

Week 9

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How Risky Is Your Company?

Success brings profits, growth, and unbounded optimism. But it also has a way of blinding executives to the many organizational dangers that creep in at the same time. How much internal risk is hiding within your company? Use the risk exposure calculator to find out.

BY ROBERT SIMONS

IN GOOD TIMES, IT'S EASY TO FORGET ABOUT RISK. Optimism abounds when markets are growing and revenue and profits are up. The business is hiring new people, increasing the scale of operations, and searching out new and exciting opportunities for growth. Indeed, in such boom periods, the future looks so bright—to paraphrase the pop song—you have to wear sunglasses.

Yet it's in good times that managers need to be most watchful for signs of impending danger. Such is the paradox of success: it has an uncanny way of setting a company up for trouble, if not outright attack. And not only from outside sources, such as competitors or regulators, but, just as important, from within the organization itself.

Consider how an aggressive, can-do culture often arises when a company's sales and profits soar. Such a culture usually accounts for bold initiatives and satisfied clients, but it also can end up silencing any messenger carrying bad news about

*Robert Simons is the Charles M. Williams Professor of Business Administration and a director of research at Harvard Business School in Boston, Massachusetts. He is the author of *Levers of Control: How Managers Use Innovative Control Systems to Drive Strategic Renewal* (Harvard Business School Press, 1995) and *Performance Measurement and Control Systems for Implementing Strategy* (Prentice-Hall, 1999).*

a company's practices. Success can also require an organization to invest in new computer systems to carry the load of increased orders. That growth is reason to celebrate, except that the all-too-common failure to integrate new technology is a disaster waiting to happen.

Success, in other words, should make executives nervous. Better yet, it should galvanize them to identify their level of internal risk exposure. Not all risk is bad, of course, and in fact, most organizations must take risks in order to make progress. (In some fast-moving industries, such as software and financial services, it is necessary to take on quite a bit of risk just to stay even.) But managers—especially those of successful enterprises—must always be on the lookout for the risk lurking in their organizations. The question is: how can they pinpoint the areas of risk exposure?

Over the past several years, I have developed a tool called the *risk exposure calculator*. The calculator shows the pressure points present in every organization that lead to increased risk, such as the speed of operational expansion and the level of internal competition. Depending on a company's circumstances and management style, the amount of pressure on each point can be low or high. A uniformly low score on these pressure points, it should be noted again, isn't necessarily a virtue. Remember that nothing ventured is nothing gained. But too high a score on too many pressure points can be a strong signal that a company is exposed to dangerous levels of risk. Remedial action may be necessary—and fast.

The risk exposure calculator is not a precise tool like an electronic spreadsheet or a discounted cash-flow analysis; its results are directional. It allows executives to determine if a company's risk level is in the safety, caution, or danger zone. Once executives calibrate and understand a company's risk level, they can align it with the organization's strategy.

The calculator has been tested by managers from hundreds of different companies attending Harvard Business School's executive education programs where I teach. Because the calculator shows the combined effect of risk exposure throughout a company, the typical reaction to the total score is surprise, followed by nagging discomfort. It is not as if these executives don't know that their organizations carry risk. The CEO of a manufacturing company might, for example, be fully cognizant that a new factory has been put-on-line too quickly. That single pressure has been worrisome, but not enough to keep him up at night. Using the risk calculator, however, the same CEO might discover that there is enough pressure on other critical pressure points

that his company's overall risk exposure has risen to dangerous levels.

The risk exposure calculator also gives executives the opportunity to conduct two illuminating exercises. First, managers can ask people at different levels and in different functions within a company to use the calculator—and then compare scores. In my experience, that process shows that people at the very top of the company are less aware of risk exposure than those closer to the ground. Similarly, the exercise often reveals that people in one division or business unit rate the company's exposure to risk much higher than the rest of the organization. In such cases, it is time for senior executives to find out what one business unit knows that no one else does.

Second, managers can calculate their company's current risk exposure and then calculate what it would have been 24 months ago. Comparing those scores reveals an organization's internal risk-exposure trajectory. One executive who did so found that her organization had somehow managed to soar from the safety to the danger zone. She acted swiftly to alert her senior team, and steps were taken to bring risk back under control.

In dynamic markets, taking risks is an integral part of any successful strategy. But understanding the conditions that create unhealthy levels of risk can go a long way toward preventing failure. It is critical, then, for senior executives to keep track of each pressure point. Later, we'll take a look at the steps managers can take to control those pressures, but first, let's examine the calculator in detail.

The Risk Exposure Calculator, Key by Key

The risk exposure calculator is divided into three types of internal pressures—those due to growth, to culture, and to information management. For each of those pressures, success can increase the level of risk. People subject to them make mistakes in their jobs, inadvertently or not. They skip important steps in a quality-checking process, for instance, or allow new customer service associates to answer phones without adequate training. Another common outcome of internal pressures is that people fail to share important information, especially with their bosses. Either they don't have the inclination, or they don't want to pay the price. And finally, increased pressure can cause inefficiencies or breakdowns, or both, as systems and people become overloaded and undermanaged.

Let's start with the pressure points related to growth, where the exposure to risk begins in many successful companies.

Pressure Points Due to Growth. Fast-growing businesses are often intense and exciting environments. A burgeoning company attracts the interest of employees and the capital markets alike. In pursuing strategies that emphasize growth, executives often set ambitious sales and profit goals. Those who deliver are rewarded for their work; those who fail to meet expectations do not share in the bounty. No wonder, then, that growth can lead to the first pressure point: pressures for performance.

If managed properly, pressure to achieve challenging goals can stimulate innovation, entrepreneurial creativity, and superior financial performance. However, such pressure can also bring unintended risk. Subordinates may fear that failing to meet performance expectations will jeopardize their status or compensation. Accordingly, they may feel intense pressure to succeed at all costs,

even if their actions overstep ethical bounds or contravene company policy. They may, for example, accept customers with poor credit ratings or cut quality to accelerate operations. And if pushed hard enough, employees can sometimes misrepresent their true performance to cover up any shortfalls against expectations.

Examples of such behavior are, sad to say, plentiful. Consider what happened in 1997 at the membership club CUC International. The company, which offered its customers discounts on home appliances, travel, dining, and auto parts, was run by managers intent on aggressive revenue and earnings growth. And indeed, the company consistently hit those goals—to the stock market's delight. But shortly after CUC merged with a franchising giant HFS (which franchises Ramada hotels, Coldwell Banker real estate, and Avis rental cars, among others) to

The Risk Exposure Calculator

The risk exposure calculator is a mechanism used to gauge a company's likelihood of being surprised by errors or breakdowns that could threaten the company's franchise or strategy.

Using the calculator is straightforward. For each key, rate the level of pressure in your company, scoring one as low and five as high. At the end, total your scores and interpret the results as shown to the right.

Growth						
Pressure for performance	+	Rate of expansion	+	Impact of key employees	=	
Culture						
Willingness to change and adapt	+	Willingness to take risks	+	Willingness to experiment	=	
Information Management						
Retention of knowledge and vision	+	Depth of diagnostic performance measures	+	Quality of decision-making	=	
total score =						

9 to 20: The Safety Zone

Companies that carry this low level of risk are probably safe from unexpected errors or events that could threaten the health of the business. However, managers of such companies should question whether their risk exposure score is too low. Innovative, successful companies invariably create risk pressure. If your business scores in the safety zone, perhaps it's time to take some calculated gambles.

21 to 34: The Caution Zone

Most companies will find that they fall in this middle zone. But even here, managers should be alert for high scores in any two of the three risk dimensions. For example, if your business scores high on both growth and culture, but the total score falls below 35, there is still reason for concern.

35 to 45: The Danger Zone

If you find that your total score is 35 or above, alarm bells should be ringing and fast action should follow. Use the levers of control: belief systems, boundary systems, diagnostic control systems, and interactive control systems—coupled with traditional internal controls—to protect your business from disaster.

create Cendant, it was revealed that CUC's remarkable results were fake. Employees in 22 business units had falsified accounting records and booked more than \$500 million in phony pretax profits. When confronted by investigators, the people who logged the fictitious entries said they felt pressured by their bosses to meet Wall Street's expectations.

How can managers measure their score on this point? They can ask themselves if aggressive stretch goals are set from the top down with little or no input by subordinates. If the answer is yes, then this point merits a high score. So does an environment in which performance-variable pay represents a large percentage of total compensation. High scores are also called for when managers give star performers special attention and recognition. And finally, pressure on this point is invariably high when the capital markets hold high expectations for financial results and traders bid up the stock to prove it.

The second growth-related pressure point is the rate of expansion in operations. Again, this is a good news-bad news story. New production facilities, distribution channels, and product lines are only necessary when business is booming. However, without careful planning and allocation of resources, the infrastructure to support rapid expansion may quickly become overloaded, resulting in sacrifices in quality. In other words, when calculating the pressure on this point, managers should ask them-

A high level of inexperience among employees and staff creates the third growth-related pressure point. When large numbers of people come on board quickly, managers sometimes waive background checks or lower performance standards and educational qualifications. As a result, new employees often lack adequate skills and training or don't fully understand their jobs. The fallout of such circumstances is well known: an array of small and large mistakes, from sales clerks who misinform important clients to factory workers who mishandle dangerous equipment. From unhappy customers to endangered staff, the risks posed by inexperienced people can be unnerving. When calculating the pressure on this point, then, managers might ask themselves, What percentage of our jobs are filled with newcomers—people, say, with less than 12 months experience with the company? Other tell-tale signs that pressure is climbing include increased customer complaints about service, and employees who make too many "stupid" mistakes. Those problems may seem like simple irritants to senior managers of a growing business, but they are important alarm bells.

Inexperience brings with it an additional risk, especially in unstructured, high-innovation businesses. It takes a lot of time for new people to learn, let alone internalize, a company's values. Often they simply don't know what constitutes acceptable behavior—or put another way, what kind of behavior is completely out of bounds. Consider what happened in the late 1980s and early 1990s when Nordstrom, the fashion retailer, sharply increased the number of its stores across the United States and hired scores of new managers to staff them. Even though Nordstrom had always prided itself on

being fair—some would say generous—toward its employees, a few overzealous managers intimidated subordinates into underreporting work hours in an attempt to meet sales-per-hour quotas. This miscreant behavior resulted in a series of lawsuits and government actions that absorbed management's attention and damaged Nordstrom's otherwise fine reputation.

Pressure Points Due to Culture. No businesses can survive over the long term—let alone prosper—without the entrepreneurial risk taking that drives innovation and creativity. But success can embolden risk takers too much; money is loose, confidence high. For some, the urge to gamble with the company's assets and reputation—all in the name of greater gains—becomes irresistible. And so very often people in successful enterprises invest in

Success can embolden risk takers too much; money is loose, confidence is high.

selves, Are operations expanding faster than our capacity to invest in more people and technology?

The answer, clearly, was no at American Express, when in 1987 top management decided to aggressively expand the scope of the company's franchise. In addition to the well-known American Express card, which requires customers to pay outstanding balances in full each month, a new Optima card was launched that encouraged customers to roll over unpaid balances and pay finance charges. The new business was ramped up quickly to accommodate the increased volume. But with little previous experience in consumer credit markets, Optima managers badly misjudged delinquency rates on the new cards. The result: write-offs in excess of \$150 million and a quarterly loss for the prestigious Travel Related Services division.

excessively risky deals, forge alliances with people or businesses that may not have the ability to honor their contracts, or make promises to customers that are impossible to fulfill. Again, rewarding entrepreneurial initiative is generally the right thing to do. But as the rewards for entrepreneurial behavior rise, so too does risk exposure.

Consider what happened at Bankers Trust Company, a traditional commercial bank during much of its history. In the early 1990s, senior management transformed the business into an aggressive investment bank that issued innovative financial instruments. Bankers and traders were rewarded for creating and pushing new products as fast as they could. By 1993, based on the success of such entrepreneurial behavior, the company was earning more than \$1 billion on revenue of \$4.7 billion. In 1995, however, Bankers Trust was sued by several clients, including Procter & Gamble, for misrepresenting the risks associated with these new financial products. The result was over \$250 million in fines and customer-reimbursement costs and the ouster of Bankers Trust's CEO and other top executives.

How can managers calculate a score for this pressure point? One way is to determine what percentage of the business is based on new products and services that have been generated by creative, risk-taking employees. The higher the number, the higher the score. Another cause for a high score on this point is an environment in which people are allowed—even urged—to operate like the Lone Ranger, and only return to base when they have captured the "spoils." And finally, an increasing frequency in failed new products or services or unsuccessful deals is a sign that exposure to risk is mounting.

Another cultural pressure point has to do with information—particularly as it flows upward. To their peril, executives running successful organizations often develop a resistance to bad news. They want to be surrounded by people who share their pride in the business and exude confidence about reaching demanding performance goals. People who speak of obstacles, problems, or impending dangers are derided as annoying naysayers and accused of not being team players. Yet it is often these individuals—many of whom communicate daily with frontline employees, customers, and suppliers—who are best able to see risk creeping in. In cultures where the philosophy is "the boss knows best," many learn not to speak out about such risk.

The result? In the worst case, top-level managers are the last to know about critical changes in the competitive environment. At Kmart, for example, managers were reportedly reluctant to tell the leader-

ship team about problems in the business, even as Wal-Mart was quickly overtaking them. While upstart competitor Sam Walton was known for prodding his subordinates to deliver bad news quickly so that they could figure out how to improve, Kmart's CEO Joseph Antonini had a reputation for surrounding himself with people who would not challenge his views. Eventually, in 1995, the shareholders and the board forced him out. Similar stories about senior managers at the "old" IBM and General Motors have been told to explain the companies' spectacular declines from industry preeminence. (New top management, of course, has now reversed their fortunes.)

To calculate the score on this pressure point, managers must ask themselves some difficult questions: How much bad news do I actually hear? Have I surrounded myself with "yes men"? The answer to those questions will help determine their score.

The last explosive ingredient in the mix of cultural pressure points is internal competition. In many organizations, managers believe that they are in a horse race with their peers for promotions and rewards. And often they are right. Senior executives frequently set up such contests to stimulate exceptional effort. However, when employees perceive advancement and promotion as a zero-sum game, internal competition can have unintended side effects. The most common result is a decrease in information sharing. After all, if you know something important about customers or processes that your rival doesn't, why give away your advantage?

To compound the problem, employees feeling the pressures of internal competition may gamble with business assets, potential credit losses, and the company's reputation in their attempts to enhance short-term performance. In such instances, risks and rewards are not evenly distributed. If the gamble succeeds, there is an upside for both the employee and the company. But if the gamble fails, the employee may—at worst—lose his or her job. The organization can also be left with catastrophic losses. That's exactly what happened at Barings Bank in 1995. Nick Leeson executed transactions that at first appeared to create exceptional levels of profit. To win respect and rewards, he was in fact gambling company assets in an attempt to cover ever-mounting losses. When the dust settled, Leeson was in custody on fraud charges. His actions destroyed a 200-year-old institution.

To calculate their score on the internal competition pressure point, managers might simply ask themselves, Do we manage and motivate by horse races here? They could also consider how performance reviews are conducted at their company. Are

employees ranked and compared with one another, or are they evaluated on their own merits? If the answer is the former, then the score should be high. Managers might also think about what happens when star performers are promoted. Do other people get fired—or quickly leave—at the same time? Companies with such up-or-out environments have high levels of internal competition and should receive a high score on this point.

