JEREMY HOPE | PETER BUNCE | FRANZ RÖÖSLI

The Leader's Dilemma

HOW TO BUILD AN EMPOWERED AND ADAPTIVE ORGANIZATION WITHOUT LOSING CONTROL

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How to Build an Empowered and Adaptive Organization Without Losing Control

By Jeremy Hope, Peter Bunce and Franz Röösli

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Contents

Foreword **v**

Preface **vii**

Some definitions **ix**

Introduction
The organization as an adaptive system 1

1 **Principle #1 – Values** **33**
Bind people to a common cause, not a central plan

2 **Principle #2 – Governance** **57**
Govern through shared values and sound judgment, not detailed rules and regulations

3 **Principle #3 – Transparency** **89**
Make information open and transparent; don't restrict and control it

4 **Principle #4 – Teams** **105**
Organize around a seamless network of accountable teams, not centralized functions

5 **Principle #5 – Trust** **121**
Trust teams to regulate and improve their performance; don't micro-manage them

6 **Principle #6 – Accountability** **139**
Base accountability on holistic criteria and peer reviews, not on hierarchical relationships

7 Principle #7 – Goals **157**
Set ambitious medium-term goals, not short-term fixed targets

8 Principle #8 – Rewards **179**
Base rewards on relative performance, not fixed targets

9 Principle #9 – Planning **203**
Make planning a continuous and inclusive
process, not a top-down annual event

10 Principle #10 – Coordination **225**
Coordinate interactions dynamically, not through annual budgets

11 Principle #11 – Resources **239**
Make resources available just-in-time, not just-in-case

12 Principle #12 – Controls **257**
Base controls on fast, frequent feedback, not on budget variances

13 Implementation insights **283**

14 Make management change your legacy **305**

Notes **309**

Index **325**

Foreword

This book addresses a paradox about the nature of management in large organizations. On the one hand, the pace of change in the business world today feels faster than it has ever been. There is plentiful evidence of corporate failure, there is widespread distrust of senior executives, and there are many observers calling for dramatic changes in how organizations are run. On the other hand, the standard "command and control"-based model of management, the one that has served us for more than a century, continues to dominate the business landscape.

This is not a new paradox. Every generation of management researchers and consultants argues that we need to make profound changes in how work gets done, and since at least the 1930s the primary emphasis has been on such themes as empowering workers, flattening hierarchies and creating greater levels of trust. And, yet, for all the careful research, and for all the evidence that some companies are experimenting with new ways that appear to offer a better way, the amount of real and lasting change is small. When we look at the *management* systems for getting work done in large organizations today – how we motivate people, control activities, and set objectives – they are little different from the ones used by our grandparents.

Some management books try to sidestep this paradox: they focus on the things that are changing in the business world and leave readers to figure out what to do differently; or they provide a new perspective on the paradox. Other books focus on one part of the story only, perhaps giving some new techniques for motivating employees or measuring performance. But in *The Leader's Dilemma* Jeremy Hope, Peter Bunce and Franz Röösli avoid any such tactics.

First of all, they take on the whole challenge – the organization as a complex system of interconnected parts – and they make it clear that you cannot just cherry-pick the ideas that suit you. Rather, you have to see how all the different parts of the story connect to each other, and think through the consequences of your actions. Second, they confront the paradox that large organizations seem immune to the changes that they need to make. Their argument is alluded to in the subtitle of the book: *How to build an empowered and adaptive organization without losing control*. The way forward, they argue, lies on the knife-edge between anarchic self-organization on the one side, and traditional command and control on the other.

The Leader's Dilemma lays out an agenda for change in large organizations built around 12 principles, such as "bind people to a common cause, not a central plan" and "make planning a continuous and inclusive process, not a top-down annual event." All of these principles will be familiar to a business audience, but the point is that while the words are frequently used, they are rarely enacted. So Hope, Bunce and Röösli provide lots of examples of how these principles can be applied in practice: well-known companies like Southwest Airlines and Whole Foods Market, and lesser-known companies like Sydney Water Corporation and Tomkins.

Their agenda is all about putting people first – about building an adaptive system around the needs and aspirations of employees, not treating the organization as an "obedient machine." The curious thing about this agenda is that it didn't emerge from an HR conference, or from a class in organizational behavior at a business school; it came out of an industry group called the "Beyond Budgeting Round Table," or BBRT, founded by Jeremy Hope, Robin Fraser and Peter Bunce a decade ago.

The BBRT is a group of finance and accounting professionals, all with personal experience of the limits to traditional top-down, fixed-target based budgeting. Inspired by a few enlightened companies such as Svenska Handelsbanken, they sought to find alternatives to the traditional budgeting process. But such is the interconnected nature of large organizations that a rethinking of budgeting quickly led to a rethinking of the entire management architecture of large organizations.

This book is the result of that process. The authors are professionals who wouldn't normally have started from a "people"-focused agenda but ended up there because it was the only possible place to end up if you want to make organizations more effective over the long term. The authors also understand deeply how difficult it is for those in positions of power to loosen up on the levers of control. So this is an important book: it offers a synthesis of a lot of recent thinking about how to improve management in large organizations, and it provides a clear agenda for change. If you are interested in building an adaptive and progressive company, this book gives you the ideas and inspiration to make it happen.

Julian Birkinshaw
Professor of Strategic and International Management
London Business School

Preface

One summer Albert Einstein's students complained that the questions on this year's exam paper were no different from those on the previous one. "Well, yes," said Einstein, "the questions were indeed the same. What the students needed to understand, however, was that the answers had changed!" If the question on today's management exam paper is "How does the way we manage need to change to meet today's challenges?" then the answers are indeed different from those most leaders would have given a few years ago.

