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THE LEADER'S DILEMMA

HOW TO BUILD AN EMPOWERED AND ADAPTIVE ORGANIZATION WITHOUT LOSING CONTROL

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Acknowledgements

The BBRT is an independent, international research collaborative and shared learning network of member organizations that is at the centre of a movement to help organizations transform their management models to enable sustained, superior performance.

The Beyond Budgeting model has been derived from the BBRT's research into the 'best practices' of exceptional organizations.

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The Leader's Dilemma

> I have discovered that the best innovation is sometimes the company, the way you organize a company.[1]
>
> Steve Jobs, *Former CEO of Apple*

The Leader's Dilemma

Many leaders have visions of building 'strategy-focused', 'quality-driven', 'lean and agile', 'team-based' and 'customer-focused' organizations. They all want to cut bureaucracy and empower their people. They all want to manage strategies instead of budgets and adapt to each new reality rather than be a slave to the plan. But few can see a way to do this within the 'command-and-control' management models they have inherited.

This is the leader's dilemma. How can he or she dismantle the bureaucracy and budget and build empowered and adaptive organizations yet maintain coordination and control? What does an alternative management model look like and how do they get from where they are today to where they want to be in three or five years from now?

Introduction

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 he awakes the tortoise is at the finishing 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. The tortoise always wins 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, like tortoises, 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 (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, WorldCom 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.

Why has the Hare-like management model failed?

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? 15 percent growth in earning-per-share feels good, so that's what we will 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 oil price would change from $147 per barrel to under $40 within six months or that consumer demand for cars and property would fall by 30-40 percent within a similar period? There are so 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.

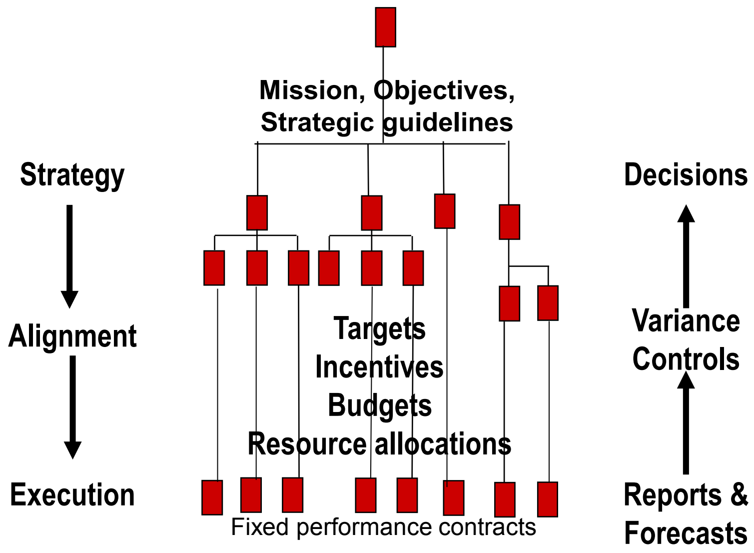
The traditional management model is commonly known as 'command and control'. As figure 1 illustrates, strategy is translated into targets, budgets and incentives that are cascaded down the organization and direct and dictate what people do. Each division, function and department is then accountable for meeting their numbers and must explain any variances from plan to a higher authority.

Command and control model under pressure

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 of goods and services to be more innovative in order to meet changing customer needs. The life cycles of products, strategies and business models are shrinking thus 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 being efficient on its own is no longer a sustainable competitive position in the global economy. Everyone now works in a global labor force and 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.

Figure 1 – The Command and Control Model



Differentiation can be applied in many areas including how products are produced, delivered and consumed. Customers increasingly have needs that 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 no longer 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?

How has the command and control model become so toxic?

To answer this question let's retrace the history of savings and loans organizations (known as "Building Societies") in the UK. 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 was passed to allow building societies to "demutualize." This meant that they could convert their status into 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 who 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 ex-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 fifteen years after becoming public companies, the 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 tail, it emerged that in the same week that news broke of the collapse of RBS its former chief executive, Fred Goodwin, had asked for and received a doubling of his pension pot before he would agree to leave the bank. This took his pension pot to £16 million, which will pay out £693,000 annually for life.[3]

The same dramas were playing out elsewhere, particularly in America 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.

What went wrong?

So 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.

- **Aggressive targets and incentives encouraged the wrong behavior.** The rise in 'pay-for-performance' over the past twenty 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 football players (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.