Pressure Points Due to Information Management. The final set of pressures in the risk exposure calculator relates to the flow of information within a company. In short, when systems to manage information are inadequate, havoc ensues—and risk exposure mounts.

Success in the marketplace is often accompanied by increasingly sophisticated products, by innovations in the way that customers are served, and by creativity in bundling new products or services. All these changes can increase the complexity of transactions. When that happens, fewer people fully understand the nature of the risks that these transactions create and how to control them. For example, cross-border agreements in international operations, creative financing of customers' purchases, and elaborate consortium arrangements can all produce highly complex contracts. If only a handful of experts in the organization truly grasp the resulting obligations and contingent cash flows, the risks hidden on the balance sheet can become a mystery to the senior managers who need to understand them most. In calculating the pressure on this point, then, ask yourself if you truly understand the complex and sometimes arcane language of the deal-making experts in your company. If the answer is no, score your risk exposure accordingly.

The increase in complexity due to highly leveraged derivative financial products—that is, financial instruments whose value fluctuates based on changes in the values of other underlying assets—has caused more than one well-managed company to sustain substantial losses. A perfect example is Metallgesellschaft Refining & Marketing (MGRM), an American subsidiary of the large German industrial corporation Metallgesellschaft. In the early 1990s, MGRM began selling long-term fixed-price fuel oil contracts. At the same time, as a hedge against price volatility, MGRM bought short-term oil futures on the New York Mercantile Exchange. When oil prices began their precipitous decline in 1993, the business was forced to pay more than \$50 million per month to cover margin calls. Managers of the parent company became alarmed and, against the advice of MGRM executives, liquidated the futures positions at a significant loss. The par-

ent board blamed subsidiary managers for lax operational control; subordinate managers claimed that the parent did not fully understand the nature of the futures positions and had overestimated the potential risks. Who was right? Because of the complexity of the transactions, it is hard to say, but losses on the liquidated positions exceeded \$1 billion and brought Metallgesellschaft to the edge of bankruptcy.

Success can also mean an increase in the volume and velocity of transactions, which often overloads information systems. The dangers here are obvious. Managers have less opportunity to scrutinize transactions to ensure that they adhere to preapproved policies. Overloaded or inadequate computer systems may not be able to capture the information essential to support growth. That's what happened at People Express—the now defunct low-cost, no-frills airline. As the business took off, it quickly reached a point where its rudimentary information systems lacked the ability to accurately analyze

Pounding the Calculator Keys at One Company

To demonstrate how the risk exposure calculator works, let's show how it might have revealed the risk brewing at Kidder Peabody before its disastrous fall in 1994, when over \$350 million of false profits were uncovered and its parent, General Electric, decided to dispose of Kidder Peabody's assets.

In hindsight, it is easy to see that many of the pressure points on the risk exposure calculator were at dangerously high levels. Indeed, the company's score would have been close to straight fives in all categories for a total of 45—at the very top of the danger zone.

First, consider the growth dimension. Even before General Electric purchased Kidder Peabody, pressure for performance at the company was extremely high—not unlike the pressure at other Wall Street firms. From all accounts, the acquisition heightened the demand for results. The rate of expansion was likewise intense. After all, GE Capital was pouring money into Kidder so that the business could expand aggressively. At the same time, the number of inexperienced people at Kidder was mounting. GE managers sent in to oversee the company after the acquisition—while expert at running an industrial company—did not fully understand the operations or the nature of financial service products. Moreover, Joseph Jett, the trader hired for the fixed-income desk, was young and had no training or experience in buying and selling specialized types of bonds. Pushing this score up even

available seat miles so that managers could set the right prices to maximize profit. Six years after its successful launch, the company went bankrupt. More recently, America Online suffered the consequences of inadequate information-processing capacity in the face of increased transaction volume: service shutdowns and blackouts reverberated throughout its system just as many new customers were trying to come on board.

To determine the score on this point, managers should do a rough calculation in their heads. What were the complexity, volume, and velocity of information a year ago? Have they risen, and by how much? The answers to those questions are not precise, but they can give a strong indication of whether the score should be high or low.

Success also puts pressure on the internal reporting systems that measure critical performance variables, such as return on capital employed, same-store sales, order backlogs, and product or service quality. In bad times, managers usually pore over

such facts and figures as they try to divine the source of their problems. In good times, however, managers will frequently let this process slide. There are two reasons. First, rapid growth often renders these systems outdated and inadequate to the new demands of the business. And second, it's human nature. If everything is going well and profits are high, there's little reason to plow through mounds of data in order to find anomalies or ways of making small improvements.

How can a manager calculate a score on this pressure point? One signal that a high score is called for is, simply, a feeling of frustration—a sense that it's hard to get the right data at the right time. When there are gaps in diagnostic performance measures, managers end up getting the information they need by making phone calls and walking around. In short, they spend a lot of time doing the work a computer system should be doing.

Another way to calculate the score on this point is to ask, How often do I fight fires? If the answer is

further was the fact that there were few shared values between managers at GE, a carefully managed industrial company, and those at Kidder, a freewheeling financial trading business.

As for culture, GE's and Kidder's senior managers had certainly created an environment that rewarded entrepreneurial risk taking. Those who could find ways to exploit market imperfections or who could create new financial products were well compensated. Thus, Jett, who was ultimately discovered to be booking false profits, had previously been feted by top management as Kidder's "man of the year." His 1994 annual bonus was \$9 million. Notwithstanding his outward success, however, several people close to his operation questioned the nature of the profits that he was generating. But there was such executive resistance to bad news—especially given the rewards and accolades that were being showered on the trader—that those with suspicions were quickly quieted. There was also intense internal competition as traders and managers vied for promotion, recognition, and large bonuses.

Finally, consider the quality of information management at Kidder. Transaction complexity and velocity were both increasing rapidly as Jett placed orders to buy and sell billions of dollars worth of bonds. Illogical explanations for complicated trades were not questioned by managers who later claimed ignorance of the real nature of these transactions. Diagnostic performance

measures were faulty and incomplete. Jett had stumbled on a glitch in the firm's computer program that allowed him to record huge unrealizable profits. Diagnostic early-warning systems that should have alerted senior managers to the dangers of these outstanding positions were either nonexistent or ignored. Because of a lack of systematic early-warning systems, senior managers at Kidder and GE were never provided with the critical signals that would have alerted them to serious problems.

Finally, Kidder scores high on decentralized decision making. Not only is GE a highly decentralized organization, but Kidder, too, allowed major decisions to be made by employees at the trading desks without direct management oversight. When Jett's supervisor was asked why he didn't watch his people closely, he said that it was not part of his job and that he relied on others to alert him if anything was amiss.

Who was to blame for Kidder's ignorance of its enormous risk exposure? Jett claimed that he was not culpable because he had never hidden his actions from superiors. In turn, his bosses claimed that they were not responsible because they had relied on the company's diagnostic control systems and internal auditors to alert them if anything was wrong. In hindsight, blame must be placed on the shoulders of those managers who failed to appreciate the risk pressures due to growth, culture, and information management that were mounting within the company.

often, then it's likely that your information systems are not providing the right information in a timely fashion. And finally, give yourself a high score if the last time you looked at data on performance was more than a month ago, or if you're unlikely to complain if monthly performance reports are late or missing. This invariably means that you are not using diagnostic controls effectively.

The final information-management pressure point in the risk exposure calculator is decentralized decision making. When companies expand quickly, local managers are often given a great deal of autonomy to make decisions. Indeed, top-level corporate managers are typically involved only in matters of resource allocation, goal setting, and performance reviews. Of course, decentralization yields many advantages. It enables local business units to respond quickly to market demands, allows more creativity and innovation, and it can enhance the motivation and career satisfaction of managers.

But again, these positive effects also have their downsides. First, local managers acting without a larger sense of their organization's corporate strategy may unknowingly take on too much risk. Second, decentralized organizations do not have well-defined information channels for sharing information either sideways or upward. If senior executives are not hearing important information until it's too late, then they need to give themselves a high score on this pressure point. (To see how the risk exposure calculator is actually applied, see the insert "Pounding the Calculator Keys at One Company.")

Now that we've identified all the pressure points that contribute to risk exposure, let's take a look at what managers can do after they've calculated their score.

Five Questions About Risk

Most managers understand the relationship between risk and reward. But a second relationship is equally important: the relationship between risk and awareness. Taking risks is not in itself a problem—but ignorance of the potential consequences is an entirely different matter. Even for the most technical categories of external risk—sovereign risk, counterparty risk, credit risk, market risk—if managers are aware of their nature and magnitude, they can take appropriate steps to avoid the hidden dangers.

The same is true of internal risk exposure. Once managers know where it exists in the organization, and at what levels, they can act. In many cases, however, that's easier said than done. Over the years, I have spoken with many managers who work for

companies that fall into the calculator's danger zone. They often say that they have done everything possible within their organizations to control risk. "What actions are left?" they ask.

The answers can be found in a series of questions. These questions correlate with the four "levers of control" that I developed from intensive research over a ten-year period. (For a model of the levers of control, see the exhibit "The Levers of Control.") The levers, simply stated, are the mechanisms managers can adjust to control risk as a company pursues its strategy. There is one question for each of the four levers: belief systems, boundary systems, diagnostic control systems, and interactive control systems. Working together, these four levers give managers the tools to balance profit, growth, and control. Each of them must be carefully aligned with a business's strategy. A fifth and final question relates to what are commonly known as internal controls—the checks and balances designed to safeguard assets and ensure reliable information. Internal controls do not vary with strategy; they are, however, an essential foundation for controlling risk in all organizations.

The managers of many successful companies have implemented the levers-of-control model and in doing so have found a way to drive maximum performance while ensuring adequate safeguards against risk. The following questions are designed to help you do the same.

Question #1: Have senior managers communicated the core values of the business in a way that people understand and embrace? Many of the critical pressure points in the risk calculator measure the likelihood that employees are misconstruing the intentions of senior managers or are taking on unacceptable levels of risk for personal gain. Belief systems—communicated through mission statements, credos, and statements of values—can go a long way toward creating a culture that rewards integrity and makes clear the types of choices that should be made when confronted with temptation or unfamiliar situations. Effective belief systems are an essential safeguard in rapidly growing, high-pressure businesses.

But to effectively communicate core values and beliefs, managers must do more than go through the motions of writing a mission statement. They must reinforce their stated beliefs through visible actions. That is, they must demonstrate that a mission statement or credo is more than a plaque for the wall—they must prove it is a living document. At Johnson & Johnson, top managers periodically meet with all business unit managers to debate and reaffirm the importance of their long-standing

credo. Indeed, members of the company's senior team will even meet with small groups of employees and vet the credo word-by-word. Such extraordinary practices demand a great investment of time, but they are worth it for the enormous clarity they bring to questions of policy and practices and for the clear understanding they convey about what is right and wrong.

Question #2: Have managers in your organization clearly identified the specific actions and behaviors that are off-limits? Every business faces the possibility that some employees may step outside the bounds of normally accepted business practices. They may promise customers too much, for instance, or accept a client who has a poor record of paying his bills. Some missteps, however, are more serious than others—they may actually harm the franchise of the business. Therefore, for any given business strategy, managers must determine what behaviors or actions could damage the business's

reputation and declare those actions categorically off-limits.

Consultants and auditors, for example, depend on their reputation for trustworthiness as an essential asset for effective competition. Ask yourself how long McKinsey & Company could stay in business if clients suspected that client data were being leaked to competitors. Because of such clear franchise risks, McKinsey and firms like it have explicit codes of conduct that forbid any behavior that could be perceived as compromising the confidentiality of client data. At PricewaterhouseCoopers, the accounting firm responsible for tallying the votes for the Academy Awards, boundaries for business conduct are made clear to anyone associated with the awards: Tell anyone other than your supervisor about the outcome of the votes, and you'll be fired. Establishing unambiguous boundaries is a quick but effective way of reining in risk and protecting a firm's most valuable asset.

The Levers of Control

To control the internal risk that accompanies strategy, managers have levers of control at their disposal. Ask yourself the following questions to see if those levers are being pulled in your organization. The question at the very bottom relates to

what are commonly known as internal controls—the checks and balances that safeguard assets and ensure reliable information. Internal controls do not vary with strategy; they are, however, an essential foundation for controlling risk in all organizations.

Belief Systems

Have senior managers communicated the core values of the business in a way that people understand and embrace?

Boundary Systems

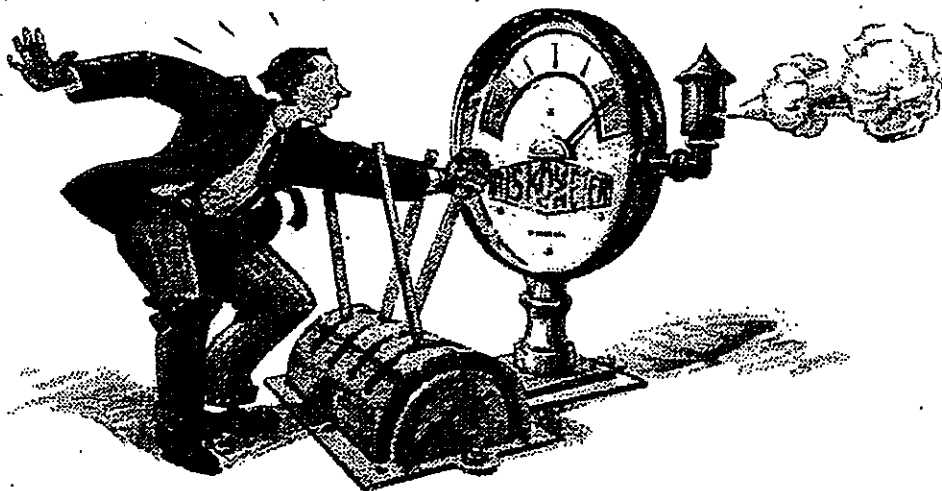
Have managers in your organization clearly identified the specific actions and behaviors that are off-limits?

Diagnostic Control Systems

Are diagnostic control systems adequate at monitoring critical performance variables?

Interactive Control Systems

Are your control systems interactive and designed to stimulate learning?



Internal Controls Are you paying enough for traditional internal controls?

ARTWORK BY DOUGLAS JONES

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Question #3: Are diagnostic control systems adequate at monitoring critical performance variables? Because success makes it so easy to neglect or dismiss diagnostic control systems, managers have to be sure to invest in these systems in boom times and ensure that everyone is focusing on the right critical performance variables. Sometimes existing systems and measures are adequate. In other cases, success calls for new variables. Managers need to determine which performance variables matter most in present circumstances and then design ways to ensure that key managers are regularly informed of those figures. Managers may choose to focus diagnostic measures on operations (such as quality and throughput), on critical balance sheet assets (such as credit loss exposure), or on the competitive environment (such as customer complaints or bids lost to competition). Watching the right numbers can be an important way to find out if the future doesn't look so bright.

