equipment
27. Product/service differentiation
28. Product/service quality
29. Promotion
30. Public relations
31. Purchasing
32. Quality control
33. Research and development
34. Sales
35. Technology and patents

To set the stage for the remainder of the analysis, it is important to state clearly how each strength has helped the organization and how each weakness has hindered it. In many instances, the strengths are the primary catalysts for the organization's successes, and its weaknesses are the main reasons why it has failed in certain endeavors.

combination of resources, the particular types of synergies that occur will differ from one firm to another. Leveraging these synergies into sustained competitive advantages is a key task of top management (see Case Analysis 9-1).

9-5 Opportunities and Threats

The last two elements of the SWOT analysis—opportunities and threats—are associated with factors outside the organization. As such, they emerge from the earlier analyses of the industry and the macroenvironment (i.e., political-legal, economic, social, and technological forces). Although an industry-level analysis may identify general factors, this stage moves to the firm level and considers how the external forces could affect the organization under consideration. For example, an analysis

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of the social forces affecting investment houses may identify consumer acceptance of the Internet as a social force affecting the industry. Considering online broker Ameritrade, this force may be translated into both opportunities (e.g., a growing market of potential online investors who are still utilizing traditional brokers) and threats (e.g., intense competition from the myriad of Internet sources that may erode the loyalty of current customers to Ameritrade offerings).

External opportunities and threats must not be confused with *internal* strengths and weaknesses. Factors associated with the firm such as a poor financial position, an ineffective marketing strategy, or a strong brand image are internal factors and therefore must be classified as strengths or weaknesses. In contrast, factors outside the firm such as demographic changes, competitive threats, or recent legislation are external factors and therefore must be classified as opportunities or threats. At the international level, certain external factors should be considered as prospective opportunities and threats, including the cyclical or seasonal nature of the industry in which the firm operates and the intensity of global competition.

It is also critical to distinguish between *opportunities* and *alternatives,* although the distinction can sometimes appear to be one of semantics. Opportunities represent the application of macroenvironmental forces to a specific organization. Alternatives emanate from the SW/OT matrix (discussed in section 9-6) and represent specific courses of action that the organization may choose to pursue. The two are related but must be differentiated. For example, increasing societal interest in Cajun food may present an opportunity for a restaurant. When considered relative to internal factors (via the SW/OT matrix) such as the company's existing locations in Louisiana and its strong reputation for innovative cuisine, this opportunity may lead to an alternative for the company to consider, such as introducing a new line of Cajun offerings (see Case Analysis 9-2).

Case Analysis 9-2

Step 18: What Opportunities Exist for the Organization?

Step 19: What Threats Exist for the Organization?

In the SWOT analysis, one must not only identify strengths and weaknesses, but also translate the analysis of the macroenvironment and industry into opportunities and threats. Although these issues were addressed at the industry level earlier in the analysis, they should be integrated into a discussion that highlights specifically how they present opportunities to or threaten the organization. For example, if it was previously noted that the industry rises and falls abruptly with economic conditions, then the prospects of a recession may pose a major threat for the firm. If it was noted that technological advances have not yet been incorporated into production processes in the industry, then application of this technology may become an opportunity worth considering for the organization.

There is no set target for the number of strengths, weaknesses, opportunities, or threats that should be identified. When only several of each are identified, however, it is likely that the analysis is superficial and does not address key issues. When the list becomes too long—as would be the case if all thirty-five of the items listed in Case Analysis 9-1 were associated with strengths and weaknesses—the list becomes cumbersome to manage in the remaining steps of the analysis. In this situation, it is necessary to consider pooling several items into one when feasible. For example, "expertise in advertising" and "a strong sales force" could be merged into "marketing expertise."

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9-6 The SW/OT Matrix

SW/OT Matrix
A tool for generating alternative courses of action by identifying relevant combinations of internal characteristics (i.e., strengths and weaknesses) and external forces (i.e., opportunities and threats).

After the SWOT analysis is completed, alternative courses of action may be analyzed by creating a **SW/OT matrix**.[9] The SW/OT matrix extends the SWOT analysis by using it as a tool for generating strategic alternatives for the firm. A matrix is created with strengths and weaknesses listed vertically on the left side and opportunities and threats listed across the top. Alternatives emerge from the combination of one or more strengths/weaknesses from the left side of the matrix with one or more opportunities/threats from the top. For example, a company that can develop and produce high-quality electronic products in a short time—a strength—could take advantage of an increased consumer interest in portable DVD players—an opportunity—by developing and marketing one, a strategic alternative. This does not mean that the company should necessarily pursue such a strategy, but merely that the alternative warrants further consideration. The SW/OT matrix is a systematic means of developing strategic alternatives available to the organization, but it requires brainstorming and creative skills as well. The SW/OT matrix helps top managers position a firm in its environment so that it leverages its strengths while minimizing the detrimental effects of its weaknesses.

In general, four categories of alternatives emerge from the SW/OT matrix, each representing the combination of one or more strengths or weaknesses with one or more opportunities or threats.

1. *Strength–Opportunity*. These "offensive" alternatives tend to be the most common and involve utilizing an organizational strength to address an opportunity.
2. *Weakness–Threat*. These "defensive" alternatives involve taking corrective action to eliminate or minimize a weakness so as to minimize the effect of a threat.
3. *Strength–Threat*. These alternatives involve utilizing a strength to eliminate or minimize the effect of a threat and may be offensive or defensive.
4. *Weakness–Opportunity*. These alternatives involve shoring up a weakness so that the organization can take advantage of an opportunity and may be offensive or defensive.

Typically, most of the individual internal-external combinations (i.e., matches between strengths/weaknesses and opportunities/threats) will not produce viable alternatives. Further, several different combinations of internal and external factors can produce the same alternative. Some of the alternatives that emerge might be eliminated from further consideration for obvious reasons (e.g., taking the action would be illegal). In addition, a given SW/OT matrix might generate a large number of alternatives in a particular category, whereas only a few may be generated in other categories. Once generated, strategic alternatives should be analyzed further.

Figure 9-1 provides a simplified example of a SW/OT matrix for McDonald's. Assume that the SWOT analysis for McDonald's identified strengths of financial stability, brand recognition, and a strong ability to produce consistent products throughout the world. Two weaknesses were identified as well: inconsistent financial performance in international markets and a heavy dependence on fried foods. The two key opportunities were economic growth in emerging economies and the increasing health consciousness of the U.S. population. Two threats were highlighted as well: the possible mandates that will raise employment costs in the United States and the increasing popularity of easy-to-prepare microwaveable foods. A thorough SWOT analysis for McDonald's would develop many more than two or three factors in each category and might even challenge the oversimplification of the factors identified in this example. Nonetheless, the number and

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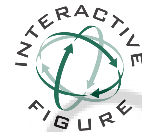
FIGURE 9-1 SW/OT Matrix

	Opportunities 1. Economic growth in emerging economies 2. Increasing health consciousness of population in United States and other countries	**Threats** 1. Possible increase in U.S. minimum wage and mandates requiring employers to provide health care 2. Popularity of easy-to-prepare grocery items
Strengths 1. Financial stability and resources 2. Brand name and recognition 3. Consistency of products and service	**Alternative 1:** Launch new locations in growing economies such as China and Mexico (S1, S2, O1) **Alternative 2:** Develop and emphasize more healthier foods (W1, W2, O2)	
Weaknesses 1. Inconsistent financial performance in international markets 2. Dependence on fried foods	**Alternative 3:** Introduce McDonald's frozen foods in grocery outlets (S2, S3, T2) **Alternative 4:** No strategic change	



complexity of the factors are kept to a minimum so that the process of developing alternatives can be clearly illustrated.

Following the example, three possible alternative courses of action can be identified for further consideration. First, McDonald's could emphasize its financial and brand strengths and seize an emerging market opportunity by expanding aggressively into growing economies such as China and Mexico. Second, McDonald's could address its weaknesses of declining market share and dependence on fast foods and capitalize on a greater health awareness in the United States and other parts of the world by developing and emphasizing more healthy foods. Third, McDonald's could emphasize its brand name and consistency strengths and address the threat of increased popularity of easy-to-prepare grocery items by introducing its own line of grocery products. Of course, this simple example considers only a few hypothetical items in each of the SWOT categories and does not suggest that McDonald's should *necessarily* adopt any of these alternatives.

It is worth noting that continuing to implement the current strategy in its present form—the so-called no change option—should be considered. This alternative (denoted as the final option in the previous example) should be analyzed as critically as the others. Selecting the no change alternative should *not* be considered as a low-risk option, because resisting change may be just as likely to expose a firm to great danger as embracing it (see Case Analysis 9-3).

Evaluating the pros and cons of strategic alternatives in a detailed, objective, and thorough manner is critical. Problems with implementation can often be traced to the lack of a thorough evaluation of the strategic alternatives available to a firm. For example, it is easy to assume that well-known brands will be readily accepted in new markets or that competitors will not respond effectively to major strategic changes. Even major retailers, however, can find themselves battling stiff local competition when they expand abroad.[10]

In addition, the direction of a strategic change can affect the difficulty of its implementation. In general, a business pursuing differentiation can shift to low cost more easily than a low-cost business can shift to differentiation. Because a low-cost business is likely to be associated with value rather than quality, it is difficult to convince buyers that they should pay more because its products

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Case Analysis 9-3

Step 20: What Strategic Alternatives Are Available to the Organization?

Alternatives are organizational courses of action that (1) are worth considering because they offer some potentially positive benefits, and (2) are within the realm of possibilities for the organization. For starters, one alternative is to continue with the present strategy. Sometimes this alternative is the most desirable, but typically some changes are needed. Additional alternatives should be identified from the SW/OT matrix in two ways. First, one should consider more fully utilizing strengths to take advantage of existing opportunities or palliate threats if the organization is not presently doing so. For example, if an organization has excess production capacity and there exists a market not presently served, then moving into this market is worth considering. Second, one should also consider taking action to minimize the weaknesses so that the organization can pursue opportunities or minimize the effect of threats. It is critical to identify the S/W-O/T combinations that result in the identification of each alternative, but it is not worthwhile to include alternatives that are obviously implausible or unattractive (e.g., McDonald's could close its fast-food stores to concentrate on promoting frozen foods through grocery outlets) for the sake of creating a list. All of the alternatives to be considered should be viable alternatives, at least at first glance.

There is no set number of alternatives that should be generated. As with the identification of elements within the SWOT, having too few alternatives implies a superficial analysis, whereas too many alternatives can become difficult to assess.

Step 21: What Are the Pros and Cons of These Alternatives?

Some of the alternatives identified in step 20 may be mutually exclusive, whereas others may not. Inevitably, one must assess the attractiveness of each alternative. It is not appropriate to "sell" one or two that will be recommended later. Rather, pros and cons must be objectively identified for each alternative. All alternatives have costs, and some have limited prospects for success, factors which should be converted to dollars when possible. For example, quality circles may be proposed as a solution to low morale without considering the costs. Quality circles require a commitment of time (i.e., lost production) and effort if they are to be successful, and management must also be willing to implement suggestions. In the final analysis, quality circles may be desirable, but no strategy can be implemented free of cost.

Interestingly, the quality circles recommendation has another problem. Most scholars and practitioners have reported that quality circles are effective only when they are part of a larger approach to employee empowerment. As such, a quality circle alternative should consider an overall strategic change as related to the organization's human resources, not simply the implementation of a technique.

It is important to consider competitive responses in concert with this and the subsequent case analysis step. For example, a McDonald's drop in price for the Big Mac cannot be considered in isolation of a likely price cut at Burger King. In many cases, anticipated retaliation is a con of the alternative and could ultimately render the alternative as undesirable. Assuming that competitor behavior will not change over time—especially in response to a major strategic change—is shortsighted.

Step 22: Which Alternative(s) Should Be Pursued and Why?

This phase necessitates an objective and subjective analysis of the pros and cons associated with each alternative. It is critical not to select an alternative without both arguing for its selection and explaining why other alternatives were rejected. When two

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or more options are mutually exclusive, eliminating the options not chosen is just as important as selecting the desired choices. Although it is important to spend time analyzing the alternatives, one must resist the temptation to overanalyze and avoid making the difficult choices, a process often referred to as "analysis to paralysis."

are differentiated. Volkswagen found this out when sales plummeted after the carmaker added pricey features to the moderately positioned Golf. Many consumers simply were not willing to pay the additional charge for a vehicle whose quality and prestige was perceived to be somewhat modest.[11]

9-7 Issues in Strategy Formulation

Crafting a strategy is not an easy task, even with the assistance of tools such as the SW/OT matrix. When a strategy appears attractive, certain issues should be considered before it is implemented. Four such issues are discussed in this section.

9-7a Evaluating Strategic Change

Should an organization change course when performance declines or should it stay the course? On the one hand, its strategic managers may choose to commit to a strategic course of action for an extended time and enjoy the benefits of specialization, expertise, organizational learning, and a clear customer image. Alternatively, an organization can remain flexible so that it does not become committed to products, technology, or market approaches that may become outdated. In a perfect world, organizations commit to predictable, successful courses of action, and strategic change is only incremental. However, outcomes are not always predictable.

Source: Ablestock.com

As with many strategic issues, there are two compelling sides to this debate. When traditional firms perform poorly, their strategic managers are exhorted by business analysts to promote flexibility and strategic renewal to improve profitability. In contrast, when bold strategic changes fail, pundits assert that a company must return to its "core business." Hence, it is easy to migrate freely from one side of the debate to the other, often with convincing empirical and intuitively appealing arguments.

The needs for strategic flexibility or commitment can be debated on at least four grounds. First, a strategy tends to yield superior performance when it fits with the organization's environment. Without strategic flexibility, an organization cannot adapt to its changing external environment. Even if an organization's strategy and its environment are in concert, an environmental shift may necessitate strategic change to maintain alignment. In addition, changes in competition and technology necessitate a change in the knowledge base within the organization if it is to prosper. The state of the environment is not always fully understood by strategy formulators, and top managers may be most likely to contemplate a strategic change when perceived environmental uncertainty is high.

In contrast, however, a change in any key strategic, environmental, or organizational factor may entice strategic managers in a business to modify its strategy to incorporate these changes. However, since such variables are constantly evolving, this is a challenging process, and strategic inaction may minimize uncertainty. Indeed, a strategic change is most risky when competitors are better equipped to respond if it is deemed successful. As such, strategic change can challenge the assumptions of all organizational members and may be difficult to implement even with employee support.

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Second, flexibility is necessary if an organization is to seek first-mover advantages by entering a new market or developing a new product or service prior to its competitors. Being a first mover can help secure access to scarce resources, increase the organization's knowledge base, and result in substantial long-term competitive advantage, especially when switching costs are high. Maintaining commitment to the firm's strategy can preclude movement into attractive strategic domains.[12]

However, even when strategic change results in a successful new product or service, there is no assurance that this success can be maintained. In fact, competitors may distort consumer perceptions and reap the benefits of the initial strategic change. When a consumer goods company imitates another, for example, consumers may purchase the imitation product thinking it is the original. If consumers dislike the product, this dissatisfaction can be transferred to the original. On the other hand, if the consumer likes the product, the consumer may realize that the product is an imitator and transfer the positive associations with the original product to that of the imitator. Either scenario can prove costly to the originator.

Third, even when a firm's environment is relatively stable, strategic change can be attractive when the organization's set of unique human, physical, capital, and informational resources change. Resource shifts necessitating strategic change may be more prevalent in some organizations than in others. Following this logic, strategic change can improve an organization's ability to adapt by forcing healthy changes within the business. The initial pain associated with change may be offset by the emergence of a lean, rejuvenated organization with a fresh focus on its goals and objectives.[13]

Consumer confusion may result from strategic change, however, even when the new strategy represents a better fit with the firm's resources. For example, if a business employing a low-cost strategy attempts to switch to a differentiation strategy, its price-oriented customers may become confused and leave in pursuit of another low-cost leader, while those willing to pay a premium price for differentiated products may not recognize or positively perceive the strategic change. Many will likely recall remnants of the previous strategy—perhaps advertising campaigns—and may not even consider the organization for future business.

Fourth, strategic change may be necessary if desired performance levels are not being attained by the organization. In many cases, a change in strategy may be required to improve the ability of the business to generate revenues or profits, increase market share, and/or improve return on assets or investment. In many cases, new CEOs are recruited for that purpose.

In contrast, however, the measures required to implement a change in strategy may necessitate substantial outlays of capital, thereby further denigrating the organization's financial position. Considering the Miles and Snow typology discussed in section 7-2 as an example, a shift from a prospector or analyzer strategy to a defender strategy may require investments in sophisticated production equipment to lower production costs, a characteristic more important to effective implementation of a defender strategy. Likewise, a shift from defender or analyzer to prospector may require substantial outlays to develop or enhance R&D facilities.

The decision to incorporate a substantial change in strategy can be alluring, especially when performance is poor. It is necessary, however, to recognize the costs associated with strategic change *before* committing resources.

9-7b Social Responsibility and Managerial Ethics

Strategy decisions should not be based solely on projected effects on financial performance. An organization's strategies at all levels should be compatible with its stance on social responsibility and ethics. Strategic alternatives should

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be considered in light of stated positions on social responsibility. Marketers of alcoholic beverages must consider whether attractive advertising campaigns may attract minors as well. A manufacturer must consider the effects of a prospective plant relocation on the community where it is currently located. Video game developers, for example, must consider how much violence is acceptable in the games they market to various age groups. Hence, every organization faces social responsibility and ethical considerations.

9-7c Effects on Organizational Resources

Executing a strategy requires resources that could be used for another purpose. The most obvious example is capital. If a firm pursues aggressive expansion into an uncharted geographical area, for example, the capital required will not be available for other purposes such as R&D or a new advertising campaign. If a firm launches a service enhancement effort by requiring sales representatives to make more frequent visits to existing customers, they will not be able to pursue new accounts as vigorously as before. These tradeoffs should be considered before a strategy is adopted.

Unfortunately, many firms do not fully consider such tradeoffs. Instead, they devise strategies whose success depends on "doing more with less." Managers and employees are stretched thin while new programs are implemented without eliminating old ones. In the end, an organization may find itself performing lots of activities, but none of them well.

9-7d Anticipated Responses from Competitors and Customers

Strategies are not implemented in a vacuum. Competitive responses should be expected when a substantial strategic change is employed. In many situations, the prospective gains associated with a strategic change will be reduced when the response is considered. For example, the development of new products may produce few new customers if competitors respond quickly by developing a similar offering.

In some cases, considering the retaliation makes an otherwise attractive strategic alternative undesirable. Consider, for example, that American Airlines could probably secure more fliers than Delta on common routes if its fares were priced below those of the rival. If American initiated a price cut, however, Delta would almost certainly match it. It is likely that the reduced fares would attract few additional fliers to either airline. Hence, both airlines would be forced to operate the same routes with virtually the same number of customers at lower routes. When competitive retaliation is considered in this example, American is probably best served not to spark a price war with Delta.

Consider another example that illustrates the fact that changes in the competitive environment do not always materialize as one might expect. When an airline hub closes, for example, one might expect flights to and from the affected city to increase in price because of the departed competitor. In the United States, however, discount airlines often fill the empty gates, actually fostering greater price competition.[14] Hence, one could argue that it may be in the best interest of traditional carriers *not* to drive less competitive rivals out of key hubs, lest they be bombarded by greater competition.

Customer responses can be difficult to predict, but responses to strategic change should be anticipated and accounted for, especially when substantial shifts in prices or product line occur. When eBay announced a hike in its fee structure in early 2005, for example, many customers took notice, closed their eBay "stores," and pursued other means of promoting and selling their wares.[15]

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9-8 Summary

The SWOT analysis serves as the basis for the formulation of strategies at all levels. The SWOT summarizes the organization's internal (i.e., strengths and weaknesses) and external (i.e., opportunities and threats) characteristics. Strengths and weaknesses emanate from an analysis of human, organizational, and physical resources. Opportunities and threats are based on analyses of the macroenvironment and industry. The SW/OT matrix generates strategic alternatives by combining internal and external factors delineated in the SWOT analysis.

Before a strategy is selected, however, several other considerations should be made. These include the costs associated with strategic change, the strategy's fit with the organization's stance on social responsibility and managerial ethics, effects on organizational resources, anticipated responses from competitors, and potential difficulties in implementing the strategy.

Key Terms

gap analysis
human resources
organizational resources
physical resources
strategic capabilities
SWOT analysis
SW/OT matrix
value chain

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Review Questions and Exercises

1. What is the value chain? How is it useful to strategy formulation?
2. How do a SWOT analysis and SW/OT matrix help managers in the strategic decision-making process?
3. What types of alternatives can be generated from a SW/OT matrix?
4. Should an organization change strategies when performance declines? Explain.

Practice Quiz

True of False

1. The first step in crafting a strategy is the SWOT analysis.
2. The value chain is an analytical technique for identifying organizational opportunities and threats.
3. Opportunities and threats emerge from the analysis of macroenvironmental and industry forces.
4. A factor can be both an opportunity and a strength.
5. Another name for an opportunity is an alternative.
6. Choosing the no change strategy and thereby recommending that the current strategy be continued is the least risky option.

Multiple Choice

7. The tool that enables an organization to position itself to take advantage of particular opportunities in the environment while avoiding or minimizing environmental threats is called
   A. PEST analysis.
   B. SWOT analysis.
   C. TQM analysis.
   D. none of the above
8. The description of activities that comprise the economic performance and capabilities of the firm is known as
   A. the value chain.
   B. process innovation.
   C. quality assessment.
   D. none of the above
9. To sustain competitive advantage, firms must acquire or develop resources that are
   A. difficult for competitors to imitate.
   B. long lasting.
   C. difficult for competitors to acquire on the market.
   D. all of the above
10. Physical resources include:
   A. production facilities.
   B. plant locations.

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C. production capacity.

D. all of the above

11. Which of the following could not be an example of a weakness?

A. product quality

B. fierce competition

C. human resources

D. All of the above could be weaknesses.

12. Which type of alternative is always defensive in nature?

A. strength-opportunity

B. strength-threat

C. weakness-opportunity

D. weakness-threat

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READING 9-1

Insight from *strategy+business*

Organizations are constantly changing. Sometimes change is needed simply to keep up with the environment. At other times, change must be initiated to correct key problems in strategy or performance. The problem, however, is that initiating any type of change can be difficult. This chapter's strategy+business reading offers ten suggestions for instituting change effectively.

The Ten Principles of Change Management

Tools and techniques to help companies transform quickly.

By John Jones, DeAnne Aguirre, and Matthew Calderone

Way back when (pick your date), senior executives in large companies had a simple goal for themselves and for their organizations: stability. Shareholders wanted little more than predictable earnings growth. Because so many markets were either closed or undeveloped, leaders could deliver on those expectations through annual exercises that offered only small modifications to the strategic plan. Prices stayed in check; people stayed in their jobs; life was good.

Market transparency, labor mobility, global capital flows, and instantaneous communications have blown that comfortable scenario to smithereens. In most industries—and in almost all companies, from giants on down—heightened global competition has concentrated management's collective mind on something that, in the past, it happily avoided: change. Successful companies, as Harvard Business School Professor Rosabeth Moss Kanter told *strategy+business* in 1999, develop "a culture that just keeps moving all the time."

This presents most senior executives with an unfamiliar challenge. In major transformations of large enterprises, they and their advisors conventionally focus their attention on devising the best strategic and tactical plans. But to succeed, they also must have an intimate understanding of the human side of change management—the alignment of the company's culture, values, people, and behaviors—to encourage the desired results. Plans themselves do not capture value; value is realized only through the sustained, collective actions of the thousands—perhaps tens of thousands—of employees who are responsible for designing, executing, and living with the changed environment.

Long-term structural transformation has four characteristics: scale (the change affects all or most of the organization), magnitude (it involves significant alterations of the status quo), duration (it lasts for months, if not years), and strategic importance. Yet companies will reap the rewards only when change occurs at the level of the individual employee.

Many senior executives know this and worry about it. When asked what keeps them up at night, CEOs involved in transformation often say they are concerned about how the work force will react, how they can get their team to work together, and how they will be able to lead their people. They also worry about retaining their company's unique values and sense of identity and about creating a culture of commitment and performance. Leadership teams that fail to plan for the human side of change often find themselves wondering why their best-laid plans have gone awry.

No single methodology fits every company, but there is a set of practices, tools, and techniques that can be adapted to a variety of situations. What follows is a "Top 10" list of guiding principles for change management. Using these as a systematic, comprehensive framework, executives can understand what to expect, how to manage their own personal change, and how to engage the entire organization in the process.

1. **Address the "human side" systematically.** Any significant transformation creates "people issues." New leaders will be asked to step up, jobs will be changed, new skills and capabilities must be developed, and employees will be uncertain and resistant. Dealing with these issues on a reactive, case-by-case basis puts speed, morale, and results at risk. A formal

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approach for managing change—beginning with the leadership team and then engaging key stakeholders and leaders—should be developed early, and adapted often as change moves through the organization. This demands as much data collection and analysis, planning, and implementation discipline as does a redesign of strategy, systems, or processes. The change-management approach should be fully integrated into program design and decision making, both informing and enabling strategic direction. It should be based on a realistic assessment of the organization's history, readiness, and capacity to change.

2. **Start at the top.** Because change is inherently unsettling for people at all levels of an organization, when it is on the horizon, all eyes will turn to the CEO and the leadership team for strength, support, and direction. The leaders themselves must embrace the new approaches first, both to challenge and to motivate the rest of the institution. They must speak with one voice and model the desired behaviors. The executive team also needs to understand that, although its public face may be one of unity, it, too, is composed of individuals who are going through stressful times and need to be supported.

   Executive teams that work well together are best positioned for success. They are aligned and committed to the direction of change, understand the culture and behaviors the changes intend to introduce, and can model those changes themselves. At one large transportation company, the senior team rolled out an initiative to improve the efficiency and performance of its corporate and field staff before addressing change issues at the officer level. The initiative realized initial cost savings but stalled as employees began to question the leadership team's vision and commitment. Only after the leadership team went through the process of aligning and committing to the change initiative was the work force able to deliver downstream results.

3. **Involve every layer.** As transformation programs progress from defining strategy and setting targets to design and implementation, they affect different levels of the organization. Change efforts must include plans for identifying leaders throughout the company and pushing responsibility for design and implementation down, so that change "cascades" through the organization. At each layer, the leaders who are identified and trained must be aligned to the company's vision, equipped to execute their specific mission, and motivated to make change happen.

   A major multiline insurer with consistently flat earnings decided to change performance and behavior in preparation for going public. The company followed this "cascading leadership" methodology, training and supporting teams at each stage. First, 10 officers set the strategy, vision, and targets. Next, more than 60 senior executives and managers designed the core of the change initiative. Then 500 leaders from the field drove implementation. The structure remained in place throughout the change program, which doubled the company's earnings far ahead of schedule. This approach is also a superb way for a company to identify its next generation of leadership.

4. **Make the format case.** Individuals are inherently rational and will question to what extent change is needed, whether the company is headed in the right direction, and whether they want to commit personally to making change happen. They will look to the leadership for answers. The articulation of a formal case for change and the creation of a written vision statement are invaluable opportunities to create or compel leadership-team alignment.

   Three steps should be followed in developing the case: First, confront reality and articulate a convincing need for change. Second, demonstrate faith that the company has a viable future and the leadership to get there. Finally, provide a road map to guide behavior and decision making. Leaders must then customize this message for various internal audiences, describing the pending change in terms that matter to the individuals.

   A consumer packaged-goods company experiencing years of steadily declining earnings determined that it needed to significantly restructure its operations—instituting, among other things, a 30 percent work force reduction—to remain competitive. In a series of offsite meetings, the executive team built a brutally honest business case that downsizing was the only way to keep the business viable, and drew on the company's proud heritage to craft a compelling vision to lead the company forward. By confronting reality and helping employees understand the necessity for change, leaders were able to motivate the organization to follow the new direction in the midst of the largest downsizing in the company's history. Instead of being shell-shocked and demoralized, those who stayed felt a renewed resolve to help the enterprise advance.

5. **Create ownership.** Leaders of large change programs must over-perform during the transformation and be the zealots who create a critical mass among the work force in favor of change. This requires more than mere buy-in or passive agreement that the direction of change is

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acceptable. It demands ownership by leaders willing to accept responsibility for making change happen in all of the areas they influence or control. Ownership is often best created by involving people in identifying problems and crafting solutions. It is reinforced by incentives and rewards. These can be tangible (for example, financial compensation) or psychological (for example, camaraderie and a sense of shared destiny).

At a large health-care organization that was moving to a shared-services model for administrative support, the first department to create detailed designs for the new organization was human resources. Its personnel worked with advisors in cross-functional teams for more than six months. But as the designs were being finalized, top departmental executives began to resist the move to implementation. While agreeing that the work was topnotch, the executives realized they hadn't invested enough individual time in the design process to feel the ownership required to begin implementation. On the basis of their feedback, the process was modified to include a "deep dive." The departmental executives worked with the design teams to learn more, and get further exposure to changes that would occur. This was the turning point; the transition then happened quickly. It also created a forum for top executives to work as a team, creating a sense of alignment and unity that the group hadn't felt before.

6. **Communicate the message.** Too often, change leaders make the mistake of believing that others understand the issues, feel the need to change, and see the new direction as clearly as they do. The best change programs reinforce core messages through regular, timely advice that is both inspirational and practicable. Communications flow in from the bottom and out from the top, and are targeted to provide employees the right information at the right time and to solicit their input and feedback. Often this will require overcommunication through multiple, redundant channels.

   In the late 1990s, the commissioner of the Internal Revenue Service, Charles O. Rossotti, had a vision: The IRS could treat tax-payers as customers and turn a feared bureaucracy into a world-class service organization. Getting more than 100,000 employees to think and act differently required more than just systems redesign and process change. IRS leadership designed and executed an ambitious communications program including daily voice mails from the commissioner and his top staff, training sessions, videotapes, newsletters, and town hall meetings that continued through the transformation. Timely, constant, practical communication was at the heart of the program, which brought the IRS's customer ratings from the lowest in various surveys to its current ranking above the likes of McDonald's and most airlines.

7. **Assess the cultural landscape.** Successful change programs pick up speed and intensity as they cascade down, making it critically important that leaders understand and account for culture and behaviors at each level of the organization. Companies often make the mistake of assessing culture either too late or nor at all. Thorough cultural diagnostics can assess organizational readiness to change, bring major problems to the surface, identify conflicts, and define factors that can recognize and influence sources of leadership and resistance. These diagnostics identify the core values, beliefs, behaviors, and perceptions that must be taken into account for successful change to occur. They serve as the common baseline for designing essential change elements, such as the new corporate vision, and building the infrastructure and programs needed to drive change.

8. **Address culture explicitly.** Once the culture is understood, it should be addressed as thoroughly as any other area in a change program. Leaders should be explicit about the culture and underlying behaviors that will best support the new way of doing business, and find opportunities to model and reward those behaviors. This requires developing a baseline, defining an explicit end-state or desired culture, and devising detailed plans to make the transition.

   Company culture is an amalgam of shared history, explicit values and beliefs, and common attitudes and behaviors. Change programs can involve creating a culture (in new companies or those built through multiple acquisitions), combining cultures (in mergers or acquisitions of large companies), or reinforcing cultures (in, say, long-established consumer goods or manufacturing companies). Understanding that all companies have a cultural center—the locus of thought, activity, influence, or personal identification—is often an effective way to jump-start culture change.

   A consumer goods company with a suite of premium brands determined that business realities demanded a greater focus on profitability and bottom-line accountability. In addition to redesigning metrics and incentives, it developed a plan to systematically change the company's culture, beginning with marketing, the company's historical center. It brought the marketing staff into the process early to create enthusiasts for the new philosophy who adapted marketing campaigns, spending plans, and incentive programs to be more accountable. Seeing these culture leaders grab onto the new program, the rest of the company quickly fell in line.