- **Regulation and risk management has failed.** Why didn't the regulatory system work? Almost without exception all the firms that collapsed had unqualified financial statements.[4] One reason is that rules don't change behavior. When confronted with more regulations large companies employ lawyers to work out how to get around them.

- **Central control is more difficult and expensive.** In repeated attempts to realign strategy, structure and systems over the past twenty 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.

- **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.[5] 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.

- **Employees are neither engaged nor empowered.** In the 1970s and 80s 'empowerment' was a concept that exercised the minds of many leaders. Though many 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.

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.

We need to rethink the management model

These problems have been festering for many years. Successive leaders have spent billions of dollars on reorganizations, downsizing programs and management tools trying to solve them. 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 a hundred 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 1962 landmark 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 company's resource allocation decisions. 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.[6]

While 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, we must remember that, like mass production, it served twentieth 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 their knowledge is increasingly needed and valued. Most innovations come from employees rather than specialist research departments.[7] 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 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.

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. 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 and have led 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, is 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."[8]

He also takes 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."[9] 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'.[10] His 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."[11]

Economic, scientific and management thinking

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 man's deepest 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."[12]

But, according to Beinhocker, the dream of a clockwork universe ended for science in the twentieth century, and is ending for economics in the twenty-first. 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.[13] 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.[14]

While economists were pursuing their vision of the economy as an equilibrium system, during the latter half of the twentieth century, physicists, chemists, and biologists 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," notes Beinhocker. "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."[15]

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).

Systems thinking

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. [16] 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.[17] 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.[18]

Meg Wheatley believes that the correct scientific metaphor for management should be taken from *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.[19]

"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."[20]

There are numerous types of 'systems' including biological systems (for example, the human body), mechanical systems (for example, a thermostat) and social systems (for example, a business organization). A complex system is usually made up of many smaller systems, or subsystems. For example, a business organization is made up of many processes and sub-processes that continuously connect and combine to achieve a goal (for example, 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."[21]

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 1950's, 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 into the system by other means (in other words, by cheating). Given a complex environment, this 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.[22]

Within the context of this paper 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 these thoughts 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

The adaptive management model

Traffic lights and roundabouts provide a good analogy between the command and control management model and the empowered and adaptive model. Both are ways of managing traffic, with the traffic light the person who designed the system is in control, based on feed backs from the road sensor. This is top-down control where the motorist can only obey the signals. The Roundabout provides another alternative. In this case the motorists have to think for themselves and determine when it is safe to enter and leave the roundabout, so the motorist is in control and the system operates without any top-down control. Of course there are a few ground rules (governance) such as when entering giving way to traffic already on the roundabout. But self-organization and self-regulation work.

These contrasting models of how organizations work have major implications for management thinking and practice. Figure 2 shows how the 'obedient machine' 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.

Figure 2 – 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 of '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

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 ‘reengineer’ 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, reengineering 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 twenty-first 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 IT and accounting holy grail.

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 and endless restructuring, reorganizing and reengineering 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.

The alternative view is that organizations are adaptive systems and this model takes us down a different pathway. The organization has a noble purpose beyond shareholder value; the goal is to adapt and endure; people are motivated by self-fulfillment rather than money; people work in self-managed teams; information is unbounded and transparent; and control comes from fast, frequent feedback.

Many leaders buy into the adaptive systems view. Most have visions of building ‘strategy-focused’, ‘quality-driven’, ‘lean and agile’, ‘team-based’ and ‘customer-focused’ organizations. They all want to cut bureaucracy and empower their people. They all want to manage strategies instead of budgets and adapt to each new reality rather than be a slave to the plan. But few can see a way to do this within the management models they have inherited. This is the leader’s dilemma. How can he or she dismantle the bureaucracy and budget and build empowered and adaptive organizations yet maintain coordination and control? What does an alternative management model look like and how do they get from where they are today to where they want to be in three or five years from now?

They should take comfort from the fact that they are neither alone nor are they pioneers. The early life forms of a management model based on adaptive systems have been around for quite a long time. A few visionary leaders such as Herb Kelleher at Southwest Airlines (USA), Taiichi Ohno at Toyota (Japan), Jan Wallander at Handelsbanken (Sweden), William Davidson at Guardian Industries (USA), Bill Gore at W.L. Gore & Associates (USA), Götz Werner at dm drogerie-markt (Germany), Egon Zehnder at Egon Zehnder International (Switzerland), John Mackey at Whole Foods Market (USA) and Ken Iverson at Nucor Steel (USA) have always passionately believed in empowering people with information and providing them with the scope, authority and support to make key decisions.