Question #4: Are your control systems interactive and designed to stimulate learning? Managers can stay abreast of many critical performance variables by relying on exception-based diagnostic reports, but such documents represent a one-way flow of information. An additional and important way to monitor risk exposure is through certain interactive control systems—that is, systems that force managers to engage in conversations about strategic uncertainties. If used properly, the debate that these control systems trigger can raise important questions about customers, technology, competitors, regulation, markets—anything that might change a company's way of doing business. Any number of systems can be used interactively: profit plans, performance scorecards, technology-monitoring systems, or brand revenue systems. The only requirement is that interactive meetings for discussing the data become routine enough that they don't fall by the wayside. Used as mechanisms to gather information, interactive control systems open information channels from the bottom of the organization to the top, an essential way to combat risk.

Again, Johnson & Johnson provides an illustration of a company that uses an effective risk-controlling device. Its managers use their profit-planning and long-range-planning system in a highly interactive way to continually assess opportunities and threats. As they constantly revise projections, managers are forced to confront three questions: What has changed? Why? and What are we going to do about it? Through such an interactive process, Johnson & Johnson's managers have successfully navigated the shoals of the changing health care industry and

have managed to stay, year after year, on the short-list of America's most admired companies.

Question #5: Are you paying enough for traditional internal controls? In this age of balanced scorecards and enterprisewide information systems, many organizations have relegated internal controls to the dustbin. I'm referring here to time-tested practices such as segregating duties, limiting access to critical information, and adequately staffing key control and risk management positions, such as controllers and internal auditors.

Why have some companies let those controls go? One of the main reasons is the wave of reengineering and downsizing that has occurred over the past decade. On the one hand, these initiatives have successfully refocused and streamlined businesses, making them healthier and more competitive. On the other hand, they have also removed much of the redundancy and middle management oversight that were the traditional backbone of internal control systems.

There is no fixed amount or percentage that a company should be paying for the checks and balances that are the mainstay of internal controls. But there is one rule of thumb. As a company grows, the money invested in such systems should be growing commensurately. It may feel wasteful at the time—especially since success makes risk seem so remote—but it is money well spent. That's a fact, unfortunately, that many managers don't learn until it's too late.

A Calculator and a Magnifying Glass

Attaining success is the reason that many people enter business in the first place. It feels great. And perhaps that's why once you achieve it, the last thing you want to hear is: Watch out—risk looms! But executives running successful enterprises can't let the brightness of the day—or the future—blind them. They need to shed their sunglasses and find a magnifying glass to search their organizations for the risks that may be multiplying within. A pair of binoculars might be called for as well. Sometimes risk creeps into the organization at quite a distance from the top.

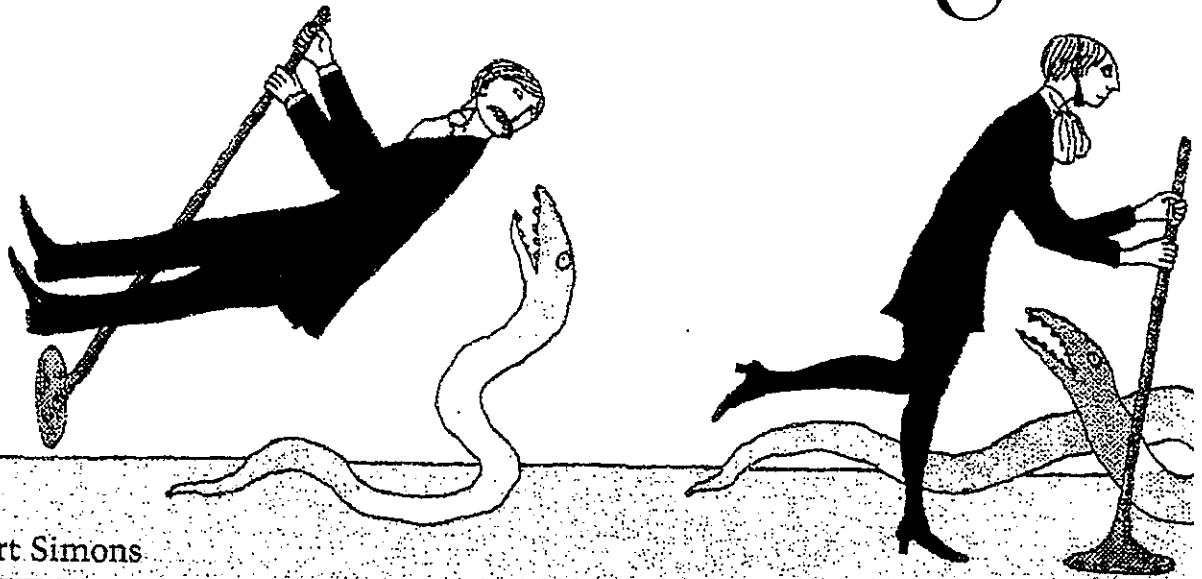
The risk exposure calculator won't, in and of itself, decrease an organization's risk. But it will suggest where risk is growing and how fast. With that insight, managers can take the steps they need to protect their success. Not all risk is bad. It's up to you, then, to decide if your business's level of risk calls for mere watchfulness or for strong action.

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How can managers promote innovation while avoiding unwelcome surprises?

Control in an Age o



by Robert Simons

A fundamental problem facing managers in the 1990s is how to exercise adequate control in organizations that demand flexibility, innovation, and creativity. Competitive businesses with demanding and informed customers must rely on employee initiative to seek out opportunities and respond to customers' needs. But pursuing some opportunities can expose businesses to excessive risk or invite behaviors that can damage a company's integrity.

Consider the spate of management control failures that have made headlines in the past several years: Kidder, Peabody & Company lost \$350 million when a trader allegedly booked fictitious profits; Sears, Roebuck and Company took a \$60 million charge against earnings after admitting that it recommended unnecessary repairs to customers in its automobile service business; Standard Chartered Bank was banned from trading on the Hong Kong stock market after being implicated in an improper share support scheme. The list goes on. In each case, employees broke through existing control mechanisms and jeopardized the franchise of the business. The cost to the companies—in damaged reputations, fines, business losses, missed opportunities, and diversion of management attention to deal with the crises—was enormous.

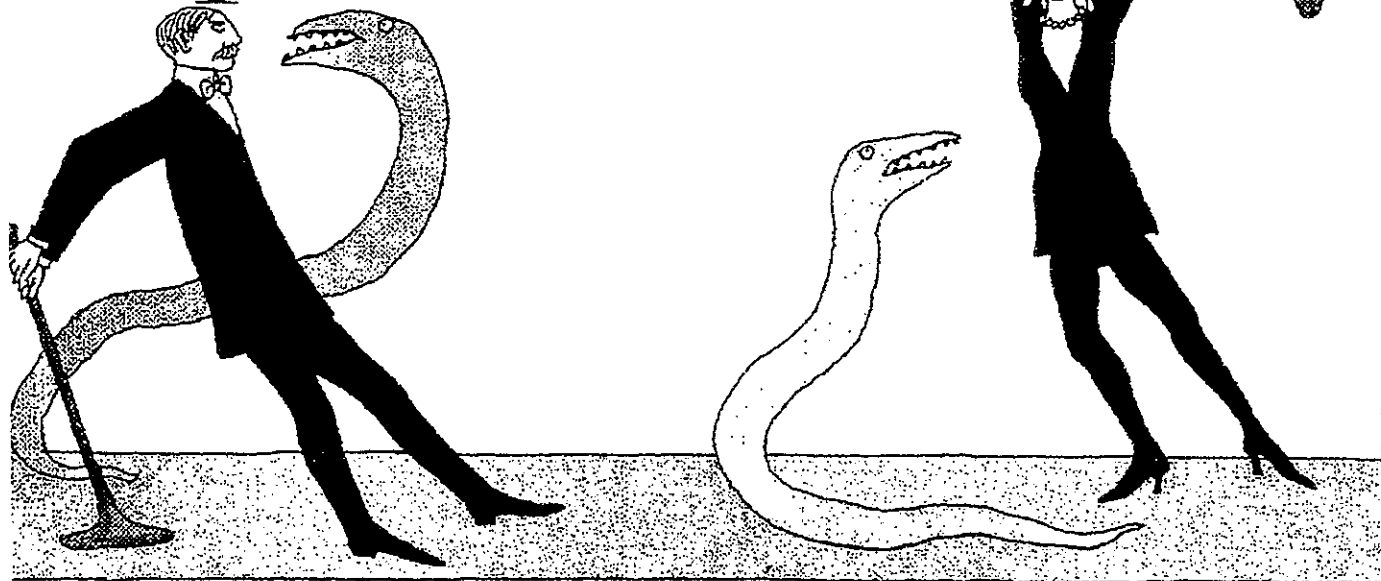
How do senior managers protect their companies from control failures when empowered employees

are encouraged to redefine how they go about doing their jobs? How do managers ensure that subordinates with an entrepreneurial flair do not put the well-being of the business at risk? One solution is to go back to the fundamentals of control developed in the 1950s and 1960s for machinelike bureaucracies. In that era, managers exercised control by telling people how to do their jobs and monitoring them with constant surveillance to guard against surprises. Although this approach sounds anachronistic for modern businesses, it is still effective when standardization is critical for efficiency and yield, such as on an assembly line; when the risk of theft of valuable assets is high, such as in a casino; or when quality and safety are essential to product performance, such as at a nuclear power plant.

However, in most organizations operating in dynamic and highly competitive markets, managers cannot spend all their time and effort making sure that everyone is doing what is expected. Nor is it realistic to think that managers can achieve control by simply hiring good people, aligning incentives, and hoping for the best. Instead, today's managers must encourage employees to initiate process improvements and new ways of responding to customers' needs—but in a controlled way.

Fortunately, the tools to reconcile the conflict between creativity and control are at hand. Most

Empowerment



managers tend to define control narrowly—as measuring progress against plans to guarantee the predictable achievement of goals. Such diagnostic control systems are, however, only one ingredient of control. Three other levers are equally important in today's business environment: beliefs systems, boundary systems, and interactive control systems.

Each of the four control levers has a distinct purpose for managers attempting to harness the creativity of employees. Diagnostic control systems allow managers to ensure that important goals are being achieved efficiently and effectively. Beliefs systems empower individuals and encourage them to search for new opportunities. They communicate core values and inspire all participants to commit to the organization's purpose. Boundary systems establish the rules of the game and identify actions and pitfalls that employees must avoid. Interactive control systems enable top-level managers to focus on strategic uncertainties, to learn about threats and opportunities as competitive conditions change, and to respond proactively.

Diagnostic Control Systems

Diagnostic control systems work like the dials on the control panel of an airplane cockpit, enabling the pilot to scan for signs of abnormal func-

tioning and to keep critical performance variables within preset limits. Most businesses have come to rely on diagnostic control systems to help managers track the progress of individuals, departments, or production facilities toward strategically important goals. Managers use these systems to monitor goals and profitability, and to measure progress toward targets such as revenue growth and market share. Periodically, managers measure the outputs and compare them with preset standards of performance. Feedback allows management to adjust and fine-tune inputs and processes so that future outputs will more closely match goals.

But diagnostic control systems are not adequate to ensure effective control. In fact, they create pressures that can lead to control failures—even crises. Whether managers realize it or not, there are built-in dangers when empowered employees are held accountable for performance goals—especially for difficult ones—and then left to their own devices to achieve them. For example, Nordstrom, the upscale fashion retailer known for extraordinary customer

*Robert Simons is the Charles M. Williams Professor of Business Administration at Harvard Business School in Boston, Massachusetts. His book *Levers of Control: How Managers Use Innovative Control Systems to Drive Strategic Renewal* was published in December 1994 by the Harvard Business School Press.*

Each of the four control levers has a purpose for managers attempting to balance creativity and control.

service, recently found itself embroiled in a series of lawsuits and investigative reports related to its sales-per-hour performance-measurement system. Used to track the performance of its entrepreneurial salespeople, the system was designed to support the service orientation for which Nordstrom is famous. But without counterbalancing controls, the system created the potential for both exemplary customer service and abuse. Some employees claimed that first-line supervisors were pressuring them to under-report hours on the job in an attempt to boost sales per hour. Settling those claims cost Nordstrom more than \$15 million.

I recently conducted a study of ten newly appointed chief executive officers to understand better how they used measurement and control systems to implement their agendas. Within the first months of taking charge, many of the new CEOs established demanding performance goals for division managers and increased the rewards and punishments associated with success and failure in achieving those goals. In response to the pressures, several division managers manipulated financial data by creating false accounting entries to enhance their reported performance. The managers were fired, but not before they had inflicted damage on their organizations. In one memorable case, a retail company had been making inventory and markdown decisions based on the falsified data, a practice that resulted in significant losses. These are not isolated incidents. The Big Six accounting firms have observed a substantial increase in errors and fraud over the past five years as organizations downsize and reduce the resources devoted to internal controls. With the elimination of many middle management jobs, basic internal controls, such as segregation of duties and independent oversight, have often been sacrificed.

One of the main purposes of diagnostic measurement systems is to eliminate the manager's burden of constant monitoring. Once goals are established and people have performance targets on which their

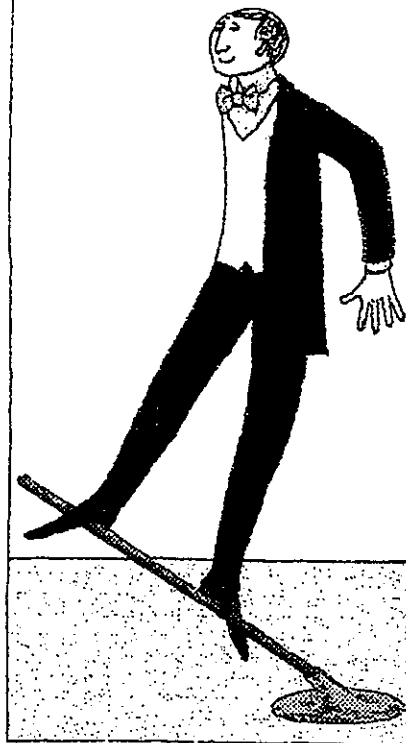
rewards will be based, many managers believe they can move on to other issues, knowing that employees will be working diligently to meet the agreed-upon goals. Yet the potential for control failures as the performance bar is raised and employees' rewards are put at risk underscores the need for managers to think about the three other essential levers of control.

Beliefs Systems

Companies have used beliefs systems for years in an effort to articulate the values and direction that senior managers want their employees to embrace. Typically, beliefs systems are concise, value-laden, and inspirational. They draw employees' attention to key tenets of the business: how the organization creates value ("Best Customer Service in the World"); the level of performance the organization strives for ("Pursuit of Excellence"); and how individuals are expected to manage both internal and external relationships ("Respect for the Individual").

Senior managers intentionally design beliefs systems to be broad enough to appeal to many different groups within an organization: salespeople, managers, production workers, and clerical personnel. Because they are broad, beliefs statements are often ridiculed for lacking substance. But this criticism overlooks the principal purpose of the statements: to inspire and promote commitment to an organization's core values. Still, the statements achieve their ends only if employees believe, by watching the actions of senior managers, that the company's stated beliefs represent deeply rooted values. If employees suspect that managers are going through the motions of the latest fad, cynicism will set in.

Indeed, some managers adopt missions and credos not out of any real commitment but because they seem fashionable. However, managers who use their missions as living documents—as part of a system to guide patterns of acceptable behavior—have discovered a powerful lever of control. At Johnson & Johnson, for example, senior managers



meet regularly with subordinates throughout the company to review and reaffirm the beliefs recorded in J&J's long-standing credo, which articulates clearly and passionately the company's responsibilities to customers, employees, local communities, and stockholders. Managers throughout the organization recognize the value that senior managers place on the exercise and respond accordingly. When problems arise, such as when J&J faced the Tylenol crisis, the strong beliefs system embedded in its credo provided guidance regarding the types of solutions to search for.