The traditional "command and control" management model was never perfect. In an industrial age when suppliers could sell all their output to eager customers, business leaders could "plan and control" their way to the future. Annual plans and budgets were negotiated with the corporate center; all divisional and line managers had to do was to follow the plan and meet the numbers. This model was already in trouble in the 1990s as customer loyalty collapsed in the wake of globalization, privatization and the Internet revolution, but in the credit crunch of 2007–9 it turned into a liability as organizations failed to anticipate and respond to the economic eruptions that engulfed world markets. The trouble is that increasing levels of uncertainty and turbulence are here to stay.

Another crucial change is that the next generation of managers weaned on Facebook and YouTube are used to sharing just about everything with their families and friends. But when they enter the workplace they are faced with antiquated systems and closed mindsets that make transparency and sharing so difficult. There is little doubt that to attract and keep the best people in the future, leaders will need to make their organizations more engaging, transparent and fulfilling places to work.

This book is about rethinking how we manage organizations in a post-industrial, post-credit crunch world where, according to strategy guru Gary Hamel, innovative management models represent the only remaining source of sustainable competitive advantage.[1] It is also about releasing people from the burdens of stifling bureaucracy and suffocating control systems, trusting them with information and giving them time to think, reflect, share, learn and improve.

It is an outcome of the work we have been engaged in for over 10 years in the "beyond budgeting" movement (we use "budgeting" as another term for "command and control" management). In our 2003 book *Beyond Budgeting* Jeremy Hope and Robin Fraser set out 12 principles that represented the "best of best practices" at that time. These have stood the test of time. This book provides more depth and case examples based on these principles. We have also integrated these principles with "systems thinking" and illustrated how they enable organizations to become more empowered and adaptive.

This book is aimed at leaders who want to change their management cultures and build organizations that will adapt, improve and endure for generations to come.

No book is completed without the help and support of many people. We would like to acknowledge the support of Robin Fraser, Steve Player, Bjarte Bogsnes and Steve Morlidge, who have not only contributed to this book but also been instrumental in pushing the boundaries of Beyond Budgeting. We would also like to thank many Beyond Budgeting members who have generously given their time to facilitate case studies and interviews that we have drawn on extensively throughout this work. Also, our publisher Rosemary Nixon and her team have given us expert guidance throughout the process. Our sincere thanks go to them all.

Some definitions

It is important that we all share the same understanding of what key terms mean throughout this book. For example, many people find it difficult to distinguish between a budget, a target, a goal and a forecast, yet a clear definition of these terms *as they are applied in practice* is crucial for designing and implementing any management model. It is also fundamental to reading this book. Our definitions are set out below and are applied throughout.

A *management model* describes how an organization sets goals and strategy; how it motivates and rewards people; how it steers its course through plans, budgets and forecasts; how it makes decisions and allocates resources; and how it measures and controls performance.

A *command and control management model* assumes that an organization has many layers of management and that strategy and key decisions are highly centralized. Targets, plans, budgets, resources and controls flow down the hierarchy in the form of annual instructions, and subsequently flow back up the hierarchy in the form of results. The annual budget coordinates all plans and resources and is the "glue" that holds the management model together. We use the word "budgeting" as a generic term for command and control management, and thus "beyond budgeting" means beyond command and control toward a management model that is more empowered and adaptive.

An *adaptive management model* assumes that an organization has few layers of management and that strategy and key decisions are devolved to front-line teams who have the scope and authority to respond rapidly to emerging threats and seize new opportunities as they arise. Fixed plans and budgets are usually replaced with more flexible systems including quarterly business reviews and rolling forecasts. The glue that holds the organization together is fast, open and transparent information.

A *target* is usually short-term (often one year) and fixed. It invariably becomes a fixed performance contract between one organizational level and another. In the cultural climate of many organizations, such contracts or commitments must be met, which often leads to undesirable behavior.

A *goal* is usually aspirational and set over the medium term (two to five years). A goal should stretch managerial ambition so that an organization or work unit maximizes its performance potential, as opposed to making incremental performance improvements over the previous period.

A *budget* is a plan expressed in financial terms against which performance will be measured. It is a tool for allocating scarce resources and for committing managers to a predetermined financial outcome, usually on an annual basis. It also acts as a constraint on spending and a basis for evaluating management performance and rewards. A budget also defines authority levels and influences how managers behave in large organizations.

A *plan* is a set of actions that derive from a strategic review and aim at improving the performance of the organization or any of its subsets such as divisions or front-line teams.

A *forecast* is a financial view of the future derived from a manager's best opinion of the "most likely outcome," given the known information at the time it is prepared. Thus it should be unbiased, reflect all known events (good and bad), and, of course, be realistic. It should also be a moving window (or rolling forecast) that always looks between 12 and 24 months ahead.

INTRODUCTION

The organization as an adaptive system

What ultimately constrains the performance of your organization is not its operating model, nor its business model, but its management model.[1]

Gary Hamel, *The Future of Management*

Most of you will remember Aesop's fable about the tortoise and the hare who decide to have a race on a sunny day. The brash, confident hare thinks he has won the race before it even starts and decides to have a nap under a tree half way through. But when the hare awakes, the tortoise is at the finish line.

Too many business leaders think and act like hares. They think they can grow shareholder value at unrealistic rates each year by setting aggressive targets and incentives and then (like the hare) "predict and control" their future results through detailed budgets and short-term decisions. Tortoises don't make such promises, predictions or assumptions. Instead they keep their eye on the path ahead and continuously improve their performance. Tortoises always win in the end. Their aim is to adapt to changing conditions, beat their peers and endure over long periods of time. The best organizations are adaptive systems that continuously learn, adapt and improve.

