Manage Your Culture – Or Be Managed By It

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THE AWESOME POWER OF CULTURE

As time passes, the words associated with major events and important issues often devolve into a kind of shorthand. Mention the Internet bubble, for example, or September 11, and you will inevitably conjure up a set of images and assumptions. Those assumptions are usually widely shared – they are what we have come to tell ourselves is the meaning of the event—and they become increasingly unexamined as the event they're associated with recedes into the past. And they are, as often as not, wrong.

So it is with Enron. It is now almost three years since the scandal first erupted. Over that time, millions of words have been written, thousands of speeches given. The meaning of Enron has calcified into a handful of images and assumptions: the debacle was the product of rogue executives run amok; of a daisy-chain of cronyism linking Wall Street, auditors, and Corporate America; of a board that failed in its oversight duties; of an accounting system ripe for, and even geared for, abuse. In other words, Enron was created by a set of problems we can fix from without, by reforming, legislating and regulating everything from corporate governance to financial reporting.

Much of that may well be true, but it also misses the point. The main causes of Enron's collapse – and of most of the corporate implosions of the last couple of years – were not external, and cannot be addressed by more policing, stronger rules or heavier punishments. The real failure at Enron and its ilk was a failure of internal leadership – a failure to establish, practice, measure and reward the right values. In other words, the leaders of Enron failed to create the right culture. And the real message of the past year's debacles – one that corporate leaders ignore at their peril -- is that culture is probably the single greatest determinant of a company's success or failure. Get the culture wrong, and it doesn't matter what else you get right.

The shaping and management of culture is an essential task for leaders. Unfortunately, that's a notion many hard-nosed managers still find difficult to accept. All too often, they dismiss culture as "soft stuff," and feel more at home with the "hard stuff" – sales reports, organizational charts, product specifications and the like. Culture may be soft, but so is water. Like the relentless erosion of a stream, the so-called soft stuff of culture is more likely to undermine your strategy than hard stuff is. And as IBM's Lou Gerstner has pointed out, the soft stuff is really the hard part of management. "Fixing the culture is the most critical – and most difficult – part of a corporate transformation," he said. Fail to manage your culture, and your culture will end up managing you.

ENRON AND IBM

That unforgiving reality is one of the crucial lessons of Enron. From a strategic standpoint, the leaders of Enron almost got it right. Initially created by the 1985 merger of two regulated gas-pipeline companies, Enron was a middling, lackluster company mired in a hidebound industry on the brink of a brutal consolidation. But under its new leadership, the company worked a startling transformation.

One of the ironies of Enron, in fact, is that it did many of the things that legions of management thinkers have advocated in a blizzard of articles and books since the 1980s. It began with a new strategy based on out-of-the-box thinking and insightful analysis of broad industry trends. As the government was moving in the 1990s to deregulate, first, natural gas, and later electricity markets, Enron was determined to make itself over to dominate these new, growing markets. Instead of pushing gas through pipelines, it would become a sort of financial-services firm, specializing in trading energy commodities. In 1990, some 80% of Enron's revenues came from its regulated gas-pipeline business. By 2000, 95% of its revenues and more than 80% of its operating profits came from the division that encompassed its energy trading business and EnronOnline, its web-based commodity-trading portal.

There is little to quibble with in Enron's initial strategic shift. Nor were the cultural changes that Enron avowedly pursued in support of its new strategic goals unworthy ones. It aimed to create a fast-moving, innovative organization out of a sluggish and bureaucratic one. It became risk-taking and entrepreneurial. It remade itself from an asset-based to a knowledge-based competitor. It adopted a global outlook. And surely, the lesson to be drawn from Enron and its ilk is not that Corporate America needs to become more risk-averse, insular and complacent.

In practice, however, the cultural makeover Enron's leaders attempted in support of their new strategy was fundamentally flawed. They failed at the central task of leadership – the creation, maintenance, and daily embodiment of the right culture. Far from bolstering Enron's strategy to become "The World's Leading Company," they unleashed a runaway culture of individual corruption and venality that turned it into the world's biggest bankrupt.

Fortunately, recent business history also offers an example of how a successful cultural transformation can literally save a company. The IBM that Gerstner joined in 1993 was, like Enron, sluggish, cautious, conservative – and slowly strangling. And like Enron's leaders, Gerstner had a strategic vision for the company: It would fight the critical challenge of the personal computer revolution by playing to its strengths, delivering integrated information-technology solutions to its customers.