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9. **Prepare for the unexpected.** No change program goes completely according to plan. People react in unexpected ways; areas of anticipated resistance fall away; and the external environment shifts. Effectively managing change requires continual reassessment of its impact and the organizations willingness and ability to adopt the next wave of transformation. Fed by real data from the field and supported by information and solid decision-making processes, change leaders can then make the adjustments necessary to maintain momentum and drive results.

   A leading U.S. health-care company was facing competitive and financial pressures from its inability to react to changes in the marketplace. A diagnosis revealed shortcomings in its organizational structure and governance, and the company decided to implement a new operating model. In the midst of detailed design, a new CEO and leadership team took over. The new team was initially skeptical, but was ultimately convinced that a solid case for change, grounded in facts and supported by the organization at large, existed. Some adjustments were made to the speed and sequence of implementation, but the fundamentals of the new operating model remained unchanged.

10. **Speak to the individual.** Change is both an institutional journey and a very personal one. People spend many hours each week at work; many think of their colleagues as a second family. Individuals (or teams of individuals) need to know how their work will change, what is expected of them during and after the change program, how they will be measured, and what success or failure will mean for them and those around them. Team leaders should be as honest and explicit as possible. People will react to what they see and hear around them, and need to be involved in the change process. Highly visible rewards, such as promotion, recognition, and bonuses, should be provided as dramatic reinforcement for embracing change. Sanction or removal of people standing in the way of change will reinforce the institution's commitment.

Most leaders contemplating change know that people matter. It is all too tempting, however to dwell on the plans and processes, which don't talk back and don't respond emotionally, rather than face up to the more difficult and more critical human issues. But mastering the "soft" side of change management needn't be a mystery.

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Strategy Execution: Structure 10

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Chapter Outline

10-1 Organizational Structure
- 10-1a Vertical Growth
- 10-1b Horizontal Growth

10-2 Structural Forms
- 10-2a Functional Structure
- 10-2b Product Divisional Structure
- 10-2c Geographic Divisional Structure
- 10-2d Matrix Structure
- 10-2e Assessing Organizational Structure

10-3 Corporate Involvement in Business Unit Operations

10-4 Corporate Restructuring

10-5 Summary

Key Terms

Review Questions and Exercises

Practice Quiz

Notes

Reading 10-1

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The best conceived strategic plans often fail from a lack of planning for their execution. Effective strategy implementation requires managers to consider many issues, including structural, cultural, and leadership concerns.[1] These considerations should be made *before* a strategic alternative is selected and then detailed *after* strategy formulation. This chapter emphasizes the relationship between strategy and structure, especially within the context of strategy execution. Leadership and cultural concerns are addressed in Chapter 11.

10-1 Organizational Structure

Organizational Structure
The formal means by which work is coordinated in an organization.

Organizational structure is the formal means by which work is coordinated in an organization. As the focus of this chapter, an organization's structure dictates reporting relationships and defines where and how the firm's work will be done. It establishes a framework for identifying levels in the organization where decisions will be made. In many respects, the structure sets the stage for strategy execution. A given structure might be appropriate for one particular strategy, but not another.

The long-standing debate among scholars is whether a firm's strategy should follow its structure or vice versa. Most practitioners, however, recognize that each is influenced by the other. In the short term, strategic managers should evaluate and consider the firm's structure when crafting the strategy, recognizing that modifying the structure is rarely easy or inexpensive. In addition, they should be willing to modify the firm's structure as required to fit with any necessary strategic change. In the long term, because a firm's strategy is a key driver of its performance, the structure should be built around the strategy to ensure its effectiveness.

Simple Structure
An organizational form whereby each employee often performs multiple tasks, and the owner-manager is involved in all aspects of the business.

Although some new businesses are launched on a large scale, many start small with an owner-manager and a few employees. Neither an organizational chart nor a formal assignment of responsibilities is necessary. Each employee often performs multiple tasks and the owner-manager is involved in all aspects of the business, a form of organization often called a **simple structure**. This structure may remain intact for only a few months in a fast growing organization or for years in a small family business such as a rural convenience or hardware store.

In organizations with a simple structure, early survival depends on an increase in demand for the company's products or services. As the organization grows to meet this demand, however, a more permanent division of labor tends to form. The owner-manager, who once was nearly involved in all functions of the enterprise, begins to play more of a leadership role and therefore assigns additional employees to more specialized functions. Growth of the firm reaches a certain point, however, where top managers must evaluate the effectiveness of the evolving system of coordinating tasks and consider modifying it if necessary, so that the structure evolves along with the strategy.

Because the simple structure is inappropriate when a firm grows beyond a certain point, other alternatives must be considered. For such organizations, the structure exists to provide control and coordination for the organization. As such, the structure designates formal reporting relationships and defines the number of levels in the hierarchy.[2] (See Figure 10-1.) There are logical reasons for organizing work along various lines. For example, work can be organized along function so employees can work only in their areas of specialty, by product

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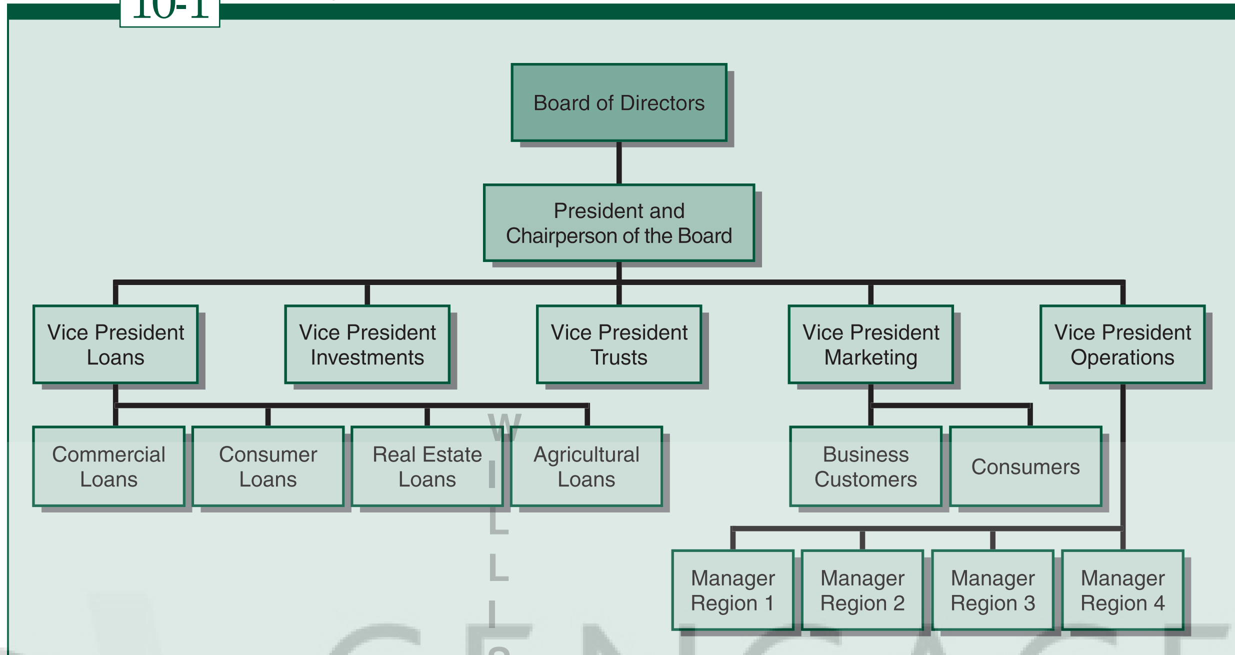
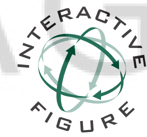
FIGURE 10-1 Security Bank Organization Chart





so decisions about products can be made in an integrated fashion, and along geographical lines so decisions can be tailored to unique needs of various geographical regions. It is also reasonable to assume that individuals can and should work across the structure when necessary. Nonetheless, there is no single best structure, and the one selected for any organization will have its own set of benefits and challenges. Interestingly, many large, well-known companies change structures frequently as their environments change.

The extent to which organizational activities are appropriately grouped affects how well strategy is implemented. For instance, customers may be confused when they are contacted by multiple sales representatives for the same company, each representing a different product line. In addition, it is difficult to hold a product divisional manager fully responsible for product sales if this person has little or no control over either the development or the production of the product.

In addition, firms with multiple related businesses usually require greater coordination of their business units' activities than those operating in only one business. However, as an organization becomes more complex, coordinating activities becomes more difficult, especially in organizations with related businesses.

10-1a Vertical Growth

The growth of the organization expands its structure, both vertically and horizontally. **Vertical growth** refers to an increase in the length of the organization's hierarchy (i.e., levels of management). The number of employees reporting to each manager represents that manager's **span of control**. A **tall organization** has

Vertical Growth
An increase in the length of the organization's hierarchical chain of command.

Span of Control
The number of employees reporting directly to a given manager.

Tall Organization
An organization characterized by many hierarchical levels and a narrow span of control.

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Flat Organization
An organization characterized by relatively few hierarchical levels and a wide span of control.

Centralization
An organizational decision-making approach whereby most strategic and operating decisions are made by managers at the top of the organization structure (at corporate headquarters).

Decentralization
An organizational decision-making approach in which most strategic and operating decisions are made by managers at the business unit level.

many hierarchical levels and narrow spans of control; a **flat organization** has few levels in its hierarchy and a wide span of control from top to bottom. In reality, organizations fall somewhere in between the two extremes. Hence, organizations are seen as being either relatively tall or relatively flat.

When a structure is marked by **centralization**, most strategic and operating decisions are made by managers at the top of the organization structure. Centralized structures push decisions to managers at higher levels who are presumed to have greater experience and expertise. Although clear lines of responsibility and accountability exist, top managers may lack the hands-on experience that managers have at middle and lower levels. Decision making occurs slowly and the lower-level managers may be less committed to those decisions made at higher levels.

Alternatively, when a structure is characterized by **decentralization**, most strategic and operating decisions are made by managers at lower levels of the organization structure. Decentralized firms seek to overcome the difficulties of centralization by pushing each decision to the lowest level where it can be made effectively. Decentralization can take advantage of the intellectual capital that an organization develops across managerial ranks. Decisions are made more rapidly by managers with direct knowledge about a situation. Decentralization can cloud lines of accountability when poor decisions are made and can often result in poor coordination across units in the organization. These potential disadvantages notwithstanding, it is not difficult to see why many progressive organizations have moved toward greater decentralization in the last two decades.

The extent to which decision making should be decentralized depends on several factors, one of which is organizational size. In general, very large organizations tend to be more decentralized than very small ones, simply because it is difficult for the CEO of a very large company to stay abreast of all of the organization's operations. In addition, firms with large numbers of unrelated businesses tend to be relatively decentralized, whereby corporate-level management determines the overall corporation's mission, goals, and strategy, and lower-level managers make the actual operating decisions. Finally, organizations in dynamic environments must be relatively decentralized so that decisions can be made quickly, whereas organizations in relatively stable environments can be managed more systematically and centrally because change is rather slow and fairly predictable. In such cases, most decisions are routine, and procedures can often be established in advance.

John Child has studied extensively the link between firm size and number of management levels. According to Child, the average number of hierarchical levels for an organization with three thousand employees is seven levels.[3] Consequently, one might consider such an organization with fewer than seven hierarchical levels to be relatively flat, and one with more than seven to be relatively tall. Because tall organizations have a narrow span of control, managers in such organizations exercise a relatively high degree of control over their subordinates, and authority tends to be relatively centralized. Conversely, authority is more decentralized in relatively flat structures because managers have broad spans of control and must therefore grant more flexibility to their employees. Because decisions are more likely to be made at lower levels in flat organizations, it is advisable for employees to have a more generalist orientation.

From a strategic perspective, both organizational types possess certain advantages. Tall, centralized organizations foster more effective coordination and

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communication of the business's mission and goals to all employees. Planning and its execution are relatively easy to accomplish because all employees are centrally directed. As such, tall organizational structures may be best suited for environments that are relatively stable and predictable, although experts have begun to suggest that tall structures do not yield the same advantages today as they once did.

Flat structures also have advantages. Administrative costs tend to be less than those in taller organizations because fewer hierarchical levels require fewer managers and support personnel. Decentralized decision making also gives managers at various levels more authority, which may increase their satisfaction and motivation.[4] The greater freedom in decision making also encourages innovation. Hence, flat structures are best suited to more dynamic environments, such as those in which most Internet businesses operate. Quality tends to improve when decision making is decentralized closest to the level at which the decisions will be implemented.

Flatter organizations, with relatively few hierarchical levels and wide spans of control, tend to work more effectively in dynamic environments, whereas taller organizations may operate more effectively in stable, predictable environments. Not all of a firm's business units need to adopt the same structure. If some business units operate in relatively dynamic environments while others compete in relatively stable environments, then structural differences may be necessary.

Other factors can also influence the appropriate structure for an organization. Heavy involvement in outsourcing and offshoring is one such factor. Because outsourcing reduces internal activities, it can flatten the structure and increase decision-making speed.[5] Outsourcing can stifle the bureaucracy, enabling firms to concentrate on key strategic concerns such as shortening the cycle time for new products or new models of existing ones.

10-1b Horizontal Growth

Horizontal growth refers to an increase in the breadth of an organization's structure. The owner-manager and a few employees may perform all of the functions in a new business. With growth, however, each function expands so that no one individual can be involved in all of the company's functions, and the structure of the organization is broadened to accommodate the development of more specialized functions. Owner-managers who are unable to let go of former realms of responsibility as their new duties increase are often referred to disparagingly as micromanagers.

Increases in organizational size usually lead to additional organizational layers and bureaucracy. Although large organizations are often presumed to benefit from economies of scale and therefore be more efficient, a large firm may actually become both less efficient and less capable of meeting the needs and expectations of its customers over time. Top management often addresses the burgeoning bureaucracy by instituting a more **horizontal structure**, which has fewer hierarchies. The organizational restructuring so pervasive throughout the 1980s and 1990s has often involved forming a more horizontal structure through **downsizing**, whereby one or more hierarchical levels—typically middle managers—are eliminated. Additionally, employee layoffs often occur in order to cut costs and eliminate some of the bureaucracy that invariably accompanies multiple organizational layers. As layers are reduced, decision making becomes decentralized.

Interestingly, downsizing often fails to achieve desired results, especially in the long term. Studies suggest that approximately 50 percent of downsized

Horizontal Growth
An increase in the breadth of an organization's structure.

Horizontal Structure
An organizational structure with fewer hierarchies designed to improve efficiency by reducing layers in the bureaucracy.

Downsizing
A means of organizational restructuring that often eliminates one or more hierarchical levels from the organization and pushes decision making downward in the organization.

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firms actually lower costs, and many of these firms also suffer declines in productivity. When cuts are applied equally to all departments, both efficient and inefficient ones lose employees without regard to performance level. When buyouts are offered to relatively high-paid, longtime employees, the firm can be faced with a drastic loss of critical experience. In addition, the positive changes in the formal organization created by downsizing often lead to dysfunctional consequences in the informal organization. Survivors (i.e., employees who remain after the cuts) are typically less loyal to the organization and wonder if they will be cut next. Hence, downsizing is a viable strategic alternative, but one whose long-term ramifications must be seriously considered before it is adopted.[6]

Firms occasionally seek to downsize for the specific purpose of eliminating part of the workforce so that it can be rebuilt in a different manner. Downsizing may occur after an acquisition if there are substantial cultural differences between the two firms and the acquiring firm wishes to reorient the new combined workforce.

10-2 Structural Forms

This section describes four general alternative structures that may be adopted to meet the strategic needs of the organization. Some structures tend to fit with a certain firm level of competitive strategies, although this relationship is not always clear.

10-2a Functional Structure

Functional Structure
A form of organizational structure whereby each subunit of the organization engages in firm-wide activities related to a particular function, such as marketing, human resources, finance, or production.

The initial growth of an enterprise often requires that it be organized along functional areas. In the **functional structure**, each subunit of the organization engages in firm-wide activities related to a particular function, such as marketing, human resources, finance, or production. (Figure 10-2 illustrates one example of a functional structure.) Managers are grouped according to their expertise and the resources they use in their jobs. A functional structure has certain strategic advantages. Most notably, it can improve specialization and productivity by grouping people who perform similar tasks. When functional specialists interact frequently, improvements and innovations for their functional areas evolve, which may not have otherwise occurred without a mass of specialists organized within the same unit. Working closely on a daily basis with others who share one's functional interests also tends to increase job satisfaction and lower turnover. In addition, the functional structure can foster economies of scale by centralizing functional activities.

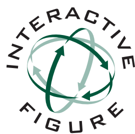
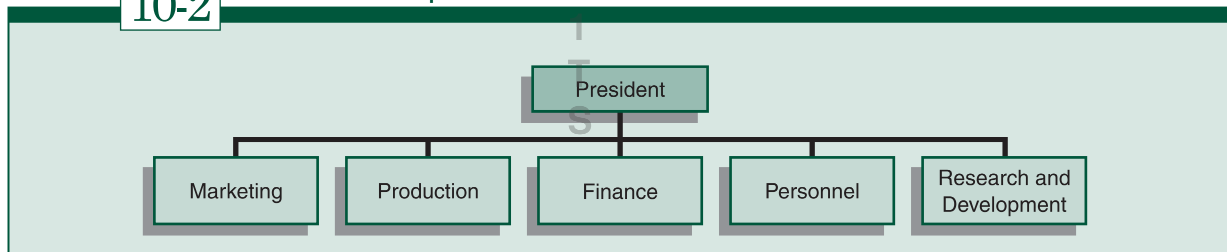


FIGURE 10-2 A Partial Example of Functional Structure



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Because of its ability to group specialists and foster economies of scale, this form tends to address cost and quality concerns well. However, the functional structure also has its disadvantages. Because the business is organized around functions rather than around products or geographic regions, pinpointing the responsibility for profits or losses can be difficult. For example, a decline in sales could be directly linked to problems in any number of departments, such as marketing, production, or purchasing. Members of these departments may blame other departments when firm performance declines.

In addition, a functional structure is prone to interdepartmental conflict by fostering a narrow perspective of the organization among its members. Managers in functional organizations tend to view the firm totally from the perspective of their field of expertise. The marketing department might see a company problem as sales related, whereas the human resource department might view the same challenge as a training and development concern. In addition, communication and coordination across functional areas are often difficult because each function tends to have its own perspective and vernacular. R&D, for example, tends to focus on long-term issues, whereas the production department generally emphasizes the short run. Grouping individuals along function minimizes communication across functions and can foster these types of communication problems.

In sum, the functional structure can serve as a relatively effective and efficient means of controlling and coordinating activities. For this reason, it may be appropriate for defenders and low-cost businesses that emphasize efficiency in established markets. The current emphasis, however, is on customer service and speed, challenges that the functional structure may not be as well equipped to address. Depending on the specific issues facing an organization, a division along product or geographical lines may be more appropriate to other businesses.

10-2b Product Divisional Structure

The **product divisional structure** divides the organization's activities into self-contained entities, each responsible for producing, distributing, and selling its own products or services. This structure is often adopted when a business has several distinct product lines. For example, a software developer may organize along three product lines: business, productivity, and educational applications. Each division would have its own functional areas, such as R&D, marketing, and finance. For this reason, the product divisional structure may be most appropriate for diversified firms. This structure is used both in manufacturing and service organizations.

Product Divisional Structure
A form of organizational structure whereby the organization's activities are divided into self-contained entities, each responsible for producing, distributing, and selling its own products.

The product divisional structure has certain advantages. Rather than emphasizing functions, the structure emphasizes product lines, resulting in a clear focus on each product category and a greater orientation toward customer service. Pinpointing the responsibility for profits or losses is also easier because each product division becomes a **profit center**, which is a well-defined organizational unit headed by a manager who is accountable for its revenues and expenditures. The product divisional structure is also ideal for training and developing managers because each product manager is, in effect, running his or her own business. Hence, product managers develop general management skills—an end that can be accomplished in a functional structure only by rotating managers from one functional area to another.[7]

Profit Center
A well-defined organizational unit headed by a manager accountable for its revenues and expenditures.

The product divisional structure also has its disadvantages. Because product divisional firms generally have multiple departments performing the same

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function, the total personnel expense for manufacturing is likely to be higher than if only one department were necessary. The coordination of activities at headquarters also becomes more difficult, as top management finds it harder to ensure consistency among the various departments. This problem can become substantial in large organizations with forty or more product divisions. Finally, because product managers emphasize their own product area, they tend to compete for resources instead of working together in the best interest of the company.

10-2c Geographic Divisional Structure

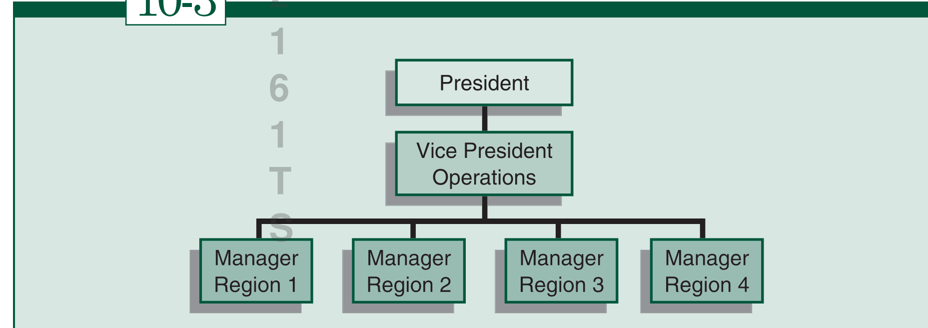
Geographic Divisional Structure
A form of organizational structure in which jobs and activities are grouped on the basis of geographic location .

When a firm's operations are dispersed through various locations, top executives often employ a **geographic divisional structure**, whereby activities and personnel are grouped by specific geographic locations (see Figure 10-3). This structure may be used on a local basis (i.e., a city may be divided into sales regions), on a national basis (i.e., southern region, mid-Atlantic region, Midwest region), or even on an international basis (i.e., North American region, Asian Region, Western European region). The primary impetus for the geographic divisional structure is the existence of two or more distinct markets that can be segmented easily along geographical lines. For this reason, differentiated businesses or those unable to standardize product or service lines because of geographical market differences may implement a geographic divisional structure.

There are two key advantages to organizing geographically. First, products and services may be tailored more effectively to the legal, social, technical, or climatic differences of specific regions. For example, relatively small 220-volt appliances may be appropriate for parts of Asia where living quarters tend to be limited and the American 110-volt system is not used. In addition, insurance companies are often organized along state and national boundaries because of legal differences. Second, producing or distributing products in different locations may give the organization a competitive advantage. Many firms, for example, produce components in countries that have a labor cost advantage and assemble them in countries with an adequate supply of skilled labor.

The disadvantages of a geographic divisional structure are similar to those of the product divisional structure. Often, more functional personnel are required because each region has its own functional departments. Coordination of company-wide functions is often more difficult, and area managers may emphasize their own geographic regions to the exclusion of a company-wide viewpoint.

FIGURE 10-3 A Partial Example of Geographic Divisional Structure



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10-2d Matrix Structure

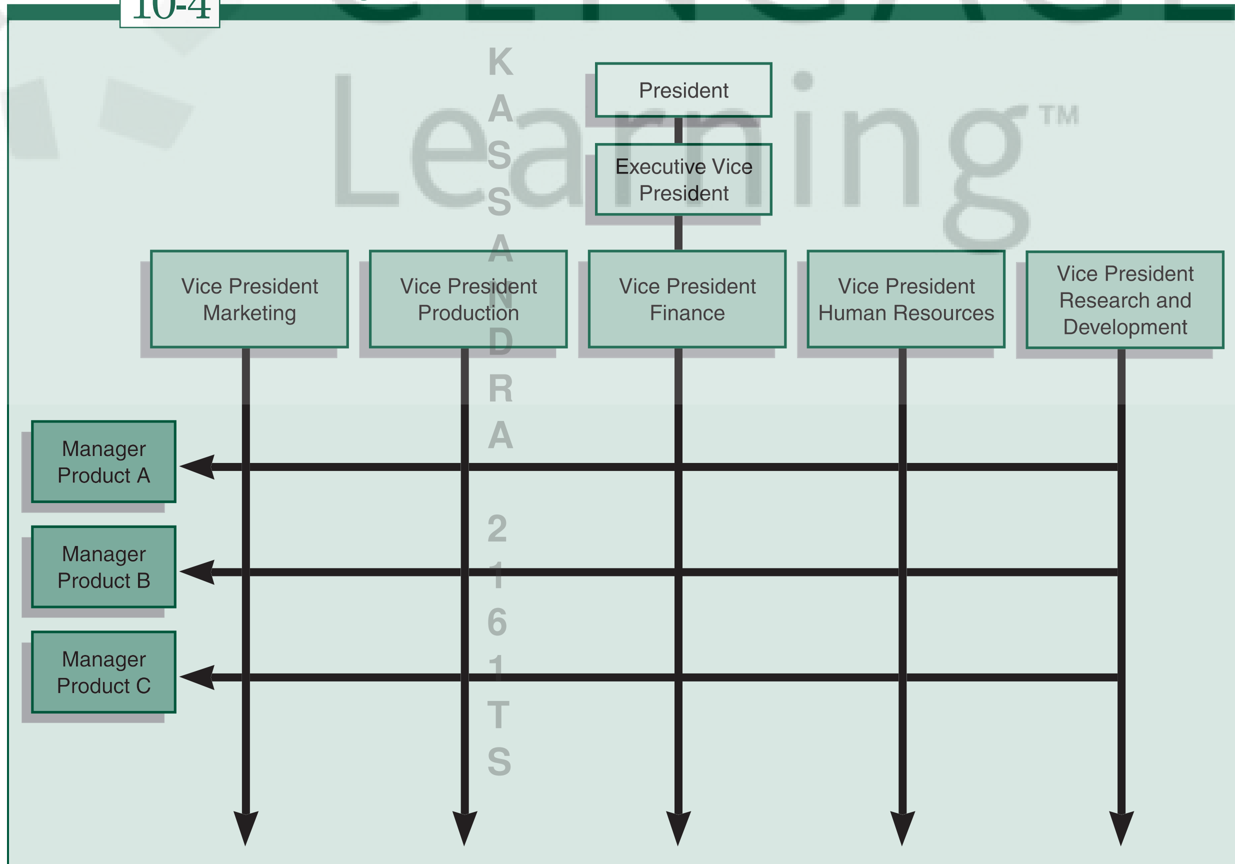
In a general sense, the functional and divisional structures—both product and geographical—can be viewed as opposite ends of a continuum. The traditional demands for quality and price may pull an organization toward the functional end, whereas demands for service and speed may pull the organization toward the divisional end. To address these demands, top managers may settle on one of the two poles or may attempt to position the organization between the extremes. One such approach that has gained considerable popularity in recent years is the matrix structure.

Unlike the other structures that are characterized by a single chain of command, the **matrix structure** is a combination of the functional and product divisional structures (see Figure 10-4). Hence, personnel within the matrix have two (or more) supervisors: a functional boss and a project boss. In one project, a project manager might pull together some members of the organization's functional departments. After the project is completed, the personnel in the project return to their functional departments. Hence, some individuals may be assigned to more that one team at the same time.

Matrix Structure
A form of organizational structure organized around projects that combines the functional and product divisional structures.

Consider that many common organizational tasks require expertise from a variety of backgrounds. Effective new product development requires contributions from such areas as R&D, marketing, and production. Enhancing a

FIGURE 10-4 Matrix Organizational Structure



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consumer product firm's e-commerce capability requires contributions from information technology, marketing, supply chain management, and merchandising. An initiative to improve customer satisfaction requires expertise in sales, inventory management, and production. The matrix structure is designed to address these multifaceted problems because it pools the necessary expertise required.

The matrix structure is most commonly used in organizations that operate in industries with a high rate of technological change, such as software development, management consulting, medical care, and telecommunications. Because of its complexity, the matrix structure is not as common as the other structures. However, recent developments in network technology have helped managers in many matrix organizations overcome some of the confusion and duplication that can accompany the structure. As such, matrix approaches are likely to continue to expand, especially in industries governed by technology.

A variation to the traditional project form of the matrix structure is reflected in the form of organization pioneered by Procter & Gamble (P&G) in 1927. At P&G, rather than a project manager being in charge of a temporary project, each of P&G's individual products has a **brand manager**. Like a project manager, the brand manager pulls various specialists, as they are needed, from their functional departments. Each brand manager reports to a category manager, who is in charge of all related products in a single category. The category manager coordinates the advertising and sales efforts so that competition among P&G products is minimized. Interestingly, P&G continues to modify its brand management approach as the environment changes, and has recently undergone a shift toward a more global orientation.[8]

Brand Manager
The project manager in Proctor & Gamble's version of the matrix structure.

The matrix structure offers four key advantages. First, by combining the functional and product divisional structures, a firm can enjoy many of the advantages of both forms. Second, a matrix organization is flexible because employees may be transferred with ease between projects with different time frames. Third, a matrix permits lower-level functional employees to become heavily involved in projects and gain valuable experience. Finally, top management in a matrix is freed from day-to-day involvement in the operations of the enterprise in order to focus on strategic leadership.

The matrix structure also has disadvantages. First, because coordination across functional areas and across projects is so important, matrix personnel spend considerable time in meetings exchanging information, ultimately growing the bureaucracy and raising personnel costs. Second, matrix structures are characterized by considerable conflict, both between project and functional managers over budgets and personnel, and among the project managers themselves over similar resource allocation issues. Finally, reporting to two managers simultaneously violates a basic premise of management (i.e., each employee should report to only one boss) and can create role conflict when different bosses provide conflicting instructions.

10-2e Assessing Organizational Structure

Structures in some firms are relatively easy to assess by examining the organization chart. It is not as easy to delineate in other firms, however. Functional, product divisional, geographic divisional, and matrix structures are often combined to create an approach uniquely tailored to the strategic needs of the firm. (Figure 10-5 illustrates a combination structure.) It is interesting to note that a number of firms combine two or more of the structures according to the specific needs of the firm and the philosophy of its top executives. Yum Brands, for example, has a division for each of its domestic restaurant holdings (e.g., KFC, Pizza Hut, Taco Bell, Long John Silvers, and

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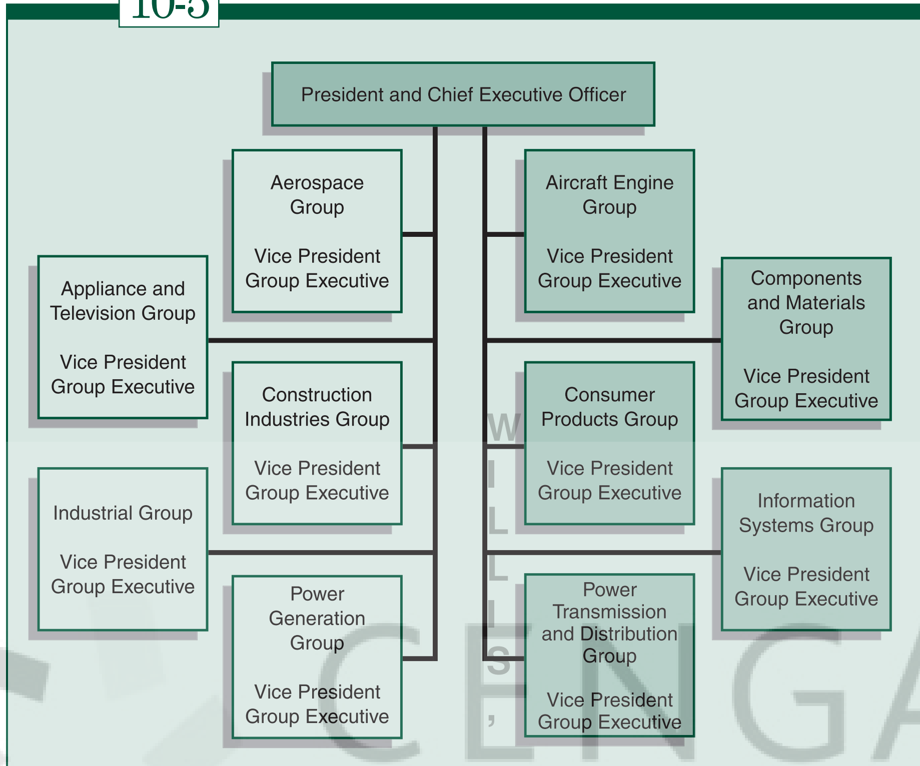
FIGURE 10-5 A Partial Example of a Combination Structure



A&W Restaurants). Another division, however, is based on geography and includes units in all three of the restaurant brands located outside the United States. Hence, implementing a single, pure structure is not necessary.