Unfortunately, in the business world, when tortoise-type organizations appoint new leaders they can turn into hares. Royal Bank of Scotland (founded 1727), Citigroup (1812), Lehman Brothers (1850), Washington Mutual (1889), Merrill Lynch (1914) and AIG (1919) had all adapted and endured for, in most cases, a century or more but collapsed when a new leadership generation changed the way they were managed. The result was the credit crunch of 2007–9, when trillions of dollars were wiped off corporate balance sheets, leaving governments around the world with no option but to step in with taxpayers' funds to avoid a catastrophic collapse of the financial system.

What followed was the worst recession since the 1930s. Everyone is asking the same questions: How did it happen? How did the banking sector, full of mature organizations with long histories of steady growth and run by highly professional people, suddenly collapse? Why did governance and regulatory systems fail so badly? Who is accountable? What lessons can we learn? And how do we prevent it from happening again?

Commentators have pointed their fingers at naïve central bankers, inept regulators, unrealistic ratings agencies, passive politicians, greedy executives, aggressive salespeople, unscrupulous mortgage brokers and short-selling hedge funds. While all these actors in this tragedy (or was it a farce?) are culpable in one way or another, the roots of the crisis lie elsewhere. They are deeply embedded in the management model itself. Hijacked by financial engineers a few decades ago, lent credence by academics and pseudo-management science, and seized upon by macho leaders and private equity partners, it was a slow-burning fuse waiting to explode.

The harbingers of this crisis were visible several years ago when Enron, World-Com and many other large corporations collapsed, triggering the Sarbanes-Oxley (SOX) legislation. Like today, fingers were pointed at greedy executives and inept regulators but, also like today's crisis, the root causes lay in a corrupt culture and a flawed management model.

If you doubt this conclusion, think about how the typical management model works.[2] Like the hare in the fable, leaders sit down once a year and plan the annual race: "What target will excite the market and boost the share price? Fifteen percent growth in earning-per-share feels good, so that's what we'll choose." The next step is to cascade this target down the organization so each division, business unit, function and department owns a piece of it. Tough negotiations take place as the less pliable managers protest that such growth is impossible. But most meekly accept the target and hope for the best. The incentive scheme helps to win them over. Once the budget is agreed the leadership team, just like the hare, thinks the race is over. They have done their job. Investors like the target and the share price responds favorably. Execution is a given.

The trouble is that this "predict and control" view of management is increasingly unhinged from reality. What happens if customer demand takes an unexpected turn for the worse (or even for the better)? What happens if there is a fire or flood, or a key supplier suffers a serious problem? What happens if a new competitor enters the market or an existing competitor changes prices or introduces a new "killer" business model? What happens if commodity prices, interest rates or inflation indexes gyrate up or down? In 2008, who predicted that the price of oil would drop from $147 per barrel to under $40 within six months, or that consumer demand for cars and property would fall by 30 to 40 percent within a similar period? There are many uncertainties that can derail the most carefully crafted targets, plans and budgets, and they are becoming more common and exaggerated over time. Many leaders have been forced to reset and recalibrate targets and budgets many times as they have tried to maintain some semblance of control.

The decline and fall of "command and control"

The traditional management model is commonly known as "command and control." As Figure I.1 illustrates, strategy is translated into targets, budgets and incentives that are cascaded down the organization, directing and dictating what

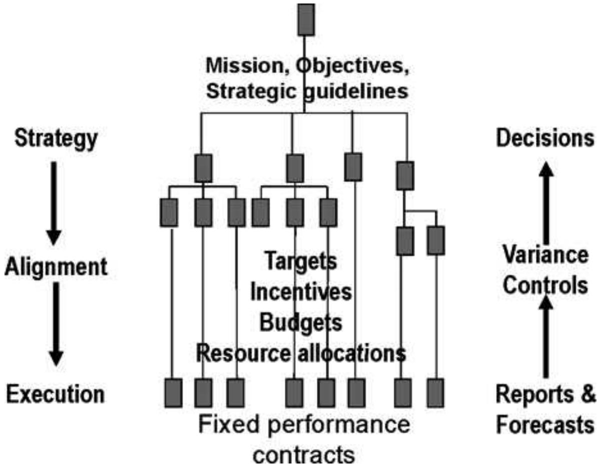
Mission, Objectives,
Strategic guidelines
Strategy
Alignment
Execution
Targets
Incentives
Budgets
Resource allocations
Fixed performance contracts
Decisions
Variance Controls
Reports & Forecasts

FIGURE I.1 The command and control model

people do. Each division, function and department is then accountable for meeting their numbers and must explain any variances from plan to a higher authority.

The command and control model is under pressure for many reasons. The switch in power from the supply chain to the demand chain (including marketers, consumers, designers and retailers) is forcing all suppliers to be more innovative in order to meet changing customer needs. The life cycles of products, strategies and business models are shrinking, placing greater pressure on the speed of response and continuous renewal of strategies. Entry costs into many different markets are falling as more products and services are delivered digitally. And innovation has moved from the exclusivity of the R&D department to anyone, anywhere, anytime.

Centralized, inflexible (command and control) organizations find it difficult to compete in this world of fast adaptation, continuous innovation and customer participation. They were designed for producing affordable products and services through standard processes as efficiently as possible. But merely being efficient is no longer a sustainable competitive position in the global economy. Everyone now works in a global labor force: there will always be someone cheaper than you. So the key to competitive advantage is differentiation. To avoid the "me-too" commodity trap, the focus of innovation is moving from products to services and from the exclusivity of the R&D department to employees, customers and business partners.