These leaders were successful primarily because they focused their attention (either explicitly or implicitly) on creating wealth over the longer term. They were also deep thinkers and introduced a different belief system to their organizations. They rejected command and control management and promoted leaders who naturally adopted a style that emphasized purpose, values, humility, ethics, and that inspired people to raise their performance. As well as being open and accessible, they were also good listeners. It is a leadership style encapsulated in this statement by Southwest Airlines founder Herb Kelleher: “Leadership is being a faithful, devoted, hard-working servant of the people you lead and participating with them in the agonies as well as the ecstasies of life.”[23]

In more recent times, a group of organizations across industries and geographies have decided to follow the same path as these visionary leaders. Though for most of them the elapsed time is insufficient to draw firm conclusions about their long-term success the initial signs are positive. These organizations include American Express (USA), Statoil (Norway), HCL Technologies (India), Telenor (Norway), Telekom Malaysia (Malaysia), Coloplast (Denmark) and Hilti (Liechtenstein).

Figure 3 – The adaptive management model

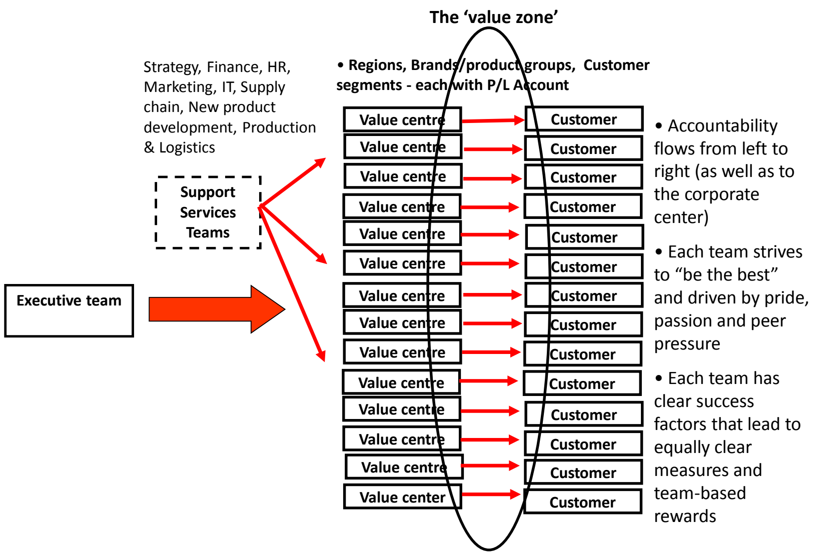


Figure 3 illustrates the shape and important features of the ‘adaptive’ management model. The major change is that the traditional organizational pyramid is turned on its side to face the customer. Accountability flows from left to right across three teams: The *executive team* is the C-level suite responsible for setting business purpose, high-level goals and strategic direction as well as challenging other teams to maximize their performance. *Support services* teams such as design, production, logistics, supply chain, finance, human resources, marketing, and information technology are responsible for serving and supporting value centers. *Value center* teams are responsible for formulating and executing strategy and for continuously improving their performance against peers. They invariably have their own profit and loss accounts and are typically created around businesses/markets, brands/product groups and regions/countries. In knowledge- and service-based organizations value is no longer created in the R&D department or the head office suite. It is created in the 'value zone', that is, at the interface between a company and its customers.

The 12 principles of the adaptive management model and how you can embrace them are summarized in Figure 4.

Figure 4: The 12 Beyond Budgeting Principles
Change in Leadership
Governance & transparency
1. **Values** – bind people to a common cause; not to a central plan
2. **Governance** – govern through shared values and sound judgment; not detailed rules and regulations
3. **Transparency** – make information open and transparent; don't restrict and control it
Accountable teams
4. Organize around a seamless network of accountable teams; not around centralized functions
5. **Trust** – trust teams to regulate and improve their performance; don't micro-manage them
6. **Accountability** – base accountability on holistic criteria and peer reviews; not on hierarchical relationships
Change in Processes
Goals & rewards
7. **Goals** – set ambitious medium-term goals; not short-term, fixed targets
8. **Rewards** – base rewards on relative performance; not on meeting fixed targets
Planning & controls
9. **Planning** – make planning a continuous and inclusive process; not a top-down annual event
10. **Coordination** – coordinate interactions dynamically; not through annual budgets and planning cycle
11. **Resources** – make resources available as needed; not through annual budget allocations
12. **Controls** – base controls on fast, frequent feedback; not on budget variances

These principles are explained in full by Hope, Bunce and Röösli in their book "The Leader's Dilemma: How to build and empowered and adaptive organization without losing control"[24].