Summarizing the previous sections, the appropriate structure for a given firm can depend on the following factors.

1. Level of corporate involvement in business unit operations
2. Compatibility of the existing structure with the firm- and business-level strategies
3. Number of hierarchical levels in the organization
4. Extent to which the structure permits the appropriate grouping of activities
5. Extent to which the structure promotes effective coordination
6. Extent to which the structure allows for appropriate centralization or decentralization of authority

The next section addresses a philosophical concern that can influence the structure as well.

10-3 Corporate Involvement in Business Unit Operations

Top management philosophy is a key determinant of an organization's structure, especially in large firms with multiple business units. The extent to which corporate managers are involved in business-level operations varies from one firm to another. Involvement is sometimes seen as a stabilizing force and is welcomed by top executives in business units. Some business unit managers, however, refer to

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"corporate" in a less than positive light and may view such involvement as interference or stifling to progress.

Studies have concluded that corporate involvement can greatly influence business profitability.[9] Some firms have diversified into unrelated businesses and tend to operate in a relatively decentralized fashion, however. In decentralization, firms tend to employ small corporate staffs and allow the business unit managers to make the most of their own strategic and operating decisions, including functional areas such as purchasing, inventory management, production, finance, research and development, and marketing. Alternatively, firms whose business units are in the same industry or in related industries usually follow a centralization pattern, whereby major decisions affecting the business units tend to be made at corporate headquarters. Many corporations operate between these two extremes.

Organizations seeking the benefits of centralization often select a functional structure. The more commonality in those functional activities across the firm's business units, the greater the tendency is to coordinate those activities at the corporate level. Centralization can result in efficiencies and consistencies across all business units. For instance, quantity discounts are larger if the purchases are negotiated at the corporate level for all business units, rather than having each business purchase them separately.

Centralization, however, can also be inefficient, especially when a firm attempts to control the activities of a diverse array of business units. As the organization grows, larger corporate staffs are required, increasing the distance between corporate management and the business units. Top managers are forced to rely increasingly on their staff for information, and they communicate downward to the business units through their staff. These processes can lead to communication and coordination problems, as well as to a proliferation of bureaucracy.

Although synergy among business units may not be minimized, decentralized corporations can often eliminate these problems because highly decentralized firms maintain only skeletal corporate staffs.[10] Many firms seeking the benefits of decentralization organize along a matrix structure. Decisions in matrix structures are typically made by content experts throughout the organization regardless of their management levels. In general, product divisional and geographic divisional structures tend to lie between the functional and matrix structures in terms of centralization and decentralization. Although there is a clear link between structure and degrees of centralization and decentralization, an organization can pursue greater centralization or decentralization within any of the structures.

10-4 Corporate Restructuring

Even after a firm matures, it is uncommon that its structure would stay the same over time. Structures are normally modified from time to time as the firm changes markets, moves into new industries, performs poorly, or hires a new chief executive.

Corporate Restructuring
A change in the organization's structure to improve efficiency and firm performance.

A major structural change may be considered when an organization is performing well, although it most commonly occurs when performance is poor and the firm is thus pursuing a retrenchment strategy. In this situation, retrenchment is often accompanied by a reorganization process known as corporate restructuring. **Corporate restructuring** refers to a change in the organization's structure to improve efficiency and firm performance. Restructuring efforts can include such

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actions as realigning divisions in the firm, reducing the amount of cash under the discretion of senior executives, and acquiring or divesting business units.[11] Although corporate restructuring can refer to a simple change in structure—perhaps from a functional approach to a product divisional approach—it often accompanies more aggressive changes as well.

Source: Ablestock.com

Progressive firms restructure when it becomes clear that a change is necessary. Unfortunately, some managers resist change and ultimately may be forced to do so. Firms that *voluntarily* restructure when necessary ordinarily do not have to be concerned with hostile takeover bids or externally forced, *involuntary* restructuring. However, firms that do not manage for value may eventually be forced to restructure by outsiders, a process that is usually more costly.

Even well-known leading companies progress through product and economic cycles that require them to restructure on occasion. Fast-food giant McDonald's, for example, posted a fourth quarter 2002 loss of $344 million, its first in thirty-seven years. The firm responded with a restructuring plan that included fewer new stores, greater product and marketing emphasis on existing outlets, and store closings in 2003 in the United States and Japan, its two largest markets.[12]

When properly executed, minor or major corporate restructuring efforts can enable a firm to execute its strategies more effectively. Structural changes have a downside, however. Actions such as closing or combining offices, eliminating positions, and modifying reporting relationships may not only increase costs for a firm but can also result in other negative effects. Specifically, the concept of restructuring tends to conflict with emphasis on human resources as the key source of a firm's competitive advantage. The job cuts typically associated with restructuring can damage morale, encourage survivors to consider leaving before they are laid off, and place a greater focus on minimizing costs rather than fostering creativity and excellence. Hence, the long-term effects of corporate restructuring—especially downsizing—should be seriously considered before a plan is implemented.[13]

10-5 Summary

Successful strategy implementation requires a fit between strategy and structure. Strategic managers may choose to structure the organization around functions, products, or geography, or they may choose a matrix approach. Each structure has its own advantages and disadvantages.

There are a number of considerations when assessing an organization's structure. In the functional structure, each subunit of the organization engages in firm-wide activities related to a particular function, such as marketing, human resources, finance, or production. The product divisional structure divides the organization's activities into self-contained entities, each responsible for producing, distributing, and selling its own products. When a firm's operations are dispersed through various locations, top executives often employ a geographic divisional structure, whereby activities and personnel are grouped by specific geographic locations. The matrix structure is a combination of the functional and product divisional structures.

Corporate restructuring refers to a change in the organization's structure to improve efficiency and firm performance. Restructuring efforts can include such actions as realigning divisions in the firm, reducing the amount of cash under the discretion of senior executives, and acquiring or divesting business units.

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Key Terms

brand manager
centralization
corporate restructuring
decentralization
downsizing
flat organization
functional structure
geographic divisional structure
horizontal growth
horizontal structure
matrix structure
organizational structure
product divisional structure
profit center
simple structure
span of control
tall organization
vertical growth

Review Questions and Exercises

1. What is the difference between a tall organization and a flat organization? What are the advantages and disadvantages of each?
2. What forms of organizational structure are available to strategic managers? What are the primary advantages and disadvantages of each?
3. What is the matrix structure? Why has it become so popular in recent years?
4. What is corporate restructuring?

Practice Quiz

True of False

1. Corporate restructuring is a corporate strategic approach that includes such actions as realigning divisions in the firm, reducing the amount of cash under the discretion of senior executives, and acquiring or divesting business units.
2. A flat organization has many hierarchical levels and narrow spans of control.
3. Horizontal structures have fewer managerial levels than vertical structures.
4. In general, a functional structure tends to be most appropriate for differentiated businesses.
5. Corporate restructuring refers to changes that include modifications in the organizational structure.
6. Progressive firms restructure only when firm performance declines.

Multiple Choice

7. The formal means by which work is coordinated in an organization is called the
   - **A.** organizational structure.
   - **B.** organizational culture.
   - **C.** organizational dynamic.
   - **D.** none of the above
8. An increase in the breadth of an organization's structure is known as
   - **A.** centralization.
   - **B.** decentralization.
   - **C.** horizontal growth.
   - **D.** vertical growth.
9. Which of the following structures tends to be the most centralized?
   - **A.** functional structure
   - **B.** product divisional structure
   - **C.** geographic divisional structure
   - **D.** matrix structure
10. The notion of a profit center is consistent with which form of organizational structure?
    - **A.** functional structure
    - **B.** product divisional structure
    - **C.** geographic divisional structure
    - **D.** matrix structure
11. Which form of organizational structure is actually a combination of two other forms?
    - **A.** functional structure
    - **B.** product divisional structure
    - **C.** geographic divisional structure
    - **D.** matrix structure
12. Which of the following structures tends to be the most decentralized?
    - **A.** functional structure
    - **B.** product divisional structure
    - **C.** geographic divisional structure
    - **D.** matrix structure

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READING 10-1

Insight from *strategy+business*

Even well-orchestrated plans can fail as a result of poor execution. In recent years, business leaders have begun to pay more attention to problems associated with strategy implementation. This chapter's strategy+business reading highlights many of these problems and provides suggestions for solving them.

The Four Bases of Organizational DNA

Trait by trait, companies can evolve their own execution cultures.

By Gary Neilson, Bruce A. Pasternack, and Decio Mendes

Every economic era has a theme. The 1960s are still recalled as the "Go-Go" years, when Wall Street was fueling mergers and conglomerations of unprecedented scale. The 1990s were the "Internet Boom" years, when a rising economic tide lifted the boat of just about any company with a plausible business model tale to tell. The agonizingly slow recovery since the Internet bubble burst has inspired the latest motif. Executives no longer believe that a strategy—consolidation, transformation, or breakaway—is enough. "We've made the right strategic decision, but my organization isn't motivated or set up right to get on with it," they are saying. "Everyone says they understand the vision, but the businesses and functions just aren't working together to get results."

Welcome to the Era of Execution

Execution has become the new mantra for this first decade of the new millennium. Larry Bossidy, who led AlliedSignal Inc.'s turnaround and its merger with Honeywell International Inc., wrote a book with Ram Charan, titled *Execution: The Discipline of Getting Things Done* (Crown Business, 2002), that's been on the business bestseller lists for more than a year. Former IBM CEO Louis V. Gerstner Jr. put forth the same message in his memoir, *Who Says Elephants Can't Dance? Inside IBM's Historic Turnaround* (HarperBusiness, 2002). In it, he says flatly that the revival of the computer giant wasn't due to vision. "Fixing IBM," he wrote, "was all about execution."

Boards of directors, increasingly impatient with CEOs who don't deliver, have climbed on the execution bandwagon too. Booz Allen Hamilton's annual study of CEO succession trends showed that forced turnover of underperforming CEOs at major corporations reached a new high in 2002, rising a staggering 70 percent from 2001 and accounting for 39 percent of all chief executive transitions.

But is execution simply a matter of firing the CEO and bringing in a charismatic leader who can get on with "getting things done"? Not at all. Underlying the quest for an execution-driven enterprise is one central question: How does a company design its organization to execute the strategy—whatever the strategy is—and successfully adapt when circumstances change?

Execution is woven deeply into the warp and woof of organizations. It is embedded in the management processes, relationships, measurements, incentives, and beliefs that collectively define the "rules of the game" for each company. Although we often think of companies as monolithic entities, they're not. They're collections of individuals who typically act in their own self-interest. Superior and consistent corporate execution occurs only when the actions of individuals within it are aligned with one another, and with the overall strategic interests and values of the company. Performance is the sum total of the tens of thousands of actions and decisions that, at large companies, thousands of people, at every level, make every day.

Because individual behaviors determine an organizations success over time, the first step in resolving dysfunctions is to understand how the traits of an organization influence each individual's behavior and affect his or her performance. We like to use the familiar metaphor of DNA to attempt to codify the idiosyncratic characteristics of a company. Just as the double-stranded DNA molecule is held together by bonds between base pairs of four nucleotides, who sequence spells out the exact instructions required to create a unique organism, we describe the DNA of a living organization as having

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four bases that, combined in myriad ways, define an organization's unique traits. These bases are:

Structure. What does the organizational hierarchy look like? How are the lines and boxes in the organization chart connected? How many layers are in the hierarchy, and how many direct reports does each layer have?

Decision Rights. Who decides what? How many people are involved in a decision process? Where does one person's decision-making authority end and another's begin?

Motivators. What objectives, incentives, and career alternatives do people have? How are people rewarded, financially and nonfinancially, for what they achieve? What are they encouraged to care about, by whatever means, explicit or implicit?

Information. What metrics are used to measure performance? How are activities coordinated, and how is knowledge transferred? How are expectations and progress communicated? Who knows what? Who needs to know what? How is information transferred from the people who have it to the people who require it?

Any metaphor can he pushed too far, of course. Although the basic comparison of corporate and human DNA is often invoked in general discussions of institutional culture and conduct, we think it provides a practical framework senior executives can use to diagnose problems, discover hidden strengths, and modify company behavior. With a framework that examines all aspects of a company's architecture, resources, and relationships, it is much easier to see what is working and what isn't deep inside a highly complex organization, to understand how it got that way, and to determine how to change it. (See "Focus: Testing Quest Diagnostics' DNA.")

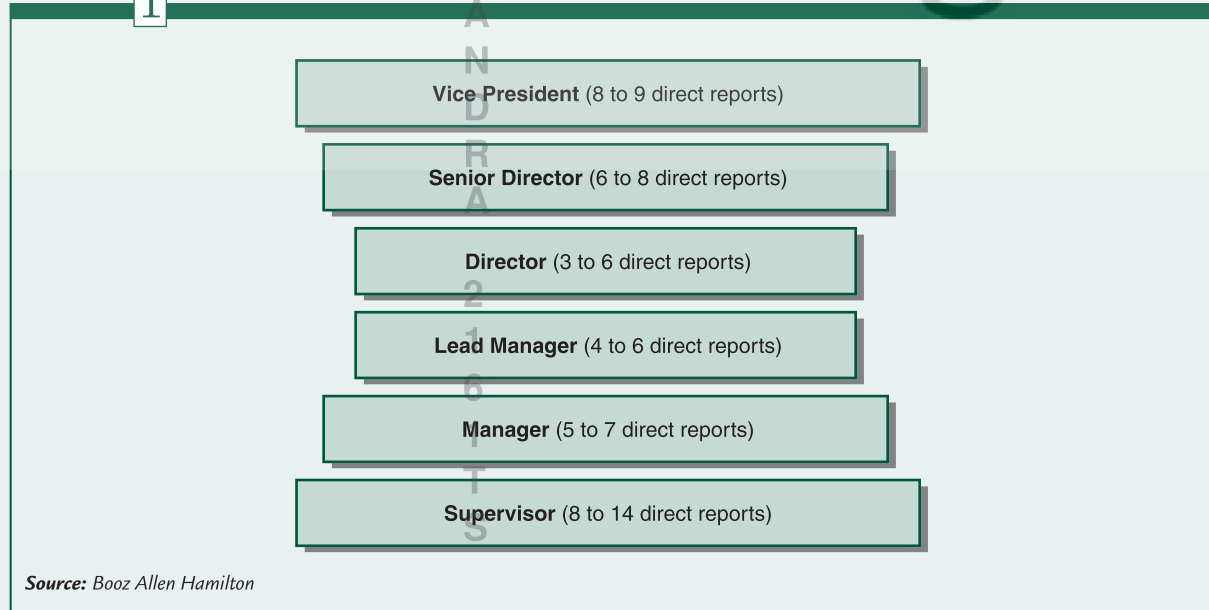
Structure

In principle, companies make structural choices to support a strategy (for example, the decision to organize business units around customers, products, or geography). In practice, however, a company's organizational structure and strategic intent often are mismatched. The variance can usually he exposed by, in effect, superimposing the organization chart—an efficient communicator of power and status in a firm—over a business unit's strategic plan.

A common structural problem impeding the execution of strategy is the existence of too many management tiers (deep layers), with too many individuals at each tier having too few direct reports (narrow spans). Portrayed graphically, this structure resembles an hourglass. (See Exhibit 1.) Narrower spans in the middle often result from unclear decision rights and the company's mix of motivators. Generally, a structure shaped this way indicates trouble.

There are many reasons a certain management position may legitimately call for a narrower or wider span than another position's. Managers in complex jobs that

EXHIBIT 1 The Hourglass Organization



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require them to create and maintain multiple information linkages across individual units cannot handle the same number of direct reports as managers with simpler information aggregation roles. But it's also easy for spans to become too narrow for no legitimate reason.

Consider the spans of control for three senior positions at one consumer goods company with which we have worked. As shown in Exhibit 2, the category/product line manager had five direct reports, compared with seven and 10 reports for senior managers at two best-practice companies. The vice president of sales had six direct reports, versus eight and 10 at the other companies. The manufacturing manager had only seven direct reports; in other companies, similar managers had 11 or more. We have taken this measurement at more than 100 companies, and our data indicates that this company fell well outside the range found at comparable firms.

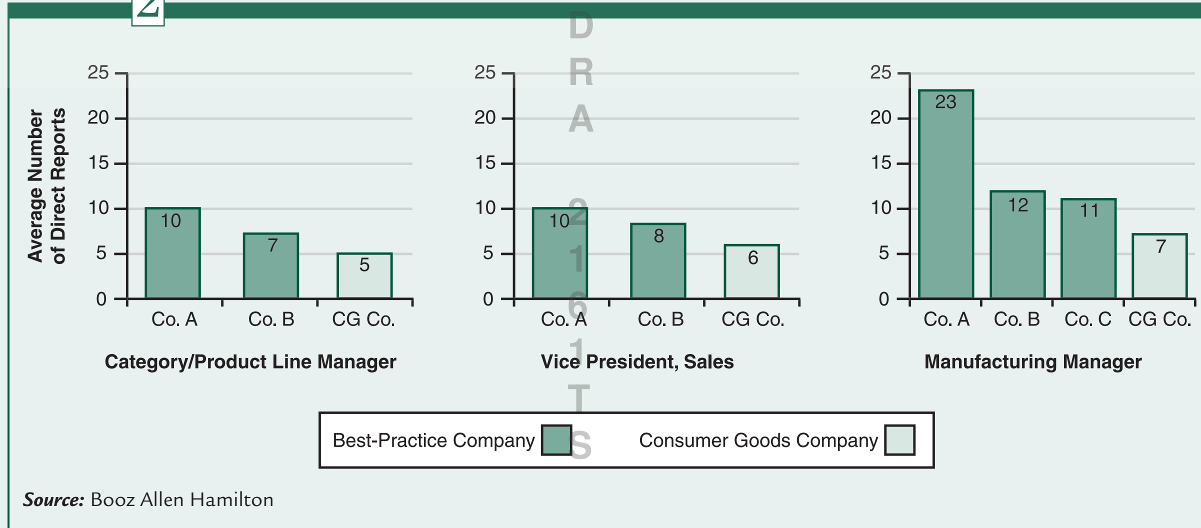
In our experience, numbers this far off the norm provide strong evidence that a company's spans are narrower than they should be. Often this results in a structure that has too many layers as well. This became evident when we explored how senior managers at the consumer goods company spent their time. About a third of it was devoted to making plans, ensuring target corporate goals were met, and dealing with exceptions and high-impact/high-risk decisions, all appropriate roles for these managers. But they were spending far too much time (roughly 40 percent) justifying and reporting performance to senior executives above them and participating in tactical, operational decisions with their direct reports. In other words, too much of their time was devoted to second-guessing the work of people below them and preparing reports so that superiors could second-guess their work. They should have been giving more of their time to preparing action plans to achieve the strategic and operational objectives of the company.

This structure kept the consumer goods organization from executing to its potential. Among specific dysfunctions we found:

- Because there were no clear standards that allowed basic decisions to be made at lower levels, decisions regarding such matters as authorization for PC purchases and travel were decided too high in the organization.
- Managers and supervisors tended to discourage their staffs from troubleshooting to resolve routine problems on their own.
- Managers rotated rapidly through jobs, reaching senior positions without sufficient experience. Not only did they require close supervision, but they continually struggled to figure out what they needed to know.
- The company seemed to rapidly promote its best and brightest just so it could retain them. This added unnecessary layers to the hierarchy and created more work at lower levels.
- Large cross-departmental meetings filled the workday. The rationale was to have all parties "in one room to resolve the issues."

All of this activity is costly—these are managers with salaries in the low six figures. Their compensation, plus

EXHIBIT 2 Comparing Spans of Control



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the actual cost of their activities, pushed the company's general and administrative costs to a level that was 20 percent higher than the average of our benchmark companies. Because each of its many layers got involved in almost every decision, the company's speed to market was slowing, and it was losing share to new, more nimble competitors in several categories.

The obvious structural change was to reduce layers and increase spans—that is, to add direct reports to each manager. We recommended a new structure that resulted in a reduction of 10 percent of the positions in the management ranks across all six divisions. Ultimately, with the elimination and repositioning of managers and support staff, about 2,300 management jobs were cut, which saved the company more than $250 million.

Still, simply cutting layers and extending spans would have had little long-term effect if underlying behaviors didn't change. One way the company could do this was by setting clear standards (e.g., which PC to buy and which airline to fly) so high-level managers would not need to review every transaction and provide approvals. With a monthly report, they could easily track exceptions to the standards. Another solution: Reset promotion expectations to slow the upward movement of managers and encourage more horizontal moves—use promotions not just as a reward, but to develop a manager's breadth of experience. Long and cumbersome reporting processes designed to satisfy' the information preferences of each layer and the tremendous desire for detail also had to go. In their place would be a report on the key lagging and leading measures of critical business activity, a top-down setting of targets, and the monitoring of variances. To further dissolve the reflexive addition of layers, the company also had to do more managerial training and communicate better about the change in promotion principles. Following the restructuring and changes in management, time to market for product introductions shrank by months, enabling the company to regain the first-to-market advantage it had traditionally held.

Decision Rights

Decision rights specify who has the authority to make which decisions. Clarifying these rights puts flesh on an organization chart and makes crystal clear where responsibility lies.

Clear decision rights enable wider spans and fewer layers, which translates into lower costs and speedier execution. Unarticulated decision rights are more than a time sink; they're a central cause of substandard performance—and even of nonperformance. An employee at a financial-services company expressed this problem quite concretely in a focus group we conducted, saying, "Responsibilities are blurred intentionally around here so everyone has an excuse for not getting involved."

At one industrial company, we found yet again that senior executives were spending too much time reviewing small projects. It turned out the company had not reassessed managers' spending-approval limits in more than 10 years. We suggested the authorization process be adjusted so that managers lower in the organization could be accountable for the final approval of more projects. The capital expenditure amount requiring CEO authorization was raised from $5 million to $15 million. The objective was to free up senior managements time to focus on the longer-term issues associated with market growth and potential acquisitions. Based on historical analysis, it was determined that raising the level at which projects required CEO authorization to $15 million would reduce the number of projects crossing the CEO's desk by 49 percent. All large projects would still come to the CEO, so the aggregate value of projects approved at the top would decline by only 13 percent.

Decision rights become blurred for many reasons, not all of them intentional. After a large industrial company completed a leveraged buyout, the management of one of its business units became the new entity's corporate management, charged with reviewing the operating decisions of all business units. That change required every level of management to take on greater decision-making responsibility—an unnatural act for executives accustomed to hands-on involvement in operating unit decisions. Rather than allow their general managers to make basic decisions about product design and resource allocation, the CEO and COO still involved themselves deeply in these activities. Meanwhile, they were neglecting other areas where their attention was expected, notably strategic planning, long-range business portfolio decisions, and the firm's financial condition.

The solution was to create a process for corporate officers to delegate decisions to the business unit's general managers. An executive committee was established to review business unit decisions, and several general managers were charged with integrating marketing, product engineering, and manufacturing. These structures and processes made effective delegation possible.

It doesn't take a leveraged buyout to distort a company's decision-rights structure. People naturally lean toward the familiar when faced with change. Executives

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promoted to new positions often cling to their prior responsibilities, burdening themselves with unnecessary tasks and disempowering their subordinates. The press of the urgent at the business unit level drives out the important at the corporate level. The lesser decisions seem concrete and knowable. Forward thinking and big decisions regarding long-term direction seem undefined, amorphous, and tougher to tackle.

Often the process of assigning decision rights is a response to a crisis or a shift in political power. When this happens, decisions can fall between the cracks. Or they can be made twice by different parties. Or they can be reviewed repeatedly, becoming a Sisyphean exercise in backsliding.

It is possible to assign decision rights systematically and rationally. At a global industrial company, we helped create an organizational matrix of functions, products, and geographies. The structure was under-girded by a set of specific organizational and decision-making principles, among them: responsibility does not imply exclusive Authority; different units should have joint goals and performance measures; and certain positions need to report upward to multiple managers.

Over several months, we worked with the company to apply these and several other principles to more than 300 critical decisions. Because we undertook this effort explicitly while also changing the structure, the company was able to execute its new strategy faster, and with fewer missteps. The overall change process took two years (one less than had been anticipated). The company returned to profitability, reduced its net debt by the targeted amount, and reached several other critical financial goals a year ahead of schedule.

Making decision rights explicit in companies in which they are not requires management to set rules for the most common business situations—and for each position. In effect, the company is creating a constitution that says who will decide what and under what circumstances.

The decision rights of groups must also be clear. At a consumer goods company, we saw large numbers of executives meeting frequently to resolve conflicts among functional units. It appeared that operations, finance, and marketing were each doing an excellent job of analyzing new factories, new products, and new business opportunities, but they weren't talking to one another along the way. Operations planned the perfect factory—without guidance from finance on the cost. In marathon meetings, managers from each function brought their independent analyses together. Then they struggled to reach a joint conclusion, because each unit, by that time, was wedded to its own recommendation.

To solve this silo problem, one top executive was made responsible for managing a cross-functional team, so there would always be communication across disciplines. As a result, only a few top executives were needed to make routine decisions, and the company reduced dedicated staff support for these efforts by more than 30 percent.

Motivators

The third of the four bases in a company's DNA-like makeup involves motivation. Employees generally don't deliberately act counterproductively; they don't try to derail a company's strategy. Rather, they respond quite rationally on the basis of what they see, what they understand, and how they're rewarded. An exhortation to follow the vision and pursue the strategy is only so much air if the organization's incentives and information flows make it difficult for employees to understand and do what they're supposed to do.

An organization can send confusing signals to individuals in many ways. Think about what happens when an appraisal system inflates performance ratings. At a consumer goods company we once worked with, employees were appraised on a 1 to 10 scale. Eighty percent received a rating of 9 or above, and everyone felt good. But superior employees didn't feel they needed to do any better. Other workers thought their performance was acceptable when it wasn't. Appraisers were avoiding the unpleasant task of delivering bad performance ratings, and the organization wasn't giving them any reason to be tough. For every deficient employee who stayed at the company because the organization said he or she was competent, the company's execution suffered. Because of its unwillingness to differentiate people's contributions through performance assessments and raises, the company lost the opportunity to send important feedback to employees on what was relevant to executing the strategy—and where their performance was unsatisfactory.

Several years ago we worked with the new CEO of a technology company who had been the head of a business unit and had served for several years on the executive committee that made investment decisions. The new CEO knew from experience that the committee wasn't tough enough on new investment requests. They were a collegial group; members supported their colleagues'

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investment requests with the understanding their own requests would be supported in return.

The new CEO wanted a more discriminating process that would judge investment proposals on their merits. He also knew executive committee members faced little downside from approving unsound investment requests. Future bonuses might suffer if company performance wasn't good, but that money wasn't already in their pockets.

So the CEO introduced a new system to change this attitude: Each committee member was required to take out a personal loan of $1 million and invest it in company stock (the loan was guaranteed by the company, so the individuals could borrow at good rates). Unlike an outright stock grant, this scheme ensured that the executives had existing wealth at risk, and that they would lose money, and perhaps the ability to repay the debt, if they permitted poor investment decisions. With this new incentive to scrutinize investment requests, the committee became much tougher and more effective. And after a few sessions, teams began bringing better-researched and smarter investment proposals to the table because they knew if they didn't, the committee was likely to turn them down.

There are other market mechanisms that can be used to send more accurate signals to managers about the cost and value of certain activities. This approach was used successfully at a large agribusiness company that came to us for help in improving the services of its human resources department. The HR department's performance had always been judged by how well it stayed on budget. Internal customer satisfaction was rarely measured. Each customer was allocated a share of the HR budget, but these figures didn't represent the true cost of the services. Meanwhile, customers had little influence on the kind and amount of services they received. Neither HR nor its customers had an incentive to offer or ask for services tailored to the specific needs of a division.

Working with the company, we created a scorecard to measure HR performance on such things as call center response time and payroll errors. Achieving scorecard targets became a significant component of management incentives and rewards. HR's internal customers were given the right to negotiate service level agreements with HR. The true cost of services was established using outside benchmarks. Once HR's customers understood what they were paying for and could better manage their costs, they had an incentive to use HR services more wisely. Today, they often decline or reduce some services and request new ones. The market-based measurement and incentive program improved the quality of the company's HR services and reduced costs by more than 15 percent.

Organizations that are ready to implement multiple profit-and-loss statements and market-based motivational systems will find that these powerful new tools can help them operate effectively with less command-and-control oversight. But not all companies are ready for these systems; it takes strong leadership, persistence, and patience to introduce them and overcome employee resistance to using them.

Information

Underlying a company's ability to ensure clear decision rights and to measure and motivate people to apply them is one critical matter: information.

Making sure high-quality information is available and flowing where it needs to go throughout a company, all the time, is among the most challenging tasks of the modern corporation, and one of the most under-appreciated contributors to high performance and competitive advantage. A 2002 study of the management and financial performance of 113 Fortune 1000 companies over the five-year period 1996 to 2000, conducted by Booz Allen Hamilton and Ranjay Gulati of the Kellogg School of Management at Northwestern University, found that the companies with the highest shareholder returns were more focused on managing and enhancing communication with their customers, suppliers, and employees than other firms in the study.

We have seen this information-performance linkage often in practice. A few years ago, the board of an agricultural grower and processor became concerned about the company's operating efficiency. Among other problems, farm managers were using equipment without discipline—ordering a machine at will, driving it hard, and returning it with an empty gas tank, all because headquarters was responsible for maintenance and replacement costs. Our benchmark data indicated that this company's expenses were far higher than those of independent farms. We worked with corporate and farm management to develop a new business model, centered on turning each farm into an independent business. For this to happen, farm managers needed new information—specifically, individual farm P&Ls that reflected, among many other things, the cost of the equipment they used. The

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redesigned organization executed more efficiently, as reflected in a 48 percent jump in its imputed share price in the first year.

Better information flows did more than keep costs down; they helped allocate scarce resources far more efficiently than before. The company had a silo problem—literally and figuratively. Any field ready for harvest had a peak yield window of about 15 days. But there was only so much mill capacity during the peak window. Coordinating and timing the harvesting and milling activities fell to a hapless employee at headquarters, a central planner who relied on historical data that didn't reveal much about current conditions.

We showed in a simulation that if farm managers could bid for use of the mill on particular dates, it would strikingly improve the company's efficiency. If a manager saw that his highest-yielding acreage was ready to harvest and couldn't wait because rain was predicted, he could bid more for mill time. No longer would someone back at headquarters have to hunker down with a spreadsheet, making educated guesses based on the previous year's yield data and taking frantic phone calls from farm managers. Market-based pricing of mill time would allocate scarce resources better than a central planner could. And with this new system, decisions would reflect the real-time knowledge of the farmer in the field observing the sky, testing the ripeness of the crop, hour by hour, acre by acre.

Adaptive DNA

Although we have illustrated the four bases of organizational DNA separately to emphasize their distinct characteristics, they clearly are intertwined. Changing structure requires changing decision rights; to make effective decisions, employees need new incentives and different information. At the agricultural grower and processor, the new structure touched each of these elements—the individual farm as a business required new decision authority for farm managers, new metrics by which to measure their performance, and new rewards based on their individual success. This interdependency is evident in all of these company stories.

Considering—and changing—a company's DNA holistically means weaving intelligence, decision-making capabilities, and a collective focus on common goals widely and deeply into the fabric of the organization so that each person and unit is working smartly—and working together. It's one thing to achieve well-coordinated intelligence among senior executives. It's another thing entirely to touch every level of an organization all the way down to the loading dock. What every employee does every day, aggregated across the company, constitutes performance.