In the past, a company's mission was usually understood without reference to core values or formal beliefs; employees knew that they worked for a bank or a telephone company or a company that made shock absorbers. However, businesses have become much more complex in recent years, making it more difficult for individuals to comprehend organizational purpose and direction. Moreover, in many businesses, downsizing and realignment have shattered strongly held assumptions about the values and foundations of businesses and their top-level managers. Employees no longer know whom to trust. At the same time, their expectations for meaningful careers have risen as education levels

have increased. Without a formal beliefs system, employees in large, decentralized organizations often do not have a clear and consistent understanding of the core values of the business and their place within the business. In the absence of clearly articulated core values, they are often forced to make assumptions about what constitutes acceptable behavior in the many different, unpredictable circumstances they encounter.

Beliefs systems can also inspire employees to create new opportunities: they can motivate individuals to search for new ways of creating value. We all have a deep-seated need to contribute – to devote time and energy to worthwhile endeavors. But companies often make it difficult for employees to understand the larger purpose of their efforts or to see how they can add value in a way that can make a difference. Individuals want to understand the organization's purpose and how they can contribute, but senior managers must unleash this potential. Effective managers seek to inspire people throughout their organizations by actively communicating core values and missions. As top-level managers rely increasingly on empowered employees to generate new ideas and competitive advantage, participants from all parts of an organization need to

Harness Employees' Creativity with the Four Levers of Control

Potential	Organizational Blocks	Managerial Solution	Control Lever
To contribute	Uncertainty about purpose	Communicate core values and mission	Beliefs systems
To do right	Pressure or temptation	Specify and enforce rules of the game	Boundary systems
To achieve	Lack of focus or of resources	Build and support clear targets	Diagnostic control systems
To create	Lack of opportunity or fear of risk	Open organizational dialogue to encourage learning	Interactive control systems

understand as clearly as possible their company's purposes and mission.

Beliefs systems can augment diagnostic control systems to give today's managers greater amounts of control. But they are only part of the answer. Think of them as the yang of Chinese philosophy—the sun, the warmth, and the light. Opposing them are dark, cold boundaries—the yin—which represent the next lever of control.

Boundary Systems

Boundary systems are based on a simple, yet profound, management principle that can be called the "power of negative thinking." Ask yourself the question, If I want my employees to be creative and entrepreneurial, am I better off telling them what to

do or telling them what *not* to do? The answer is the latter. Telling people what to do by establishing standard operating procedures and rule books discourages the initiative and creativity unleashed by empowered, entrepreneurial employees. Telling them what *not* to do allows innovation, but within clearly defined limits.

Unlike diagnostic control systems (which monitor critical performance outcomes) or beliefs systems (which communicate core values), boundary systems are stated in negative terms or as minimum standards. The boundaries in modern organizations, embedded in standards of ethical behavior and codes of conduct, are invariably written in terms of activities that are off-limits. They are an organization's brakes. Every business needs them, and, like racing cars, the fastest and most performance-oriented companies need the best brakes.

Human beings are inventive, and, when presented with new opportunities or challenging situations, they often search for ways to create value or overcome obstacles. But empowerment—fueled by inspiration and performance rewards—should never be inter-

preted as giving subordinates a blank check to do whatever they please. People generally want to do the right thing—to act ethically in accordance with established moral codes. But pressures to achieve superior results sometimes collide with stricter codes of behavior. Because of temptation or pressure in the workplace, individuals sometimes choose to bend the rules. As the recent problems at Kidder, Peabody and Salomon Brothers show, entrepreneurial individuals sometimes blur or misinterpret the line between acceptable and unacceptable behavior. At Salomon Brothers, a creative trader attempting to increase investment returns violated U.S. Treasury bidding rules and short-circuited existing controls; the aftermath of the scandal destroyed careers and impaired Salomon's franchise. Similar problems at Kidder, Peabody involving fictitious securities trades resulted in massive losses and ultimately led to the sale of the business. Clearly, the consequences of a misstep can be severe.

Boundary systems are especially critical in those businesses in which a reputation built on trust is a key competitive asset. A well-respected bank with a global franchise states as a part of its business principles that its three main assets are people, capital, and reputation. Of all these, it notes, the last is the most difficult to regain if impaired. To guard against damage to its reputation, the bank's code of conduct forbids individuals both from developing client relationships in "undesirable" industries, such as gambling casinos, and from acting as intermediaries in unfriendly takeovers, which senior managers believe could undermine the perceived trustworthiness of the company.

Large consulting firms like McKinsey & Company and the Boston Consulting Group routinely work with clients to analyze highly proprietary strategic data. To ensure that their reputations for integrity are never compromised, the firms enforce strict boundaries that forbid consultants to reveal information—even the names of clients—to anyone not employed by the firm, including

Beliefs systems can be thought of as the yang to the yin of boundary systems.



1. My colleague, Professor Charles Christenson, coined this term in a 1972 Harvard Business School working paper.

spouses. They also clearly state in their codes of professional conduct that individuals must not misrepresent themselves when attempting to gather competitive information on behalf of clients.

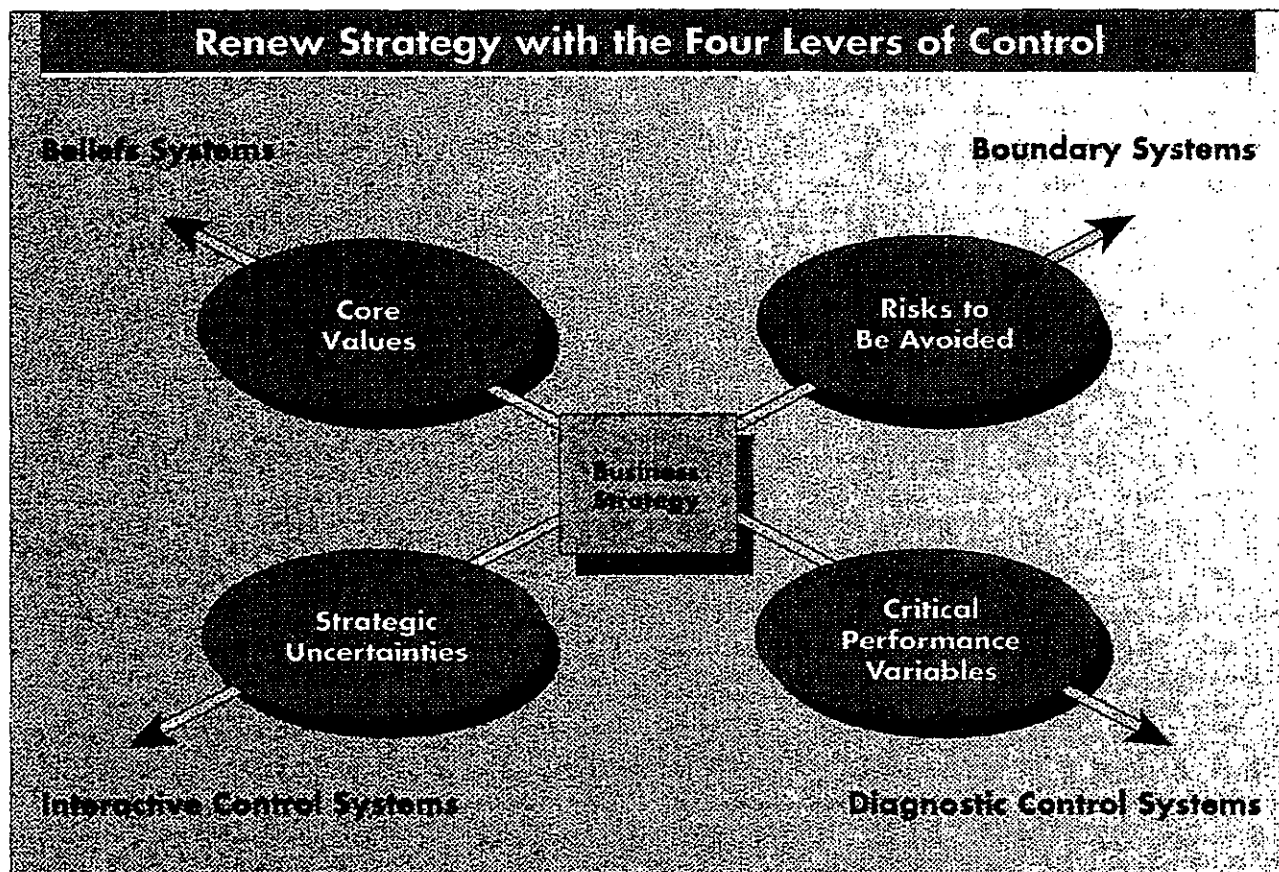
Unfortunately, the benefits of establishing business conduct boundaries are not always apparent to senior managers. Too often, they learn the hard way. Many codes of conduct are instituted only after a public scandal or an internal investigation of questionable behavior. Over the years, General Electric has instituted codes of business conduct that prohibit activities relating to improper payments, price fixing, and improper cost allocation on government contracts. Each of those codes was instituted after a major crisis impaired the integrity of the business. For instance, when GE was forced to suspend its \$4.5 billion business as supplier to the U.S. government in 1985, CEO Jack Welch responded by strengthening internal controls and issuing a clear policy statement that forbade the behaviors that had landed GE in trouble: improper cost allocations on government contracts. Similarly, senior managers at Wall Street investment firms

did not pay much attention to business conduct boundary systems until the disclosure of improper behavior by a small number of employees at Salomon Brothers nearly destroyed the business. Again, senior managers at investment firms across the country scrambled to install compliance systems

Boundary systems are an organization's brakes. And, like racing cars, the fastest companies need the best brakes.

to avoid a similar crisis in their own firms.

Effective managers anticipate the inevitable temptations and pressures that exist within their organizations. They spell out the rules of the game based on the risks inherent in their strategy and enforce them clearly and unambiguously. Some behaviors are never tolerated: the firing of the manager who inflated his or her expense report by \$50 is a familiar story in many organizations. On the sur-

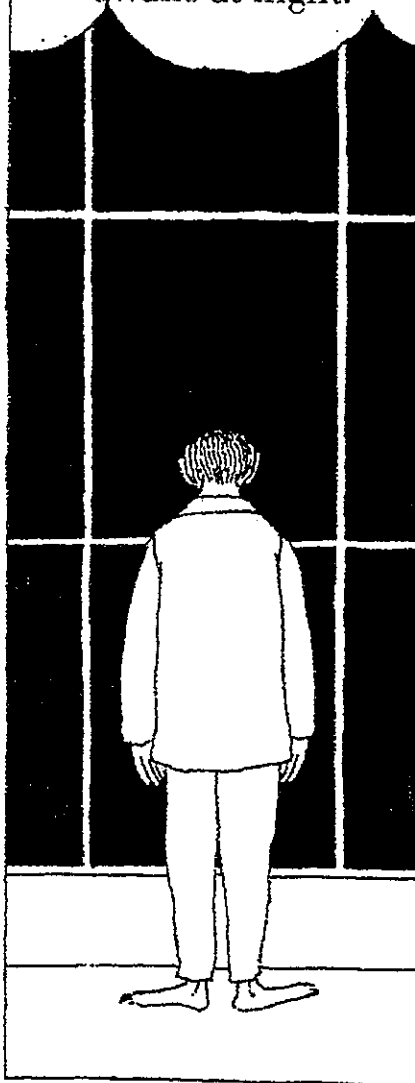


Interactive control systems track the uncertainties that keep senior managers awake at night.

face, the punishment may seem too harsh for the crime, but the purpose of such punishment is to signal clearly to all managers and employees that the consequences of stepping over ethical boundaries are severe and nonnegotiable. As performance-oriented organizations grow and become more decentralized, the risks of failure increase. Managers must rely more and more on formal systems in order to ensure that the boundaries are communicated and understood.

Not all boundaries concern standards of ethical conduct. Strategic boundaries focus on ensuring that people steer clear of opportunities that could diminish the business's competitive position. A large computer company, for example, uses its strategic planning process to segregate its product and market opportunities into what managers call *green space* and *red space*. Green space is the acceptable domain for new initiatives. Red space represents products and markets in which senior managers have decided they do not want to pursue new opportunities, although the organization could compete in those products and markets given its competencies. A British relief organization uses a similar system to monitor strategic boundaries; it maintains a *gray list* of companies whose contributions it will neither solicit nor accept. Managers at Automatic Data Processing (ADP) use a strategic boundary list that delineates the types of business opportunities that managers must avoid. The guidelines provide ADP managers with clarity and focus. This technique has contributed to 133 consecutive quarters of double-digit growth in earnings per share—a record unmatched by any other company traded on the New York Stock Exchange.

Working together, boundary systems and beliefs systems are the yin and yang that together create a dynamic tension. The warm, positive, inspirational beliefs are a foil to the dark, cold constraints. The result is a dynamic tension between commitment and punishment. Together, these systems transform limitless opportunity into a focused domain



that employees and managers are encouraged to exploit actively. In combination, they establish direction, motivate and inspire, and protect against potentially damaging opportunistic behavior.

Interactive Control Systems

When organizations are small, key managers and employees can sit around the same table and informally explore the impact of emerging threats and opportunities. But as organizations grow larger and senior managers have less and less personal contact with people throughout the organization, new formal systems must be created to share emerging information and to harness the creativity that often leads to new products, line extensions, processes, and even markets. Unfortunately, diagnostic control systems, which highlight shortfalls against plans, won't suffice. Instead, senior managers need sensing systems more like the ones used by the National Weather Service. Ground stations all over the country monitor temperature, barometric pressure, relative humidity, cloud cover, wind direction and velocity, and precipitation. Balloons and satellites provide additional data. These data are monitored continuously from a central location in an effort to identify patterns of change.

Managers need similar scanning mechanisms. Like weather-tracking systems, interactive control systems are the formal information systems that managers use to involve themselves regularly and personally in the decisions of subordinates. These systems are generally simple to understand. Through them, senior managers participate in the decisions of subordinates and focus organizational attention and learning on key strategic issues.

Making a control system interactive invariably demands attention from participants throughout the business. At Pepsico, for example, the weekly release of new Nielsen market-share numbers creates a flurry of activity as 60 or 70 people throughout the organization begin working on the data in

anticipation of the inevitable scrutiny and queries of senior management. Senior managers schedule weekly meetings to discuss the new Nielsen information, to challenge subordinates to explain the meaning of changed circumstances, and to review action plans that subordinates have developed to react to problems and opportunities.

Interactive control systems have four characteristics that set them apart from diagnostic control systems. First, they focus on constantly changing information that top-level managers have identified as potentially strategic. Second, the information is significant enough to demand frequent and regular attention from operating managers at all levels of the organization. Third, the data generated by the interactive system are best interpreted and discussed in face-to-face meetings of superiors, subordinates, and peers. Fourth, the interactive control system is a catalyst for an ongoing debate about underlying data, assumptions, and action plans.

Interactive control systems track the strategic uncertainties that keep senior managers awake at night—the shocks to the business that could undermine their assumptions about the future and the way they have chosen to compete. Depending on the business, these uncertainties might relate to changes in technology, customers' tastes, government regulation, and industry competition. Because interactive control systems are designed to gather information that might challenge visions of the future, they are, by definition, hot buttons for senior managers.