And again like the leaders of Enron, Gerstner also quickly recognized that IBM's culture – which had grown inward-looking and out of touch with the marketplace – posed a serious roadblock to his strategy. Gerstner described the new culture he wanted to create at IBM as one of "restless self-renewal." He knew that an entrenched organization like IBM would be highly reluctant to change, and he also understood that there was only one way to get it to do so. He would have to lead the fight from the front ranks, like a general heading a charge. "If the CEO isn't living and preaching the culture and isn't doing it consistently, then it just doesn't happen," he had said in the 1980s, when he was CEO of American Express.

Enron officially went belly-up just a little more than a year ago, the victim of a cancerous culture run out of control. And Gerstner has recently retired in triumph from IBM, having probably saved the company with a profound cultural transformation. Their sharply different stories, along with many of the other tumultuous recent events in U.S. business, have some new and important things to tell corporate leaders about the awesome power of culture and its critical role in the life and death of corporations.

WHAT IS CORPORATE CULTURE?

Like societies, smaller units of human organization have their own cultures. Over time, any organization tends to develop shared assumptions and values that deeply influence its members' behavior. The behaviors that define a corporate culture persist because they are rewarded, while behaviors that run counter to the culture are penalized. Corporate culture is a way of answering such questions as: "How do decisions get made here?" "How is information shared among our people?" "Which results are most important to us?" "What kind of behavior tends to earn raises and promotions?" In short, a company's culture defines "the way we do things around here."

A company's culture, then, is a method for solving its internal and external problems. Those problems will inevitably change over time, and as the complex of problems and challenges faced by a company shifts, the company's game plan for addressing those problems and challenges – its strategy – should also shift. And as its strategy changes, so, usually, should its culture.

Talk of cultural change often troubles people who confuse values with ethics. Values include ethics, but are not limited to them. And let me be clear. There are certain moral principles that should *never* change, such as honesty, integrity, fairness, social responsibility, and respect for others. They are not at issue here. On a different level, there are other behaviors that are *valued* but that are not immutable principles. These values are much more tightly tied to the success of a strategy, and *must* change if a company is going to adapt successfully to the changes in its environment.

The environment is shifting in similar ways for many companies: Their markets, sourcing and competition are becoming global; their traditional industry boundaries are disappearing; their businesses are being deregulated; and the Internet is empowering their buyers and squeezing their margins. In response, many firms are seeking to drive similar changes in their cultural values -- changes like these:

- From conservative to risk-taking and experimental
- From consensus-driven to individually accountable
- From efficient to innovative
- From product-focused to customer-focused
- From punishing mistakes to tolerating mistakes

These are cultural values that do not involve issues of morality. And they have enormous power to determine the success or failure of a company's strategy.

Interestingly, many of them are also the changes that Enron sought to enact. To thrive in its new deregulated environment, Enron CEO Ken Lay knew, the company would have to transform its sclerotic, slow-moving, and cautious culture. Just as he believed that Enron would prosper by creating new markets, he believed that the free market should serve as a model for Enron's internal structure. That's a pretty fair expression of the alignment of culture with strategy.

Similarly, IBM was being buffeted by changes in its environment in the 1980s. Rapid advances in semiconductor technology were drawing its customers away from IBM-style mainframe computers, or "big iron," and into the so-called client/server world ruled by PCs. By 1993, when Gerstner joined the company, the core mainframe business was collapsing. After earning a record $5.9 billion in 1990, Big Blue had lost a stunning total of $7.8 billion in 1991 and 1992. Its rapidly declining mainframe sales weren't being replaced by client/server revenues; the company was hemorrhaging cash; and its image in the eyes of the public, its customers, and its lenders was seriously tarnished. Gerstner believed that nothing short of a fundamental change in the company's business model was required. And in his view, there was no greater barrier to his plans than the rigid, complacent culture at IBM.

As both Ken Lay and Lou Gerstner knew, their organizations' cultures had to change to fit their new strategies. Managing that sort of intentional, directed cultural change is an extremely difficult leadership challenge. And as Enron and IBM demonstrate in strikingly different ways, it is also a do-or-die mission for top management.

FOUR MYTHS ABOUT CORPORATE CULTURE

Something like 80% of attempts to change corporate cultures end in failure (though not necessarily so spectacular a failure as Enron's). But I believe we know why, and can therefore materially improve the odds of success. The poor management of culture usually stems from four myths – false assumptions about culture that managers often believe to be true. Here they are.

1. Culture is vague and mysterious.
2. Culture and strategy are separate and distinct things.
3. Culture can't be measured and rewarded.
4. Our leaders' role is to communicate what our culture is.

Let's debunk these myths point by point.