The best organizational designs are adaptive, are self-correcting, and become more robust over time. But creating such an organization doesn't happen quickly; it can take several years to get the basics right, and there is always a need for fine-tuning. This may explain why leaders of companies that are truly ailing—and who need to reassure shareholders as fast as they can—often don't have the patience for changing decision rights, motivators, and information flows. They're more likely to cut the structure and see what happens than to take time to ensure that structural changes actually result in sustained productivity improvements and steady gains in shareholder value. But neglecting this hard work may also partly explain why some of these CEOs are no longer in charge.

No company may ever totally master the enigma of execution. But the most resilient and consistently successful ones have discovered that the devil is in the details of organization. For them, organizing to execute has truly become a competitive edge.

Focus: Testing Quest Diagnostics' DNA

DNA testing can be as valuable to corporate health as it has become to human health care. An analysis of a company's "genetic material" can isolate the underlying causes of and potential solutions to organizational dysfunctions, and even head off problems before they start.

Consider the case of the U.S.-based medical laboratory testing company Quest Diagnostics. Originally a division of Corning Incorporated, Quest Diagnostics grew in the 1990s through the acquisition of hundreds of small independent testing laboratories. Spun off from Corning in 1997, the company was losing money and battling fines for billing fraud and other abuses in a number of the laboratories it had bought. Chairman and CEO Ken Freeman, then the newly appointed leader of Quest Diagnostics, recognized that the DNA of an enterprise formed by the union of so many different entities, each born in a different time and place, with many different parents, could readily become a monster. So he was determined to focus his attention on improving organizational DNA across the entire company.

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Immediately after the spin-off, Mr. Freeman and his top management team took control of key decision rights to ensure that the company's turnaround effort was coherent and driven hard. When the company acquired SmithKline Beecham Clinical Labs in August 1999, they again deliberately centralized decision rights among a small senior team. A set of integration teams headed by the leaders of both companies methodically worked through the long-term vision and short-term tactics for each area of the new company, again, to ensure consistency across the enterprise. The financial payoff was immediate: Prior to the deal, revenues had typically declined upward of 20 percent following a major acquisition. In this case, Quest Diagnostics not only didn't lose business, revenues grew at or above industry growth rates during the integration process. This was the first time such postmerger growth occurred in the industry.

As Quest Diagnostics' turnaround progressed, decision rights were decentralized gradually, first by placing supervisors into various units who led change and taught employees new behaviors, and then by empowering frontline staff. Although many parts of the Quest Diagnostics organization are now high performers and largely self-directed, it has taken seven years to get there.

Today when Quest Diagnostics acquires a company, Mr. Freeman and his team concentrate on two of the four organizational bases, *motivators* and *information*, recognizing their interdependency and combined influence on individual and organizational behavior. Among the first "gene therapies" they perform is to introduce a comprehensive and varied set of metrics that go well beyond the typical financial performance measures that most companies use. There are measures for customer retention, the time it takes to pick up a call in the call center, the time it takes to process a specimen in the labs, employee satisfaction and attrition rates, and more. The system is designed so that all employees know how they can personally influence one or more core performance measures.

The only way this information can influence the day-to-day behavior and decisions of employees throughout the organization is if decision makers have the information on hand when they need it. Quest Diagnostics posts various metrics on different timetables depending on the type of management issue: Customer retention metrics are posted at least once a month; specimen turnaround time is posted every morning.

Finally, the company ties these metrics to individuals' bonus payments so that information not only informs, but also motivates productive behavior. Since virtually everyone in the company can affect customer retention in some way, Quest Diagnostics uses the customer retention metric very broadly in its performance-based compensation programs. Ultimately, the bonuses of all 37,000 Quest Diagnostics employees depend in some way on meeting the customer retention target.

"If we have a shared goal that says we're going to reduce customer attrition, that doesn't mean it is only for people in sales. It impacts people picking up the specimens, people who draw and perform tests on the specimens, and certainly people in billing. If there are lots of complaints, the customer is going to leave. By having shared goals, you get speed and alignment," says Mr. Freeman.

To make the motivators as specific and powerful as possible, customer retention metrics are measured not just organization-wide. They are divided up by region, so that people are paid on the basis of customer retention performance in their own region, where they can have the greatest influence.

The aligning and motivating power of bringing information and incentives together is reflected in the firm's strong financial performance. Since Quest Diagnostics was spun off from Corning in 1997, the company's stock price has increased 730 percent, compared with a 41 percent increase in the S&P 500 Index during the same period. Having successfully carried out a classic turnaround and taken the lead in consolidating the industry, Quest Diagnostics is now driving growth organically and has become the clear leader in the U.S. medical laboratory testing market. Last year, the company earned $322 million on $4.1 billion in revenues.

–G.N., B.A.P., and D.M.

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Strategy Execution: Strategic Change, Culture, and Leadership 11

Chapter Outline

11-1 Organizational Culture and Strategy
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- 11-1b Shaping the Culture
- 11-1c Global Concerns

11-2 Strategic Leadership
- 11-2a Leadership Style
- 11-2b Leadership in Practice

11-3 Executing Strategic Change

11-4 Summary

Key Terms

Review Questions and Exercises

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Reading 11-1

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When a new strategy is executed, an old one is discarded. The strategic change that occurs as a result is not always easy to direct. Managing strategic change can be a difficult task even when everyone agrees that it is needed and understands what will occur as a result. Even so, techniques to institutionalize the change must be developed. Barriers and resistance to change should be recognized so that strategies can be developed to overcome them.

Executing a strategy can become quite challenging, especially when a strategic change of great magnitude is involved. When the environment changes rapidly or abruptly, progressive firms take steps to capitalize on new opportunities and minimize negative effects of the changes.[1] Change can be brought about by factors such as the need to address increased competition, improve quality or service, reduce costs, or align the firm with the practices and expectation of its partners. Strategic change can be revolutionary, such as when a firm changes its product lines, markets, or channels of distribution. Strategic change can also be less radical, such as when a firm overhauls its production system to improve quality and lower its costs of operations.

Because changing strategies is often cumbersome, it may not be desirable even when changes in the macroenvironment and industry suggest problems for the current strategy. Shifting the strategic intent may confuse customers and employees, may require structural changes in the organization, and can result in major capital investments. In short, costs associated with a major strategic change are not always justified by the benefits.[2]

Evaluating the appropriateness of strategic change is a complex process. Consider several examples. In 2003, McDonald's faced its first quarterly loss as a public company. Rather than increase its efforts to market inexpensive products to children, the burger giant responded with higher priced items such as the $4.50 California Cobb salad and the $3.89 grilled chicken club sandwich, all the while retaining its dollar menu with items such as double cheeseburgers, chicken sandwiches, and side salads. As a result, revenue increased 33 percent from 2002 to 2005, while profits more than doubled. McDonald's also responded with a more aggressive approach to new product development instead of relying on its franchises to generate ideas, a slow process that led to the Big Mac in 1968, the Egg McMuffin in 1973, and the Happy Meal in 1979. The firm hired chef Dan Coudreaut as director of culinary innovation in 2004, a decision that led to the successful Asian salad and the value-priced snack wrap in 2006.[3]

Frequent strategic shifts have occurred in the airline industry since the early 2000s. Southwest Airlines has reported profits every year since its inception, fueled by a consistent reliance on low costs, no frills, and low fares. In the early 2000s, however, younger low-cost carriers such as JetBlue, Frontier, and America West experienced more rapid growth, thanks in part to a greater emphasis on factors such as entertainment, food service, and first-class seating. In late 2003, Southwest announced it would begin flying into Philadelphia—a hub for U.S. Airways—in 2004, a move signaling a possible shift from the airline's historical avoidance of busy airports ruled by major carriers.

Southwest made another similar jump when it moved into Denver International Airport in January 2006, where airport fees average around $9 per passenger as opposed to the industry average of $5. Southwest had avoided such costly airports in the past and now faces intense price competition there with Denver-based low-cost carrier Frontier Airlines, and some extent from United Airlines, which controls over half of the Denver market.[4] Some analysts believed that this strategic change marked the beginning of a departure from Southwest's strict

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low-cost position.[5] Others believe that Southwest's growth and success in the early 2000s, coupled with intense competition from low-price upstarts, has begun to erode Southwest's cost advantage. In an effort to remain strong, Southwest CEO Gary Kelly argues that airlines must compete daily for every customer, embrace change in the marketplace, and remember that price alone is not sufficient to generate customer loyalty.[6]

As upstarts begin to resemble their veteran counterparts, their strategies often shift as well. Budget carrier JetBlue, for example, went public in 2002 and passed the $1 billion revenue mark in 2004. In 2005, CEO David Neeleman announced plans to expand its fleet from 80 airplanes to 275 by the end of 2010.[7] As niche players like Southwest and JetBlue grow and lose their emphasis on focus, openings are created for new competitors to fill gaps they leave unserved. In 2007, upstart ExpressJet entered the scene, focusing on point-to-point service across twenty-four midsize cities where such service currently does not exist. ExpressJet maintains modest costs but offers free snacks, sandwiches, and cold pasta dishes, as well as new leather seats and satellite radio. By utilizing a fleet of fifty-seat Embraer jets, ExpressJet hopes to fill a void too small to attract major carriers with larger aircraft.[8]

Strategic change in the airline industry has not been limited to modest size carriers and upstarts. In 2006, United Airlines made a strategic shift that parted course with its large U.S. counterparts. Instead of seeking profits by cutting costs and service, United retained and even enhanced services—such as roomier seats—deciding to focus on increased revenues instead of lower expenses. United management hopes that this shift will enable the carrier to distinguish itself from the other major carriers.[9]

Strategic change of a great magnitude can be difficult to implement (see Strategy at Work 11-1). Employees resist change for a variety of reasons, including personal factors, lack of information about the change, and poor design of the support system. Simply stated, strategic change is easier said than done. For example, Home Depot launched a major effort in the early 2000s to eliminate store clutter and enhance customer service. Instead of finding sales associates eager to help them with their purchase decisions, customers were tripping over wooden pallets and dodging forklifts. Employees are now barred from stocking shelves and operating forklifts during key shopping hours. These changes resulted in improved customer service vis-a-vis rival Lowe's.[10]

The decision whether to institute a strategic change can be difficult. This chapter discusses two key areas associated with executing strategic change: organizational culture and leadership. Both dimensions must be aligned with the strategy and be managed properly if a strategy is to be implemented effectively.

11-1 Organizational Culture and Strategy

Strategic decisions rendered by top management should be consistent with the culture of the organization. **Organizational culture** refers to the shared values and patterns of belief and behavior that are accepted and practiced by the members of a particular organization.[11] It includes accepted work practices and traditions, and defines how managers and workers treat each other and can expect to be treated. It fosters peer pressure that encourages members of the organization to behave in certain ways.

Organizational Culture
The shared values and patterns of belief and behavior that are accepted and practiced by the members of a particular organization.

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STRATEGY AT WORK 11-1

Decades of Strategic Change at Sears

Sears was arguably the most successful U.S. retailer until the entire retail industry began to undergo dramatic changes in the late 1970s. The Sears private-label business was eroded by the growing popularity of specialty retailers such as Circuit City, and its once low-cost structure was decimated by Wal-Mart.

The retailer's response to these changes has not always been consistent. Initially, Sears reacted by attempting to emphasize fashion with such labels as Cheryl Tiegs sportswear, but high-fashion models were not consistent with the Sears middle-America image. Sears then attempted to convert its antiquated image into a financial supermarket by purchasing Dean Witter Financial Services and Coldwell Banker Real Estate. However, in-store kiosks never caught on with customers, and the expected synergy between these two subsidiaries and the Sears Allstate Insurance and Discover Card business units failed to materialize.

Next, management modified the store's image to one that sold nationally branded merchandise along with private-label brands at "everyday low prices." The idea was to create individual superstores within each of the Sears outlets to compete more effectively with powerful niche competitors. Sears departed from its traditional practice of holding weekly sales to save on advertising expenses and inventory handling while offering new low prices, which turned out to be, in some cases, higher than old sale prices. By this time, customers were totally confused. In 1992 alone, Sears lost almost $4 billion, its worst performance ever.

In 1993, Sears terminated its big catalog operations, began spinning off some of its businesses unrelated to general merchandising, overhauled its clothing lines, eliminated more than 93,000 jobs, and closed 113 stores. In 1995, Sears reentered the catalog business. This time, instead of a big book Sears catalog, it set up joint ventures to provide smaller catalogs. Sears provides its name and its 24 million credit card customers. Its partners select the merchandise, mail catalogs, and fill orders.

By 1996, Sears had begun to benefit from its strategic shift to moderately priced apparel and home furnishings. In 1999, Sears branched out further, developing "The Great Indoors" to attract women to the traditionally male-dominated home improvement market. This format was in response to the fragmented nature of the home remodeling business, particularly on the higher end where services such as decorating and installation are often involved. The format targeted as its primary customers women age thirty to fifty years old earning in the $50,000 range.

In late 2001, Sears announced another strategic shift designed to position the firm as a solid, even more discount-oriented retailer. The company announced the elimination of a substantial number of cashiers and other employees, the integration of centralized checkouts, and shifts in the product mix, all designed to improve efficiency in the stores.

In late 2002, Sears acquired Lands' End, a leading marketer of traditionally designed clothing and related products. By the mid-2000s, Sears had incorporated the brand into its retail outlets. Sears was acquired by Kmart in early 2005 for $11 billion, marking the beginning of a new chapter in its strategy. Financial difficulties for the newly combined firm in 2007 point to another restructuring effort in the late 2000s.

Sources: E. Scardino, "Sears Looking for the Best Fit," DSN Retailing Today, *23 February 2004; "Sears Retrenches for the Future: Retailer's Makeover Includes Layoffs and a Discount Image,"* National Home Center News, *19 November 2001; "Home Goods Concept Anchors Multi-Format Strategy,"* DSN Retailing Today, *11 December 2000, 49; K. Hutchison, "Sears to Announce Long-Term Plans, Creating Buzz among Many Analysts,"* DSN Retailing Today, *22 October 2001, 2–3; A. Ward, "Sears 'On Course' Despite Hard Retail Conditions, CEO Says,"* Wall Street Journal Interactive Edition, *9 May 1996; K. Fitzgerald, "Sears, Ward's Take Different Paths,"* Advertising Age, *31 July 1995, 27.*

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Because each organization develops its own unique culture, even organizations within the same industry and city will exhibit distinctly different ways of functioning. The organizational culture enables a firm to adapt to environmental changes and to coordinate and integrate its internal operations.[12] Ideally, the values that define a firm's culture should be clear, easy to understand by all employees, embodied at the top of the organization, and reinforced over time.

Subculture
A culture within a broader culture.

Cultures not only form at the organizational level, but also within the organizational culture. These organizational **subcultures** can develop around such factors as location, functional responsibility, or managerial level. Cultural similarities

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among sales representatives at an organization, for example, typically differ from those among production workers.

The first and most important influence on an organization's culture is its founder. Some founders have strong beliefs about business practice or have strict procedures for transacting affairs. Their assumptions about success—as well as those of other early top managers—form the foundation of the firm's culture.[13] For instance, the primary influence on McDonald's culture was the fast-food company's founder, Ray Kroc. Although he passed away in 1984, his philosophy of fast service, assembly-line food preparation, wholesome image, cleanliness, and devotion to quality are still central facets of the organization's culture.[14]

Whether the founder or not, a firm's CEO also plays a significant role in its culture. JCPenney CEO Mike Ullman, for example, has taken steps to loosen up the retailer's stodgy culture since joining the firm in 2004. Specifically, Ullman targeted the stringent code of conduct and in-house hiring requirements that he believed increased turnover and made recruiting more difficult. During Ullman's tenure, JCPenney replaced its art collection with employee photos and began to emphasize the use of first names and business-casual attire, including jeans on Friday.[15]

Views and assumptions concerning an organization's distinctive competence comprise one of the most important elements of culture, particularly in new organizations. For example, historically, innovative firms are likely to respond to a sales decline with new product introductions, whereas companies whose success is based on low prices may respond with attempts to lower costs even further.[16] However, it is possible to modify the culture over time as the environment changes, rendering some of the firm's culture obsolete and even dysfunctional. New elements of the culture must be added as the old elements are discarded.

Stories are also an important component of culture. Whether true or fabricated, accounts and legends of organizational members can have a great influence on present-day actions of managers and workers alike. UPS employees tell stories of drivers who go the extra mile through adverse weather to deliver packages on time. Microsoft employees retell stories of programmers who work long hours to meet demanding production schedules. These stories create expectations and can inspire workers to perform similar feats in their daily jobs.

Organizational culture can facilitate or hinder the firm's strategic actions. Studies have shown that firms with strategically appropriate cultures, such as PepsiCo, Wal-Mart, and Shell, tend to outperform other corporations whose cultures do not fit as well with their strategies. A strategy-culture fit can support strategy execution because the activities required from middle managers and others in the organization are consistent with what is already taking place. When the strategy does not fit with the culture, it is necessary to change one or both. For example, a firm caught in a changing environment may craft a new strategy that makes sense from financial, product, and marketing points of view. Yet the strategy may not be implemented because it requires significant changes in assumptions, values, and ways of working.[17] All things considered, changing a strategy is easier than changing culture, and both are often required for organizations to be successful.[18]

For many firms, achieving a strategy-culture fit means creating an **adaptive culture** whereby members of an organization are willing and eager to embrace any change that is consistent with the core values.[19] Such a culture values taking initiative and risk; exhibiting creativity, trust, and employee involvement; and desiring continuous, positive organizational change. Adaptive cultures are especially important for firms that emphasize high growth or innovation (e.g., prospectors), as well as

Adaptive Culture

A culture whereby members of an organization are willing and eager to embrace any change that is consistent with the core values.

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Innovation
Developing something new.

Inert Culture
A conservative culture that encourages maintenance of existing resources.

those operating in turbulent environments. Adaptive cultures encourage initiative and emphasize **innovation**—developing something new—whereas **inert cultures** are conservative and encourage maintenance of existing resources. For companies such as Google and eBay, an adaptive culture is an essential part of their success.

11-1a Cultural Strength and Diversity

Strong Culture
A culture characterized by deeply rooted values and ways of thinking that regulate firm behavior.

Some cultures influence firm activities more than others. A **strong culture** is characterized by deeply rooted values and ways of thinking that regulate firm behavior. Top managers model that behavior and create peer pressure that reinforces the notion that others in the organization should behave likewise. Strong cultures develop over time, generally a decade or longer.

A strong culture that embodies appropriate values can be a valuable resource for a firm, especially when it reinforces values inherent in the organization's strategies. Effective strategy execution occurs when all facets of the organization, including the culture, mesh. Effectiveness is then likely to increase when a firm's strategy and culture reinforce each other.[20] JCPenney's strong culture grounded in its key principles on ethics and customer orientation has contributed to its success and survival as a leading U.S. retailer for over a hundred years.[21]

Conversely, when a strong culture is unhealthy and embodies destructive characteristics, it can strain firm performance. For example, such characteristics include a strong emphasis on politics to get things done, a disregard for ethical standards, territorialism among departments, and strong resistance to change. Needless to say, strong dysfunctional cultures can hinder organizational performance.[22]

Weak Culture
A culture that lacks values and ways of thinking that are widely accepted by members of the organization.

Unlike a strong culture, a **weak culture** lacks values and ways of thinking that are widely accepted by members of the organization. There is no clear, widely accepted business philosophy, and managers approach their responsibilities in different ways. In general, this lack of cultural consensus does not support strategy execution.

Diversity
The extent to which individuals within an organization are different.

A concept related to the notion of strong and weak cultures is **diversity**, the extent to which individuals within an organization are different. People today commonly speak of the need to pursue diversity as a means of competitive advantage. The term *diversity* can be defined in several ways, however. Some use it to reference differences over which individuals clearly have no choice, such as age, race, ethnicity, gender, and physical disability. Others extend this definition to include differences over which individuals may have control, such as marital status, religion, and sexual preference.[23] Still others use the term simply to reference differences in ways of thinking.

Research linking diversity and performance is largely inconclusive, however, in part because of competing conceptualizations of what it means for an organization's membership to be diverse.[24] Diversity's link to cultural strength is an interesting one. The latter, simpler notion of diversity—differences in ways of thinking—is strikingly similar to the concept of a weak culture. In this respect, greater diversity can hinder firm performance. Studies focusing on diverse top management teams, however, have found that diverse ways of thinking among top managers lead to more creative, comprehensive, and effective strategies.[25]

The value of diverse ways of thinking appears to be most critical during strategy formulation. A diverse top management team can pool its vast backgrounds and perspectives to create innovative strategies without blind spots. For those responsible for executing a strategy, typically middle and lower-level managers, less diversity is required. In this stage, processes for implementation may be clearly defined, and managers are simply charged with following them. Hence, a strong culture with less diversity of thought is likely preferable in this regard.

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11-1b Shaping the Culture

Cultural change is a complex process. Just as cultures do not develop overnight, rarely are they changed in a short time. Culture change is possible but efforts often fail, due primarily to a lack of understanding about *how* a culture can be changed and *how long* it is likely to take.[26]

Top executives can influence and shape the organization's culture in at least five ways.[27] The first means is to systematically pay attention to areas of the business believed to be of key importance to the strategy's success. The top executive may take steps to accomplish this goal formally by measuring and controlling the activities of those areas, or less formally by making specific comments or questions at meetings. These specific areas should be ones identified as critical to the firm's long-term performance and survival, and may include such areas as customer service, new product development, or quality control.

The second means involves the leader's reactions to critical incidents and organizational crises. The way a CEO deals with a crisis, such as declining sales or technological obsolescence, can emphasize norms, values, and working procedures, or even create new ones. When Saturn's chief executive chose to destroy a group of vehicles produced with faulty coolant instead of simply draining the radiators, he sent a strong pro-quality message to his workers.

The third means is to serve as a deliberate role model, teacher, or coach. When a CEO models certain behavior, others in the organization are likely to adopt it as well. For example, chief executives who give up their reserved parking place and park among the line workers send a message about the importance of status in the organization.

The fourth means is the process through which top management allocates rewards and status. Leaders communicate their priorities by consistently linking pay raises and promotions, or the lack thereof, to particular behaviors. Simply stated, rewarded behavior tends to continue and become ingrained in the fabric of the organization. This not only applies to middle and lower-level managers, but can apply at top levels of the organization as well.

The fifth means of shaping the culture is to modify the procedures through which an organization recruits, selects, promotes, and terminates employees. An organization's culture can be perpetuated by hiring and promoting individuals whose values are similar to those of the firm and whose beliefs and behaviors more closely fit the organization's changing value system. Firms should spend the time necessary to properly screen candidates and evaluate them on their fit with the desired organizational culture. The easiest way to affect culture over the long term is to hire individuals who possess the desired cultural attributes.

11-1c Global Concerns

Global concerns can also complicate the role of organizational culture. In many respects, an organization's culture can be viewed as a subset of the national culture in which the firm operates. As such, operating outside one's own country can create special challenges in areas such as leadership and maintaining a strong organizational culture. For example, leaders of some nations resist innovation and radical new approaches to conducting business, whereas others welcome the change. Such national tendencies often become a part of the culture of the organization in those countries.

The self-reference criterion, the unconscious reference to one's own cultural values as a standard of judgment, also presents a potential problem. Managers often believe that the leadership styles and organizational culture that work in their home country should work elsewhere. However, each nation—like each organization—has its own unique culture, traditions, values, and beliefs. Hence, organizational values and norms must be tailored to fit the unique culture of each

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country in which the organization operates, at least to some extent. The need to customize values and norms can create special challenges, however, when firms from different countries become partners or even merge their organizations.

11-2 Strategic Leadership

Leadership
The capacity to secure the cooperation of others in accomplishing organizational goals.

Announcing a strategic change usually does little to inspire those responsible for implementing the change. The top management team has several means at its disposal to encourage managers and other employees to implement the strategy, one of which is leadership. The CEO is recognized as the organization's principal leader, one who sets the tone for its activities. A manager exhibits (managerial) **leadership** when he or she secures the cooperation of others in accomplishing a goal (see Strategy at Work 11-2).

STRATEGY AT WORK 11-2

Planning for CEO Succession

Wal-Mart's legendary CEO, Sam Walton, handed over the reigns of power to David Glass in early 1998. Only two years later, Glass transferred control to H. Lee Scott. How did Wal-Mart execute these changes in leadership, and leadership styles, without negative consequences? Five lessons for a successful CEO transition have been suggested from the Wal-Mart experience.

1. Firms should cross-train high-level executives to broaden their exposure as much as possible. Doing so prevents the learning curve for the new CEO from being too steep.
2. Firms should expose the heir apparent and other top executives to board members so they know what the board expects from top management.
3. Firms should discuss potential conflicts associated with the new roles for both the incoming and the outgoing CEOs. Plan to deal with any potential problems (like Walton, Glass stayed on in an advisory capacity after he stepped down as CEO).
4. The new CEO should conduct meetings on the other side of the executive desk.
5. Everyone involved should stay humble and not overestimate the new CEO's ability to institute rapid change.

Sources: A. Zimmerman, "Defending Wal-Mart," Wall Street Journal, *6 October 2004, B1, B10; Zimmerman, "How Wal-Mart Transfers Power,"* Wall Street Journal, *27 March 2001, B1, B4; B. Ortega,* In Sam We Trust: The Untold Story of Sam Walton and Wal-Mart, the World's Most Powerful Retailer *(New York: Times Books, 2000); P. Pitcher, S. Chreim, and V. Kisfalvi, "CEO Succession Research: Methodological Bridges over Troubled Waters,"* Strategic Management Journal *21(2000): 625–648.*

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Strategic leadership is more than managerial leadership. It involves creating the vision and mission for the firm, developing strategies, and empowering individuals throughout the organization to put those strategies into action. It includes determining the firm's strategic direction, aligning the firm's strategy with its culture, modeling and communicating high ethical standards, and initiating changes in the firm's strategy when necessary. Strategic leadership establishes the firm's direction by developing and communicating a vision of the future and inspires organization members to move in that direction.[28] Unlike strategic leadership, managerial leadership is generally concerned with the short-term, day-to-day activities.[29]

Strategic Leadership
Creating the vision and mission for the firm, developing strategies, and empowering individuals throughout the organization to put those strategies into action.

Effective strategic leadership is the link between strategy formulation and strategy execution. Without it, otherwise effective strategies will not likely be implemented as planned. Developing a firm's mission, vision, and strategies is not sufficient. Effective strategic leaders inspire managers and even nonmanagers to take the necessary steps to realize them. They build and promote an organizational culture that supports firm strategies and they set the tone for ethical behavior.

Source: Comstock.com

11-2a Leadership Style

Every leader has a distinctive **leadership style,** or consistent pattern of behavior exhibited in the process of governing and making decisions. Some leaders are flamboyant, whereas others are reserved and contemplative. Some seek broad-based participation when making decisions, whereas others arrive at decisions primarily on their own with little input from others. Regardless of style, participation can help build employee commitment to the firm's goals and strategies and is generally seen as a positive approach to decision making.[30]

Leadership Style
The consistent pattern of behavior that a leader exhibits in the process of governing and making decisions.

There is little agreement on what might constitute a single best leadership style; however, two basic approaches can be identified.[31] Leaders employing a **transactional leadership** style use the authority of their office to exchange rewards such as pay and status for employees' work efforts and generally seek to enhance an organization's performance steadily, but not dramatically. By contrast, leaders employing a **transformational leadership** style inspire involvement in a mission, giving followers a vision of a higher calling, thereby seeking more dramatic changes in organizational performance. In effect, the transformational leader motivates followers to do more than they originally expected to do by stretching their abilities and increasing their self-confidence.[32] Transformational leaders also tend to promote innovation throughout the organization.

Transactional Leadership
The capacity to motivate followers by exchanging rewards for performance.

Transformational Leadership
The capacity to motivate followers by inspiring involvement and participation in a mission.

Transformational leadership is typically associated with innovation. Austrian economist Joseph Schumpeter identified five types of innovation: (1) new products, (2) new materials or resources, (3) new markets, (4) new production processes, and (5) new forms of organization.[33] It often occurs through a process Schumpeter called **creative destruction**, whereby managers consciously and constantly destroy the old by recombining its elements into new forms.

Creative Destruction
A process whereby managers consciously and constantly destroy the old by recombining its elements into new forms.

Leaders are typically categorized as transactional or transformational based on their overall pattern of behavior. Contrary to popular opinion, the transformational leader is not always a dynamic, vibrant, charismatic personality type.[34] A number of CEOs have transformed their organizations during times of turbulence without being charismatic figures. Indeed, a charismatic personality can be an asset to a transformational leader (and to a transactional

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Management Focus on **Innovation**

Johnson & Johnson Leadership Emphasizes Innovation

To say the least, Robert Wood Johnson, chairman of Johnson & Johnson, was ahead of his time when he wrote the company's credo in the 1940s. The credo took the unusual step of declaring that the organization's primary responsibility was to "the doctors, nurses, and patients . . . mothers and fathers and all others who use our products and services." This customer-driven focus had been the basis of J&J's success to that point, and it continues to pervade the company today, serving as common ground for the organization's 170 operating companies. J&J's business today is driven by three basic commitments.

1. Commitment to the credo
2. Commitment to decentralized management
3. Commitment to the long term

Within the credo's framework—and in some ways because of it—J&J constantly emphasizes innovation, often measuring its success by the percentage of sales from products introduced in the last five years. In the 1980s, this percentage was around 30 percent. Today, it is close to 35 percent. As a result of this high level of innovation, the organization has increased its sales by more than $3 billion and added more than eight thousand new employees over the last decade.

Sources: Robert M. Fulmer, "Frameworks for Leadership," Organizational Dynamics, *March 2001, 211–220; and Fulmer, Philip A. Gibbs, and Marshall Goldsmith, "Developing Leaders: How Winning Companies Keep on Winning,"* Sloan Management Review, *Fall 2000, 49–59.*

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leader, to a lesser extent), but it is not a prerequisite for success (see Strategy at Work 11-3).

11-2b Leadership in Practice

Most leaders exhibit both transactional and transformational styles, to varying degrees (see Figure 11-1). Consider General Electric's Jack Welch, who retired in 2001 after two decades as CEO. Welch was known for his impatient, aggressive, and alternatively charming and overbearing image, and he pushed workers in GE plants and offices to constantly improve efficiency. However, Welch also demonstrated an uncanny charisma and strong drive as top executive. Widely known as one of America's most effective CEOs, Welch integrated components of both transactional and transformational styles.[35]

Emotional Intelligence
One's collection of psychological attributes, such as motivation, empathy, self-awareness, and social skills.

Regardless of leadership style, a leader's likelihood of success has also been tied to **emotional intelligence**, one's collection of psychological attributes, such as motivation, empathy, self-awareness, and social skills. Executives who possess a passion for their work, are socially oriented, and understand their own needs, as well as those of their subordinates, are more likely to gain the trust, confidence, and support necessary to lead their organizations.[36]

Although transformational leadership styles have gained increased popularity in recent years, transactional styles may be most appropriate in relatively predictable environments. Because predictability has become less common in recent years, however, many scholars and practitioners see a movement toward a transformation style as attractive for many organizations. Changing the predominant style in an organization, especially from transactional to transformational, can be a difficult process.

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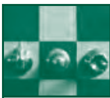

STRATEGY AT WORK 11-3

Leadership at Southwest Airlines

Herb Kelleher built Southwest Airlines into one of the most profitable and fast growing airlines in the country through an emphasis on low-cost operations. In doing so, he also managed to win the trust and respect of his employees through his leadership style.

Texas businessman Rollin King and attorney Herb Kelleher founded Air Southwest in 1967 as a regional airline linking Dallas, Houston, and San Antonio. Southwest made its first scheduled flight in 1971 and passed the billion-dollar revenue mark in 1989. Today, Southwest Airlines remains a predominantly short-haul, high-frequency, low-fare airline providing service within the United States. The Dallas-based carrier offers approximately 2,700 daily flights throughout much but not all of the country.

Southwest is a classic no-frills airline, although service is generally perceived to be excellent, and on-time performance rivals or exceeds its larger peers. Meals are not served, although passengers are encouraged to bring their own food on the plane. In addition, there are no reserved seats. The first thirty passengers to check in at the gate are allowed to board first and select their seats, followed by the next thirty, and so on. Southwest minimizes costs by operating out of smaller, less costly airports when possible.