Differentiation can be applied in many areas, including how products are produced, delivered and consumed. Customers' needs increasingly go beyond the standard product or service, and they are prepared to pay more to satisfy them. Opportunities exist in every product and market category to provide more options from the basic product to the full menu. In fact, in some cases (e.g. cars), the standard product is nothing more than a loss leader. The profit comes from value-added options and finance packages. Being able to satisfy wide-ranging customer needs at the lowest cost is today's opportunity.

Another problem facing the centralized organization is that the Facebook generation is not prepared to be told what to do. In their personal lives they are used to fast, open collaboration between colleagues, and they are bringing these expectations into the workplace. They want to know about values, goals, plans and results. They want more engagement and fulfillment. And they are only willing to contribute their passion and creativity if the climate is one that encourages transparency and trust. It is clear that the rules of the management game have changed and there is no going back.

But the final (and perhaps fatal) blow has been delivered by the credit crunch. How has the command and control model become so toxic that a generation of macho leaders, financial engineers and private equity investors were able to use it to pursue the maximization of short-term shareholder value and personal wealth at almost any cost, destroy so many great organizations and take the whole financial system to the brink of collapse?

To answer this question, let's retrace the history of savings and loans organizations (known as "building societies") in the UK.

How the pursuit of "shareholder value" ruined many large UK Building Societies

One of the authors was born and raised in a part of northern England where many small savings and loans organizations were major features of the business landscape, with names such as "Halifax" (now part of HBOS and recently acquired by LloydsTSB) and "Bradford and Bingley" (now part nationalized and part owned by Spanish bank Santander). Building societies were owned by and existed for the benefit of their depositors and borrowers (their members). Indeed, their original purpose was to raise money through deposits and lend that money to their members (usually within the same community) to buy a house. Apart from occasional mergers, they grew steadily (within the limits of their income) and some (like the Halifax) became giants of the industry. Their aim was to adapt and endure, and for over 150 years they achieved this purpose admirably. But in the 1980s their world changed.

In 1986 a new Act of Parliament was passed to allow building societies to "demutualize." This meant that they could convert their status to banks and become listed companies. In the 1990s, driven by the prospect of directors and members making capital gains from the listing of the shares, many took advantage of this Act and became public companies. All seemed to start well. But over the next decade new "professional" highly paid managers arrived and took action to "maximize shareholder value," "implement niche strategies," "align management incentives," "leverage the asset base," "create off-balance-sheet vehicles," "trade in innovative financial products" and "manage risk."

Their aim was to reach their goal (now to "maximize shareholder value") as quickly as possible, so that within a few years they would make the company so attractive that they could either acquire other companies or be acquired themselves. Whichever path was taken (and whether the company continued to exist or not), shareholders (and managers) would win. And in an age of deregulated markets, low interest rates, rising property prices, "innovative" financial products and gullible borrowers, everything was looking rosy. Shareholder values were booming, financial bonuses were exploding and mortgages were flying out of the door as borrowers who were previously excluded from the market were able to buy cheap products based on little or no evidence of secure income. But in 2007 their world changed again.

In August 2007, one of the more aggressive former UK building societies, Northern Rock, collapsed. Its high-growth oriented business model, based on raising short-term debt to fund aggressive growth in mortgage sales, ceased to function. And by September 2008 many of its UK rivals including RBS (Royal Bank of Scotland), HBOS, Alliance & Leicester and Bradford & Bingley had either been nationalized or taken over by more stable institutions.

In less than 15 years after the building societies became public companies, their smart operators, educated at the best universities and business schools, had decimated a whole industry, leaving shattered communities and thousands of angry employees and shareholders wondering what went wrong. In a bizarre twist to the banking tale, it emerged that in the same week that news broke of the collapse of RBS its former chief executive, Sir Fred Goodwin, had asked for and received a doubling of his pension fund before he would agree to leave the bank. This took his pension to £16 million, which will pay out £693,000 annually for life.[3]

The same drama was playing out elsewhere, particularly in the United States as Bear Sterns, Lehman Brothers, Washington Mutual, Countrywide Financial, AIG, Merrill Lynch, Citigroup, Fannie Mae and many other financial services organizations collapsed and were forced to seek government help. Even the great Goldman Sachs was in trouble. In less than a generation, all these tortoise-like organizations had turned into hares. They thought that making money was easy. All they had to do was set aggressive targets, underpin them by even more aggressive bonuses and wait for profits to increase and share values to rise.

The downward spiral of decline – what went so disastrously wrong?

The decline and fall of command and control management didn't happen overnight. It was a gradual deterioration. Here are some of the key steps along this fateful journey:

- **“Shareholder value” became an obsession.** One of the reasons why many organizations have gone off the rails is that their leaders lost sight of why they were in business. While they all no doubt had mission statements with all the right words in them, what came across to employees and customers was that the only purpose in evidence was to maximize short-term shareholder value. But if organizations are seen as purely money-making machines, then we are all in trouble. Of course they need to make money to reinvest and renew the business and make a decent return on the risk capital invested, but this shouldn’t be *why* they are in business. Indeed, if the purpose is perceived as only making money, then it should come as no surprise that people act in their own self-interest. Nor should it surprise anyone that power, greed and corruption are the outcomes.