A senior manager's decision to use a specific control system interactively—in other words, to invest time and attention in face-to-face meetings to review new information—sends a clear signal to the organization about what's important. Through the dialogue and debate that surround the interactive process, new strategies often emerge. Consider the case of a well-known hospital supply company. The company is a low-cost producer, supplying disposable hospital products for intravenous drug delivery such as plasma containers, tubing, and syringes. Even though efficiency, quality, and cost control are important competencies, these concerns do not keep managers awake at night. (They are well understood and can be managed effectively with diagnostic control systems.) Instead, senior managers worry that technological breakthroughs will undermine their ability to deliver products valued by the market. Accordingly, they use a project management system interactively to focus organizational

attention on a dozen or so emerging technological issues. Senior managers meet monthly for several days to debate the impact of technologies—introduced by competitors or in related industries, or developed in-house—on their business. These meetings become intense as the managers challenge one another to assess the impact of new information and develop responses. From this dialogue, new strategies emerge.

Senior managers at *USA Today*, Gannett Company's daily newspaper, use a similar process to review information contained in a simple package of reports delivered each Friday. Three weekly reports give senior managers a picture of how they have done in the previous week and what conditions lie ahead for the upcoming few weeks. The data in the Friday packet range from year-to-date figures to daily and account-specific information. These data

Interactive control systems focus on constantly changing information that senior managers consider potentially strategic.

provide insight into changing industry conditions and the advertising strategies of key customers. They allow managers to look at the big picture and provide enough detail to identify specific vulnerabilities, opportunities, and the source of any problems that require proactive responses.

Each week, senior managers at *USA Today* schedule intensive face-to-face meetings with key subordinates to analyze and interpret the report data. Among the regular topics of discussion and debate are advertising volume against plan, committed future volume by issue, and new business by type of client. In addition to looking for unexpected shortfalls, managers also look for unexpected successes. From these meetings, significant innovations have been proposed to deal with unanticipated downturns and to capitalize on unanticipated opportunities. Innovations have included launching a new market-survey service for automotive clients, introducing fractional-page color advertising, selling exclusive inserts dedicated to specific customers and products, and using circulation salespeople to sell ad space in regional locations.

Of course, managers in other businesses choose different kinds of control systems to use interactively depending on the strategic uncertainties as-

sociated with their business strategies. For example, Johnson & Johnson uses its profit-planning system interactively to focus attention on the development and protection of innovative products in its various markets. Managers periodically reestimate the predicted effects of competitive tactics and new product rollouts on their profit plans for the current and the following year. The recurring questions posed by managers are: What has changed since our last forecast? Why? What are we going to do about it? The results are new ideas and action plans.

Balancing Empowerment and Control

Effective managers empower their organizations because they believe in the innate potential of people to innovate and add value. For instance, the reason Nordstrom salespeople provide exceptional customer service is that they are selected and trained to act entrepreneurially. In turn, they have the freedom and motivation to tailor their service to each customer's needs. To unleash this type of potential, senior managers must give up control over many kinds of decisions and allow employees at lower levels of the organization to act independently. Good managers work constantly to help employees rise to their potential. In small organizations, managers do this informally. While eating or traveling together, they communicate core values and missions, the rules of the game, and current targets – and they learn about significant changes. As companies become larger, more decentralized, and geographically dispersed, senior managers are no longer in constant contact with all the employees who will identify and respond to emerging problems and opportunities. Nonetheless, the guiding principles of communication and control are every bit as important.

A large international construction company respected for its quality and customer service provides a clear illustration of how the control levers support one another. The company has more than 25 offices in the United States and abroad; as a result, project managers and employees make multi-million-dollar decisions far from the company's top-level managers. The senior managers who set the company's overall direction and strategy ensure that they have adequate control of their far-flung operations by using all four levers of control.

To communicate core values, they rely on a beliefs system. The company's widely circulated credo refers to the importance of responsibility, of collective pride in engineering quality, of financial success, and of integrity. It concludes with an overall objective handed down by the founder: "To be the best."

These inspirational beliefs are offset by clear boundaries. Managers are forbidden, for example, to work in certain countries where facilitating payments and bribes are required to do business, because these sorts of actions jeopardize the company's belief in integrity. The company also maintains a *turkey list* to communicate to managers the types of projects that the company has learned are not profitable and should be avoided. (For example, senior managers have learned from bitter experience to steer clear of sewage-disposal-plant construction.) The list is adjusted from time to time as managers learn where their competencies lie and where they don't.

Managers gain still more control by using a variety of diagnostic controls – among them profit plans, budgets, and goals and objectives. These control systems do not require very much attention from senior management other than the time spent setting annual goals and monitoring exceptions to see that events unfold according to plan. One control system, however, is used interactively. The project management system focuses attention on the strategic uncertainties that managers want everyone to monitor: the company's reputation in the trade, the shifting perceptions of customers, and the ideal skill mix required in various project teams. The new data are used as a catalyst to force regular face-to-face discussions in which managers share information and attempt to develop better ways to customize their services and adjust their strategies in a changing market.

Collectively, these four levers of control set in motion powerful forces that reinforce one another. As organizations become more complex, managers will inevitably deal with increasing opportunity and competitive forces and decreasing time and attention. By using the control levers effectively, managers can be confident that the benefits of innovation and creativity are not achieved at the expense of control.

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4.4 Securing Control

4.4.1 Risk and Control

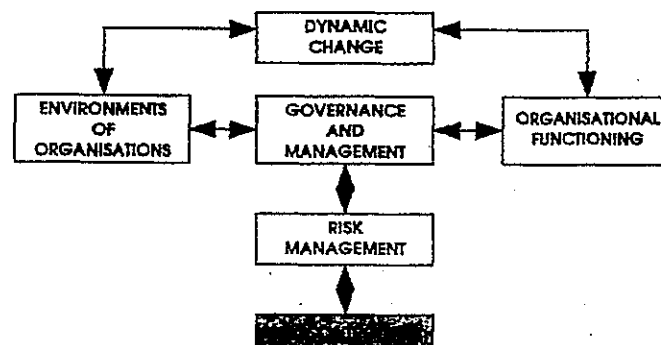
Having established processes for managing risk exposures, the issue arises as to whether these processes are functioning as intended - as the organisation seeks to realise its strategies while experiencing dynamic change (see 4.2.5, 4.3.5 above). Is the organisation *in control*, as it pursues 'value at risk' under these conditions (Competency 6.1.3)?

Viewed in this way, the focus of control in organisations is on 'value at risk' and its management, as critical underpinnings of strategy realisation and the attainment of objectives (Delphi 2.6; Perspectives 5.2.6). More specifically, the focus of control will be on the *risk parameters* accepted or established for the range of exposures sustained by an organisation as it negotiates value creation under dynamic conditions and in the face of uncertainty (see 4.3.4, 4.3.5 above; Competency 6.1.3; Assessing Competency 3.9). An organisation will be 'in control' if:

- * *risk parameters* appropriately reflect shifting exposures, and
- * *risk strategies and treatments* meet the conditions established by the *risk parameters* relating to particular exposures.

Risk management and control are different types of organisational process, though they are related. *Risk management processes* develop organisational understandings about, and treatment systems for 'value at risk' (see 4.3.5 above). *Control processes* establish, and develop organisational understandings about the *efficacy* of risk management processes under conditions of change. Where 'value at risk' is not managed effectively, then an organisation has the potential (at least) to become 'out of control'. Arguably, control processes serve no organisational purpose other than to negate or highlight this possibility (Competency 6.1.3). Being 'in control' implies that an organisation's changing risk exposures are understood and managed effectively.

In practice control processes are likely to be aligned with risk management processes in organisations, and both are likely to be dimensions of larger governance and management processes (Assessing Competency 3.9). The following diagram is illustrative:



Control has been described as the exercise of 'powers', taken or given, within 'zones of discretion', where varying degrees and types of autonomy are made available (see 2.2.2 above); *accountability* refers to forms of control that are operative when there is some possibility of autonomy.

Control and accountability engage both thought and (inter-) action in organisations; and different forms of control and accountability invoke thought and action in different ways. For example, different forms of control or accountability may utilise different types of knowledge or value framework, and different types of information. Similarly, different dimensions of relationships, different relationship structures, and different modes of action may be utilised (see 2.2.4 above).

Organisations are likely to utilise different forms of control/accountability, in varying combinations. The forms of control/accountability used are likely to reflect the institutional and cultural location of an organisation, as well as the distinctive environment it faces and the distinctive mode of functioning it adopts (see 2.2.5, 2.3.4 above). Thus, overtly or otherwise, the forms of control/accountability adopted are the result of a *design* process where they are suited to an organisation and its contexts (see 2.2.1 above). The design achieved may be appropriate, efficient and effective - or it may be otherwise (*Competency 6.1.3*); in the latter case, the forms of control used may inhibit the pursuit of 'value at risk' or fail to highlight failures in risk management processes - thereby lowering the possibility of an organisation being 'in control'.

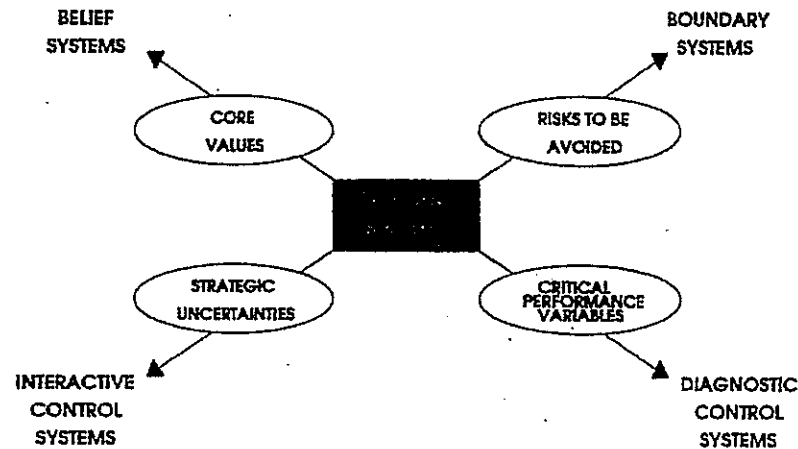
"The creation of control structures in an organisation is a delicate process involving trial and error, fine-tuning, and the need to address constant change. The organisation might be over-controlled in key risk areas, thus inhibiting its effectiveness in value creation; or it might be under-controlled, thus leading to unexpected or unacceptable risk exposures. Over- or under- control might be the result of inappropriate mixes of forms of control, or the consequences of patterns of control that are divorced from considerations of effectiveness of value creation within established risk parameters, or the result of using control structures that neither anticipate nor respond to dynamic shifts in risk exposures. Moreover, good intentions with respect to control may fail to be realised (*Competency 6.1.3*).

Simons (1995), for example, references some of the considerations and problems involved in the design and use of effective control systems when he refers to a "balancing act". "Control systems" need to selectively "balance the inherent tensions between (1) unlimited opportunity and limited attention, (2) intended and emergent strategy, and (3) self-interest and the desire to contribute. Underlying these tensions is the desire to do right, to achieve, to contribute, to create" (p.28). According to Simons, controls need to be designed so that they don't create "blocks" in effective organisational functioning; instead they should be designed as an overall system, so as:

- To reduce the risk of temptation or pressure, management control systems are used selectively to specify and enforce the organisation's rules of the game.
- To bring focus and resources to individuals seeking the opportunity to achieve, management control systems are used selectively to build and support clear stretch targets.
- To stimulate innovation, management control systems are used selectively to inspire and motivate organisational participants to create and search for new opportunities.
- To reduce the fear of challenging the status quo, management control systems are used selectively to open organisational debate and dialogue and thereby trigger organisational learning" (pp.28, 29).

Simons (1995) draws on an appropriate "nesting" of four types of control system (he calls them 'levers of control'), in managing the "inherent tension" between "creative innovation" and "predictable goal achievement", so that both are "transformed into profitable growth" (p.29). He labels the four types of control system as follows: belief systems (the expression and adoption of certain *core values* across an organisation); boundary systems (which *proscribe* certain forms of *behaviour* by organisational members, whilst leaving open a domain for initiative and innovation);

diagnostic control systems (*feedback* systems focused on predictable control variables); and interactive control systems (whereby the *leadership* of the organisation focuses attention and dialogue throughout the organisation on what they see to be a recurring and important *agenda*). Together the four levers can be used to espouse the core values to be used in decision making, clearly avoid certain types of risk, focus attention on critical performance variables, and stimulate opportunity-seeking in the face of uncertainty. Thus, "belief systems and interactive systems expand and define the opportunity space of the firm. Boundary systems and diagnostic systems constrain and focus attention on strategic domains and opportunities" (p.29). Appropriately designed and used, the four levers of control both focus strategy realisation and recreation. The following diagram is illustrative (p.39):



Simons' four levers of control are illustrative versions of three of the types of control/accountability associated with the archetypal forms of social order which are embodied (in various ways) in the design of organisations and institutions (see 2.2.4 above): clans, markets, hierarchies, fiefs. More or less, belief systems are adaptations of communal control (see 2.2.3.1 above), boundary systems and diagnostic feedback systems are adaptations of administrative control and accountability respectively (see 2.2.3.3 above), and interactive control systems are a version of subsumptive control (see 2.2.3.4 above). Strangely, the systems described by Simons do not seem to invoke or utilise contractual control (see 2.2.3.2 above), except perhaps as a variant of diagnostic control systems. Moreover, they do not reference risk exposures and their management overtly, except in the restricted case of boundary systems. They are used to steer organisational strategy development and implementation in environments replete with risk (high in competition, volatility, uncertainty), without establishing risk as a point of articulation between value creation and organisational control.

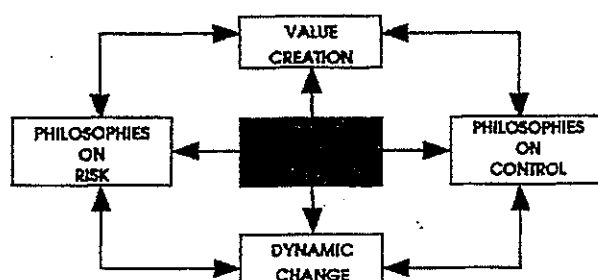
While the design of organisations to suit environments of dynamic change is likely to draw on organisational models that are adapted to these environments in various ways (see 4.2.1 above), it is also likely to embody archetypal forms of social order in various configurations (see 2.2.1 above). These archetypal forms of social order will be embodied in the organisation models sampled, as well as in surrounding institutions and national cultures (see 2.3.4 above). Thus, the characteristic types of control/accountability associated with each of the forms of social order are likely to be imported into organisations as they are designed. Clans, markets, hierarchies and fiefs will be represented in organisational designs in characteristic patterns; and so will communal control, contractual control, administrative control, and subsumptive control.

Moreover, these designs will be modified constantly, as an organisation experiences change and finds a future (*Delphi 2.6*).

The design of organisations, under these conditions, is likely to call on more sophisticated understandings of the nature of control in organisations, and the ways in which control and risk are woven together in organisational functioning and value creation (*Competency 6.1.3; Delphi 2.6*).