Southwest has enjoyed twenty-nine consecutive years of profits, including 2001 when the 9/11 attacks riveted other American carriers into deep losses. High productivity, combined with the airline's lack of frills, gives Southwest a 43 percent cost advantage over its large Dallas-based rival, American Airlines. In fact, the airline has been the only major U.S. carrier to avoid layoffs and maintain a full flight schedule since that time. The company even began hiring additional employees in early 2002.

Southwest is known for its fun-loving, service-oriented culture. Flight attendants seem to be amateur comedians, a practice that subsided after the events of 9/11, but had reemerged by 2003.

Kelleher, who stepped down as CEO in 2001, helped establish a reputation for the company as one of the top employers in the United States. *Fortune* typically recognizes Southwest as one of the most admired companies in its annual surveys.

Kelleher was (and still is) genuinely respected by Southwest employees. He established excellent rapport with personnel and avoided the bitter negotiations that have characterized labor contracts at several other airlines. Through profit-sharing plans, cross-utilization of workers, and Kelleher's concern for employees, the company developed a culture of trust and loyalty. As CEO, Kelleher was highly visible. He would often take Southwest flights and frequently visited the aircraft maintenance areas. The visits were invariably upbeat and optimistic, with Kelleher dressing in a casual fashion (often in a Southwest Airlines shirt) and joking with the crew. He knew individuals' names and even sent birthday and Valentine's Day cards to each employee.

Kelleher handed over the CEO reins to VP James Parker in 2001, although Kelleher retained his position as chairman of the board.

Sources: J. Barlow, "Legendary Herb Has Done It His Way," Houston Chronicle, *22 March 2001, online edition; P. Adams, "Southwest Air Founder, Kelleher, Yielding Reins,"* Baltimore Sun, *20 March 2001, 1C; K. Labich, "Is Herb Kelleher America's Best CEO?"* Fortune, *2 May 1994, 44–52; P. O'Brian, "Southwest Airlines Is a Rare Air Carrier: It Still Makes Money,"* Wall Street Journal, *26 October 1992, A1.*

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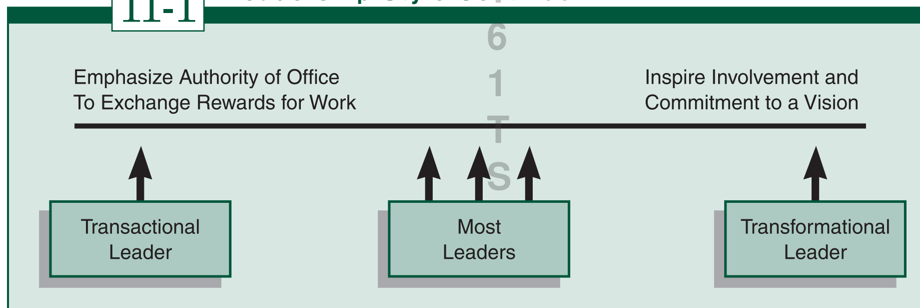
FIGURE 11-1 Leadership Style Continuum



11-3 Executing Strategic Change

This chapter has outlined the benefits, costs, and considerations for implementing a strategic change. Indeed, strategic change is a complex process; and clear, detailed steps for instituting a change are difficult to develop, because organizations differ markedly in terms of industry, external environment, strategy, structure, culture, and leadership. For this reason, a simple three-step process for executing an effective strategic change is needed.[37]

This model can be applied regardless of the type of strategic change under consideration. In this context, the notion of strategic change is broadly defined and includes both changes in a strategy and changes in related factors (e.g., structure, leadership, and culture) that support the success of a strategy.

Recognize the Need for Change. First, the need for change must be recognized, and key managers in the organization must be made aware of that need. Although this step may appear simple at first, some individuals inevitably perceive the need for change before others. In addition, this task may be difficult if the organization currently seems to be doing okay. From an implementation standpoint, however, the best time to initiate change is when the organization is functionally well, not when it is in crisis. From a practical standpoint, it is difficult to execute a strategic change when only a visionary top executive sees the need to change in the first place.

Managers in poor performing firms are usually first to recognize the need for change, and often replace their CEOs with outsiders. These new leaders can sometimes make the decisions that an insider might be reluctant to make, and bring a fresh perspective to the firm and its problems. On the other hand, outsiders may have to spend months learning the business and developing a network of contacts before they can make decisions of any magnitude. However, hiring an outsider can send a message that current executives are not worthy of promotion.

An organization tends to allocate resources to the factors that led to current success, not necessarily the factors that are associated with future success. To overcome this tendency, leaders should broaden their measurement of performance to include comparisons to their competitors and to industry norms, not just last year's performance. In addition to the typical economic indicators, such as profitability, earnings per share, and market share, performance measures should also include factors such as customer satisfaction and product quality.

Create a Shared Vision. Once the need for change is established, leaders must inspire organizational members with a vision of what the organization can become if its members are willing to change. The vision might be one of excellent customer service, industry leadership, or a leaner firm following a restructuring. The change effort is not as likely to be successful when members of the firm do not share the same vision for the company's future organization.

The CEO should lead the effort and identify and model high performance standards. Transformational leaders seek to stretch their followers' abilities, and high performing organizations rarely pursue moderate goals or performance standards. Their public behavior should reflect their own excitement and energy at all levels of the organization.[38] Transformational leaders must also effectively communicate their vision to all members of the organization. A lack of vision can

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Case Analysis 11-1

Step 23: How Should the Alternative(s) Be Implemented?

After alternatives have been evaluated and one or more have been selected, a plan for their execution must be developed. There are no simple outlines for effective implementation; each plan for implementation is unique to the organization and the alternatives recommended. Nonetheless, it must clearly detail precisely how the organization should implement the selected alternative(s). In doing so, potential problems may arise—many of which are an extension of some of the pros and cons aforementioned—and must be addressed. For example, if raising product quality and prices is proposed, then the problems associated with present customers who may not perceive the increase in quality or who may not be willing to pay a higher price should be considered. Hiring a consultant is not an acceptable recommendation!

Consider the following restaurant example. Suppose, based on the analysis, that it is recommended that Pizza Hut introduce a low-fat pizza. Stating that the organization should "just do it" would not be sufficient. Key questions to be considered in the plan for implementation include the following:

1. What are the characteristics of the new product (low-fat cheese, "lite" crust, etc.; actual fat and calorie levels should have been discussed in the pros and cons earlier)?
2. Should this product be implemented at all locations simultaneously? What are the pros and cons of such action?
3. How should this new product be marketed?
4. How will this new product affect sales of existing pizzas?
5. What problems have other fast-food restaurants had in delivering high-quality, low-fat products to their customers?
6. Specifically, what should Pizza Hut do to avoid the pitfalls and/or capitalize on the successes?
7. How much will this new product introduction cost?
8. How much time is necessary for training employees in the preparation of the new product?

Notice in this example that some of these issues may have been introduced in the alternative evaluation phase, and others extend beyond implementation into the control function. It is acceptable to make references to earlier statements and arguments.

One final note: The execution phase of the case analysis is required even if no major strategic changes are adopted. It is still necessary to explain in detail how the firm will execute the current strategy effectively in the coming years. It is not sufficient to suggest that the firm simply "stay the course" or "keep doing what it is already doing." Arguments such as, "If it ain't broke, don't fix it" are weak, as firms often fail because they resist change during profitable periods.

cloud organizational efforts, whereas clear communication of a vision creates a focus for the employees' efforts.

Institutionalize the Change. Finally, the firm's leadership must institutionalize the desired strategic changes. The adage "change starts at the top" is true in this regard. Without a strong commitment from the top executive and the top management team, the proposed strategic change is less likely to succeed.

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The top executive must also realize that building a lasting change takes time. For example, encouraging organizational members to work and interact in different ways may require a new reward system, and changes may be necessary in systems for pay increases and promotions. Without adequate rewards, employees are unlikely to see involvement in initiating change as worthy of their efforts.[39] Minor changes in the system will likely produce minor changes in behavior.

The need for concise, accurate, and timely information is critical at all three stages of the change process.[40] Leaders should not rely exclusively on their associates for information, but should be accessible to all the members of the organization and to its customers. CEOs should also actively encourage others on their top management teams to act as devil's advocates so that group members seek agreement even in the face of conflict.

Top-down change efforts are not always successful. Top managers may attempt to institutionalize an ambitious change without pretesting, education, or employee participation, or they may follow a rigid change procedure that appeared to work elsewhere without considering unique characteristics of the organization.[41] For this reason, bottom-up approaches have been suggested whereby managers and line workers recognize the need for change and develop new strategies jointly. Regardless of approach, the importance of employee participation in the process at all levels cannot be easily understated.[42] (See Case Analysis 11-1.)

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11-4 Summary

Executing a strategy can be challenging, especially when a significant strategic change is involved. Hence, the decision to institute such a change is not easy. Two key areas associated with executing strategic change—organizational culture and leadership—must be considered. Organizational culture can facilitate or hinder the firm's strategic actions. Successful strategy execution requires a strategically appropriate culture, one that is appropriate to, and supportive of, the firm's strategy. Modifying the culture is sometimes necessary, but doing so is usually difficult.

The leadership style of the top executive and the top management team is also closely linked to a firm's ability to implement a given strategy. Each leader may adopt a transactional or a transformational style, although most effective leaders utilize both styles to some extent. Effective leadership is critical when a firm seeks to implement a major strategic change.

Key Terms

adaptive culture
creative destruction
diversity
emotional intelligence
inert culture
innovation
leadership
leadership style
organizational culture
strategic leadership
strong culture
subculture
transactional leadership
transformational leadership
weak culture

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Review Questions and Exercises

1. Give an example of an organization whose culture is appropriate for its strategy. Explain.
2. Strategies involving mergers and acquisitions are particularly vulnerable to cultural problems. Mergers between two organizations often are easier to accomplish on paper than in reality. Reality may reveal that the cultures of the organization fail to mesh as easily as corporate assets. Research the history of the DaimlerChrysler merger on the Internet. Learn as much as you can about each original company's organizational culture. What cultural problems did the two companies experience? Did these problems contribute to the split in 2007?
3. Explain transformational and transactional leadership styles and give examples of each. Identify the conditions under which each is likely to be effective.
4. To what extent can leaders institute change in their organizations? Practically speaking, how is this accomplished?

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Practice Quiz

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True or False

1. Organizational culture can facilitate or hinder the firm's strategic actions.
2. Because each organization develops its own unique culture, even organizations within the same industry and city will exhibit distinctly different ways of functioning.
3. Transactional leaders inspire involvement in a mission, giving followers a vision of a higher calling.
4. Most effective leaders exhibit traits associated with both transformational and transactional leadership styles.
5. Because environments have become less predictable in recent years, a transformational leadership style may be most appropriate for the majority of firms.
6. The first step in initiating strategic change is to create a shared vision.

Multiple Choice

7. Deeply rooted values and ways of thinking that regulate firm behavior characterize
   - **A.** a strong culture.
   - **B.** a weak culture.
   - **C.** the organizational culture.
   - **D.** none of the above
8. A lack of values and ways of thinking in a firm characterize
   - **A.** a strong culture.
   - **B.** a weak culture.
   - **C.** the organizational culture.
   - **D.** none of the above
9. In general, an organizational culture
   - **A.** cannot be changed.
   - **B.** can only be changed by a charismatic leader.
   - **C.** can be changed easily if proper procedures are followed.
   - **D.** none of the above
10. The unconscious reference to one's own cultural values as a standard of judgment is known as
    - **A.** emotional intelligence.
    - **B.** the self-reference criterion.
    - **C.** global awareness.
    - **D.** none of the above
11. One's collection of psychological attributes such as motivation, empathy, self-awareness, and social skills is known as
    - **A.** emotional intelligence.
    - **B.** leadership traits.
    - **C.** leadership style.
    - **D.** none of the above
12. Top-down change efforts
    - **A.** are not always successful.
    - **B.** can be augmented through employee participation.
    - **C.** are not necessarily more effective than bottom-up efforts.
    - **D.** all of the above

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READING 11-1

Insight from *strategy+business*

This chapter's strategy+business reading builds on last chapter's reading by delving deeper into the importance of strategy execution. Specifically, seven types of organizations are identified, four of which possess serious problems in terms of effective implementation. Understanding one's "organizational DNA" is the first step in improving a firm's ability to execute well-crafted strategies effectively.

The Seven Types of Organizational DNA

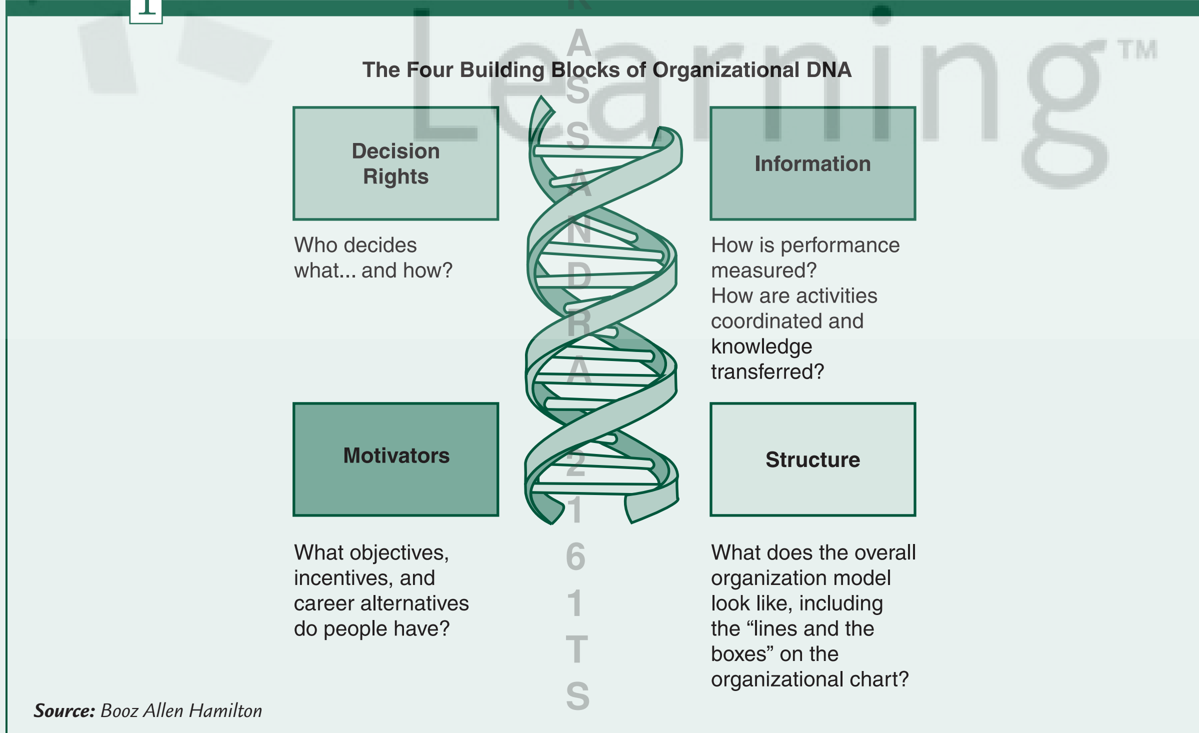
An exclusive survey shows most companies possess traits that inhibit their ability to execute.

By Gary Neilson, Bruce A. Pasternack, and Decio Mendes

"Execution" has become the new watchword in boardrooms, as CEOs and directors watch sound strategies fail at the hands of organizations that cannot or will not effectively implement them. The first step in resolving these dysfunctions is to understand how the inherent traits of an organization influence—and perhaps even determine—each individual's behavior; and how the collective behavior affects company performance.

We like to use the familiar metaphor of DNA to codify the idiosyncratic characteristics of a company. (See "The Four Bases of Organizational DNA," *s+b,* Winter 2003.) Like the DNA of living organisms, the DNA of living organizations consists of four building blocks, which combine and recombine to express distinct identities, or personalities. These organizational building blocks—structure, decision rights, motivators, and information—largely determine how a firm looks and behaves, internally and externally. (See Exhibit 1.)

EXHIBIT 1 Breaking Down an Organization's Genetic Code



Source: *Booz Allen Hamilton*

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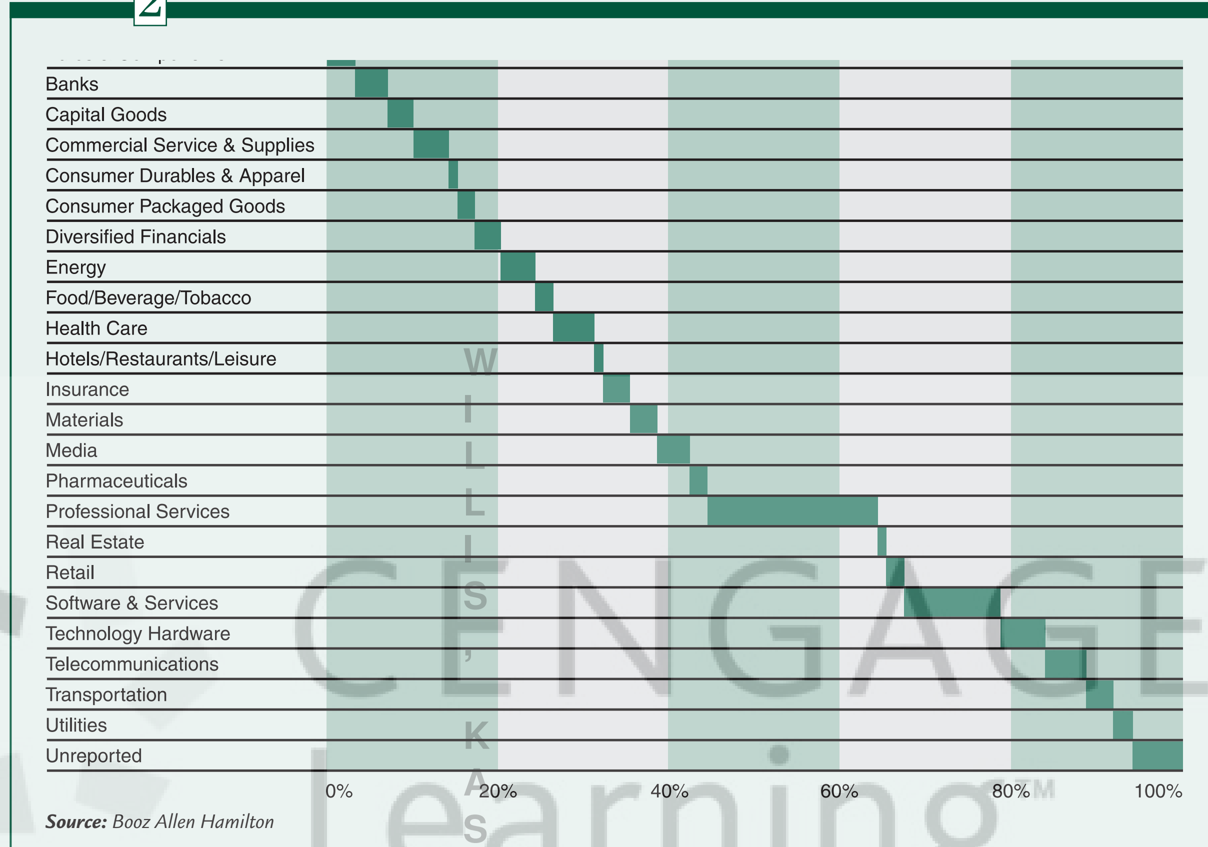
EXHIBIT 2 Org DNA Assessments: Industry Breakdown



Source: *Booz Allen Hamilton*

Last year, we developed a short, online self-assessment tool called the Org DNA Profiler™ (www.orgdna.com) to measure an organization's relative strength in each of these four areas, on the basis of individual employees' responses to 19 questions. Survey responses are fed through proprietary software to generate one of seven prototypical organizational profiles—or, to continue the genetic metaphor, "species." (See "The Seven Organizational Species.")

We launched the Org DNA Profiler on December 9, 2003, and in the first two weeks, collected 4,007 completed assessments. (See "The Org DNA Profiler Methodology.") Respondents came from companies of all sizes in a wide variety of industries, including financial services, pharmaceuticals, telecommunications, energy, and consumer packaged goods, and represented every function and every level in the corporate hierarchy. (See Exhibits 2 and 3.)

The responses (and the thousands more we have continued to collect) prompt six observations about the prevalence of dysfunction among business organizations and the reasons for their maladies:

1. **Most organizations are unhealthy.** More than 60 percent of respondents found their organizations fit one of the four species associated with subpar performance: Passive-Aggressive, Fits-and-Starts, Outgrown, or Overmanaged.
2. **Organizational DNA changes as companies grow.** As a rule, small companies report more Resilient and Just-in-Time behaviors. As they grow, they may centralize and demonstrate more Military traits. Once their annual revenues cross the $1 billion threshold, operations necessarily decentralize, but often badly, as revealed in the higher incidence of Fits-and-Starts and Passive-Aggressive profiles. Once past the $10 billion mark, companies have obviously demonstrated some key success traits but are not necessarily free from dysfunction.
3. **Altitude determines attitude.** Survey results indicate sharp differences between senior-management responses and those of lower-level personnel, suggesting a disconnect between the organizations that senior

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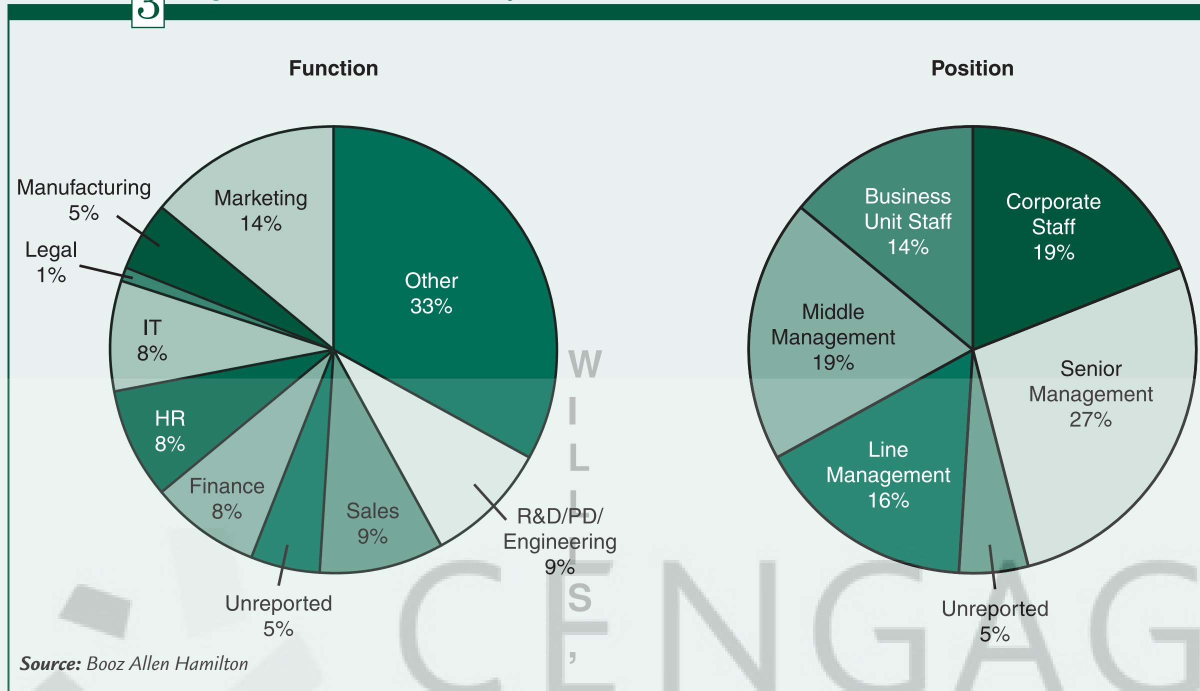
EXHIBIT 3 Org DNA Assessments, by Function and Position



Source: *Booz Allen Hamilton*

executives believe they've established and the organizations they are actually running.

4. **Nonexecutives feel micromanaged.** Although senior managers appear to view their self-professed involvement in operating decisions as good, junior managers overwhelmingly reported feeling a lack of maneuvering room.
5. **Decision rights are unclear.** More than half of those completing surveys indicated they believed that the accountability for decisions and actions in their organizations was vague.
6. **Execution is the exception, not the rule.** Fewer than half of all respondents agreed that "important strategic and operational decisions are quickly translated into action" in their organizations. Poor information flows seem mostly to blame.

Unlike humans and other organisms, organizations have the ability to *change* their DNA by adjusting and adapting their building blocks. Our survey findings suggest steps companies can take both to better understand the nature of their difficulties and to improve their execution capabilities.

The Checkup

Our review of the 4,000-plus assessments showed that most organizations are unhealthy. Of the seven organizational species, only three—Resilient, Just-in-Time, and Military—can be described as relatively free from dysfunction, or "healthy." Only 27 percent of the survey responses resulted in one of these three healthy profiles. More than 60 percent of respondents indicated that the traits and behaviors of their organizations were unhealthy in some way. Their responses describe firms unable to act decisively or effectively.

The most prevalent species was Passive-Aggressive; 31 percent of respondents reported organizational behaviors consistent with this type. Overmanaged was the second largest category, at 18 percent. The healthiest species is the Resilient firm. Yet only 15 percent of respondents indicated that their companies fit this profile. We found significant differences among industries in their degree of passive-aggressiveness, from a low of 17 percent of people in the durables and apparel sector who indicated their companies fell into this category, to a high of 40 percent among insurance-industry respondents. The surveys show that the more highly regulated the industry, the greater the level of passive-aggressive behavior. Similar variations existed among departments, with overhead and staff functions perceiving passive-aggressiveness in their companies more than manufacturing and sales personnel. (See Exhibit 4.)

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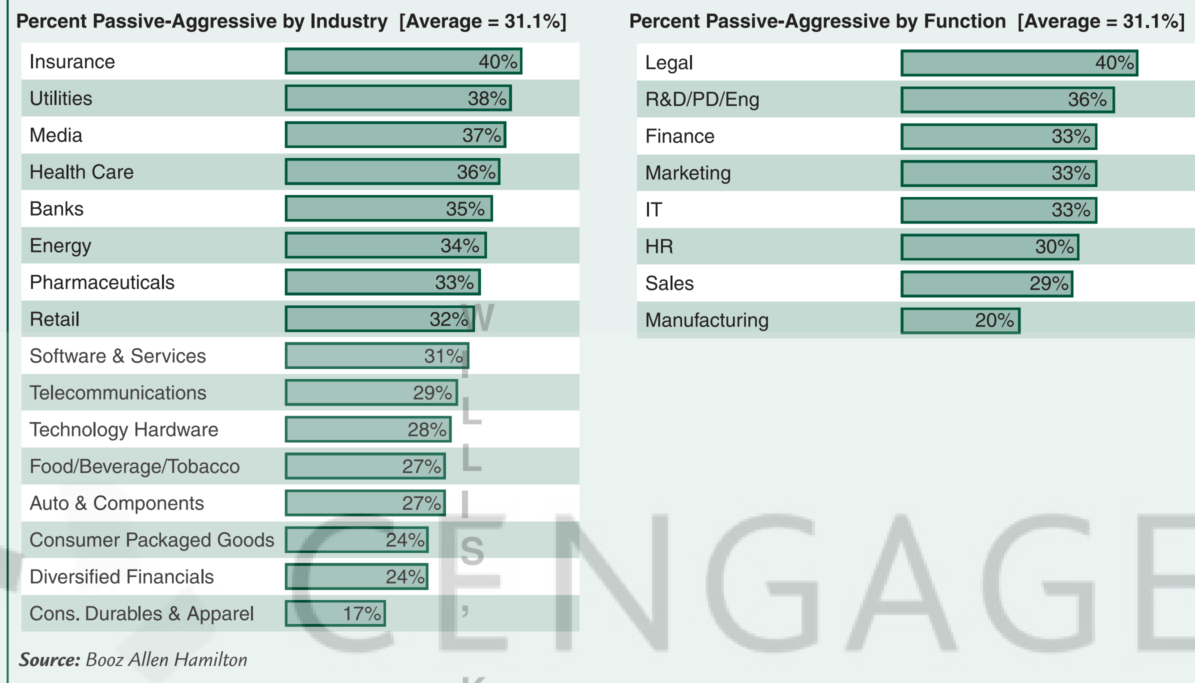
EXHIBIT 4 The Prevalence of Passive Aggressiveness



Source: *Booz Allen Hamilton*

The surveys suggest that companies pass through different "genotypes" as they grow and that they hit a kind of Darwinian barrier when their embedded traits and behaviors hinder their ability to perform according to their aspirations. Astute managers appreciate these subtle shifts and can help their organizations transition to new models as the company expands. (See Exhibit 5.)

Specifically, in analyzing organizational behaviors by the size of the company, we see a four-step evolutionary process by which companies grow into—and occasionally out of—dysfunction:

Step 1: $0-$500 Million. Responses from small companies are more likely than those from their larger counterparts to indicate Resilient or Just-in-Time profiles—organizations that are effective at executing and adapting to change in their environment. This finding is intuitive because small companies tend to be younger, and therefore more attuned to and aligned with the vision and strategy of the founders. Moreover, their small size allows them to adapt more nimbly to market shifts.

Step 2: $500 Million-$1 Billion. As firms cross the $500 million threshold, many seem to address their growing coordination challenges by centralizing authority in a strong senior team that drives the business. Not surprisingly, the Military profile reaches its peak in this revenue segment. In addition, we see a sharp increase in the Overmanaged profile, suggesting that many firms in this size range become bureaucratic, slow, and overly politicized as an expanding middle management starts to second-guess and interfere in lower-level decision making.

Step 3: $1-$10 Billion. Once past the $1 billion mark, organizations become too large and complex to be run effectively by a small senior team via command-and-control mechanisms. Companies are thus forced to decentralize. Given the marked increase in Fits-and-Starts profiles in this revenue range, the transition to a decentralized organizational model appears to go badly in many cases. Local managers may be given the authority to make decisions, but not the incentives or information to make them well. Passive-Aggressive profiles also increase in companies of this size, because incoherent and uncoordinated structures and processes create inertia, confusion, and ultimately a failure to execute.

Step 4: More than $10 Billion. To survive and grow to this size, companies clearly have had to figure out how to execute and adapt, and Resilient profiles do make a comeback in this segment. Even so, plenty of very large organizations still struggle to execute effectively.