MYTH ONE: CULTURE IS VAGUE AND MYSTERIOUS

Some business leaders hold the view that there is nothing definite or concrete about culture, that it is therefore not manageable, and that it's a waste of time even to try. This "no nonsense" school of thinking argues that success comes from setting ambitious business goals and focusing relentlessly on measurable outcomes, such as cash flow and return on assets or simply on the "bottom line."

The truth is that, far from being vague and indefinable, culture expresses itself through very specific, observable everyday behaviors that are every bit as tangible as cash flow and have just as profound an effect on organizational success. Those who take this macho, real-men-don't-give-a-damn-about-culture approach are unconsciously consenting to become victims of circumstance. This is a cop-out for effective leadership.

In fact, culture is so specific and concrete that a faulty one can sink a company, as Ken Lay learned. Lay and his protégé, Jeffery Skilling, clearly understood some of the dynamics of cultural change. To create a new way of life at the company, they knew they had to change many of the mechanisms that shaped corporate behavior at Enron, including its organizational structure and its policies for recruitment, job transfer and promotion – and, in particular, its systems of measurement and reward.

The two leaders took a sharp axe to Enron's multi-layered, bureaucratic hierarchy, creating a relatively flat organization with only three formal layers between the CEO and the lowest-level worker. They recruited the sharpest young minds from leading B-schools, competing for talent with Wall Street and top consulting firms to hire some 250 MBAs every year. Once they signed on, Enron's young hotshots were given both extraordinary latitude and the prospect of extraordinary rewards. And as hard as Enron worked to hire talent, it also created a Draconian system of employee evaluation that quickly forced many people back out the door.

As we shall see, the fierce pressure of this performance-review system sent line managers into a destructive dealmaking frenzy that ultimately brought the company down. The important point here is that as Enron's culture went wrong, it revealed itself in specific and observable behaviors. These behaviors manifested themselves long before they undermined the company, and could have been corrected. Unfortunately, the review system also became a kind of ongoing, inhouse inquisition that turned Enron's headquarters into a palace of favor-currying courtiers. Bad news was never passed along, dissent never voiced. No one, it seems, noticed that the pictures being painted at Enron had no clouds.

From their public remarks at the time, it's clear Lay and Skilling thought they were creating the cultural foundation of the ultimate New Economy Company. They certainly didn't set out to destroy their company and reputations. But because they failed to manage the transformation as an ongoing process, the company came to be managed, not by them, but by unwanted cultural behaviors that sprang up and went unchecked.

MYTH TWO: CULTURE AND STRATEGY ARE SEPARATE AND DISTINCT THINGS

Some managers believe that culture and strategy should be kept separate, just like church and state. This notion is also badly flawed. It's often based on a belief that there's something sacrosanct about a company's culture, and that it shouldn't be tainted by business considerations. This mindset treats culture as an end in itself, rather than as a means to an end. But as we've already noted, corporate culture is a mechanism for coping with particular challenges. So the performance of a business organization and the specifics of its culture are interdependent.

This is why trying to define cultural values in the abstract – which some managers try to do – is a meaningless exercise. As a strategy coach to corporations, I've been amazed at how often I get asked to help management teams define their values as a *prelude* to defining their strategies. This is an invitation I always refuse, for the simple reason that it gets the process back-to-front. Companies should *first* define their strategy. Only then will they be able to define those values and the attendant behaviors that will help them achieve success in the pursuit of that strategy. The more clearly and simply they define their strategy, the easier it will be to describe what those behaviors need to be. In other words, first be clear on how you will win; then define the values and behaviors that will lead you to victory.

Lou Gerstner understood this sequence in remaking IBM: strategy first, culture second. Not that he didn't immediately recognize the daunting cultural woes at Big Blue – chief among them, in his view, its sharp separation into internally competitive silos – powerful geographic units and powerful product divisions. In his memoir of his time at IBM, "**Who Says Elephants Can't Dance?"**, he notes just how preposterous some of this had become. He was shocked, for example, to see IBM's regional office for Alabama and Mississippi send its own earnings release to the media.

Yet before he tackled IBM's culture, Gerstner first made his major strategic decision. When he arrived at the company, he inherited a plan, already well underway, to break the company into a number of operating companies, or "Baby Blues." Gerstner rejected this idea, and formulated a strategy that would instead turn IBM's unrivalled size and scope to competitive advantage. As a former CEO of American Express and a client of IBM, he believed that large enterprise customers would increasingly demand top-to-bottom technology solutions. Who better to provide them than IBM, with its vast resources in hardware, software and services?