- **Aggressive targets and incentives encouraged the wrong behavior.** The rise in “pay-for-performance” over the past 20 years has reinforced a culture of “business is about making money” and “management is about meeting the target.” CEOs in particular have been treated by the media like celebrity athletes (many have agents and lawyers as part of their “team”) who appear to be more interested in maximizing their short-term rewards than in longer-term success. Many executives at failed banks used accounting trickery and financial engineering to meet aggressive targets, achieve large bonuses and satisfy demanding shareholders. Like drugs, targets and incentives are addictive. But also like drugs, they come with many side effects.[4] They provide the illusion that leaders can “predict and control” future outcomes in a fast-changing, highly unpredictable world. Target-setting is often a game of charades that rewards skilled political operators rather than the best team-builders or innovative thinkers. While many leaders would no doubt argue that targets and incentives stretch and motivate, the evidence suggests that they stifle innovation and growth as well as drain energy and demotivate people. The result is unhappy customers and underperforming companies.[5]

- **Regulation and risk management has failed.** Why didn’t the regulatory system work? One reason is that rules don’t change behavior. Almost without exception, all the firms that collapsed had unqualified financial statements.[6] When confronted with more regulations, large companies employ lawyers to work out how to get around them. Moreover, large companies are more likely to capture the most talented professionals, who are able to run rings around their counterparts in regulatory authorities. The reality is that too many organizations continue to operate in a gray area between what’s right or wrong and too often step over the wrong side of the ethical line. When a short-term profit opportunity beckons, there is always a way to “explain away” the ethical dilemma or the risk. All the time and money spent on regulation and compliance has failed to change management mindsets, leaving a culture of self-interest, unethical behavior and outright fraud intact.[7] In July 2010 Citigroup agreed to pay a $75 million penalty for repeatedly making misleading statements in earnings calls and public filings through 2007. Apparently, Citigroup said it had reduced its investment banking unit's exposure to subprime-mortgage-backed securities to $13 billion or less, when the actual exposure was closer to $50 billion.[8] In the UK, corporate fraud losses hit a record £1bn in the first half of 2010, with about 49 percent of these frauds occurring in the finance and insurance sectors.[9]

- **Central control is more difficult and expensive.** In repeated attempts to realign strategy, structure and systems over the past 20 years or so, many leaders have expanded their control systems as increasing numbers of standard setters, compliance officers, risk managers, performance controllers, project leaders, internal consultants, quality controllers, customer relationship managers, business analysts, management advisors and many other back-office management positions have proliferated. And most of these new roles have come with expensive IT systems, training courses and management controls. The management control bureaucracy can often represent several layers of management: the people who work there do little else but handle information and make decisions that link high-level strategy with low-level execution. The levels of waste can be astonishing.[10]

- **Trust has declined.** The public perception of large corporations is at its lowest point in recent history. Just 33 percent of European and 40 percent of US consumers say that they trust large global corporations to act in society's best interest all, most, or even some of the time.[11] Too many organizations use the creativity of their people not to develop new business models and products to attract new customers but to think up as many (often devious) ways as possible to squeeze more profit from existing customers without offering much in return. For example, a substantial proportion of retail banking profits comes from penalizing customers for breaking arbitrary, complicated rules about minimum balances, credit limits and payment deadlines. Mobile phone companies make much of their money out of the minutes we don't use. Hotels and travel operators make it hard to find out about discounts or upgrades, and some airlines have computer algorithms that run so often that it is impossible to identify what the "normal" price of a flight ought to be. A "surveillance" culture is emerging as leaders use technology to check the time their people spend online, the time it takes to answer the telephone, and the time it takes to complete a call to a customer. Computer spyware and even cameras are used to check their every movement. The result is even less loyalty and more cheating.

- **Employees are neither engaged nor empowered.** In the 1970s and 80s "empowerment" was a concept that exercised the minds of many leaders. Though some leaders used the right words, their actions were undermined by intractable middle managers and suffocating control systems that demanded obedience to the plan. Little has changed. A 2007 Towers Perrin survey of nearly 90,000 employees worldwide found that only 21 percent felt fully engaged at work (meaning they're willing to go the extra mile to help their companies succeed) and 38 percent were disenchanted or disengaged. The result is an "engagement gap" between the discretionary effort companies need and what people actually want to invest, and companies' effectiveness in channeling this effort to enhance performance. That negativity has a direct impact on the bottom line. Towers Perrin found that companies with low levels of employee engagement had a 33 percent annual decline in operating income and an 11 percent annual decline in earnings growth. Those with high engagement, on the other hand, reported a 19 percent increase in operating income and 28 percent growth in earnings per share.[12] The result is that too few people are engaged in strategy and innovation, which remain exclusive, top-down processes. And frontline teams now spend increasing amounts of their time on annual budgets, irrelevant reports, burdensome administration and unnecessary meetings.

The failure of the command and control model means that the wrong story is being told about business. Joe Public hears more about excessive pay, defective products and environmental disasters than about the huge contribution that businesses all over the world make to the well-being of everyone. Where would we be without life-saving drugs, flat-screen TVs, laptops, mobile phones, low-cost airlines and so on? None of these breakthroughs could have been achieved by individuals working alone. They all needed thousands of people to collaborate effectively within and across large corporations to bring new products and services to market. There is an urgent need to eradicate the root causes of bad behavior and enable leaders to tell a more uplifting and inspiring story about business today.

Rethinking the management model

All these problems have been festering for many years. Successive leaders trying to solve them have spent billions of dollars on reorganizations, downsizing programs and management tools. But few have succeeded. The trouble is that the problems are *systemic*. They are embedded in management theories and mental models that most leaders base their management practices upon. For over 100 years these theories and models have been derived from some variant of "classical economics" and "command and control" management, both of which assume that the primary role of managers (agents) is to maximize value for shareholders (principals).