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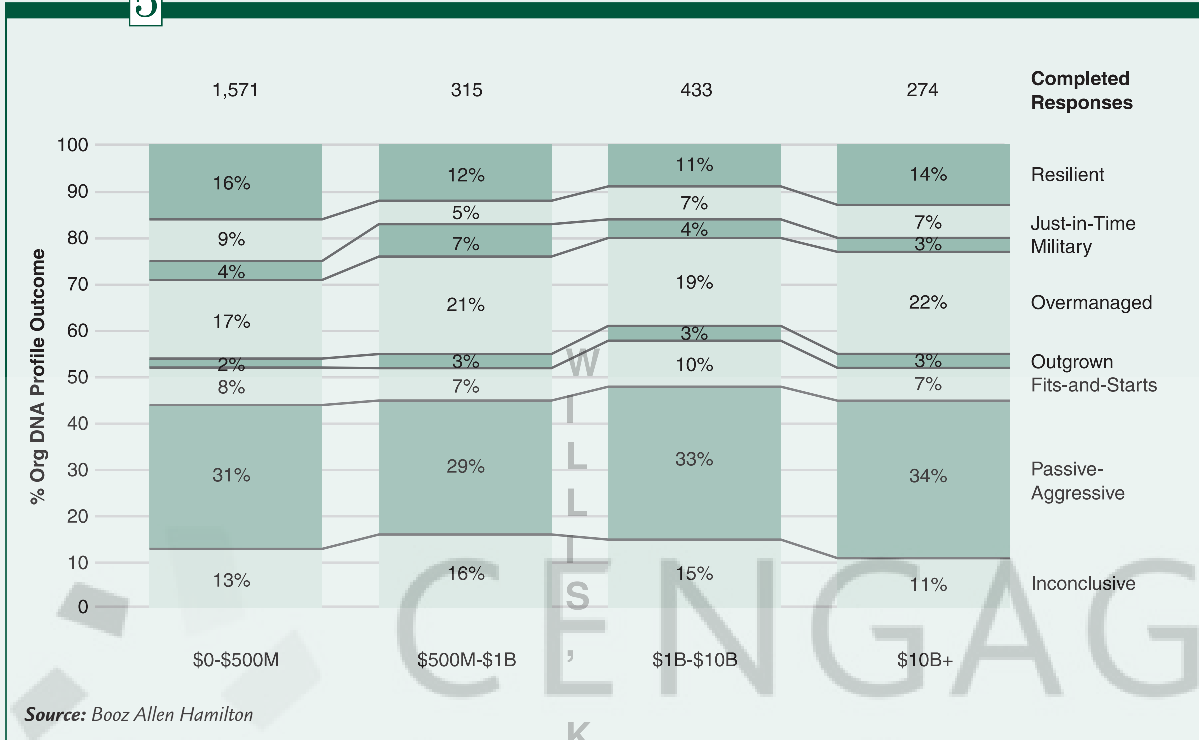
EXHIBIT 5 Organizational Profiles, by Company Size



Source: *Booz Allen Hamilton*

Overmanaged profiles increase and Fits-and-Starts profiles decrease in the $10 billion + segment. This finding suggests that many of the largest companies may try to "fix" a badly decentralized organization by adding layers of management and bureaucracy. Passive-Aggressive is the most prevalent profile in companies of this size, indicating that, although people may agree on the strategic plan, few are really implementing it.

But nothing is preordained. Companies are not fated to cycle through the Military, then Fits-and-Starts, and then Passive-Aggressive phases as they grow. Those firms that are aware of these patterns can anticipate and break them.

Upstairs, Downstairs

Our survey results indicate sharp differences in perception between upper management and lower-level groups, suggesting that senior executives may be out of touch with the rest of their organization. Specifically, senior managers are consistently more optimistic in their views of organizational health, a finding that echoes numerous other organizational research studies.

More than any other group in the organization, senior managers we surveyed saw their firms as "healthy." Indeed, senior executives were twice as likely as any other group to view their companies as Resilient. Consistent with this comparative optimism, senior management answers translated into unhealthy profiles—Overmanaged, Outgrown, Fits-and-Starts, and Passive-Aggressive—almost 30 percent less often than those of other groups. (See Exhibit 6.)

Senior management's positive bias is reflected in all categories. On virtually every question that tracks to the Resilient profile, senior executives reported the "desirable" response more often than any other segment of respondents. Most strikingly, senior managers were far more willing than others in the organization to agree with the statement, "Important competitive information gets to headquarters quickly." Given the yawning gap between their perceptions of their organizations' effectiveness and that of every group that reports to them, one might question how well informed senior managers really are. As business operations grow increasingly complex and the pressure for greater accountability mounts, top management would do well to reassess data flows within the company and institutionalize access to timely, relevant, and accurate information.

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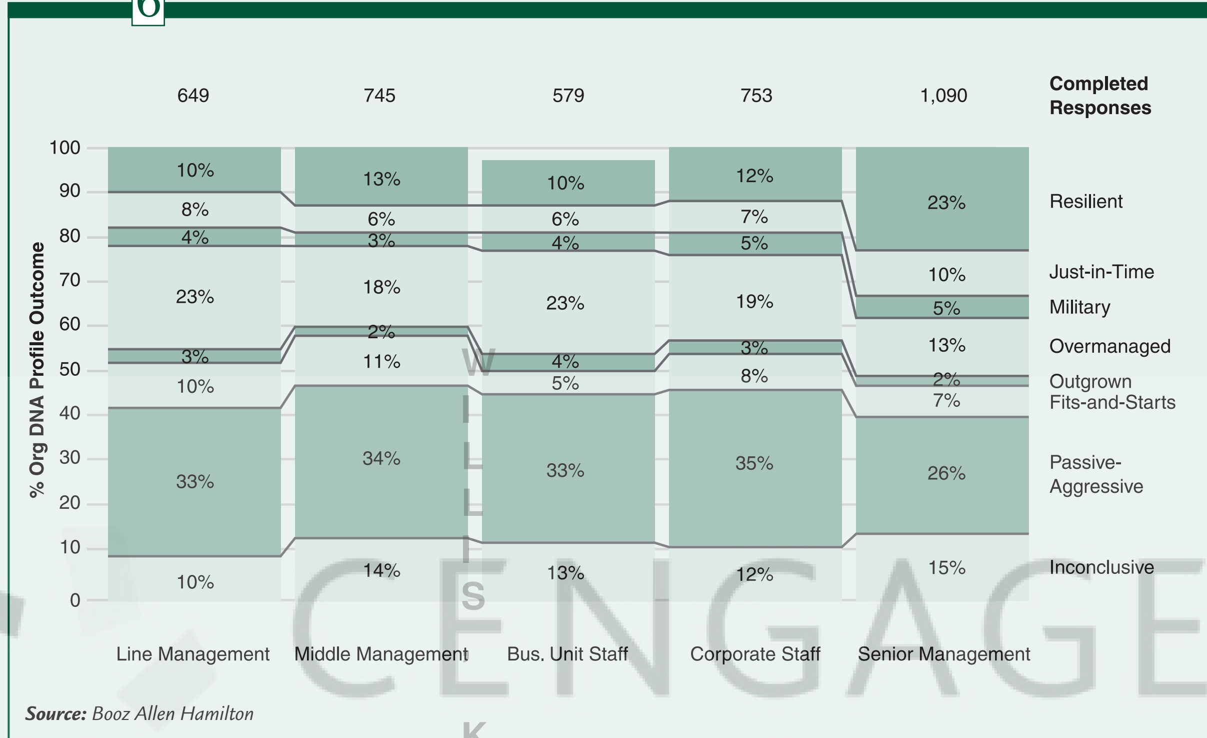
EXHIBIT 6 Organizational Profiles, by Management Positions



Source: *Booz Allen Hamilton*

These results also appear to indicate a discrepancy between senior executives' favorable perceptions of the organizational structures and processes they have established, and the actual adoption and utilization of those structures and processes. This finding is consistent with our client experience.

In contrast to their superiors, line managers and midlevel managers and business unit staff tend to be pessimistic in their assessments of organizational effectiveness. Nearly 70 percent of their surveys indicated unhealthy profiles. Line managers and business unit staff feel Overmanaged; 23 percent of them described behavior consistent with this profile. Midlevel and line managers believe their organizations struggle to pull in the same direction at the same time, as evidenced by the high incidence of Fits-and-Starts profiles.

Corporate staff personnel are slightly more optimistic. Perhaps they are far enough removed from daily operations that they are less aware of organizational problems. Most notably, they do not perceive the same Overmanaged behaviors that other nonexecutives report. One survey question that drew a consistent response across organizational levels was, "Managers above me in the hierarchy 'get their hands dirty' by getting involved in operating decisions." More than half of all respondents reported this happening "frequently," with senior managers, at 65.4 percent, citing this tendency in their companies more than any other group.

But survey results suggest this is where the consensus. Although senior managers likely view their involvement in operating decisions as good (given their overall positive bias), junior managers reported feeling in micromanaged. There is widespread agreement among business unit and corporate staffs as well as line managers, that "decisions are often second-guessed." Fewer senior managers see it that way.

There is also a disparity in beliefs regarding the role of' corporate staff. Although business unit staff, line management, and middle management believe that "the primary role of corporate staff is to *support* the business units," corporate staff respondents believe their role is to *audit* those units, a view senior management overwhelmingly supports.

These differences in perception can lead to significant organizational dysfunction. Business unit personnel may feel frustrated as they spend more time reporting up the hierarchy than doing productive work. Not surprisingly, lower-level employees reported a higher incidence

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of "analysis paralysis" and excessively bureaucratic decision making in their organizations. Feeling distrusted, underestimated, and trapped in an overly politicized environment, those with initiative and exceptional talent may well defect.

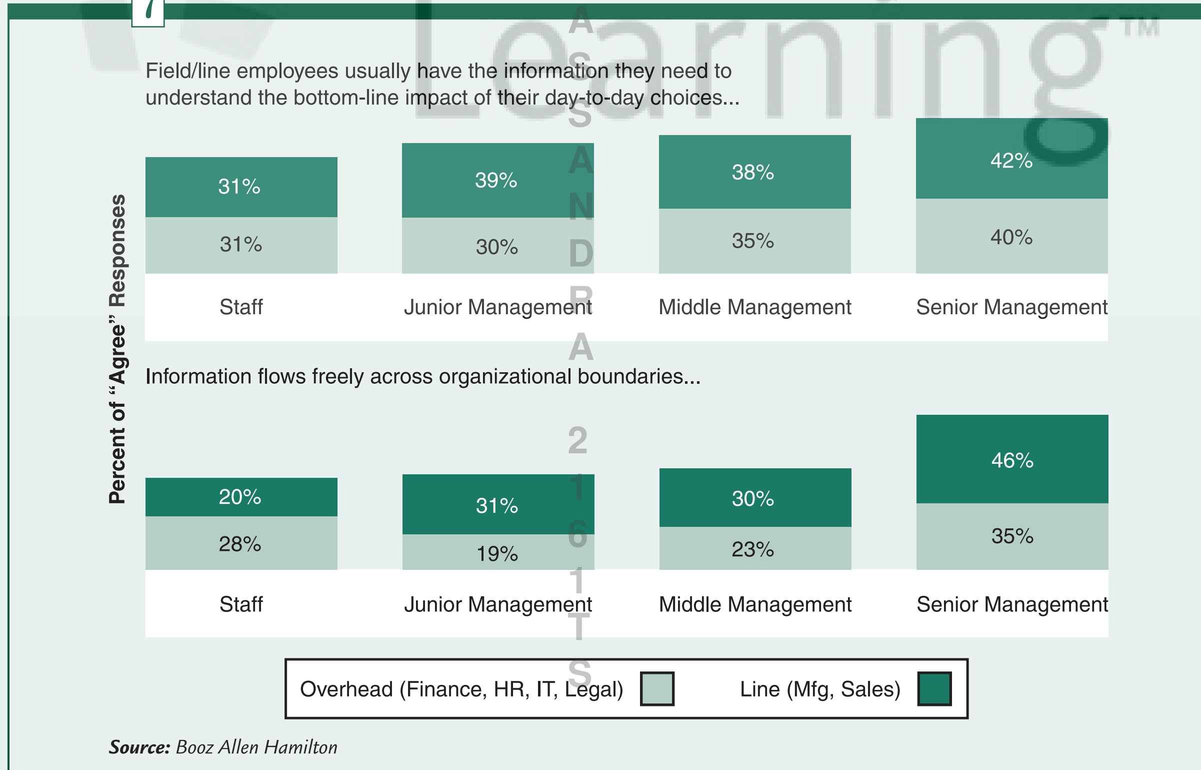
Decisions, Decisions

If lower-level employees are feeling stifled by excessive bureaucracy and layers of micromanagement, it could be because decision rights are poorly communicated in many organizations. More than half of the Org DNA Profiler respondents indicated that they felt the accountability for decisions and actions was unclear in their organizations. This finding was consistent across all organizational levels, though senior management was slightly more sanguine.

Although decision rights are vague across the board, the lack of understanding seems particularly acute within overhead functions (e.g., human resources, finance, and information technology), where redundant "shadow staff" frequently multiply to fill the gaps left by incomplete or poorly specified responsibilities. Since so many organizations now outsource overhead functions to third-party vendors, decision rights in those organizations may be hampered by unclear service-level agreements and governance mechanisms. In line organizations (such as manufacturing and sales), decision rights—except at the lowest levels—are slightly clearer, perhaps because those organizations face more direct market pressure to resolve conflicting or poorly specified responsibilities that interfere with responsiveness to the customer.

In combination with generally unclear decision rights, lack of timely and relevant information contributes to ineffective execution. A majority of respondents at all levels reported that "field/line employees frequently lack the information they need to understand the bottom-line impact of their day-to-day choices," and a majority disagreed with the statement that "information flows freely across organizational boundaries." As always, senior managers were slightly more upbeat in their assessments, but most still took a dim view in their responses to these questions. (See Exhibit 7.)

EXHIBIT 7 Decision Rights and Information Flows: Perceptions, by Position



Source: *Booz Allen Hamilton*

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Consistent with their views on decision rights, overhead employees are the most negative in their assessment of information flows. Although still sore points, information access and decision rights are less of a struggle for line organizations. Still, survey responses overwhelmingly point to the need for improved information, tools, and incentives for decision makers in all parts of the organization.

Preliminary results from the Org DNA Profiler assessment tool show that most companies today face organizational impediments to effective and rapid execution. Although 37 percent of respondents from small companies thought their organizations translated strategy into action quickly, only 29 percent of the respondents from the largest companies agreed with that statement.

Respondents at all levels in companies across industries indicated that their organizations struggle to execute decisively and effectively. Fewer than one-third of nonexecutive respondents agreed that "important strategic and operational decisions are quickly translated into action" in their organizations. Even at the most senior levels, fewer than 50 percent of respondents indicated that their companies act decisively in implementing strategy. Whether they fall into the Passive-Aggressive profile or the Outgrown, their organizational DNA is thwarting their own best efforts—and ultimate success.

As they confront their problems, companies are also contending with an increasingly complex global marketplace, where change buffets them relentlessly. According to our early results, fewer than half of the Org DNA Profiler respondents at all nonexecutive levels agreed that their companies "deal successfully with discontinuous change in the competitive environment." Even among senior managers, only half agreed with this statement.

Gene Therapy

When an organization's DNA is poorly configured, the firm exhibits unhealthy symptoms and counterproductive behaviors. The first step in fixing these problems is to identify and isolate them. That is the purpose of the Org DNA Profiler assessment tool. Using a framework that examines all aspects of a company's architecture, resources, and relationships, the tool allows management to gain insight into what is and is not working deep inside a highly complex organization.

But generating a profile is not the point; it is only an exercise designed to focus leaders on the root causes of their organizations' dysfunctions and execution problems. It is up to management to translate these findings into sustainable solutions. Using the Org DNA Profiler as a starting point for discussion, top executives, business unit heads, and staff leaders (a group that might be 10 people or more than 100) can meet to identify the impediments to effective execution in their organization and develop programs and processes to overcome them. The organizational DNA framework helps companies identify and expose hidden strengths and entrenched weaknesses so that managers can focus efforts on reinforcing what works in their organization and modifying what does not.

The Seven Organizational Species

In working with companies to diagnose and overcome organizational impediments to effective execution, we have identified seven broad types of organizations:

The Resilient Organization. This organization is flexible enough to adapt quickly to external market shifts, yet it remains steadfastly focused on and aligned with a coherent business strategy. This forward-looking organization anticipates changes routinely and addresses them proactively. It attracts motivated team players and offers them not only a stimulating work environment, but also the resources and authority necessary to solve tough problems.

The Just-in-Time Organization. Although not always proactive in preparing for impending changes, this organization has demonstrated an ability to "turn on a dime" when necessary, without losing sight of the big picture. Although it manages to hold on to good people and performs well financially, it has not made the leap from good to great. This organization tends to miss opportunities by inches rather than miles, and to celebrate successes that are marginal rather than unequivocal. Despite its frustrations, however, it can still be a stimulating and challenging place to work.

The Military Organization. Often driven by a small, hands-on senior management team, this organization succeeds through sheer force of will, the will of its top executives. It can conceive and execute brilliant strategies—sometimes repeatedly—but its middle-management bench can be shallow and short lived. This organization's biggest liability is preparing for growth beyond the tenure of its current leaders. Junior talent in this organization typically learns by seeing rather than doing, and middle management often defects as up-and-comers realize they must leave the nest to get flying experience.

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The Passive-Aggressive Organization. So congenial that it seems conflict free, this is the "everyone agrees but nothing changes" organization. Building a consensus to make major changes is no problem; implementing them is what proves difficult. Entrenched, underground resistance from the field can defeat a corporate group's best efforts. Lacking the requisite authority, information, and incentives to undertake meaningful change, Line employees tend to ignore mandates from headquarters, assuming "this too shall pass." Confronted with an apathetic organization, senior management laments the futility of "pushing Jell-O."

The Fits-and-Starts Organization. Scores of smart, motivated, and talented people populate this organization, but they do not often pull in the same direction at the same time. When they do, they can execute brilliant, breakout strategic moves, but the organization typically lacks the discipline and coordination to repeat these successes on a consistent basis. It is an environment that lures intellect and initiative—smart people with an entrepreneurial bent—because the opportunities to pursue an idea and to take responsibility for executing it are abundant. The result, however, can be an organization with a disjointed self-image on the verge of spinning out of control.

The Outgrown Organization. This firm has outgrown its organizational model; it is bursting at the seams. Too large and complex to be effectively controlled anymore by a small team of top executives, it has yet to "democratize" decision-making authority. Consequently, much of the organizations potential remains untapped. By keeping power centralized, the organization tends to move slowly and often finds it cannot get out of its own way. Such firms routinely miss opportunities and consistently fail to execute effectively.

The Overmanaged Organization. Burdened with multiple layers of management, this organization tends to suffer from "analysis paralysis." When it does move, it moves slowly and reactively, often pursuing opportunities later or less vigorously than its competitors do. More consumed with the trees than the forest, managers spend their time checking one another's work rather than scanning the horizon for new opportunities or threats. These organizations, which are frequently bureaucratic and highly political, tend to frustrate self-starters and results-oriented individuals.

—G.N., B.A.P., and D.M.

The Org DNA Profiler™ Methodology

The Org DNA Profiler'™ assessment tool categories organizational character based on employees responses to a five-minute survey composed of 19 questions. This assessment tool, although based on individuals' survey responses, focuses on the traits and behaviors of the organization as a whole rather than on the individuals who populate it, although certain general demographic data (e.g., position/level, division, industry, annual revenue) is collected to enhance the analysis.

Each question addresses organizational behavior with regard to one of the four building blocks of organizational DNA: decision rights, information, motivators, and structure. The responses are then fed through proprietary software that assigns the organization described to one of seven organizational species.

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Org DNA Profiler assessment tool: www.orgdna.com

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Strategic Control 12

Chapter Outline

12-1 Step 1: Focus of Strategic Control
12-2 Step 2: Strategic Control Standards (Benchmarks)
    12-2a PIMS Program
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    12-2c Product and Service Quality
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Strategic Control
The process of determining the extent to which an organization's strategies are successful in meeting its goals and objectives.

The strategic management process is not complete when a strategy has been executed. It is also necessary to evaluate its success or failure, and take steps to address problems that may have arisen along the way. **Strategic control** consists of determining the extent to which the organization's strategies are successful in meeting its goals and objectives. The execution process is tracked and adjustments to the strategy are made as necessary.[1] It is during the strategic control process that gaps between the intended and realized strategies (i.e., what was planned and what really happened) are identified and addressed.

The process of strategic control can be likened to that of steering a vehicle. After the strategy accelerator is pressed, the control function ensures that everything is moving in the right direction. When a simple steering adjustment is not sufficient to modify the course of the vehicle, the driver can resort to other means, such as applying the break or shifting gears. In a similar manner, strategic managers can steer the organization by instituting minor modifications or resort to more drastic changes, such as altering the strategic direction altogether.

The need for strategic control is brought about by two key factors, the first of which is the need to know how well the firm is performing. Without strategic control, there are no clear benchmarks and ultimately no reliable measurements of how the company is doing. A second key factor supporting the need for strategic control is organizational and environmental uncertainty. Because strategic managers are not always able to accurately forecast the future, strategic control serves as a means of accounting for last-minute changes during the implementation process. In addition, competitors may respond immediately to a change in strategy, requiring that managers consider additional modifications.

The notion of strategic control has recently gained a "continuous improvement" dimension, whereby strategic managers seek to improve the efficiency and effectiveness of all factors related to the strategy. In other words, control should not be seen as an action necessary only when performance declines. Rather, managers should think critically when considering strategic control and look for opportunities to enhance performance even when things seem to be going well.

Strategic control can be exerted by the CEO, the board of directors, or individuals outside the top management team. The roles played by boards of directors, institutional investors, and shareholders who monitor firm strategies and often instigate control vary across firms. The influence of the board and others notwithstanding, ongoing strategic control is largely a function performed by the top management team. A five-step strategic control process can be utilized to facilitate this process, as depicted in Figure 12-1.

1. Top management determines the focus of control by identifying internal factors that can serve as effective measures for the success or failure of a strategy, as well as outside factors that could trigger responses from the organization.
2. Standards or benchmarks are established for internal factors with which the actual performance of the organization can be compared after the strategy is implemented.
3. Management measures or evaluates the company's actual performance, both quantitatively and qualitatively.
4. Performance evaluations are compared with the previously established standards.
5. If performance meets or exceeds the standards, corrective action is usually not necessary. If performance falls below the standard, then management must take remedial action.

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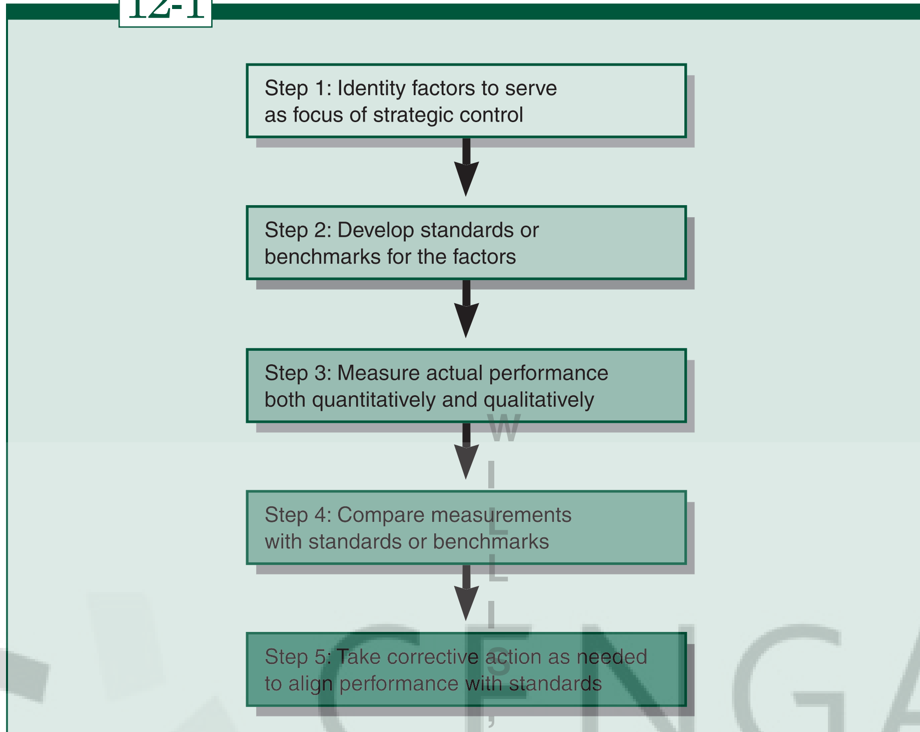
FIGURE 12-1 Five-Step Strategic Control Process



12-1 Step 1: Focus of Strategic Control

The focus of strategic control is both internal and external because it is top management's role to align the internal operations of the enterprise with its external environment. Relying on quantitative and qualitative performance measures, strategic control helps maintain proper alignment between the firm and its environment.

Although individual firms usually exert little or no influence over the external environment, macroenvironmental and industry forces must be continuously monitored because shifts can greatly influence the organization. The purpose of monitoring the external environment is to determine whether the assumptions on which the strategy is based remain valid. In this context, strategic control consists of modifying the company's operations to more effectively defend itself against external threats that may arise or become known.

Considering internal operations, top management must assess the strategy's effectiveness in accomplishing the firm's mission and goals: If the firm seeks to be the industry's low-cost producer, for example, its managers must compare its production efficiency with those of competitors and determine the extent to which the firm is attaining its goal. In the broad quantitative sense, management must assess the strategy's effectiveness in attaining the firm's objectives. For example, management can compare a firm's 3.7 percent market share with its stated objective of 4.1 percent to determine the extent to which its strategy is effective.

Firm performance may be evaluated in a number of ways. Management can compare current operating results with those from the preceding quarter or year. A qualitative judgment may be made about changes in product or service quality.

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Quantitative measures may also be used, including return on investment (ROI), return on assets (ROA), return on sales (ROS), and return on equity (ROE), and growth in revenues.

A key problem with performance measurement is that one measure can be pursued to the detriment of another. The common goals of growth and profitability represent an example of this phenomenon. Many firms pursue growth by investing in R&D or new product development, or by slashing prices to gain customers. Either approach tends to reduce profits, at least in the short term. This reality was reflected in Ford's decision to cut North American production in the early 2000s and sacrifice market share to enhance profits. Ford's market share declined from about 22 percent in 2001 to below 19 percent in 2004, but profits increased steadily during this same period.[2]

12-2 Step 2: Strategic Control Standards (Benchmarks)

Profitability is the most commonly utilized performance measure and is therefore a popular means of gauging performance and exerting strategic control. Additional financial measures may also be helpful, such as many of the ratios discussed in Chapter 8.

Control standards should be established for the internal factors identified in the previous step. However, the focus should not consider past performance. Doing so can be myopic because it ignores important external variables. For example, a rise in a business's ROA from 8 percent to 10 percent may appear to be a significant improvement, but this measure must be evaluated in the context of industry trends. In a depressed industry, a 10 percent ROA may be considered outstanding, but that same return in a growth industry may be disappointing if the leading firms earn 20 percent. In addition, an increase in a company's ROA is less encouraging if performance continues to lag behind industry standards.

Competitive Benchmarking
The process of measuring a firm's performance against that of the top performers, usually in the same industry.

Often, strategic control standards are based on **competitive benchmarking**, which is the process of measuring a firm's performance against that of the top performers, usually in the same industry. After determining the appropriate benchmarks, a firm's managers set goals to meet or exceed them. **Best practices** are processes or activities that have been successful in other firms. These too may be adopted as a means of improving performance. Sources of competitive benchmarking standards are discussed in sections 12-2a through 12-2e (also see Strategy at Work 12-1).

Best Practices
Processes or activities that have been successful in other firms.

12-2a PIMS Program

PIMS (profit impact of market strategy) program
A database that contains quantitative and qualitative information on the performance of more than 5,000 business units.

The **profit impact of market strategy (PIMS) program** is a database that contains quantitative and qualitative information on the performance of thousands of firms and more than 5,000 business units. PIMS was developed in the 1960s as a result of General Electric's efforts to determine which factors drive profitability in a business unit.[3] GE's top managers and corporate staff began to assess business unit performance in a formal, systematic fashion. In 1975, other companies were invited to join the project, and the American Strategic Planning Institute (www.pimsonline.com) was founded to manage the effort. The original PIMS survey involved about 3,000 business units in 200 firms between 1970 and 1983. Data collection continued after 1983, however, with about 4,000 businesses currently included.

Each of the participating businesses provides quantitative and qualitative information to the program, such as market share, product and service quality,

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STRATEGY AT WORK 12-1

Benchmarking for E-Business at UPS

The Internet currently plays a substantial role in benchmarking. According to Steve Johnson, co-director of the e-commerce program at Andersen Consulting in Chicago, "It's useful to understand where you want to go. Organizations need to find target audiences that [they're] trying to communicate with…and then, with regard to each of those target audiences, what are your specific objectives in terms of the outcomes that you're trying to achieve? And then that should lead you to a system of relevant benchmarks."

According to Mark Czarnecki, president of The Benchmarking Network Inc., an organization in Houston that runs and monitors benchmarks among companies, "Before a company can even begin to devise its benchmarks, it must first examine its core business processes. Those include developing and selling products and services to Web customers and running an organization's online operations as efficiently as possible. Once those core processes have been determined, companies need to figure out how much those processes are costing them. Then, based on that information, businesses can compare their cost structures to those of other companies and evaluate their own performance over time."

United Parcel Service (UPS) has been particularly successful at developing its e-business. UPS has been benchmarking its online tracking system every December since the site was launched in 1994. Having a benchmark to measure those requests has helped to keep UPS at the forefront of its e-commerce race with rival companies such as FedEx and DHL. According to UPS spokesman Steve Holmes, "Online tracking requests are certainly a very important benchmark that we look at, because it's probably the most widely used information that our customers access."

UPS has adopted a combination of integrated paper-based information and electronic messaging to improve efficiency in its processing of orders. UPS believes that in today's hyper-speed business environment, secure, efficient, and streamlined communications are key components. The service enables users to send and track digital files securely across the Internet. It also provides delivery confirmation, proof of receipt, and a password-protection option.

UPS has adopted this strategy in an effort to outmaneuver the U.S. Postal Service and FedEx for the steadily increasing number of Internet sales shipments. UPS continues to perform well, as it receives more than a million package-tracking requests every day through its Web site.

Sources: G. Gately, "HP and UPS Offer 'E' Alternative to Overnight Delivery," E-Commerce Times, *28 March 1999; M. Hillebrand, "UPS Offers Free Access to Online Tracking Site,"* E-Commerce Times, *5 October 1999.*

new products and services introduced as a percentage of sales, relative prices of products and services, marketing expenses as a percentage of sales, and research and development expenses as a percentage of sales. Two profitability measures are used: net operating profit before taxes as a percentage of sales (ROS), and net income before taxes as a percentage of total investment (ROI) or of total assets (ROA). Participating firms have access to the data in aggregate form (i.e., no specific entries from other firms), whereas only limited data are available to nonparticipating organizations. Interestingly, the PIMS studies found the market-perceived quality relative to that of competitors was the single best predictor of market share and profitability.

Each of the PIMS variables has implications for strategic control. For example, top managers may discover that a business with low-quality measures may also be spending substantially less in research. R&D efforts may be enhanced to address the discrepancy. PIMS data has its limitations, however. A positive correlation between two PIMS variables, for example, does not necessarily mean that one causes the other. Hence, decision makers should exercise caution when interpreting the results.

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12-2b Published Information for Strategic Control

Fortune magazine annually publishes the most- and least-admired U.S. corporations with annual sales of at least $500 million in such diverse industries as electronics, pharmaceuticals, retailing, transportation, banking, insurance, metals, food, motor vehicles, and utilities. Corporate dimensions are evaluated along factors such as quality of products and services, innovation, quality of management, market share, financial returns and stability, social responsibility, and human resource management effectiveness. Publications such as *Forbes, Industry Week, Business Week*, and *Industry Standard* also provide performance scorecards based on similar criteria. Although such lists generally include only large, publicly traded companies, they can offer high-quality strategic information at minimal cost to the strategic managers of all firms, regardless of size. Published information on three measures—quality, innovation, and market share—can be particularly useful, as discussed in sections 12-2c through 12-2e.

12-2c Product and Service Quality

Over the years, there has been a positive relationship between product and service quality—including both the conformance of a product or service to internal standards and the ultimate consumer's *perception* of quality—and the financial performance of those firms. Conforming to internal quality standards is not sufficient. Products and services must also meet the expectations of users, including both objective and subjective measures.[4]

Fortune assesses quality by asking executives, outside directors, and financial analysts to judge outputs of the largest firms in the United States.[5] Its studies consistently demonstrate a significant relationship between product and service quality and firm performance. Although the PIMS program assesses quality through judgments made by both managers and customers instead of asking executives and analysts, its findings also support a strong positive correlation between product quality and business performance.[6]

Consumer Reports is also an excellent source of product quality data, evaluating hundreds of products from cars to medications each year. Because *Consumer Reports* accepts no advertising, its evaluations are relatively bias free, rendering it an excellent source of product quality information for competing businesses. Even if the products of a particular business are not evaluated by this publication, that company can still gain insight on the quality of products and services produced by its competitors, suppliers, and buyers.