4.4.2 Philosophies on Control

As with risk exposure, organisations take general positions on their approach to control and accountability, 'knowingly' or otherwise. These positions can be referred to as *philosophies on control* (*Competency 6.1.3, 8 Element 2.1*). More than likely there will be some form of *alignment* between an organisation's philosophies on control and its approach to value creation and change, and its philosophies on risk (see 4.3.2 above). The following diagram is illustrative:



This alignment is likely to reflect the *composition* of the organisation, as it draws on distinctive mixes of clans, markets, hierarchies and fiefs as forms of social order (see 2.2.6 and 2.3.4 above). The following Table is illustrative:

	FORMS OF SOCIAL ORDER UTILISED			
	CLANS	MARKETS	HIERARCHIES	FIEFS
POSITION ON VALUE CREATION	Conservation	Dissemination	Creation	Proclamation
PHILOSOPHY ON RISK	Averse	Seeker	Avoider	Ignorer
PHILOSOPHY ON CONTROL	Communal	Contractual	Administrative	Subsumptive

While the composition of an organisation is likely to utilise all of the forms of social order and all of the types of control identified with them, it might be possible to characterise the organisation's dominant approach to control. Thus, an organisation's *general* philosophy on control might be said to be bureaucratic (administrative), collegial (communal), devolved (communal or administrative), imposed (administrative or subsumptive), hard (administrative or contractual), soft (communal or subsumptive), and so on.

Universities are said to use dominantly collegial philosophies on control, though they do utilise administrative controls (grudgingly), contractual controls (suspiciously), and do tolerate leadership decrees as a form of subsumptive control (if it is built on respect, rather than simple authority). Government bureaucracies are said to use dominantly administrative philosophies on

control, though they do utilise contractual controls (carefully), communal controls (reluctantly) and authoritative decree (naturally). Political parties tend to vary between dominant philosophies of communal control ('democratic parties') or subsumptive control ('issue driven' parties), whilst using contractual and administrative control (reluctantly).

At this general level, there is likely to be *consistency* between an organisation's philosophies on risk and its philosophies on control. Thus, an organisation which is risk averse would not be expected to embrace subsumptive control as its dominant philosophy; or an organisation that seeks or ignores risk is unlikely to be able to tolerate the processes associated with communal control.

Lying behind an organisation's characteristic philosophies on control, is the nature of the *powers* it invokes in securing control (see 2.2.2, 4.4.1 above). Within 'zones of discretion', where does it stand between the parameters of personal domination and personal autonomy? How does it mix control and accountability in using contractual and administrative forms of control? Does it favour hierarchical, mediated, peer, or adaptive approaches to control? Does it utilise physical, material, or symbolic powers?

One way of identifying the powers invokes is as a *reflection* of the reactions or receptiveness of those who are controlled. Are the orientations (either as predispositions or reactions) of those controlled - alienation (distrust, disaffiliation), calculative (oriented to personal gain), or moral (oriented to the common good)? Are those controlled receptive to it and the form it takes? Is their consent required, over-ruled or ignored? Are restrictions on autonomy understood and accepted?

An organisation's philosophies on control, then, can be *determined* from a number of different directions:

- * in terms of *alignments* that might be expected from observations of approaches to change and value creation, and philosophies on risk;
- * in terms of the *forms of social order* drawn on in composing the organisation, or the institutions and cultures within which it is located;
- * in terms of *consistencies* that might be expected with identified philosophies on risk;
- * in terms of the nature of the *powers* invoked in securing control; and
- * in terms of the reflections cast by the *reactions* or *receptiveness* of those controlled.

An organisation's (dominant) philosophies on control might be uncovered through various types of investigation (*Competency 7, 8 Element 2.1*). External or internal assessments of an organisation's philosophies on control and their effects on organisational functioning might be utilised, along with the espoused views of key stakeholders. The degree of penetration of philosophies on control within the consciousness of employees (or others) might be probed, along with their manifestation in organisational work processes and everyday communications; or their appearance may be sought, implicitly or explicitly, in communications between the organisation and its various stakeholders. Again, organisations might simply state that they follow a particular philosophy on control (eg; COSO, COCO), with investigations revealing this to be so or otherwise (*Competency 8 Element 2.1; Perspectives 5.2.6*).

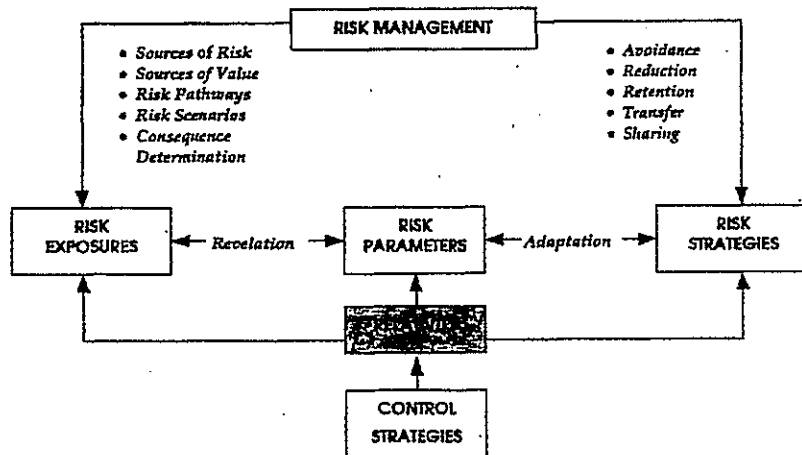
4.4.3 Control Strategies

While philosophies on control are reflective of an *organisation generally*, control strategies are established *relative to* an organisation's patterns of risk exposure and its risk strategies (Competency 6.1.3). Control strategies are 'designed' to ensure that:

- * an organisation's changing risk exposures are *revealed*, and are *captured* by the risk parameters it uses to establish risk strategies; and
- * an organisation's risk strategies meet the conditions established by the risk parameters in relation to *particular exposures* (see 4.4.1 above).

Control strategies focus on the *risk parameters* that are relative to *particular exposures*, because they define the bases on which the risk exposures will be managed strategically. Risk parameters establish the significance of an exposure, its underlying drivers or causes, and how the cost/benefit of strategy alternatives for dealing with it are (to be) weighed? Moreover, risk strategies are adapted to risk parameters in relation to particular exposures (see 4.3.3 above).

While control strategies focus on the strategic management of revealed risk exposures, they need also to consider the process of revelation itself – exposures that are not understood or revealed are unlikely to be managed strategically, and so the organisation is unlikely to be (or remain) 'in control' in relation to them. The following diagram is illustrative:



Against this background, the design or use of control strategies may be explored, by asking:

- * What is to be the *object/focus* of control – conduct, resource use, task performance/goal attainment, prescribed behaviour (see 2.2.2 and 2.2.4 above)?
- * How is *information* to be developed and used in the control process – unelaborated personal answerability, elaborated verified information, directly monitored formal information, unelaborated hierarchical review (see 2.2.4 above)?
- * How is *judgement* to be exercised in the control process, and by whom – by peers relative to group norms, by resource 'owners' relative to risk and returns, by superiors relative to goals

and standards, or by 'leaders' relative to the implicit obligations they impose on 'followers' (see 2.2.4 above)?

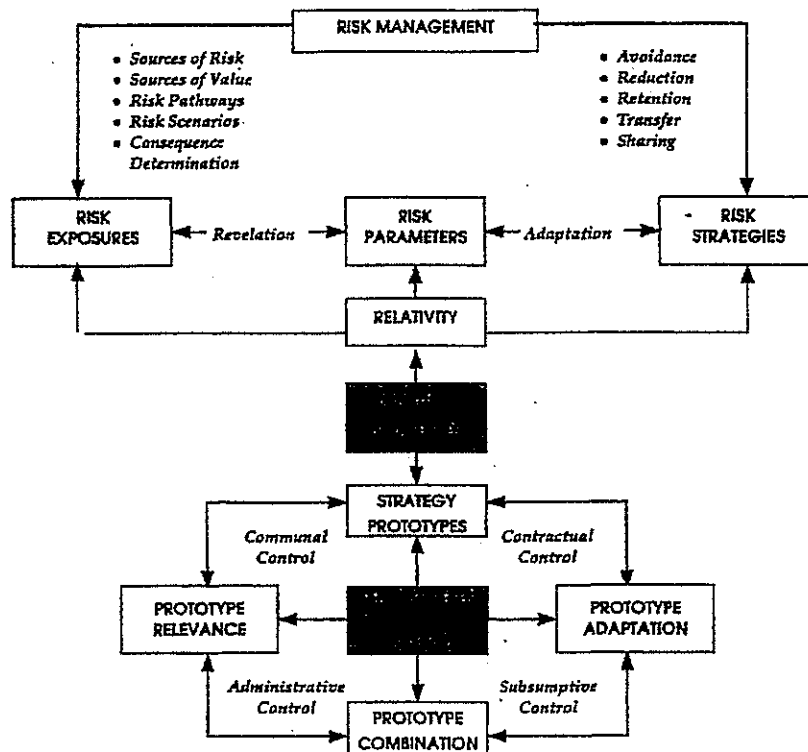
- * What types of *sanctions/rewards* are to be assigned, and by whom – collegial exclusion/inclusion, monetary losses/resource withdrawal, hierarchical/negotiated relative to task performance/goal attainment, summary exclusion from group (see 2.2.4 above)?
- * Is control to be invoked *ex ante*, or accountability *ex post* (see 2.2.2, 2.2.4 above)?
- * What types of *restrictions* are to be placed on personal autonomy along a control/accountability spectrum – negotiation/mediation, mutual/peer control, devolved control, adaptive control, self-control (see 2.2.2 above)?

Answers to these questions overall are likely to point to:

- * *control strategy prototypes* that are *relevant* to strategic management of a particular risk exposure or type of risk exposure – communal accountability, contractual control/accountability, administrative control/accountability, or subsumptive control (see 2.2.3, 2.2.4 above);
- * the way in which each control strategy prototype might be *adapted* to the risk exposure/type of risk exposure being managed – in terms of information use, judgement processes, sanctions/rewards, or restrictions on autonomy;
- * the way in which adapted control strategy prototypes might be *mixed/combined* in securing control over a particular risk exposure or type of risk exposure (eg; communal accountability plus administrative accountability) – this mix/combination is likely to be necessary as more than one risk strategy may be drawn on in managing a risk exposure (see 4.3.5 above).

Further, it might be expected that revealed control strategies in use or those recommended for use would be *consistent* with an organisation's philosophies on control (see 4.4.2 above). Indeed control strategies in use might be an *indicator* of an organisation's philosophies on control.

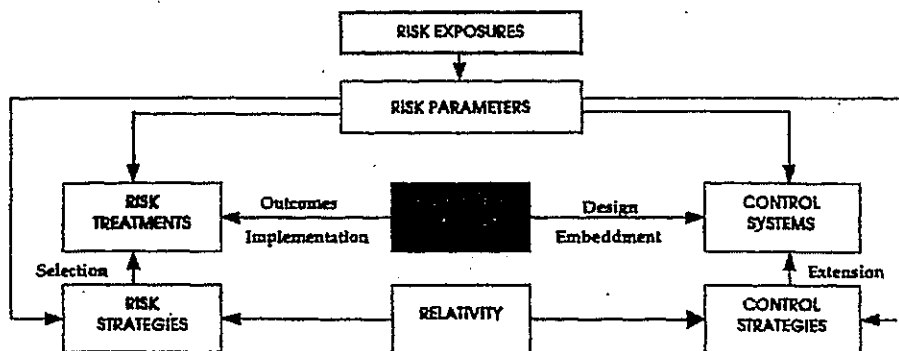
The control strategies of an organisation, then, consist of the adaptations and combinations of archetypal forms of control (here called, 'control strategy prototypes') that are seen as relevant to particular (types of) risk exposures, consistent with its philosophies on control. The following diagram is illustrative:



4.4.4 Control Systems

The control systems of an organisation are an extension of its control strategies, and involve a *substantive alignment* with the treatment options selected for particular (types of) risk exposures (see 4.3.4, 4.4.3 above).

Control systems engage with the *risk parameters* relevant to a particular exposure by reference to the expected outcomes of selecting risk treatments, and with *risk treatment systems* in terms of planned implementation. Control systems are designed to ensure either that the implementation of risk treatments secures the outcomes expected, or to reveal progressively any failures in regard to outcomes and/or implementation. Control systems are most likely to be effective if they are aligned with, or embedded in risk treatment systems. The following diagram is illustrative:



Control systems are unlikely to be effective if they do not engage with the specifics of risk treatment outcomes sought or specific implementation plans and activities. Such ineffectiveness is likely to result in a 'loss of control', with the organisation potentially becoming 'out of control' in relation to particular (types of) risk exposures (see 4.4.1 above).

In 'designing' control systems, care needs to be taken that:

- * the variables involved in the selection of treatment options are *recognised* (the significance of the 'value at risk', the risk drivers associated with the exposure, and the costs/benefits of the treatment);
- * the planned process of treatment implementation is not *inhibited*;
- * the costs associated with their design or implementation either do not negate the benefits expected from selected treatments, or are incorporated in the treatment selection process (Competency 6.1.3).

4.4.5 Control Structures

The control strategies and systems aligned with specific (types of) risk exposures can be 'aggregated' as an overall framework or *structure of control* for an organisation (Competency 6.1.3); these control structures elaborate and represent an organisation's philosophy on control, and so should be consistent with it (Competency 7 Element 2.3).

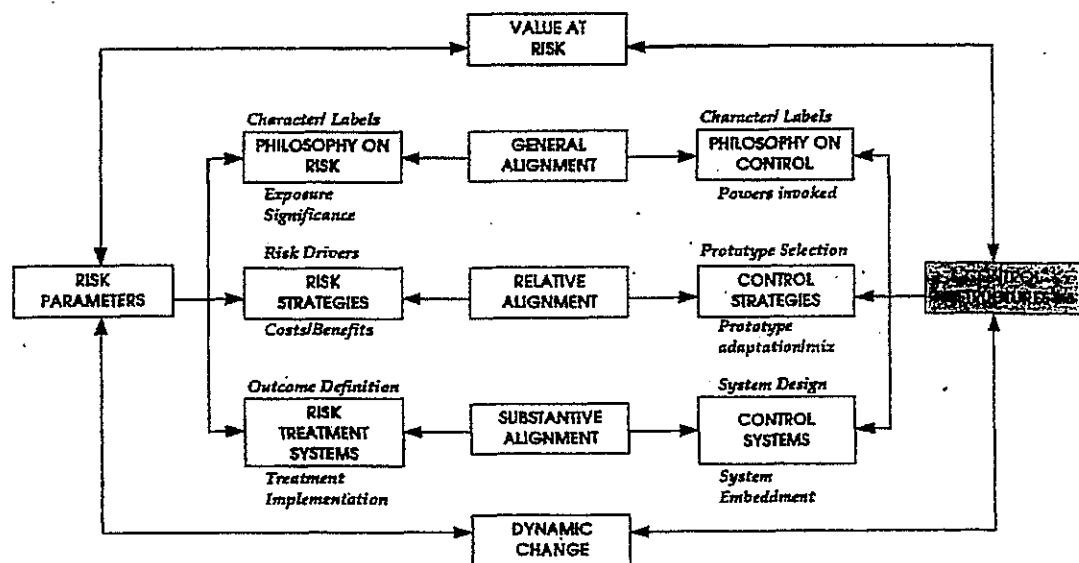
The control structures of an organisation are likely to emerge through a *consistent pattern* of selecting, adapting and combining a limited number of control strategy prototypes (see 4.4.3 above) - and through the *progressive design* of control systems that are consistent with control strategies (see 4.4.4 above). Thus, an organisation will develop its own *distinctive forms* of communal accountability, contractual control/accountability, administrative control/accountability, and subsumptive control. When risk exposures arise or change, these distinctive forms will be used as a 'ready-made' resource, being deployed strategically and as systems of control.