In his landmark 1962 book *Strategy and Structure* Alfred Chandler explained that the reason this command and control model proved so powerful was that it emphasized the decentralization of responsibility to operating divisions whose activities were planned, coordinated and controlled by a strong corporate center – the "general office," in Chandler's terms – which also made the decisions about resource allocation. He showed how the management process created by this organization allowed companies to apply their resources more efficiently to opportunities created by changing markets and developing technologies.[13]

The command and control model has been subject to much criticism over recent years for focusing on the hierarchy rather than the customer and requiring high costs to support its bureaucratic control systems. However, we must remember that, like mass production, it served 20th-century companies and their customers reasonably well, as productivity and living standards were steadily improved. Throughout this time, when manufacturing was a much larger part of most economies than it is today, employees served machines and simply did what was specified in their employment contract. Their knowledge was of little value. They were just cogs in a huge wheel that was driven from the center.

In today's service- and digital-based economy, however, machines serve people, and human knowledge is increasingly needed and valued. Most innovations come from employees rather than specialist research departments.[14] The reason for this dramatic role reversal is that to compete in today's fast-changing markets organizations need to attract and keep the best people, innovate continuously, respond rapidly to change, satisfy customer needs at the lowest cost and act ethically. These new competitive imperatives are not easily met by command and control organizations. Creativity cannot be centrally planned and controlled, and leaders are finding that they have little choice but to devolve power and responsibility to people closer to the customer.

But if employees are expected to take responsibility for decisions and be accountable for their actions, they need a framework that gives them the freedom and confidence to act and that guides them to the right choices. This framework should tell them something about the purpose of the business. It should tell them why they should give their time and commitment to this organization. It should tell them about what the organization values and the principles that govern relationships with colleagues both within the organization and with external parties. It should inform them about goals and performance expectations. It should inform them about the operating boundaries within which they should work. And it should tell them about the support, information and resources they will receive to enable them to perform.

Business schools: the pursuit of misguided models

None of these changes come naturally or easily to leaders that have attended the top business schools or risen through the ranks of most large corporations over the past 25 years. Despite the pioneering work of many great social scientists (such as McGregor and Maslow), it seems to be the economic and financial theorists (such as Williamson and Friedman) that leaders have most closely followed and whose ideas they have applied. The late management scholar Sumantra Ghoshal believed that many of these theories and ideas developed in leading business schools have done much to sustain command and control thinking and practice, leading to many of the problems we are experiencing today. Ghoshal summarized them in the following way: "In courses on corporate governance grounded in agency theory, we have taught our students that managers cannot be trusted to do their jobs – which, of course, are to maximize shareholder value – and that to overcome 'agency problems,' managers' interests and incentives must be aligned with those of the shareholders by, for example, making stock options a significant part of their pay. In courses on organization design, grounded in transaction cost economics, we have preached the need for tight monitoring and control of people to prevent 'opportunistic behavior.' In strategy courses, we have presented the 'five forces' framework to suggest that companies must compete not only with their competitors but also with their suppliers, customers, employees, and regulators."[15]

Ghoshal also took issue with the "scientific" model adopted by many business schools (an approach that economist Friedrich Hayek described as "the pretense of knowledge"). As Ghoshal noted, this pretense has demanded theorizing based on partialization of analysis, the exclusion of any role for human intentionality or choice, and the use of sharp assumptions and deductive reasoning."[16] The aim was to turn management into a "real" science like physics (Ghoshal was originally a physicist). He believed that this pseudo-scientific approach has far-reaching consequences. Because human behavior and relationships can't be modeled, they are conveniently ignored. So you simply end up with equations based on financial numbers (often with simple "cause-and-effect" relationships). This explains why so many managers practice "management by numbers."[17] Ghoshal's scathing attack came together in this evocative statement:

> *"Combine agency theory with transaction cost economics, add in standard versions of game theory and negotiation analysis, and the picture of the manager that emerges is one that is now very familiar in practice: the ruthlessly hard-driving, strictly top-down, command-and-control focused, shareholder-value-obsessed, win-at-any-cost business leader."*[18]

Economics: a failure to embrace new thinking

While management thinking has been treading water for decades, economic thinking has moved on. Author of *The Origin of Wealth* Eric Beinhocker believes that business leaders can learn many lessons from these recent shifts. "Traditional economic theory sees the economy as a rubber ball rolling around the bottom of a large bowl," explains Beinhocker. "Eventually the ball will settle down into the bottom of the bowl, to its resting, or equilibrium point. The ball will stay there until some external force shakes, bends, or otherwise shocks the bowl, sending the ball to a new equilibrium point. The mainstream paradigm of economics over the past hundred years has portrayed the economy as a system that moves from equilibrium point to equilibrium point over time, propelled along by shocks from technology, politics, changes in consumer tastes, and other external factors.[19] Thus the dynamism of the economy comes from a process of equilibrium, then shock, then new equilibrium, then shock, then new equilibrium, and the economy moves from one *temporary equilibrium* to another."[20] This is known as "punctuated equilibrium."

But according to the scientific community, economic thinking is in some sort of time warp. In the early 1980s a number of scientists and economists decided to get together at the Santa Fe Institute and compare notes. One of the physicists commented that looking at economics reminded him of his recent trip to Cuba. As he described it, in Cuba you enter a place that has been almost completely shut off from the Western world for over 40 years by the US trade embargo. For the physicists, much of what they saw in economics had a similar "vintage" feeling to it. It looked to them as if economics had been locked in its own intellectual embargo, out of touch with several decades of scientific progress, but meanwhile ingeniously bending, stretching and updating its theories to keep them running.[21]

The same observation can be made about management thinking: after all, most management and accounting theory is derived from classical economics. Like traditional economists, most business leaders (and academics) have been living in their own "Cuba," blissfully ignorant of progress in scientific thinking about how systems work (we'll get to a definition of a "system" shortly).