Specific published information may also exist for select industries. One of the best known is the Customer Satisfaction Index released annually by J. D. Power for the automobile industry. A survey of new-car owners each year examines such variables as satisfaction with various aspects of vehicle performance; problems reported during the first ninety days of ownership; ratings of dealer service quality; and ratings of the sales, delivery, and condition of new vehicles.[7] Numerous Internet sites (e.g., Virtualratings.com) offer quality ratings associated with industries for everything from computers to university professors.

Broadly speaking, the Internet serves as an excellent resource for strategic managers seeking quality assessments for its industry. For example, some sites (e.g., www.dealtime.com) provide consumer ratings of vendors. Although such information is not always reliable, feedback forums can provide strategic managers with valuable insight into the quality perceptions of their customers. Even Amazon.com ranks all books on sales volume and provides opportunities for readers to post comments to prospective buyers.

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12-2d Innovation

Innovation is a complex process and is conceptualized, measured, and controlled through a variety of means. Some researchers use expenditures for product research and development and process R&D as a "surrogate" measure.[8] Expenditures on developing new or improved products and processes also tend to increase the level of innovation, a finding also supported by PIMS data.[9] However, it should not be assumed that all innovation-related expenditures yield the same payback.

Some firms plan and control their programs for innovation very carefully. 3M, for instance, has established a standard that 25 percent of each business unit's sales should come from products introduced to the market within the past five years. Not surprisingly, 3M invests about twice as much of its sales revenue in R&D as its competitors.[10] This approach is consistent with 3M's differentiation and prospector orientation at the business level.

12-2e Relative Market Share

Market share is a common measure of performance for a firm. As market share increases, control over the external environment, economies of scale, and profitability are likely to be enhanced. In large firms, market share often plays an important role in managerial performance evaluations at all levels in the organization. Because market share gains ultimately depend on other strategic variables, such as consumer tastes, product quality, innovation, and pricing strategies, changes in relative market share may serve as a strategic control gauge for both internal and external factors.

For successful smaller businesses, market share may serve as a strategic control barometer because some businesses may strategically plan to maintain a low market share. In this event, the strategic control of market share emphasizes variables that are not targeted at growth and includes tactics that encourage high prices and discourage price discounts. Limiting the number of product or markets in which the company competes also serves to limit small market share. A small market share combined with operations in limited product or markets may allow a company to compete in domains where its larger rivals cannot. Hence, for some companies, emphasizing increases in relative market share can trigger increases in cost or declines in quality and can actually be counterproductive.[11]

12-3 Steps 3 to 5: Exerting Strategic Control

Exerting strategic control requires that performance be measured (step 3), compared with previously established standards (step 4), and followed by corrective action (step 5), if necessary. Strategic control may be exerted in a number of different ways, such as through multilevel performance criteria, through performance itself, and through organizational variables.

12-3a Strategic Control through Competitive Benchmarking

Strategic control should occur constantly at various organizational levels and within various functions of the organization. Realistic performance targets, or benchmarks, should be established for managers throughout the organization. At the organizational level, factors such as profitability, market share, and revenue growth may be applied. The most appropriate performance benchmarks are those associated with the strategy's success, and those over which the organization has control.

Benchmarks should also be specific. For example, if market share is identified as a key indicator of the success or failure of a growth strategy, a specific market share should be identified, based on past performance and industry norms.

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Without specificity, it is difficult to assess the effectiveness of a strategy after it is implemented if clear targets are not identified in advance.

Control at the functional level may include factors such as the number of defects in production or composite scores on customer satisfaction surveys. Like organization-wide benchmarks, functional targets should also be specific, such as "3 defective products per 1,000 produced" or "97 percent customer satisfaction based on an existing survey instrument."

Generally speaking, corrective action should be taken at all levels if actual performance is less than the standard that has been established unless extraordinary causes of the discrepancy can be identified, such as a halt in production when a fire shuts down a critical supplier. It is most desirable for strategic managers to consider and anticipate possible corrective measures *before* a strategy is implemented when possible.

12-3b Control through Performance

Control through performance occurs at the organizational level by comparing the company's profitability or market share growth to others in the marketplace. For example, the collective market share for cable television providers consistently declined throughout the 1990s. Many cable customers switched to less expensive satellite providers such as DirecTV and Dish Network. By the early 2000s, cable's competitive advantage of simplicity and complete local network programming had eroded in light of the satellite providers' ability to offer small, easy-to-install, and discreet satellite dishes and to include local networks as part of the service plan. As a result, cable companies began cutting rates in 2002 in an effort to regain lost market share.[12]

Balanced Scorecard
An approach to measuring performance based on an array of quantitative and qualitative factors, such as return on assets, market share, customer loyalty and satisfaction, speed, and innovation.

Because individual measures of performance can provide a limited snapshot of the firm, certain companies now use a balanced scorecard approach to measuring performance. The **balanced scorecard** measurement is not based on a single quantitative factor, but on an array of quantitative and qualitative factors, such as return on assets, market share, customer loyalty and satisfaction, speed, and innovation.[13] The balanced scorecard approach looks beyond profits by considering other factors that contribute to the overall health of the firm and position it for strong performance in the future. The key to employing a balanced scorecard is to select a combination of performance measures tailored specifically to the firm. This approach has helped a large number of firms better understand performance issues.[14]

The PIMS program provides a broad range of benchmarks against which a firm's performance can be compared. Top managers may also monitor the price of the company's stock as relative price fluctuations suggest how investors value the performance of the firm. A sudden drop in price makes the firm a more attractive takeover target, whereas sharp increases may mean that an investor or group of investors is accumulating large blocks of stock to engineer a takeover or a change in top management.

Formal Organization
The official structure of relationships and procedures used to manage organizational activity.

12-3c Control through Formal and Informal Organizations

Strategic control can occur directly through the formal organization or indirectly through the informal organization. The **formal organization**, the official structure of relationships and procedures used to manage organizational activity, can facilitate or impede a firm's success. When an organization's structure is no longer appropriate for its mission, strategic control can initiate a change. Top managers can exert formal control through such actions as modifying the structure or changing the reward system.

Business Process Reengineering
The application of technology and creativity to eliminate unnecessary operations or drastically improve those that are not performing well.

Popularity has increased for a means of exerting control through the formal organization called **business process reengineering**, which is the application

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of technology and creativity to eliminate unnecessary operations or drastically improve those that are not performing well. As such, companies sought to eliminate any process that did not add value to the organization's goods and services. For example, many consumer goods manufacturers during this period began to rethink their packaging operations, and many of them eliminated large, cumbersome boxes in favor of less costly shrink-wrapping. Some analysts have noted a reemergence of this trend in the early 2000s.[15]

In the 1990s and early 2000s, some organizations shifted from functional or product divisional structures to matrix structures and experienced considerable unanticipated difficulty. Substantial structural changes cannot be easily implemented and typically require a large amount of training and development. Strategic managers at many of these firms underestimated the complications associated with transforming their organizational structures into a more complex matrix structure.

Whereas the formal organization concerns the official structure, the **informal organization** refers to the norms, behaviors, and expectations that evolve when individuals and groups come into contact with one another.[16] The informal organization is dynamic and flexible and does not require managerial decree to change. Simply stated, informal relationships can promote or impede strategy implementation and can play a greater role than the formal organization. Strategic control through the informal organization often involves attempts to modify the organization's culture.

Informal Organization
Interpersonal norms, behaviors, and expectations that evolve when individuals and groups come into contact with one another.

When top executives use the formal organization effectively, the informal organization tends to reinforce the formal organization and promote the same values. However, when the organization's value system is unclear or even contradictory, the informal organization will ultimately develop its own, more consistent set of values and rewards. For example, every organization claims to reward high job performance. However, when promotions and pay increases go to individuals who have the greatest seniority (regardless of their level of performance), employees will lose motivation and develop their own set of informal rules concerning what will and will not be rewarded.

Management must recognize its limitations concerning the informal organization. Specifically, management can *influence*, but cannot control, the informal organization. The most effective means of influencing the informal organization is to develop and promote a formal organization that is consistent with the core values of the firm. The informal organization becomes dysfunctional when it develops means to address inconsistencies in the formal organization.

The relationship between the formal and informal organizations should not be underestimated. In general, any change in structure may also necessitate an appropriate modification in the organization's reward system so that the new forms of desired behavior will be properly rewarded. When management fails to align the formal organization's reward systems with new expectations, the informal organization typically changes to counterbalance the inconsistencies[17] (see Case Analysis 12-1).

12-4 Crisis Management

When a gunman killed thirty-three students and professors on the Virginia Tech campus in 2007, first responders and campus officials were thrust into a crisis of great magnitude.[18] Although university administrators should not be caught off guard, a catastrophe such as this is largely unpredictable and unavoidable. Indeed, any organization can be faced with a **crisis,** defined as any substantial disruption in operations that physically affects an organization, its basic assumptions, or

Crisis
Any substantial disruption in operations that physically affects an organization, its basic assumptions, or its core activities.

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Case Analysis 12-1

Step 24: How Should the Selected Alternative(s) Be Controlled?

How can one know in one, three, five, or ten years if an alternative has been successfully implemented? What should be done if sales or profits do not increase as planned? To facilitate answers to these questions, one needs to apply the five-step control process with as much specificity as possible.

First, identify what will be measured (i.e., how one will determine the extent to which the company is successful). Second, set the standards. For example, if ROA and "number of new profitable stores" are selected in step 1, then one might identify 15 percent ROA and twenty-two stores per year as standards or targets.

How were the standards developed? Consider the industry and past performance. If the industry mean for ROA is 15 percent, then 15 percent might be an appropriate target of performance for the company. The selected strategy can also be considered. If 110 additional retail locations are planned over the next five years, then twenty-two stores per year might be an appropriate target. It is important to clearly state how the standards were derived. Guessing, however, is not sufficient.

After performance is measured (step 3) and compared to the standards (step 4), corrective action may be taken (step 5). In the context of a case analysis, it is not possible to measure performance after the strategic recommendations are implemented. Therefore, one should suggest alternative courses of action that might be taken if the standards are not reached. Considering the preceding example, what changes (if any) should be made if only fifteen profitable stores are opened in the first two years or if ROA is only 8 percent? What changes (if any) should be made if the company reaches its target of twenty-two profitable stores, but ROA falls to 2 percent? At what point (if any) should the company consider retreating from the recommended alternative(s)? It is critical to provide considerable detail to demonstrate that all prospective future outcomes have been considered when outlining the present course of action. Of course, it is important to exert strategic control and take corrective action when necessary, not just at the end of a specified term.

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its core activities.[19] Such crises can include any low-probability, high-impact event that threatens the livelihood of the organization. Crises are typically characterized by ambiguity of cause, effect, and means of resolution, and a belief that the organization must respond quickly.[20] **Crisis management** refers to the process of planning for and implementing the response to a wide range of negative events that could severely affect an organization.

Crisis Management
The process of planning for and implementing the response to a wide range of negative events that could severely affect an organization.

Some potential crisis events are more likely than others in certain types of firms. Airlines, for example, may focus crisis preparations on prospective events such as spikes in fuel prices and hijackings, whereas a small hardware store may plan for events such as the abrupt loss of a key employee or a natural disaster. Simply stated, firms can and should prepare for the crises they are most likely to face.

Crisis preparation is especially critical when a crisis can be avoided. In September 2006, for example, the Guangdong (China) Entry-Exit Inspection and Quarantine Bureau found one type of Proctor & Gamble's SK-II line of cosmetics tainted with low levels of chromium and neodymium. These metals can cause skin diseases and have been banned from cosmetics in a number of countries, including China. This situation presented a business problem—a potential crisis—for P&G. Unfortunately, the company did not address the situation effectively.

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P&G initially refused to suspend sales of the SK-II line and hesitated to offer refunds to customers, doing so only after metals were discovered in more SK-II products. Angry consumers broke into a P&G office in Shanghai, resulting in widespread negative publicity in China.[21] The progression of these events caused this business problem to escalate into a crisis for the firm.

One of the most prominent examples of a crisis in recent history is the terrorist attacks on September 11, 2001, to New York City's World Trade Center and the U.S. Pentagon in Washington, D.C.[22] For some organizations, the attack resulted not only in the tragic loss of a large number of employees, but also a loss of key facilities and data.[23] Terrorism, however, represents only one form of crisis events.

Certain potential organizational crises also warrant consideration, such as fires and other natural disasters, economic crises (e.g., extortion, boycotts, bribery), and political unrest such as urban riots.[24] Even *bioterrorism*, the use of biological agents for terrorist purposes, has become a major concern. One recent survey reported that approximately two-thirds of executives are not confident that their organizations would be safe in the event of a biological or chemical attack, even though 80 percent of the organizations in question have crisis management plans in place.[25]

A more recent area of crises relates to information age activities, including computer system sabotage, copyright infringement, and counterfeiting. Criminals throughout the world can extort thousands of dollars from organizations fearful of a Web crash. So-called cyber-blackmailers may have the ability to disrupt or even halt Internet activity associated with certain sites.[26] The effects of crises on an organization can vary widely around the world and can be especially traumatic in emerging nations where recovery can be more difficult and costly.[27]

Numerous large firms faced major crises during the past few decades. Several commonly cited examples are discussed here. In 1984, gas leaked from a methyl isocyanate tank at a Union Carbide plant in Bhopal, India, killing approximately 3,800 persons and totally or partially disabling about 2,700 more. It was later learned that the leak occurred when a disgruntled employee sought to spoil a batch of the chemical by adding water to the storage tank. The incident was reported to officials at company headquarters in the United States after a twelve-hour delay, an event which sparked a widespread view that the firm was negligent and covering up details. India's Supreme Court later provided a $470 million settlement for victims and their families.[28]

In 1989, the Exxon Valdez tanker hit a reef in Prince William Sound, Alaska, spilling approximately 250,000 barrels of oil. Although there was no loss of human life, the loss of animal and bird life was extensive, and negative press was daunting. The company's untested crisis management plan said such a spill could be contained in five hours, but it was not implemented for two days. Exxon eventually spent about $2 billion to clean up the spill and another $1 billion to settle claims associated with the disaster.[29]

In 2003, The New Delhi Center for Science and Environment published a report asserting that local samples of Pepsi and Coke products contained pesticide residues at thirty times the acceptable limits in Europe. India's Parliament stopped serving the beverages and Indian nationalist activists in Allahabad smashed bottles and vandalized the property of a Coke distributor. Daily sales dropped by about one-third in less than two weeks, further curtailing efforts by the soft drink giants to spawn consumption of a product in a country where the average resident consumes less than one soft drink per month. The soft drink giants responded by questioning the methodology and credentials of the group's laboratory.[30]

In 2004, McDonald's chief executive Jim Cantalupo died suddenly from a heart attack. Less than six hours later, McDonald's board named president and chief

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operating officer Charlie Bell as his successor. The board had already intended for Bell to succeed Cantalupo at some point, but its quick, decisive action quelled many fears about the future of this leading fast-food chain. This response highlights the importance not only of planning for CEO succession but also of preparing for unexpected medical emergencies. Many experts suggest that boards should always be prepared for an unexpected loss of the top two executives in their firms.[31]

MSNBC and CBS Radio faced a publicity crisis in 2007 when radio talk show host Don Imus made disparaging and racially insensitive comments about members of the Rutgers University women's basketball team. CBS Radio initially suspended Imus from its radio program for two weeks, but MSNBC followed shortly thereafter by canceling its television simulcast of the program after firms began to pull their advertisements from the show and consumers threatened boycotts of other firms and the networks. CBS Radio fired Imus from the radio show several days later. The Imus incident could be seen as an extension of an ongoing broadcasting crisis for CBS, however. With Howard Stern's departure for Sirius Satellite Radio in 2005 and the growing popularity of satellite radio's talk show personalities like Andrew Wilkow, CBS is struggling to retain market share in a fiercely competitive industry.[32]

How a firm responds to a crisis can ultimately determine its survival and long-term success. Following the devastation of New Orleans from Hurricane Katrina in 2005, for example, grocer Winn Dixie contemplated closing shop in the area where it operates about 125 stores. Because Winn-Dixie was in Chapter 11 bankruptcy, the firm could exit with fewer repercussions than other grocers would face, because bankruptcy protection makes it easier to cancel costly store leases. CEO Peter Lynch saw it as an opportunity, however, choosing instead to use the millions of dollars the company would receive in insurance payments to rebuild the stores to be brighter and better stocked. Instead of departing the ravaged region, Winn-Dixie is banking on a strong rebound in New Orleans.[33]

Crisis Management Team
A cross-functional group of individuals within the organization who have been designated to develop and plan for worst-case scenarios and define standard operating procedures that should be implemented prior to any crisis event.

Managing a crisis can be a complex process. Hence, it is helpful to view crisis management as a three-stage process. *Before the crisis*, organizations should develop a **crisis management team**, a cross-functional group of individuals within the organization who have been designated to develop and plan for worst-case scenarios and define standard operating procedures that should be implemented prior to any crisis event. Ideally, the team should represent all functional areas of the organization and should facilitate action necessary to prevent or minimize the effect of potential crisis events. For example, an organization anticipating labor unrest at a company facility may hire additional security guards or contract with a private agency to provide additional security.

Proactive organizations that continually assess their vulnerabilities and threats and develop crisis management plans tend to be adequately equipped when a crisis occurs. Proper preparation requires research of the literature, of the industrial sector, and of the company itself. Information is needed to properly prepare for the crisis events. When managers understand which crisis events are more likely to occur, they can plan for the event more effectively and foster a business culture that is ready to meet the challenge if and when a crisis occurs.[34]

Source: Comstock.com

During the crisis, an organizational spokesperson should communicate effectively with the public to minimize the effect of the crisis. For example, after being unprepared when Tylenol capsules were laced with cyanide, killing seven people in 1982, Johnson & Johnson improved its preparation, responding to a 1986 lacing incident by acknowledging the crisis with the public and instructing all consumers to return products for a refund.[35] Presentations to the public should be prompt, honest, professional, and streamlined through a single person or office.

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Case Analysis 12-2

Step 25: What Crisis Events Should the Firm Anticipate? What Are the Future Prospects for the Company?

Given the nature of the firm, its industry, and the recommended strategies, what crisis events are most realistic? This type of analysis varies considerably by firm and industry. Although it is impossible to anticipate and prepare for every conceivable crisis that a firm may face, attention should be placed on those that are most likely to occur, can be avoided or palliated, and are likely to result in substantial losses.

How do the strategic recommendations differ from the current strategy? Will the outlook for the company change as a result of these recommendations? Will the organization be successful in the coming decade? What strategic issues were not addressed in the recommendations that may become more important in the next few years? Why were they not addressed in the present analysis?

After the crisis, communication with the public should continue as needed, and the cause of the crisis should be uncovered. Understanding the cause can help executives minimize the likelihood that the crisis will occur again and improve preparation for the crisis if it does.[36]

Throughout these stages, three key points should be highlighted. First, organizational leaders should take crisis management seriously. Sooner or later, every organization will face a crisis, and survival may hinge on the organization's ability to manage the situation properly. Second, steps should be taken to prevent or reduce the likelihood of crisis events when such action is practicable. Finally, even when a crisis cannot be avoided, it should be handled appropriately. Managing a crisis requires an investment of time attending to specific activities before, during, and after such an event. How a crisis is managed can have a tremendous effect on the organization in both the short and long term.

Unfortunately, although few executives would reject these points, many acknowledge that their firms are not as prepared as they should be. This inconsistency occurs for three reasons. First, some executives view crisis events as largely unpredictable or unavoidable, and therefore not worthy of precious managerial time and resources. Second, many managers believe that they lack the time to adequately prepare for potential crises. Third, some leaders recognize the need for crisis planning and are willing to commit the time, but simply lack the expertise necessary to make the appropriate preparations.

Crisis management is a key component of strategic control, and arguably the entire strategic management process. Investing sufficient time, energy, and resources into preventing crises when possible and managing them when necessary can pay dividends (see Case Analysis 12-2).

12-5 Summary

The strategic control process consists of determining the extent to which the company's strategies are successful in attaining its goals. This process is accomplished through five steps. First, top management must determine what serves as a measure of a strategy's success and, therefore, needs to be controlled. Next, standards of performance should be developed for these elements. Management then measures performance along these lines both quantitatively and qualitatively and compares the actual performance to the standards. Reasons for discrepancies

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between actual measures and standards are analyzed, and corrective action is taken to resolve any areas where performance needs to be enhanced.

Crisis management refers to the process of planning for and implementing the response to a wide range of negative events that could severely affect an organization. Like strategic control, crisis management is an ongoing process.

Key Terms

balanced scorecard
best practices
business process reengineering
competitive benchmarking
crisis
crisis management
crisis management team
formal organization
informal organization
PIMS program
strategic control

Review Questions and Exercises

1. What are the five steps in the strategic control process?
2. Why is it critical to identify the appropriate strategic control standards for a firm?
3. Should corrective action always be taken when performance falls below the predetermined standard? Likewise, should correction action never be taken when performance meets or exceeds the predetermined standard? Explain.
4. Explain how competitive benchmarking is used in strategic control. What are some commonly used competitive benchmarks?
5. What is crisis management and why is it important?

Practice Quiz

True or False

1. Strategic control should be ongoing and occur throughout the strategic management process.
2. The PIMS program is a government-sponsored effort to improve strategic planning effectiveness in the United States.
3. Corrective action should usually, but not always, be taken at all levels if actual performance is less than the standard that has been established.
4. Strategic control can be exerted through either the formal or informal organization.
5. Crisis management refers to efforts made to eliminate the possibility that the organization can be affected negatively by unforeseen events.
6. Crisis management involves a series of steps that can be taken before a crisis occurs, while it is occurring, and after it has passed.

Multiple Choice

7. Strategic control is important because
   - **A.** it is difficult to know how well the firm is performing without it.
   - **B.** the organization's environment is uncertain and always changing.
   - **C.** lower-level managers need an effective means of providing feedback to top management.
   - **D.** A and B only
8. The strategic control process begins by
   - **A.** identifying appropriate performance measures.
   - **B.** establishing standards of performance.
   - **C.** measuring performance.
   - **D.** taking corrective action as needed.
9. The process of measuring a firm's performance against that of the top performers, usually in the same industry, is known as
   - **A.** competitive positioning.
   - **B.** performance measurement.
   - **C.** benchmarking.
   - **D.** PIMS analysis.
10. Sources of published information for strategic control available to the public include all of the following except
    - **A.** the *Wall Street Journal*.
    - **B.** *Consumer Reports*.
    - **C.** PIMS data.
    - **D.** many trade journals.

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11. Benchmarks should be

A. broad, not specific.

B. associated with the strategy's success.

C. outside the firm's control.

D. all of the above

12. Which of the following approaches bases the measurement of performance on an array of quantitative and qualitative factors instead of a single quantitative measure in the organization, such as profitability?

A. balanced scorecard

B. PIMS analysis

C. competitive benchmarking

D. none of the above

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READING 12-1

Insight from *strategy+business*

In the past, many industries contained firms that approached their business activities in similar ways. Today, as this chapter's strategy+business reading explains, new entrants are taking markedly different approaches to organizing their business activities. Many are providing their customers with superior value and are challenging their traditional counterparts for industry leadership.

Format Invasions: Surviving Business's Least Understood Competitive Upheavals

By Bertrand Shelton, Thomas Hansson, and Nicholas Hodson

Two of the most intense competitive wars in modern business history are being waged simultaneously today—both centered in the United States, but already spreading to Europe and beyond. General Motors and Ford, once global leaders in automobile manufacturing but now unprofitable and losing market share, seem helpless to defend their home markets against intruders like Toyota and Nissan. Among airlines, household names like United and US Airways have been driven into bankruptcy by intruders once viewed as niche carriers, such as Southwest Airlines. In both cases, struggling incumbents offer the same explanations: weakened industry demand, excessive labor costs, legacy pension obligations, and rising oil prices.

But these standard explanations are misleading. In the 1990s, incumbents like GM, Ford, United, and US Air (now US Airways) were already losing market share and money whenever they faced the intruders directly. Only rising markets elsewhere kept them profitable. Today, even if their employment costs were equalized, their pension obligations were lifted, and crude oil prices returned to $28 per barrel, they would still have higher costs and lower quality than their new competitors.

The real explanation is format invasion. Every business has a format—its own distinctive way of organizing the many activities involved in delivering its product or service. Incumbents suffer (as GM, Ford, United, and US Airways have suffered) when intruders enter their markets wielding new types of business formats. These new ways of assembling commonplace assets deliver familiar goods and services at massively lower cost, often 20 to 40 percent lower, while maintaining or improving quality. The traditional market leaders fail to recognize the power and potential of their competitors' new formats. They cling instead to their old familiar formats, and gradually but inevitably lose ground to the new ones.

Some business observers credit technological innovation as being the most critical factor in transforming an industry. But successful new formats do not rely on new or proprietary technology. Indeed, incumbents often have broader and deeper technological capabilities than intruders. Instead, new formats achieve their massive cost advantage by changing several of the business's main functions at once, often reaching backward to include suppliers or forward to include distributors. These changes are tightly interlinked: The new format "works" only when it's adopted as a whole, which makes the transition to a new format daunting for incumbents.

Other observers equate market development and growth with a "killer app"—a new feature or hit product, like the Chrysler minivan, the Apple iPod, or Pfizer's Viagra. Hence the frenetic chase for the new feature or hit product that will open the wallets of an existing market segment or galvanize a new one. But a new business format has little to do with innovative features or technological novelty. Rather, *massively lower cost* is the killer app in many markets —as companies as diverse as Dell, Inditex (Zara) apparel, Countrywide Financial, Nucor, Wal-Mart, and Charles Schwab, as well as Toyota and Southwest Airlines, have shown. Toyota's lean manufacturing methods, which ruthlessly eliminated the waste in its production systems, led to costs far below those of the Big Three Detroit automakers. Southwest's point-to-point format for air travel vastly reduced the ground and flight costs inherent in the "hub-and-spoke" format of the airline industry's established leaders. In recent decades, intruders wielding new business formats have trounced traditional incumbents across a wide range of industries: personal-computer manufacturing, car care, mortgage lending, stockbrokerage, steel, and many varieties of retailing, from groceries to books to gasoline.

An effective format invasion throws open for question the prevailing operating assumptions of an industry.

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Consider, for example, two recent format invasions in the European gasoline retail sector. The predominant format for the past several decades was the large, self-service gas station combined with a convenience store, which had supplanted the older format of small, full-service gas stations with repair bays. Jet, now a subsidiary of ConocoPhillips, has entered the Scandinavian market with a wholly new format: a completely unattended gas station. Effectively, it is a giant vending machine. By eliminating the station manager, cashiers, and other support costs, the new stations require only half as much margin per liter of gas to earn an attractive return. They can offer an almost unbeatable combination of low prices and convenient locations.

Meanwhile, in the United Kingdom and France, grocery chains have initiated a different kind of format invasion in the same sector, moving aggressively into gasoline, leveraging their existing stores and infrastructure to sell gasoline at much lower costs and prices. Gasoline is just one more product for a grocery chain, whose entire motor fuel department need be only a handful of people, compared with the hundreds employed by the old-format oil companies to support similar market share levels.

Both new formats are coming to the United States. Grocers, general merchandisers, and warehouse clubs have all begun offering gasoline, many of them using unattended operations like Jet's. They now serve about 10 percent of the U.S. national gasoline market, and much more in some markets, notably Texas. It remains unclear which variant of these new formats will win, with the answer likely varying by local market. But one thing seems clear: The traditional format is losing, and will continue to lose.

It may seem remarkable that this pattern recurs so often. Yet that's the reality of format invasions. Highly sophisticated incumbent companies, with years of experience and strong market positions, ignore and resist a new format's opportunities to reduce cost, while upstart new entrants embrace and exploit them. Intruders wielding new business formats in just this way have shattered traditional competitors across a wide swath of industries, in countries ranging from the United States to France to Japan. As a result, companies championing new business formats are among the largest creators of shareholder value. Conversely, incumbent companies' failure to respond effectively accounts for a great deal of shareholder value destruction. (See Exhibit 1.)

The pattern continues. New format invasions seem to be occurring now in industries as diverse as fashion apparel, commercial aircraft, and wireless communications. And (investors, take note) we see many established companies responding to format invasions with the same tactics that have failed other incumbents before. But there is good news for executives of established companies. Format invasions are not overnight successes; there is time to respond. And incumbents need not be losers. Established companies in large industries—armed as they are with substantial assets, intellectual capital, and customer relationships—can defeat the invasions and emerge as winners, if they recognize:

- Where new formats come from
- How new formats take over a market
- Why incumbent companies so often fail to respond to new formats
- How to take advantage of a new format.

Birth: Reconceiving Costs

Over time, an industry's prevailing format becomes a victim of its own accomplishments. The quest within one company to earn a premium or bring down costs in targeted activities succeeds—and is then copied across the industry. Competitors may become less distinct, in both features and performance, and the category commoditizes. Growth may slow, but the industry can carry on in a state of equilibrium for quite a long time.

Then an innovative new format appears. One day, somebody reexamines the activities common across the industry and discovers or develops a completely new way of performing them. Quite often, this new pattern involves a focus on activities that the industry's leading companies had not noticed, much less singled out for attention. But by focusing on these overlooked factors, the innovator finds ways to configure or reconfigure the company's assets, people, and processes to greatly reduce the activities' costs.

Southwest Airlines provides a famous contemporary example. Once in the air, Southwest is no more efficient than its traditional competitors. But Southwest was the first airline to focus its institutional attention on the least interesting part of aviation: the time an airplane sits at the gate. By dramatically reducing that turnaround time and ruthlessly applying the same logic to all its operations, Southwest developed a 40 percent or greater cost advantage that its old-format competitors seem helpless to meet. (See "Airline Invasions: 'Barbarians' at the Gates," page 9.)

For a not-so-famous example, take Inditex, the European apparel maker best known for its major brand, Zara. In the mid-1990s, European fashion apparel was dominated by specialty brands that put out new lines of clothing each season, hoping to catch the eye of trend-conscious consumers. These firms were on a

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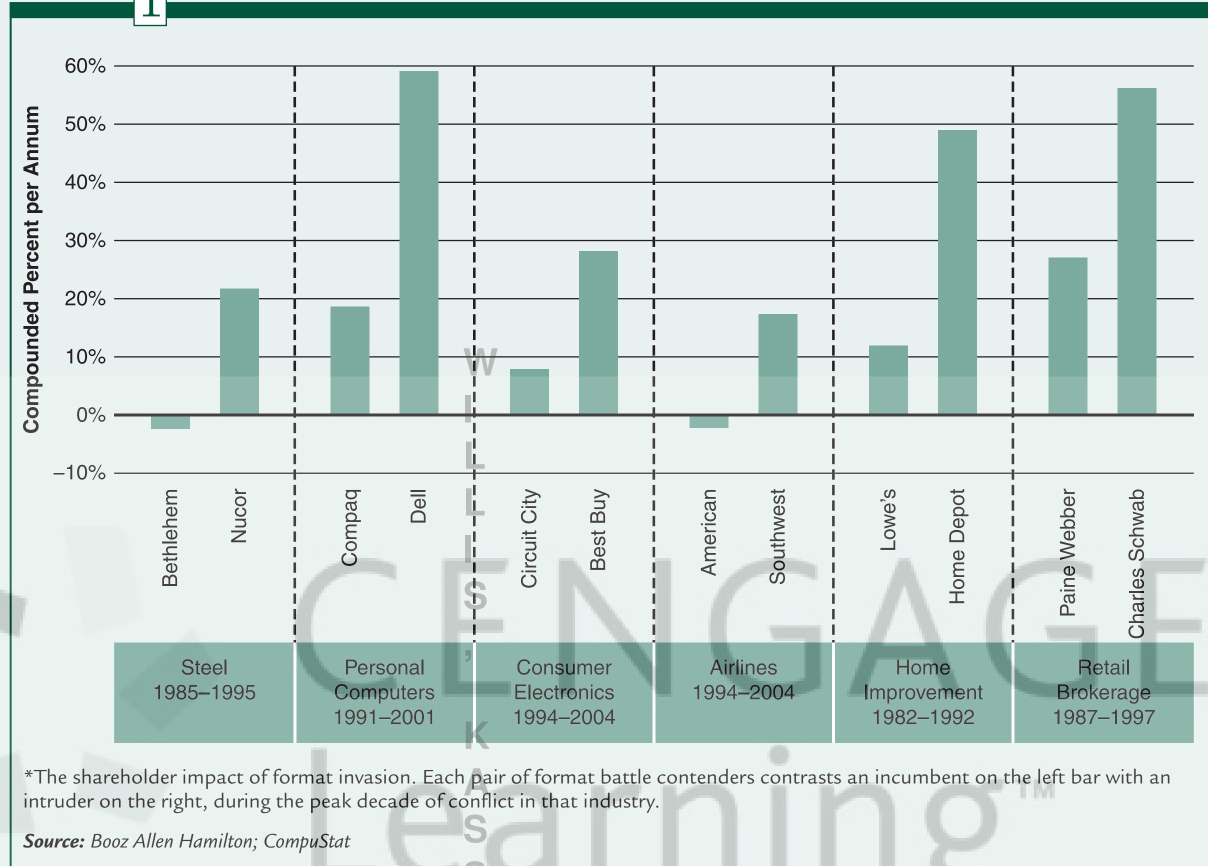
EXHIBIT 1 Shareholder Return for New-Format Intruders vs. Old-Format Incumbents*



*The shareholder impact of format invasion. Each pair of format battle contenders contrasts an incumbent on the left bar with an intruder on the right, during the peak decade of conflict in that industry.