With this decision made, Gerstner then moved rapidly to remake IBM's culture in alignment with his strategy. In order to offer its customers integrated solutions, IBM had to become an integrated company, and that meant declaring war on the fiefdoms. To help him wage the battle, he called for 5,000 volunteers, known as "Gerstner's Guerillas." These proponents of change, he wrote to the staff, should be:

> *Committed to the long-term success of all IBM…Commitment to your career and to your business unit are not enough. Zealous in making things work for the customer, especially when the customer's needs require the involvement of several different parts of IBM. Turf barons and baronesses need not apply.*

Note how the cultural behaviors and attitudes Gerstner called for were in direct support of his "integrated solutions strategy," in that they replaced intramural competition with cooperation. As he told his guerillas, "We can't share knowledge, we can't reach out to customers, if we continue to operate in silos inside IBM. If we're going to share knowledge, if we're going to increase our speed, if we're going to have a complete connection between our customers and us, we have to integrate inside of IBM. We've got to work as a team. We can't be part of a division or a product; we've got to be part of IBM – coming together, delivering solutions."

As both IBM and Enron demonstrate, it is not a strong culture per se that creates organizational success. The key is to create a strong and *relevant* culture -- i.e. one that directly promotes the strategic aims of the business – by measuring and rewarding the right behaviors. And that brings us to Myth No. 3.

MYTH THREE: CULTURE CAN'T BE MEASURED AND REWARDED

This myth is an extension of the first myth, that culture is something vague and mysterious, and that it has a life of its own.

The first thing to understand is that the existing culture in an organization is already being measured and rewarded. That's why it exists in the first place. As we described earlier, individuals in an organization are constantly being judged for their compliance with expected norms of behavior. Inappropriate behavior is discouraged through sanctions of one kind or another, and desired behaviors are rewarded in various ways – anything from pay raises and promotions to pats on the back.

But if you are seeking to change a culture, it's imperative to decide on the new behaviors you need, and then to measure and reward them. As the old saying goes, what gets measured gets done; what gets rewarded gets done repeatedly. The key is to be very specific about the desired behaviors, and then very deliberate about measuring and rewarding those behaviors. New York City, for example, used to measure its police officers by how many arrests they made. After its now-famous CompStat program shifted the focus to measuring crime and its reduction – and held local commanders accountable for achieving results – the city's crime rate dropped sharply.

Enron, once again, offers a disastrous counter-example. Its leaders instituted a system of measurement and rewards that encouraged individualism and self-enrichment above all else. In the "rank-and-yank" system, each employee would receive a 360-degree-type evaluation every six months by a five-member group, including his or her boss. The boss would then present the evaluation to the 20-member Performance Review Committee, which ranked the employees on a one-to-five scale. The PRC was required to place 15% of all the people it evaluated into the lowest category; these staffers would be eventually be "yanked" from Enron. At the opposite end of the scale, managers in the top 5% got bonuses that were two-thirds higher than those that went to the next 30%. Those bonuses were determined by individual and business-unit performance, with no mention of overall corporate results. As Lay said, "An important part of our corporate culture is individualized compensation in each of our business activities."

Skilling apparently believed his system would foster a culture of hard-driving, non-politicized excellence at Enron – in effect, applying the Darwinian forces of the free market to its internal operations, just as Lay had vowed. As he told a reporter, "The performance evaluation was the most important thing for forging a new strategy and culture at Enron – it is the glue that holds the company together."

In a way, he was right. His system of measurement and reward did forge a new culture – just not the one he intended. Notwithstanding Enron's dutiful values statement, which was full of noble words like integrity, respect, communication and excellence, there was really a single, overriding priority at the company: increasing reported earnings per share and, in turn, the stock price. The achievement of that priority, by any means possible, was the only thing Enron really measured and rewarded – with terrible consequences.

In order to survive the rank-and-yank process, and in order to get their multi-million-dollar bonuses, staffers had to deliver consistently bigger and more lucrative deals, which management could then use to meet increasingly optimistic growth targets and propel Enron's stock ever upward. Enron valued those deals using mark-to-market accounting, in which the value of long-term trading transactions would be predicted based on complex models, and then booked as current revenue. This accounting approach, together with the compensation system's narrow focus on individual or business-unit performance, as opposed to corporate performance, forced staffers into ever more exotic, riskier transactions – ones that offered little or no benefit to Enron's customers, made little or no economic sense, and did little or nothing to build Enron's long-term presence in its markets. Transmitted through Enron's systems of measurement and reward, the exclusive focus on earnings mutated each of those cultural virtues Skilling aimed for into its evil twin: risk-taking became recklessness; entrepreneurialism became irresponsibility; excellence became arrogance and ruthlessness; individual accountability became cutthroat competition. And ultimately, the system pushed executives over the line into criminality. Enron got what it measured and rewarded. Its leadership simply measured and rewarded the wrong things.