For example, most business leaders still view the organization as an obedient machine with levers that can be pulled to change efficiency, speed and direction. Its origins go back to Sir Isaac Newton's model of the physical world as a clocklike mechanism – one gear turns, which makes another gear turn, and so on. This notion of cause-and-effect addresses one of the deepest human fears – that of losing control. Most managers still use machine metaphors for business change such as "reengineering the parts" and getting the organization to "fire on all cylinders." Author of *Leadership and the New Science* Margaret Wheatley put it this way:

> *"Amid all the evidence that our world is radically changing, we still think of organizations in mechanistic terms, as collections of replaceable parts capable of being reengineered. We act as if even people were machines, redesigning their jobs as we would prepare an engineering diagram, expecting them to perform to specifications with machinelike obedience. Over the years, our ideas of leadership have supported this metaphoric myth. We sought prediction and control, and also charged leaders with providing everything that was absent from the machine: vision, inspiration, intelligence, and courage. They alone had to provide the energy and direction to move their rusting vehicles of organization into the future."*[22]

From clockwork to complex systems

But, according to Beinhocker, the dream of a clockwork universe ended for science in the 20th century, and is ending for economics in the 21st. The economy is too complex, too nonlinear, too dynamic and too sensitive to the twists and turns of chance to be amenable to prediction over anything but the very shortest of terms.[23] While Beinhocker is talking about the economy as a whole, the same point is valid for its subsets, including organizations of every kind.

Other traditional economic assumptions have also been under attack in recent years. Whereas traditional economists still believe in functional integration, agency theory, and "rational economic man" (someone who only responds to "carrot and stick" performance drivers such as targets and incentives), a new breed of "behavioral" economists such as Herbert Simon, Daniel Kahneman and Amos Tversky have shown that while people are intelligent in their decision-making, they are intelligent in ways very different from the picture presented by traditional economics. Real people are actually quite poor at complex logical calculations, but very good at quickly recognizing patterns, interpreting ambiguous information and learning. Real people are also fallible and subject to biases in their decision-making. Finally, they engage in what Herbert Simon called *satisficing*, whereby one looks for a result that is "good enough" rather than the absolute best.[24]

While economists were pursuing their vision of the economy as an equilibrium system, physicists, chemists, and biologists during the latter half of the 20th century became increasingly interested in systems that were far from equilibrium, that were dynamic and complex, and that never settled into a state of rest. Beginning in the 1970s, scientists began to refer to these types of systems as complex systems. In brief, a complex system is a system of many dynamically interacting parts or particles. In such systems the micro-level interactions of the parts or particles lead to the emergence of macro-level patterns of behavior. Beinhocker uses the example of a whirlpool to explain this behavior: "A single water molecule sitting in isolation is rather boring," he notes. "But if one puts a few billion water molecules together and adds some energy in the right way, one gets the complex macro pattern of a whirlpool. The pattern of the whirlpool is the result of the dynamic interactions between the individual water molecules. One cannot have a whirlpool with a single water molecule; rather, the whirlpool is a collective or 'emergent' property of the system itself."[25]

Systems thinking: acting on the whole rather than the parts

Organizations are like whirlpools. Despite the fine words in mission statements and strategy documents, it is the thousands of decisions taken every day by hundreds of managers that create (or destroy) value for customers and ultimately shareholders. Innovation, adaptation and collaboration are increasingly seen as emergent properties of the collective organization culture (i.e. the values, norms, standards, and processes that connect people together to create and deliver products and services to customers).

As Fitjof Capra explains in his synthesis of "systems thinking" *The Web of Life,* "systems thinking" does not concentrate on basic building blocks but rather on the basic principles of organization. "Systems thinking" is "contextual," which is the opposite of analytic thinking. Analysis means taking something apart to understand it; systems thinking means putting it into the context of the larger whole," notes Capra.[26] He emphasizes the point that living systems are integrated wholes whose properties cannot be reduced to those of smaller parts. Their essential or "systemic" properties are properties of the whole, which none of the parts have. They arise from the "organizing relations" of the parts, i.e. from a configuration of ordered relationships that is characteristic of that particular class of organisms, or systems. Systems properties are destroyed when a system is dissected into isolated elements.[27] What is destroyed when a living organism is dissected is its pattern. The components are still there, but the configuration of relationships between them – the pattern – is destroyed, and thus the organism dies.[28]

Meg Wheatley believes that the correct scientific metaphor for management should draw on *quantum* rather than Newtonian physics. She makes the same point as Capra: that one of the key differences is a focus on holism rather than parts. Systems are understood as whole systems, and attention is given to *relationships within those systems* (the root meaning of the word "system" derives from the Greek *synhistanai,* "to place together"). To understand things systemically literally means to put them in context, to establish the nature of their relationships.[29]

"When we view systems from this perspective," notes Wheatley, "we enter an entirely new landscape of connections, of phenomena that cannot be reduced to simple cause and effect, or explained by studying parts as isolated contributors. We move to a land where it becomes critical to sense the constant workings of dynamic processes, and then to notice how these processes materialize as visible behaviors and forms."[30]

Seeing businesses as adaptive systems

There are numerous types of "systems" including biological systems (for example, the human body), mechanical systems (a thermostat) and social systems (a business organization). A complex system is usually made up of many smaller systems or subsystems. For instance, a business organization is made up of many processes and subprocesses that continuously connect and combine to achieve a goal (such as satisfying customer needs).