Where to start?

Implementing these principles can seem a daunting prospect with no clear idea where to start. Many companies have started with the annual budget process, which actually affects several principles. One of the main elements of the command-and-control model is the budget process. Budgets were brought in to support the management methods of the 1920s – nearly 100 years ago. But the world has changed drastically since the 1920s. Today budgets support an elaborate guessing game. The people at the top invent a set of numbers (targets) and then through the budget template ask every department to come up with a budget. They then see if this matches the targets (which they did not disclose). Then we go around the whole process again and again until the budgets match the targets. Meanwhile the world and the competition have moved on and the targets are no longer valid, and nor is the budget. Why do we only do this once a year, how do we manage in between? We need to manage continuously and re-plan when events change, be event-driven and not calendar-driven.

Above all we need to first understand what the budget does now and how we can do these elements better and in a more empowered and adaptive manner. Then we don't lose control, whatever that means. The budget is involves targets and rewards, planning and forecasting and resource allocation. It ends up with the same number, but with conflicting purposes. We start by separating out these three elements and then we improve them as follows:

The Budget Purpose	Step 1 – Separate	Step 2 – Improve
Budget = • Target • Forecast • Resource allocation	Target – what we want to happen	• Ambitious • Relative KPIs where possible • Holistic performance evaluation
	Forecast – what we think will happen	• Unbiased – expected outcome • Limited detail
	Resource allocation	• Dynamic – no annual allocation • KPI targets, mandates, decision gates & criteria
"Same number – conflicting purposes"	"Different numbers"	"Event driven – not calendar driven"

But it doesn't end there. The issues that result from this separation of the purposes of the budget involve all the Beyond Budgeting principles. Another good reason for starting with the budget is that it is the great centralizing act; it reinforces the command-and-control management model. It is extremely difficult to move to an empowered and adaptive model when budgets are still in place. By separating out the budget purposes and improving them we remove this centralizing act and provide people with the mechanisms to manage in a more proactive and empowered manner.

The future of management is based on 'empower and adapt'

The adaptive management (or Beyond Budgeting) model is not about implementing new regulations or tools to 'fix' a few broken parts. It is about unleashing huge amounts of ambition, courage, creativity and collaboration within your organization. It is about learning from a few pioneers how to make your organization feel and act more like a community with a common purpose that is free, open, accessible and interactive. It is about turning the organization on its side to face the customer and ensuring that accountability is clear and information is transparent. And it is about building a business that is free from the burdens of stifling bureaucracy, aggressive targets, misaligned incentives, stifling budgets and suffocating controls and enables and encourages people to think, reflect, collaborate, learn and improve.

The challenge: tackling entrenched mindsets

At the present time, management in the twenty-first century doesn't feel that different from management in the twentieth century. This paper aims to change that perception. But tackling entrenched mindsets and overturning decades of accepted management practices will not be an easy challenge. It takes courage, time, patience, perseverance and dedication. Most business leaders are not geared for that. They want things to happen quickly because they are likely to be in the job for only a short time and they want to reap the benefits on their watch. But as many business leaders are discovering, it is a winning formula in an increasingly unpredictable and competitive world. Leaders need to get their thinking straight before launching into major change programs that typically aim at 'fixing' particular problems. They need to act on the whole system rather than its parts. This isn't another 'improvement project'. It's a new way of thinking about management in the twenty-first century organization.

The Beyond Budgeting Round Table (BBRT)

The BBRT is an international shared learning network of member organizations with a common interest in improving their management models to enable sustained, superior performance. BBRT helps organizations learn from world-wide best practice studies and encourages them to share information, past successes and implementation experiences to move beyond command and control.

The BBRT promotes a set of principles that lead to more dynamic processes and front-line accountability. Organizations that follow this approach transform their management model in line with these principles, which are outlined in *The Leader's Dilemma: How to build an empowered and adaptive organization without losing control*, published by Jossey Bass. For more information about the BBRT globally visit www.bbrt.org and for North America www.bbrtna.org .

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