The structures of control of an organisation are likely to be reviewed and revised only if there is a significant change in the pattern of risk exposures faced by an organisation. For control structures represent a prior investment by an organisation, and will be embedded in its belief structures and its functioning.

The control structures of an organisation are *structured* along a number of dimensions:

- * At the most general level they are *aligned* with the risk parameters established to treat 'value at risk' under conditions of dynamic change;
- * There is likely to be *consistency* developed or sustained between an organisation's philosophy on control, its control strategies and its control systems;
- * There will be particular, and different forms of *alignment* sustained respectively between philosophies on control and philosophies on risk (general, organisation level alignment), control strategies and risk strategies (alignments *relative* to the risk exposure (types) considered or at issue), and control systems and risk treatment systems (alignments governed by the *substantive* treatments implemented and outcomes sought).

The following diagram is illustrative:



Control structures may be established as a result of an explicit, deliberative organisational process, or they may simply emerge as a pattern over time as risk exposures are recognised and treated. In either case, an organisation will embody some type of control structure in its functioning, simply because it will face risk of one type or another. These control structures might be assessed for their suitability or effectiveness (*Competency 7 Element 2.3*). Such assessments might consider whether control structures:

- * are *holistic* in their coverage of organisational risk exposures and risk parameters;
- * sustain appropriate types of *alignment* with organisational philosophies on risk, risk strategies and risk treatment systems;
- * sustain appropriate and *consistent* relationships between an organisation's philosophy on control, its control strategies, and its control systems respectively;

- * *penetrate* sufficiently in terms of organisational understanding, adherence and functioning;
- * adequately cope with shifts in *contextual conditions* or *circumstances*;
- * align with *best practice*, relative to the overarching institutions or cultures within which an organisation is located.

These assessments may uncover strengths and weaknesses in control structures, areas where control is not working or not working appropriately, and areas or situations where the organisation appears to be 'not-in-control' (*Competency 8 Element 2.3*). Suggestions or recommendation for revisions or improvements may flow from such assessments (*Competency 7 Element 2.4, 8 Element 2.4*).

An organisation's risk management processes and its associated control structures are particularly vulnerable at four points. *First*, in recognising risk exposures or shifts in risk exposures; if risk exposures are not recognised, they are unlikely to be effectively treated or controlled. *Second*, in *comprehending* the risk exposures and control structures of an organisation holistically; such a failure in comprehension is likely to lead to piecemeal risk treatments and controls, without a determination that the organisation is 'in control'. *Third*, in assigning significance to risk exposures relatively, so that appropriate risk treatments and controls can be mobilised; inappropriate risk treatments and controls may result in significant value losses and/or unnecessary costs. *Fourth*, in *anticipating* shifts in risk exposures, so they can be treated and controlled proactively; many (potential) risk exposures need to be managed and controlled prior to their occurrence or organisational action that will engage them - otherwise it will be too late (Dembo and Freeman 1998).

Recognition, comprehension, assigning significance, and anticipation are all dimensions of an organisation's sense-making structures (see 2.1.3 above). Hence, a critical aspect of risk management and control structures in organisations involves the *negotiation of understanding* across an organisation - about values at risk, the realities of organisational engagements, and expectations about the future. That which is not understood is unlikely to be managed or controlled effectively.

However, as with risk management (see 4.3.5 above), organisations may experience difficulty in creating understanding about the nature and purpose of control amongst its participants. This difficulty may arise partly from a failure to adopt a rich enough language for talking about control, and partly from deficiencies in the processes used to draw the language into everyday use so that appropriate frameworks of meaning are created within the organisation. Thus, the selection of a *conceptual framework* as a language for structuring thinking and communication about control becomes critical, as a basis for developing understanding about control within an organisation (*Competency 6.1.3, 7, 8 Element 2.1 and 2.4*).



Maytag: Leaving a Foreign Subsidiary Free as a Bird

In an unbelievable blunder, Maytag's foreign subsidiary in the United Kingdom accomplished a horror story of decentralized management. This might also be called abdication of authority, and the consequences of such abdication.

The atmosphere at the annual meeting in the little Iowa town of Newton had turned contentious. As Leonard Hadley faced increasingly angry questions from disgruntled shareholders, a thought crossed his mind: "I don't deserve this!" After all, he had been CEO of Maytag Corporation for only a few months, and this was his first chairing of an annual meeting. But the earnings of the company had been declining every year since 1988, and in 1992 Maytag had had a \$315.4 million loss. No wonder the stockholders in the packed Newton High School auditorium were bitter and critical of their management. But there was more. Just the month before, the company had suffered the public embarrassment and costly atonement resulting from a monumental blunder in the promotional planning of its United Kingdom subsidiary.

Hadley doggedly saw the meeting to its close and limply concluded, "Hopefully, both sales and earnings will improve this year."¹

THE FIASCO

In August 1992, Hoover Limited, Maytag's British subsidiary, had launched this travel promotion: Anyone in the United Kingdom buying more than £100 (UK pounds) worth of Hoover products (about \$150) before the end of January 1993 would get two free round-trip tickets to selected European destinations. For £250 worth of Hoover products, buyers could get two free round-trip tickets to New York or Orlando.

A buying frenzy resulted. Consumers had quickly figured out that the value of the tickets easily exceeded the cost of the appliances necessary to be eligible for them. By the tens of thousands, Britons rushed out to buy just enough Hoover prod-

ucts to qualify. Appliance stores were emptied of vacuum cleaners. The Hoover factory in Cambuslang, Scotland, that had been making vacuum cleaners only 3 days a week was suddenly placed on a 24-hour, 7-days-a-week production schedule—an overtime bonanza for the workers. What a resounding success for a promotion! Hoover managers, however, were unhappy.

Hoover had never expected more than 50,000 people to respond. And of those responding, it expected far fewer would go through all the steps necessary to qualify for the free trip and really take it. But more than 200,000 not only responded but qualified for the free tickets. The company was overwhelmed. The volume of paperwork created such a bottleneck that by the middle of April only 6,000 people had flown. Thousands of others either never got their tickets, were unable to get the dates requested, or waited for months without hearing the results of their applications. Hoover established a special hotline to process customer complaints, and these were coming in at 2,000 calls a day. But the complaints quickly spread, and the ensuing publicity brought charges of fraud and demands for restitution.

Maytag dispatched a task force to try to resolve the situation without jeopardizing customer relations any further. But it acknowledged that it was "not 100% clear" that all eligible buyers would receive their free flights.² The ill-fated promotion was a staggering blow to Maytag financially. It took a \$30 million charge in the first quarter of 1993 to cover unexpected additional costs linked to the promotion. Final costs were expected to exceed \$50 million, which would be 10 percent of UK Hoover's total revenues. This was especially damaging for a subsidiary acquired only 4 years before, that had yet to produce a profit.

Adding to the costs were problems with the two travel agencies involved. The agencies were to obtain low-cost space-available tickets and would earn commission selling "packages," including hotels, rental cars, and insurance. If consumers bought a package, Hoover would get a cut. However, despite the overwhelming demand for tickets, most consumers declined to purchase the package, thus greatly reducing support money for the promotional venture. So Hoover had greatly underestimated the likely response and overestimated the amount it would earn from commission payments. This raises the issue of loss leaders. How much should we use loss leaders as a promotional device? This topic is discussed in the following box.

If these cost overruns had added greatly to Maytag and Hoover's customer relations and public image, the expenditures would have seemed more palatable. But with all the problems the best that could be expected would be to lessen the worst of the agitation and charges of deception. And this was proving to be impossible. The media, of course, salivated at the problems and were quick to sensationalize them:

One disgruntled customer, who took aggressive action on his own, received the widest press coverage, and even became a folk hero. Dave Dixon, claiming he was cheated out of a free vacation by Hoover, seized one of the company's repair vans in retaliation.

¹ Richard Gibson, "Maytag's CEO Goes Through Wringer at Annual Meeting," *The Wall Street Journal* (April 29, 1993), p. 15.

² James R. Miller, "Maytag U.K. Unit Finds a Promotion Is Too Successful," *The Wall Street Journal* (April 29, 1993), p. 15.

ISSUE BOX

SHOULD WE USE LOSS LEADERS?

Leader pricing is a type of promotion with certain items advertised at a very low price—sometimes even below cost—in which case they are known as *loss leaders*—in order to attract more customers. The rationale is that such customers are likely to purchase other regular-price items as well, increasing total sales and profits. If customers do not purchase enough other goods at regular prices to more than cover the losses incurred from the attractively priced bargains, then the loss leader promotion is ill advised. Some critics maintain that the whole idea of using loss leaders is absurd: The firm is just “buying sales” with no regard for profits.

While UK Hoover did not think of its promotion as a loss leader, in reality it was: The company stood to lose money on every sale if the promotional offer was taken advantage of. Unfortunately for its effectiveness as a loss leader, the likelihood of customers purchasing other Hoover products at regular prices was remote, and the level of acceptance was not capped, so losses were permitted to multiply. The conclusion has to be that this was an ill-conceived idea from the beginning. It violated these two conditions of loss leaders: They should stimulate sales of other products, and their losses should be limited.

Do you think loss leaders really are desirable under certain circumstances? Why or why not?

Police were sympathetic: they took him home, and did not charge him, claiming it was a civil matter.³

Heads rolled. Initially, Maytag fired three UK Hoover executives involved, including the president of Hoover Europe. At the annual meeting Mr. Hadley also indicated that others might lose their jobs before the cleanup was complete. He likened the promotion to “a bad accident ... and you can’t determine what was in the driver’s mind.”⁴

Receiving somewhat less publicity was the fact that corporate headquarters allowed executives of a subsidiary such wide latitude that they could saddle parent Maytag with tens of millions of dollars in unexpected costs. Did not top corporate executives have to approve ambitious plans? A company spokesman said that operating divisions were “primarily responsible” for planning promotional expenses. Although the parent may review such outlays, “if they’re within parameters, it goes through.”⁵ This raises the issue, discussed in the following box, of how loose a rein foreign subsidiaries should be allowed.

³ “Unhappy Brit Holds Hoover Van Hostage,” *Cleveland Plain Dealer* (June 1, 1993): D1; and Simon Reeve and John Harlow, “Hoover Is Sued Over Flights Deal,” *London Sunday Times* (June 6, 1993).

⁴ Gibson, “CEO Goes Through Wringer,” A5.

⁵ Miller, “Maytag UK Unit,” A9.

ISSUE BOX

HOW LOOSE A REIN FOR A FOREIGN SUBSIDIARY?

In a decentralized organization, top management delegates considerable decision-making authority to subordinates. Such decentralization—often called a “loose rein”—tends to be more marked with foreign subsidiaries, such as UK Hoover. Corporate management in the United States understandably feels less familiar with the foreign environment and more willing to let the native executives operate with fewer constraints than a domestic subsidiary has. In the Maytag/Hoover situation, decision-making authority by British executives was evidently extensive, and corporate Maytag exercised little operational control, being content to judge performance by ultimate results achieved. Major deviations from expected performance goals, or widespread traumatic happenings—both of which happened to UK Hoover—finally gained corporate management attention.

Extensive decentralization has many advantages: First, top management effectiveness can be improved because time and attention is freed for presumably more important matters; second, subordinates are permitted more self-management, which should improve their competence and motivation; and third, in foreign environments, native managers presumably understand their unique problems and opportunities better than corporate management, located thousands of miles away, possibly can. But the drawbacks are as we have seen: parameters within which subordinate managers operate can be so wide that serious miscalculations may not be stopped in time. Because top management is ultimately responsible for all performance, including actions of subordinates, it faces greater risks with extensive decentralization.

“Since the manager is ultimately accountable for whatever is delegated to subordinates, then a free rein reflects great confidence in subordinates.” Discuss.

BACKGROUND ON MAYTAG

Maytag is a century-old company. The original business, formed in 1893, manufactured feeder attachments for threshing machines. In 1907 the company moved to Newton, Iowa, a small town 30 miles east of Des Moines, the capital city. Manufacturing emphasis turned to home laundry equipment and wringer-type washers.

A natural expansion of this emphasis occurred with the commercial laundromat business in the 1930s, when coin meters were attached to Maytag washers. Rapid growth of these coin-operated laundries took place in the United States during the late 1950s and early 1960s. The increased competition and soaring energy costs of the 1970s hurt laundromats. In 1975 Maytag introduced new energy-efficient machines and “home style” stores that rejuvenated the business.

The Lonely Maytag Repairman

For years Maytag reveled in a marketing coup, with its washers and dryers enjoying a top-quality image, thanks to ads in which a repairman laments his loneliness because of Maytag’s trouble-free products. The result of this dependability and qual-

ity image was that Maytag could command a price premium: "Their machines cost the same to make, break down as much as ours—but they get \$100 more because of the reputation," grumbled a competitor.⁶

During the 1970s and into the 1980s, Maytag continued to capture 15 percent of the washing machine market and enjoyed profit margins about twice that of competitors. Table 16.1 shows operating results for the period 1974 to 1981. Whirlpool was the largest factor in the laundry equipment market, with a 45 percent share, but this was largely because of sales to Sears under the Sears brand.

Acquisitions

For many years, until his retirement December 31, 1992, Daniel J. Krumm had influenced Maytag's destinies. He had been CEO for 18 years and chairman since 1986, and his tenure with the company encompassed 40 years. In that time the home-appliance business had encountered some drastic changes. The most ominous occurred in the late 1980s with the merger mania, in which the threat of takeovers by hostile raiders often motivated heretofore conservative executives to greatly increase corporate indebtedness, thereby decreasing the attractiveness of their firms. Daniel Krumm was one of these running-scared executives, as rumors persisted that the company was a takeover candidate.

Largely as a defensive move, Krumm pushed through a deal for a \$1 billion buyout of Chicago Pacific Corporation (CPC), a maker of vacuum cleaners and other appliances with \$1.4 billion in sales. As a result, Maytag was burdened with \$500 mil-

lion in new debt. Krumm defended the acquisition as giving Maytag a strong foothold in a growing overseas market. CPC was best known for the Hoover vacuums it sold in the United States and Europe. Indeed, so dominant was the Hoover brand in England that many people did not vacuum their carpets, but "hoovered the carpet." CPC also made washers, dryers, and other appliances under the Hoover brand, selling them exclusively in Europe and Australia. In addition, it had six furniture companies, but Maytag sold these shortly after the acquisition.

Krumm had been instrumental in transforming Maytag, the number four U.S. appliance manufacturer—behind General Electric, Whirlpool, and Electrolux—from a niche laundry-equipment maker into a full-line manufacturer. He had led an earlier acquisition spree in which Maytag had expanded into microwave ovens, electric ranges, refrigerators, and freezers. Its brands now included Magic Chef, Jenn-Air, Norge, and Admiral. The last years of Krumm's reign, however, were not marked by great operating results. As shown in Table 16.2, revenues showed no gain in the 1989–1992 period, while income steadily declined.