Seeing social systems such as business organizations as complex, adaptive systems has profound implications. As cybernetics expert Steve Morlidge explains, "Instead of viewing them as functional machines whose performance can be optimized, they are in reality creative, adaptive entities that explore, experiment and learn over time, changing their goals and strategies, and transforming themselves and their environment. This means that instead of basing our strategies and actions on *prediction,* with the development and implementation of a plan designed to take us from 'here and now' to 'there and then,' we have to adopt more frequent monitoring and reassessments, with an awareness and capacity to change course to make use of what works and discard what doesn't. This is an approach that recognizes the constant need to learn about what is happening and to try to make sense of it as quickly as possible."[31]

Systems theory tells us that the traditional mechanical model *cannot* be effective, except in a very stable environment. As Steve Morlidge explains, Ross Ashby's Law of Requisite Variety, formulated in the 1950s, sets out the necessary relationship between the complexity of the environment, the flexibility of a control system and the specificity of the goals imposed on the system. The more complex the environment, and the "tighter" the targets, the more flexibility the control system must have: "only variety can absorb variety." Failure to provide "requisite variety" will result in instability (boom and bust) and ultimately system failure. The only way out is to "game the system," such as artificially injecting flexibility by other means (in other words, by cheating). Given a complex environment, Ashby's Law tells us, the only way that complex organizations *can* be successfully controlled is through exploiting the capacity of a system for self-organization and self-regulation. In other words, we need to adopt an organic model.[32]

An alternative model based on adaptive systems

Within the context of this book it is only possible to scratch the surface of "systems thinking," but even so, it offers a viable alternative theory to the mechanistic view that has underpinned management thinking and practices for too long and should now be consigned to history. To summarize, there are four principles that we can use as the foundation stones of an alternative management model:

1. Organizations are whole systems (the whole system rather than the parts determines performance).
2. Organizations are webs of relationships that are unpredictable (rather than cause-and-effect relationships that are predictable).
3. Organizations are self-organizing and self-regulating (they don't require central coordination and control).
4. Change is best seen as integrative and adaptive rather than project-driven and reactive.

How different organization *models lead to different* management *models*

These contrasting models of how organizations work have major implications for management thinking and practice. Table I.1 shows how the "obedient machine"

TABLE I.1 Contrasting models

Organization model	Organization as an obedient machine	Organization as an adaptive system
	Organizations are made up of a collection of replaceable parts (parts determine the performance of the whole)	Organizations are whole systems (the whole system determines performance)
	Organizations comprise "cause-and-effect" relationships that are predictable	Organizations are webs of relationships that are unpredictable
	Organizations need central planning, coordination and control	Organizations are self-organizing and self-regulating
	Change is reactive and project-driven	Change is integrative and adaptive
	↓	↓
Management model	Command and control	Adaptive management
	Aim is to bind people to a plan	Aim is to bind people to a cause
	Governance is based on rules and regulations	Governance is based on values and judgment
	Information is bounded and restricted	Information is unbounded and transparent
	Natural organization form is functional hierarchy	Natural organization form is team-based network
	Teams are micro-managed	Teams are trusted to make decisions
	Teams are accountable for narrow targets	Teams are accountable for holistic success criteria
	Goal is to meet a short-term fixed target	Goal is to continuously improve relative to peers
	People are rewarded based on meeting short-term targets	Teams are rewarded based on relative improvement
	Strategy is an annual top-down event	Strategy is a continuous and inclusive process
	Plans are coordinated centrally through annual planning cycles	Plans are coordinated locally based on dynamic interactions
	Resources are available just-in-case	Resources are available just-in-time
	Control comes from centrally agreed budgets	Control comes from fast, frequent feedback

view leads to command and control management and the "adaptive systems" view leads to a different set of principles that we have called "adaptive management." We believe that the 12 principles of adaptive management sit comfortably with systems thinking.

The organization-as-an-obedient-machine model takes leaders down the pathway of shareholder value maximization, short-term targets (and "fixing" the results);

individual financial incentives; employee contracts; central planning, coordination and control; central resource allocations and budgetary control. The core assumption is that everything is controllable if an organization can be broken down into its constituent parts and the right steering mechanisms and metrics used to ensure that each part achieves its optimum performance (each part is likely to have its own target and measures independent of others). If there is a problem with any part, a range of "tools" can be used to "fix" or "re-engineer" the problem. But focusing on each separate part is likely to lead to dysfunctional behavior as one unit tries to improve its performance at the expense of another (this is known as "sub-optimization").

If the organization is struggling to satisfy shareholder expectations it appoints a new CEO who can apply the necessary "shock treatment" in terms of restructuring, re-engineering and reorganization. In other words, like the "punctured equilibrium" view of the economists, many analysts and boards believe it is the direct action of "heroic" leaders (the "shock" to the system) that creates the necessary dynamism, innovation, change and value creation. Too many leaders believe that they are responsible for changing the organization. So when the engine is misfiring they bring in the organizational "fixers" with their toolboxes full of spanners and levers that can retune the necessary parts. Few have any faith that the people actually doing the work might have a view about how it can be improved.

This machine-like model represents the current "management cockpit" view of leadership – a sort of 21st-century computer game in which a few leaders at the center control the actions of hundreds of front-line managers by monitoring variances against a fixed plan in "real time." In this model, measurement replaces management. The aim is to design judgment out of the system. Many leaders see this vision as the ultimate goal of technology – a sort of holy grail of IT and accounting.

But there is deep cynicism about these approaches based on machine-like assumptions. It is increasingly tough (and expensive) to keep strategies, structures and systems in constant alignment in a fast-changing world. Change is invariably reactive and disruptive; endless restructuring, reorganizing and re-engineering programs come and go with, in most cases, temporary relief but little longer-term effect. Employees are small cogs in this giant organizational wheel of fortune. The result is that leaders consistently fail to connect with their people and thus miss the opportunity of harnessing a potentially huge store of "free" knowledge and creativity.