Contrast Enron's experience, once again, with that of IBM. One of Gerstner's first steps in his effort to break down the company's network of powerful fiefdoms was to change the compensation system. He replaced an undifferentiated, largely fixed system with a pay-for-performance approach of variable rewards. And where bonuses had been paid to executives based solely on the results of their individual business units, he now tied much of incentive compensation to the performance of IBM as a whole. In fact, bonuses for the highest-level executives, including those who ran the business units, were based *entirely* on companywide results. One level down, 60% of bonuses were now tied to Big Blue's overall performance.

MYTH FOUR: OUR LEADERS' ROLE IS TO COMMUNICATE WHAT OUR CULTURE IS

We frequently hear something like this from the leaders of companies in the midst of major change: "Now that we're striving to become more agile, innovative, and risk-taking, we need a plan to communicate the new culture to our employees." The company then launches flurry of pep rallies and issues lofty values statements that find their way onto plaques on walls and plasticized wallet cards. These are empty gestures that build cynicism rather than motivation. A company's culture is not a document. It's a way of life.

It's true, of course, that a leader must consciously and deliberately transmit the culture to employees. And clear communication is vital. Employees cannot perform unless they know specifically what is expected of them. But verbal and written communication works only if leaders *behave* the culture faithfully, visibly and sincerely. If they behave the culture in an exemplary way, they will set the expectations unambiguously. If they don't, it doesn't matter what they say. The moment a leader's words and deeds diverge, his leadership will fail. As Ralph Waldo Emerson put it, "what you do speaks so loudly that I cannot hear what you say."

Enron's ethics code may have told employees that they were not to seek to enrich themselves at the company's expense. But the senior executives who participated in the off-balance-sheet partnerships that ultimately brought Enron down earned tens of millions from them, and their financial interests in the transactions were often in direct opposition to the company's. Is it any wonder that Enron's actual culture was one of frantic self-enrichment?

Let there be no mistake: Leaders can delegate many operational things, but they cannot delegate their responsibilities for culture, which are an inseparable part of the way they lead. This was at the heart of Enron's failure of leadership. It is clear that, having put the machinery of cultural change in motion, Lay and Skilling then became oddly detached from the process they began. Lay was a remote, "big-picture" leader, one who focused on working the levers of government to create a political and regulatory environment favorable to Enron. And Skilling too evinced little interest in day-to-day operations; he delegated many management responsibilities, and relied heavily on other executives for details of what the many divisions of the company were up to.

CONCLUSION

Corporate America now faces a crisis of confidence brought on by a pattern of misbehaviors at company after company. The question for leaders is what we have learned from this crisis.

The common thread in many of these corporate implosions is a culture that somehow went awry. As Gerstner writes, "I came to see, in my time at IBM, that culture isn't just one aspect of the game – it *is* the game." Culture is an enormously powerful force; creating and sustaining the *right* culture is a stiff challenge, but it is a central task of leadership, and one that cannot be delegated. A leader's main role is not so much to manage a company, as to manage how the company is managed. Leaders must determine what the company stands for, whose interests it will serve, and how. They must seek, and convey, clarity of principle.

The right culture must be backed by the right system of measurement and rewards. The corporate scandals teach us that measuring and rewarding nothing but the bottom line or the stock price can end up creating an atmosphere of rampant avarice, in which self-enrichment rather than business-building becomes the norm.

Earnings growth is critical, of course. But leaders must ask themselves what behaviors drive *sustainable* earnings growth – and measure and reward those behaviors. Typically, that means broadening a company's field of vision to encompass not just shareholders, but other stakeholders, such as customers, suppliers, employees and communities. It means awarding raises and bonuses based not just on individual performance or the short-term value of revenue-goosing deals, but on companywide results, and on measurements of customer satisfaction, repeat purchases, environmentally sound practices, staff turnover and other long-term company-building indicators.

And the final lesson of Corporate America's recent woes is that leaders must live their cultures, must embody their values in every word and deed. A greedy, self-enriching management will get a greedy, self-enriching rank and file. At the end of the day, these failures have all been leadership failures. The national debate about the business scandals is increasingly focusing on possible regulatory remedies. But we will never regulate our way to better leadership. The fault, dear leaders, is not in our rules, but in ourselves.