Trouble

Although the rationale for internationalizing seemed inescapable, especially in view of a recent wave of joint ventures between U.S. and European appliance makers, the Hoover acquisition was troublesome. It was a major brand in England and in Australia, but Hoover had only a small presence in Continental Europe. Yet this was where the bulk of the market was, with some 320 million potential appliance buyers.

The probabilities of the Hoover subsidiary capturing much of the European market were hardly promising. Whirlpool was strong, having 10 plants there in contrast to Hoover's two plants. Furthermore, Maytag faced entrenched European competitors such as Sweden's Electrolux, the world's largest appliance maker; Germany's Bosch-Siemens; and Italy's Merloni Group. And General Electric had also entered the market with joint ventures. Europeans' fierce loyalty to domestic brands raised further questions as to the ability of Maytag's Hoover to penetrate the

TABLE 16.1 Maytag Operating Results, 1974–1981
(in \$ millions)

	Net Sales	Net Income	Percent of Sales
1974	\$229	\$21.1	9.2%
1975	238	25.9	10.9
1976	275	33.1	12.0
1977	289	34.5	11.5
1978	325	36.7	11.3
1979	369	45.3	12.3
1980	346	35.6	10.2
1981	409	37.4	9.1
Average net income percent of sales: 10.8%			

Source: Company operating statistics.

Commentary: These years show a steady, though not spectacular, growth in revenues and a generally rising net income, except for 1980. Of particular interest is the high net income percentage of sales, averaging 10.8% over the 8-year period, with a high of 12.3%.

TABLE 16.2 Maytag Operating Results, 1989–1992

	Revenue	Net Income	% of Revenue
	(000,000)		
1989	\$3,089	131.0	4.3%
1990	3,057	98.9	3.2
1991	2,971	79.0	2.7
1992	3,041	(315.4)	(10.4)

Source: Company annual reports.

Commentary: Note the steady erosion of profitability, while sales remained virtually static. For a comparison with profit performance of earlier years, see Table 16.1 and the net-income-to-sales percentages of this more "golden" period.

⁶ Brian Bremner, "Can Maytag Clean Up Around the World?" *Business Week* (Jan. 30, 1989), p. 88.

European market without massive promotional expenditures, and maybe not even then.

Australia was something else. Hoover had a good competitive position there, and its refrigerator plant in Melbourne could easily be expanded to include Maytag's washers and dryers. Unfortunately, the small population of Australia limited the market to only about \$250 million for major appliances.

Britain accounted for one-half of Hoover's European sales. But at the time of the acquisition, its major appliance business was only marginally profitable. This was to change: After the acquisition it became downright unprofitable, as shown in Table 16.3 for the years 1990 through 1992, as it struggled to expand in a recession-plagued Europe. The results for 1993, of course, will reflect the huge loss for the promotional debacle. Hardly an acquisition made in heaven.

Maytag's earlier acquisitions also were becoming soured. Its acquisitions of Magic Chef and Admiral were diversifications into lower-priced appliances, and these acquisitions did not meet expectations. But they left Maytag's balance sheet and its cash flow weakened (see Table 16.4). Perhaps more serious, Maytag's reputation as the nation's premier appliance maker became tarnished. Meanwhile, General Electric and Whirlpool were attacking the top end of its product line. As a result, Maytag found itself in the number three or number four position in most of its brand lines.

TABLE 16.3 Operating Results of Maytag's Principal Business Components, 1990–1992

	Revenue (000,000)	Income ^a (000)
1990		
North American Appliances	\$2,212	\$221,165
Vending	191	25,018
European Sales	497	(22,863)
1991		
North American Appliances	2,183	186,322
Vending	150	4,498
European Sales	486	(865)
1992		
North American Appliances	2,242	129,680
Vending	165	16,311
European Sales	502	(67,061)

^a This is operating income, that is, income before depreciation and other adjustments.

Source: Company annual reports.

Commentary: While these years had not been particularly good for Maytag in growth of revenues and income, the continuing, and even intensifying, losses in the Hoover European operation had to be troublesome. And this was true even before the ill-fated early 1993 promotional results.

TABLE 16.4 Long-Term Debt as a Percent of Capital from Maytag's Balance Sheets, 1986–1991

Year	Long-Term Debt/Capital
1986	7.2%
1987	23.3
1988	48.3
1989	46.8
1990	44.1
1991	42.7

Source: Company annual reports.

Commentary: The effect of acquisitions, in particular that of the Chicago Pacific Corporation, can be clearly seen in the buildup of long-term debt. In 1986 Maytag was virtually free of such commitments; 2 years later its long-term debt ratio had increased almost sevenfold.

ANALYSIS

Flawed Acquisition Decisions

The long decline in profits after 1989 should have triggered strong concern and corrective action. And perhaps it did, but the action was not effective because the decline continued, culminating in a large deficit in 1992 and serious problems in 1993. As shown in Table 16.2, the acquisitions brought neither revenue gains nor profitability. One suspects that in the rush to fend off potential raiders in the late 1980s, the company bought businesses it might never have bought under more sober times and that it also paid too much for these businesses. Further, they cheapened Maytag's proud quality image.

Who Can We Blame in the UK Promotional Debacle?

Corporate Maytag management was guilty of a common fault in its acquisitions. It gave newly acquired divisions a loose rein, letting them continue to operate independently with few constraints: "After all, these executives should be more knowledgeable about their operations than corporate headquarters would be." Such confidence is sometimes misguided. In the UK promotion, Maytag management would seem as derelict as management in England. Planning guidelines or parameters were far too loose and under-controlled. That subsidiary management could burden the parent with \$50 million of unexpected charges, and to have such a problem erupt with no warning, borders on the absurd.

Finally, the UK executives' planning for this ill-conceived travel promotion defies all logic. They vastly underestimated the demand for the promotions offer and greatly overestimated paybacks from travel agencies on the package deals. Yet it took no brilliant insight to realize that the value of the travel offer exceeded the price of the appliance—indeed, 200,000 customers rapidly arrived at this conclusion—and that such a quantity of a deal would be a disaster.

should have seen that the promotion could prove to be extremely costly to the company. Was it a miscalculation or complete naivete on the part of executives and their staffs, who should have known better?

How Could the Promotion Have Avoided the Problems?

The great problem resulting from an offer that was too good could have been avoided without scrapping the whole idea. A cost-benefit analysis would have provided at least a perspective as to how much the company should spend to achieve certain benefits, such as increased sales, greater consumer interest, and favorable publicity. See the following information box for a more detailed discussion of the important planning tool of a cost-benefit analysis.

INFORMATION BOX

COST-BENEFIT ANALYSIS

A cost-benefit analysis is a systematic comparison of the costs and benefits of a proposed action. Only if the benefits exceed the costs would we normally have a "go" decision. The normal way to make such an analysis is to assign dollar values to all costs and benefits, thus providing a common basis for comparison.

Cost-benefit analyses have been widely used by the Department of Defense in evaluating alternative weapons systems. In recent years such analyses have been sporadically applied to environmental regulation and even to workplace safety standards. As an example of the former, a cost-benefit analysis can be used to determine if it is socially worthwhile to spend \$X million to meet a certain standard of clean air or water.

Many business decisions lend themselves to a cost-benefit analysis. It provides a systematic way of analyzing the inputs and the probable outputs of particular major alternatives. While in the business setting some of the costs and benefits can be quantitative, they often should be tempered by nonquantitative inputs to reach the broadest perspective. Schermerhorn suggests considering the following criteria in evaluating alternatives.⁷

- **Benefits:** What are the benefits of using the alternatives to solve a performance deficiency or take advantage of an opportunity?
- **Costs:** What are the costs to implement the alternatives, including direct resource investments as well as any potential negative side effects?
- **Timeliness:** How fast will the benefits occur and a positive impact be achieved?
- **Acceptability:** To what extent will the alternatives be accepted and supported by those who must work with them?
- **Ethical soundness:** How well do the alternatives meet acceptable ethical criteria in the eyes of multiple stakeholders?

What numbers would you assign to a cost-benefit analysis for Maytag Hoover's plan to offer the free airline tickets, under an assumption of 5,000 takers? 20,000 takers? 100,000 takers? 500,000 takers? (Make any assumptions needed as to costs.) What would be your conclusions for these various acceptance rates?

A cost-benefit analysis should certainly have alerted management to the possible consequences of various acceptance levels and to the significant risks of high acceptance. However, the company could have set limits on the number of eligibles: perhaps the first 1,000, or the first 5,000. Doing this would have held or capped the costs to reasonably defined levels and avoided the greater risks. Or the company could have made the offer less generous, perhaps by upping the requirements or by lessening the premiums. Such more moderate alternatives would still have made an attractive promotion but not the major uncontrolled catastrophe that happened.

UPDATE—LEONARD HADLEY

In the summer of 1998, Leonard Hadley could look forward and backward with some satisfaction. He would retire the next summer when he turned 65, and he had already picked his successor. Since assuming the top position in Maytag in January 1993, and confronting the mess with the UK subsidiary his first few months on the job, he had turned Maytag completely around.

He knew no one expected much change from him, an accountant who had joined Maytag right out of college. He was known as a loyal but unimaginative lieutenant of his boss, Daniel Krumm, who died of cancer shortly after naming Hadley his successor. After all, he reflected, no one thought that major change could come to an organization from someone who had spent his whole life there, who was a clone so to speak, and an accountant to boot. Everyone thought that changemakers had to come from outside, like Al Dunlap of Scott Paper and Sunbeam. Well, he had shown them, and given hope to all No. 2 executives who resented Wall Street's love affair with outsiders.

Within a few weeks of taking over, he'd fired a bunch of managers, especially those rascals in the UK who'd masterminded the great Hoover promotion that cost the company dearly. He determined to get rid of foreign operations, most of them newly acquired and unprofitable. He just did not see that appliances could be profitably made for every corner of the world, because of the variety of regional customs. Still, he knew that many disagreed with him about this, including some of the board members who thought globalization was the only way to go. Still, over the next 18 months he had prevailed.

He chuckled to himself as he reminisced. He had also overturned the decades-long corporate mindset not to be first to market with new technology because they would "rather be right than be first." His "Galaxy Initiative" of nine top-secret new products was a repudiation of this old mindset. One of them, the Neptune, a front-loading washer retailing at \$1,100, certainly proved him right. Maytag had increased its production three times and raised its suggested retail price twice, and still it was selling like gangbusters. Perhaps the thing he was proudest of was getting Maytag products in Sears stores, the seller of one-third of all appliances in the United States. Sears' desire to have the Neptune is what swung the deal.

As an accountant, he probably should be focusing first on the numbers. Well, 1997 was certainly a banner year with sales up 10.9 percent over the previous year, while profitability as measured by return on capital was 16.7 percent, both sales and profit gains leading the industry. And 1998 so far was proving to be even better, with sales jumping 31 percent and earnings 88 percent.

⁷ John R. Schermerhorn, Jr., *Management*, 6th ed. (New York: Wiley, 1999), p. 61.

He remembered the remarks of Lester Crown, a Maytag director: "Len Hadley has—quietly, softly—done a spectacular job. Obviously, we just lacked the ability to evaluate him [at the beginning]."

He knew he had surprised everybody in the organization by going outside Maytag for his heir apparent. He is Lloyd Ward, 49, Maytag's first black executive, a marketing expert from PepsiCo, and before that Procter & Gamble.⁸

Beware overpaying for an acquisition. Hoping to diversify its product line and gain market share overseas, Maytag paid \$1 billion for Chicago Pacific in 1989. As it turned out, this was far too much, and the debt burden was an albatross. Chief Executive Leonard Hadley conceded as much: "In the long view, it was correct to invest in these businesses. But the timing of the deal, and the price of the deal, made the debt a heavy load to carry."⁹

Zeal to expand, and/or the desire to reduce the attractiveness of a firm's balance sheet and thus fend off potential raiders, do not excuse foolhardy management. The consequences of such bad decisions remain to haunt a company, and the ill-advised purchases often have to be eventually sold off at substantial losses. The analysis of potential acquisition candidates must be soberly and thoroughly done, and rosy projections questioned, even if this means the deal may be soured.

Beware giving too loose a rein, thus sacrificing controls, especially of unproven foreign subsidiaries. Although decentralizing authority down to lower ranks is often desirable and results in better motivation and management development than centralization, it can be overdone. At the extreme, where divisional and subsidiary executives have virtually unlimited decision-making authority and can run their operations as virtual dynasties, then corporate management essentially abdicates its authority. Such looseness in an organization endangers cohesiveness; it tends to obscure common standards and objectives; and it can even dilute unified ethical practices.

Such extreme looseness of controls is not uncommon with acquisitions, especially foreign ones. It is easy to make the assumption that these executives were operating successfully before the acquisition and have more firsthand knowledge of the environment than the corporate executives.

Still, there should be limits on how much freedom these executives should be permitted—especially when their operations have not been notably successful. In Maytag's case, the UK subsidiary had lost money every year since it was acquired. Accordingly, one would expect prudent corporate management to have condoned less decentralization and insisted on tighter controls than it might otherwise.

⁸ Sources include Maytag annual reports, and Carl Quintanilla, "Maytag's Top Officer, Expected to Do Little, Surprises His Board," *The Wall Street Journal* (June 23, 1998), pp. A1 and A8.

⁹ Kenneth Labich, "What Companies Fail," *Fortune* (November 14, 1994), p. 60.

In decision planning, consider a worst-case scenario. There are those who preach the desirability of positive thinking, confidence, and optimism, whether it be in personal lives, athletics, or business practices. But expecting and preparing for the worst has much to commend it, since a person or a firm is then better able to cope with adversity, avoid being overwhelmed, and more likely to make prudent rather than rash decisions.

Apparently the avid acceptance of the promotional offer was a complete surprise; no one dreamed of such demand. Yet, was it so unreasonable to think that a very attractive offer would meet wild acceptance?

In using loss leaders, put a cap on potential losses. Loss leaders, as we noted earlier, are items promoted at such attractive prices that the firm loses money on every sale. The expectation, of course, is that the customer traffic generated by such attractive promotions will increase sales of regular profit items so that total profits will be increased.

The risks of uncontrolled or uncapped loss leader promotions is vividly shown in this case. For a retailer who uses loss leaders, the loss is ultimately capped as the inventory is sold off. With UK Hoover there was no cap. The moral is clear: Attractive loss leader promotions should be capped, such as the first 100 or the first 1,000 or for one week only. Otherwise, the promotion should be made less attractive.

The power of a cost-benefit analysis. For major decisions, executives have much to gain from a cost-benefit analysis. It forces them to systematically tabulate and analyze the costs and benefits of particular courses of action. They may find that likely benefits are so uncertain as to not be worth the risk. If so, now is the time to realize this, rather than after substantial commitments have already been made.

Without doubt, regular use of cost-benefit analyses for major decisions improves executives' batting averages for good decisions. Even though some numbers may have to be judgmental, especially as to probable benefits, the process of making this analysis forces a careful look at alternatives and most likely consequences. For more important decisions, input from diverse staff people and executives will bring greater power to the analysis.

CONSIDER

What additional learning insights can you add?

QUESTIONS

1. How could the promotion of UK Hoover have been better designed? Be as specific as you can.
2. Given the fiasco that did occur, how do you think Maytag should have responded?
3. "Firing the three top executives of UK Hoover is unconscionable. It smacks of a vendetta against European managers by an American parent."