Source: *Booz Allen Hamilton; CompuStat*

relentless treadmill, designing, sourcing, and distributing product for each season on an eight- to 12-month cycle. Although this was highly profitable if a firm's seasonal offering "hit the market"—selling a good proportion of product at full retail price—such good seasons were invariably interspersed with weaker ones, when much of the product sold only at heavy markdowns. Since all players had essentially identical business formats, they competed to reduce manufacturing costs by sourcing from China, India, and other low-cost locales.

Zara took a wholly different approach. Management realized that the biggest cost in fashion apparel is not in production and distribution (fabric, cutting, stitching, shipping, etc.) but in the margin forgone in marked-down sales of unpopular product. As a result, Zara created a business format capable of delivering a design from sketch to shelf in six weeks or less, allowing its designers and merchants to observe trends and respond rapidly, rather than making educated guesses about what customers might want eight months in the future. This approach has its costs: Zara's manufacturing facilities are located in relatively high-cost Spain. However, Zara sells around 80 percent of its product at full price, twice the percentage most competitors achieve. Confident that its product portfolio is mostly "hits," Zara can price its product profitably at about 25 percent less than competing brands. The resulting extraordinary sales volumes have generated very attractive returns, fueling rapid expansion.

New formats often migrate; they jump across categories, customer segments, and geographies. Sam Walton borrowed Wal-Mart's supercenter concept—general merchandise plus food—from France's hypermarkets. Toys "R" Us transported the self-serve supermarket from groceries to toys. Southwest Airlines started in 1971 as an intrastate airline in Texas. Only in the last 10 to 15 years did Southwest break out from being a short-haul regional player to become a national force—and only within the past five to 10 years have airlines such as Ryanair and JetBlue successfully carried the Southwest format into markets without a similar point-to-point competitor.

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Takeover: Capturing Demand

Time and time again, intruders in a wide variety of industries around the world have used the same tactics successfully to invade and take over existing markets. Invasions typically occur in four stages:

Stage I—Equilibrium. At the outset, incumbent-format firms serve their entire market. These firms play by variations on the same business rules, using largely the same approaches to product design, production, and marketing. Of course, each has its own slight distinctions in features, amenities, and pricing, and one or another company may tweak those to gain a temporary advantage. But these aren't decisive, since each player quickly imitates the others' worthwhile improvements.

This period can last for decades. U.S. supermarkets replaced neighborhood stores as the main purveyors of groceries in the 1950s. They lived in quiet equilibrium until Wal-Mart and the warehouse clubs finally invaded their markets with new formats in the 1990s.

Stage II—Intrusion. Most markets have a considerable amount of price-sensitive demand hanging around—both customers willing to change suppliers for a discount ("penny switchers") and noncustomers willing to start buying if prices fall low enough. For a new-format intruder, these customers represent a very attractive startup market. They don't value "frills"; they prefer a bare-bones offering at a lower price, and they don't have much loyalty to incumbent brands. So the intruder tailors its initial offering to their preferences, stripping out amenities that the new format could otherwise provide, to reduce costs still further.

Capturing these customers requires a careful pricing strategy. They don't look just for a good price, but for the absolute best price, gravitating elsewhere if the price goes even modestly higher. A successful intruder exploits this pattern, translating its cost advantage into prices at the very bottom of the market. These prices attract customers in extraordinary volume that more than compensates for the margin lost in the discount. Thus, a relatively low price, near the market bottom, is not as profitable as the lowest price at the market bottom. In the early stages of invasion, this phenomenon works to the advantage of the lowest-cost intruders.

At the same time, even price-sensitive customers know the difference between "bare bones" and "shoddy." They're naturally suspicious that a below-market price reflects inferior product quality or poor service. So a typical successful intruder works hard to build and maintain a reputation for candor, no-frills quality, reliability, and excellent customer service. It secures its relationship with customers through the openness of its menu and the clarity of its choices. The tendency of a new format to improve its product's quality and consistency helps establish that reputation.

Stage III—Expansion. The extraordinary profits that flow from the new format's huge cost advantage nurture rapid expansion: double-digit growth at margins hitherto unheard of in the industry. Format innovations aren't usually patentable technologies, so additional entrants soon emerge, imitating the new format. They would naturally prefer to compete against the old-format players than to compete against one another, so these imitators target market segments—customers, products, or geographies—into which the new format hasn't yet penetrated. A free-for-all ensues, as the new-format intruders race to occupy as much market "space" as they can.

Old-format incumbents may try to meet the intruders' low prices. But that seldom lasts long, since the incumbents labor under two disadvantages: the significantly higher costs inherent in the old format, and the broader amenity set they have customarily offered. So they typically redefine their target market upward, forsaking the price-driven customers now flocking to the intruders. There is a tempting but ultimately shortsighted rationale for abandoning these customers: Many of them are new to the category, "so we never actually *lost* them."

Retreating up-market relieves the incumbents' immediate pressures, but only postpones the problem. As the new format proliferates, it further erodes the old-format players' business, draining away their volume and depressing their prices. Their financial returns deteriorate, and investment in the old format gradually ceases.

The recent flurry of activity among European airlines nicely illustrates this expansion phase. Ryanair, easyJet, and a plethora of other new-format competitors have piled into the European air-travel market. They expanded far more rapidly than their acknowledged model, Southwest, did in the U.S., precisely because the U.S. example demonstrated how much potential the new format has.

The intensifying financial pressures on old-format European carriers already have eliminated some (Swissair, Sabena) and encouraged others to merge (KLM with Air France). Yet some of these incumbents remain convinced that the new-format upstarts are

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"for backpackers, not for businesspeople" and "cannot extend into long-haul markets"—as one executive at a traditional European airline told us quite recently.

Stage IV—Consolidation. The new-format players continue to expand, broadening their target market beyond price-sensitive customers. Adding amenities without giving up the new format's cost advantages becomes their next challenge; if they surmount it, they become very attractive to mainstream customers.

As the mainstream fills up with new-format players, competition among them pushes prices down toward the new format's long-run level, reducing their margins to more "normal" levels. At that point, the remaining traditional-format players must crumble, or retreat into minor niches. Meanwhile, the toughening environment gradually forces the new-format players to switch their attention from expansion to grinding competition among themselves—through incremental efficiencies, differentiated amenities, or intensified sales campaigns—with better performers acquiring weaker ones. Eventually, equilibrium is reestablished and the new business format dominates the market.

Incumbents: Misperceiving the Threat

We have found no cases in which an incumbent responded to a new business format successfully without essentially adopting it. It's true that many incumbents survive for quite some time in the face of a format invasion; they prune product lines, retrench operations, and scale back investment (if only because the business is generating less cash than it previously did). But none prosper over the long run unless they adopt the new format. No economically sound alternative seems to exist. Why do incumbents so consistently fail to recognize this, and let the intruders take away their markets?

Two classic misperceptions lie behind this common development. First, incumbents often mistakenly ascribe the new format's cost advantage to better factor prices, such as lower wages and benefits for employees or lower prices paid to suppliers. That explanation, despite being attractively straightforward, misses the central point—that the new format uses fewer resources, rather than merely paying less for those it uses.

This misperception sets incumbents on a path of fruitless confrontation with unions and suppliers. They reason that if their competitors got better factor prices, it was because they themselves hadn't been "tough" enough. Automakers, supermarkets (under pressure from Wal-Mart), and traditional airlines provide ready examples of old-format players distracted by these confrontations.

Second, incumbents often confuse the intruders with "value" or "budget" companies. In their view, the "value" company is making a niche play, appealing to the most price-conscious customers in its market. A "value" make of automobile is smaller, with a less-powerful engine and fewer extra features than a mainstream car, and thus carries a lower price tag. Similarly, a "value" department store offers no-frills products and fewer services and amenities than a mainstream store in the same market, at a lower price point. But these "value" companies rely on the same traditional business format as their mainstream competitors: They all face the same menu of trade-offs between amenities and price. The "value" companies just make different choices from that menu—choices attuned to the price conscious customers they've targeted. These traditional-format "value" competitors don't threaten the market's mainstream traditional companies.

In contrast, new-format companies create a different and better menu for themselves by operating in strikingly new ways that slice out slabs of cost. (See Exhibit 2.) The new format can deliver either a high or low level of features and amenities less expensively than the old format. Format invaders thus represent a long-term threat to the mainstream traditional companies in the sector, unlike other companies that merely pitch their offerings at the "value" end of the market.

This misperception fatally weakens the incumbents' efforts to counter the new-format intruders at each stage in the cycle. Early on, seeing the intruders as simple "value" companies, the incumbents may try competing head-to-head against them with a "value" offering of their own, providing lower features and amenities at a lower price, but still based on the old format. Examples include General Motors' Vega, an early (1970s) response to low-end import cars, and the lower-priced "value" subsidiaries of mainstream airlines.

Of course, the incumbents' "value" offerings can't truly meet the intruders' pricing head-to-head: Their cost disadvantage forces them to seek some premium above the intruders' price. But that misses the central point of the intruders' entry tactics—that price-sensitive customers respond to prices *at* the market bottom, not *near* it. Near-bottom pricing causes the incumbents to give up margin without commanding much volume. So the incumbents' "value" offerings quickly fail.

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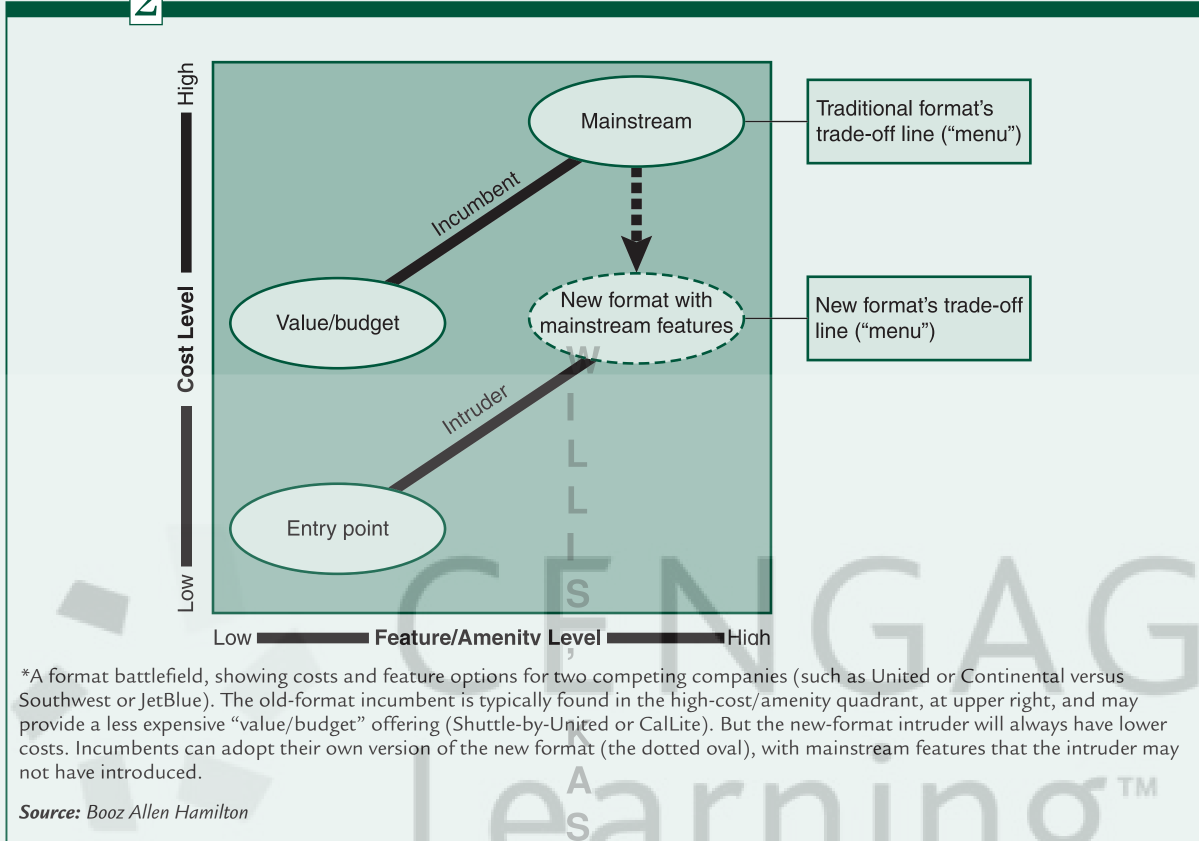
EXHIBIT 2 Strategic Options for Old and New Formats*



*A format battlefield, showing costs and feature options for two competing companies (such as United or Continental versus Southwest or JetBlue). The old-format incumbent is typically found in the high-cost/amenity quadrant, at upper right, and may provide a less expensive "value/budget" offering (Shuttle-by-United or CalLite). But the new-format intruder will always have lower costs. Incumbents can adopt their own version of the new format (the dotted oval), with mainstream features that the intruder may not have introduced.

Source: *Booz Allen Hamilton*

Later, the same misperception leads incumbents to believe they can retreat up-market safely, since they believe the new-format intruders can't follow. But in fact, the intruders have no such limitation—their new format can combine high features or amenities with low costs. Toyota's lean business format produces the top-of-the-line Lexus as well as the entry-level Corolla. Similarly, Target and Wal-Mart use the same extraordinarily efficient business format; Target has merely chosen to focus it on customers and merchandise that are farther upscale than Wal-Mart's.

Conversely, incumbents often reject the notion of adopting the new format on the grounds that doing so would require abandoning their up-market feature and amenity offering, and thus cause an unthinkable revenue loss. They fail to see a major opportunity: that *the company can combine high features and amenities with the new format's low costs.* There is a realistic opportunity, for instance, for a traditional airline to continue providing high levels of service while adopting Southwest's more efficient production model. (In Exhibit 2, the traditional airline could move down the dotted line to the new format with mainstream features.)

This confusion also seems to underlie Harvard Business School Professor Clayton Christensen's well-known views on format competition. Professor Christensen argues that innovative products and business formats (or "value networks," as he calls them) begin life underperforming the requirements of a market's core customers. Later, as the intruder's performance improves, it gains the ability to enter the incumbents' core markets. Whatever the merits of this view with respect to technological innovations such as improved disk drives, it does not apply to new business formats. The choice of business format and the choice of amenity level are largely independent of each other. Most format innovations indeed appear at the low end of the market, but this is only because that represents

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the simplest and most expedient route for the intruder to monetize its innovation.

When a new-format intruder offers more features and amenities than its traditional competitors do, they will not necessarily be the same mix. The new format makes some amenities easier and some harder to provide, so the intruders do what any seller would do: accentuate their advantages. Airline passengers, for example, may wait a bit longer for connecting flights on Southwest, but they get nonstop flights more frequently. Retail customers may drive a bit farther to shop at a "big box" store, but they can choose from a broader variety of goods. In any case, these differences tend to be modest; the new format's lower costs and prices swamp any differences in its amenity mix.

Late in the cycle, as new-format intruders take ever more market share, the increasingly strapped incumbents often start to merge. From one perspective, these mergers appear inevitable and beneficial: Old-format companies face a contracting market, which simply cannot support as many of them as it before (even if the overall market remains robust). However, the traditional companies often expect more from this kind of industry consolidation than it can provide. Too often, they view consolidation as a real fix, rather than seeing it correctly as another step in their decline. This is because they view their collective overcapacity as the problem, rather than recognizing it as a symptom of the format invasion.

The Incumbent's Opportunity

Some incumbents have responded successfully to a format invasion. When they do, the results are extraordinarily profitable. We've looked at several companies that took on a format invasion successfully, and at several others that more or less tried but failed. Nothing we've seen indicates that the companies that made a successful transition to a new format had any greater depth of technical, financial, or operational resources than the peers they left behind. Nor did we find that they had "less to lose" by giving up the old format. But the winners adhered to a few basic principles, while avoiding some clear pitfalls.

The experience of Best Buy and Circuit City over the past decade comes close to being controlled experiment on this point. At the outset, nothing about Best Buy's market position or format distinguished it from Circuit City. If anything, Circuit City had more resources with which to innovate. But Best Buy identified and acted upon an opportunity where Circuit City did not.

In 1980, Circuit City was a rapidly growing electronics retailer, with a better format than traditional TV dealers. Customers viewed floor samples, made their selection—usually with help from a commissioned salesperson—and paid for the merchandise. They then took their receipt to a separate pick-up window, near the store exit, to collect their purchases. Many other retailers copied this format, including a small but successful electronics chain named Sound of Music, based near Minneapolis.

Then, in 1981, a Sound of Music store in Roseville, Minn., was hit by a tornado, forcing managers to hold a clearance sale with the inventory stacked on the sales floor. It was an unexpectedly wild success. Through this random event, company founder Richard Schulze discovered that a discount, no-frills, self-serve value proposition could be both very attractive to customers and very profitable for the company. After a couple of years of experimentation, Mr. Schulze opened his first warehouse-style, truly self-serve superstore in 1983, changing the company's name to Best Buy at the same time. The following year Mr. Schulze, sensing his new format's cost advantage over the incumbent leader, Circuit City (still thriving at that time), committed his company to a "won't be undersold" pricing policy. Mr. Schulze continued to adjust the new format during the next few years; in 1989, he launched a "grab and go" store, with salaried rather than commissioned salespeople.

Between 1994 and 2004, Best Buy gradually eclipsed Circuit City—earning a compound total shareholder return of 28 percent per year while Circuit City managed just 8 percent (despite a rapidly expanding market for consumer electronics). Circuit City lost market leadership in the sector beginning in 1997, but continues to follow its old format strategy. By now, it's a troubled company.

Companies that successfully survive a format invasion seem to have four common attributes:

1. *Successful incumbents start with a clear and accurate vision of how the new format works for their competitors—how it serves customers adequately at much lower cost.* Undeniably, that's hard work. A new format focuses on unfamiliar aspects of the business; an accurate vision must grasp what that new focus is. But the new format differs from the traditional format in so many ways—spread across so many parts of the business yet knitted so closely together—that it's hard to see. The successful companies don't just assemble a factual, detailed view of the new format; they fit those details into a realistic overall picture.

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2. *Successful incumbents undertake the new format as an integrated whole, recognizing its tightly interlinked nature.* Too often, incumbents experiment halfheartedly with imitating a new format, layering bits and pieces of it onto their existing business. They modify just one element of their traditional business at a time, or they make a modification but don't pursue its implications through the rest of the business. Few companies have an appetite for making a flying leap to a whole new operating model—which is another way of explaining why so few incumbents make the transition to a new format. But the alternative—piecemeal adoption—just won't produce results.
3. *Successful incumbents adapt the new format in ways that don't compromise its cost advantages.* They provide a basic-level offer that meets the intruders' bottom-level prices profitably at the *basic* amenity level. This reclaims the bottom-of-market volume that they would otherwise forfeit to the new-format competitor. To this, they may add products or services with more features or amenities than the intruder has yet offered. They resist the temptation to blend the new format with the traditional format—an approach usually justified as "we're doing it, but our way." That approach rarely succeeds. After all, the new format moved away from the old to achieve some specific objectives; it's hard to move back without compromising them. These blends often fritter away much of the new format's cost advantage without any decisive offsetting gain in customer appeal.
4. *Successful incumbents make the new format their core business, not a side offering.* Assuming that a competitor's new format has already proved itself in the marketplace, execution is needed. Launching a side experiment signals that management sees the new format as a niche offering, with no bridge to changing the core business. It's easy for an organization to get excited at the outset about an experiment and invest a lot of energy in it ("Finally, we are actually doing something about the new format threat"), but it's ultimately ineffectual.

The story of the Home Depot format invasion of the 1980s, and the response by Lowe's Companies Inc. in the 1990s, shows how an incumbent company can come successfully to terms with a new format. Traditionally, Lowe's sold construction materials, mainly to professional homebuilders, through an extensive chain of small full-service outlets. In 1982, Home Depot introduced "big box" retailing in a "home improvement center" format: a much larger store (90,000 square feet versus 15,000 for a Lowe's outlet) with dramatically lower unit operating costs, due mainly to the labor savings from scale and self-service. The new format spread rapidly and profitably, displacing traditional-format competitors—largely hardware and building supply stores.

Throughout the 1980s, Lowe's struggled to respond, trying to blend its traditional format with the new home improvement center. The company built larger stores (25,000 square feet) and modified its offerings and layout to accommodate both professionals and consumers. It didn't work. By 1988, Lowe's had fallen behind Home Depot in size, profitability, and shareholder returns. (See Exhibit 1.)

At that point, almost a full decade after the birth of Home Depot's format, Lowe's finally recognized the new format's power. In 1989, the company built an experimental home improvement center. In 1992, management committed to the format and started converting to new stores rapidly. (See Exhibit 3.) Since then, the profitability, growth, and shareholder returns of Lowe's have exceeded those of Home Depot.

Strategy for Survival

Format invasions seem almost certain to continue, probably with increasing frequency, as ideas for new formats flow ever more easily across industry and regional boundaries. The lessons for established companies in those markets seem clear.

- **Scan your markets regularly for format invaders.** Whenever a competitor—especially a new entrant—starts gaining market share by offering familiar products at below-market prices, suspect the possibility of a format invasion. If the new format continues growing, what will you do? Look askance at assumptions that the new format will apply only to some "value" niche. In particular, question any plans or actions that would forfeit down-market segments.
- **Understand the competitor's new format thoroughly,** including the full potential of its cost and quality advantages. Recognize that its "logic" will likely be unfamiliar, so aim to see it on its own terms. In particular, resist the temptation to assume that the intruder's success depends simply on lower factor prices, selling below costs, or other measures you could never emulate (even if these elements are truly in the picture somewhere). Then, translate that understanding into a forecast of the new format's likely success over the next five to 10 years. Caution: Incumbents often unconsciously water down these forecasts on grounds of "realism." With a new format, forecasting extraordinary growth *is* realism.
- **Approach the new format as an opportunity.** At this point, you're likely well ahead of most incumbents

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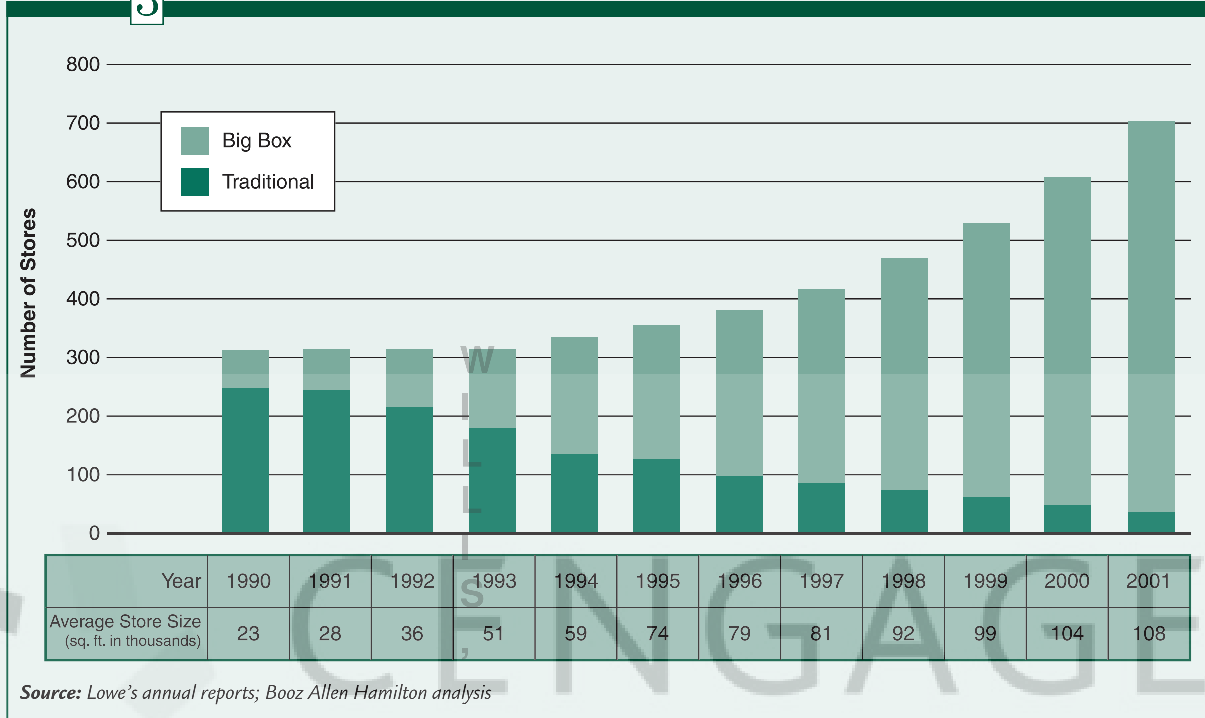
EXHIBIT 3 The Evolution of Lowe's Retail Format



Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Average Store Size (sq. ft. in thousands)	23	28	36	51	59	74	79	81	92	99	104	108

Source: *Lowe's annual reports; Booz Allen Hamilton analysis*

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facing a successful new-format competitor. So you now have a significant opportunity to grow and profit at your traditional competitors' expense. In a mature market, the new format may well be the best opportunity available to your company. Make an assessment of its potential; then (if warranted) focus the company on seizing it.

- **Design your moves from the market back.** A practical plan for exploiting the new format does *not* start from your company's current position. Rather, it starts by asking, How could we imitate our most successful new-format competitor, with parity offerings, parity costs, and parity prices leading to growth and profits equaling theirs? (You won't necessarily implement this parity plan, but it forces your company's thinking away from its traditional format and toward the new one.)
- **Be cautious in adding features and amenities.** They may well be justified to build market share by appealing to mainstream customers, but that will happen only if they reinforce the new format's core advantages. (That's one reason why understanding the new format thoroughly is important.) A test: Does your new plan include a bare-bones offering that profitably matches your new-format competitors head-to-head on price and features? (If it doesn't, then your design has probably slipped away toward a less profitable "blended" format.)
- **Make the new format your mainstream business.** It's natural to field-test a new business format before committing to it wholeheartedly. But experimentation and niche marketing can become ends in themselves. Any plan for a test should define a successful outcome and the rollout plan that will follow, carrying the new format into the heart of your business.
- **Don't get distracted by merger possibilities.** Against the backdrop of a format invasion, combinations among traditional competitors present the illusion of progress. Unfortunately, because the combined incumbent remains fundamentally disadvantaged, the merged company's greater scale seldom provides enough benefits to offset the burdens of an old format. (However, a company that has adopted the new format successfully may find it worthwhile to acquire other old-format companies and bring them through the same transition.)

As for the two biggest format invasions going on right now, we don't know whether the incumbent automakers or airlines will survive or succumb. Some may well retain industry leadership, growing their businesses and delivering attractive shareholder returns over the long term. If so, they will do it by finally adopting and

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adapting the superior new formats that have overtaken them—the formats that enabled the Southwest Airlines and Toyotas of the world to succeed and prosper in the same economic and market conditions in which the old formats proved to be uncompetitive.

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Real-Time Case 15: FedEx

Between 1969 and 1971, Fred Smith secured $90 million in financing to launch Federal Express, a service that originally provided overnight and second-day delivery to twenty-two major cities in the United States. FedEx began delivery in 1973, and the company enjoyed immediate success. FedEx was the first major air transport firm to implement a "hub and spoke" system, whereby all packages were flown to a central location (Memphis) each night and redistributed by air to their destinations in the predawn hours. The airline shift from parcels to passengers and the strike at UPS in 1974 all contributed to the firm's early market share gains. FedEx went public in 1978.

By the late 1980s, FedEx had begun to move internationally, purchasing Tiger International (also known as Flying Tigers) and carriers in Japan and Italy. In 1989, FedEx doubled its international volume. In 1995, FedEx created Latin American and Caribbean divisions and became the first U.S. express carrier to offer direct flights to China.

In 1996, FedEx introduced the first Internet-based shipping management system, known as interNetShip. Another UPS strike in 1997 sent 850,000 packages a day to FedEx, creating more opportunities for the firm. In 1998, FedEx averted a pilot strike of its own, prompting the company to outsource more of its flights.

In 2000, Federal Express adopted its nickname FedEx as its official company name. Today, FedEx provides transportation, e-commerce, and supply chain management services, including worldwide express delivery, ground small-parcel delivery, small quantity freight delivery, and supply chain management services.

FedEx remains the world's leading express delivery company, with more than 60,000 drop-off locations, 670 aircraft, and about 40,000 vehicles, delivering over 3 million packages to about 220 countries and territories every business day. FedEx has even partnered with the U.S. Postal Service to provide air transportation for postal express shipments, an arrangement that allows FedEx to utilize post offices' critical package drop-off locations. FedEx acquired Kinkos in early 2004 in an effort to serve a broader array of shipping and office-related needs, particularly those of small business owners. In 2007, FedEx acquired its Chinese partner, DTW Group, and launched the first one-day guaranteed service in the country later in the year.

FedEx has organized its operations into multiple businesses: FedEx Ground, FedEx Express (which accounts for almost 70 percent of revenues), FedEx Freight, FedEx Custom Critical, and FedEx Kinkos.

Founder Fred Smith remains the CEO and owns approximately 6 percent of FedEx shares. Smith is known as a popular and cagey leader, both inside and outside of the company.

Perspectives

- Keane, A. G., "Searching for shippers," *Traffic World*, 12 January 2004. In an effort to increase its shipping business, UPS acquired Mail Boxes Etc. in 2001, renaming them UPS stores in 2003. FedEx kept pace in 2004, acquiring Kinkos for $2.4 billion.
- Creamer, M., "DHL bets on flexibility as it moves on FedEx, UPS in U.S.," *Advertising Age*, 6 September 2004. DHL is embarking on a challenge to the express delivery market in the United States controlled by UPS and FedEx by emphasizing superior customer service.
- Dade, C., "FedEx says profit gains may be sluggish," *Wall Street Journal*, 22 March 2007, A11. The close link between FedEx performance and overall economic conditions is discussed.
- Stanley, B., "FedEx raises stakes in China market," *Wall Street Journal*, 21 March 2007, A12. FedEx launched the first one-day guaranteed delivery service in China in mid-2007, offering time-definite service between nineteen major cities and day-definite service between more than a couple hundred others.

Case Challenges

- The Internet has alleviated the need for overnight delivery of many documents. How has FedEx survived and even prospered in the midst of this key technological change?
- Should FedEx be partnering with a key competitor and protected government entity, the U.S. Postal Service?

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- Do FedEx and UPS offer the same delivery services, or has each chosen to focus on different forms of delivery and customer needs? Explain.
- Was FedEx wise by moving aggressively into China? Can the Chinese market support FedEx's one-day delivery services? Explain.

Internet Sites of Interest

- Corporate Web site: www.fedex.com
- Web sites of key competitors: www.ups.com, www.airborne.com, www.dhl.com
- *Transport News*: www.transportnews.com

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